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Chinese Insolvency Law Symposium: Developing an Insolvency Infrastructure

17-18 November 2000

Venue: Council Chamber
The University of Hong Kong
Hong Kong, China

Co-sponsored by:

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1

Introductory Materials

2

Session 1
Chinese Bankruptcy and Reorganization Law:
Legal Responses

Panel 1

3

Session 1 continued

Panel 2

4

Session 1 continued

Panel 3

5

Session 1 continued

Panel 4

6

Session 2

Cross-Border Insolvency Issues, with a focus on
matters involving the HKSAR & Mainland China

Panel 1

7

Session 2 continued

Panel 2

8

Session 3
Chinese Bankruptcy and Reorganization Law:
Administrative Responses

Panel 1

9

Session 3 continued

Panel 2

10

Additional Papers

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This symposium will involve discussions among academics, insolvency practitioners, judges, and government officials from mainland China, the Hong Kong SAR, and overseas on PRC insolvency law reform and cross-border insolvency issues between mainland China and the HKSAR

DAY 1 - 17 NOVEMBER 2000

9:00-9:30 Registration

Session 1 - Chinese Bankruptcy and Reorganization Law: Legal Responses

Presentations on the latest draft of the New Chinese Bankruptcy Law, development of Chinese bankruptcy law since 1986, including analysis of the 1986 State-Owned Enterprise Bankruptcy Law and other bankruptcy laws; rule of law issues, problems arising when there is systemic insolvency, and comparative perspectives

9:30-9:45 Welcoming Remarks

Albert HY Chen, Dean & Professor, Faculty of Law, University of Hong Kong

Wang Weiguo, Dean & Professor, Department of Economic Law, Chinese University of Politics and Law & Member, Working Group for Drafting the New Chinese Bankruptcy Law, Beijing, China

Charles D Booth, Associate Professor, Faculty of Law, University of Hong Kong

9:45-11:00 Panel 1

Chair:

Zhang Xianchu, Associate Professor, Faculty of Law, University of Hong Kong

Speakers:

Zhu Shao Ping, Chair of the Working Group for Drafting the New Chinese Bankruptcy Law & Director, Economic Law Department of the Financial Committee under the Standing Committee of the National People's Congress, Beijing, China

Wang Weiguo, Dean & Professor, Department of Economic Law, China University of Politics and Law & Member, Working Group for Drafting the New Chinese Bankruptcy Law, Beijing, China
Institutional Reasoning in Drafting New Bankruptcy Law of China

Cao Shou Ye, Senior Judge, Supreme People's Court, Beijing, China & Author of the
Supreme Court's Interpretations on Bankruptcy Law
A Judicial Perspective on China's Bankruptcy Law

11:00-11:15 Tea and Coffee Break

11:15-12:45 Panel 2

Chair:

Wang Wei Guo, Dean & Professor, Department of Economic Law, Chinese University of
Politics and Law & Member, Working Group for Drafting the New Chinese
Bankruptcy Law, Beijing, China

Speakers:

Wu Jingming, Associate Professor & Deputy Director, Department of Economic Law, China
University of Politics and Law, Beijing, China
**Relationship between Bankruptcy Liquidation and Ordinary Liquidation of
Legal-Person Enterprise**

Li Yongjun, Professor, Department of Economic Law, China University of Politics and Law
& Member, Working Group for Drafting the New Chinese Bankruptcy Law, Beijing,
China
**Reconsideration of the Reorganization System in China's Bankruptcy Law and
Relevant Issues**

Zhang Xian Chu, Associate Professor, Faculty of Law, University of Hong Kong &
Charles D Booth, Associate Professor, Faculty of Law, University of Hong Kong
**Chinese Bankruptcy Law in an Emerging Market Economy:
The Shenzhen Experience**

12:45-2:00 Lunch

2:00-3:30 Panel 3

Chair:

Ronald Harmer, Consultant, "Blake Dawson Waldron (Australian law firm) & Staff
Consultant, Asian Development Bank

Speakers:

Cao Shi Bing, Judge, Supreme People's Court, Beijing, China

Qian Hong Tao, Manager of Legal Affairs Department, Beijing Branch of Xianda Asset-
Management Company, Beijing, China

Shi Jianzhong, Associate Professor, Department of Economic Law, China University of Politics and Law, Beijing, China

Insolvency of Groups:

Problems Involving Parent Companies and Their Affiliates

Commentators:

Aiman Nariman Mohd-Sulaiman, Associate Professor, Private Law Department, International Islamic University, Selangor, Malaysia

Corporate Group Liability in Insolvency – a Malaysian Perspective

Yu Guanghua, Associate Professor, University of Hong Kong Faculty of Law

The Effect of the Developing of a Market Economy on Chinese Bankruptcy Law

3:30-3:45 **Tea and Coffee Break**

3:45-5:30 **Panel 4**

Chair:

Charles D Booth, Associate Professor, Faculty of Law, University of Hong Kong

Speakers:

Ronald Harmer, Consultant, Blake Dawson Waldron (Australian law firm) & Staff Consultant, Asian Development Bank

Evaluation of the Draft of a New PRC Insolvency Law

Henry Pitney, Senior Counsel & Head, Private Sector Legal Group, Office of the General Counsel, Asian Development Bank

A New Insolvency Structure for the PRC

Commentators:

Judge Lloyd D George, USDC, District of Nevada, Las Vegas, Nevada, USA

Judicial Management

John Grobowski, Baker & McKenzie, Hong Kong

John Lees, Ferrier Hodgson, Hong Kong

Steven L Schwarcz, Professor, Duke University School of Law & Faculty Director of the Duke Global Capital Markets Center, Durham, NC, USA

Basics of Business Reorganization in Bankruptcy

He Shi Piao, Assistant Chair of the Working Group for Drafting the New Chinese Bankruptcy Law & Director, General Office of the Financial Committee under the Standing Committee of the National People's Congress, Beijing, China
Chinese Cross-Border Insolvency Issues

Liu Rong Jun, Professor, Zhongshan University School of Law, Guangzhou, China
Chinese Cross-Border Insolvency Issues

Shi Jingxia, University of International Business and Economics, Beijing, China
Chinese Cross-Border Insolvencies: Current Issues and Future Developments

11:00-11:15 Tea and Coffee Break

11:15-12:45 Panel 2

Chair:

Charles D Booth, Associate Professor, Faculty of Law, University of Hong Kong

Speaker:

Mark Hyde, Clifford Chance, London, England
Practical Issues Arising from Hong Kong SAR Insolvency Proceedings of Companies with Assets in Mainland China

Commentators:

Paul Heath QC, Hamilton, New Zealand, Member of the New Zealand Law Commission, Wellington, New Zealand
A Commentary on Cross-Border Insolvency Issues

Prudence Mitchell, CMS Cameron McKenna, Hong Kong
GITIC

Shinjiro Takagi, Professor, Dokkyo University (Retired Justice of Tokyo High Court (Court of Appeal)), Tokyo, Japan
Japanese Points of View to the Draft Chinese Bankruptcy Law (Comments to be presented by Arnold Quittner)

Arnold Quittner, Pachulski, Stang, Ziehl, Young & Jones, Los Angeles, CA, USA

Philip Smart, Associate Professor, University of Hong Kong Faculty of Law
Recent International Developments: Lessons for China?

Clare Wee, Senior Counsel, Asian Development Bank

12:45-2:00 Lunch

Session 3 - Chinese Bankruptcy and Reorganization Law: Administrative Responses

Presentations on the role to be played by asset-management companies in mainland China, recent reforms in other Asian countries that have addressed systemic insolvency problems through the creation of debt restructuring agencies and of “formalized” informal procedures for negotiating corporate rescues; and the likelihood of success of instituting such reforms in mainland China.

2:00-3:30 Panel 1

Chair:

Judith Sihombing, Senior Lecturer, University of Hong Kong Faculty of Law

Speakers:

Lou Jianbo, Fellow, Centre for Commercial Law Studies, University of London, Lecturer in Chinese Commercial Law, Cambridge University & Lecturer in Law, Peking University, Beijing, China

Asset-Management Companies and Debt Equity Swaps: Can They Really Work in China?

Qian Hong Tao, Manager of Legal Affairs Department, Beijing Branch of Xianda Asset-Management Company, Beijing, China

Wang Weiguo, Dean & Professor, Department of Economic Law, China University of Politics and Law & Member, Working Group for Drafting the New Chinese Bankruptcy Law, Beijing, China

Commentator:

Liu Yan, Associate Professor, Peking University Law School, Beijing, China
Mainland China's Accounting Standards for Debt Structure

3:30-3:45 Tea and Coffee Break

3:45-4:45 Panel 2

Chair:

Douglas Arner, Assistant Professor, University of Hong Kong Faculty of Law & Fellow, Centre for Commercial Law Studies, University of London

Commentators:

Paul Lejot, Axia Capital Partners Ltd, Hong Kong

Tim DeSieno, Bingham Dana LLP, Singapore
Regional Developments

Rabindra Nathan, Shearn Delamore & Co, Kuala Lumpur, Malaysia
Recent Malaysian Reforms

Roman Tomasic, Dean & Professor, Faculty of Business & Law, Victoria University,
Melbourne, Australia & Adjunct Professor of Law, China University of Politics and
Law, Beijing, China

4:45-5:15 Concluding Remarks

Wang Weiguo, Dean & Professor, Department of Economic Law, Chinese University of
Politics and Law & Member, Working Group for Drafting the New Chinese
Bankruptcy Law, Beijing, China

Charles D Booth, Associate Professor, Faculty of Law, University of Hong Kong

Fees:

Attendance for one day will cost HK\$2,000 (US\$265), for two days, HK\$3,000 (US\$395)

Discounts are available for Friends of the Faculty and Members of the Hong Kong Society of Accountants, Insolvency Interest Group, or Inter-Pacific Bar Association. one day, HK\$1,500 (US\$200); two days, HK\$2,000 (US\$265).

Simultaneous Translation:

Simultaneous translation between English and Mandarin will be provided.

CPD Credits:

6 CPD credits/per day will be awarded to attendees who are members of the Law Society of Hong Kong. CPD credits will also be awarded to attendees who are members of the New York Bar or the California Bar.

Symposium Organizing Committee:

Douglas Arner, Faculty of Law, University of Hong Kong
Charles Booth (Chairman), Faculty of Law, University of Hong Kong
Judith Sihombing, Faculty of Law, University of Hong Kong
Philip Smart, Faculty of Law, University of Hong Kong
Wang Weiguo, Department of Economic Law, China University of Politics and Law
Zhang Xian Chu, Faculty of Law, University of Hong Kong

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John Craig & Arnold Quittner, Inter-Pacific Bar Association
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The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

Institutional Reasoning in Drafting New Bankruptcy Law of China

Wang Weiguo

INSTITUTIONAL REASONING IN DRAFTING NEW BANKRUPTCY LAW OF CHINA

*Wang Weiguo**

Introduction

In line with the legislation plan of the Standing Committee of the 8th NPC, the Fiscal and Economic Committee of the PRC National People's Congress has organized the drafting work for renewing bankruptcy law since March 1994. In the autumn of 1995 the Draft Bankruptcy Law ("the 1995 Draft") containing 10 chapters and 193 articles was proposed to the higher authority. In the next year, the drafting process was actually shelved due to some reasons. After four years past, the drafters were called up and informed of a new working schedule for the drafting work in March 2000. The re-start is fundamentally continuation of the former efforts. A draft named "the Business Bankruptcy and Reorganization Law", formulated on the basis of the 1995 Draft, was discussed at a symposium in July 2000.

During the four-year rest period of the drafting work, there were some significant events that might be influential upon our further efforts, e.g. the deepening of SOE reform, China's entering into WTO, the Asian financial storm, and new achievements of overseas and domestic researches on bankruptcy law. When reviewing the 1995 Draft today, we realize that there are a number of issues that are still disputable or need to be reconsidered under the circumstances of the new experience and achievements.

Bankruptcy law is placed in such a realm that is full of conflicts of interests. Dealing with the conflicts there are different opinions related to legal policies and institutional designs. The task of legislature is not simply to pick up any of them but to find a better solution with good reasoning. This paper intends to make a discussion on the different ideas around some of the major issues.

1. The Scope of Application

The existing 1986 Enterprise Bankruptcy Law and the 1991 Civil Procedure Law limit their application to the scope of enterprise legal persons. Up to now partnerships, sole proprietorships and natural persons are not subject to bankruptcy proceedings.

In early 1994 there was a debate on the scope of application and three propositions were concluded. The first is so-called "large scope" position, suggesting the new law to be applicable to all types of enterprises, legal persons or non-legal-persons, and all natural persons. Second, it is also proposed by "small scope" position that the new law should be applied to merely enterprise legal persons, just as the existing laws stipulated. Thirdly, the "medium scope" position stood inbetween, preferring a scope including enterprise legal persons, partnership enterprises with their partners, sole proprietorships with their investors.

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The last opinion has been adopted by the 1995 Draft.

There are two focuses in the arguments. The one is whether non-legal-person enterprises should become included in bankruptcy proceedings. The other is concerning the necessity and possibility of involvement of natural persons.

As a matter of fact the voice for "large scope" was not strong enough. Several arguments led to the conclusion that at the present stage China could not push insolvent individuals into bankruptcy unlimitedly. The first argument is that in Chinese history there has long been no bankruptcy system for general individuals. The traditional moral criterion requires people to pay debts faithfully so that all the unpaid debts are supposed to be carried forward from generation to generation. At the second place, in Chinese society the consumers' common attitude is "saving the future" rather than "overdrawing the future" so that the concept of "consumer insolvency" is not important in this country. Thirdly, in China's transition period lots of ordinary individuals are unable to pay debts for complicated reasons, social or personal, and cannot be fairly shamed by declaration of bankruptcy. Forth, the capacity of the judicial system and professional service is insufficient to deal with so large number of cases of individual insolvency, that are sometimes more difficult by reason that, among others, insolvent individuals' property is often laborious to be found and captured.

The "small scope" theory was supported by some officials and judges. They stressed on the difficulties in some technical matters, for instance enforcement and exemption of individual debtors' property. The key question here is whether the non-legal-person enterprises should be included in the scope of bankruptcy law. According to the official statistics, at the end of 1994 China had 8.37 million enterprises in total and among them 4.178 million were non-legal-person ones. Under such circumstances the situation that half of the economic entities are kept out of bankruptcy proceedings does not meet the requirements of equal treatment and unified regulation in market economy. Furthermore, it can be seen that the problem of enforceable property also appears in ordinary civil execution but there has never been an argument that individuals are not eligible under the Civil Procedure Law.

The fundamental reason for adopting "medium scope" position in the 1995 Draft is that the new bankruptcy legislation aims mainly at the legal framework for the development of "socialist market economy", in which all the business persons and commercial debts can be regulated uniformly and equally. The "medium scope" scheme may be categorized to the model of traditional "merchant bankruptcy" system that can be seen in French and Italian bankruptcy legislation.

2. Commencement Criterion

The term "bankruptcy cause" is commonly used in China, that refers to one or several factual elements by which a bankruptcy procedure can be applied and a debtor can be declared bankrupt. The existing Enterprise Bankruptcy Law defines such cause with three elements: (1) poor operation and management, (2) serious losses, and (3) inability to repay debts. In the 1995 Draft it is simplified to a single element, i.e. "unable to pay due debts". This element may be presumed on fact of "cessation of payment".¹

¹ Article 3 of the 2000 Draft Business Bankruptcy and Reorganization Law reads: "When a debtor is unable to pay due debts, all its debts shall be liquidated in accordance with the procedures provided in the Law. The cessation of payment by a debtor is presumed as inability of payment."

The Drafting Committee provides two reasons for this single-element definition. First, it is clear and definite so as to be applied easily. Second, it is consistent with the international practice.²

In the drafting process someone argued that the simplification of bankruptcy cause would result in large-scale increase of bankruptcy cases, and therefore suggested to maintain "serious losses" as another element in the definition. This viewpoint is incorrect. Opening up the gate of bankruptcy proceedings does not necessarily mean that more and more enterprises in financial difficulties will be pushed into the abyss of bankruptcy liquidation. Instead, the Draft intends to push them ahead to explore the possibility for rehabilitation by applying timely the proceeding of reorganization or composition that shall be given in the new law. Even in case that an enterprise is not recoverable, earlier commencement of bankruptcy liquidation is more benefit to both creditors and the society in the sense of saving assets and reducing losses as far as possible. On the other hand, just as pointed out by senior judges of the Supreme People's Court when discussing the Draft, the element of "serious losses" is not manipulable because in judicial practice there is no test to identify the seriousness of losses.

In addition to the criterion stated above, that is commonly applicable to all sorts of proceedings in the Draft, there is a special criterion for commencement of reorganization proceeding -- the likelihood of inability to pay due debts owing to difficulties in business and finance. It can be seen that the legislation encourages enterprises in financial difficulties to enter into judicial reorganization before the situation of insolvency has apparently come about. It follows such an idea that when dealing with a sick horse it is better to cure it as early as possible.

3. Administrator

According to the existing Enterprise Bankruptcy Law, during the period between acceptance of bankruptcy case and bankruptcy adjudication the debtor's assets shall be managed by the debtor itself; it is only after the bankruptcy adjudication that the assets shall be taken over by the team of bankruptcy liquidators. Therefore there is a large room for a debtor to conceal, unlawfully distribute or waste its assets.

The 1995 Draft has filled up this gap, providing that the people's court shall appoint an administrator when accepting insolvency case. The administrator shall take over the control of day-to-day management and operations of the debtor's property and be responsible to the people's court. The operations of the administrators shall be subject to the monitoring by the creditors' meeting. Administrator shall attend creditors' meetings, reporting the performance of his mission and answering questions. In reorganization proceeding, furthermore, the administrator shall be in charge of formulation of a draft reorganization plan.

The reason for appointment of administrator is not merely to avoid losses from debtor's unlawful conducts, but to maintain the value, especially the going concern value, of the assets. This is benefit to not only the creditors' interests in liquidation but also the common interests of creditors and the debtor in reorganization, so as to keep consistent with the international trend of shifting the concentration of bankruptcy law from debt liquidation to business

² For example, Section 17 of the Germany Insolvent Statute of 1994 reads: "(1) Illiquidity shall be the reason to open insolvency proceedings. (2) The debtor shall be deemed illiquid if he is unable to meet his mature obligations to pay. Illiquidity shall be presumed as a rule if the debtor has stopped payment."

rehabilitation.

Anyhow, there are still some questions for further consideration.

(1) Administrator or the debtor, who shall be entrusted to manage the assets?

In United States, for instance, most of the insolvent debtors are authorized automatically to control assets and continue business operation as a "debtor in possession" under Chapter 11 of the Bankruptcy Code. The advantage of this arrangement is that the debtor has more skill and incentive to do business well. The disadvantage is the likelihood of the debtor's "moral hazard" that risks the creditors' interests. In present China such kind of hazard is so serious that few people feel at ease if an insolvent company is highly entrusted in managing assets itself in bankruptcy procedure. It seems that rescuing the debtor and protecting the creditors are incompatible objectives. In some countries, for instance UK, Australia, French and Japan, assets and business of an insolvent debtor are usually entrusted to one or several legally-appointed administrators.

Anyhow, compromise solutions are also thinkable. In the Germany Insolvent Statute of 1994, provisions on "Personal Management" in Part Seven allow a debtor to manage and dispose the assets involved in the insolvency proceedings under surveillance by a custodian if the insolvency court orders such personal management while deciding on the opening of the proceedings. The preconditions to this order are (1) the debtor's request, (2) the consent of the creditor who petitioned the opening of the proceedings, and (3) the expectation that the order will not lead to a delay in the proceedings or other disadvantages to the creditors.

In China the 1995 Draft, assets and business are generally authorized to administrator. In the period of reorganization, however, the administrator is entitled to appoint the debtor's management with the mission of carrying out the business operation of the enterprise. Those appointed persons shall ask for the administrator's consent when performing any of the actions specified in the Law. This scheme appears cautious but flexible. It provides the debtor a chance to contribute the business continuation during the bankruptcy proceedings even though it is subject to some restraints.

(2) Administrator or creditors' meeting, who has superior power over the assets?

The 1995 Draft sets out great deal of powers for administrators, for instance taking over the control of all the property, determining the day-to-day expenditure and other necessary spending of the debtor, request for determining whether the debtor continues to operate, management and disposal of property of the debtor, and so on. On the other hand, the Draft also provides the creditors' meeting and its representative, i.e. supervisors, a strong position to monitor administrator's performance. Almost all the dispositions of the debtor's property and related rights performed by administrator must be consented by supervisors or creditors' meeting. For example, assignment of the stock of goods, lending money and pledging property as security, transfer of movables worth more than RMB 1,000 for the purpose of business continuance, are often necessary for administrator's function. If we hope a more efficient administration, why not to give administrator more discretionary powers?³ One of

³ Comparatively, many other countries give administrators much stronger power in control and disposition of insolvency assets. For instance, in England, the Insolvency Act 1986 stipulates in Section 14 that the administrator "may do all such things as may be necessary for the management of the affairs, business and property of the company". In Australia Corporations Law provides in Section 437A that the administrator (a) has control of the company's business, property and affairs; (b) may carry on the business and manage the property and affairs; (c) may terminate or dispose of all or part of the business, and may dispose of any of the property; (d) may perform any function, and exercise any power, that the company or any of its officers could usually perform or exercise.

the reasons lies in the situation that China wants thousands of insolvency practitioners. Before such a profession is developed it could be safe to give priority to adequate protection of creditors. There is no doubt that China has a long way to go for developing and maintaining an ethical and competent profession of bankruptcy practitioners.⁴ Anyway, the new legislation is a good beginning and "a good beginning is half the battle."

4. Encumbered Assets and Secured Creditors

Business rehabilitation has long been one of the objectives of the bankruptcy legislation of China. In the 1986 Enterprise Bankruptcy Law there is a chapter on composition and renovation proceedings. Although these proceedings have proven failed to be utilized for some special reasons,⁵ the demand for business rehabilitation has never ceased and even become stronger along with the deepening of the economic reform.

When viewed internationally, jurisdictions fall into four main groups as regards their attitude to security as a protection against insolvency - (1) those very sympathetic (e.g. English-based countries, Sweden); (2) those fairly sympathetic (e.g. Germany, Netherlands, Japan, Switzerland, United States); (3) those quite hostile (e.g. Belgium,, most Latin American countries, Spain) and (4) those very hostile (e.g. Austria, France, Italy).⁶

When designing Chapter 5 proceeding, the drafting team made a favorable consideration to security. On the one hand, they highlighted the necessity of automatic stay for the purpose of corporate rehabilitation. On the other hand, they attempted to maintain the interests of secured creditors. The treatment of encumbered assets and secured creditors may be sketched as the following.

(1) Automatic stay

The 1995 Draft stipulate: "After the acceptance of insolvency case by the people's court and prior to the bankruptcy adjudication, all the rights of mortgage, pledge and lien over the debtor's property or property rights shall stop exercise." This situation shall continue until the reorganisation plan is executed, or the proceeding terminates without fulfillment of reorganisation plan. As a general rule, when the insolvency case goes into the proceeding of composition or bankruptcy liquidation, the secured claims are unfrozen automatically as soon as the proceeding is opened.

(2) Time limit and termination

The Draft takes some measures to avoid unreasonable delay that is harmful to the secured creditors. First, the length of the period of reorganisation observation is limited to "not exceed 12 months", unless a specified extension is proven necessary and permitted by the court. Second, the creditors are entitled to ask the court to terminate the period of reorganisation observation ahead of schedule by one of the reasons specified in the Law.⁷

⁴ For detailed analysis, see Bahin (Kam) Kamarul, *The Role of Bankruptcy Practitioners and the Draft Bankruptcy Law of the People's Republic of China: An Empirical Perspective*, Australian Journal of Corporate Law, Vol.9, No.3, December 1998, pp.272-283.

⁵ See, Wang Weiguang, *Adopting Corporate Rescue Regimes in China: A Comparative Survey*, Australian Journal of Corporate Law, Vol.9, No.3, December 1998, pp.237-239.

⁶ See, Philip R. Wood, *Principles of International Insolvency*, Sweet & Maxwell, London, 1995, pp.177-178.

⁷ Article 104(1) of the 1995 Draft lists the reasons as the following: (1) The business and financial conditions of the debtor continue to deteriorate, showing little or no hope of rehabilitation; (2) The debtor cheats, or reduces enterprise property in bad faith, or delays unreasonably, or has other acts obviously harmful to the interests of the creditors; (3) The administrator is impossible to perform his missions because of the acts of the debtor's corporate organs and other personnel.

(3) Perishable assets

Perishable assets is a problem concerned with by the drafters. The 1995 Draft provides that in the period of reorganisation observation the mortgagees, pledgees and lienors to the debtor shall not exercise the right of disposal to the security collateral. However, if the movables subject to pledge or lien will possibly be damaged or devalued, the pledgors or lienors may auction off or sell them and have the prices obtained thereby to be lodged.

(4) Disposition of assets

Administrator is not empowered to dispose security unless the secured is protected adequately. The Draft provides that, to continue a debtor's business operation, the administrator may retrieve a movable subject to pledge or lien, with the condition of offering superseded security.

Therefore we share the principle conclusions of the IMF Legal Department:

"In the context of a rehabilitation proceeding, a stay on the ability of secured creditors to exercise their rights against the collateral during the entire period of the proceedings is critical. However, this does not reduce the need to provide such creditors with adequate protection (including relief from the stay when such protection cannot be given) and, in that context, this provides an additional reason for imposing time limits on the duration of the proceedings."⁸

5. Creditors' Meeting

The 1986 Enterprise Bankruptcy Law grants creditors' meeting only three categories of functions and powers: (1) to examine and confirm claims; (2) to vote on a draft composition agreement; (3) to vote on schemes for disposition and distribution of bankruptcy property.

The 1995 Draft expands functions and powers of creditors' meeting to eight categories: (1) to elect and replace supervisors; (2) to investigate filed claims; (3) to determine the continuance or suspension of debtor's business operation; (4) to vote on a composition agreement; (5) to vote on a reorganization plan; (6) to vote on a scheme for management of the debtor's assets; (7) to vote on a scheme for disposition of bankruptcy property; (8) to vote on a scheme for distribution of bankruptcy property. Among them category 1 is related to the design of administrator, categories 3, 5 and 6 are mainly related to the design of reorganization proceeding.

Additionally, the creditors' meeting or individual creditors may exercise the following rights: (1) to request the court to dismiss and replace the administrator or bankruptcy liquidator in case he is incompetent, or neglects his duty, or has other illegal acts; (2) to request the court to declare the debtor bankrupt in case it breaches the terms of satisfaction in the composition agreement; (3) to request the court to make a decision on discontinuing part or entire operations of the debtor, or imposing necessary restrictions on its business activities in the period of reorganization observation; (4) to request the court to make a decision to terminate the reorganization procedure in case one of the specified circumstances takes place after the opening of reorganization proceeding; (5) to request the court to make a decision to terminate the execution of the reorganization plan in case the reorganizing enterprise is unable or refuses to follow the reorganization plan.

⁸ IMF Legal Department, *Orderly & Effective Insolvency Procedures: Key Issues*, published by the International Monetary Fund, 1999, p.70

Briefly speaking, the Draft insist in a fundamental principle when it expands the functions and powers of the creditors' meeting, that is, strengthening the status and function of creditors in bankruptcy proceedings. This principle is significant to the entire system of bankruptcy law, just as the IMF Legal Department states:

"Given that creditors are key beneficiaries of the insolvency process, the law should be designed and implemented in a manner that enables them to play an active role in this process. They should normally be the decision makers in a number of key areas. For example, during liquidation proceedings, it is advisable that creditors be given the authority to dismiss the liquidator (discussed below), approve the temporary continuation of the business by the liquidator, and approve a private sale. In rehabilitation proceedings, they should normally have the authority to dismiss the administrator and propose and approve a rehabilitation plan. In addition, the law should give them a role in requesting or recommending action from the court, including, for example, a recommendation that the rehabilitation proceedings be converted to liquidation. Giving creditors an active role in the process is particularly important when the institutional framework is relatively underdeveloped. Creditors will lose confidence in the process if all of the key decisions are made by individuals that are perceived as having limited expertise or independence."⁹

6. Composition

The 1986 Enterprise Bankruptcy Law lies its original guideline in the purpose of impelling enterprises to improve their management and operation, not expecting to see many enterprises going bankrupt. That is the reason why the Law adopts composition proceeding. What seems unique is that the Law joins a government-handled renovation proceeding with the composition proceeding together. The joint proceedings are stipulated as the following:

-- Commencement of the joint proceedings relies on three conditions: (1) the case is petitioned by creditor(s) rather than the debtor; (2) the government agency authorized to master the debtor enterprise puts forward a request for renovation to the court and the creditors' meeting, referring to a scheme of renovation with the period of no more than two years, within three months after the acceptance of the case; (3) in the meantime the enterprise submits a draft composition to the creditors' meeting.

-- When the draft composition is approved by the meeting and confirmed by the court, it becomes an effective agreement, then the bankruptcy proceeding is suspended.

-- When the composition agreement becomes effective, the enterprise is renovated in the charge of the authorized agency. The scheme of renovation shall be discussed by the workers' congress and the progress of the renovation shall be reported to the workers congress and the creditors' meeting.

-- If the enterprise becomes able to perform the composition agreement after the renovation, the bankruptcy case shall be closed. Otherwise, the enterprise does not perform the composition agreement, the court shall adjudicate it to be bankrupt

Not surprisingly, in the past ten years, the cases applying these joint proceedings were extremely few (near zero), although up to ten thousands of bankruptcy cases were accepted by the people's courts of deferent levels. There are mainly two reasons. First, almost no

⁹ IMF Legal Department, *ibid*, p.74.

authorized agency has the incentive to bear such a costly, troublesome and sometimes risky mission. After all, it has no concern in the interests of the agency or its officers. Secondly, creditors have no basis to trust the authorized agency, for the Law does not grant any means for creditors to control or influence the process of renovation, nor does it impose any responsibility upon the authorized agency for its misfeasance or blamable failure in the process.

The 1995 Draft simplifies the composition procedure to a large extent.

First, the opening of the composition proceeding becomes much easier. On one hand, a debtor when filing petition for acceptance of an insolvency case may, in the meantime or afterwards, apply for composition. On the other, either debtor or any of the creditors is allowed to apply to the court for composition.

Second, If the court deems that the debtor's composition application meets the provisions of the Law, it shall make a decision for opening of composition proceeding and call the creditors' meeting to vote on the draft composition agreement. After the decision the rights of mortgage, pledge and lien to the debtor's property shall be relieved from the stay.

Third, if the composition agreement is approved by the creditors' meeting, it becomes valid by confirmation of the court and at the same time the insolvency case is closed.

Forth, the valid composition agreement is enforceable as a contract, but non-performance of this agreement by the debtor shall lead to an immediate adjudication of bankruptcy.

This simplification is mainly due to the adoption of reorganization proceeding. During the drafting process some foreign and domestic experts suggested to give up composition proceeding, following the examples of France in 1985 and Germany in 1994. The drafting group considered this suggestion carefully. The conclusion was that we would better keep this proceeding because there were some small cases that might be rescued by more flexible and cheaper ways. In our mind, actually, composition proceeding is a traditional and simple tool while reorganization proceeding is a modern and complicated machine. It seems good enough to cultivate a small garden with a hoe rather than a tractor.¹⁰

Additionally, the 1995 Draft provides that after the acceptance of insolvency case by the court, a debtor may request the court to approve a composition agreement reached out-of-court with unanimous agreement from all the creditors. In such circumstances the court shall make a decision to close the insolvency case.

In recent years out-of-court workout has become popular in many countries. The general trend is that successful business rehabilitation should rely more upon compromise between the parties and even involvement of non-party investors. Legal proceedings are always rigidly handled and most of the judges are not familiar with business operation and market transactions practically. Therefore a wise policy is to provide a larger room for parties' discretionary arrangement. On the other hand, thinking about the possible abuse and misuse, we set some requirement such as unanimous agreement for court approval.

7. Reorganization

Reorganization proceeding is very significant in China's new bankruptcy legislation. It had

¹⁰ The same scheme can be seen in UK Insolvency Act 1986 which contains both a chapter on composition proceeding named "Company Voluntary Arrangements" and a chapter on reorganization proceeding named "Administration Orders."

yet been considered until the first version of the draft was completed. When the first draft was further discussed, the US Chapter 11 was introduced and looked into. Then based on a consensus that a modern mechanism for business rehabilitation might be adopted, the drafting team worked out a new chapter, namely Chapter 5, on reorganisation proceeding, with some relevant provisions added in other chapters.

The sketch of the reorganisation proceeding may be shown as the following:

-- When application for insolvency case is accepted by court on condition that the debtor meets the requirements stipulated by law, reorganization proceeding may be applied for simultaneously, or later on but before bankruptcy adjudication.

-- When the case is accepted, an administrator is appointed by the court and takes over all the assets and affairs of the company at once.

-- As soon as the case is accepted, all the proceedings or other efforts for claims, either unsecured or secured, are frozen.

-- In a specified period the administrator is authorized to control the property and business operation of the enterprise. Protective provisions for the business continuation are granted.

-- The administrator drafts a reorganisation plan and hands it over to the creditors' meeting. The meeting votes the plan in different groups. When it is passed, or even failed but anyhow meets the requirements provided by law, it is submitted to the court for confirmation.

-- When the plan is confirmed the assets and business are taken over by a reorganisation executor.

-- Upon the execution of reorganisation plan is completed the case is closed or otherwise goes to the exit.

The original inducement for the adoption of modern corporate rescue regime is the fact that China has so many enterprises having been insolvent and the society cannot afford the disaster of enterprises going bankrupt on a large scale. On the other hand, it was realized that a traditional composition is too simple and mild to meet the needs of business rehabilitation. It can be therefore concluded that the objective of the draft reorganisation proceeding is to rescue enterprises in difficulties while fairly clearing their debts.¹¹

Further academic researches have strengthened the legal policy that stresses on, and work for, corporate rescue. Three theories are taken as the supports.

First of all, the theory of going concern value. It is proved that the value of a company, especially a large one, as a going concern is much higher than the obtainable money when it is

¹¹ As stated by the Fiscal and Economic Committee of the NPC in its explanatory report on the draft law:

"Reorganisation as a reconstructive debt-clearing regime purports to prevent enterprises, especially large and medium ones, that are hopeful to be rehabilitate, from bankruptcy liquidation. On the basis of Chinese national conditions, with reference to the experience of foreign legislation on insolvency, the Draft provides for reorganisation in Chapter 5 the scope of application, fundamental procedure, protective measures, formulation and execution of plan, as well as precautions against abuse of the procedure. These provisions may lead those being insolvent or likely to be insolvent to get away from going bankrupt via reorganisation, and may avoid chain bankruptcy of enterprises and huge unemployment thereafter. It is of particular immediate significance and favorable to interest of creditors to keep the business of a reorganizing enterprise continuing, so as to stop the worsening of its financial and business situation, and to keep off the serious losses as a result of bankruptcy liquidation. Such provisions in the Draft are not only necessary but also feasible. As to those on formulation and execution of reorganisation plan, there have been considerable experience from the economic reform. The rules on reorganisation in the Law are fit to the actual situation of the enterprises in our country and not hard to be handled. In the meantime, the Draft sets out rigorous rule on monitoring the formulation, adoption, confirmation and execution of reorganisation plan, so that it is reachable to forestall any abuse of reorganisation proceeding by a debtor intending to escape from liabilities."

sold out in piecemeal through liquidation. Rescue of an insolvent corporation implies saving the value for creditors, and in a sense for the society as well.

Secondly, the theory of common interests. Both a debtor and its creditors will be sacrificed if the debtor goes bankrupt, or otherwise both are benefited from the rehabilitation of the debtor. So far as the creditors are concerned, to rescue the debtor means to save themselves in the meantime. If they can get more repayment from the survival of the "sick horse" (the enterprise in distress) than the allocated "horse meat" (dividends on a liquidation), it is hardly reasonable to refuse it.

Third, the theory of social interests. Those impaired by corporate bankruptcy are not only the creditors, but also many other groups such as employees, obligees to the debtor's creditors, the community of where the debtor is, the national and local revenues. It seems unjustifiable to give up the effort of corporate rescue by yielding to the preference of some creditors, for instance the chargees, and ignoring the detriment suffered by the others.

The following three issues illustrate the efforts under the above guideline.

(1) Commencement of proceeding

In Chapter 5 of the Draft it is provided that the Chapter 5 proceeding applies to enterprise legal persons with the state specified as commencement criterion and however the possibility of rehabilitation. Here two factors, eligible debtors and grounds for petition, need to be noticed.

Eligible debtors. The Chapter 5 proceeding applies to only enterprise legal persons, i.e. corporations or other enterprises registered as legal persons. This is similar to UK proceeding of Administration Order and Australian proceeding of Corporate Voluntary Administration, which are applicable to merely companies. Such a design seems quite careful. In some other countries, legislatures are much bolder. For example, the US Chapter 11 applies to most business enterprises, corporate or unincorporated, and individuals, and the French *redressement judiciaire* applies to individual merchants, craftsmen and farmers, and all legal entities subject to private law. At the very beginning of the draft of Chapter 5, it was considered to have the reorganization proceeding applied to all persons within the general scope of the draft law. Then considering that the proceeding was more likely to be abused at the sacrifice of the creditors in cases of non-legal-person enterprises, that were usually in small-scale and short of normal accounting, we decided to make the limitation and meanwhile provided the composition proceeding as an alternative.

Grounds for application. The Chapter 5 proceeding may be applied when two grounds is settled: (1) the fact or the likelihood of inability of repayment, and (2) possibility of rehabilitation. If a company is obviously hopeless to rehabilitate at the time of filing, it has no grounds for application. For proving the grounds when petition it is required to submit together with relevant evidence. Though the term "relevant evidence" needs to be further defined, the aim of this Article is clear: to prevent the proceeding from abuse.

(2) Business operation

In the Chapter 5 proceeding, administrator becomes more powerful in controlling and operating the company's business. The Draft provides that in the period of reorganisation observation administrator is empowered to determine independently the continuance of the debtor's part or entire business.

To strengthen administrator's power in business operation, the Draft adds a power of

personnel control. He is entitled to appoint the debtor's management or other personnel, or some outsiders, with the mission of carrying out the business operation. The persons so appointed shall ask for the administrator's consent when performing any of the specific actions listed in the Draft.

Besides, there are more provisions to assist the business operation of the reorganizing enterprise. By way of illustration, the Draft provides that, in the period of reorganisation observation, debts arising for the purpose of continuance of the debtor's business operation is deemed as debts of common benefit. Furthermore, the debtor may guarantee the loans borrowed for its business continuance with the property not subject to any security right. This provision is of special importance to business rehabilitation, because the availability of continuing finance is one of the decisive factors to corporate rescue. It can be seen that if the post-commencement contracts of financing have priority over pre-existing unsecured creditors, once the reorganisation fails the unsecured creditors are subordinate and actually bear the costs of the experiment. The policy decision to this problem is hard and even painful. Up to the date many countries do not grant priority to post-commencement creditors even though some pioneer countries e.g. US, UK and France have done.¹² In China it is widely understood that corporate rescue is directly related to the interests of employees, the weakest group in the society, and therefore has stronger moral grounds.

In order to diminish the unsecured creditors' possible losses as a result of excessive expansion of the post-commencement debts, the Draft provides some measures to restrict it. First, the use of the loans shall be specified and subject to control and supervision. Second, the court may, at the request of the interested persons, make a decision on discontinuing part or entire operations of the debtor, or imposing necessary restrictions on its business activities. Third, if the business and financial conditions of the debtor continue to deteriorate, showing little or no hope of rehabilitation, the people's court may, at the request of the interested persons, make a decision to terminate the reorganisation procedure.

(3) Formulation of the plan

Apart from continuation of the debtor's business as stated above, one main focus of Chapter 5 is the institutions for formulation, adoption, confirmation, and execution of reorganisation plan.

As designed by the drafters, formulation of reorganisation plan may be a process of consultation. In Chapter 5 it is provided that the administrator when formulating a draft reorganisation plan should obtain the assistance by the debtor and listen to the creditors, investors and representatives of staff and workers.

In regard to what should be contained in the plan, it is generally provided that a reorganization plan shall stipulate the following particulars: (1) a scheme for operation of the reorganizing enterprise; (2) a scheme for readjustment of the claims; (3) a scheme for satisfaction of the claims; (4) reorganisation executor; (5) the period for execution of reorganisation plan; (6) other schemes beneficial to enterprise reorganisation.

Then there are some further mandatory or permissive provisions given. The schemes for readjustment and satisfaction of the claims must follow the classification of claims, which consists of four sorts: claims secured with property, labor claims, tax claims, and ordinary

¹² See, US Bankruptcy Code, Sections 503(b)(1), 364; UK Insolvency Act 1986, Section 19; French Law No. 85-98, Article 40.

claims. Further, some readjustment methods are stipulated with regard to different categories of claims: (1) reduce the repayment amount of claims on a pro rata basis; (2) extension of payment in lump-sum or installment; (3) changes in other terms or conditions; (4) conversion of a portion or all the creditors' claims into equity. Additionally, to encourage various flexible and practicable schemes, some directive provisions are given. For instance, the plan may provide a scheme of merger or separation for the reorganizing enterprise. It may also provide a scheme on raising fund for the reorganizing enterprise.

Bearing in mind that the situation of enterprises in difficulties stands in endless variety, the Draft does not intend to provide any ready-made solutions on behalf of the parties and practitioners. The legislation limits its mission to the extent that an insolvent enterprise may be protected to keep running as a going concern on one hand, and the relative parties may get together to work out proper schemes in the framework of negotiation and compromise.

On the other hand, by reason that corporate rescue is closely related to social interests, some judicial interference should be necessarily included. In Chapter 5 it is provided that the reorganization plan adopted by the creditors' meeting shall be confirmed by the court. It is also provided that, when a plan fails to be adopted, there is an opportunity to request the court to confirm the plan on condition that the plan meets the specified requirements.¹³ This is comparable to so-called "cram down" rule in US Chapter 11 procedure.¹⁴

8. Liquidation

The 1995 draft esteems order and efficiency as the major objectives for improvement of liquidation proceeding. As commonly recognized, the 1986 Enterprise Bankruptcy Law has been out-of-date. Apart from many other shortcomings, its liquidation procedure is too general to be used to solve the practical matters and thus leaves a large room for debt-escapers. In the past decade, huge amount of bank assets lost in the increasing movement of enterprise bankruptcy. This is partly due to fraudulent and other illegal conducts of the relevant persons (debtors, government officials, assets buyers, etc.), and partly due to the inefficiency of the legal proceeding that wants consummate rules and qualified judges.

The significance of orderly and effective bankruptcy procedure has been well concluded by IMF legal experts as the following:

Recent experience has demonstrated the extent to which the absence of orderly and effective insolvency procedures can exacerbate economic and financial crises. Without effective procedures that are applied in a predictable manner, creditors may be unable to collect on their claims, which will adversely affect the future availability of credit. Without orderly procedures, the rights of debtors (and their employees) may not be adequately protected and different creditors may not be treated equitably. In contrast, the consistent application of orderly and effective

¹³ The requirements prescribed in Chapter 5 of 1995 Draft include: (1) According to the plan, claims secured with property will be fully satisfied, and the losses brought about by the extension will be fairly compensated, and there will be no impairment to their security rights, except the terms otherwise stipulated in the plan has been adopted by the group of claims secured with property; (2) According to the plan, labor claims and tax claims will be fully satisfied, or otherwise the adjusted ratio of payment has been adopted by the relevant voting group; (3) The ratio of payment obtained by unsecured claims according to the plan will not be less than that supposed to be obtained by the same claims via proceeding of bankruptcy liquidation at the time when the plan is submitted for confirmation; (4) The order of claim satisfaction provided in the plan does not violate the provisions in Article 106 of the Law; (5) The scheme for enterprise rehabilitation is feasible, and not inconsistent with the State industrial policy.

¹⁴ See, Section 1129(b) of the US Bankruptcy Code.

insolvency procedures plays a critical role in fostering growth and competitiveness and may also assist in the prevention and resolution of financial crises: such procedures induce greater caution in the incurrence of liabilities by debtors and greater confidence in creditors when extending credit or rescheduling their claims.¹⁵

In drafting the new law, many issues in bankruptcy liquidation were dealt with under the fundamental principles of collectivity, equitableness and transparency. Some of them are described in the following as illustrations.

(1) Ex officio adjudication

According to the existing bankruptcy law of China, the courts are not empowered to ex officio adjudicate an insolvent debtor to be bankrupt.¹⁶ This is helpless to cope with the problem of "race for separate satisfaction", i.e. competition in catching assets from the debtor, following the proverb that the early bird gets the worm. In order to prevent this fashion and meet the need of collective and equitable satisfaction of all creditors over the assets of an insolvent debtor, the 1995 Draft grant the power of ex officio adjudication to any courts with jurisdiction over an insolvency cases, providing that, where the court when hearing a civil case or exercising a civil execution discovers the debtor to be under the circumstances of insolvency as specified in the Law, it may ex officio adjudicate the debtor bankrupt.

(2) Liquidators

In comparison with the existing bankruptcy law, the Draft puts some features on the institution of liquidators. First, liquidators shall not be officials from government agencies any more.¹⁷ They are supposed to be lawyers, accountants and other relevant practitioners. Second, the office of liquidator may be taken by one or several persons, unlike the existing bankruptcy law that always requires a "liquidation team". This change reflects such a fact that in a case of small business insolvency a single liquidator may bring about higher efficiency and lower expenses. Third, the position of liquidator may be assumed by the administrator in the same case. This may keep the continuity of the business operation and administration of the assets. Finally, there are provisions concerning the qualifications, appointment, remuneration and expenses, liability and dismissal of either administrators or liquidators, which are all determined by courts.

Furthermore, considering the needs for maintenance of the assets of estate as a going concern, the Draft grants liquidator the authority to determine the performance or cancellation of the contracts that have not been fully performed by both the debtor and the counterparty.¹⁸

¹⁵ IMF Legal Department, *ibid*, p.1.

¹⁶ The Opinions of the Supreme People's Court on Several Issues in the Implementation of the Enterprise Bankruptcy Law stipulates in section 15: "If, during the process of civil proceedings or civil execution procedures, a people's court finds that a debtor is insolvent, it shall notify the debtor that it may apply to the local people's court for bankruptcy." "If no application is filed for bankruptcy, the people's court have no power to declare that debtor bankrupt, and any original proceeding or execution procedure may be carried out without interruption."

¹⁷ The Enterprise Bankruptcy Law stipulates in Article 24, paragraph 2: "The members of the liquidation team shall be designed by the people's court from among the superior departments in charge, government finance departments, and other relevant departments and professional personnel."

¹⁸ Article 146 of the 1995 Draft stipulates:

As for a bilateral contract unperformed by the bankrupt, bankruptcy liquidators shall be entitled to decide if it will be cancelled or continue to be performed.

The counterpart in an executory contract may specify a deadline to the bankruptcy liquidators, and urge them to make a decision within this period as to whether the contract is to be cancelled or continue to be performed. The liquidators' failure to answer upon the expiration of the period shall be regarded as a cancellation of the contract.

If the liquidators decide to continue the performance of the contract, whereas the counterpart requests

Sometimes an executory contract may be assigned, as a single item or put together with the going concern, to a willing third party for value.

(3) Claims

The general principle of equitable treatment is always restricted by legal policies of some other laws. First, the demand for protection of security rights and other real rights from the civil law leads to the priority of secured claims in bankruptcy liquidation. Second, the demand for administration of bankruptcy procedure from the bankruptcy law itself leads to the preferential position of the administration expenses and debts of common benefit over all other unsecured claims. Third, the demands for protections of labor rights and taxation from the labor law and the tax law lead to the preferential position of labors and taxation over the ordinary claims in ranks of distribution. Therefore, as stated by IMF legal experts, "equitable treatment does not require equal treatment."¹⁹

In the context of China's new bankruptcy law, equitable treatment in liquidation proceeding can be seen in several aspects. First, claims in same situation shall apply the same rules. Second, all claims which have occurred before the commencement of the bankruptcy case, mature or immature, monetary or non-monetary, shall be deemed as, or converted to, the same mature and monetary claims. Third, the resolutions on disposition and distribution of the assets shall be made by creditors collectively through their meeting.

(4) Assets

In the 1995 Draft, "bankruptcy property", a term equivalent to assets of estate, consists of the total property and property rights of all kinds that belong to the bankrupt at the time of bankruptcy adjudication, and the property and property rights of all kinds obtained by the bankrupt after the bankruptcy adjudication but prior to the close of insolvency case. This is consistent with the international trend.²⁰ Just as IMF legal experts state: "As a general rule, the assets of the estate should include the property of the debtor as of the date the insolvency proceedings begin plus the assets acquired by the liquidator after that date."²¹

Unlike the existing bankruptcy law, the 1995 Draft does not exclude the encumbered assets from the scope of bankruptcy property.²² The main reason for that lies in the possibility that the liquidator may retrieve a collateral by paying off the debt or rendering substitute security in order to keep the business going or sell the assets as a whole body. This approach embodies the policy that the collective of ordinary creditors should have more opportunity to get benefit from the assets under the circumstances that the legal status of a secured creditor is not substantially shaken.

them to provide relevant security within an agreed or reasonable period, but the liquidators have not provided security during the period, this shall be regarded as a cancellation of the contract.

Where liquidators cancel a contract, if the counterpart has paid earnest money, the claim for return of the money shall be a bankruptcy claim limited by the amount of the earnest.

When a contract is cancelled under the provisions in the preceding four paragraphs, the counterpart's claims for damages shall be regarded as bankruptcy claims.

¹⁹ IMF Legal Department, *ibid*, p.6.

²⁰ For example, the Germany Insolvency Statute of 1994 stipulates in Section 35: "The insolvency proceedings shall involve all of the assets owned by the debtor on the date when the proceedings were opened and those acquired by him during the proceedings (assets involved in the insolvency proceedings)."

²¹ IMF Legal Department, *ibid*, p.38.

²² Article 28, paragraph 2, of the Enterprise Bankruptcy Law provides: "Property that already constitutes security collateral is not bankruptcy property; the portion of the value of the security collateral exceeding the amount of the debt that it secures is bankruptcy property."

9. Individuals involved

According to the 1995 Draft, an individual may be involved in bankruptcy proceedings as a partner of partnership enterprise or an owner of sole proprietorship. Bearing this in mind, the Draft puts some provisions to deal with the special matters related to the involved individuals.

(1) Bankruptcy adjudication

It is stipulated that if a partnership's assets are not sufficient to pay off its due debts, the court shall adjudicate all its partners to be bankrupt in the meantime when adjudicating the partnership enterprise bankrupt. However, if the partners have offered property that is enough to clear off all the partnership's debts, the court shall not adjudicate the partners bankrupt at the time when adjudicating the partnership bankrupt.

This rule implies that partners should have rescued the insolvent partnership by contributing property or taking other measures (e.g. workout) before, or applying composition proceeding after, the acceptance of the insolvency case. If they failed to do so it should be deemed that they did not intend to maintain the partnership. Under such circumstances, the only choice is to rescue themselves from bankruptcy adjudication by paying off all the debts that the partnership owes, or otherwise to bear the shame as bankrupts and meanwhile assume the unpaid debts after the closure of the bankruptcy case. This rule should benefit the creditors to the insolvent partnership.

The same rule shall apply *mutatis mutandis* to bankruptcy of sole proprietorship.

(2) Exemptions

If the bankrupt is a natural person, the expenses necessary for the livelihood of the bankrupt and the people he supports and daily necessities do not belong to the bankruptcy property, and the individual bankrupt, with approval of bankruptcy liquidators, is entitled to take them back. This is the rule on individual exemption in the 1995 Draft.

It is noticeable that in many western countries the general trend calls for expanding the scope of the exempted property for insolvent individuals.²³ Comparatively, the scope of exemption is narrow. The reason for this situation is that the proposed new bankruptcy law applies to merely business individuals. According to the existing Civil Procedure Law, the scope of the individual property exempted from civil execution is limited to "necessities for livelihood" of the debtor and his family dependents. If the new bankruptcy law expands the scope for merchants, there will be inequitable standards for different groups of citizens.

(3) Discharge

The Draft stipulates that an individual bankrupt shall use all his property gained after the close of insolvency case to repay the residual claims until he is discharged. The rules on discharge provided in the Draft bear the following features.

First, conditional discharge. The residual claims, except liabilities for intentional violation of personal rights, shall be discharged when the specified period of time related to the repayment ratio by the end of the bankruptcy case has expired.²⁴ Additionally, only honest,

²³ For example, the value of the exempted property in Section 522 (d) of the US Bankruptcy Code has increased to a large extent. In 1999 the standard becomes, among others, property for residence up to \$16,150 (\$7500 in 1978), motor vehicle up to \$2,575 (\$1,200 in 1978), jewelry up to \$1,075 (\$500 in 1978).

²⁴ The specified period of time varies as the following:

(1) In case of not less than 30% of the total bankruptcy claims having been paid off at the time of close of insolvency case, three years have passed since the day of the close of insolvency case; or

(2) In case of not less than 20% but less than 30% of the total bankruptcy claims having been paid off at the time of close of insolvency case, five years have passed since the day of the close of insolvency case; or

non-fraudulent person can be discharged.²⁵ These provisions are supposed to encourage the honest and diligent people who have conducted as beneficial to their creditors as possible. The longest period specified for discharge is ten years, half the length of the statute of limitations in the civil law,²⁶ aiming at the benefit of the "fresh start" for the individual merchants.

Second, automatic discharge. Whenever the specified period of time is expired and all the relevant conditions are met, the individual shall be discharged automatically; no legal proceeding for discharge is needed. The reason for this provision is to fit the national situation that our country has large territory and huge population and our judicial system has already heavy burdens.

Third, voluntary repayment. If the bankrupt voluntarily pays off a relieved debt after the discharge, the benefit acquired therefrom by a creditor shall be protected by law. This is consistent with the traditional moral norm and the provision in civil law.²⁷

10. Insolvent SOEs

In the process of drafting new bankruptcy law, who to deal with insolvent State-owned enterprises ("SOEs") has been a very difficult problem. The Explanatory Report on the 1995 Draft states: "Due to the historical reasons and the special situation in the period of transition from the old regime to the new one, the bankruptcy of SOEs especially the old ones are very difficult, mainly in respect to, first, the settlement of the staff and workers in the bankrupt enterprise and, second, the ability of the State-owned banks, the major creditors to SOEs, to endure the bankruptcy events." In order to crack these hard nuts, the Draft contains a chapter on "special provisions for bankruptcy of State-owned enterprises", providing some special rules on SOE bankruptcy.

First, if an enterprise applies for acceptance of insolvency case, it shall submit a written approval of the State-authorized department over the enterprise. This rule intends to give the authority a chance to make a pre-commencement scheme to solve the above-mentioned problems.

Second, the income from assignment of the land use right shall be used for settlement of the staff and workers in the bankrupt enterprise; and the surplus after the settlement, if any, shall be included in the bankruptcy property. This is conforming No. 59 document concerning SOE bankruptcy issued by the State Council in 1994, which takes settlement of the unemployed as of overwhelming superiority.

Third, Public welfare utilities such as tenements for employees, schools, hospitals, and kindergartens set up by SOEs shall not be included in bankruptcy property, except those

(3) In case of not less than 10% but less than 20% of the total-bankruptcy claims having been paid off at the time of close of insolvency case, seven years have passed since the day of the close of insolvency case; or

(4) In case of less than 10% of the entire bankruptcy claims having been paid off at the time of close of insolvency case, ten year have passed since the day of the close of insolvency case.

²⁵ The Draft stipulates that those who are sentenced criminal punishment because of bankruptcy crimes, or have the illegal acts set forth in the bankruptcy law, shall not be discharged.

²⁶ Article 137 of the General Principles of the Civil Law reads: "A limitation of action shall begin when the entitled person knows or should know that his rights have been infringed upon. However, the people's court shall not protect his rights if 20 years have passed since the infringement. Under special circumstances, the people's court may extend the limitation of action."

²⁷ Article 138 of the General Principles of the Civil Law reads: "If a party chooses to fulfill obligations voluntarily after the limitation of action has expired, he shall not be subject to the limitation."

which are not necessary to continue and can be sold as a whole. These utilities shall be taken over as a whole and managed by the local government in the domicile of the bankrupt enterprise. However, the tenements for employees newly built up after the effective date of the Law shall be included in bankruptcy property.

It can be seen that the 1995 Draft is trying to balance the different demands of labor settlement and bank protection. In 1996 the State Council issued several documents on SOE bankruptcy, providing that bankruptcy property, even security collateral, can be utilized to settle the labors.

In the drafting process some scholars have disagreed such a practice that is detrimental to the order of equity and faith in market transaction and the financial stability. Based on further discussions in 2000, the recent Draft has taken off the special chapter on SOE bankruptcy, leaving the settlement problem solved by local governments and authorizing the State Council to issue regulations on bankruptcy of the SOEs established prior to the date of implementation of the Company Law.

11. Cross-Border Insolvency

Up to the date, the problem of cross-border insolvency is still unsolved. In the 1995 Draft there is a principle article stating that "no procedure of bankruptcy or composition or reorganization that begins outside the domain of the People's Republic of China has force upon a debtor's assets that locate within the territory of the People's Republic of China". Obviously this provision falls into the doctrine of territorialism. The another feature of this provision is the uncompleted wording, not saying a single word about the effect of Chinese procedure upon the assets abroad.)

When working with the 1995 Draft the team realized that the international trend was aiming at a universalist model and China should keep pace with it. But at that time the trend was not clear enough and most of the developed countries had not reformed their legislation. The uncompleted provision implies the need for further efforts. We must wait until the conditions become mature.

(The first condition is the clearness of the international trend. We feel happy to learn that the UNCITRAL Model Law on Cross-Border Insolvency adopted in 1997 has been worldwide interested. It contributes a good basis for international convergence. However, it needs some time to have the Model Law known and understood in China, especially by the law circle and the law-making related officials.)

The second condition is ripeness of China's legislative design. We have to deal with some particular questions. For instance, shall we make a whole chapter with a number of articles on detailed procedural rules or merely a single article on general principle of reciprocity or even universality? Should we distinguish the cross-border insolvency between China and foreign

²⁸ In a recent meeting of the drafting team discussing revision of the 2000 Draft held in August 2000, it was suggested to revise the article on cross-border insolvency as the following:

No insolvency proceeding that begins outside the domain of the People's Republic of China has force upon a debtor's assets that locate within the territory of the People's Republic of China, except the one that falls into the situation specified in the second paragraph of this Article.

An insolvency proceeding that begins outside the domain of the People's Republic of China shall be given reciprocal treatment in accordance with Articles 267, 268 of the Civil Procedure Law of the People's Republic of China, if the law of the country where the proceeding begins recognizes the force of the decisions made in accordance with this Law upon the debtor's assets that locate in that country, and also recognizes that the administrator or liquidator appointed in accordance with this law is entitled to take over the assets or file a

countries and that between Mainland China and the special regions such as Hong Kong, Macao and Taiwan? Importantly, it should be borne in mind that the UNCITRAL Model Law does not attempt to substantively unify the national legislation in different countries, and China has to design a model that is adaptable to the national situation on one hand and harmonized with the international practice on the other.

12. Legal Responsibilities

Sanctions against various illegal conducts are necessary for maintenance of the legal order of bankruptcy proceedings. The 1995 Draft places a special chapter, Chapter 9 on "Legal Responsibilities" to bear this mission. Besides, some provisions on avoidance of pre-commencement transactions and transfers are put in another chapter as a consequence of acceptance of insolvency cases.

The illegal conducts dealt with in Chapter 9 may be categorized into two sorts.

The first sort contains the acts of a debtor and its relative persons, including (1) breach of duty to explain,²⁹ (2) breach of duty to submit,³⁰ (3) fraudulent acts of bankruptcy,³¹ (4) partial acts of bankruptcy;³² (5) waste acts of bankruptcy.³³

civil action or civil execution against the assets in that country, so as to bring the assets into the administration and disposition under this Law.

The provision in the above paragraph apply *mutatis mutandis* to an insolvency proceeding that begins the special administration areas of the People's Republic of China.

²⁹ Article 184 of the 1995 Draft reads:

If a debtor or a debtor's representative who is bound to attend a creditors' meeting still refuses, without justifiable reasons, to appear at the meeting after a summons of the people's court, the court might summon the debtor through arrest warrant and impose a fine of RMB 1000 to 5000.

If a debtor or any other person with obligation of disclosure refuses to make a statement or an answer, or provides a false statement or answer, the people's court might impose him a fine of RMB 1000 to 5000.

If the acts mentioned above constitute crimes, criminal responsibilities shall be investigated in accordance with the law.

³⁰ Article 185 of the 1995 Draft reads:

If a debtor violates the Law and refuses to submit, or submits falsely, property statements, debt information, credit information or the relative financial statements to the people's court, the court might impose a fine of RMB 2000 to 10,000.

If a debtor violates the Law and refuses to transfer the property, and the books, documents, files and seals related to the property, to the administrator or bankruptcy liquidators, the people's court might impose the person or persons directly responsible a fine of RMB 2000 to 10,000.

If the acts mentioned above constitute crimes, criminal responsibilities shall be investigated in accordance with the law.

³¹ Article 186 of the 1995 Draft reads:

If a debtor has any of the acts stipulated in Article 27 of the Law or any of the following within 12 months prior to the acceptance of insolvency case by the people's court, the court might impose the person or persons directly responsible a fine of RMB 10,000 to 100,000; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law:

(1) Selling property at abnormally low price;

(2) Paying off undue debt ahead of time;

(3) Giving up obligatory claims;

(4) Fabricate or destroy evidentiary material relevant to property, thus making the property ~~unavailable~~.

³² Article 187 of the 1995 Draft reads:

If a debtor has any of the following acts, the people's court might impose the person or persons directly responsible a fine of RMB 5000 to 50,000; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law:

(1) Pledging property as security for satisfaction of an unsecured debt, within 12 months prior to the acceptance of insolvency case by the people's court;

(2) Paying off an individual claim or claims even though having been aware of its inability to pay off due debts, within 6 months prior to the acceptance of insolvency case by the people's court.

³³ Article 188 of the 1995 Draft reads:

If a debtor has or should have been aware of its inability to pay off due debts but still unreasonably spends money and property or squanders the property, the people's court might impose the person or persons

The second sort related to the acts of institutions and participants, including (1) accepting bribe;³⁴ (2) offering bribe;³⁵ (3) misconduct in office.³⁶

Most of the above are absent in the 1986 Enterprise Bankruptcy Law. However, in that Law there is a provision concerning the personal responsibilities of the management or officials for causing the insolvency of an enterprise.³⁷ Recently the drafting team considered to add a provision of this kind into the draft law.³⁸

According to China's legislative practice, criminal penalties must be stipulated in the Criminal Law. Therefore it is expected that when the new bankruptcy law promulgated, the provisions on penalties against bankruptcy crimes will be issued by the National People's Congress through a separate criminal legislation.

Conclusion

Of course there are still a number of other issues that need to be discussed. People may understand that China is stepping on the path of institutional transition and inevitably confronted with lots of challenges domestically. (Bankruptcy law is a typical area in which so many different values and interests are conflicting each other.) From 1994 when the drafting team organized, nearly seven years have passed. We are still working, waiting and learning. What I have learned from the long process is that the spirits of pragmatism, compromise and gradual evolution constitute the major characteristics of the legal reform in China.

In the spirit of pragmatism, we always take the practical problems as the start-point, the

directly responsible a fine of RMB 3000 to 30,000; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

³⁴ Article 189 of the 1995 Draft reads:

If during a bankruptcy procedure any of the administrators, reorganization executors, bankruptcy liquidators, supervisors, creditors or their proxies asks for or accepts a bribe or other illegitimate interest, by taking advantage of his position, the people's court might impose a fine of RMB 10,000 to 100,000 according to the circumstances; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

³⁵ Article 190 of the 1995 Draft reads:

If during bankruptcy procedure, anyone offers a bribe or other illegitimate interest to any of the administrators, reorganization executors, bankruptcy liquidators, supervisors, creditors or their proxies, the people's court might impose the person or persons directly responsible a fine of RMB 2000 to 30,000; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

³⁶ Article 192 of the 1995 Draft reads:

If any of the administrators, reorganization executors, bankruptcy liquidators, supervisors causes heavy losses to the creditors, the debtor or a third party, as a result of his misconduct in office or other illegal act, the people's court might impose a fine of RMB 10,000 to 100,000 and a detention; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

³⁷ Article 42 of the Enterprise Bankruptcy Law reads:

After an enterprise is declared bankrupt, the government supervisory departments and audit departments shall be on duty to find out the responsibilities for the bankruptcy of the enterprise.

Where the legal representative of the bankrupt enterprise bears the major responsibility for the bankruptcy of the enterprise, administrative sanctions shall be applied.

Where the superior departments in charge of the bankrupt enterprise bear the major responsibility for the bankruptcy of the enterprise, administrative sanctions shall be applied to the leaders of such superior department in charge.

³⁸ The suggested provision is as the following:

After an enterprise legal person is adjudicated bankrupt, the people's procuratorate or the audit organ, supervisory organ of the people's government, if it deems necessary, may investigate the personal responsibilities of the management, financial executives and other relevant personnel for the bankruptcy of the enterprise.

If any of the management, financial executives and other relevant personnel of the enterprise causes bankruptcy of the enterprise by acts of corruption, embezzlement, malpractice or other illegal acts, the people's court shall impose a fine of RMB 10,000 to 100,000 in addition to the liability for damages to the investors and creditors of the enterprise; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

workable solutions as the aim and the effective results as the test. While looking at and looking into the realities we realize that the theoretic analysis and experiential proof are of equal importance. While researching the cases in the reform and hearing the demands from the society, we keep drawing lessons from the successful examples abroad.

In the spirit of compromise, we always keep a tolerant mind and a moderate attitude in dealing with the different or divergent appeals. We are trying to persuade people to think about the common interests and mutual benefits. We are also using traditional wisdom and modern knowledge to work out some medium schemes to solve the disputes among various extremes.

In spirit of gradual evolution, we push the train ahead from one milestone to another. We have to follow the legislative procedure and waiting patiently for decisions from the authority. We get used to sitting on a cold bench and thinking with a warm heart. We understand the meaning of the proverbs that "a melon falls when it is ripe" and "with water flowing a ditch is completed".

Although we have worked hard and still have a lot of hard work to do, we feel proud of the achievement that we have got. It is proved that the 1995 Draft has been highly appraised and valuably advised in China and abroad. By way of illustration, in April 2000, the China Law Committee of the American Bar Association made a report on the Draft.³⁹ The general comment of the report reads:

The Committee acknowledges that the draft law is a product of a tremendous amount of work and study and is a significant improvement over the existing legislation on the subject. It not only clarifies a number of issues that are unclear in the current regime but also has all of elements of a modern insolvency law. If adopted, the law will help increase foreign investors' confidence.

The conclusion of the report put a further comment as the following:

The draft law is already a product of a tremendous amount of study and work. It is a foundation on which a predictable and consistently applied legal framework can be built. The implementation of the Bankruptcy Law, which inevitably affects the banking and financial institutions and social welfare systems, however, will likely pose even bigger challenges. Developing an efficient institutional and regulatory framework, therefore, should be more important than drafting a state-of-the-art law.

Recently, a group of experts of the World Bank completed a draft report on bankruptcy of State enterprises in China. In its conclusion, the report suggests "rapid introduction of a new bankruptcy regime for non-state enterprises and incorporated SOEs".⁴⁰ It states:

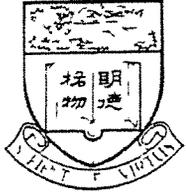
A new Bankruptcy Law has been drafted in 1995-96. It would apply to state-owned and non-state enterprises. The draft is much improved relative to the older legislation, and largely resembles the bankruptcy laws of market economies. Among other things, it envisages a proper trustee function, strengthens the role of creditor committees, provides an elaborate option of court-supervised reorganization that can be initiated by debtors. While the technical content of the law has not been fundamentally challenged since it

³⁹ NBA Section of International Law and Practice, *Report of Recommendations of the American Bar Association's China Law Committee on the Draft Bankruptcy Law of the People's Republic of China*.

⁴⁰ East Asian and Pacific Region Private Sector Development Unit, the World Bank, *Bankruptcy of State Enterprises in China -- A Case and Agenda for Reforming the Insolvency System*, Washington, DC., Draft May 27, 2000.

was drafted, the country's leadership has so far chosen not to submit the law to parliament. The Government and Party seem mainly concerned that the social implications of SOE bankruptcy, if pursuant to a uniform new law, could slip out of their control. In reaction to this concern, an alternative version of the draft includes a special chapter on SOE bankruptcy. However, the legal profession tends to reject the idea of a law that treats state-owned debtor enterprises differently than non-state ones. The result of this gridlock is the absence of a well-functioning bankruptcy regime for the increasingly important non-state economy.

I believe that Chinese people will never forget all the efforts made by foreign friends in assisting China in the development of the rule of law.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

Relationship between Bankruptcy Liquidation and Ordinary Liquidation of Legal-Person Enterprise

Wu Jingming

Relationship between Bankruptcy Liquidation and Ordinary Liquidation of Legal-Person Enterprise

*Wu Jingming**

Liquidation of enterprise is a legal action to be exercised, when an enterprise has been terminated due to some causes, to finally settle, evaluate, handle and distribute its property, credit, debt and outstanding affairs. As provided in China's existing enterprise laws, any enterprise terminated due to any cause shall be liquidated according to the legal procedure. However, as the liquidation of enterprise termination due to non-bankrupt cause is an entire self-action with neither restriction of legal provisions nor effective supervision mechanism, the enterprise shall, under the guise of liquidation, dispose property for dodging creditors or cancel the enterprise without liquidation. Such cases are very frequent in China in recent years that not only injure heavily the creditor's interests, but also interfere the normal social economic order. Creditors will file petition for liquidation to local court in the cause of protecting their interests through special mandatory procedure as liquidation. While the debtors will fail to get the credit paid because it is difficult to identify whether the non-bankrupt enterprise has the qualification of bankrupt subject because there is not applicable scope of application of current bankrupt system of China. This thesis states my viewpoints on solving the above issue through substantial analysis on non-bankruptcy liquidation and bankruptcy liquidation and the difference between them.

I. Ordinary Liquidation

Non-bankruptcy liquidation, also called ordinary liquidation, that has wide suitability of subject application including all current enterprise types in China. The enterprise types include: state-owned enterprises, collective enterprises, enterprises of Chinese-foreign investment, Chinese-foreign cooperative joint ventures, and exclusively foreign-funded enterprises (classified with ownership); company enterprise, partnership enterprises, and individual-funded enterprises (enterprise formation classified with the standards of capital structure and liability form). This thesis does not include liquidation of partnership enterprises and individual enterprises as they are non-legal-person enterprises.

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It is provided in current enterprise law and company law of China the cause of ordinary liquidation is non-bankrupt termination including two categories. One is voluntary termination, i.e. voluntary disbanding, performed in: (1) The business term agreed in constitutions, agreement or contract has expired or other causes of dissolution regulated in constitutions has occurred. The enterprises shall be dissolved as the business term specified in the articles of association, agreement or contract has expired where is no will of prolongation, or the dissolution cause specified in constitution is established. (2) The enterprise shall be dissolved subject to agreement of 2/3 or more shareholders after the management of the enterprise has decided to dissolve the enterprise. (3) Inability of continuous operation when the enterprise has suffered great loss from force majeure. The enterprise shall be dissolved under its own decision when it has great loss due to severe natural disasters or war that bring inability of continuous operation. (4) The enterprise has failed to reach its target satisfactorily and where there is no prospect of development has been found. (5) The enterprise is dissolved due to merging and split. Another category is the mandatory dissolution, including (i) Dissolution under the decision of institutions authorized by the State for investment or department authorized by the State as well as competent department of the government. Those exclusively state-funded enterprises shall be dissolved under the decision of institutions or department authorized by the State. State-owned enterprises of other types or Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures, wholly foreign-owned enterprises, and foreign-invested enterprises shall be dissolved under the decision of their competent administrative institutions or approving organs. (ii) Dissolution under order for the cause of violating the law and administrative code, mainly those enterprises causing serious pollution or damage to local environment and has failed in harnessing pollution in due course hence being ordered to be closed by local government provided for the law. (iii) Being terminated provided for the law, which is the main and the most-occurred cause for coercive dissolution arising from various causes mainly: a) the business license shall be revoked provided by law due to failure in operation within legally specified period since the date of establishment. It is provided that all companies or other legal-person enterprise shall, if it has failed to operate within six months without reasonable ground shall be due to provoke its business licenses by registration organ;¹ b) the enterprise has been found no business action within a certain length of time in its existence. It is provided in the two aforesaid regulations the business license of companies, in condition it has terminated its business for six months or longer successively, for one year in case of other legal-person enterprises, shall be revoked by enterprise register organ; c) the enterprise has failed to submit to annual inspection; d) the business license has been terminated due to other illegal actions; e) the business license has been revoked provided by law due to serious commit against economic law and code, including: improper competitive action against the Law against Unfair Competition, action against Production Quality Law and the Law for Protecting Consumer's Rights and Interests, producing and selling products that has not accorded with safety standard, or personal injury or property damage of users caused by such.

¹ See, Article 62 of the Administration Bylaw on Company Registration of the PRC and Article 22 of the Administration Bylaw on Legal Person of Enterprise of the PRC.

The legal-person enterprise shall commence ordinary liquidation procedure upon its termination caused by the aforesaid causes. The liquidation procedure shall be complicated or simple subject to different reasons for liquidation. In the case of liquidation for enterprises under dissolution due to merging and split, as the credit and debt of the former enterprise shall be succeeded by the changed enterprise, the procedure is very simple as the liquidation does not include final distribution of property, while discharging debt is not an indispensable procedure as its debt can be settled down when operating liquidation or to be secured by equivalent property. Apart from this, the ordinary procedure of liquidation is as the following.

First, determining liquidation date. The liquidation date is the starting date of the liquidation period as well as the starting date of liquidation procedure begins. It is provided in current law that the liquidation date shall be taken as the date the liquidation team sets up and a liquidation panel shall be set up within fifteen days after the dissolution has been decided in voluntary dissolution when the setting up date is taken as standard date. The date of setting up liquidation panel shall be decided by relative authorities for mandatory dissolved enterprise.

Second, setting up liquidation panel. Liquidation panel is a legal institution necessary, on behalf of enterprise legal person, for executing liquidation, the structural factor for enterprise liquidation. The setting up course and trustees of liquidation are different as enterprises dissolved for different causes; the process of setting up liquidation panel is different for enterprises with different nature. To those enterprises that have been dissolved voluntarily, the members of liquidation panel for common limited liability stock companies and common limited liability companies shall be selected from shareholders by the board of directors; the members of liquidation panel of common state-owned enterprises shall be selected by its competent upper department; the members of liquidation committee of Chinese-foreign equity joint ventures, Chinese-foreign cooperative enterprises and foreign-invested enterprises shall be appointed by its board of directors, joint administration committee and foreign investor and to be submitted to the authority for approval; the members of liquidation panel of Chinese-foreign contractual joint ventures shall be composed of directors, registered accountants or lawyers of China; the members of foreign-invested enterprises shall be composed by its legal representative, representative of creditors, and representative of competent organs. To those enterprises has been mandatory dissolved, the liquidation panel is, which shall be organized by competent authority, the members of its liquidation panel shall be composed by shareholders, trustees dispatched by relevant authority, accountants, lawyers, as stipulated, under the leadership of the management of the enterprise or the competent authorities. The court shall, upon application of all concerning parties, appoint members of liquidation panel betimes for liquidation to those enterprises, no matter what the reason for dissolution is, has failed to set up liquidation panel within legal term.

Third, releasing liquidation announcement. The liquidation panel shall, after establishment, issue a bulletin to the public within the legally specified time and any creditor who has identified address, shall be given the notice upon which debtors shall declare obligatory right. It is provided in the Company Law there shall be given notice to any holder of such a Company Law, within 10 days from the date the liquidation panel establishes, and make at least three announcements on newspapers within sixty days, and creditor shall, within thirty days (Ninety days for those who has failed to receive such notice) after it has received the notice, declare debtor obligatory right.

Fourth, performance of duties. The liquidation panel shall commence its liquidation duties, examine property, discharge debts, formulate balance sheet and list of property, work out liquidation scheme which shall be submitted to the shareholders meeting or relevant competent authority that aims confirmation. The liquidation panel shall, whereas the liquidation scheme has been approved, pay liquidation fee, salary, wage, labor insurance premium, debit tax, and discharge debts.

Fifth, distribution of remaining properties. Liquidation panel shall, after the aforesaid debt has been discharged, distribute the remaining property in accordance with investment ratio of the investors. For Chinese-foreign equity joint venture, Chinese-foreign cooperative enterprises and exclusively foreign-invested enterprises, the part of remaining property exceeding the registered capital shall be regarded as profit and the income tax is due to be paid whereas by law.

Sixth, formulation of the liquidating report and registration of termination. The liquidation panel shall formulate liquidation report, which shall be submitted to the shareholder meeting and competent organs to get their approval. Chinese-foreign equity joint ventures, Chinese-foreign cooperative enterprises and foreign-invested enterprises shall be submitted the liquidation report to the board of directors or the joint administration committee and approval organ, which, after it has been approved by the aforesaid organs, shall report to the original registration organ and register termination, and termination bulletin shall be released thereafter.

Analysis indicates there is great difference between ordinary liquidation and bankruptcy liquidation. Its unique characteristics are stated the following aspects:

First of all, there lies numerous and complicated direct causes for ordinary liquidation. The "direct causes" here are the causes directly leading to the liquidation, which may arise from termination at the desire of capital contributors, or dissolution caused by external causes such as force majeure etc., or being closed by order because of illegal action, or dissolution under administrative performance of administrative departments such as revoking business license. While the direct external cause is the single cause that leads bankruptcy, that is bankruptcy declared by the court because it has failed in discharging due debts.

The next, the set-up of liquidation institution of ordinary liquidation had remarkable autonomy. The members of liquidation institution in voluntary dissolution shall be appointed by the management of the individual in such case provided by law; while the liquidation institution shall be composed by relative authoritative organ, it is not provided in the law whom shall be candidates of the members, a great nature and autonomy shall be found in such case.

The third, the liquidation course of ordinary liquidation has great voluntariness. Although the law provision of liquidation institute, the legal measure and process are the necessities in ordinary liquidation, external supervision and restriction as strong as bankrupt liquidation shall not be conducted to ordinary liquidation, which conduct strong voluntariness during the course of liquidation. There hence arise some problems.

The fourth, no strict legal provisions on discharge order of common liquidating debts. Whereas ordinary liquidation generally is not caused by debt crisis, the assets usually surpass its debts, and the situation is not as serious as an intimidation to the interests of creditors including staffers of the party, the state and other creditors, the law provides to pay off debts individually other than tendering in order.

II. Bankruptcy Liquidation

Bankruptcy liquidation is a legally specified mandatory liquidation, also named juridical liquidation. The scope of bankruptcy liquidation is limited in company business under current conditions. the Corporate Bankruptcy Law (Trial Version) is applicable to state-owned corporate business, while Chapter 19 of the Procedure of Repaying Debt of Corporate Business's Bankruptcy (Chapter 19) of the Civil Procedure Law applicable to non-state-owned corporate business.

The causes resulting in the bankruptcy liquidation are very simple and single compared with the causes resulting in non-bankruptcy liquidation, namely, the enterprise commences the bankruptcy liquidation procedure only after the people's court has released the bankruptcy announcement to lead to its termination. That the court makes bankruptcy announcement must satisfy the following conditions, namely the first, the bankruptcy cause occurs in an enterprise, i.e. the enterprise has reached the boundary of bankruptcy. The cause of the enterprise bankruptcy is the failure in tendering due debts. That is, the enterprise is asset deficient to tender due debt. It is possibly inability to tender due debts with assets, i.e. the asset-liability ratio is over 100%, or, the asset enter main is less than due debts, although the asset exceeds due debts, the quick ratio below 100%. Simultaneously, the credit standing has been worsened severely, and has no attraction to potential investors to invest or to contract new loans to repay the old debt. B) there is an entity who files the petition for bankruptcy. In current situation of China, the case of bankruptcy is commenced by the filing of petition. The subjects that have qualification to file the petition for bankruptcy shall be creditor, debtor and the liquidation panel in ordinary liquidation procedure. The creditor and the debtor shall have the right to file the petition for bankruptcy to the court upon the causes of enterprise bankruptcy. Petition for liquidation shall be filed to the court immediately upon discovery of the causes of enterprise bankruptcy. C) the composition has been vetoed. The veto may arise from: Being vetoed at the beginning, as the state-owned enterprise that files petition for bankruptcy by itself shall not be composed as the law provides, and the composition affairs has been vetoed during implementation of the composition agreement, as the debtor has failed to implement the veto agreement after it has come to terms, or the property standing continuously worsen during the implementation of veto agreement, or the action that has seriously damaged the interests of creditor, the composition has been vetoed at expiry; debts have been failed to tender at expiry of the agreed period.

Liquidation panel shall be set up within 15 days after declaration of the court on declaration on bankruptcy and the case is commenced. Bankruptcy liquidation has, compared with ordinary liquidation, remarkable characteristics:

- 1) The cause resulted in the liquidation is single which is omitted hereby as the cause for liquidation is stated in the above paragraphs.
- 2) The setting up of the liquidation institution has enforceability. That the juridical organ interferes directly the building of the liquidation panel is one of the important differences of bankruptcy liquidation from the ordinary liquidation. The Bankruptcy law stipulates the court that accept and hear the case shall designate the members of the liquidation panel from the

upper competent department of the enterprise under filing, the financial department of the government and professional accountant within legal time to compose the liquidation panel to take over the enterprise under filing. The "appoint" here embodies the authoritative position of the court in building the liquidation panel in the process of bankruptcy liquidation. However there exist many problems in practicable technical operation. As the majority of the members of the liquidation panel appointed by the court are officials of government departments, the court is sometimes very difficult to be satisfied, i.e. failure in appointment, on which the juridical interpretation of the supreme court stipulates further, "prior to the building of the liquidation panel, the people's court shall hold a conference with the local government of the same level to appoint by official letter the members of the liquidation panel from the competent department of the upper level of the enterprise under filing, departments of financial, industry and commerce administration management, planing, audit, tax, commodity price, labor and personnel affaires departments and professional personnel. Once being designated, the unit and personnel concerned are not allowed to evading or desert the post with any pretexts. The leader of liquidation panel shall be appointed by the court." It is obviously embodied the administrative style under planed economic system of bankruptcy liquidation lies in the fact the court makes use of the administration intervention and administration order of the government in the composing of bankruptcy liquidation. Nevertheless, there lies the possibility most members of the liquidation panel may fail to provide reasonable work time in liquidation panel resulted in less liquidation efficiency because of their busy official work. This is not coincidental with the requirement to bankruptcy process for normalization, specialization and marketization of the liquidation panel market economy. Administrative intervention to the liquidation panel should be limited to avoid conflict for interests between all departments in liquidation course. Nevertheless, some probing and reform in socialization of liquidation panel has been carried out in some areas. For instance, a liquidation intermediary institution composed of lawyers and accountants has been set up in Shenzhen and the institution shall dispatch personnel upon notice of the court to commence liquidation upon bankruptcy cases. It is a good example for reference of composing new bankruptcy law. The enforceability of composing of the liquidation panel should be embodied mainly in the leadership upon the court.

- 3) Normalization and complexity of liquidation process. Legal process of bankruptcy liquidation is substantially a juridical procedure not directly carried out by the court, whereas the liquidation institution shall work under strict supervision of the court and the creditors meeting. Section 3 of Article 24 of the Enterprise Bankruptcy Law stipulates the liquidation panel shall be responsible and report work to the people's court. The juridical interpretation of the Supreme Court stipulates the liquidation panel shall attends as a nonvoting delegate the creditors meeting and is under supervision of the same. Therefore, the liquidation panel shall exercise the liquidation act under dual supervision in implementing its liquidation duty and which, without any willfulness as in ordinary liquidation, shall protect the interests of creditors in a larger extent.

As the enterprise under filing has limited asset, treatment to every credit or debt and assets may have concern to interests of immediate or vital interests of all creditors, therefore

the Enterprise Bankruptcy Law stipulates strict prescriptive period and enforcement procedure of exercising some specified rights in the course of bankruptcy liquidation: recall right of recall right holders, the setoff right of setoff right holders, and the right of rescission enforced by the liquidation panel and the obligatory right that has equity security. In the procedure of bankruptcy liquidation, handling of these rights makes bankruptcy liquidation more complicated than ordinary liquidation.

- 4) The distribution of asset enter main must be strictly amendable to legal sequence. As the enterprise in bankruptcy has limited property that is insufficient to repay all its debts, wherefore dividing the credits of creditors into privileged credits and common bankruptcy credits by nature is to be required. The privileged credits are preferential obligatory rights in distribution of bankrupt property as they a) are not the equity security credits, b) shall be claimed preferentially prior to bankrupt procedure, c) shall not accede bankruptcy liquidation distribution. As the Enterprise Bankruptcy Law stipulates in Article 37, the bankruptcy asset, after the bankrupt fee has been appropriated preferentially, the bankrupt property shall be discharged in the following sequence: (1) due salaries and labor insurance premiums; (2) due tax, (3) bankrupt credits, (1) and (2) are privileged credits, while the (3) is common credit. The privilege of salary is based on the real situation of China. As the system of low salary and high employment right has been the labor system in China for a long term, salary has been staying at the standard of keeping lowest living standard. The failure of salary payment for the reason of bankrupt will seriously influence normal livelihood of staffers, which may bring steadiness of social order. The due labor insurance premium payable by the enterprise shall be listed privileged credits as insurance is an aid to staffers upon age and illness, which is also of great importance to interests of staffers. The next, the tax of the enterprise due to the state, as the tax to the state, as the must to be paid off, shall be listed as the second sequence where the enforceability of tax is embodied: the lost of tax due to the state by immunity of the enterprise in bankruptcy shall not be allowed. The common credits of ordinary liquidation obligatory rights shall be paid with the remaining part after due salaries, due labor insurance premiums, and due tax have been paid out.

In performance of bankrupt distribution, must implement principles as a) the bankrupt property must be distributed in legal sequence, only all the discharging requirements of the last creditor have been satisfied, the bankrupt equity shall be distributed to the next creditor. The bankruptcy equity shall be distributed on proportion in the case the bankruptcy equity has failed to tender all credits of the same sequence. These principles embody in full the unique legal enforceability of bankrupt distribution different from the general liquidation distribution.

III. Solution to the Conflict between the Two

Analysis proves that the two liquidations have great difference arising from the will of ordinary liquidation and the enforceability of bankruptcy liquidation. The interests of debtors shall be damaged or threatened at the time the enterprise has been dissolved when a) the capital contributor has decamped and nobody has taken the responsibility to pay off debt, or b) revoking registration without liquidation, or c) the upper level competent department, in order to evade

debts, simply evokes its enterprise at the lower level with debts. All of these will directly damage or threaten interests of creditors. This variety of cases has accounted for a great weight in economic cases accepted by the court in present juridical practice. Whereas the legal system in China in this aspect is yet imperfect on whether the bankruptcy procedure is introduced when the aforesaid circumstance occurs to protect interests of creditors through the mandatory repayment of debts. Therefore, there is great need to formulate a unified liquidation law for normalizing this issue. It is suggestible that full attention be paid to this respect in formulation of a new bankruptcy law. The following is my viewpoints in these respects for solution.

1) Formulating ordinary liquidation law to strengthen the liquidation responsibility of corporate business and to enhance the right for creditors to participate in the liquidation.

It is found that there is no unified normalizing document on ordinary liquidation in China, while independent legislation has been formulated by some local authorities. The People's Congress of Shenzhen Special Economic Zone has formulated and enforced local regulations on liquidation for years, which may be used for reference in formulation of such law by the central government.

Some enterprises, after having been voluntarily dissolved, have refused to carry out legally the liquidation, regardless whether their property is enough to offset the debts, and exercise the practice of all distributing up, or terminate the enterprises when they are in heavy debts. Even though the creditors shall file claims to the court for protecting their rights and interests, and even though the court has made decision to benefit creditors, the post remedy is unhelpful to the event as the equity of the enterprise has been disposed up. Therefore, it shall be clearly stipulated in legislation that enterprise shall, within legal time as of the date of making decision on dissolution or starting from the date of occurrence of cause in fact of dissolution, notify creditors and release announcement many times. The creditors shall, within the legal time upon receiving the notice or the date of first announcement release, have the rights to declare credits. The creditors with large credits and the representatives of creditors with small credits shall have the right to participate in procedures of enterprise liquidation and, the enterprise liquidation panel shall not exercise liquidation act to dispose of the enterprise's property prior to expiration of the credit declaration time limit. For those enterprises that have failed to distribute notice and to release announcement, or cancel registration without liquidation, the legal responsibility and till the criminal responsibility of the legal representatives and persons directly in charge of enterprises shall be investigated directly. Hence, full intervention of creditors and the conflicting interests of creditors and the enterprise can be used to supervise enterprise liquidation, an effective measure to prevent trouble before it happens.

(2) Definite stipulation to the subject position of the enterprise shall be made after the business license of the enterprise has been revoked

Revocation of business license is an action of administrative organ to dissolve an enterprise through administration. The enterprise shall, after its business license has been revoked, alike to dissolution by other causes, commence liquidation procedure, discharge debts, and then cancel registration. While leaves a question on if the enterprise, after its business license has been revoked, has refused to make liquidation, or, evades deliberately debts, resulting in failure of creditors to claim for debts, is granted to file bankruptcy to the court? There are two different

viewpoints currently. One of them believes that the enterprise has obtained legal personality at the date of issuance of the "Business License for Enterprise", therefore presence or lack of business license of corporate business is the sole basis of capacity of legal person of enterprise. The enterprise shall have no capacity of legal person after the business license has been revoked. The bankruptcy system of China is only applicable to legal person, therefore enterprise, after the business license has been revoked, shall not be the subject of bankruptcy thereafter. While another viewpoint believes that attainment of business license of corporate business is both the evidence for enterprise to obtain legal personality and the mark for enterprise to acquire the right to operate. Revocation of business license is only deprivation of the right of operation, not cause of elimination of its capacity of legal person.² Therefore, the court shall accept the creditors' application for bankruptcy and place a case upon file. Different knowledge and lack of clear legal provisions have led to the result that the court has refused most motion for bankruptcy, that is disadvantage to protect the legal rights and interests of creditors.

The author supports the second viewpoint, i.e. the revocation of business license shall not eliminate the capacity of legal person of an enterprise, and it is the elimination of operation right granted by the state. Because a) Article 40 of General Provisions of Civil Law stipulates: "In termination of legal-person enterprise, legal liquidation shall be carried out, all activities other than liquidation shall not be granted". Article 47 of the same stipulates also, "liquidation team shall be set up to perform liquidation upon dissolution of enterprise ". This indicates that no matter what the cause leading termination is, liquidation is a necessary procedure. Furthermore, revocation of business license is not the same matter of cancellation of registration, the capacity of legal person only eliminates upon canceling registration. B) Article 196 of the Company Law stipulates, in liquidation due to company's dissolution, the liquidation team shall, upon discovering of the insufficiency of company equity for discharging debts in course of liquidation, file the petition immediately for bankruptcy to the people's court. This provision indicates also that there exists still the legal personality of the company in course of ordinary liquidation, otherwise the law would not stipulate ordinary liquidation is shifted to the bankrupt liquidation. C) the change in nature of legal person after the business license has been revoked and before liquidation has completed, is not the elimination of legal personality. The enterprise shall exist as an operating legal person before its business license has been evoked, while the enterprise shall exist as a liquidating legal person after the business license has been revoked. Substantially, it is still the same legal person.

Based on the aforesaid reasons, because the legal personality of the enterprise shall not eliminate after its business license has been revoked, creditors may file petition for liquidation to the court and the court shall place a case upon filing. Thus, it will not only reduce evading debts, and will also protect, to the maximum extent, interests of creditors. It will play important role in protecting the normal social and the economic order thereby.

² Zhou Bin, "Issues on Non-bankrupt Revocation of Enterprise Legal Person in China", *The Science of Law*, No. 4, 2000.



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Speaker

Reconsideration of the Reorganization System in China's Bankruptcy Law and Relevant Issues

Li Yongjun

Reconsideration of the Reorganization System in China's Bankruptcy Law and Relevant issues

*Li Yongjun**

I. The drafters' acknowledgement of the reorganization system's value

In the first draft of the new Bankruptcy Law made in 1994, there was no mention of the reorganization system. This is mainly a result of the insufficient acknowledgement of the reorganization system's value, and its difference from the composition system in particular. With the speeding up of China's market-oriented reform, large and medium-sized state-owned enterprises ("SOEs") are confronted with dangerous situations while the existing bankruptcy system can not offer any active remedy. This stimulates people to think about such a question: What is the difference between composition and reorganization?

Though the primary goal of establishing the composition system is to avoid the negative effects bankruptcy may incur to the society, but the system's defects, such as lack of remedy means, have confined it to passive avoidance without the possibility of turning to active prevention and remedy. The implementation process of composition is the process of creditors' rights being utilized and meanwhile that of debtors (legal persons) going extinct. Few enterprises can survive the composition procedure.

When enterprises have fallen into the pit of rotten reputation, it is impossible for them to collect any money; and composition agreements can not impose restrictions on owners of real rights for security in implementing their rights in this respect. Therefore, there are no chances for debtors to recover from their difficulties.

The reorganization system is a legal procedure in which enterprises in difficulty can be rescued. Due to its various measures for helping enterprises overcome their difficulty and avoiding the unwanted effects the bankruptcy of enterprises may bring to the society, it is preferred and attached much importance to by many countries.

It is after the first worldwide economic crisis that rebuilding-style procedures began to arise and develop. Most of the reorganization systems emerged during this period. The most recent large-scale modification of bankruptcy law originated in the United States in 1978 when the country began to lead a world-wide move focusing on the enhancement of reorganization and composition legislation.

The reasons for many countries to attach much importance to reorganization legislation lie in the following fact: the various measures adopted in the reorganization system are conducive to the revitalization of debtors while the composition system does not have such measures at all.

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These measures include, (1) impose restrictions on the implementation of real rights for security, (2) have the presence of shareholders in the reorganization procedure to make up for the lack of financial resources, (3) let enterprises issue new shares to collect capital, (4) allow partial transference of the enterprises' assets for capital that is required in the reorganization, (5) allow the ownership of an enterprise to be transferred when it can not get new injection of money aiming at its revitalization. The variety of measures for reorganization system offers more opportunities for enterprises to recover. For example, since 1964, Japan has experienced 80 cases of enterprise bankruptcy, among which 66 have recovered by choosing the reorganization procedure. Based on this, Japanese scholars point out, "It can be said that company revitalization imposes restrictions on the exercise of rights by the socially and financially strong on one hand, and on the other, offers certain protection to the weak, promotes the continuous rebuilding of enterprises, and minimizes the malignant effects from enterprise bankruptcy.¹"

Besides, the composition system revolves around creditor protection, which means that it gives no protection for the implementation of real rights for security and excludes the authentic owner of enterprises from its procedure. The composition procedure is strongly self-governing, and the conference of creditors has great power, so whether a composition agreement can be passed relies completely, instead, on the conference of creditors. It is due to this that courts, even if they have reasons for their belief that composition is conducive to the avoidance of enterprise bankruptcy, unemployment of workers and the interests of the society as a whole, can not interfere.

Different from this, the reorganization procedure is characterized by its high costs, appalling social prices and complex process. It is the interests of the society as a whole, not those of the creditors, that enjoy most of its protection. Conflict of interests in the reorganization procedure are even more complicated--more conflicting parties such as the creditors and the debtor, the creditors and the shareholders, the shareholders and the debtor. It restricts the practice of the rights of security, and weakens the power of decision-making by voting by different groups so as to make the passage of the plan more easily.

These features of reorganization procedure meet the needs of the Chinese government to rescue SOEs by active measures. Practices are pushing legislation forward. Under this situation, the reorganization system is stipulated in the draft Bankruptcy Law.

II Issues in the legislation for reorganization

(1) The issue of application scope

The application scope of the reorganization system means to whom the reorganization procedure is applicable. This is the first issue to be solved for the reorganization procedure. Its significance lies in making sure the qualifications of applicants or validity of self-appliance.

When one that is not the subject of the reorganization system applies for his own reorganization or he is the subject of others' application, the court can reject the application. Such an application scope is regulated by the reorganization system itself. Reorganization legislation in many countries has explicit stipulations for this. For example, Article 1 of Japan's Company Revitalization Law stipulates that the law is applicable to stock companies in difficulty but with hope of being rebuilt. Article 2 of France's Law on Judiciary Reorganization and Liquidation of Enterprises in Difficulty regulates, "Judiciary reorganization is applicable to all businessmen, craftsmen, farm runners and legal persons in private law."

If the most typical or classical bankruptcy can be said as that of individuals (natural persons), then the classical reorganization is that of legal persons. When talking about the development history of the reorganization system, we know that reorganization aims to avoid unemployment of workers incurred from enterprises going bankrupt and economic losses from chain responses of relevant enterprises, and lessen social upheavals. From this we can say that the major target of its application is legal persons instead of ordinary natural persons because the latter's bankruptcy will not result in serious negative social effects and the composition procedure is more suitable for them. When bankruptcy is declared after failure to reach a composition for natural persons, preferential treatment of exemption will be given to help them restart their businesses with the aim of self-revitalization. But for business-runners, many countries lay down regulations that the reorganization procedure shall be applied as natural persons that run businesses have the same nature as legal persons in private law--they sometimes employ workers and their bankruptcy has certain degree of negative social effects--with the only difference lying in scale. We believe such regulations are of great significance.

In drafting China's new Bankruptcy Law, there arose disputes around the application scope of the reorganization system. Some proposed that strict regulations should be made, and the best choice is to select stock companies or even the listed ones as the subjects. Their reasons are that the reorganization procedure is characterized by its high costs, appalling social prices and complex procedure and it mainly protects the interests of the society as a whole instead of those of creditors. Compared with the composition procedure, the reorganization procedure has stronger interference from public forces, and creditors are confronted with stricter restrictions and have to suffer larger losses. It's due to such facts that the reorganization procedure requires that its subject must be enterprises that have social values. Moreover, given the appalling social prices, the failure of reorganization will bring serious damages to creditors and shareholders. The secured creditors are the least willing to introduce the reorganization procedure. As a result, these people reach the conclusion that strict limitations should be imposed on the application scope of the reorganization procedure in legislation and courts should be very cautious in accepting applications for reorganization and never allow the start of such a procedure without a real hope of the debtors' "being rebuilt".

Others, however, argued that narrow regulations should not be made in legislation for the application scope of the reorganization procedure. All should be decided by courts in their working process in light of particular cases. Based on this, the current draft Bankruptcy Law

stipulates that the reorganization procedure is applicable to "legal persons with the prospect of being rescued".

This regulation implies the reasonable worry about abuses of the reorganization procedure. Due to the special *satu quo* of China's SOEs, the government has made all possible efforts to rescue the enterprises in difficulty. It is possible that the reorganization procedure is started at the cost of interests of other creditors, those of the secured creditors in particular. If this comes true, the real goal of legislation will be distorted.

(2) Reasons for reorganization

The presence of reasons for reorganization is the prerequisite to start the procedure. The concept of reasons for reorganization refers to the failure of debtors to pay back their debts or the fact that they don't have the ability to pay back their debts. In this sense, we can see reasons for reorganization has a broader range than those for bankruptcy.

The goal of the reorganization procedure is different from that of the bankruptcy procedure in that it aims to rescue enterprises. Therefore, when reasons are sufficient for debtors to go bankrupt but not yet for being reorganized, courts should examine whether there is prospect for the debtors to be rescued. If the reorganization procedure is started at the lack of prospect for debtors to be rescued, the bankruptcy procedure will have to be launched at last, which renders the reorganization procedure useless. It is based on this that Article One of Japan's Company Revitalization Law has the following explicit stipulation, "The company revitalization procedure is applied to stock companies in difficulty but with prospect of being rebuilt ". Our Bankruptcy Law also stipulates that the reorganization procedure must be started when there is prospect for legal persons to be rescued.

(3) Link-up of the reorganization procedure with the bankruptcy procedure and the composition procedure

A. Transition of the reorganization procedure and the bankruptcy procedure

As aforementioned, overlap exists in the reasons for reorganization and for bankruptcy. When debtors do not have the ability to pay back their debts or have stopped their payment, interested persons are entitled to making a choice between the reorganization procedure and the bankruptcy procedure. The question is, after a choice is made, can the two procedures be transitioned into each other and with what kind of conditions can they be transitioned?

a. Transition of the bankruptcy procedure to the reorganization procedure

The commencement of the bankruptcy procedure does not necessarily exclude the transition toward the reorganization procedure. This is a widely recognized principle by many countries, but the condition and process for transition are different in each case. In France and Japan, their stipulations are comparatively loose than others'. For example, Japan's Company

Revitalization Law stipulates that the bankruptcy procedure can be transited, after it has been started, into the reorganization procedure before a bankruptcy declaration. In light of Article 31 of this law, companies in the process of liquidation or special liquidation or after bankruptcy can apply for reorganization. The application under such a situation, however, must be decided with the agreed method for modification of chapter in Article 343 of Business Code, i.e., the application must be passed by more than two-thirds of all votes of shareholders that have more than a half of the issued shares.

In Taiwan, the Company Law stipulates that the transition from the bankruptcy procedure to the reorganization procedure can only be launched before a bankruptcy declaration, and if the ruling on a bankruptcy declaration has been made, the court can reject the application for reorganization.

In the United States, conditions for transition are not so strict. Debtors have absolute rights to decide which procedure of transition will be applied. After interested persons' application and a hearing, the court may change the procedure in Article 7 (liquidation procedure) into that in Article 11 (reorganization procedure) at any time they like. The prerequisite is that the second procedure must be applicable to debtors in the first. According to Article 107 of Bankruptcy Law of the United States, individuals, companies and partners that can be debtors in Article 7, except brokers for securities and for commodity, are all allowed to apply for transition to the procedure in Article 11.

A significant question should not be ignored: Can there be only one time for the reorganization procedure to be adopted in a bankruptcy case? The reasons for raising the question are as follows, <1> Laws for reorganization usually stipulate that the termination or failure of reorganization does not necessarily mean the transition into the bankruptcy procedure. It is only when there are reasons for bankruptcy that the transition into bankruptcy procedure can be launched. Such regulations can be found in Article 307 of Taiwan's Company Law and Article 23 of Japan's Company Revitalization Law. <2> Some countries stipulate in their reorganization laws that the reorganization procedure can be applied for after a bankruptcy declaration. According to <1>, if there are only reasons for reorganization instead of bankruptcy, i.e., there is possibility for debtors to have no ability to pay back their debts, the debtors apply for reorganization and the court rule on the start of reorganization procedure, but the debtors fail in the end to reach an agreement on any reorganization scheme with creditors and shareholders, which leads to the termination of the reorganization procedure though there are insufficient reasons for bankruptcy declaration by the court. Under such a situation, can debtors reapply for the reorganization procedure after debtors or creditors have applied for the bankruptcy procedure? If creditors, not debtors, apply, can their application be approved? In light of <2>, if a debtor applies for the reorganization procedure in the process of bankruptcy, and the reorganization fails and ends in a bankruptcy declaration, can the debtor reapply for reorganization? Can creditors reapply for the reorganization procedure?

We believe that restrictions by law are necessary in this respect. This is because reorganization, different from composition, has high costs and social prices, and frequent transitions of

systems will surely cause huge amounts of squandered resources, which is in favor of neither the debtors nor the creditors. If debtors have applied for reorganization before the bankruptcy procedure is started, then they should not apply for any transition of procedures in the bankruptcy procedure, but creditors or shareholders can. It is meaningless to apply for the reorganization procedure after a bankruptcy declaration. By that time, creditors that have real rights for security have implemented their exemption rights and all costs and debts of common benefit have been paid, so the debtors' assets have almost nothing left, which means the debtors have lost the material basis for reorganization. An exception in this case is that the shareholders of the company are willing to add capital to increase the company's financial resources, but this is rare in reality. Therefore, we feel the stipulation in Taiwan's Company Law, namely, the application for reorganization should be made before the bankruptcy procedure is started, is comparatively reasonable. Given this fact, our new Bankruptcy Law stipulates in Article 81 that debtors or creditors may apply for reorganization after the people's court has filed a bankruptcy case and before the declaration of the debtors' bankruptcy.

b. Transition from the reorganization procedure to the bankruptcy procedure

Theoretically, the rejection of the reorganization procedure, or the termination of reorganization due to its plan's failure to be passed or to the procedure's failure will not necessarily be transited into the bankruptcy procedure. Composition, however, will experience a natural transition into the bankruptcy procedure at its failure to be launched. The difference lies in that reasons for reorganization are not so strict as those for bankruptcy and when composition fails, the court can reasonably declare the debtors' bankruptcy. Article 23 of Japan's Company Revitalization Law stipulates, "On the occasion of rejecting a company's application for the start of a revitalization procedure before its bankruptcy is declared, terminating the revitalization procedure or refusing to accept the revitalization plan, the court shall declare by its authority the company's bankruptcy. " Article 307 of Taiwan's Company Law has similar regulation. So does our Bankruptcy Law.

c. Calculation of claims for common benefit in the transition of the reorganization procedure into the bankruptcy procedure

Firstly, When debtors are declared bankrupt at the termination of their company' reorganization procedure, the claims for common benefit arising from other procedures that no longer have effect since the start of the reorganization procedure is the claims for common benefit in the bankruptcy procedure.

Secondly, claims for common benefit arising from the process of applying for company reorganization, terminating the reorganization procedure, or refusing to accept the reorganization plan is regarded as claims for common benefit at the declaration of bankruptcy.

B. Transition between the reorganization procedure and the composition procedure

a. Transition from composition procedure to reorganization procedure

It is commonly allowed by laws in many countries that, after the commencement of composition procedure and before the composition agreement goes in effect, parties in interests file a petition for reorganization procedure. According to Articles 2 and 4 of the Law on Judicial Reorganization and Liquidation for Enterprises in Difficulty, the composition procedure instead of the reorganization procedure shall be first applied to runners of farming industry that adopt the form of non-business company and the reorganization procedure can only be adopted when compositions can not be achieved. Besides, when debtors reach composition agreements with creditors in light of No. 84-148 law but fail to carry out their responsibilities, the reorganization procedure can also be applied. There is, however, a question: If a composition agreement has not yet been carried out after it was signed, or is in the process of being carried out, can the interested persons apply for the start of the reorganization procedure? Japan's reorganization law and the Bankruptcy Law of the United States allow such applications, while Taiwan's Company Law does not. We hold that under such a situation, the law should forbid the application for reorganization. The reasons are that though composition is largely different from reorganization, it still has the function of avoiding debtors' disassembly, its procedure has a lower cost than that of the reorganization procedure and it carries out more of the principle of the creditors' party autonomy. Since agreements have been reached between debtors and creditors on the issues of claims and debts and their force has been admitted by the court, the application for reorganization should not be allowed any more.

b. Transition from the reorganization procedure to the composition procedure

It must be pointed out that the reorganization procedure can not be directly transited into the composition procedure because composition is based upon the debtors' application and the court can not by its authority declare the start of the composition procedure. Therefore, when a reorganization application is rejected, or a reorganization plan is refused or terminated, the reorganization procedure will not be directly transited into the composition procedure unless there is an application by the debtors for composition.

(4) A question around real rights for security

Real rights for security are of great significance to the success of reorganization. If the reorganization procedure can not effectively impose restrictions on the implementation of real rights for security, after owners of such rights have done what they are entitled to do, the reorganization of an enterprise will become groundless for the enterprise's assets no longer exist.

The question we meet in reorganization legislation is: If an applicant does not directly apply for the reorganization procedure but for the bankruptcy procedure, is it necessary to impose restrictions on the implementation of real rights for security? The reason for such a question is that, if the bankruptcy procedure and reorganization procedure can be transited into each other, an applicant may change into the reorganization procedure after he has applied for the bankruptcy procedure. If no restrictions are imposed on the implementation of real rights for

security at the beginning of an application, the future transition toward reorganization procedure will become groundless. Thanks to this point, our Bankruptcy Law stipulates that the mortgage, pledge and lien to the debtors' assets or rights will be halted before bankruptcy is declared after an bankruptcy case is filed in the people's court.

The goal of such a stipulation is to guarantee the success of reorganization, but the harsh restriction on the owner of security interest, and the application of such a stipulation to SOEs in particular will have some effect on the interests of many creditors. This question is really worth our attention.

(5) The practical application of procedures

The procedures of bankruptcy law have a strong inclination for practical uses. The lack of practices and standardization of practical application in this field renders it a heavy task to put the new Bankruptcy Law into practical uses.



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**Chinese Insolvency Law Symposium:
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Speakers

Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience

**Xianchu Zhang
Charles Booth**

Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience

**Findings from interviews with judges from the Bankruptcy Division of the
Shenzhen Intermediate People's Court and bankruptcy practitioners in Shenzhen ***

By Xianchu Zhang and Charles D. Booth*****

Introduction

In 1986 the People's Republic of China ("China") enacted its first national bankruptcy law – the Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation) (the "Chinese Bankruptcy Law")¹ – as part of an emerging legal framework for the country's transition from a planned economy to a market economy. At the time of its enactment the bankruptcy law was considered a significant political and economic breakthrough that was necessary to apply some market pressure on China's State-Owned Enterprises ("SOEs") to become more efficient.² However, the rapid development of economic reforms in China soon exposed serious limitations in the Chinese Bankruptcy Law.

First of all, the law applies only to SOEs and not to Chinese economic organizations generally. Secondly, since the law was enacted before China pursued further economic reforms beginning in 1993,³ many of the bankruptcy law provisions guaranteeing government involvement and control began to conflict with the introduction of market-centered rules. Thirdly, relatively few bankruptcy cases have been

* Copyright © Xianchu Zhang & Charles D. Booth. All rights reserved. Mr. Booth would like to acknowledge the financial support provided by the Committee on Research and Conference Grants at the University of Hong Kong towards his travel expenses in conducting the interviews in Shenzhen. Both authors would like to express their gratitude to their colleague, Philip Smart, for commenting on an earlier draft of this article.

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¹ Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation), Standing Committee of the National People's Congress, Dec. 2, 1986 [hereinafter the Chinese Bankruptcy Law]. For an English translation, see General Office of the Legal Commission under the Standing Committee of the National People's Congress (compilation), LAWS OF THE PEOPLE'S REPUBLIC OF CHINA (CIVIL AND COMMERCIAL LAWS) 684-95 (1998).

² For a detailed review of the legislative history and the controversies encountered, see CAO SIYUAN, THE STORM OVER BANKRUPTCY (1987) (in Chinese). An English translation appeared in installments in CHINESE LAW & GOVERNMENT (Jan.-Feb & Mar.-Apr. 1998).

³ Following Deng Xiaoping's southern tour in which he called for bold economic reforms, the Constitution of the PRC was amended in 1993, thereby legitimating the practice of a socialist market economy. See Article 7 of the Constitutional Amendment of 1993.

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commenced under the 1986 law.⁴ At first glance, this low number appears surprising given the weak financial position of SOEs generally. For example, a national survey in 1997 of 14,923 large- and mid-sized SOEs revealed that 40.5% were in the red with total losses of RMB 58.9 billion; and the situation in 1998 was even worse.⁵ Although SOE performance has been improving throughout 2000, the non-performing loans owed by SOEs to state-owned banks are still estimated to be between 25-50% of their total lending.⁶ These figures demonstrate that before the Chinese Bankruptcy Law can be "strictly" applied to all insolvent SOEs, the Chinese government must first address two other related problems: (1) the massive level of unemployment and its potentially destabilizing effect on social stability⁷ and (2) the possible collapse of China's state-owned banks.⁸

The fourth limitation pertains to the Chinese Bankruptcy Law itself. The law is clearly inadequate for many of the problems and issues that arise in bankruptcy cases. With only 43 short articles, the law is too general and often vague. The Chinese Supreme Court has tried to remedy the situation by issuing a comprehensive interpretation with 76 articles,⁹ but this is not a long-term solution.

To address these limitations,¹⁰ in 1994 the Chinese government began a review of the Chinese Bankruptcy Law, and a comprehensive first draft of a new law was completed in 1995. However, certain conditions (primarily the problems related to unemployment and potential social instability) caused the draft to be shelved with the

⁴ According to the statistics of the Siyuan Consulting Firm (a firm specializing in bankruptcy and mergers and acquisitions), from 1989 to 1996 only 11,580 bankruptcy case were accepted by all levels of the People's Court throughout China. CAO SIYUAN, DANGSHUO ZESHUO (SAY WHAT WE SHOULD SAY) (in Chinese) 156 (1998). To put this number in perspective, this low number of cases occurred at a time when there were over 8 million enterprises and commercial households registered in China (pre-1996).

⁵ Qiu Xiaohua & others, *Dazhong Xing Guoyou Qiye Yuning Xingshi Burong Leguan (The Operational Conditions of Large and Mid-sized State Owned Enterprises Are Not Bright)*, 2 ZHONGGUO GUOQING GUOLI (STATE CONDITIONS) 21 (1999).

⁶ Pauline Loong, *What WTO Means for Chinese Banking*, ASIAMONEY 20, 21 (July/Aug. 2000). The level of lending to SOEs by state-owned banks in earlier years has been estimated as high as 75%.

⁷ In fact, the Chinese government is in the process of enacting social security legislation.

⁸ According to World Bank analysis, China's long-term fiscal sustainability has been threatened by the contingent liabilities of the banking sector arising from the SOE reform. The World Bank believes that the problems are larger than official statistics suggest and that long-term fiscal stability depends largely how the government addresses them. WORLD BANK, CHINA: WEATHERING THE STORM AND LEARNING THE LESSONS 50 (1999).

⁹ Printed in the Research Office of the Supreme People's Court (compilation), ZHONGHUA RENMIN GONGHEGUO ZUIGAO RENMIN FAYUAN CIFA JIESHI QUANJI (THE ASSEMBLAGE OF JUDICIAL INTERPRETATIONS OF THE SUPREME PEOPLE'S COURT OF THE PRC), Vol. 1949-1993 (in Chinese) (1994), [hereinafter SUPREME COURT'S OPINIONS].

¹⁰ Due to space limitations, this article will not provide a detailed discussion of other defects in the Chinese Bankruptcy Law. For further discussion of these matters, see Roman Tomasic, Angus Francis, & Kiu Hua Wang, Chpt. 2. *China*, in ROMAN TOMASIC & PETER LITTLE (eds.), *INSOLVENCY LAW & PRACTICE IN ASIA* 21-63 (1997); Ronald Winston Harmer, *Insolvency Law and Reform in the People's Republic of China*, 64 *FORDHAM L. REV.* 2563-2589 (1996); Steven L. Seebach, *Bankruptcy Behind the Great Wall: Should U.S. Business Seeking to Invest in the Emerging Chinese Market be Wary?* 8 *TRANSNAT'L LAW.* 351-373 (1995).

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national legislature. The drafting process only resumed in 1998,¹¹ and is now continuing.¹² A recent draft of a new bankruptcy law (the "New Chinese Bankruptcy Law") has recently been completed and is being released for comment.

Against this backdrop of the national bankruptcy law, the bankruptcy practice in the Shenzhen Special Economic Zone (the "Shenzhen SEZ" or "Shenzhen") offers an interesting and informative comparison and perhaps some lessons for China in reforming its national bankruptcy law. To gain a clearer understanding of Shenzhen insolvency law, the Faculty of Law at the University of Hong Kong ("HKU") and the Department of Economic Law at the China University of Politics and Law in Beijing ("CUPL") conducted interviews of members of the Shenzhen judicial, legal, and political branches who are familiar with bankruptcy law and practice in Shenzhen.¹³ These interviews were conducted from February 16-18, 2000, by team members from HKU¹⁴ and CUPL¹⁵ as part of a joint research project.¹⁶

The Shenzhen investigation started with a half-day meeting with six of the ten judges of the Bankruptcy Division of the Shenzhen Intermediate People's Court (the "Shenzhen Bankruptcy Court"), including a Deputy President of the Court. The research group then interviewed six bankruptcy practitioners who frequently serve as members of liquidation committees in bankruptcy cases (the "liquidators").¹⁷ The final meetings involved six lawyers who engage in general bankruptcy practice in Shenzhen and three

¹¹ In the interim, in 1997 the State Council adopted a national policy to prefer mergers and acquisitions to bankruptcy in the reform of SOEs. See s. 9 of the State Council Supplementary Notice on Trial Implementing Mergers & Acquisitions and Bankruptcy of State-Owned Enterprise and Reemployment of Their Workers in Certain Cities, Mar. 2, 1997, published in 8 *Zhonghua Renmin Gongheguo Guowuyuan Gongbao (The Bulletin of the State Council of the PRC)* 312, 317 (1997). It was stated that the policy to encourage mergers and acquisitions should be further implemented with preferential treatment and relaxed restrictions.

¹² See Wang Weiguo, *Adopting Corporate Rescue Regimes in China: A Comparative Survey*, 3 AUSTRALIA J. CORP. L. 234 (1998). In 1998, the enactment of a new bankruptcy law was listed in the Legislative Plan of the new National People's Congress as an unfinished project of the previous congress. SEE WANG WEIGUO, PO CHAN FA (BANKRUPTCY LAW) 43-44 (1999).

¹³ Since the meeting was conducted in a free-style discussion with a question-answer format, it is difficult to identify each participant's words. Thus, this article consolidates the views and comments of the participants. The authors are responsible for all errors and misunderstandings, if any, arising from this report of the discussions.

¹⁴ Including the co-authors and Liu Nanping. Non-attending team members included Philip Smart (who helped design the questionnaires) and Say Goo.

¹⁵ Including Dean Wang Weiguo and five of his colleagues. Dean Wang is also a member of the Drafting Group of the New Bankruptcy Law of China.

¹⁶ The Shenzhen interview project was the first area of collaboration pursuant to an Insolvency Research Agreement entered into by the Faculty of Law at the University of Hong Kong and the Department of Economic Law at the Chinese University of Politics and Law in March 1999. Further interview projects will be held in other Chinese cities over the next few years.

¹⁷ One of the lawyers, Mr. Wang Fuxiang, has published a book based on his personal experiences entitled *Bankruptcy Liquidation and Lawyers' Practice*. WANG FUXIANG, POCHAN QINGSUAN YU LUSHI SHIWU (BANKRUPTCY LIQUIDATION AND LAWYERS' PRACTICE) (in Chinese) (1998). The book includes 53 standardized liquidation documents including notices, reports, confirmation letters, various agreements and petitions, which evidence the streamlined liquidation practice in Shenzhen.

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officers from the Legal Affairs Committee of the Standing Committee of the Shenzhen People's Congress, which is the local legislature.

Part I of this article provides a comparison between Shenzhen insolvency law and the national bankruptcy law. Part II focuses on the practice of insolvency law in Shenzhen and sets out the results of the interviews conducted in Shenzhen in February 2000. Part III concludes with some overall observations.

I. An overview of Shenzhen bankruptcy law

Established as an SEZ in the early 1980s, Shenzhen started to implement an open-door policy and to engage in market-based economic practices ahead of other regions of mainland China. As a result, in Shenzhen the driving force behind economic development was not the state sector, but rather was a diversified structure that included both foreign investment enterprises and domestic Chinese private firms. Local rules were enacted in Shenzhen to deal with the issues arising from this practice. Shenzhen had its own Bankruptcy Provisions on Foreign Related Companies in 1986 (the "Shenzhen Bankruptcy Provisions"),¹⁸ even before the promulgation of the national Chinese Bankruptcy Law. Moreover, to facilitate market developments in Shenzhen, in 1992 the Standing Committee of the National People's Congress delegated to the Shenzhen SEZ the special legislative power to adopt regulations applicable to the SEZ as long as they did not contradict the national Constitution or the basic principles of the national laws and decrees.¹⁹ The Shenzhen SEZ soon took advantage of this delegation of legislative power and enacted the Shenzhen SEZ Enterprise Bankruptcy Regulations on 10 November 1993 (the "Shenzhen Bankruptcy Regulations") to replace the 1986 Shenzhen Bankruptcy Provisions.²⁰

The Shenzhen Bankruptcy Regulations differ from the Chinese Bankruptcy Law in many respects. First of all, the scope of the Shenzhen law is much broader than the national law, for the Regulations create a uniform system applicable to all enterprises that

¹⁸ The Shenzhen Bankruptcy Provisions on Foreign Related Companies were adopted by the Standing Committee of the Guangdong People's Congress on November 29, 1986 [hereinafter the Shenzhen Bankruptcy Provisions], and published in the General Office and the Economic Law Research Centre of the Guangdong Government (compilation), GUANGDONG SHENG FAGUI GUIZHANG HUIBIAN (COLLECTIONS OF LEGAL REGULATIONS AND PROVISIONS OF GUANGDONG (1984-1986) 185-195 (1997).

¹⁹ For an English translation of the Standing Committee's delegation of these power, see the Legal Affairs Commission of the Standing Committee of the National People's Congress (compilation) [hereinafter the Legal Affairs Commission], THE LAW OF THE PEOPLE'S REPUBLIC OF CHINA (1990-1992) 524 (1993). In this regard, it should be noted that according to art. 100 of the national Constitution, other local enactments may not contradict the Constitution, national laws or administrative regulations. As such, the discretion of the delegated legislative power granted to the SEZ is broader than the normal local legislation. This special delegated legislative power was further reconfirmed in a recent Law of Legislation that was adopted this year. Art. 65 of the Law of Legislation of 2000. For an English translation, see Supplement No. 5 *China Economic News* 1-8 (2000).

²⁰ For an English translation, see CCH Asia Pacific (compilation), CCH CHINA LAWS FOR FOREIGN BUSINESS (SPECIAL ZONES AND CITIES), Vol. 1, s. 71-055 at 25014-25374 (1999) [hereinafter CCH].

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either are registered or reside within the SEZ.²¹ In bankruptcy proceedings in Shenzhen, the Shenzhen Court may apply the Shenzhen Bankruptcy Regulations to the extent that they do not conflict with the principles underlying the Chinese Bankruptcy Law.

Secondly, the Shenzhen Bankruptcy Regulations include a simplified bankruptcy test. Under the Chinese Bankruptcy Law, the insolvency tests for determining whether an SOE is bankrupt include (1) whether an SOE is able to pay its debts when due and (2) whether the incurring of serious losses by an SOE were a result of poor management and the inability of the government authority concerned to provide support measures to the SOE.²² By contrast, Article 3 of the Shenzhen Bankruptcy Regulations does not include an equivalent of the second prong of the test and instead stipulates that a bankruptcy order shall be entered only if an enterprise is unable to pay its debts when due. This simplified definition of bankruptcy avoids the need for a bankruptcy court to enquire into the difficult, and often disputed, matters involving the management of insolvent SOEs.

This second factor is related to the third, and perhaps the most important distinction: the Shenzhen Bankruptcy Regulations focus more on the application of market-oriented principles than on the relationship between an enterprise and the relevant government authority. The opposite is true of the Chinese Bankruptcy Law. It has been observed that the national SOE bankruptcy law "is essentially a procedure to be applied by the Government, not invoked at the option of debtors or creditors."²³ Moreover, once a case has been commenced under the Chinese Bankruptcy Law, unless the upper-level state authority of the debtor SOE takes the initiative to reorganize the SOE,²⁴ a settlement proposal will not be available. In contrast, Shenzhen bankruptcy practice is subject to much less administrative control. For example, under the Shenzhen Bankruptcy Regulations government approval is not a necessary condition for an enterprise bankruptcy, or for a settlement in a bankruptcy proceeding. Once a case has been commenced, Article 25 of the Shenzhen Regulations provides the debtor itself with the decision whether to propose a settlement. Moreover, Article 28 empowers the court to examine and approve the settlement proposal and Article 30 mandates the court to appoint a supervisory committee composed of professionals (including accountants and lawyers) to monitor the implementation.

Fourth, the Shenzhen Bankruptcy Regulations include additional bankruptcy procedures and provisions that are not available in the Chinese Bankruptcy Law, including the following: rules for the court to supervise the liquidation committee; a special chapter dealing with small bankruptcy cases; and more detailed rules governing set-offs.

²¹ Shenzhen Bankruptcy Regulations, art. 2.

²² Chinese Bankruptcy Law, art. 3. Art. 8 of the national law provides that an SOE, as a debtor, may not file a voluntary bankruptcy petition without first getting approval from its upper-level government authority and art. 3 that a petition filed by a creditor may be dismissed or suspended if the government provides financial support for the SOE or applies for reorganization.

²³ Donald C. Clarke, *Regulation and its Discontents: Understanding Economic Law in China*, 2 STAN. J. INT'L L. 283, 299-300 (1992).

²⁴ Chinese Bankruptcy Law, arts. 3 & 17.

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Lastly, the judicial practice of Shenzhen for handling bankruptcies differs from the practice followed by other courts under the Chinese Bankruptcy Law. In 1993 China's first bankruptcy judicial division was established within the Intermediate People's Court of Shenzhen. This has led to the development in Shenzhen of a specialized judicial branch with perhaps the most insolvency experience of any judicial division in China. Since its formation, the Shenzhen Bankruptcy Court has led other Chinese courts in three categories, namely: (1) the number of bankruptcy cases accepted per annum; (2) the number of bankruptcy cases heard per annum; and (3) and the total number of bankruptcy cases handled per annum.²⁵

The experience gained from handling this heavier workload has also led the Court to streamline its management of bankruptcy cases in a variety of ways. For example, the Court has adopted the Responsibility and Operational Procedures of the Bankruptcy Division (the "Bankruptcy Division Procedures") and the Time Limitation and Certain Checking Points;²⁶ and has developed thirty standardized judicial documents including notices, inquiries, appointments, and rulings applicable to different stages of bankruptcy proceedings.²⁷ In addition, the judicial documents adopted by the Shenzhen Bankruptcy Court also fill in some gaps in the national framework. For example, the Chinese Bankruptcy Law fails to provide a time limit for a court to approve a settlement agreement; but Point 10 of the Time Limitation and Certain Checking Points requires the court to render its decision within ten days.

In sum, the Shenzhen bankruptcy regime, on the one hand, has improved the Chinese Bankruptcy Law in many ways, in part through the adoption of market-orientated economic principles and the development of a more liberal piece of legislation. Judges sitting on the Shenzhen Bankruptcy Court are more experienced and better specialized in dealing with bankruptcy cases than are their counterparts elsewhere in China. However, on the other hand, the Shenzhen Bankruptcy Regulations are not a panacea and suffer from many limitations themselves, which are discussed in Part II below.

II. Shenzhen bankruptcy practice: the perspective of judges, lawyers, and legislators

Bankruptcy statistics

From 1995 to 1998, the Shenzhen Bankruptcy Court accepted 316 bankruptcy cases. Of these cases, approximately 20% involved SOEs as debtors and another 20%, foreign-related enterprises. Of the cases involving SOEs, only one recorded case involved a large-sized SOE bankruptcy, and as of the time of the interviews the

²⁵ The then President of the Shenzhen Bankruptcy Court, Xu Liangdong discusses the judicial experience of the Shenzhen Bankruptcy Court over the past few years in a recent book: XU LIANGDONG, POCHAN ANJIAN SHENLI CHENGXU (TRIAL PROCEDURES OF BANKRUPTCY CASES) (in Chinese) (1997).

²⁶ Both judicial instruments are printed as annexes in Xu's book, *id.* at 415-429.

²⁷ *Id.* at 255-286.

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complexity of the case had not allowed for the reaching of a final resolution. Although these numbers may not sound terribly onerous by Western standards, the lack of supporting institutions (discussed below) makes bankruptcy cases in Shenzhen much more difficult to handle than other cases. Point 55 of the Bankruptcy Division Procedures explicitly recognizes that bankruptcy cases consume great amounts of both time and effort, as they involve many different types of economic disputes and legal proceedings. A deputy head of the Shenzhen Bankruptcy Court pointed out that the minimum length of time to complete a bankruptcy case in the Division was nine months and many uncompleted cases had been on going for over two years. Overall, with the exception of bankruptcy cases being handled under summary procedures, the average completion time for bankruptcy cases in Shenzhen is normally two years.²⁸ A general formula has been developed in Shenzhen to calculate the approximate amount of man-hours needed for a bankruptcy – the handling of one bankruptcy case is treated as the equivalent of eight other cases; in small bankruptcy cases, the ratio is reduced to the equivalent of four.²⁹

The judges noted that the increasing rate of bankruptcies in Shenzhen may, in part, be traced to the ongoing restructuring of the Shenzhen economy. Since 1993 the SEZ government has been upgrading the city's industrial structure to include more technology intensified and service-based businesses. As a result, many labour intensified manufacturing and processing plants were required to either "transform" themselves or move out of Shenzhen.³⁰ The judges noted, however, that the overall number of formal bankruptcy cases dealt with by the judiciary accounted for only a small percentage of these corporate "transformations." Many insolvent firms ended their operations without any liquidation or formal dissolution. Rather, their owners or investors just disappeared, and earned the name of "three no enterprises": no business place, no books of account, and no assets. In many instance of this kind, the debtors were residents of Hong Kong and fled to foreign jurisdictions where the People's Court could not reach them.

The average recovery rate for creditors in bankruptcies in Shenzhen is not high. In a typical case, after the claims of secured creditors and workers have been satisfied, there is little left to pay general unsecured creditors. The average rate of recovery for creditors in Shenzhen is less than 10%. Mention was made of at least one case in which the rate of return was as low as 0.026%.³¹ On the upper end, there were cases where 10 or 20 % was repaid, but these cases were quite rare. One reason given for the low rate of

²⁸ XU, *supra* note 25, at 35. A two-year period greatly exceeds the average for ordinary civil litigation in China. Under art. 135 of the Civil Procedure Law of PRC, a case being handled in a trial of first instance should normally be completed within six months, and certain special situations may allow for a six-month extension. Any further extension of civil proceedings must be approved by the upper-level People's Court.

²⁹ XU, *supra* note 25, at 427.

³⁰ For a discussion of the enforcement of this policy, see Zhang Xianchu, *Economic Legislation in the Pearl River Delta* in JOSEPH Y. S. CHENG (ed.), *THE GUANGDONG DEVELOPMENT MODEL AND ITS CHALLENGES* 133-134 (1998).

³¹ These figures apparently echo the national conditions. According to a survey of 131 SOE bankruptcy cases in the first half of 1996, the average rate of recovery was approximately 10%. CAO SIYUAN (ed.), JIANBING YU POCHAN CAOZOU SHIWU (*PRACTICE OF MERGERS AND ACQUISITIONS AND BANKRUPTCY*) 391 (1997).

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payment was that the liquidation committee is usually unable to find purchasers for the corporate property and another was that the assets of the debtor often disappear during the period between the filing of a bankruptcy petition and the appointment of a liquidation committee.

Relationship with government authorities

Although, as noted above, the Shenzhen Bankruptcy Regulations do not require the approval of relevant state-authorities for the bankruptcy of a state-owned or controlled company, some administrative agencies have continued to assert the application of a state policy requiring such approval. However, as a result of the incorporation of many SOEs, the state-authorities can now assert this approval right at another level, for many state authorities have become controlling shareholders of these incorporated SOEs. In other words, a state authority may now wear two hats at the same time – as both the majority shareholder of a company and as the policy maker with responsibility for the market economy. Thus, many of the interviewees noted that it would be absurd (at least in a case commenced by a debtor company) for a state authority to be responsible for protecting state assets, while at the same time being under a legal duty to deal with creditors fairly.

However, once a case is commenced the government frequently plays a significant role. The Shenzhen bankruptcy judges consider government support and assistance as necessary conditions to the smooth handling of bankruptcy cases by the judiciary. The judges identified certain key areas where they have to coordinate closely with the government, including the following: determining the amount of workers' settlements; disposing of state assets; and transferring land use rights.³² They also noted, however, that government involvement, at times plays a negative role. Some of the judges claimed that the government sometimes attempts to exert political influence over the judiciary. For example, mention was made of some judicial proceedings in which government authorities intervened in an effort to protect state assets. This put the judges in a very difficult position for deciding whether special protection should be given to the state interest to the detriment of other creditors.

³² Many SOEs have used state land (without being required to pay compensation to the government) through the allocation under the planned economy. Some SOEs have even used their land use rights as capital contributions when establishing joint ventures with foreign investors and other firms. After the real estate market in China officially opened at the end of 1980s, land use rights became marketable, which created valuable assets for many SOEs. When many of these SOEs became bankrupt, difficult issues arose in the bankruptcy cases as to how to include (and value) these land use rights as part of the property of the estate for the purpose of making distributions to creditors. The government as the landowner may demand control over the purpose of the land use based on the government development plan, the transfer price, and other terms of transfer. A notice of the State Council states that the funds to resettle workers of a bankrupt SOE shall first be allocated from the proceeds of the land right transfer, even if the right of land use has previously been provided as collateral to another party. Sec. 5 of the Supplementary Notice of the State Council Concerning Trial Implementation of SOE Merger and Bankruptcy and Re-employment of Workers in Certain Cities, Mar. 2, 1997 [hereinafter State Council Notice], published in 8 *Zhonghua Renmin Gongheguo Guowuyuan Gongbao (State Council Bulletin of the PRC)* 312, 315 (1997) (in Chinese).

WORK-IN-PROGRESS.

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Another interesting issue is to what extent the judiciary may have to accept the conclusion or decision of an administrative authority concerning the bankruptcy of a state-owned or controlled company. Currently, within the State Administration of Industry and Commerce ("SAIC"), which is the state authority in charge of business registration and cancellation, there is a liquidation department responsible for liquidation proceedings in a non-bankruptcy context. But once the SAIC finds an enterprise to be insolvent, it is required to transfer the case to the People's Court. Sometimes, certain preliminary rulings may even have been made. The issue as to whether the judiciary should be bound by these administrative holdings poses a challenge in those cases where the judiciary might reach a different conclusion as to whether the company is, in fact, insolvent. In the Chinese socialist system, there is no tradition of judicial independence and the judiciary does not have a track record of overruling administrative decisions. Moreover, a judicial refusal to take a case referred to it by the SAIC may leave the parties concerned caught in the middle of a dispute between two powerful state organs. However, the docile acceptance of such cases from the SAIC would surely jeopardize the judicial standards and the professional independence of the judiciary.

In other areas as well, the unclearly defined relations between the various state organs and the bankruptcy court may cause complications in the administration of bankruptcies. The serious problems arising in regard to the investigation and prosecution of fraud are discussed below.³³ Related difficulties arise in regard to preventing debtors from escaping from their financial obligations and absconding from the mainland. In this area, the Shenzhen judges feel that their powers are limited. They noted that according to a circular of the Supreme People's Court issued in 1987, a People's Court may enter an order preventing a resident of Hong Kong or Macau who has no assets in the mainland for execution and who refuses to provide security for his unsettled debts from leaving the mainland.³⁴ However, the judges have found that it has been difficult to implement this circular because of the lack of collaboration among the courts and the public security, border control, and People's Procuratorate offices. For example, they noted several civil cases in which by the time all the state branches in Shenzhen agreed to take preventive action, the debtors concerned had already escaped from the jurisdiction.

Another issue involving the need for cooperation between the judiciary and state authorities concerns the preferential treatment given to SOE workers in comparison to employees of non-state enterprises. It must be borne in mind that the insolvency of an SOE is more like the insolvency of a municipality than of a company.³⁵ In the past, an SOE provided its workers not only with working positions, but also with education, housing, and other social security benefits. Thus, bankrupting an SOE has great social implications. To maintain social stability in the light of the significant number of SOE insolvencies in recent years, the government and judiciary have each adopted policies to

³³ See *infra* text accompanying notes 40 to 50.

³⁴ Replies of the Supreme People's Court on Certain Issues Concerning Economic Dispute Cases Involving Interest of Hong Kong and Macau, Oct. 19, 1987, published in the Research Office of the Supreme People's Court (compilation), *supra* note 9, at 1899.

³⁵ Thus, to put it in a U.S. context, a bankruptcy of an SOE is more like a Chapter 9, rather than a Chapter 11, proceeding under the U.S. Bankruptcy Code.

WORK-IN-PROGRESS.

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guarantee the protection of the living standards of workers of bankrupt SOEs. For instance, as noted above, a notice of the State Council states that the proceeds of the land right transfer shall be first used to settle workers of a bankrupt SOE, even if the right of land use has previously been provided as collateral to another party.³⁶ Similarly, the Shenzhen Bankruptcy Court has taken the view that, if possible, after the filing of a bankruptcy petition workers of SOEs should be paid at least 70% of their normal salary; and after the bankruptcy declaration, workers should be paid according to the minimum living standards adopted by the Shenzhen Government. In addition, certain additional living allowances should be paid during the liquidation, at a rate based on the enterprise's financial condition.³⁷ Also, according to a State Council Notice, the settlement standard of SOE workers shall generally be three times that of the local workers' average salary of the previous year.³⁸ However, no such standards are available to settling workers of enterprises of not owned by the state, and employees in non-state sectors have been complaining about this lack of equal treatment. In some cases, the judges and liquidation committees have to exercise their powers and influence to persuade and pressure non-SOE workers and other parties concerned to compromise in order to uphold social stability.

The complexities involving the payments to workers are further complicated by conflicts over taxes. The liquidation in a bankruptcy usually bases its payments to creditors on the company's books of account, but in many cases these figures are quite different from those of the state tax authorities. Moreover, if the taxation authorities do not get repaid in full, they will not give permission for the bankrupt company's business registration to be cancelled, thereby making it difficult, if not impossible, to bring the bankruptcy proceedings to a conclusion. This practice appears to conflict with the modern trend favoring the abolition of taxation priorities in insolvency.³⁹

Bankruptcy fraud and crimes

Matters involving bankruptcy fraud and crimes were raised independently by the judges, liquidators, and bankruptcy lawyers, and were among the most serious issues raised in the interviews. There was a strong consensus as to the growing ineffectiveness of both the Chinese Bankruptcy Law and Shenzhen Bankruptcy Regulations, and the related rules and procedures, in dealing with these matters. Debtors have been getting quite clever in carrying out well-planned fraudulent schemes to dissipate corporate assets to the detriment of creditors. The success of their schemes arises from a variety of factors including the lack of coordination between the judiciary and government authorities; the inadequacy of the bankruptcy laws themselves and the lack of bankruptcy court jurisdiction to police fraudulent activities.

³⁶ See *supra* note 32.

³⁷ Xu, *supra* note 25, at 246.

³⁸ Sec. 5 of the State Council Notice, *supra* note 33, at 315.

³⁹ Getting rid of priorities for taxation authorities forces the authorities to improve their debt collection practices. The evidence from Australia shows that after the Australian taxation authorities lost their priority in insolvencies, the authorities actually increased the amounts collected from debtors in tax arrears.

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The lawyers noted that in a growing number of cases the commencement of a bankruptcy proceeding itself was part of an overall scheme to defraud creditors. A common *modus operandi* was for a company to dispose of its assets pre-petition, thereby leaving an empty shell for creditors. In a few of these cases, by the time a bankruptcy petition was filed there were no assets, no bank accounts, and no longer even a place of business. In at least one such case, these factors led the Shenzhen Bankruptcy Court to refuse to accept the case. It is becoming increasingly common for the perpetrators of these schemes to flee by the time a petition has been presented. The lawyers pointed to several cases involving joint ventures between Hong Kong and mainland parties in which the Chinese partners ultimately had to repay debts undertaken in the name of the joint ventures after the Hong Kong parties disappeared with the funds. Because the perpetrators often flee, by the time the bankruptcy case is commenced the directors or general managers or managers then in charge often have little knowledge of the insolvent companies operational history. As such, many of them are facetiously referred to as "the last emperor" or "the bankruptcy boss."

Unfortunately, the Shenzhen judges are frequently inadequately armed in confronting these abuses. Although it is true that the PRC Criminal Law includes certain provisions applying to bankruptcy-related crimes, these provisions do not extend to violations of disclosure obligations, the waste or abandonment of property, and bankruptcy fraud.⁴⁰ The separation of powers among the various state organs contributes to the inability of bankruptcy branch of the Shenzhen Court to effectively deal with bankruptcy fraud. Most importantly since the bankruptcy court is part of the commercial law side of the People's Court it has no duty, nor manpower to conduct any criminal investigations. As a result, without the cooperation of the public security department and the People's Procuratorate, a bankruptcy judge is likely to be able to do little even if criminal activities are discovered. On many occasions the liquidation committees have filed a complaint alleging fraud, but it proved difficult to get evidence and requests to transfer the case to another court were denied due to the lack of direct evidence. There have been some partial successes, however. Mention was made of one case in which after the filing of a bankruptcy petition, but before the appointment of a liquidation committee, an SOE started disposing of its corporate assets and paid RMB 1,000,000 to a creditor. The liquidation committee later collected the RMB 1,000,000 and fined the legal representative RMB 500.

Current insolvency practices and procedures exacerbate these problems. For example, as Wang Fuxiang has noted, auditing is only conducted in regard to the assets and accounts of the enterprises concerned, and does not extend to the directors' spending or personal transactions. Without this expanded scope of enquiry, it is often impossible to identify corrupt or inappropriate actions of the directors. Moreover, in the liquidation process, the limited resources and low efficiency does not allow the liquidation committee to verify each and every account or note.⁴¹ Thus, the greater the number of accounts, the less likely that an irregularity will be spotted in any individual account.

⁴⁰ See Li Yongjun, *Major Issues in the Drafting of the New Chinese Bankruptcy Law*, CHINA L. 74, 76 (Aug. 2000).

⁴¹ Wang, *supra* note 17, at 41-45.

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Some local enactments have been made in an attempt to confront these problems, but they too have not overly successful. For example, Article 91 of the Shenzhen Bankruptcy Regulations provides that a legal representative of an enterprise shall not be a legal representative of any other enterprises within three years if he is responsible for the bankruptcy of the enterprise. However, the judges noted that some debtors avoided the application of this provision by gaining control of newly established enterprises through the use of the names of family members. The lawyers also noted that many legal representatives often fail to cooperate with the liquidation committee. Another common problem is the failure of management to keep adequate books of account. As noted above, there have been a few recent cases in which no books of account have been kept. Interestingly, the view of the lawyers was that SOE accounts were generally in better shape than the accounts of foreign joint ventures.

There was a strong consensus among both the judges and the lawyers that new criminal provisions should be added to the Shenzhen bankruptcy law to enable the courts and liquidation committees to more effectively combat criminal and fraudulent activities. Another suggestion was that provisions should be added to mandate that legal representatives cooperate with the liquidation committees. In fact, in the draft of the new Chinese Bankruptcy Law, some provisions have been recommended that would allow a bankruptcy court to detain a legal representative when he violates his responsibilities and require him to pay a 5000 RMB fine.

The lawyers also expressed their concern with the growing amount of abuse of corporate entity. They noted that many companies or subsidiaries are seriously under-capitalized from the very beginning, often using the corporate vehicle as a fraudulent device.⁴² Other problems arise in regard to complicated schemes involving transaction schemes among affiliates in a corporate family. However, the lack of the common law doctrine of "lifting the corporate veil" in the Chinese company legislation⁴³ or of substantive consolidation in the bankruptcy legislation⁴⁴ often makes it impossible for creditors to reach the real party responsible for the debts.

Another problem is that some of the relation-back periods prove too short to effectively attack fraudulent transactions, thereby enabling crafty debtors to enter into transactions to the detriment of creditors. Both the Chinese Bankruptcy Law and the Shenzhen Bankruptcy Regulations empower the court to invalidate fraudulent or unfair transactions made within six months of the acceptance of the bankruptcy case by the People's Court.⁴⁵ However, in a number of well-planned incidents, as mentioned by the judges and lawyers, responsible parties disposed of enterprise assets in fraudulent

⁴² According to the Company Law, a statutory minimum capital that must be actually paid-in is a legal condition for establishing a company. See Company Law, arts. 23, 25, 26, 27, 28, & 78, published in the Legal Affairs Commission (compilation), *supra* note 19, at 274-276 & 285.

⁴³ For a discussion of this problem, see Zhang Xianchu, *Piercing the Company Veil and Regulation of Companies in China* in WANG GUIGUO & WEI ZHENYING (eds.), *LEGAL DEVELOPMENTS IN CHINA: MARKET ECONOMY AND LAW* 129-143 (1996).

⁴⁴ It was noted that the problems involving affiliates will not be addressed in the New Chinese Bankruptcy Law.

⁴⁵ Art. 35 of the Chinese Bankruptcy Law and art. 18 of the Shenzhen Regulations.

WORK-IN-PROGRESS.

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transactions more than six months before the commencement of the relevant bankruptcy case, thereby escaping the application of the six-month avoidance period.

Several of the lawyers therefore argued that the liquidation committee should be allowed to enforce all avoidance claims set out in the liquidation law, regardless of the fact that the statutory limitation period was exceeded, on the basis that the timing problems did not result from the debtor's negligence but rather from the debtor's fraudulent intention to leave the bankrupt enterprise an empty shell. However, in those cases in which third parties invoke the statutory limitation defense, the lawyers suggested that the court should make its decision by looking into the relations and transactions between such parties and the debtor.⁴⁶ Given that China is a country with a long civil law tradition, the lawyers acknowledged that without explicit legislative criteria, the People's Court may not be able to function on an equitable basis as would the judiciary in a common law jurisdiction.⁴⁷

To support their argument in favor of a flexible interpretation of the statutory limitation periods, the lawyers pointed out that changes could be made that are analogous to the treatment of late-registered claims under Article 15 of the Shenzhen Bankruptcy Regulations. Unlike the national law,⁴⁸ the Regulations provide a creditor's lawyers with more room to argue for delayed claim registration. Article 15 states that a creditor that fails to register a claim after the bankruptcy petition is filed shall be deemed to abandon its claim. However, this provision shall not apply to the situation where the failure to register is not caused by the creditor's fault and the delayed filing is made before the distribution of the bankrupt assets. All of the lawyers agreed that this flexible rule is more reasonable. They pointed to an example showing the benefits of this provision in which a Hong Kong creditor was permitted to retain his claim although he missed the registration deadline, because the public notice of the bankruptcy proceeding was only carried in a local Shenzhen newspaper.⁴⁹

The lawyers set out other areas in which the legislation needs to be changed to combat activities that are part of schemes used by companies on the edge of bankruptcy. For example, it is becoming a common practice in China for a troubled enterprise to force its employees to choose between making contributions to the enterprise and being dismissed. The judges reported a case pending in the Shenzhen Bankruptcy Court in which an enterprise forced 2,000 of its employees to contribute over RMB 70 million to the enterprise before it became bankrupt. Despite each contributor receiving a note evidencing his or her "contribution," the true intention was to circumvent the state

⁴⁶ See also Wang, *supra* note 17, at 136-137.

⁴⁷ The recent draft of the New Chinese Bankruptcy Law apparently tries to address this concern by imposing criminal liability against certain fraudulent activities that take place within twelve months of the commencement of the bankruptcy proceeding. New Chinese Bankruptcy Law, art. 186 (on file with the authors).

⁴⁸ Art. 9 of the Chinese Bankruptcy Law provides that any claims of creditors must be filed within three months of the public notice of the start of the bankruptcy proceedings; otherwise the claims shall be deemed to be abandoned.

⁴⁹ Since then, the trend is for bankruptcy notices to also be published in the *Renming Faguan Bao* (People's Court Journal), a nationally circulated newspaper with a special section for such judicial notices.

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restriction on unlawful capital raising without the approval of the state authority. The court is now facing a dilemma as to how to resolve the status of these contributions made by the workers. On the one hand, to treat workers as mere equity holders would allow the enterprise to benefit from its use of strong-arm tactics and unfair influence, would serve as recognition by the court of the unlawful scheme, and would put the workers in a situation with little likelihood of recovery.⁵⁰ On the other hand, to treat the workers as preferred creditors by taking their duress into account, would arguably be unfair to existing preferred creditors.

This broad variety of fraudulent and questionable behavior by enterprises has led many of the bankruptcy lawyers and liquidators to note that although the bankruptcy regime is supposed to protect creditors as well as debtors, at present to a large degree it has instead become a means to defraud creditors. They reported that since 1994 some lawyers have even developed a business of so-called "bankruptcy planning," in which advice is provided with the intention of assisting a firm in avoiding as many of its liabilities as possible by enabling the firm to take advantage of the defective bankruptcy legislation and competition among governmental institutions. In certain cases, the lawyers designed a chain of bankruptcies to prevent a creditor from collecting its debt: a loan was obtained with a guarantee; after the assets were transferred, both the debtor and the debtor's guarantor together filed bankruptcy petitions, leaving the creditor with no party from whom to claim. In such circumstances, the appointed liquidation committees find their work very difficult. Given the small amount of assets left and the little chance of recovery in most cases, creditors seem to have little incentive to demand a vigorous examination of the debtor's financial details and a complete investigation into the real reasons for the bankruptcy. However, a few cases were noted in which in-depth investigation by the authorities led to the discovery and recovery of assets dissipated by the companies; but such cases were clearly in the minority.

Inadequacy of bankruptcy institutions and laws

There was a general consensus that the most serious problem with the Chinese and Shenzhen bankruptcy laws was the lack of applicable, clearly written legal rules. Currently, the Chinese Bankruptcy Law – although it is the longest national special legislation⁵¹ – contains only 43 articles. The Shenzhen Bankruptcy Regulations, in turn, contain 93 provisions. Although the Shenzhen Regulations (and the Bankruptcy Division Procedures) supplement the Chinese Bankruptcy Law in many areas, nevertheless the legislation continues to be inadequate to resolve many of the issues that arise in Shenzhen bankruptcies.

⁵⁰ Some state authorities have issued documents to stop this practice. For example, the State Commission of Economy and Trade in a recent circular prohibited local governments or enterprises from forcing their employees to make contributions to troubled enterprises. See the Notice of the Commission on Issues Concerning Stopping Massive Sales of Small-Scale State Owned Enterprises, July 10, 1998, published in *Renmin Ribao (People's Daily)*, July 11, 1998.

⁵¹ In addition, the Company Law of 1993 has ten articles dealing with company bankruptcy (Chpt. 8, arts. 189-198), and the Civil Procedure Law as amended in 1991 includes eight articles on the bankruptcy of legal person enterprises other than SOEs and companies (Chpt. 19, arts. 199-206).

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One problem is that many of the provisions are vague, which often leads to disputes over interpretation. For example, Article 11 of the Chinese Bankruptcy Law stipulates that after a bankruptcy case is accepted by the People's Court, any procedure to enforce other civil obligations against the debtor shall be stayed. The Supreme People's Court has interpreted this provision as suspending any executory measures that have not yet been completed.⁵² Where a mainland company with assets in several mainland jurisdictions runs into financial difficulty, this interpretation often leads to a race among the swiftest to grab the corporate assets – competing creditors and courts race to complete (or to facilitate the completion of) the execution of the debtor's assets. In some cases, the same piece of property has been “claimed” by different courts from different jurisdictions and certain courts have even back-dated their documents to justify their orders of execution.

Other problems are caused by gaps in the legislation. One example noted by the judges was that under the Chinese Bankruptcy Law, the liquidation committee shall not be established until a bankruptcy order is entered.⁵³ However, neither the Chinese Bankruptcy Law nor the Shenzhen Bankruptcy Regulations provides any guidance as to who should be in charge of the debtor's assets in the gap period between the court's acceptance of the case and its issuing of the bankruptcy order.⁵⁴ To address this omission, the Shenzhen Bankruptcy Court has developed the practice of creating a supervisory committee to function during this period. Thus, in Shenzhen, once a court accepts a case, the supervisory committee will monitor the activities (which may involve continuing business operations) of an enterprise. Once a bankruptcy order is made, the supervisory committee will then be responsible for handling the liquidation. But without any legislative guidance, the court is unable to clearly define the precise legal status of the supervisory committee and its scope of authority during the gap period, and conflicts still arise.

The liquidators and judges agreed as to the difficulty in defining the legal status of the supervisory committee in charge of the assets of the debtor during the gap period. They offered some examples to illustrate the situation. In some cases the public security and the People's Procuratorate or the SAIC refused to allow a supervisory committee to have its own seal, on the ground that the committee lacked legal authority. In other cases, public utility companies suspended their services to the debtor in clear disregard of the repeated requests from a supervisory committee to restore the operation of services to the troubled enterprise.

Also missing from national legislation is the standard of compensation to be paid to the liquidation committee. As a result, the court has to exercise its discretion on compensation issues on a case-by-case basis. To address this problem, in Shenzhen the People's Court has set out the compensation standards of the liquidation committee based

⁵² Supreme Court's Opinions, s. 12(1), *supra* note 9, at 1867.

⁵³ Chinese Bankruptcy Law, art. 24.

⁵⁴ This is quite an important issue, for it is not uncommon for a company to try to improperly dispose of assets during this period.

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on the amount of the bankruptcy assets. There are five categories in the Court's provisions:

- RMB 20,000-50,000 if the assets total less than RMB 500,000;
- RMB 50,000-100,000 if the assets total between RMB 500,000 to 1 million;
- RMB 100,000-150,000 if the assets total between RMB 1 million to 5 million;
- RMB 150,000 to 200,000 if the assets total between RMB 5 million to 10 million; and
- RMB 200,000 to 300,000 if the assets total more than RMB 10 million.

The standards may be subject to the court's further adjustment according to the complexity of the particular case.⁵⁵ However, some of the lawyers reported that in some cases they could not receive any compensation at all; partially because of the lack of funds due to rampant fraudulent activities or the adoption of the social policy to provide workers with a maximum settlement. As a result, the People's Court may have to appoint certain lawyers or firms as liquidators in some easy cases as a means to compensate them for their previous losses.

One of the most difficult areas involves the failure of the current legal regime to adequately establish which obligations are provable in bankruptcy. Perhaps the best example is in regard to set-off, where the statutory language is too vague to be of much utility. Article 33 of the Chinese Bankruptcy Law merely states that if a creditor owes debts to the bankrupt enterprise, set-off may be allowed before the liquidation. Without any legislative standards to apply, the judges therefore consider themselves unable to comfortably resolve debates arising as to set-off.

Other problems arise from the failure of the legislation to specify who should file and register special claims, which include workers' wages, workers' social and unemployment insurance premiums, and taxes owed to the state. The Shenzhen Bankruptcy Court imposes this legal duty on the debtor, who is best placed to know the amounts of these claims. Nevertheless, in practice, it proves difficult to enforce this duty. Since the debtor's management officers rarely have any meaningful assets of their own as compared with the large sum of these claims, they would be unable to personally answer for failing to exercise their legal duty to register these debts.

Moreover, the failure of the bankruptcy laws and regulations to define the term an "obligation" leads to the filing of further unexpected claims. According to a commonly accepted theory, obligations may include both monetary claims and the performance of specific conduct.⁵⁶ Consequently, in some bankruptcy cases certain workers have even sought for the court to handle their claims for the loss of their

⁵⁵ Xu, *supra* note 25, at 148-49.

⁵⁶ In China, a socialist country with a civil law background, the prevailing view has been that an "obligation" is limited to property relations. However, the argument that obligation should be extended to cover certain non-property relations has indeed raised by scholars. YU QUANNENG & MA JUNJU, XIANDAI MINFAXUE (STUDY OF MODERN CIVIL LAW) (in Chinese) 424 (1995).

WORK-IN-PROGRESS.

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opportunity to obtain membership in the Communist Party due to the dissolution of their enterprises after being declared bankrupt.

However, the lawyers also stressed that some agreed limits to the scope of obligations had developed in liquidation practice in Shenzhen. First of all, they noted that in addition to some general provisions of the Chinese Bankruptcy Law, Article 64 of the Shenzhen Bankruptcy Regulations excludes the following from the scope of a provable obligation: interest on unpaid debts accrued after the bankruptcy declaration; expenses incurred by creditors to participate in bankruptcy proceedings; claims that fail to be registered within the statutory period, claims that have lost the protection of the statutory limitation; and unexecuted administrative fines and confiscation.⁵⁷

Another interesting shortcoming in the law identified by the judges involved the distribution of the property of the estate. It is not unusual that in an enterprise bankruptcy, the only asset that remains after the property of the bankrupt proves insufficient to satisfy the creditors is the company's business license. In practice, this could prove to be a valuable asset because many business licenses are subject to the state quota and thus would have a market value. However, under the state regulations such as the Liquidation Procedures of Foreign Investment Enterprises promulgated by the Ministry of Foreign Trade and Economic Cooperation in 1996, the business license of an enterprise must be returned to the state authority upon the cancellation of the enterprise's registration at the conclusion of the liquidation.⁵⁸ Therefore, a business license cannot be traded regardless of the buyer's quality and strength. As a result, at a minimum, this rigid state regulation prevents the court and the liquidation committee from maximizing the value of the corporate assets for the benefit of creditors; in other cases, it also prevents the successful reorganization of an enterprise and the saving of jobs.

The liquidators identified other problems that arise in making distributions to creditors, such as the making of certain unclassified payments to the government. For example, a SOE debtor may have to pay the state for its right of land use. However, the real estate market was not officially open until the Constitutional Amendment legitimated the practice in 1988. Thus, the Chinese Bankruptcy Law, dating from 1986, understandably fails to include a provision regarding this practice. Nevertheless, in many cases the liquidation committee must define the legal status of such payments in order to rank the priority of the claims. If these payments are treated like state levies, the government may enjoy priority; but if they are treated as contract rights, the state must wait in line, and share *pari passu*, with other unsecured creditors.

⁵⁷ CCH, *supra* note 20, at 25352-25353.

⁵⁸ Article 33 of the Liquidation Procedures. The Procedures were approved by the State Council on 15 June 1996 and an English translation was published in CHINA L. & PRAC. 37-47, 44 (Nov. 1996). Wang has further developed his own list of inclusions and exclusions from the property of the estate. For instance, in his view, the funds of a trade union shall not be the bankrupt's assets, but rather belong to members of the union; dividends that were declared long before the bankruptcy petition but have not been taken by the shareholders shall likewise not be included in the bankrupt's assets; and the awards given by the bankrupt to its employees for their distinguished contributions to the enterprise shall not be taken back from them. Wang, *supra* note 17, at 54-55.

WORK-IN-PROGRESS.

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The overall inefficiency of the bankruptcy system and the limited ability to increase the size of the bankruptcy estate deters creditors from taking an active interest in participating in bankruptcy proceedings. For example, although the Shenzhen Bankruptcy Court has tried to increase the judicial transparency by inviting as many creditors as possible to attend bankruptcy proceedings, few creditors actually attend. Some of the lawyers noted that the courts and many of the parties participating in bankruptcies have developed an overly-negative view of the possible results that may be achieved in bankruptcy, with the result that the insolvency procedures are almost always used to liquidate the assets of an insolvent company rather than being applied with a view to reorganize or rehabilitate a company in financial distress. They pointed out that as a result, almost all bankruptcy petitions are filed at a very late stage when it is nearly impossible to rescue a company. They argued that the application of bankruptcy standards should be relaxed to encourage the filing of petitions earlier than at present. They believe that the acceptance of such bankruptcy cases would not cause a massive increase in the number of bankruptcies, but rather would play an important role in leading the various parties to enter into settlements and corporate reorganization and, thus, would provide creditors with better protection.

Cross-border insolvency

An area of growing importance for Shenzhen is the increasing number of cross-border insolvencies, often involving companies with assets in both the Shenzhen SEZ and the Hong Kong SAR. In some cases, the bankruptcy judges are confronted with in-bound cases in which Hong Kong liquidators or creditors are seeking assets in Shenzhen. In others, with out-bound matters involving whether the Shenzhen liquidation committees should seek assets located in Hong Kong. The judges and lawyers all agreed that cooperation needs to be increased in cross-border insolvencies involving Shenzhen and Hong Kong. The judges noted that they have held discussions on this topic with officials from the Hong Kong Official Receiver's office and have raised the possibility of establishing certain mechanisms in this area. A formal mechanism or high level agreement would be necessary, because the sensitivity of the relations between the Hong Kong SAR and the mainland under the principle of "one country, two systems" excludes any local People's Court from individually dealing with the Hong Kong SAR on matters involving judicial cooperation. Thus, the formation of any cross-border insolvency framework must be negotiated by the Supreme People's Court and the Hong Kong SAR judiciary or government.⁵⁹

In this regard, it is interesting to note an older case and recent developments. A 1990 decision of a People's Court in Guangdong Province, *Liwan District Construction*

⁵⁹ Since the reunification, two such agreements on judicial assistance have been concluded between the Supreme People's Court of China and the High Court and the Department of Justice of Hong Kong, respectively on the service of judicial documents (in 1998) and on the mutual recognition and enforcement of arbitral awards (in 1999). The practice has made it clear that although art. 95 of the Basic Law of the Hong Kong Special Administrative Region allows the Hong Kong SAR to maintain judicial relations with other regions of mainland China, it must be based on a framework established by the top authorities of both jurisdictions.

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Company v. Euro-America China Property Limited,⁶⁰ involved cross-border insolvency issues. The case involved a contract dispute between a mainland contractor and a Hong Kong company regarding a joint venture in Guangdong. During the Hong Kong liquidation, the Hong Kong party was wound up in Hong Kong and the Supreme Court of Hong Kong appointed a liquidator. The Guangdong Court refused to allow the liquidator to represent the Hong Kong company in the Chinese proceedings, holding that the Hong Kong liquidator lacked the authority to do so. The court also found that the agreement between the joint venture parties had been frustrated as a result of the loss of the legal capacity of the Hong Kong party following the Hong Kong winding up.⁶¹

The Guangdong Court adopted a “territoriality approach” in resolving this cross-border insolvency issue. A territoriality approach is one in which a local court refuses to recognize the extraterritorial scope of a foreign jurisdiction’s laws and refuses to allow a foreign representative (e.g., a liquidator) to claim the assets of the foreign company that are located within the jurisdiction of the local court.⁶² Although the Guangdong Court did not refer to any of the relevant provisions in Chinese insolvency legislation,⁶³ the Court’s approach was consistent with such provisions.

The Shenzhen judges said that they were not aware of this case and had no comment on it. Nevertheless, they agreed that the Shenzhen court’s own practice in regard to the recognition of foreign bankruptcies was consistent with the case and that they also endorsed the territoriality approach. The judges also noted a recent insolvency in which the Shenzhen court in fact applied such an approach. After the news of the failure of the Bank of Credit and Commerce International (“BCCI”) reached Shenzhen, upon the application of a mainland Chinese creditor the Shenzhen Intermediate People’s Court issued an order to freeze the assets of BCCI’s branch in Shenzhen. Later, BCCI’s Shenzhen assets (which totaled US\$20 million) were distributed among domestic creditors (holding claims of US\$80) in accordance with Chinese bankruptcy procedure. The Court’s position was that only domestic creditors were able to participate in the liquidation of BCCI in Shenzhen. This approach guaranteed a higher rate of recovery for mainland parties, but put foreign creditors at a disadvantage.⁶⁴

This territorial approach can be supported with reference to old Shenzhen bankruptcy law. For example, Article 5 of the old Shenzhen Bankruptcy Provisions (of 1986), provided that a bankruptcy declared abroad in accordance with the bankruptcy law of a foreign jurisdiction shall not have any effect on the assets of the insolvent company in the Shenzhen SEZ. However, this provision was not included in the current Shenzhen

⁶⁰ For the case digest, see *Liwan District Construction Company v. Euro-America China Property Ltd.*, reported and commented on by Donald J. Lewis & Charles D. Booth, *Case Comment*, 6 CHINA L. & PRAC. 27 (1990).

⁶¹ For a more detailed discussion of the case, see *id.*

⁶² For further discussion of the “territoriality approach,” see Charles D. Booth, *Living in Uncertain Times: The Need to Strengthen Hong Kong Transnational Insolvency Law*, 34 COLUMBIA J. TRANSNAT’L L. 389, 393-394 (1996) [hereinafter *Living in Uncertain Times*].

⁶³ The then existing legislation did not apply to the liquidation of the Hong Kong party to the joint venture. See Lewis & Booth, *supra* note 60, at 32.

⁶⁴ Xu, *supra* note 25, at 59-60.

WORK-IN-PROGRESS.
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Bankruptcy Regulations (dating from 1993).⁶⁵ Recently, the President of the Shenzhen Court submitted a proposal to the PRC national legislature to adopt a more flexible approach in cross-border insolvencies by permitting the application of a modified “universality doctrine” in certain situations. (In contrast to the territoriality approach, the “universality approach” is one in which a local court recognizes the extraterritorial scope of a foreign jurisdiction’s laws and allows a foreign representative to claim the assets of the foreign company that are located within the jurisdiction of the local court.⁶⁶) More specifically, the President of the Shenzhen Court argued for the adoption of a reciprocity approach in which Chinese courts would be permitted to recognize foreign bankruptcy orders and decisions from foreign jurisdictions that recognized bankruptcy orders and decisions made by the People’s Courts in mainland China.⁶⁷ The application of the territoriality approach would be retained for cases involving bankruptcies from foreign jurisdictions that failed to recognize PRC bankruptcies.⁶⁸

Moreover, the judges discussed a recent case in which a Guangdong court adopted a more “universality-based” approach in a non-bankruptcy context and both recognized and applied a Hong Kong law. In this case, the Intermediate People’s Court in Guangzhou accepted a petition filed by Hong Kong creditors against the mainland assets of a Hong Kong company that was based on a Hong Kong default judgment in their favor. To the surprise of many mainland practitioners, the court not only allowed the recovery, but also directly applied the Money Lenders Ordinance of Hong Kong even though no agreement was in place between mainland China and the Hong Kong SAR on the mutual enforcement of judgments.⁶⁹

None of the judges or liquidators were aware of any cases in which a Hong Kong creditor or liquidator entrusted a Shenzhen lawyer or law firm to recover a Hong Kong bankrupt’s assets in Shenzhen or to enforce a liquidation or bankruptcy order against a Hong Kong debtor’s assets in Shenzhen.

These issues involving the extraterritorial effect of Chinese insolvency laws also arise in the domestic within the mainland. In a recent case, these issues also overlapped with issues involving the legal effect of the bankruptcy of a parent company on its wholly owned subsidiaries.⁷⁰ When an insolvent company was in the midst of bankruptcy

⁶⁵ Interestingly, the recent draft of the New Chinese Bankruptcy law retains a provision analogous to old art. 5 of the Shenzhen Bankruptcy Provisions, *supra* note 18.

⁶⁶ For further discussion of the “universality approach,” see Booth, *Living in Uncertain Times*, *supra* note 62, at 393-394.

⁶⁷ The Law Reform Commission of Hong Kong recently similarly suggested that recognition by Hong Kong should be applied on a bilateral, rather than a unilateral, basis. THE LAW REFORM COMMISSION OF HONG KONG, REPORT ON THE WINDING UP PROVISIONS OF THE COMPANIES ORDINANCE (July 1999).

⁶⁸ Xu, *supra* note 25, at 196.

⁶⁹ For a report of the decision and comments in English, see Mary Xu & Wang Tianxi, *Meidaduo Financial Co., Ltd. v. Ruichang Real Estate Co., Ltd. et al. Involving a Loan Contract*, CHINA L. 102-104 (August 2000); Zhang Xianchu, *Foreign Law Applied by the People’s Court in China*, CCH CHINA LAW UPDATE 15-16, 24 (Aug. 2000).

⁷⁰ As noted above, Chinese bankruptcy legislation fails to include any rules dealing with the legal effect of the bankruptcy of a parent company on its wholly owned subsidiaries. See *supra* text accompanying note 44.

WORK-IN-PROGRESS.

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proceedings in Shenzhen, it was discovered that the company had a wholly-owned subsidiary in another Chinese jurisdiction. The Shenzhen liquidation committee asserted its rights to include the subsidiary's assets in the Shenzhen bankruptcy proceedings. The subsidiary vigorously opposed these actions by the Shenzhen liquidation committee on the ground that they amounted to an unjustified intervention into its business autonomy. However, the universality argument advanced by the Shenzhen liquidation committee either (1) to include the subsidiary's assets into the Shenzhen proceedings or (2) to sell the subsidiary separately and then include the proceeds into the bankruptcy assets of the bankrupt (depending on the conditions of the subsidiary) was finally accepted by the court with jurisdiction over the subsidiary.⁷¹

In regard to out-bound cross-border insolvencies, the judges and liquidators reported that although they have handled cases in which Chinese debtors have assets in Hong Kong, the Shenzhen Bankruptcy Court has never attempted to recover them. According to the judges, there were two primary reasons: (1) due to the lack of a judicial assistance agreement between the mainland and the Hong Kong SAR for bankruptcies, a liquidation committee as an entity controlled and supervised by a People's Court cannot directly contact the authorities of the Hong Kong SAR (including the Official Receiver and the court); and (2) the prohibitively high legal costs in Hong Kong.

The liquidators noted that in a few recent cases the assets of bankrupt Shenzhen enterprises had been transferred to Hong Kong as part of an intentional plan to defraud the enterprise's creditors; and in others, as part of normal cross-border investment by the debtor. In these cases, the liquidation committees hoped to attempt to recover these assets and explained the advantages of pursuing such a strategy to the creditors' meeting in an effort to gain their approval to fund recovery actions. However, in each case, the same reasons as those identified by the judges (i.e., lack of a judicial assistance arrangement and the high cost of legal services in Hong Kong) prevented them from carrying out their plans. Several of the liquidators held the view that it would be more cost-effective to use debt collectors to pursue claims in Hong Kong rather than to resort to lawyers and the commencement of formal winding-up or civil proceedings; but they all acknowledged that this had not yet been attempted.

The liquidators also identified other legal impediments to pursuing cross-border actions, noting that several legislative provisions create additional legal barriers for the

⁷¹ In this case, it is interesting to note that the Shenzhen court, although agreeing that the property of the subsidiary should be disposed of, took a more cautious position. It believed that to consolidate the liquidation of a subsidiary with that of its parent company could cause other problems, including the following: disregarding the subsidiary's independent personality; causing unfairness for the creditors of the subsidiary who are forced to join the bankruptcy proceedings of the parent company; and producing social waste and instability. Therefore the court suggested other options. For example, if a subsidiary is found to be a profitable and healthy enterprise, the court should protect the company's competitive edge by encouraging a merger or sale of the unit as a whole at a market price. In contrast, where the subsidiary is experiencing financial difficulties, but nevertheless may manage to repay all or most debts, it should be declared bankrupt or liquidated through a separate proceeding. It could also be possible to leave the decision to the subsidiary and its creditors, who may choose to repay the parent company's investment and transform the subsidiary into an independent enterprise under a new ownership structure. Xu, *supra* note 25, at 202-04.

extra-territorial recovery of corporate assets. For example, Articles 34 and 35 of the Company Law stipulate that the shareholders of a company shall not withdraw their capital contribution, but rather may only make transfers between themselves once the company is registered.⁷² Also, Article 36 of the Implementing Rules of the Sino-Foreign Equity Joint Venture Law stipulates that any transfer of a joint venture's capital must be approved by a unanimous decision of the board of directors.⁷³ Thus, a liquidation group may have a difficulty in arguing that its extra-territorial recovery overseas is not in violation of Chinese domestic law, particularly where the assets in Hong Kong are owned or controlled by a company that has not yet been made subject to a Hong Kong winding-up order.

III. Overall observations

The views of the Shenzhen bankruptcy judges, lawyers, and legislators demonstrate that Shenzhen has taken important steps to improve upon the Chinese Bankruptcy Law, namely: the promulgation of the Shenzhen Bankruptcy Regulations, which have supplemented the national law in many important areas; the establishment of a separate bankruptcy branch within the People's Court, which has helped to develop an experienced body to consider bankruptcy problems; and the willingness to create innovative legislative and judicial solutions. The national insolvency law reform process would benefit greatly from taking a close look at the Shenzhen experience.

The information from the Shenzhen interviews, nevertheless, draws a vivid picture of several areas of continuing concern, including:

- the continuing tensions between protecting the judicial independence of the bankruptcy courts and allowing involvement of, and control by, the government authorities;
- the underdevelopment of the other institutions necessary to the long-term success of the bankruptcy system;
- the lack of cooperation in many important areas between the bankruptcy courts and other government authorities in Shenzhen (as well as courts in other mainland jurisdictions);
- the fact that although Shenzhen's bankruptcy law is more modern and detailed than the Chinese Bankruptcy Law, it too is in need of improvement;
- the fact that a corporate rescue culture still does not exist in Shenzhen; and
- the need to foster cross-border cooperation in general, and with Hong Kong, in particular.

It is clear from the interviews that difficult and sensitive areas still need to be addressed as the SEZ struggles with how to resolve the conflicts between the bankruptcy courts and state authorities. This tension results from the attempt to apply an insolvency

⁷² For an English translation, see the Legal Affairs Commission, *supra* note 19, Vol. 5 (1993), at 276.

⁷³ For an English translation, see CHINA LAW REFERENCE SERIES (1996), Vol. 2, Part II, *Economic Law*, s. 2310: 10-25.

WORK-IN-PROGRESS.

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law primarily based on market-based discipline within a system in which many government units wish to retain their strong control over SOEs and remain governed by an older, state-oriented ideology. It was repeatedly noted that many government authorities remain deeply involved in bankruptcy proceedings in Shenzhen, as well as in other regions of China. The reasons are more political than legal, for what is at issue is the attempt by these authorities to maintain the state's direct interest in asset preservation and social stability. From the perspective of some state authorities, the strict enforcement of the bankruptcy law may inevitably lead to the loss of public ownership as a cornerstone of a socialist country and the collapse of SOEs as a social and political safety-net in China.⁷⁴ On the other hand, the bankruptcy courts see the application of the bankruptcy regime as an instrument of reform that furthers opposite government policy objectives. The inability to resolve these two contradictory perspectives often results in confusing and frustrating resolutions in individual cases.⁷⁵ Of course, at its core, the Chinese system is an administrative system and, as a result, the resolutions of the above tensions will, at least in the short term, most likely favor administrative domination over judicial independence and judicial control of the bankruptcy process. This, in turn, will distort the functions played by the courts in bankruptcy proceedings.

The excessive administrative involvement arises in great part because of the lack of developed social institutions to support the function of the market discipline. For example, it is estimated that if all SOEs began operating according to commercial considerations some 30 million people would become unemployed overnight.⁷⁶ As a result, until adequate social welfare and insurance systems are in place, it is impossible for Chinese insolvency law to be applied on a larger scale. Similarly, the Chinese state-owned banking sector must also be stabilized.

Other institutions are also lacking, and the general social and business environment in China is far from adequate for the operation of a market-based bankruptcy law. Professor Ian Fletcher has observed that a "further feature of the operation of insolvency law is that it purports to embody a distinctive philosophy regarding the ethical properties which are to be observed in relationships between the creditors and their insolvent debtor, and amongst the creditors themselves as a group."⁷⁷ This distinctive philosophy is notably absent from Shenzhen, as an underlying professionalism (as well as customs, conventions and commercial morality) has not adequately developed. These factors will likely evolve hand-in-hand with the development of the legal and accounting professions in general and the training of insolvency experts in particular. The current lack of expertise extends to a broad range of

⁷⁴ For example, President Jiang Zemin has repeatedly made it clear that China is a socialist market economy (which it cannot be if public ownership is not the main component) and expanding the state-owned economy is the basic guarantee for building socialism with Chinese characteristics. See *Renmin Ribao* (*People's Daily*), Nov. 21, 1995.

⁷⁵ Ron W. Harmer, *Comparison of Trends in National Law: The Pacific Rim in Symposium Bankruptcy in the Global Village*, 1 *BROOKLYN J. INT'L LAW* 139, 161-162 (1997).

⁷⁶ MARK A. GROOMBRIDGE & CLAUDE E. BARFIELD, *TIGER BY THE TAIL: CHINA AND THE WORLD TRADE ORGANIZATION* 28 (1999).

⁷⁷ IAN F. FLETCHER, *THE LAW OF INSOLVENCY* (2d ed.) 2 (1996).

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bankruptcy-related activities, including financial and forensic accounting, the evaluation of claims, and auction procedures.

The lack of cooperation between the Shenzhen Bankruptcy Court and other national and state institutions, together with the many inconsistencies and gaps and lack of workable definitions in the bankruptcy law (e.g., regarding the scope of obligations and liabilities) causes further problems. Among the most serious are the overall inefficiency in the administration of bankruptcies, the inability to combat fraudulent activities and punish wrongdoing by directors, and the low rate of distribution paid to creditors.

It is clear that the existing bankruptcy law regime in China is based almost solely on liquidation, with little attention and few provisions in the law focussing on corporate rescue or reorganization. This defect, as the Shenzhen judges and practitioners realize, not only ensures that virtually all firms entering into bankruptcy proceedings have little hope of survival, but also exacerbates the knock-on effects on the Chinese social security and financial systems. The long-term success of insolvency law in China is, to a great extent, dependent on the formation of a corporate rescue culture. According to Professor Wang Weiguo, despite the availability of provisions on reorganization in the Chinese Bankruptcy Law, of the nearly 10,000 bankruptcy cases accepted by the People's Court in the past ten years, the number of cases in which these provisions have been invoked is close to zero!⁷⁸ The improvement of the current law through the enactment of more effective corporate rescue provisions, and of incentives to use the new procedures, is a matter of pressing concern. Shenzhen would be the perfect jurisdiction in China in which to enact a trial implementation of a new reorganization law.

Lastly, the integration of the regional economy of the Shenzhen SEZ and the Hong Kong SAR necessitates the establishment of a cooperative framework between the two jurisdictions for handling cross-border insolvency issues. Granted, the significant differences in the economic systems, accounting standards, and the roles played by government should not be understated. Nevertheless, the Shenzhen bankruptcy judges and practitioners acknowledge the need to address these differences and to develop rules leading to the creation of a scheme adopting a more universality-oriented approach, at least a regional scale. Unfortunately, the 1998 draft of the New Chinese Bankruptcy Law has not yet taken this step.⁷⁹ Perhaps here too, the issue could be reconsidered in the context of promulgating a trial cross-border insolvency cooperation scheme for application in insolvencies involving the Shenzhen SEZ and the Hong Kong SAR.

The challenges facing the continuing development of China's insolvency law regime are great. But if the attitudes of the Shenzhen bankruptcy judges and practitioners whom we interviewed are indicative, it is likely that solutions to many of these problems will emerge in Shenzhen before they appear elsewhere in China.

⁷⁸ WANG, BANKRUPTCY LAW, *supra* note 12, at 238.

⁷⁹ *See supra* note 65.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

Insolvency of Groups: Problems Involving Parent Companies and Their Affiliates

Shi Jianzhong

Insolvency of Groups: Problems Involving Parent Companies and their affiliates

Shi Jianzhong *

1. Related Business with Dual Characters

In China, the first legal regulation concerning related enterprises is the "Income Tax Law of the PRC for Enterprises with Foreign Investment and Foreign Enterprises" issued in 1991. According to the definition in Article 52 of the "Implementation Regulations" of the above-mentioned law, the so-called "related enterprise" means the companies, enterprises and other economic organizations which have relations with some enterprise in the aspects of capital, operation, purchase and sales. The relations can be direct or indirect ownership or control, or they are both owned or controlled by a third party, or there is other related interest.

The form of related enterprises is mainly for pursuing certain economic goal. The motivation and objective of forming related enterprises are various, for example, to monopolize market, reduce cost, or evade tax, etc. The realization of the economic goal pursued by the related enterprises relies on certain legal means to direct and control the operation and management of other enterprises.

Up to now, concern for related enterprises in China is still limited to guaranteeing national taxation and protecting the interest of intermediate and small shareholders. The damage of creditor's rights of related enterprises caused by related business has not been paid enough attention.¹

It should be recognized that related business and related enterprises are neutral concepts. Their existence is necessary and reasonable. From the analysis of economics, related business has its positive side. For example, through confirming supply, demand and production relations between the two related parties, optimizing capital structure, and other forms, the advantages of both parties in production and operation can be fully used to achieve the goal of mutual benefit and making up for one's weak points by drawing on the strong points of the other. In the mean time, the business cost and time of trading parties can be saved, and the operation efficiency of the related enterprises can be raised. Especially in the development of China's securities market, it is used in property right reorganization, adjustment and optimal combination of industrial structure and product structure for state-owned enterprises. It plays positive roles in the reform of state-owned enterprises. However, if the related relation and its business deviate from market trade standard, situations, such as tax evasion, violation of the interest of small shareholders, and damage of creditor's rights, will occur. Therefore, clearly defining and regulating related relation and business are an urgent issue.

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¹ At present, many related businesses appear on the Chinese securities market, which has drawn great concern. But the discussion is mainly concentrated on how to protect the interest of intermediate and small shareholders, while the protection of creditors' right is not seriously concerned.

In the international context, the appearance of related relation and business emerged with the change of company organization format and management mechanism in the world and the wide spread of multinational companies, parent and subsidiary companies, holding company and affiliates. Multinational group companies often utilize related business as a mean to transfer income and cost between high tax areas and low tax areas to get legal tax evasion. If a company has many subsidiary companies within the group, some subsidiaries are profit-making and others are loss-making, then related business can be used to transfer the profit of some subsidiaries of the group to loss-making subsidiaries. While the operation achievements and profit of the whole group keep unchanged, the overall taxation level of the group can be reduced, and tax is legally evaded. In Asia, there are many family owned companies and bureaucratic enterprises, the goal of related business is not limited to tax evasion. When legal regulations for market trade are not perfect, or are not implemented with enough force, major shareholders will make use of the low transparency of enterprise supervision to transfer profit or hide losses. Once the external business environment changes or supervision is strengthened, this factor will be an important factor of enterprise bankruptcy.

According to the classification of business content, related business can be divided into related dealings in business exchanges and related dealings in property reorganization. Related dealings in business exchanges mainly occur in the production and operation of enterprises, including material procurement, product sales, providing fund and guarantee, leasing, cost transfer, etc. Related dealings in property reorganization are completed in the process of purchasing, replacing, and transferring of assets and shares. The former conforms to the general concept of related business, while the latter has obvious Chinese character and is frequently used in the present realistic legal environment.

According to the classification of the results of the business, related business can be divided into two types: the related business favoring the affiliates and that favoring the holding company. Both can use low price purchasing and high price selling of resources to make resource and profit flow to the desired destination. Planning related business favoring affiliates or holding company is one of the capital operation strategies of group companies. At the initial stage, affiliates often are used as the fund-raising window of the holding company, and the holding company supports and makes up affiliates for the purpose of fund raising. In the later stage, the advantages of the affiliates will be used to solve the problems of the existence and development of the holding company.

Therefore, it is necessary to set up a supervising mechanism to monitor whether the business operations are separated between holding company and affiliates, whether independent and complete purchasing, production and marketing systems have been established, so that it can be checked if the subsidiary companies have independent operation capability.

2. Interest Conflict Caused by Related Business

Maximizing the interest of the group company does not mean the maximization of the interest of member companies. Sometimes it is at the expense of sacrificing the interest of individual member. Therefore, in the group, not only there are interest conflicts between holding company and affiliates, but also there are interest conflicts among affiliates. If legal restrictive mechanism is not present, the largest victim is the minority shareholders and the creditors of the company, especially the creditors of the affiliates.

Although in legal personality, affiliates are still legal persons. But since affiliates may be only a tool for realizing the economic goal of the holding company in the process of overall operation of the group, the affiliates have lost their independence of economic interest. The operation of affiliates is often not for their own interest, but rather for the interest of controlling company or the whole related enterprises group. The business plan of an affiliate company may be only a part of the business plan of the group. The human resource and physical resource become the tool for the interest of parent company or group company. Hence, the legal personality independence is purely a form, that is, a legal person shell used as a tool. However, in the business processes, affiliate company operates as an independent legal entity, a market operation entity, and an obligation entity. In the dealings, it is both a subject with rights, and a subject with obligations. If the assets of the affiliates are devaluated due to the related business, the interest of minority shareholders and creditors of the affiliates will surely be damaged. The legal help for minor shareholders is not the topic of this article, but it is a very important problem.

3. The Types of Related Businesses Which Cause Losses of Creditors

- The payments and cost settlements among related enterprises (between parent company and subsidiary, or between subsidiaries) are not conducted according to the business practice between independent enterprises. The business exchanges between parent company and subsidiaries are not conducted based on fair dealing prices and routines.
- The pricing of the purchasing and sales between the company and its related enterprises is not based on the business practice between independent enterprises, for example, transferring assets at obviously unreasonable low price (physical and intangible assets).
- The due creditor rights between related enterprises are treated passively, for example, not actively asking for creditor's right, leading to exceeding the limitation of action in creditor right lawsuit.
- The creditor's rights between related enterprises are actively treated, for example, giving up the due creditor's right.
- For the overall interest of the group, the parent company abuses the shareholder's right and the subsidiary's personality.

4. Legal Help for Creditors When Related Enterprise Goes Bankrupt

Fair liquidation is the essence of Bankruptcy Law, and the principle of collectivity is the effective implementation form of fair liquidation. A most important feature of modern bankruptcy law is the principle of collectivity. The basic belief of the principle of collectivity is that when managing the assets of the debtor and handling the requests of the creditors, the time sequence of the acquisition of the assets and the occurring of the debt should not be considered. A further feature of the implementation of the bankruptcy law is its unique concept of realizing moral appropriateness. This moral appropriateness is reflected in the relation between the creditors and their insolvent debtor, and is realized among the creditors as a group.

The independence of company's legal personality is based on its economic independence. For the case of bankrupt related enterprises, if the legal personality of the subsidiary is abused and becomes the instrumentality of related business, for example sacrificing the interest of a subsidiary company to increase the competitiveness or profitability of the parent company or another one or several affiliates, and if the principle of collectivity is still limited to the scope of the single member company with independent personality, then the fairness and appropriateness pursued by the principle of collectivity will not be realized. Therefore, in the cases of related enterprise bankruptcy, the scope of the collectivity of the principle of collectivity should be seriously studied.

Possible types of related enterprise bankruptcy and the legal help for creditors

Possible cases of related enterprise bankruptcy are as follows:

- Parent company goes bankrupt, but all subsidiaries don't.
- Parent company and some subsidiaries go bankrupt.
- All subsidiaries go bankrupt, but the parent company does not.
- Some subsidiaries go bankrupt, but the parent company does not.
- The parent company and all subsidiaries go bankrupt.

Any of the above cases will involve the problem of fair compensation of the creditors of the related enterprises. Whether the creditors can be compensated fairly relies directly on whether the legal personality has been abused between the parent company and the subsidiaries.

When a member of the related enterprises goes bankrupt, the interest of the creditors of this member company will seriously be affected by the internal relations among related enterprises. For example, the bankruptcy might be caused by the improper command of the parent company, but the parent company can use its dominating position to be preferably compensated in the bankruptcy of the subsidiary. This is to transfer the

investment risk of the parent company to other creditors of the subsidiary and their interest is damaged. Hence, when related enterprises go bankrupt, some special measures must be taken to protect the creditors.

In handling bankruptcy issues of related enterprises, the most commonly used method is subordinate compensation. The so-called subordinate compensation means that in the procedure of allocating properties of the bankrupt enterprise, the compensation request of the related corporation (including the parent company, subsidiary companies and affiliates) of the debtor should be postponed until other creditors are compensated, and then the remaining properties are used to pay for the debt of related corporate.

- If the parent company and the subsidiaries are completely independent in operation, the creditor rights of the parent company are not damaged by the business of the subsidiaries, then the independence of the parent company and the subsidiaries can be confirmed, and the creditors of the parent company and the subsidiaries will implement their creditor's rights based on the properties of the parent company or the subsidiaries respectively.²[2]
- If the property and business are not separated between the parent company and the subsidiaries, or even are mixed, then the subsidiary company is actually a tool of the parent company. In this case, the creditors of the parent company and subsidiary company can divide the properties of the parent company and subsidiary company equally. If either the creditors of the parent company or the creditors of the subsidiary company is compensated preferably, there will be unfairness.³
- If there is no independence between the parent company and the subsidiary company, then the property of the subsidiary company is also the property of the parent company. When the parent company goes bankrupt, its creditors can ask for compensation with the property of the subsidiary company. But if this causes the loss of creditors of the subsidiary company, the request can be rejected, because the creditors of the subsidiary company enjoy priority for property compensation from the subsidiary company.
- If a subsidiary company goes bankrupt, even the debt of the subsidiary company occurred before the parent company controlled its business, the creditors of the subsidiary company still can ask for compensation from the parent company. But the limit is that the rights of the creditors of the parent company should not be damaged.
- If the parent company and the subsidiary company go bankrupt together, there are two possible solutions. One is to combine the properties and debts of the parent company and subsidiary company, and the combined property will be divided in proportion to the amount of debts. The other is to keep the independence of the parent

² See *Henderson v. Rounds and Porter Lumber Co.*, 99 F. Supp. 376 (W.D.Ark 1951).

³ See *Stone v. Eacho*, 128 F. 2d 284 (4th Cir. 1942)

company and subsidiary company, the creditors of the parent company and the subsidiary company will be compensated with the property of parent company or the subsidiary company respectively

Letting parent company be responsible for the debts of its bankrupt subsidiary is a way of help. But it breaks the principle of limited liability of shareholders for the debts of the company, and many factors must be considered. For example, whether the senior staff, board members or shareholders are the same for the parent company and subsidiary company, the extent of control by the parent company on the subsidiary company, whether the subsidiary company has its independent account or has its own shareholders assembly, if the parent company is widely involved in the management decision making of the subsidiary company, the degree of dependence of the subsidiary company on the parent company in administrative and financial aspects, the degree of integration of operation and property between the parent company and the subsidiary company, etc.

For the bankruptcy of related enterprises, the Chinese legislature can learn something from the regulations of civil law system countries. For example, the shareholding company law of Germany (1965) specified that the liability of the parent company to the debts of the subsidiary company depends on different situations. When the parent company holds 95%-100% shares of the subsidiary company, the parent company and the subsidiary company can be taken as integration. Its legal consequence is that apart from compensating the net losses, the parent company takes direct responsibility for all the debts of the subsidiary company. In the case of factual group company, the parent company is allowed to interfere with the business of the subsidiary company, but the parent company should compensate every individual and confirmed loss. The French bankruptcy law specified that if the parent company uses the bankrupt subsidiary company as a tool, or abuses the property of the subsidiary company (such as using the property of the subsidiary company for the interest of the group), and this causes the bankruptcy of the subsidiary company, then the court can extend the bankruptcy of the subsidiary company to the parent company, that is, putting the parent company in the bankrupt position. The shareholding company law of Germany also specified that in the case of factual group company, the parent company must compensate for the special losses of the subsidiary company caused by its interference with the business of the subsidiary company. In the procedures handling the bankruptcy of the subsidiary company, the bankruptcy dealer representing the collective interest of the creditors can directly ask the parent company to pay back. In handling the subsidiary company bankruptcy cases, the court should use balancing principle to decide whether the legal personality of the subsidiary company should be denied according to specific situation of each case.

In summary, in handling cases of bankruptcy of related enterprises, from the angle of protecting the interest of all creditors, whether to adopt separate-entity doctrine or to adopt single-entity doctrine is an important issue.

Implementing separate-entity doctrine means that the legal person position of all subsidiary companies should be confirmed. The creditors of each subsidiary company can ask for liquidation based on the property of each subsidiary company. Implementing single-entity doctrine means that the legal person positions of all subsidiary companies are denied. Each subsidiary company is viewed as a branch organization of the parent company. All creditors of the enterprise group have the right to ask for compensation in liquidation. If the above behaviors of the related enterprises are not considered, and only the independence of the company personality is stressed, the interest of the creditors of the company will be easily damaged without any help.

The Company Law of China has not defined the boundary between parent company and subsidiary company, and there is no special regulation about the special legal relationship between them. The author suggests to make use of the regulation about taking off the disguise of legal person, and to construct corresponding legal system. In addition, for the cases that the parent company abuses the personality and property of the subsidiary company and causes the bankruptcy of the subsidiary company, or the parent company carries out improper dealings during the period of bankruptcy of the subsidiary company, which leads to damaging the interest of the creditors of the subsidiary company, the Bankruptcy Law should directly specify that the legal personality of the subsidiary company can be denied and the parent company should be responsible for the bankrupt debts of the subsidiary company. In this way the creditors can get some help.

Conclusion

For the bankruptcy of group companies, normally separate-entity doctrine should be adopted. But when the personality of the subsidiary company is abused and the interest of the creditors is damaged, then the single-entity doctrine should be considered so as to guarantee that all creditors receive fair compensation, and the justice of liquidation system is maintained. Fair compensation is the essence of liquidation. This point should never be forgotten.



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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Commentator

**Corporate Group Liability in
Insolvency – a Malaysian Perspective**

Aiman Nariman Mohd-Sulaiman

**Corporate Group liability in
Insolvency - a Malaysian
Perspective.**

Aiman Nariman
Law Faculty

Lifting the corporate veil

- Need to establish fraud
- One economic entity
- One management
 - Distinguish between common directorship and controlling directors
 - Undercapitalisation
 - Wholly-owned subsidiary

**Creditors protection :Company
Act 1965**

- Personal liability of directors for an insolvent company's debts.
- A holding company may be a shadow director
 - the definition of 'director' under section 4 includes 'any person in accordance with whose directions or instructions the directors of a corporation are accustomed to act'.
- Contribution order in an insolvency.

-Cont.-

- Dividends payment under s 363
 - Available profits means profits of the holding company and not the subsidiary
 - a subsidiary can give its profits to its holding company by distribution of dividends
 - the transfer of the profits or assets
 - common directors makes this much easier to carry out – provided company is solvent.

Fraudulent trading under 304(2)

- Involvement in subsidiary's business,
- with intent to defraud creditors.
- Contribution order under 304(1)

Wrongful trading provision under 303(3)

- Section 303(3): an officer of a company who was knowingly a party to the company contracting a debt, at the time the debt was contracted, had no reasonable or probable ground of expectation of the company being capable of paying the debt
- Contribution order under 304(2)

Court-ordered schemes of arrangements under 176.

- separate meetings of several classes of creditors.
- In Malaysia where there is a rise of Islamic based financing, this would give rise to different class of creditors.

Reliance on the law of contract

- Corporate guarantee and directors' personal guarantee
- The voluntary scheme of arrangements under the CDRC

Corporate guarantee and directors' personal guarantee

- cross-guarantees from one or another company of that group
- Subject to the following rules
 - ultra vires the company's objects clause : s 31 of CA 1965
 - In parent/subsidiary company: the paramount interest is the interest of that company in the group

- some commercial benefit or advantage to the company giving the guarantee.
- easier to find a corporate benefit accruing to a holding company on a guarantee for its subsidiary
- E G - giving of guarantee enables subsidiary to carry on business profitably, allowing holding company as its shareholder to share in the profits through payment of dividends

- Harder to justify guarantee from subsidiary to holding/ company of same level
- The Singaporean Companies Act (Cap 50) section 76(8) :- given by a subsidiary in the indebtedness of its holding company is given in good faith and in the ordinary course of commercial dealings.

- The voluntary scheme of arrangements under the CDRC**
- The CDRC workout process:
 - starts with initial meetings with debtors and creditors to consider debt restructuring & obtain a temporary standstill.
 - Appointment of Creditors Committee and Lead Creditor for the debtor
 - financial institutions as secured creditors give grace period to the debtors for the CDRC to determine the financial viability of the debtor's business.

-cont-

- the creditors will not commence insolvency proceedings, legal proceedings or security demand payment of debts. Credit lines to continue

- arrangements in place unless and until the debtors or creditors formally terminates the restructuring exercise

- payment of the debts owed to the creditors, either by way of staggered payments by the issuance of warrants and bonds or by way of conversion of debt into equity..

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- E.g., Renong Group of companies, Mocom Group of Companies, Nam Fatt Group of Companies

• utilise the assets of the group for settlement of claims. A viable subsidiary makes bond issues to external creditors, exchange of new bonds with existing creditors and intra-group loans with the parent company.

- The parent company give guarantee over its assets to the subsidiary.

Problems faced by shareholders

- Monitoring problems
 - Consolidated group accounts
- Oppression.
 - 181 of the Companies Act 1965.

● Related party transaction

- KLSE's listing rules preventing an interested party from voting in a related party transaction
- I.e. transaction involving acquisition / disposal of asset or property of a listed company/subsidiary or from a related company
- Interested party :substantial shareholder or director



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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speakers

Evaluation of the Draft of a New PRC Insolvency Law

Ronald Harmer

ABSTRACT OF PAPER

EVALUATION OF THE DRAFT OF A NEW PRC INSOLVENCY LAW

R W Harmer

Consultant, Blake Dawson Waldron, Australian lawyers
Staff consultant, Asian Development Bank

1. **Absence of insolvency law history and tradition has made it difficult to both develop and apply an insolvency law regime in the PRC.**
2. **Present insolvency law system is inadequate for a market economy, concentrated on state owned enterprises, diverse number of laws containing 'fleeting' reference to insolvency. There is a clear case for reform.**
3. **New law has been in course of preparation/consideration for 5 years or so. Latest draft now under consideration by committee/s of National People's Congress. This latest draft contains much to commend. Demonstrates a willingness to examine and to incorporate experiences and precedents from other jurisdictions.**
4. **Evaluation of a proposed law is difficult because no precedent/judgement of application is possible. Also, identification of objective standards can be a problem. Comparative study work of Asian Development Bank and other international agencies (IMF and World Bank), now provide a useful guide to common 'universal' areas of policy and principle in insolvency law systems.**
5. **Using those criteria, evaluation of the draft new PRC insolvency law shows many elements of sound policy and many basic principles of a modern insolvency law regime. Examples are different forms of relief with provision for conversion from one to the other; good stay and suspension of actions provisions; a well-constructed reorganisation process; and wide coverage of antecedent transaction avoidance.**
6. **Areas that might usefully be reviewed and improved include the following:**
 - **Application to natural/legal persons (concern at mixing the two).**
 - **Although the law applies to all forms of corporate enterprise, state enterprises are still singled out for special treatment.**
 - **Greater clarity is required regarding areas of threshold commencement criteria – 'unable to pay due debts', 'cessation of payments'.**
 - **The court process and period of time for the actual commencement of an insolvency case requires review and improvement (delay in the operation**

of the stay and suspension of actions provision; absence of urgent interim provision).

- Improving the passage of the reorganisation process by, for example, imposing a time limit for the production of a proposed plan of reorganisation.
 - Setting qualifications and other standards for insolvency professionals; establishing a government funded public office to handle the bulk of cases of liquidation or bankruptcy.
 - Providing for greater involvement and more information for creditors in the reorganisation process.
 - The division of creditors into, for example, employee and tax classes is questioned as also are voting requirements (majority in number present + 2/3rds majority in value present or not). This is certain to produce deadlocks.
 - Absence of specific requirement that a reorganisation plan should be subject to objective, independent analysis.
 - Too much involvement of the court in 'administrative' detail.
 - No provision for possible amendment of plan of reorganisation.
 - Traditional priority for payment of debts is followed – question arises regarding the treatment of taxation debts.
 - Antecedent transaction avoidance provisions provide good general coverage but they are not sufficiently detailed for commercial certainty.
 - Disappointing absence of provisions regarding recognition and co-operation in cross-border insolvency cases.
7. There are also some important questions concerning institutional capacity in the PRC to apply the new law that must be addressed. These include issues concerning the capacity of judges and the courts; the training and organisation of private professionals; and the establishment of a public sector agency to conduct cases of liquidation and bankruptcy.
8. Finally, there is a need to consider related laws and their application, such as general corporate regulation; corporate governance and accounting standards and their application and enforcement; secured transactions and the treatment of secured creditors in an insolvency context.



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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

A New Insolvency Infrastructure for the PRC

Henry Pitney

Abstract

A
New Insolvency Infrastructure
For the PRC

Henry Pitney,^{**} Senior Counsel, and Head, Private Sector Legal Group
Office of the General Counsel, Asian Development Bank

1. A new bankruptcy law is long overdue in the PRC. The Draft Law represents a considerable improvement over the 1986 Enterprise Bankruptcy Law (Trial Implementation).
2. The Draft Law will no longer cover state owned enterprises (SOEs). Removal puts off problems for which SOEs are notorious. In addition there are many other laws that also need to be repealed, coordinated, amended.
3. ADB worked with the State Economic and Trade Commission (SETC) on two major technical assistance projects on SOE insolvency reform. The first was a review of the legal infrastructure related to SOE insolvency and restructuring, and the practical problems that SETC encountered in its work with SOEs.
4. The major findings of that TA which concluded in 1996 were:
 - The involvement of multiple government agencies in insolvency must be reduced.
 - An insolvency law should not in any way deal with the social welfare and debt obligations of SOEs. These issues need to be handled before a new insolvency law is created. Avoid infection of new law with old problems.
 - SOE insolvencies should be handled under a separate law, since this is a unique systemic problem.
 - Insolvency administrators should be utilized by the courts. A training scheme should be established for insolvency practitioners, including administrators, judges, liquidators, and others.
 - A new law should cover all economic units or business entities. Simple definition of insolvency based upon the cash flow test. Failure to pay a debt creates a presumption of inability to pay. Insolvencies should not be delayed due to inability to settle workers (waiting indefinitely harms the value of the enterprise, and might make a decent SOE hopelessly bankrupt).
 - Reorganization should be done only if it offers the possibility of corporate survival. No unsound companies go back into the marketplace.
 - The government should settle redundant workers, not the insolvent enterprise. Government should handle pensions, medical, housing, and unemployment benefits.

^{**} The views expressed in this paper are those of the author, and do not necessarily reflect the views of the Asian Development Bank, or the Office of the General Counsel.

- Training of insolvency judges and administrators should be started in a serious way as soon as possible.
- Accounting recommendations included the requirement of regular, external audits of the financial statements of SOEs.

5 In 1998, ADB held three regional seminars for SETC officials, judges, lawyers, academics and other insolvency practitioners who would likely be involved in implementing restructuring efforts.

6 On the Draft Law, it will cover many more business entities than the 1986 Law. A cash flow test (inability to pay debt when due) is used.

7 The law only applies to non-SOE insolvencies.

8 The Draft Law strengthens the hand of creditors, and moves from a largely 'creditor absent' to a creditor driven system. The only major exception is its avoidance of the issue of SOEs.

9 The Draft Law clearly presents the basic process of both reorganizations and liquidations.

10. The Draft Law compares reasonably well with the good practice or international practice standards. However, significant improvements could be made.

11 As for SOEs, could avoid insolvency indefinitely. If the Draft Law will no longer cover SOEs, and the department in charge might never approve the insolvency.

12. Actual practice on SOEs is quite different. Many SOEs have recently initiated bankruptcy proceedings without the approval of the department in charge and the courts have allowed this.

13. Creditors would have a difficult time to commence an insolvency proceeding against an SOE that did not wish to go into an insolvency.

14. An SOE that is favored by the Government at the present time, may not be so favored in the future. This fact, coupled with the protection from insolvency will likely mean that creditors will be increasingly reluctant to lend to SOEs.

15. What happens to the other laws, e.g., 1996 FIE Liquidation Procedures, 1991 Civil Procedure Law, the various State Council Notices (resettlement of workers) from 1997 and 1994, the 1991 Supreme People's Court Opinion on the 1986 Law.

16. There is a big question mark on insolvency administrators and their credentials, training, retention, salaries. Same is true for reorganization executors.

17. Judges need special training in the new law and its implementing procedures as well. They need a great deal of training in the restructuring area in particular.



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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

A New Insolvency Infrastructure For the PRC

Henry Pitney

(Part One)^{*}

A
New Insolvency Infrastructure
For the PRC

Henry Pitney^{**}
Senior Counsel
And
Head, Private Sector Legal Group
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Introduction

A new bankruptcy law is long overdue in the PRC. The National People's Congress named the bankruptcy law a "fundamental law" (jiben fa) some years ago. It is indeed a basic law upon which so much else rests. The draft bankruptcy law (the Draft Law), which we have before us, represents perhaps one of the most important laws this decade, if not several decades, for PRC businesses and financial institutions. This law, in short, is a critical element of the modernization of the private sector legal infrastructure. If enacted, this law would bring greater discipline to the PRC's private sector. In particular, trade creditors and financial institutions will have an important new device at their disposal to recover unpaid debts and non-performing loans in an orderly and fair way. It would not be exaggeration to say that a well-crafted law will help enable the private sector in the PRC to join the modern commercial world, by

^{*} This paper forms Part One of a joint presentation. Part Two was prepared by Mr. R. W. Harmer.

^{**} The views expressed in this paper are those of the author, and do not necessarily reflect the views of the Asian Development Bank, or the Office of the General Counsel.

protecting creditors and commercial firms from the harmful effects of insolvent companies.

The Draft Law is a great improvement over the Enterprise Bankruptcy Law (Trial Implementation) (the 1986 Law). It sets forth procedures that offer a much greater chance of succeeding with reorganization, and very sensibly places reliance on insolvency administrators, rather than the courts. As we understand, the Draft Law has just been further revised to remove state owned enterprises from the coverage of the law. [A prior draft had contained a separate chapter, Chapter 8, which provided that SOEs could only commence an insolvency proceeding if it obtained and submitted the approval of its department in charge as part of the application. Removal of the SOEs from the Draft Law clearly improves it, and puts off the problems for which the SOEs are notorious. However, my question now becomes, what orderly, efficient system will cover the SOEs? In this sense, I hope to demonstrate today that the absence of a modern law to cope with the SOEs that are insolvent is a major defect in the insolvency infrastructure of the PRC at present. ~~This aspect of the Draft Law may be a major weakness.~~ I also hope to demonstrate that the Draft Law ~~should not be put into effect~~ until there is consensus about the training, qualifications, experience, and licensing of insolvency administrators, ~~who~~ will be essential to the success of the law. Finally, I would observe that, although the law would repeal the 1986 Law, there are many other laws that also need to be repealed, coordinated, amended.

Background

It might be useful to give a bit of the historical context of the 1986 law. The Draft Law is a far cry from the rather quaint, if historically interesting, Enterprise Bankruptcy Law (Trial Implementation) of 1986. I read the 1986 Law in a translation class in 1986 immediately after it first appeared. I remember thinking how remarkable it was that, in the few short years since Deng Xiaoping had returned to power, the PRC's national legislature could even produce the 1986 Law. That 1986 Law, about 40 articles in all, announced that, in theory at least, the death of badly managed state owned enterprises was possible. I also recall being impressed that the law contemplated both liquidation and rescue. Finally, the law seemed to place great reliance on the People's Courts. This seemed curious, given the misfortunes of the judiciary during the Cultural Revolution, and the general tendency to appoint judges for many years based on their "red" credentials, and not on their technical skills or training, or their wisdom and experience as judges.

During the late 1980s, I recall reading press reports about the first SOE bankruptcies. There was considerable reporting of these in the PRC press. I remember thinking about the Chinese saying, CHENG YI JING BAI. That saying means, "punish one, and frighten 100 more". Many in the PRC really believed that the warning effect of the law was a great part of its value. That, somehow,

the warning contained in the law would be enough to make many of the badly managed SOEs turn themselves around.

However, there was a reluctance to actually use the law, which in the first place only applied to State Owned Enterprises. For starters, the law only became effective two years later. Second, it contains a provision which made it clear that the supervising department had to approve before an SOE could enter an application for bankruptcy with the local people's court. Most importantly, the PRC government feared the consequences of insolvency of many SOEs. The government felt that the social unrest might be too great, and therefore continued to support SOEs that were struggling to survive. Eventually, however, the reluctance to conduct insolvency proceedings diminished.

The 1990s

In 1994, the State Economic and Trade Commission (SETC) approached the ADB seeking technical assistance. SETC wanted assistance with laws related to restructuring of State Owned Enterprises. SETC was struggling to turn around SOEs with many social welfare problems and not a great deal of latitude to fix those problems. ADB and SETC commissioned a review of the legal infrastructure related to SOE insolvency and restructuring, and the practical problems that this caused SETC in its work with SOEs. The TA started with knowledge that the new Draft Law was under preparation, but without any

certainty that the law might focus ultimately on SOEs exclusively, SOEs and other companies, or solely on non-SOEs. ADB was nonetheless attempting to find a way to assist SETC, an executive arm of government, with whatever legislative tools it might have to help it in the monumental task of reforming and restructuring SOEs in a practical way. The TA culminated with a major conference held in Beijing in 1996 that brought together PRC and international experts on insolvency.

The major findings of that TA were:

- The involvement of multiple government agencies in insolvency must be reduced. The interference by government agencies with courts also should be eliminated.
- The social welfare and debt obligations of SOEs cannot and should not in any way be dealt with in an insolvency law. This set of issues needs to be handled before a new insolvency law is created, or the new law would simply be infected with the old problems. Similarly, the “triangular debt problem” of SOEs cannot be handled by an insolvency law, and should be handled in a uniform way to the extent possible.
- SOE insolvencies should be handled under a separate law, since this is a unique systemic problem.

- In terms of personnel, it was recommended that insolvency administrators be utilized by the courts (much as the Draft Law now contemplates). A training scheme should be established for insolvency practitioners, including administrators, judges, and liquidators.
- A better and clearer scheme should be devised for registration of security interests – this would protect banks, and allow the better SOEs to receive credit.
- A new law should cover all economic units or business entities. It should contain a simple definition of insolvency based upon the cash flow test (eg., inability to pay debts when they become due). The failure to pay a debt should create a presumption of inability to pay. Insolvencies should not be delayed due to inability to settle workers (because waiting indefinitely harms the value of the enterprise greatly, and might make a decent company hopelessly bankrupt). A new law should enable enterprise groups or holding companies with many subsidiaries to be handled or administered as one, if the court or the administrator so decides.
- The law should clarify that restructuring or reorganization may be done only if it offers the possibility of survival or at least better salvage of

assets. However, the law should not send any unsound company back into the marketplace since this is financially unsafe.

- The government should separate the duty to settle redundant workers from the insolvent enterprise, and their pensions, medical, housing, and unemployment benefits must be handled by other agencies of the government.
- Finally, a number of accounting recommendations were made. The most important of which include the requirement of regular, external audits of the financial statements of companies. In addition, more rigorous analysis of assets, and more immediate recognition of any impairment of such assets was recommended. The habit of carrying old, thoroughly impaired assets on the balance sheets should be eliminated. This and other accounting habits make it very difficult to value a company in financial difficulty, and greatly hinder efforts to detect any early warning signs of such difficulties. This in turn makes restructure any company.

One of the key findings, as mentioned above, was that training of insolvency practitioners was very minimal, and that it was particularly inadequate for those working on SOE restructuring efforts. Therefore, ADB was asked to undertake a series of training seminars. ADB held three regional seminars with

SETC officials, judges, lawyers, academics and other insolvency practitioners who would likely be involved in implementing restructuring efforts. That TA prepared three case studies based upon actual PRC insolvencies. These were used as the basic teaching materials. The seminar participants were asked to actually role play and come up with solutions and proposals for the restructuring of the case study enterprises. The TA consultants made an extensive series of recommendations concerning establishment of various training programs for insolvency practitioners. With hindsight, it would seem that the training programs would be particularly important for judges and insolvency administrators.

The Draft Law

Those were the 1980s and 1990s, and we have entered a new century. Great progress has been made on many fronts, particularly in the removal or reduction of social welfare burdens of the SOEs, and the sale, merger or restructuring of many of the smaller SOEs.

The Draft Law reflects hard work and research by the Finance and Economics Committee of the NPC and the drafting group, of which we are fortunate to have several members present here today.

The following are some highlights of the differences between the the 1986 Law and the Draft Law.

- Major differences

Cash Flow Test. The ~~first three sections~~ of the Draft Law would wipe away very significant problems under the 1986 Law. Many business entities may come under the law. Cash flow test (inability to pay debt when due). The presumption of insolvency if a payment is missed.

Non-SOEs Only. The original draft had a section on SOE insolvencies, but this has been recently removed. With that removal, the law only applies to non-SOE insolvencies. In a sense it is therefore the opposite of the 1986 Law insofar as it targets a different group of enterprises. In reality however, only certain SOEs were permitted to go bankrupt under the 1986 law.

From "creditor absent" to "creditor driven". The Draft Law would very much strengthen the hand of creditors, and is moving from a largely "creditor absent" to a creditor driven system. The only major exception is its avoidance of the issue of SOEs. This will require separate handling of SOE accounts and separate policies for all trade creditors and lenders, who have to treat SOEs in a fundamentally different way

than a corporation, for example, whose owners have no right to interfere with an insolvency proceeding of the corporation

From liquidations to reorganizations. The 1986 law permitted both chapter 11-ish reorganizations, and liquidations. In reality, however, largely only liquidations were achieved under the old law. The Draft Law shows sophisticated analysis of how the process of both reorganizations and liquidations will work.

- Major Improvements of the Draft Law

The Draft Law's application to many more forms of enterprises is a big improvement. The 1986 law applies to SOEs. The Draft Law endeavors to unify the very ad hoc treatment of the existing insolvency infrastructure. Mr. Harmer and I have compared the Draft Law to some standard norms or "good practices" of insolvency law. These "good practices" are not meant to be the perfect law. Rather, they are some internationally accepted principles by which insolvency law reformers may measure the completeness of a law's treatment of common issues in all insolvencies. They grew out of a large study of eleven Asian market economies' insolvency laws. While Mr. Harmer will elaborate more on the comparison that we have made, I would just say here that the Draft Law compares reasonably well with the "good practices" or

accepted norms of modern insolvency law and practice. However, it is also fair to say that further improvements could be made.

- Major shortcomings

Repeal of 1986 Law. Chapter 8 had also stated that no SOE may apply for insolvency unless the application has been approved by the government department in charge. This entire chapter has been removed, as we understand, as noted above. Legally speaking, this is a very significant, because it would have meant that a large segment of the economy could continue to avoid insolvency indefinitely, since the department in charge does not have to approve.

Actual Practice. As I understand, the actual practice with respect to SOEs is quite different from the requirements of the 1986 Law, or even the plan that the Draft Law temporarily had for SOEs. Many SOEs have recently initiated bankruptcy proceedings without the approval of the department in charge and the courts have allowed this. In other words, it appears that pragmatists have ignored the 1986 Law, and allowed the SOEs to liquidate and restructure, even without government approval. This would appear to be unofficially encouraged under the ZHUA DA FANG XIAO policy, which roughly translated means that the government has decided to “maintain control over the

large SOEs, but auction off the small ones". This policy has been actively pursued for the last 5 years or so.

Creditors of SOEs. Creditors would have a difficult time to commence an insolvency proceeding against an SOE that did not wish to go into an insolvency. I would be interested to learn from our Chinese friends – what can a state bank do if the department in charge of the enterprise does not approve the insolvency, but the SOE never pays its debt to the bank?

SOE Protection. In any event, this aspect of the law would seem to exclude a major part of the economy from the process and the ultimate discipline of the insolvency infrastructure. This protection under the law could create a problem for the economy – those trading with or involved with insolvent SOEs are at risk, and creditors do not have the same protections. This means that creditors will be less and less willing to deal with SOEs as well, because they know that an insolvency recovery can only occur if it is permitted by the state.

The GITIC Problem. There would also appear to be a GITIC problem. In other words, an SOE that is favored by the Government at the present time, may not be so favored in the future. In 1980 GITIC was a favored SOE, one of the 10 window companies into China. But by

1998, the PRC had decided that it had lost this special status. What is to keep the government from changing its view similarly on any particular SOE? And therefore why is any SOE reliable or deserve any credit – why would any business partner do anything but insist on cash on the barrelhead? Why would any lender wish to lend to an SOE, given this scenario, including the indefinite protection provided to many SOEs referred to above?

Integration With Other Laws. What happens to the other laws — Are the 1996 FIE Liquidation Procedures still valid? Should this be repealed, or put all under one roof? Left separate from the rest of the insolvency system?

How will the 1991 Civil Procedure Law (arts 199-206) apply to the “bankruptcy of an enterprise with legal person status”? Presumably these provisions should have no further effect.

What about the other key items of legislation or law such as the various State Council Notices (resettlement of workers) from 1997 and 1994? In addition, there is the 1991 Supreme People’s Court Opinion on the original Bankruptcy Law. Presumably this opinion will be rewritten or amended in order to recognize the major changes undertaken by the Draft Law.

Infrastructure that Can Serve Insolvency?

Flaws in the Draft Law may not be in the law at all. Issue is what software exists?

- Administrators (who would you want for your administrator—15 or 20 years experience?) What salary would you want to pay that person? Should there be at least a plan in place for their training, identification and recruitment, and means of paying prior to the enactment of the Draft Law? Should these people be non-government employees? Government officials? Should they receive a salary from government, but be retained from the private sector/
- Judges (how much do they need to know? How involved?)
- Courts themselves are really not up to the task, and are quite weak in the PRC system. Agencies of the government often thwart their efforts. So, why will it be able to make a BR law work? Local officials often encourage debtors to file for BR in order to avoid paying creditors from other provinces (FEER 8 April 99). In one case in the Northeast, we were told that a municipal government in respect of land use rights refused a court ruling, and the court had no ability to enforce its ruling.

This ability to ignore the courts is a fundamental problem. It must be changed if the Draft Law is to function properly.

- Liquidators
- Reorganization executors. Training and experience is critical, yet hard to come by.

Conclusion

The Draft Law is greatly improved over the 1986 Law. Further refinements can be made to make it a very solid law that will stand the test of time in the 21st century. A major concern remains with respect to the insolvency system for SOEs, however. Some standards should be put in place to protect trade creditors and others from the chronically insolvent SOEs that are shielded from insolvency by operation of the insolvency laws. This is not just a legal convention or arrangement, but it is sound commercial practice – no creditor will want to permit any debt or account receivable to exist when an SOE is involved, and will increasingly insist on cash payments. Finally, the new law will only be as good as the judges, the insolvency administrators, and the other practitioners who must implement it. It is important to invest in their training, recruitment, licensing, in order to make sure that the system works as designed.



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Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Commentator

**Basics of Business Reorganization in
Bankruptcy**

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**A Special Collection
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BANKRUPTCY



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Basics of Business Reorganization in Bankruptcy

by Steven L. Schwarcz

In this article, Steven Schwarcz offers an overview of Chapter 11 bankruptcy. In addition to beginning a Chapter 11 case, he also discusses administration of these cases and the plan of reorganization that a debtor must consider.

The author is a partner with the law firm of ~~Shearman & Sterling~~ ^{Kaye, Scholer} and adjunct professor of law, Benjamin N. Cardozo Law School, Yeshiva University, New York City.

Many of my clients, both domestic and international, view bankruptcy as a black box. A company goes into bankruptcy, and, perhaps, some years later emerges in a reorganized form. Some unfortunate companies, not possessing the proper talisman, never emerge at all from the black box. This article is an attempt to separate fact from myth by explaining the overall principles of a business reorganization in bankruptcy.

INTRODUCTION

In the U.S., business bankruptcy is generally governed by a federal legal

code and can take the form of either a Chapter 7 case or a Chapter 11 case. A Chapter 7 case ordinarily results in a liquidation of the company and, for that reason, is not very interesting. Most major companies do not liquidate in bankruptcy. Indeed, a company that is forced into a Chapter 7 case has the absolute legal right to convert the case to a Chapter 11.¹

A Chapter 11 case is the basis of business reorganization in bankruptcy. Once a Chapter 11 case begins, the company's creditors will organize, under the supervision of a federal

¹ 11 U.S.C. § 706(a). All section citations are to Title 11 of the United States Code, which constitutes the Federal Bankruptcy Code.

bankruptcy trustee, into one or more committees (each a creditors' committee) for the purpose of negotiating with the company.

The company that is the subject of a Chapter 11 case is referred to as the debtor. The creditors' committee and the debtor negotiate the major actions that the debtor must take to reduce operating costs, sell unnecessary assets where appropriate, and eventually compromise on a plan (called a plan of reorganization) by which the debtor is reorganized as a viable business corporation that no longer needs the protection of the bankruptcy laws.

The plan of reorganization also can restructure the amount, nature, and maturities of claims against the debtor and provide for the orderly payment of these restructured claims. Chapter 11, therefore, can affect the entire nature of a debtor and its relationship with creditors.

Every debtor and its relationship with creditors is unique. For that reason, the laws of Chapter 11 neither mandate that every plan or reorganization be the same or even similar nor that the steps taken to reach a plan of reorganization be the same. The essence of Chapter 11 is a consensus process through which the debtor and its creditors, represented for administrative convenience by the creditors' committee, negotiate and compromise their way along the path to reorganization.

It would, of course, be more efficient if, instead of negotiation, the debtor (or, alternatively, the creditors) alone made the decisions at each step. However, to permit that would lose sight of the two primary, but conflicting, goals

of bankruptcy. On the one hand, bankruptcy recognizes that assets of the debtor should be distributed for the benefit of creditors. On the other hand, it also recognizes that the debtor should be given a good faith opportunity to reorganize its business. The Chapter 11 consensus process described above is an attempt to recognize and give effect to both of these important but sometimes conflicting goals.

BEGINNING A CHAPTER 11 CASE

A company having significant financial difficulties, especially cash flow problems, might consider filing a petition for Chapter 11 to obtain the protections that the law gives to debtors. The stigma associated with bankruptcy has lessened to some degree, particularly since large and relatively viable companies, such as Manville Corporation, LTV Corporation, Texaco Inc., and Continental Air Lines, have used Chapter 11 as a way of attempting to restructure their debts.

Also, many business people mistakenly do not think of Chapter 11 as involving bankruptcy. A company may also be forced by its creditors into Chapter 11 if certain legal standards are violated, such as the company's generally not paying its debts as they come due.²

Often, the company and its creditors do not think through all of the consequences of filing for Chapter 11. The most immediate and obvious consequence for creditors is that all rights of creditors to take actions to collect debts or foreclose on collateral are immedi-

² § 30

ately and automatically suspended, or stayed.³ This is one of the most far-reaching provisions of bankruptcy law and is intended to give the debtor an opportunity to rehabilitate itself. The stay remains in effect throughout the bankruptcy case unless the court, after a hearing, lifts it for a particular creditor because that creditor has satisfied specific legal standards applicable to lifting the stay.⁴ Lifting the automatic stay does not often occur.

Creditors' Committee

As already mentioned, one important consequence of a Chapter 11 case is that the debtor and the debtor's relationship with its creditors and other third parties will become subject to the supervision of a bankruptcy judge and a bankruptcy trustee. One of the first important actions of the trustee is to appoint a creditors' committee.⁵ The law specifies ordinarily that the creditors holding the seven largest claims, if they are willing to serve, are appointed to a committee,⁶ but, in practice, the trustee will try to make the committee representative of the claims in the bankruptcy case. In major bankruptcies, it is not uncommon to see committees with as many as a dozen or more members. Typically, representatives of banks, insurance company lenders, and trade creditors will dominate the committee. Often trustees for publicly issued debt securities (espe-

cially indenture trustees) will request appointment to a creditors' committee to fulfill what they perceive as their legal obligation to act as a prudent man in times of default under the public debt securities.

Creditors' Clash

Appointment of the creditors' committee is one of the first occasions for a clash of interests. However, this time the clash is not between the debtor and its creditors but among the creditors. Often institutional creditors, such as banks and insurance companies, want to recover their claims as quickly as feasible. Because there is a time value to money, a small face-value recovery obtained this year may be more valuable to an institutional creditor than a larger face-value recovery obtained next year. The institutional creditors, therefore, are likely to seek ways to obtain a quick recovery, and these ways might include attempts to liquidate the debtor. Trade creditors, on the other hand, may have more of an interest in preserving the debtor as a viable business entity, especially if the debtor is one of the trade creditor's important customers or suppliers. Therefore, tension is created at the outset as to who—institutional or trade creditors—will dominate the creditors' committee.

There are Chapter 11 cases in which a single creditors' committee is insufficient to represent adequately the inter-

³ § 362(a).

⁴ See § 362(d).

⁵ The Attorney General appoints these trustees, called United States Trustees, who undertake the administrative, as opposed to purely judicial, responsibilities of the bankruptcy judge. See Chapter 39 of 28 U.S.C. In addition to the trustees' responsibility to monitor the progress of Chapter 11 cases and prevent delay, the trustees may submit to the judge comments on proposed reorganization plans. See 28 U.S.C. § 586(a)

⁶ § 1102(b).

ests of all the creditors. This sometimes occurs where certain claims against the debtor are contractually subordinated to other (senior) claims against the debtor. The holders of the subordinated claims may petition the bankruptcy judge for a separate committee to represent their special concerns. In some recent cases, separate committees have been formed for competitors of the debtor where the general creditors' committee has access to sensitive competitive information.

Power of Creditors' Committees

Creditors' committees are powerful entities, but their power is that of persuasion. Although technically each individual creditor has the legal right to be heard in court on each issue in a case, the judge will naturally give great emphasis to the view of a court-appointed creditors' committee that is representative of many claims in the case. Also, by law,⁷ each creditors' committee has the power to hire legal counsel, accountants, and business advisors (such as investment bankers) and to have the fees and expenses of these experts paid directly from the debtor's estate. These experts contribute significantly to the value of what the creditors' committee can say, and the committee ordinarily is not deterred by costs from doing a proper investigation and analysis of each issue in the case.

Management During Chapter 11

While in Chapter 11, the debtor ordinarily will have the same management as before bankruptcy.⁸ There is no requirement of law that pre-bankruptcy management must resign, although officers and directors closely associated with the debtor prior to bankruptcy and whose credibility has been impaired by the bankruptcy may choose to resign or may be forced out by creditor pressure. Sometimes in major cases, the debtor's board of directors will replace top management with one or more individuals who have particular experience and skill in turning around troubled companies.

In certain cases in which there has been fraud or gross mismanagement, the court will consider arguments, if advanced by creditors, for the appointment of a trustee-in-bankruptcy,⁹ who would manage the debtor in lieu of its normal officers and directors. In practice, however, bankruptcy courts are reluctant to appoint trustees-in-bankruptcy except in extreme cases, perhaps because they are reluctant to substitute court-appointed experts in place of businessmen who know the debtor and its business.

When a trustee-in-bankruptcy is not appointed, the court may (and in a large case probably will) appoint an examiner.¹⁰ The role of the examiner is not clearly defined in the Bankruptcy Code. Because of early abuses of the

⁷ § 1103(a).

⁸ Compare § 1107 with § 1108.

⁹ § 1104(a).

¹⁰ § 1104(b).

examiner role,¹¹ it has become customary in large cases for the creditors to select by consensus, at the outset of the case, a prominent lawyer of unquestioned character who will act as examiner according to a narrowly defined charter of responsibilities prepared by creditors and approved by the court. These responsibilities usually focus on the investigation of fraudulent acts of management and third parties (for example, accountants) and the possibility of recovery from these persons for the benefit of the debtor's estate.^{11A} In general, through, the role of the examiner is in the process of being established on a case-by-case basis.

ADMINISTRATION OF A CHAPTER 11 CASE

An important goal for a Chapter 11 debtor is to obtain financing to permit the debtor to continue its business operations. (As discussed, a debtor may operate in Chapter 11 much as it does outside of Chapter 11 but is subject to supervision of the bankruptcy court.) Sometimes financing may not actually be needed; the debtor will be able to save money because it no longer is obligated to pay its debt service on a current basis.¹⁷ Even in circumstances where the debtor does not need to obtain new financing, however, it may

seek new financing to indicate to trade creditors that since a financial institution has recognized the debtor as worthy of new credit, so, too, should trade creditors reestablish terms of trade credit with the debtor.

Obtaining New Financing

The Bankruptcy Code grants far-reaching powers to a debtor in Chapter 11 to enable it to raise new financing. The court may grant the new lender a special priority on its claim for repayment, ahead of the claims of other creditors not having collateral.¹³ If that is insufficient to attract potential new lenders, the court may also order that a lien be created on existing or after-acquired property of the debtor to secure repayment of the new loan. At times, the debtor needs the new financing but has no unencumbered assets on which a lien can be granted of sufficient value to entice a potential lender. In such extraordinary circumstances, the court may order that a new lender receive a first lien on property that is already subject to a lien created prior to bankruptcy.¹⁴

Sometimes new financing is provided by an existing lender. As an inducement to the existing lender to make new advances, the debtor may offer to secure both the lender's exist-

¹¹ For example, in one bankruptcy case in which the author participated, the judge appointed his colleague examiner and tried to run the case through the examiner, at times in disregard of the interests expressed by the debtor and creditors.

^{11A} For example, an examiner was appointed in the A.H. Robins case at the request of a committee of personal injury plaintiffs who alleged wrongful conduct on the part of the company's management.

¹² See the previous discussion of the automatic stay under § 362.

¹³ § 364.

¹⁴ See § 364(d). In such case, the prebankruptcy lender would have to receive adequate protection of his claim.

ing claim (to the extent it is not already secured) and its claim for the new advances. Such an arrangement, known as cross-collateralization, is subject to court approval, which may be granted after notice and a hearing.

A debtor's attempt to obtain new financing during a Chapter 11 case can raise many problems. Of particular interest is the tension between a debtor that wants new financing to purchase inventory to manufacture new products and a creditor who would prefer that no new claims, equal to or ahead of his own claim, be created by the incurrence of the new financing. The creditor probably will not be sympathetic to the desire of a debtor to manufacture more inventory that may not be readily salable.

Making Money

Once the debtor has obtained needed financing and reestablished lines of trade credit, it can begin to turn its attention to the job of making money. Because a company known to be in Chapter 11 is unlikely, at least at the outset of the case, to be in a position to expand its markets, the usual focus is on reducing operating costs and selling unneeded assets.

The debtor will often retain accountants to help identify areas where costs can be reduced and to institute controls on the incurrence of future costs. For example, a particular manufacturing plant might, under close scrutiny, be found to be obsolescent; the debtor could save significant costs by shutting

it down and terminating the employees.

Investment bankers may also be retained, especially in large cases, to identify major assets, divisions, and subsidiaries to sell. An example might be the sale of a division with an unrelated product. The debtor might not have the management skills to make the division profitable, but the product itself may have considerable commercial value. The division could be sold to a company having expertise in that product. The happy result is that the debtor would receive value for selling a division which previously was a cash drain, and the division would be managed by a new company having the expertise to render it profitable.

Third-Party Contracts

The ultimate goal of the debtor and its creditors is to reduce costs and gain effective control of the business sufficiently so that it becomes feasible to propose a plan for financial reorganization. Achieving this goal almost certainly will take months, and in a large case, could take years. During that time, third parties having contracts with the debtor may want to enforce these contracts, but they are prevented from doing so by the automatic stay, already discussed above.¹⁵ There is a procedure by which parties to contracts can attempt to compel the debtor to decide whether or not to accept, or assume, these contracts.¹⁶ In practice, however, a court is reluctant to compel the debtor to choose to assume or reject

¹⁵ § 362

¹⁶ § 365(d).

a contract prior to the plan of reorganization if the debtor has convincing arguments that it cannot properly make that decision before it thinks through the requirements of its plan of reorganization.

The debtor does, however, have the right under the Bankruptcy Code to reject a contract at any time if the debtor can show that continued performance is not in its business interests.¹⁷ If a contract is rejected, the debtor no longer must perform its obligations thereunder but will be liable for damages for breach of contract. However, the damage claim against the debtor will be a general unsecured claim and not be entitled to any special priorities in bankruptcy.

The debtor also has the right to affirm, or assume, a contract that it regards as advantageous, even if the contract, by its terms, terminates in case of bankruptcy. For example, assume the debtor has a contract with ABC Company to purchase widgets at \$5 per widget. The price of widgets has increased to \$7 per widget. The debtor could, if it cures the defaults under this contract (other than defaults generally relating to bankruptcy, insolvency, or financial condition) and provides adequate assurance of future performance, assume this contract and thereby obtain the benefit of the \$2 per widget favorable price differential. This is a powerful right of the debtor to preserve

the benefit of long-term advantageous contracts. The debtor even has the right to assign or sell these contracts to third parties.¹⁸

PLAN OF REORGANIZATION

Once the debtor has managed to control its costs and stabilize its business operations, it will begin considering how to structure its plan of reorganization. The chief purpose of the plan is to restate the contractual relationship between the debtor and its creditors in a manner that will allow the debtor to operate as a viable company outside of the protections of Chapter 11.

The debtor has the exclusive right to propose a plan of reorganization for the first 120 days after the bankruptcy commences.¹⁹ In large cases, this is rarely enough time, and the court may extend this period of exclusivity for sufficient periods to allow the debtor time to control costs and stabilize the business.²⁰ The debtor has a period of exclusivity because it was recognized that it would be awkward to allow creditors the right to file separate plans, without first giving the debtor the right to file its own plan.²¹

In a typical plan of reorganization, each of the claims against the debtor incurred prior to bankruptcy would be classified according to the Bankruptcy Code. Holders of general unsecured claims might, for example, receive

¹⁷ § 365(a). This right only extends to the rejection of executory contracts; that is, contracts where material performance is still due on both sides.

¹⁸ § 365(f).

¹⁹ § 1123(b).

²⁰ § 1123(d).

²¹ One could imagine that a creditor's plan would focus on repayment in full of claims, without sufficient regard for rehabilitation of the debtor.

payment of their claims through a combination of cash and long-term debt instruments or equity securities. Holders of claims subordinated to general unsecured claims would probably receive a significantly lesser value per dollar of claim. Claims of other classifications would be expected to receive more or less, depending on the relative ranking of the claims in a bankruptcy liquidation²² and, therefore, the relative negotiating strength of creditors holding these claims.

Key to Successful Plan

The key to a successful plan of reorganization is that it be consensual. That means, in practice, that each class of claims must receive enough value for its claims to persuade the class to vote affirmatively for the plan. The Bankruptcy Code contains certain inducements to consensus. Perhaps the most important and well known is the so-called cramdown provision.²³ In essence, this provision maintains the following:

1. A junior class (for example, a class of subordinated claims or a class of equity interests) will be legally deemed to have accepted a plan of reorganization which provides that no class senior to it receives, in the plan, value worth more than 100% of the claims represented by such senior class.

2. No class junior to it receives any value on account of its claims or interests.

Cramdown Principle

Consider a class of general unsecured claimants receiving cash and debt securities valued at 100% of the general unsecured claims. Those claimants may be able to cram down a plan of reorganization over the objection of a class of subordinated public debentures as long as no class of claims or interests junior to the subordinated public debentures receives value under the plan of reorganization.

Although in principle cramdown sounds like a powerful tool, in practice, it would require a hearing to value the debtor's assets and the benefits received by the senior claimants to ensure that no senior claimants receive more than 100% of their claims. A valuation hearing of this sort can be very expensive and time consuming and will almost certainly result in prolonged litigation as to whether the valuation was properly done. Therefore, cramdown is most important as a threat to induce junior classes of creditors to accept a plan of reorganization proposed by the debtor or by senior creditors, since there is a theoretical risk that the junior class could receive much less in a cramdown. On the other hand, the difficulty caused by the valuation hearing is also

²³ A class of claims which receives no more than 100% of its claims is not set forth in § 1129(b) but is set forth in § 1129(c). See House of Representatives Report No. 995, 95th Cong., 1st Sess.

an inducement to the debtor and holders of senior claims to offer a reasonable proposal to the holders of junior claims.¹⁵

CONCLUSION

There are many other important considerations in a Chapter 11 case not mentioned in this overview. For example, one of the most valuable assets of a bankrupt company frequently is its

federal income tax attributes. Most bankrupt companies operate at a loss for several years prior to bankruptcy and, therefore, typically will have significant carryovers to future tax years for net operating and capital losses and investment tax credits. The manner in which the bankrupt company is restructured should be tailored to maximize and preserve these carryovers.

¹⁵ That is why, for example, subordinated creditors in bankruptcy are often able to recover a portion on their claims even though senior creditors have not been paid in full.



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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Commentator

Overview of Insolvency Law Basics

Steven Schwarcz

Lecture to Chinese Insolvency Law Symposium, University of Hong Kong, 17 November 2000, by Steven L. Schwarcz, Professor of Law, Duke University, and Faculty Director, Duke University Global Capital Markets Center, e-mail: schwarcz@law.duke.edu; website: www.law.duke.edu/globalmark. This lecture is ©copyright 2000 by Steven L. Schwarcz.

Overview of Insolvency Law Basics

The purpose of my talk is to provide a conceptual overview of the reorganization process under bankruptcy – or insolvency – law by examining representative provisions of the U.S. Bankruptcy Code (the Code), especially those of Chapter 11 (Corporate Reorganization).

Introduction:

In the United States, troubled companies with inherently good businesses may undergo reorganization, but those with inherently bad businesses are often liquidated. The question is whether the company is worth more reorganized or liquidated.

The genius of Chapter 11 is twofold: *first*, it provides incentives for the parties themselves, debtors and their creditors, to effectively make this determination; *second*, these incentives also motivate the parties, in the case of reorganization, to reach voluntary agreement on the terms of the restructuring.

Possible limitations on using Chapter 11 as a basis of comparison:

Some have argued that Chapter 11 is not always a perfect system for debt restructuring. They claim it is inefficient by prolonging management and by allowing companies that should liquidate to attempt reorganization. Others disagree.

Countries, however, vote with their feet. My examination of corporate reorganization under five randomly chosen, and diverse, civil and common law insolvency regimes¹ reveals that the conceptual basis of those laws is remarkably similar to that of Chapter 11. Four of those countries' laws are actually based on Chapter 11 or its antecedent statutes in the United States, and the one law not actually based on Chapter 11 is based on principles that are remarkably similar to those of Chapter 11.

These results are consistent with recent scholarship, which predicts that "it [is] highly likely, if not inevitable, that countries [that have market economies will] develop [bankruptcy] reorganization systems that function in essentially the same way . . . [because] [t]he functional aspects of these systems [are] shaped not by culture or politics, but by necessity."²

¹Those of Japan, Germany, Argentina, Canada, and Israel.

²Lynn M. LoPucki & George G. Triantis, *A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies*, 35 HARV. INT'L L.J. 267, 342 (1994).

Significant representative provisions of Chapter 11:

Commencing the Case: Sections 301 and 303 of the Code set forth the procedures for commencing a bankruptcy case, which triggers application of the Code's substantive provisions.

Under § 301 of the Code, a debtor/company has the discretion to voluntarily file a bankruptcy petition without being insolvent or meeting other requirements. The rationale is that a debtor knows best when bankruptcy protection is appropriate.

The only further limitation on voluntary filing is that courts have imposed the requirement that a debtor must file any voluntary petition in good faith.

Involuntary filings are more restricted. Creditors may only file an involuntary bankruptcy case against debtors under § 303 in limited circumstances, such as when a debtor is generally not paying its debts when due. This requirement prevents creditors from using the threat of bankruptcy to harass ordinary debtors.

Stays: Section 362 of the Code provides that commencement of the bankruptcy case automatically stays the enforcement of all lawsuits and claims against the debtor, as well as any other actions to obtain possession of the debtor's property.

This gives the debtor breathing room from claims while attempting to restructure its debt, a process that almost certainly will require the debtor to reduce its costs and attempt to operate more efficiently.

It is possible that a stay could adversely affect pre-restructuring incentives. For example, creditors anticipating the possibility of non-payment during the restructuring period might charge the debtor higher interest rates. On balance, though, this does not appear significant enough to outweigh a stay's benefits.

Reorganization Financing: Section 364 of the Code outlines a procedure for a debtor to obtain financing for its reorganization from the credit and capital markets. This financing is commonly referred to as debtor-in-possession (DIP) financing. Reorganizing debtors need financing in order to pay employees, buy inventory, and generally operate their business.

In order to attract DIP financing, the Code gives priority to lenders and investors that provide such financing. Without this priority, financing would likely be unavailable because the information asymmetry between the debtor and potential financiers may be large (a bankrupt company rarely has full financial transparency) and also because new financiers will not want to be "taxed" by the claims of existing creditors.

Nonetheless, new money priority credit could decrease the value of creditor claims if overinvestment occurs – for example, the proceeds of the new money credit are invested in a project that is less valuable than the proceeds or otherwise misused. Chapter 11 protects against this by providing for monitoring by creditors.

A final point: by motivating private investors to provide money to the reorganizing debtor, the

priority reduces the need for the government to provide taxpayer funding for this purpose

Executory Contracts: Section 365 of the Code permits a debtor to assume or reject certain executory (essentially, unexpired) contracts and leases. This provision fosters debtor rehabilitation by allowing the debtor to choose between continued performance of beneficial contracts and termination of burdensome contracts. In the latter case, a debtor that rejects the contract or lease is deemed to breach that contract as of the date immediately preceding the bankruptcy petition. Accordingly, any claim arising out of the breach is treated as a prepetition, and therefore nonpriority, claim, which is pari passu with other prepetition claims against the debtor. The debtor may thus be able to settle that prepetition claim for a fraction of its face amount.

Discharge: Sections 524, 727, and 1141 of the Code address the discharge, or nullification, of a corporation's debts. Corporate debtors that are liquidated are not discharged from their debts. The rationale for disallowing discharge is that the corporate form is artificial, and hence assets should be re-applied to their highest uses.

The Code discharges reorganized corporate debtors, however, from debts that are not provided for in the plan of reorganization. The rationale is that "the debtor corporation . . . may continue in business after confirmation of the plan. If its debts were not discharged, typically it would immediately be in financial distress."

It might seem that discharge would significantly undermine the pre-restructuring incentives of creditors. Creditors would be protected, however, by the requirement of super-majority voting by classes of claims, which I will shortly mention.

Creditors' Committees: Section 1102 of the Code authorizes the appointment of at least one committee of creditors holding unsecured claims that are "representative of the different kinds of claims to be represented." The costs and expenses of committee members are paid from the debtor's estate. The committees' purpose is to make the representation of creditors in the reorganization process economically feasible, because few creditors would have claims large enough to justify the cost of participating on an individual basis.

Super-Majority Voting: Sections 1123, 1126, and 1129 of the Code govern the contents, acceptance, and court confirmation of the debtor's reorganization plan. Section 1126(c) provides for a form of super-majority voting that supersedes contractual or statutory voting restrictions.

For example, loans are often made by syndicates of institutional lenders, such as banks or insurance companies. These loan agreements typically require unanimous consent of the lenders in order to alter essential lending terms such as the amount of principal, the rate of interest, or the maturity schedule. In recent years, this problem has become even more difficult as public bond issues constitute an increasing share of borrowings. Bondholders that invest in a particular debtor tend to have smaller individual investments and to be more numerous than banks that lend to the same debtor. Bondholders are also less likely than banks to be accommodating in order to maintain a commercial relationship with the debtor. Moreover, because bonds are actively traded, the identity of bondholders constantly changes.

Section 1126(c) overcomes this "collective action" problem by providing that an affirmative

vote by creditors holding "at least two-thirds in amount and more than one-half in number" of the claims binds *all* creditors—even those who vote negatively or fail to vote.

Dissenting creditors, on the other hand, are protected because the Code requires that claims in each voting class have the same priority in bankruptcy. This gives each separate class the ability to veto a plan.

The negotiation process:

The experience of corporate debt restructuring is that the parties themselves—debtors and their creditors—do the negotiating, and that most U.S. bankruptcies are largely self-executing. These negotiations are self-executing because they take place under the shadow of bankruptcy law.

From the debtor's standpoint, the Code offers the debtor a number of powerful aids in its negotiations, notably 1. the automatic stay and the breathing room it brings and the motivation for creditors to negotiate a plan in order to obtain payment; and 2. the possibility of adopting a plan through super-majority voting that will legally bind all creditors even though a minority reject it.

The Code also provides negotiation aids for creditors. They can threaten the debtor with dismissal of the reorganization case or even liquidation if they do not reach a negotiated plan of reorganization.³

The other creditor negotiation aid is a senior creditor's threat to cram down a plan of reorganization over a junior creditor's objection.

Cramdown: Section 1129 of the Code sets the standards for confirmation of a restructuring plan. Most significantly, it implements the super-majority voting provisions of § 1126 by requiring acceptance of the plan by each class of claims.

However, § 1129 also recognizes that a class of claims might sometimes vote to reject the plan, and therefore it provides an exception: the plan may still be confirmed if creditors in each class receive value under the plan equal to the amount of their claims, or if creditors whose claims are junior in priority receive nothing. This rule is referred to as "cramdown," and incorporates the principle of absolute priority.

Cramdown indirectly provides creditors with an incentive to reach agreement on a plan. In order to confirm a cramdown plan, it is necessary to value the debtor as a going-concern to ensure that distributions are made in accordance with the absolute priority rule. That valuation, however, entails

³The threat of liquidation, however, may not always be compelling. Under the Code, a judge may dismiss a reorganization case or convert it to a liquidation only "for cause," such as "continuing loss[es] and . . . [the] absence of a reasonable likelihood of rehabilitation," "inability to effectuate a plan [of reorganization]," or "unreasonable delay by the debtor that is prejudicial to the creditors." The burden of proof for showing "cause" is on the creditor moving for dismissal or conversion, not the debtor. Even if the creditor satisfies that burden, the judge ultimately has discretion to decide whether or not to dismiss the case or convert it to liquidation, and judges are particularly reluctant to do the latter. As a result, the threat of liquidation can be unrealistic, especially for large debtors.

some cost and delay. Consequently, senior creditors may be willing to "give something to [junior creditors], enough to gain [their] consent and avoid cramdown." Moreover, "[v]aluation of the company is something that sophisticated participants in any significant chapter 11 reorganization avidly desire to avoid." This leads to all parties having an incentive to reach a consensual plan of reorganization

The Process of Corporate Reorganization:

I do not have time to describe the sequential steps of a Chapter 11 reorganization. They are, however, summarized in the materials distributed in my article, *Basics of Business Reorganization in Bankruptcy*.

In closing, I wish to remind you of that valuable information that is free on Duke University's Global Capital Markets Center website. The website is at www.law.duke.edu/globalmark.

It includes a complimentary research index, including papers, on a wide range of topics, including not only insolvency law but also commercial law, corporate finance, corporate governance, global financial architecture, hedge funds, mergers & acquisitions, privatization, securities law, securitization, and sovereign debt restructuring.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Commentator

Administrative Structure of the Federal Courts in the United States

Lloyd George

ADMINISTRATIVE STRUCTURE OF THE FEDERAL COURTS
IN THE UNITED STATES

by Hon. Lloyd D. George¹
Chief United States District Judge
District of Nevada

At a judicial symposium held in Warsaw in June, 1994, interest was expressed in the operation of the federal judicial administrative system in the United States. The purpose of this article is to describe, in very general terms, the administrative structure of the federal judiciary, explain why it is important to the function and independence of the judiciary, and provide several brief examples of how it works.

I. THE FEDERAL COURT SYSTEM

The Constitution of the United States establishes three separate branches of government: the Legislative, the Executive, and the Judicial.² Under the Constitution, each branch exercises

¹ I have drawn heavily upon information and suggestions provided by Mr. Peter G. McCabe, Assistant Director for Judges Programs, Administrative Office of the United States Courts; Mr. James G. Apple, Interjudicial Affairs Office, Federal Judicial Center; and Dr. Frederick Quinn, Conference on Security and Cooperation in Europe, Office of Democratic Institutions and Human Rights, Rule of Law Programs.

² Article I of the United States Constitution establishes the Legislative Branch (the Senate and the House of

functions both independent and dependent of the other branches. For instance, the Judiciary has the final word in declaring whether acts of Congress are constitutional, yet it is subject to Congress' power governing financial and certain administrative matters. The Executive Branch nominates and appoints judges, and determines prosecution policies that affect court workload. Significantly, the courts must obtain their funding each year from Congress. Thus, the Judiciary is neither subject to the complete control of the other branches, nor able to function completely independently of them.

Article III of the United States Constitution provides that "The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts³ as the Congress may from time to time ordain and establish." By statute, the Supreme Court of the United States is composed of the Chief Justice and eight associate justices. It has broad appellate

Representatives). Article II of the Constitution establishes the Executive branch (the Presidency). Article III of the Constitution establishes the Judiciary (the Supreme Court and authority to create lower courts).

Each State within the United States has established branches of government on a state level. This paper addresses only the federal judiciary, it does not discuss state judiciaries.

³ Hereafter to be referred to as "lower courts."

jurisdiction over decisions of lower federal courts. The Supreme Court is responsible for its own administration.

Pursuant to Article III of the Constitution, Congress has also established the following lower courts:

- thirteen intermediate appellate courts called courts of appeals (twelve are designated by geographic region and review the appeals of decisions of the district courts (trial courts) within their geographical regions; the Court of Appeals for the Federal Circuit, a specialty court of appeals, exercises national jurisdiction in the fields of international trade, intellectual property (such as patent law), government contracts, claims against the United States government, and veteran affairs);⁴
- the Court of International Trade; and
- district courts (trial courts).⁵

The Supreme Court, upon the recommendation of the Judicial Conference of the United States (as discussed below),

⁴ Please refer to Exhibit 1 (diagram of the circuits).

⁵ Although not necessary to an understanding of the basic concepts discussed in this article, Exhibit 2 (showing the basic structure of the United States Courts) is provided for your information. Each trial and appellate court is, to a substantial degree, autonomous. The judges of each court act as a body to set policies, establish rules, employ personnel (such as a clerk to manage administrative matters), and otherwise control the court's operations, subject to national financial management and reporting policies adopted by the Judicial Conference and administered by the Administrative Office, and the authority of a regional body, the circuit council, to issue orders to ensure the administration of justice in all courts of the circuit."

has authority to prescribe rules of procedure and evidence for the lower courts, subject to Congressional veto.

Justices of the Supreme Court and judges of the courts of appeals and the district courts are appointed by the President of the United States and confirmed by the Senate (one of the chambers of Congress). Article III of the Constitution provides that such judges "hold their Offices during good Behaviour," which means, as a practical matter, that they hold lifetime tenure unless impeached.⁶ Also, by this same Constitutional Article, these judges (who are referred to as Article III judges), may not have their salaries reduced.⁷

Congress has also established a bankruptcy court as a division of each district courts and magistrate judges as assistant or associate judges in the district courts.⁸ The judges

⁶ Impeachment is a process in which Congress brings charges of misconduct against a judge and conducts a trial.

⁷ In practical terms, the protection of a judge's salary preserves the judge's independence by preventing the use of salary reductions as political leverage by government officials.

⁸ Magistrate judges assist Article III judges by conducting criminal arraignments and, with consent, civil trials, handling many pretrial matters, and upon assignment, recommending rulings on matters addressed to the Article III judges.

of these courts are appointed by Article III judges for a fixed term, and are not appointed by the President.

Because Congress has the power to establish the lower federal courts, Congress has extensive legislative control over their administration. Congress requires annual reporting by the judiciary, and has instituted administrative, educational and policy-making structures within the judiciary.

These administrative, educational and policy-making structures serve the Judiciary and the other branches by providing a mechanism through which a dialogue and interaction between the judiciary and other branches of government may be conducted. For instance, within the administrative structure of the judiciary is an office for legislative liaison. This office works with the offices of Congressional members to remain informed about legislative measures that could impact the judiciary.

II. THE ADMINISTRATIVE ORGANIZATIONS

The following is a brief description of the principal administrative organizations within the judiciary that have been established by Congress.

1. The Judicial Conference of the United States

The Judicial Conference of the United States, as created by Congress (28 U.S.C. § 331), is the judiciary's central policy-making body of the federal judiciary on a national level. The Chief Justice of the United States presides over the Judicial Conference, which also includes the chief judges of each court of appeals, a district judge from each regional circuit (who is elected by all of the circuit and district judges of the particular circuit), and the chief judge of the Court of International Trade. Judicial Conference membership is limited to judges; there are no members from the executive or legislative branches.

In fulfilling its responsibility as the national policymaker for the federal courts, the Judicial Conference, among other things, (1) surveys the conditions of the courts and prepares plans for assignments of judges to or from circuits or districts, (2) makes recommendations to the various courts to promote uniformity of management procedures, (3) approves and submits to Congress proposed legislation and budget requests, and comments on the impact of pending legislation on the courts,⁹ (4)

⁹ When commenting on pending legislation that would affect the courts, the Judicial Conference's policy is to address matters

recommends rules of practice and procedure and rules of evidence to the Supreme Court, (5) acts on referrals from circuit councils regarding misconduct or disability proceedings against judges, (6) recommends legislation to increase the number of judgeships, and (7) makes other rules or recommendations dealing with the administration of the courts. The Judicial Conference also supervises and directs the Director of the Administrative Office of the United States Courts (which is discussed later), and selects six judges to serve on the Board of the Federal Judicial Center (which is also discussed later).

Most of the work of the Judicial Conference is carried out through committees. Committees are established by the Conference according to areas of responsibility,¹⁰ and generally meet at least twice a year (usually two months before the Judicial Conference meets). The Chief Justice of the Supreme Court appoints all members of the committees. Most committee members are Article III judges,¹¹ but bankruptcy and magistrate

of court impact, workload, and procedures, but not generally comment on matters of substantive legislative policy.

¹⁰ Please refer to Exhibit 3 (committee structure).

¹¹ As explained above, Article III judges include justices of the Supreme Court, circuit court judges and district judges. They have lifetime tenure and their salaries cannot be reduced.

judges also serve on many committees. In addition, some committees include state judges, attorneys, legal scholars and other individuals. The Administrative Office provides the staffing for all the committees, and the Federal Judicial Center provides research, advice, and educational support.

Judicial Conference committees have been established over many areas, including procedural rules, administration and case management, budget and finances, codes of conduct, international judicial relations, criminal law, security, and facilities. The Executive Committee of the Judicial Conference acts for the Conference between sessions. It sets the agenda for the Conference, resolves differences among committees, and has a special legislative coordinating role. The Chief Justice selects four circuit judges, three district judges and the Director of the Administrative Office to serve on the Executive Committee.

2. The Administrative Office of the United States Courts

The Administrative Office of the United States Courts is located in Washington, D.C. It was created by Congress (28 U.S.C. §§ 601-612) to implement regulations and policies established by the Judicial Conference; it does not formulate policy. The Director of the Administrative Office is appointed

by the Chief Justice of the United States in consultation with the Judicial Conference, and serves ex officio.

Basically, the Administrative Office is responsible for the administering national administrative policies that affect the administrative operations of all federal courts in such areas as personnel, payroll, equipment and supplies, information gathering, and similar activities. It also acts as secretariat and contracting officer for the Judicial Conference, provides program management and administrative support to court operations, formulates long-range planning and budgets, and coordinates the management of buildings and facilities for the judicial branch.

3. Federal Judicial Center

The Federal Judicial Center is also located in Washington, D.C. It was created by Congress (28 U.S.C. §§ 620-629) and is responsible for education and training of judges, court personnel, and others whose work affects the administration of justice; research, planning, and evaluation of court and case management, evaluating emerging technologies for use by the federal courts, as well as maintaining a federal judicial history program, promoting effective relations between state and federal courts, and helping organizations that provide information to

judges and officials of foreign judiciaries. The Federal Judicial Center also provides research and educational support for the Judicial Conference and its committees upon request.

The Board of the Federal Judicial Center includes the Chief Justice of the United States, the Director of the Administrative Office, two circuit judges, three district judges and one bankruptcy judge. The Director of the Federal Judicial Center is appointed by the Board, and is usually a federal judge.

4. Circuit Councils

Congress has also established a Circuit Council for each of the twelve geographic federal judicial circuit (28 U.S.C. § 332).¹² The Circuit Councils have broad authority over the administration of justice within their circuits, although their administrative policies may not conflict with the policies of the Judicial Conference.

Membership in the Circuit councils include the chief judge of the court of appeals for that circuit (who presides over the council), and an equal number of circuit judges and district

¹² Please refer to Exhibit 4. This Exhibit illustrates the structure and committees of the Judicial Council in the Ninth Circuit. Other circuit councils may have different structures and committees.

judges. Some councils have invited other judges to attend the meetings as non-voting observers.

The Circuit Councils must meet at least twice a year. Among their responsibilities, Circuit Councils have authority to recommend judgeships to the Judicial Conference, review district court rules, monitor court workloads and authorize personnel for judges. The Circuit Councils also review misconduct reports regarding judges, recommend disciplinary actions for judges accused of misconduct, and fulfill any duties delegated from the Judicial Conference.

III. CONTRIBUTIONS TO AN INDEPENDENT JUDICIARY

In addition to Constitutional provisions (such as lifetime tenure and no reductions in salary), the administrative structures and procedures already mentioned contribute to the independence of the judiciary by vesting in judges all, or at least a substantial share, of the authority necessary to ensure the operation of the judicial function. The system of administering the federal courts reflects the view that judicial independence can no longer be protected solely by secure tenure and salary. For example, even if judges are secure in their tenure, a hostile executive branch could create difficult working

conditions if it could administer the funds appropriated for the operation of the judicial branch. Or a hostile legislative branch could create rules of procedure that would eliminate the judges' authority to bring law suits to a fair conclusion. Or, with authority to educate judges about the complex and intricate matters of substantive law, procedure, and background knowledge, the executive or legislative branches could exercise considerable influence on judicial knowledge about the matters before them. To avoid these possibilities, Congress and the courts, working together, have established a system in which:

1. The Judicial Conference of the United States controls judicial administration generally.
2. Judges (through the Judicial Conference and its budget committees), prepare and submit to Congress the judiciary's request for funds to operate the system for the next year.
3. The Judicial Conference, (through its various committees), generally controls the preparation of rules of procedure for the courts (rules of civil procedure, rules of criminal procedure, rules of appellate procedure and rules of evidence).
4. Judges (through the Chief Justice and a committee of the Judicial Conference exercising oversight over the Administrative Office) control the day-to-day operations of the court (payroll, personnel, equipment and supplies, etc.).
5. Responsibility for establishing and enforcing a judicial code of conduct and exercising limited powers of discipline over judges exists exclusively within the

judicial branch (through the Judicial Conference, its committees, and circuit judicial councils).

6. Judges control the judicial education and education of court personnel by judges (through the Judicial Conference and the governing board of the Federal Judicial Center).
7. Judges participate in the management of court space and facilities (through the Judicial Conference and the Administrative Office).

Of course, no system of law and administrative arrangements is foolproof and guaranteed to ensure judicial independence. But clearly some arrangements are better than others. These arrangements work well in the United States.

IV. HOW THE SYSTEM WORKS

The following are several very limited examples of how aspects of the administrative system operate.

A. Proposed Legislation

Congress often considers legislation that would change existing laws or create new federal crimes and civil causes of action. Such legislation may increase or affect the number of civil and criminal cases brought in federal courts. In coordination with the Administrative Office and administrative liaison personnel, the Judicial Conference is informed of pending legislation, and may assign committees to evaluate it. Those

committees, utilizing the staff of the Administrative Office, and perhaps the resources of the Federal Judicial Center, evaluate the impact that the proposed legislation would have on the courts. The committees may solicit comment from judges, court administrators, and other interested individuals. After appropriate study and inquiry, the committees compile their findings and submit recommendations to the Judicial Conference.

The Judicial Conference may accept, reject or revise the recommendations. The Judicial Conference may then comment to Congress on the potential impact of the legislation on the courts. Members of the Judicial Conference, including at times the Chief Justice, and committee members, may be invited by Congress to speak at Congressional hearings regarding the proposed legislation. Congress may thereby consider the impact of the legislation on the Judiciary.

B. Rules of Procedure

Another limited example of how the administrative system works is in the establishment of rules that govern procedure in federal courts.¹³ After study and inquiry, advisory committees within the Judicial Conference formulate proposed

¹³ Please refer to Exhibit 5 (the creation of federal rules of procedure).

rules. Those proposed rules are published and comment is received from judges, lawyers and other interested individuals. After considering the comments, the advisory committees may modify the proposed rules. Eventually, the proposed rules go for review and approval to the Judicial Conference and then to the Supreme Court. If the Judicial Conference and the Supreme Court approve the proposed rules, they are submitted to Congress. If Congress raises no objections within a certain amount of time, the rules become law.

V. IMPLEMENTATION OF ADMINISTRATIVE STRUCTURES WITHIN JUDICIARIES OF EMERGING GOVERNMENTS

In the United States, the administrative structure of the judiciary developed from a Constitutional framework providing for the interrelationship of the three branches of government. Congress, which has authority to establish the lower federal courts, enacted laws establishing the administrative structure of the courts, and provided a mechanism by which the judiciary may manage itself and interact with the other branches of government.

This system has served the Judiciary of the United States so successfully that other emerging governments may wish

to incorporate, within their appropriate frameworks, some of the following basic concepts:

- (1) Promotion of interrelationship and communication between the judiciary and other divisions of government.
- (2) Assigning overall administrative responsibility to a council or commission, such as the Judicial Conference, constituted within the judicial branch and made up of judges from throughout the system.
 - (a) The creation of committees within that council or commission which allow a substantial number of judges to participate in the administration of the judiciary.
 - (b) The development of methods for self-management and the setting of professional standards by the council or commission.

VI. CONCLUSION

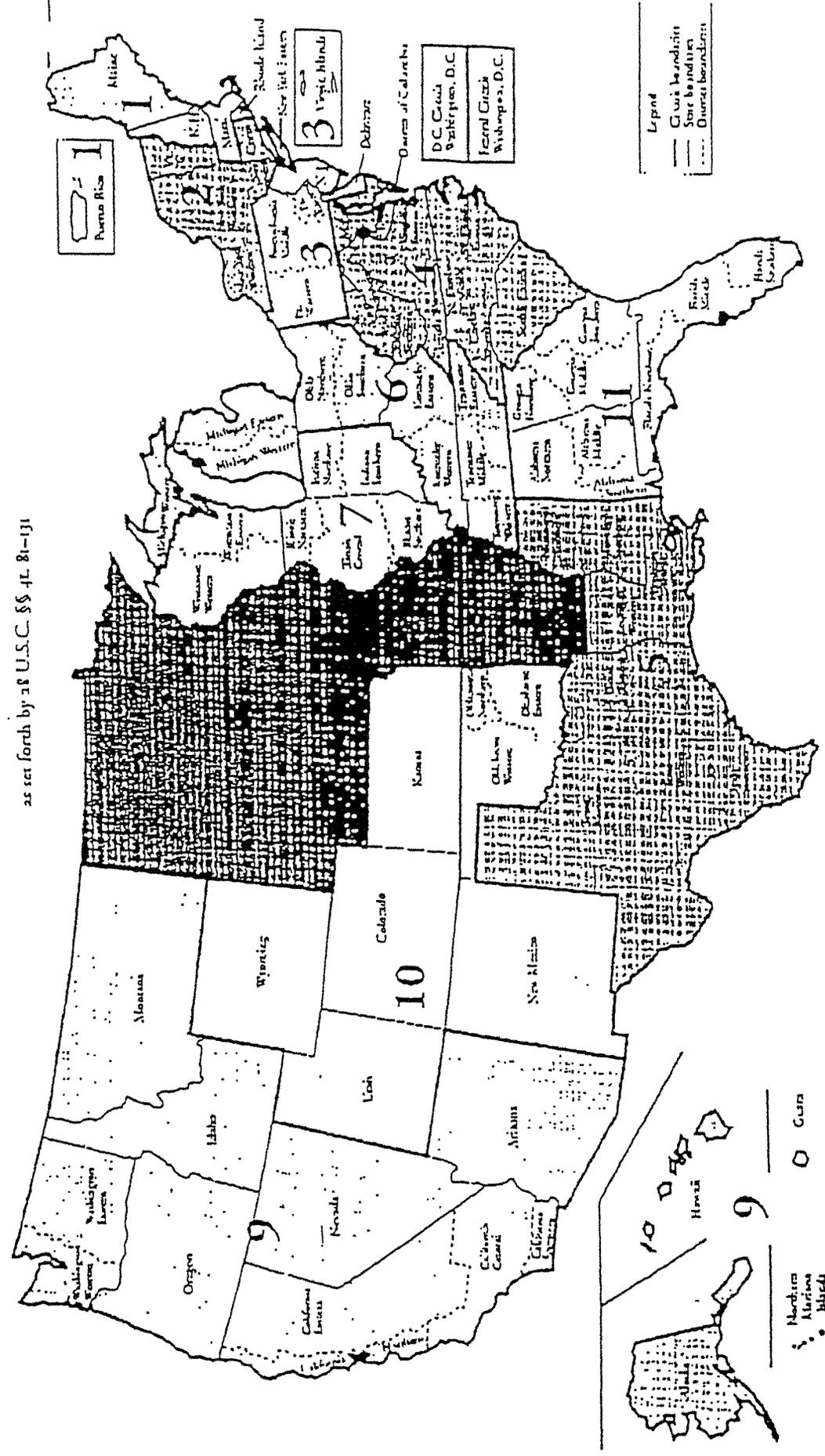
In sum, the administrative structure of the federal judiciary advances the interests of each branch of government by establishing a system of representation within the Judiciary, opening channels of communication between the branches of government, and coordinating their efforts as they relate to the federal courts. Congress, which has authority for establishing the lower courts and their administrative structures, thus shares a vested interest in the successful operation of the Judiciary. At the same time, the administrative structures and procedures

established by Congress strengthen the independence of the
judiciary of the United States.

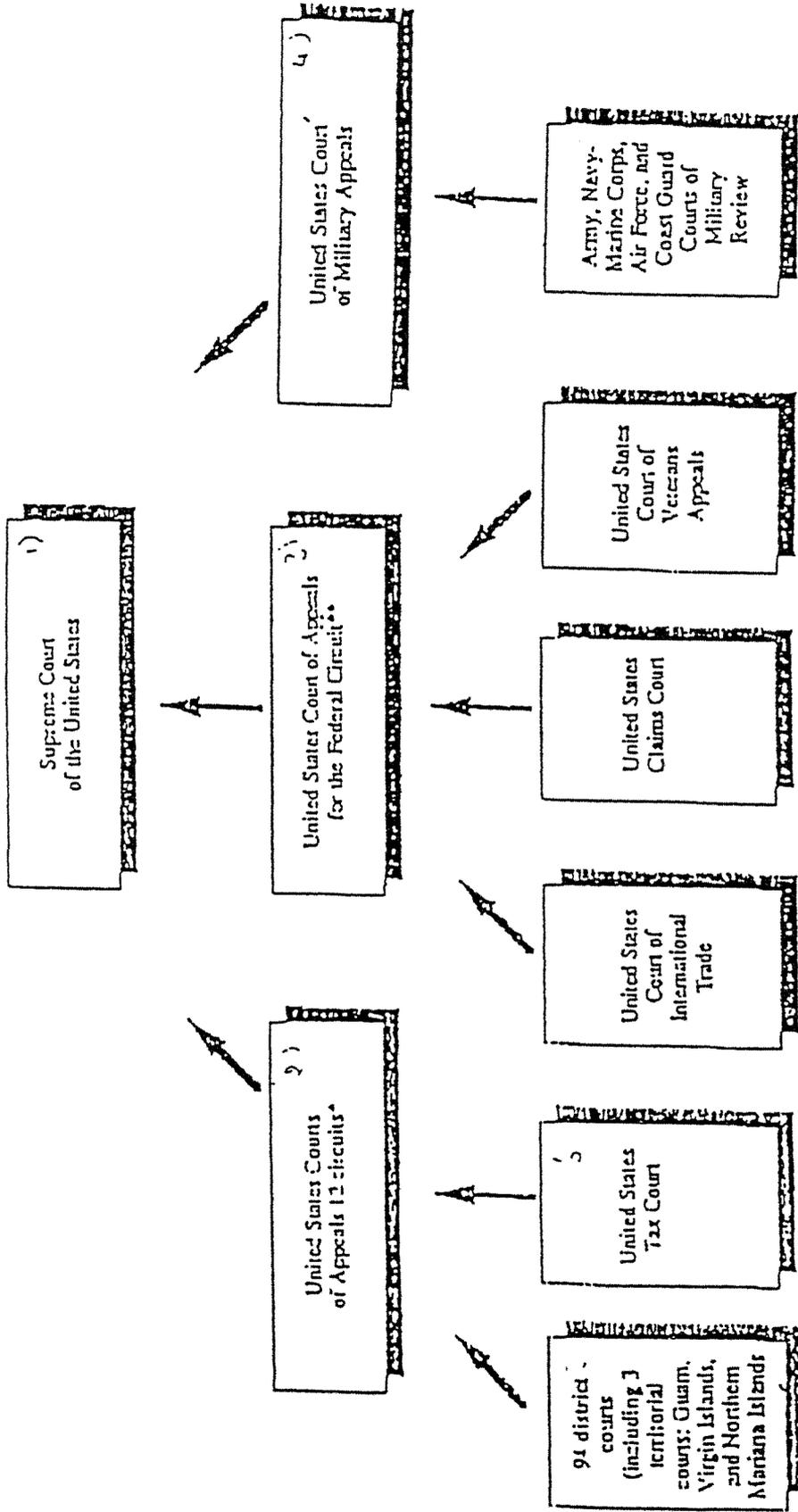
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Geographical Boundaries of U.S. Courts of Appeals and U.S. District Courts

as set forth by 28 U.S.C. §§ 41, 81-131



The United States Court System



- The 12 regional courts of appeals also receive cases from a number of federal agencies.
- The Court of Appeals for the Federal Circuit also receives cases from the International Trade Commission, the Merit Systems Protection Board, the Patent and Trademark Office, and the Board of Contract Appeals.

Judicial Conference Of The United States

Chief Justice of the
United States Supreme Court

Chief Justices of the 13
Courts of Appeal

One District Court Judge From Each
Circuit

Chief Judge of the Court
of International Trade

Administrative Office

Executive Committee

Federal Judicial Center

Committee on the Administration of the Bankruptcy System

Committee on the Budget

Committee on Court Administration and Case Management

Committee on Criminal Law and Probation Administration

Committee on Federal-State Jurisdiction

Committee on Intercircuit Assignments

Committee on Space and Facilities

Committee on Judicial Ethics

Committee on Long Range Planning

Committee to Review Circuit Council Conduct and Disability Orders

Committee on International Judicial Relations

Ad Hoc Committee on Gender Based Violence

Committee on Automation and Technology

Committee on Long Range Planning

Committee on the Code of Conduct

Committee on Court and Judicial Security

Standing Committee on Rules

Committee on Defender Services

Committee on the Judicial Branch

Committee on Judicial Resources

Committee on Administration of the Magistrate Judge System

Committee to Review Criminal Justice Act

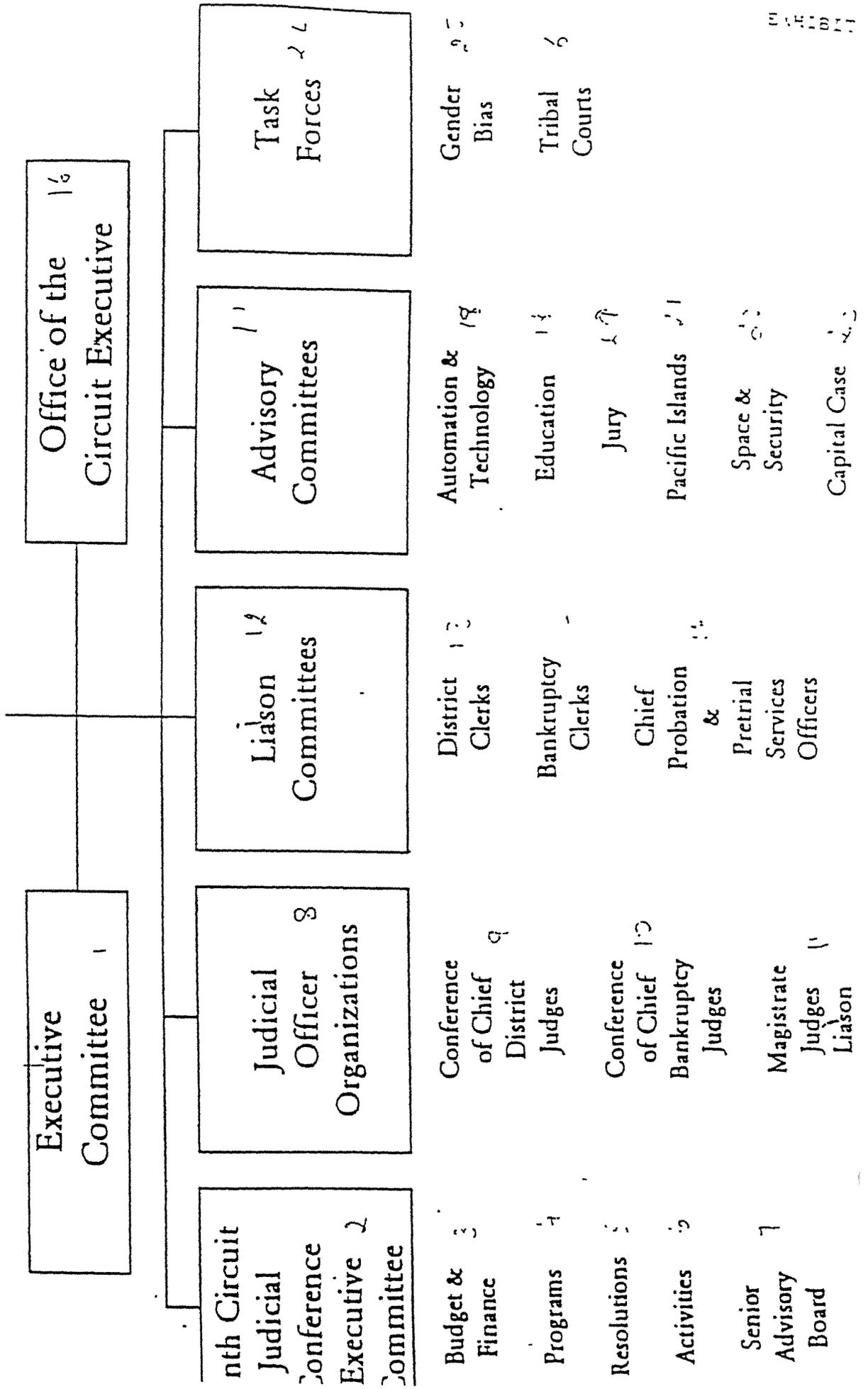
31 Advisory Committee on

34 Advisory Committee on

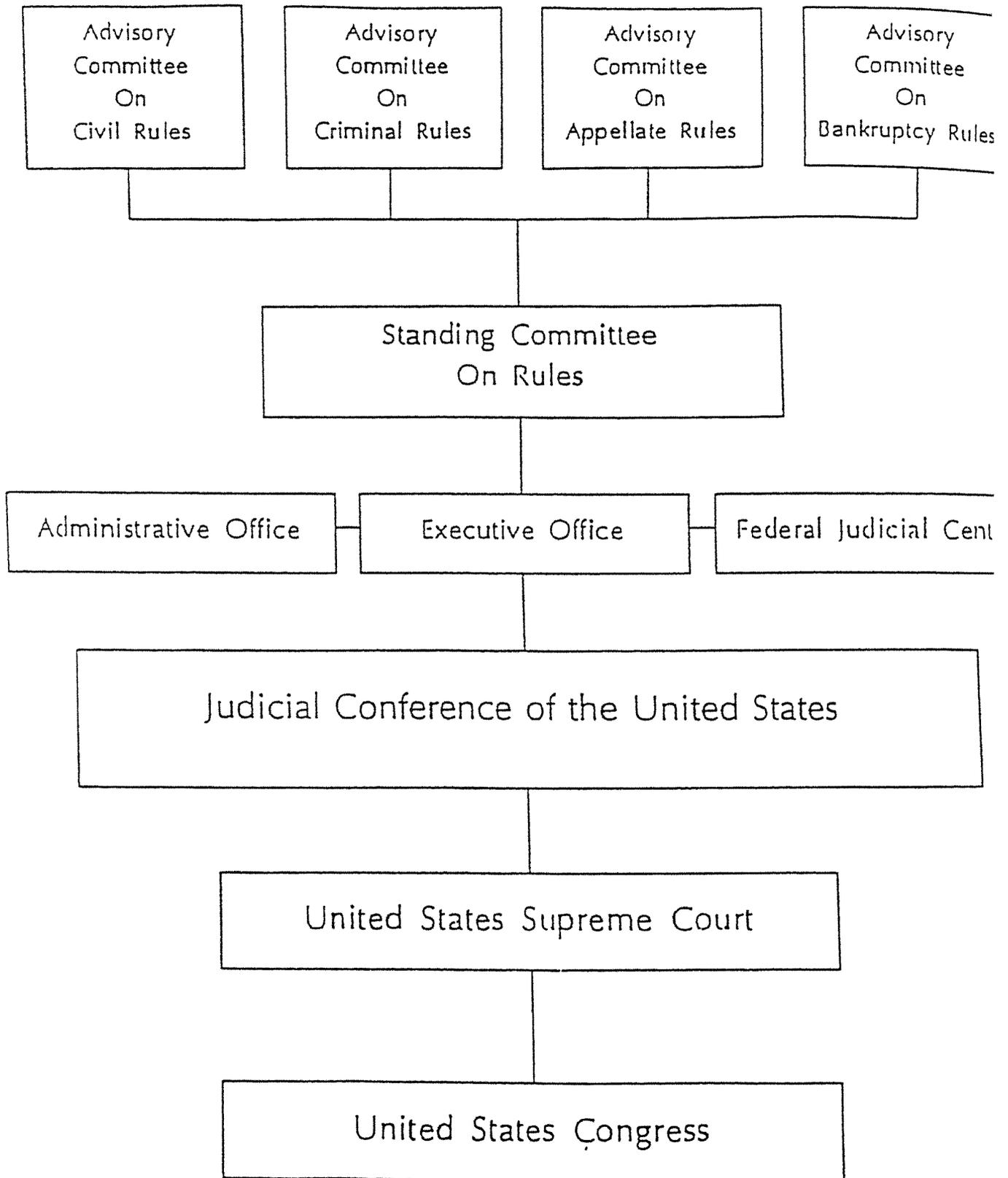
32 Advisory Committee on

34 Advisory Committee on

Judicial Council of the Ninth Circuit



Creation of Federal Rules of Procedure





The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

The UNCITRAL Model Law on Cross-border Insolvency

Gerold Herrmann

The UNCITRAL Model Law on Cross-Border Insolvency

*Jernej Sekolec**

A. GENERAL REMARKS

International organizations formulating rules on international trade have typically been reluctant to touch upon the topic of insolvency law. The reason was that meaningful international work did not seem feasible in view of the traditional reluctance of states to agree to unified solutions in this area of law.

One of the results of the rapid growth of cross-border trade and investment has been the growing number of insolvencies with cross-border implications. For example, when a company that owns assets in a number of states declares bankruptcy in one state, the states involved may take inconsistent or conflicting action. The state where the bankruptcy is declared may, for instance, attempt to claim jurisdiction over all those assets with a view to distributing them among creditors. On the other hand, the other states where the assets are located may claim jurisdiction over assets simply because they are located there.

The existing insolvency laws have often been found inadequate to address such cases. The lack of harmony between national laws poses unnecessary obstacles to the achievement of the objectives of insolvency proceedings, such as protection of the rights and interests of creditors, employees and debtors; rehabilitation of businesses that merit preservation; and, in the event of liquidation, maximization of the value of the assets available to pay the creditors. This has led to more insistent calls for international action.

When the United Nations Commission on International Trade Law (UNCITRAL) discussed the proposal to undertake work in the area, it was conscious that it would not be feasible, at least in the foreseeable future, to solve those problems by way of a wholesale unification of laws affecting cross-border insolvency proceedings. The assessment was that work should be restricted to a limited number of cross-border issues, without attempting to achieve a substantive unification of insolvency law. The areas of cross-border insolvency law where it appeared feasible to make useful progress in a relatively short time were: cooperation between courts in states where

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the debtor's assets are located; the granting of access to local courts to representatives of foreign insolvency proceedings or creditors; and giving recognition to certain orders issued by foreign courts.

The preparatory work was entrusted to an inter-governmental working group, composed of the 36 states which are members of the Commission. The work followed the traditional UNCITRAL pattern, which is that, in addition to the 36 Member States, the participants in the negotiations were also interested states which are not members of the Commission as well as relevant international organizations, including non-governmental ones, such as the International Association of Insolvency Practitioners (INSOL) and Committee J (Insolvency) of the Section on Business Law of the International Bar Association (IBA). The working group devoted four two-week sessions to the work on the project.¹ Following that, two weeks of final negotiations took place during the thirtieth session of the Commission (Vienna, 12–30 May 1997). The Model Law was adopted by consensus on 30 May 1997.²

The Model Law is designed to assist states to equip their insolvency laws with a modern, harmonized and fair framework to address more effectively instances of cross-border insolvency. Those instances include cases where the insolvent debtor has assets in more than one jurisdiction or where some of the creditors of the debtor are not from the jurisdiction state where the insolvency proceeding is taking place.

The Model Law respects the differences between national procedural laws and does not attempt a substantive unification of insolvency law. The solutions offered by the Model Law include the following:

- (1) providing access for the person administering a foreign insolvency proceeding ('foreign representative') to the courts of the enacting state and allowing the courts in the enacting state to determine what relief is warranted for optimal disposition of the insolvency;
- (2) determining when a foreign insolvency proceeding should be accorded 'recognition', and what the consequences of recognition may be;
- (3) providing a transparent regime for the right of foreign creditors to commence, or participate in, an insolvency proceeding in the enacting state;

¹ The eighteenth session (Vienna, 30 October to 10 November 1995) report is UN Doc. A/CN.9/419 (reproduced in *UNCITRAL Yearbook* (1996), vol. XXVII, Part Two); the nineteenth session (New York, 1–12 April 1996) report is UN Doc. A/CN.9/422 (reproduced in *UNCITRAL Yearbook* (1996), vol. XXVII, Part Two); the twentieth session (Vienna, 7–18 October 1996) report is UN Doc. A/CN.9/433 (reproduced in *UNCITRAL Yearbook* (1997), vol. XXVIII, Part Two); the twenty-first session (New York, 20–31 January 1997) report is UN Doc. A/CN.9/435 (reproduced in *UNCITRAL Yearbook* (1997), vol. XXVIII, Part Two).

² The Model Law is also published in *Official Records of the General Assembly, Fifty-Second Session, Supplement No. 17* (UN Doc. A/52/17, Annex I) (reproduced in *UNCITRAL Yearbook* (1997), vol. XXVIII, Part Three). The discussion at the thirtieth session concerning the Model Law is reproduced in UN Doc. A/52/17, paras 12–225 (reproduced in *UNCITRAL Yearbook* (1997), vol. XXVIII, Part One, A).

- (4) permitting courts in the enacting state to cooperate more effectively with foreign courts and foreign representatives involved in an insolvency matter;
- (5) authorizing courts in the enacting state and persons administering insolvency proceedings in the enacting state to seek assistance abroad;
- (6) providing for court jurisdiction and establishing rules for coordination where an insolvency proceeding in the enacting state is taking place concurrently with an insolvency proceeding in a foreign state; and
- (7) establishing rules for coordination of relief granted in the enacting state in favour of two or more insolvency proceedings that take place in foreign states regarding the same debtor.

B. MODEL LEGISLATION (NOT AN INTERNATIONAL TREATY)

Throughout the preparatory work, the drafting had proceeded on the assumption that the final text would be a model law rather than a convention. A model law is a text that is recommended to states for incorporation into their national legal system. Unlike an international convention, which requires the state adopting the convention to notify the depository about the adoption, a model law does not imply any such international law requirement.

In incorporating the text of the model law into its system, the state may modify or leave out some of its provisions. Once a state has enacted the model law, there is no restriction for it to change the legislation. In the case of a convention, however, the possibility of changes to the uniform text by the states parties is much more restricted. In particular trade law conventions usually either totally prohibit changes (typically referred to as 'reservations') or allow only those that are specifically set out in the convention.

The flexibility inherent in a model law is particularly desirable in those cases where it is likely that the state would wish to make various modifications to the uniform text in enacting it as a national law. The main reason for using the model legislation form for harmonizing the law of cross-border insolvency is that this area of law is closely related to the national judicial and procedural system and that, therefore, it would be difficult to agree on unified solutions. Moreover, in the case of a treaty, states tend to wait for other states to accede to the treaty and bring it into force, which often makes the implementation of a treaty a lengthy process.

The drawback of using the model law method is that the degree of harmonization achieved through a model law is likely to be lower than in the case of a convention. To offset somewhat this disadvantage, and to achieve a satisfactory degree of harmonization and certainty, it is recommended that the states make as few changes as possible in incorporating the model law into their legal systems and, in view of the international

implications of the legislation, publicize the enactments and modifications.

The Commission considered that the Model Law would be a more effective tool for modernizing international aspects of insolvency law if the text were accompanied by background and explanatory information. Such information was needed not only by executive branches of governments and legislators using the text in preparing the necessary legislative revisions, but also by other users of the text such as judges, practitioners and academics.

The UNCITRAL Secretariat prepared such background and explanatory information entitled *The Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency*.³

C. MAIN FEATURES OF THE MODEL LAW

I. Scope of Application

The Model Law applies in a number of cross-border insolvency situations. These include:

- (1) the case of an inward-bound request for recognition of a foreign proceeding;
- (2) an outward-bound request from a court or administrator in the enacting state for recognition of an insolvency proceeding commenced under the laws of the enacting state;
- (3) coordination of concurrent proceedings in two or more states; and
- (4) participation of foreign creditors in insolvency proceedings taking place in the enacting state (Article 1).

II. Types of Foreign Proceedings Covered

To fall within the scope of the Model Law, a foreign insolvency proceeding needs to possess certain attributes. These include: basis in insolvency-related law of the originating state; involvement of creditors collectively; control or supervision of the assets and affairs of the debtor by a court or another official body; and reorganization or liquidation of the debtor as the purpose of the proceeding (Article 2(a)). Within those parameters, a variety of collective proceedings would be eligible for recognition, be they compulsory or voluntary, corporate or individual, winding-up or reorganization or those in which the debtor retains some measure of control over its assets,

³ The text of the Model Law is reproduced in Annex 1 below. Information about the Model Law is available from the UNCITRAL Secretariat, Vienna International Centre, PO Box 500, A-1400 Vienna, Austria, telephone (43-1) 26060-4060; fax (43-1) 26060-5813; e-mail uncitral@unov.un.or.at; Internet website <www.un.or.at/uncitral>. The *Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency* is published as UN Doc. A/CN.9/442.

albeit under court supervision (e.g., suspension of payments; 'debtor in possession').

III. Suggested Exclusion of Insolvency Proceedings Regarding Financial Institutions

In principle, the Model Law was formulated to apply to any proceeding that meets the requirements mentioned in the preceding paragraph, independently of the nature of the debtor or its particular status under national law. However, the Model Law itself refers to the possibility of excluding from its scope of application certain types of entities, such as banks or insurance companies specially regulated with regard to insolvency under the laws of the enacting state (Article 1(2)).

The reason for the exclusion would typically be that the insolvency of such entities gives rise to the particular need to protect vital interests of a large number of individuals; that it involves regulatory authorities and policies other than those contemplated by the Model Law; or that the insolvency of those entities usually requires particularly prompt and circumspect action (for instance, to avoid massive withdrawals of deposits). For those reasons, the insolvency of such types of entities is in many states administered under a special regulatory regime.

It is not advisable to exclude all cases of financial insolvencies. In particular, the enacting state might wish to treat, for recognition purposes, a foreign insolvency proceeding relating to a bank or an insurance company as an ordinary insolvency proceeding if the insolvency of the branch or of the assets of the foreign entity does not fall under the national regulatory scheme. In excluding certain types of entities from the Model Law, the state may wish to make sure that it would not inadvertently and undesirably limit the right of the insolvency administrator, regulator or court to seek assistance or recognition abroad of an insolvency proceeding conducted in the territory of the enacting state, merely because that insolvency is subject to a special regulatory regime. Moreover, even if the particular insolvency is governed by special regulation, it is advisable, before generally excluding those cases from the Model Law, to consider whether it would be useful to leave certain features of the Model Law (e.g., on cooperation and coordination and possibly on certain types of discretionary relief) applicable also to the specially regulated insolvency proceedings.

IV. Foreign Assistance for an Insolvency Proceeding Taking Place in the Enacting State

In addition to equipping the courts of the enacting state to deal with incoming requests for recognition, the Model Law authorizes the courts of the enacting state to seek assistance abroad on behalf of a proceeding taking place in the enacting state (Article 25). Addition of the authorization for the courts of the enacting state to seek cooperation abroad may help to fill a gap in legislation in some states. Without such legislative authorization, the courts, in some legal systems, feel constrained from seeking such assistance

abroad, which creates potential obstacles to a coordinated international response in cases of cross-border insolvency.

V. Foreign Representative's Access to Courts of the Enacting State

An important objective of the Model Law is to provide expedited and direct access for foreign representatives to the courts of the enacting state. The Law avoids the need to rely on cumbersome and time-consuming letters rogatory or other forms of diplomatic or consular communications which might otherwise have to be used. This facilitates a coordinated, cooperative approach to cross-border insolvency and enables fast action when needed.

In addition to establishing the principle of direct court access for the foreign representative, the Model Law:

- (1) establishes simplified proof requirements for seeking recognition and relief for foreign proceedings, which avoid time-consuming 'legalization' requirements involving notarial or consular procedures (Article 15);
- (2) provides that the foreign representative has procedural standing for commencing an insolvency proceeding in the enacting state (under the conditions applicable in the enacting state) and that the foreign representative may participate in an insolvency proceeding in the enacting state (Articles 11 and 12);
- (3) confirms, subject to other requirements of the enacting state, access of foreign creditors to the courts of the enacting state for the purpose of commencing in the enacting state an insolvency proceeding or participating in such a proceeding (Article 13);
- (4) gives the foreign representative the right to intervene in proceedings concerning individual actions in the enacting state affecting the debtor or its assets (Article 24); and
- (5) provides that the mere fact of a petition for recognition in the enacting state does not mean that the courts in that state have jurisdiction over all the assets and affairs of the debtor (Article 10).

VI. Recognition of Foreign Proceedings

The Model Law establishes criteria for determining whether a foreign proceeding is to be recognized (Articles 15–17) and provides that, in appropriate cases, the court may grant interim relief pending a decision on recognition (Article 19). Procedural matters related to notice of the filing of an application for recognition or of the decision to grant recognition are not addressed by the Model Law; they remain to be governed by other provisions of law of the enacting state.

The determination that a foreign proceeding is a 'main' proceeding may affect the nature of the relief accorded to the foreign representative. A foreign proceeding is deemed to be the 'main' proceeding if it has been

commenced in the state where 'the debtor has the centre of its main interests'.

Key elements of the relief accorded upon recognition of the representative of a foreign 'main' proceeding include a stay of actions of individual creditors against the debtor or a stay of enforcement proceedings concerning the assets of the debtor, and a suspension of the debtor's right to transfer or encumber its assets (Article 20(1)). Such stay and suspension are 'mandatory' (or 'automatic') in the sense that either they flow automatically from the recognition of a foreign main proceeding or, in the states where a court order is needed for the stay or suspension, the court is bound to issue the appropriate order. The stay of actions or of enforcement proceedings is necessary to provide a 'breathing space' until appropriate measures are taken for reorganization or fair liquidation of the assets of the debtor. The suspension of transfers is necessary because in the modern, globalized economic system it is possible for multinational debtors to move money and property across boundaries quickly. The mandatory moratorium triggered by the recognition of the foreign main proceeding provides a rapid 'freeze' essential to prevent fraud and to protect the legitimate interests of the parties involved until the court has an opportunity to notify all concerned and to assess the situation.

Exceptions and limitations to the scope of the stay and suspension (e.g., exceptions for secured claims, payments by the debtor made in the ordinary course of business, set-off and execution of rights in rem) and the possibility of modifying or terminating the stay or suspension are determined by provisions governing comparable stays and suspensions in insolvency proceedings under the laws of the enacting state (Article 20(2)).

In addition to such mandatory stay and suspension, the Model Law authorizes the court to grant 'discretionary' relief for the benefit of any foreign proceeding, whether 'main' or not (Article 21). Such discretionary relief may consist of, for example, staying proceedings or suspending the right to encumber assets (to the extent such stay and suspension have not taken effect automatically under Article 20), facilitating access to information concerning the assets of the debtor and its liabilities, appointing a person to administer all or part of those assets, and any other relief that may be available under the laws of the enacting state. Urgently needed relief may be granted already upon filing an application for recognition (Article 21).

VII. Protection of Creditors and other Interested Persons

The Model Law contains provisions that protect the interests of the creditors (in particular local creditors), the debtor and other affected persons. These provisions, for instance, leave it to the discretion of the court whether to grant temporary relief upon application for recognition, or upon recognition, of a foreign proceeding; it is expressly stated that in granting such relief the court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are adequately protected (Article 22(1)); the court may subject the relief it grants to conditions it considers

appropriate; and the court may modify or terminate the relief granted, if so requested by a person affected thereby (Article 22(2) and (3)). In addition to those specific provisions, the Model Law in a general way provides that the court may refuse to take an action governed by the Law if the action would be manifestly contrary to the public policy of the enacting state (Article 6).

Questions of notice to interested persons, while closely related to the protection of their interests, are in general not regulated in the Model Law. Thus, these questions are governed by the procedural rules of the enacting state, some of which may be of a public order character. For example, the law of the enacting state will determine whether any notice is to be given to the debtor or another person of an application for recognition of a foreign proceeding and the time period for giving the notice.

VIII. Cross-Border Cooperation

A widespread limitation on cooperation and coordination between judges from different jurisdictions in cases of cross-border insolvency is derived from the lack of a legislative framework, or from uncertainty regarding the scope of the existing legislative authority, for pursuing cooperation with foreign courts.

Experience has shown that, irrespective of the discretion courts may traditionally enjoy in a state, the passage of a specific legislative framework is useful for promoting international cooperation in cross-border cases. Accordingly, the Model Law fills the gap found in many national laws by expressly empowering courts to extend cooperation in the areas governed by the Model Law (Articles 25–27). For similar reasons, provisions are included authorizing cooperation between a court in the enacting state and a foreign representative, and between a person administering the insolvency proceeding in the enacting state and a foreign court or a foreign representative (Article 26). The Model Law lists possible forms of cooperation and leaves the legislator an opportunity to list additional forms (Article 27).

IX. Jurisdiction to Commence a Local Proceeding

The Model Law imposes virtually no limitations on the jurisdiction of the courts in the enacting state to commence or continue insolvency proceedings. Pursuant to Article 28, even after recognition of a foreign 'main' proceeding, jurisdiction remains with the courts of the enacting state to institute an insolvency proceeding if the debtor has assets in the enacting state.

In addition, the Model Law deems the recognized foreign main proceeding to constitute proof that the debtor is insolvent for the purposes of commencing local proceedings (Article 31). This rule would be helpful in those legal systems in which commencement of an insolvency proceeding requires proof that the debtor is in fact insolvent. Avoidance of the need for repeated proof of financial failure reduces the likelihood that a debtor may

delay the commencement of the proceeding long enough to conceal or carry away assets.

X. Coordination of Relief when More than One Proceeding takes Place Concurrently

The Model Law deals with coordination between a local proceeding and a foreign proceeding concerning the same debtor (Article 29) and facilitates coordination between two or more foreign proceedings concerning the same debtor (Article 30). The objective of the provisions is to foster coordinated decisions that would best achieve the objectives of both proceedings (e.g., maximization of the value of the debtor's assets or the most advantageous restructuring of the enterprise). In order to achieve satisfactory coordination and to be able to adapt relief to changing circumstances, the court is in all situations directed to cooperate to the maximum extent possible with foreign courts and the foreign representatives (Articles 25 and 30).

When the local insolvency proceeding is already under way at the time that recognition of a foreign proceeding is requested, the Model Law requires that any relief granted for the benefit of the foreign proceeding must be consistent with the local proceeding. Furthermore, the existence of the local proceeding at the time the foreign main proceeding is recognized prevents the operation of Article 20. When there is no local proceeding pending, Article 20 mandates the stay of individual actions or enforcement proceedings against the debtor and a suspension of the debtor's right to transfer or encumber its assets.

When the local proceeding begins subsequent to recognition or application for recognition of the foreign proceeding, the relief that has been granted for the benefit of the foreign proceeding must be reviewed and modified or terminated if inconsistent with the local proceeding. If the foreign proceeding is a main proceeding, the stay and a suspension, as mandated by Article 20, must also be modified or terminated if inconsistent with the local proceeding.

When the court is faced with more than one foreign proceeding, Article 30 calls for tailoring relief in such a way that will facilitate coordination of the foreign proceedings; if one of the foreign proceedings is a main proceeding, any relief must be consistent with that main proceeding.

Another rule designed to enhance coordination of concurrent proceedings is the one on the rate of payment of creditors (Article 32). It provides that a creditor, by claiming in more than one proceeding, does not receive more than the proportion of payment that is obtained by other creditors of the same class.

D. CONCLUSION

When in a cross-border insolvency situation there is a lack of communication and coordination between courts and administrators from relevant

jurisdictions, this is often due not to the unwillingness of the authorities and persons concerned to cooperate but to inadequate legislation on cross-border insolvency matters. In such situations, it is more likely that assets would be dissipated or fraudulently concealed, or liquidated with a less than optimal result. As a consequence, not only is the ability of creditors to receive payment diminished, but so also is the possibility of rescuing financially viable businesses and saving jobs.

By contrast, mechanisms in national legislation for coordinated administration of cases of cross-border insolvency make it possible to adopt solutions that are sensible and in the best interest of the creditors and the debtor; the presence of such mechanisms in the law of a state are therefore perceived as advantageous for foreign investment and trade in that state.

The Model Law reflects practices in cross-border insolvency matters that are characteristic of modern, efficient insolvency systems. It provides a legal basis for cooperation among courts in the states where the debtor's assets are located; it further grants access to local courts to representatives of foreign insolvency proceedings or creditors; and it gives recognition to certain orders issued by foreign courts. All of this international cooperation authorized by the Model Law is subject to safeguards that ensure the protection of the creditors and other interested persons, including the debtor. In addition, any action that may be taken by a court is expressly made subject to the overall reservation of the protection of public policy.

The first reactions to the Model Law have been positive. It has good chances of becoming a worldwide standard against which the quality of national laws on cross-border aspects of insolvency will be measured.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

Chinese Cross-Border Insolvencies: Current Issues and Future Developments

Shi Jingxia

Chinese Cross-Border Insolvencies: Current Issues and Future Developments

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This article deals with several problems pertaining to cross-border insolvency, an important but ignored area in China. In this article, the current status of Chinese bankruptcy laws has been firstly addressed, with a focus on its legal blank on the cross-border insolvency and unsatisfactory judicial practice. Thereafter, the influential GITIC case has been analyzed, which furtherly highlights the inadequacy of Chinese bankruptcy legislation and crying needs for its reform. Basing on the essential principles embodied in the UNCITRAL Model Law and EU Regulation, the gaps between Chinese bankruptcy laws and international practice have been made clear. Accordingly, the developments of Chinese cross-border insolvency have been proposed in order to provide helpful references for the future legislation.

OUTLINE

I. Introduction

II. Cross-Border Insolvencies in China

A. Legal Blank on Cross-Border Insolvency

B. Judicial Practice Concerning Cross-Border Insolvencies

- 1. The LMK Nam Sang Dyeing Case*
- 2. Liwan District Construction Company Case*
- 3. BCCI (Shenzhen Branch) Case*

III. GITIC Bankruptcy Case

A. Equitable Treatment for Creditors and Registration of Foreign Debts

- 1. Foreign Creditors v. Domestic Creditors*

2. *Registered Foreign Debts v. Unregistered Foreign Debts*
3. *Individual Depositors v. Corporate Creditors*

B. Letters of Comfort

C. Liquidation Committee and Avoidable Transaction

IV. Future Developments: Reform and Cooperation

A. Reform of Chinese Bankruptcy Laws

1. *Necessity of Reform*
2. *Reference for Reform*

B. Enhancement of International Cooperation

1. *Universality versus Territoriality*
2. *Jurisdiction to Open Insolvency Proceedings*
3. *Recognition and Assistance in Insolvency Proceedings*

V. Conclusion



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I. Introduction

The recent decades have witnessed a proliferation of cross-border insolvency cases along with the development of increasing integration of the global economy. But the realm of cross-border insolvency is full of chaos over a long period of time.¹ Given the diversity in national insolvency laws which often relate to divergent political goals and cultural expectations,² it may readily be appreciated how much greater are the obstacles to the harmonization of cross-border insolvency.³ Happily, it seems that such recent initiatives as United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-border Insolvency (hereinafter “Model Law”), EU Regulation on Insolvency Proceedings (hereinafter “EU Regulation”), are gaining

★ This article was prepared mainly during my academic visit to the Center for Commercial Law Studies (CCLS), Queen Mary and Westfield College, University of London from 20 February 2000 to 19 August 2000. I would like to express special and enduring gratitude to Professor Ian F. Fletcher not only for his constructive comments on this article but also his ardent encouragement for this research. Errors of fact, judgment are of course mine. In addition, the financial support from EU-China Higher Education Cooperation Program for my academic visit to CCLS was acknowledged with appreciation as well.

¹ See e.g., Charles D. Booth, ‘Recognition of Foreign Bankruptcy: An Analysis and Critique of the Inconsistent Approaches of United States Courts’, 66 *Am. Bankr. L. J.*, at 135 (1992).

² See Douglas Boshkoff, ‘Some Gloomy Thoughts Concerning Cross-Border Insolvencies’, 72 *Wash. U. L.Q.*, at 936 (1994).

³ See, e.g., Jay Lawrence Westbrook, ‘Developments in Transnational Bankruptcy’, 39 *St. Louis U. L. J.*, at 745 (1995).

more and more approbation.⁴

China has carried on “open and reform policy”, which transformed itself from a backward country into a key player in the international community during the past two decades.⁵ As well as the accelerated growth in foreign investment and trade, globalized production and distribution of goods and services makes it inescapable for China to face more and more cross-border insolvency cases. But bankruptcy law has been lamentedly slow to develop in China⁶ and its importance to the economic development has been largely ignored over the years. In spite of several cases indicating some kind of attitude towards cross-border insolvency, the dearth of specific provisions inevitably leads to difficulties and inconvenience in practice.⁷ This situation presents a lot of issues, just as the recent GITIC case exemplifies.⁸

The primary purpose of this article is to examine the current issues of Chinese cross-border bankruptcy and then to consider possible developments in future. The main contents of various parts of this article can be summarized as follows:

In Part II, the present state of Chinese bankruptcy law is briefly reviewed in order to provide a general idea on Chinese bankruptcy legislation and judicial practice, especially in what ways problems would arise in cross-border cases containing a Chinese dimension. This part addresses firstly the basic features of Chinese bankruptcy laws and legal blank on cross-border insolvency. Thereafter, the focus shifts to the judicial practice of Chinese courts concerning foreign-related bankruptcies. This part illustrates the weakness of Chinese bankruptcy laws and highlights the pressing demand for its reform.

Part III touches upon the pending GITIC bankruptcy case, which involves numerous foreign creditors and draws far-ranging international attention. The equitable treatment for all creditors, letters of comfort, composition of liquidation committee, avoidable transactions and other legal issues in relation to this case will be deliberated in this part. In particular, this part probes into several issues which make this case more complex, including foreign creditors and domestic creditors, registered foreign debt and unregistered foreign debt, corporate creditors and individual depositors. Obviously, the issue regarding realization of creditor’s equality must be

⁴ In addition to the Model Law and EU Regulation, there are other projects having been paid more and more attention as well in recent years. These mainly include ‘The World Bank Global Insolvency Project’, ‘The Transnational Insolvency Projects’ among the member states of NAFTA, ‘Cross-Border Insolvency Concordat’ undertaken by the Committee J of IBA, etc.

⁵ See Sheryl Miller, ‘Institutional Impediments to the Enforcement of China’s Bankruptcy Laws’, 8 *Int’l Legal Persp.*, at 188, 213 (1996).

⁶ See Steven L. Toronto, ‘Bankruptcy of Foreign Enterprises in the PRC: An Interpretation of the “Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone”’, 4 *J. Chinese L.*, at 290-91 (1990).

⁷ See *infra* Part II.

⁸ See *infra* Part III.

seriously treated.

Part IV sets out possible developments of Chinese cross-border bankruptcy. Firstly, there is a pressing need for China to reform its bankruptcy law. Given the Model Law and EU Regulation are of paramount significance in this field, it might be helpful to use them as frame of reference for reform of Chinese cross-border bankruptcy. Secondly, it moves to the crucial question of international cooperation in cross-border insolvency. In particular, several basic issues, universality versus territoriality, jurisdiction to open insolvency proceedings, recognition and assistance in insolvency proceedings are given consideration in this part. These analysis aims at discovering the gap between Chinese current legislation and the Model Law so as to explore corresponding adaptation once China enacts the Model Law in future.

In Part V, it is concluded that China should adopt internationally recognized cross-border insolvency norms. The increasing acceptance of the principles embodied in the Model Law and EU Regulation provides suitable moment for China to conform its bankruptcy laws to the international standard. But at the same time, China should take its basic national conditions into account as well in order that its bankruptcy legislation could operate well in practice.

II. Cross-Border Insolvencies in China

In contrast to China's centuries-old history, Chinese bankruptcy law is still in its infancy period.⁹ The current bankruptcy system of China consists mainly of 1986 Enterprises Bankruptcy Law of PRC (Trial Implementation, hereinafter "EBL"),¹⁰ Procedure for Bankruptcy and Debt Repayment provided in the 1991 Civil Procedure Law (hereinafter "CPL"),¹¹ accompanying judiciary opinions¹² and other relevant regulations. China does not apply its bankruptcy system uniformly. The EBL only

⁹ For a good overview of the development of Chinese bankruptcy laws, See Feng Chen, 'Chinese Bankruptcy law: Milestones and Challenges', *31 St. Mary's L. J.*, at 49-52 (1999); See also Neal Stevens, 'Confronting the crisis of Insolvency in China's State-owned Enterprises: Can the Proposed Bankruptcy Law Erase the Red Ink?', *16 Wis. Int'l J.*, at 559 (1998).

¹⁰ The EBL was promulgated at the 18th Session of the Standing Committee of the 6th National People's Congress on December 2, 1986, effective as of November 1, 1988. For the English version of EBL, See 'China's New Bankruptcy Law: A translation and Brief Introduction', Douglas G Boshkoff & Yongxin Song (translated), *61 Am. Bankr. L. J.*, 1987, at 359-369; see also 'Bankruptcy Law of the People's Republic of China: Principles, Procedure & Practice', Henry R. Zheng (translated), *19 Vand. J. Transnat'l L.*, at 683-738 (1987).

¹¹ Civil Procedure Law of the People's Republic of China was adopted and came into effect on 9, April 1991. Its bankruptcy provisions are very short and basically replicate main elements of the EBL despite of some substantive differences. See Gordan G. Chang, 'Bankruptcy Law in China: Too Much or Too Little?', *5 China L. & Prac.*, at 22-23 (1999).

¹² To implement the EBL, the Supreme People's Court of P. R. of China promulgated the Opinions on Issues Concerning the Implementation of the Tentative EBL (hereinafter "The Supreme Court Bankruptcy Opinions") on November 17, 1991. Likewise, the Supreme Court promulgated the Opinions on Issues Concerning the Implementation of the CPL (hereinafter "The Supreme Court CPL Opinions") on July 14, 1992.

applies to the State-Owned Enterprises (SOEs)¹³ whereas the relevant provisions in CPL apply to the bankruptcy of non-state-owned legal persons¹⁴ There is no legislation available on the bankruptcy of natural persons in China at present

A. Legal Blank on Cross-Border Insolvency

The EBL is composed of only 43 articles included in six chapters, involving bankruptcy filing and case acceptance, creditors' meetings, reconciliation and reorganization, bankruptcy declarations and liquidation. As the first bankruptcy law in China, EBL actually embraces the dual policies of restricting substantial application of bankruptcy remedies and emphasizing conciliation.¹⁵ Besides, the absence of true market indicators and relevant legislation leads to inactive application of the EBL in China.¹⁶ Such factors as inaccurate analysis of a company's efficiency, effect on banks and other state-run firms, and interconnection between the judiciary and the administrative arms of the government, conspire against courts' applying the EBL to liquidate insolvent SOEs.¹⁷ As a result, the bankruptcy cases are rare in Chinese court despite the existence of a considerable number of technically insolvent SOEs.¹⁸

When it comes to cross-border insolvency, China lacks as yet explicit legislation at a national level. As mentioned above, EBL only applies to the SOEs and excludes all vehicles for foreign investment.¹⁹ The bankruptcy provisions in the CPL are too simple to address any specific issue on cross-border insolvency although it may apply to the foreign-related legal person. Other laws and regulations concerning foreign investment enterprises also keep silent on this issue.²⁰ Foreign-related Enterprises Liquidation Regulations²¹ provide the procedures of the normal liquidation rather

¹³ Enterprise Bankruptcy Law, art.2. Initially, EBL was to have had a broader scope of application. See Mark E. Monfort, 'Reform of the State-Owned Enterprises and the Bankruptcy Law in the People's Republic of China', 22 *Oklahoma City U. L. Rev.*, at 1078-79(1997).

¹⁴ The Supreme Court Bankruptcy Opinion, *supra note* 12, art. 74.

¹⁵ Given the vigorous use of EBL could have potentially left millions of workers unemployed, creating substantial social and political problems, it is not surprising that the EBL actually acts as mere threat of bankruptcy. See Shirley S. Cho, 'Continuing Economic Reform in the People's Republic of China: Bankruptcy Legislation Leads the Way', 19 *Hastings Int'l & Comp. L. Rev.*, at 745 (1996).

¹⁶ There are lots of criticisms towards the implementation of EBL, arguing that it seems "more bark than bite". See e.g., Jonathan L. Flaxer, 'Bankruptcy in China', *Am. Bankr. Inst. J.*, at 24 (1994).

¹⁷ For the elaboration of these factors, See Steven L. Seebach, 'Bankruptcy behind the Great Wall: Should U.S. Business Seeking to Invest in the Emerging Chinese Market Be Wary?', 8 *Transnat'l Law.*, at 355-57 (1995).

¹⁸ Most of bankruptcy cases having been heard by Chinese courts involve privately-owned enterprises, collectively owned enterprises and joint-venture enterprises. See Steven L. Seebach, *supra note* 17, at 358.

¹⁹ Whether or not the Bankruptcy law would encompass foreign enterprises was debated at length. See Henry R. Zheng, *supra note* 10, at 685; See also Shirley S. Cho, *supra note* 15, at 746.

²⁰ The Chinese legislation on foreign-related enterprises mainly include: The law on Sino-Foreign Equity Joint Ventures of P. R. of China (July 1979), The Law on Wholly-Owned Foreign Enterprises of P. R. of China (April 1986), The Law on Sino-Foreign Contractual Joint Ventures of P. R. of China (April 1988) and accompanying Implementation Rules. These Laws and Rules are, without exception, silent on the bankruptcy issues although they mention the termination and liquidation of these enterprises.

²¹ Foreign-Related Enterprises Liquidation Regulations was promulgated by the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) and effective as of 9 July 1996.

than bankruptcy liquidation of foreign-related enterprises.

Interestingly, bankruptcy provisions for foreign-related enterprises have, however, at one time been developed at a local level in Guangdong Province²² and Shenzhen Special Economic Zone (SEZ)²³ Shenzhen Rules stated that a bankruptcy declaration made in accordance with the bankruptcy law of a foreign jurisdiction shall be of no effect against the property of the debtor situated in the Shenzhen SEZ²⁴ But bankruptcy estate in the proceedings opened by Chinese courts shall include the whole assets of the debtor wherever they are located.²⁵ The rationale behind these provisions was to protect the interests of Chinese citizens and corporations. From a viewpoint of pure protectionism, this approach may be correct. None the less, such approach is harder to justify on the grounds of creditor equality since it assumed a double standard and induced unfair outcome in practice. In the meantime, viewed from the international perspective, these provisions lay emphasis on the territoriality principle, which is unappealing in the context of cross-border cooperation. For instance, given the rejection of Chinese courts to recognize the effect of foreign bankruptcy proceedings upon the debtor's assets in china, it may appear necessary for foreign liquidator to file de novo a bankruptcy case against the debtor so as to obtain these assets. The duplication of proceedings inevitably decreases the amount of payment for creditors involved.

When the foreign liquidator or creditors demand the takeover of the debtor's assets situated in China, the approach of share transfer is preferred than that of direct turnover. Under the Guangdong Regulations, a foreign liquidator would have been entitled to make suggestions about the disposal of foreign debtor's assets in the SEZ.²⁶ The debtor's assets, however, shall be generally disposed of by the way of share transfer. It is noteworthy that there are different requirements on share transfer, given the divergent vehicles of foreign-related enterprises. The procedures for share transfer involving wholly-owned foreign enterprises is simpler than those regarding sino-foreign joint ventures.²⁷ The latter shall be subject to the approval of the Chinese

²² Guangdong Special Economic Zone Foreign-Related Companies Bankruptcy Regulations (hereinafter 'Guangdong Regulations') was promulgated by the Standing Committee of the Guangdong People's Congress on Sep.28, 1986. This Regulation has been repealed and substituted by the 1993 Guangdong Province Company Bankruptcy Regulation. The new Regulation contains no provisions on cross-border insolvency.

²³ In 1979, the Chinese government created in southern China four Special Economic Zone where outsiders could invest and become owners in Chinese enterprises. The four SEZ include Shenzhen, Zhuhai, Xiamen and Shantou. Shenzhen has the largest number of foreign investors in China. Its proximity to Hong Kong gives Shenzhen access to one of the largest consumer markets in the world.

Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone (hereinafter 'Shenzhen Rules') was promulgated on Nov. 29, 1986 and became effective as of July 1, 1987. The Rules was repealed and substituted by the 1993 Shenzhen Special Economic Zone Enterprises Bankruptcy Regulations. Likewise, nor does this new Regulation contain provisions regarding cross-border insolvency.

²⁴ Shenzhen Rules, *supra* note 23, art. 5.henah

²⁵ *Ibid.*

²⁶ Guangdong Regulations, *supra* note 22, art. 40.

²⁷ The Law on Sino-Foreign Contractual Joint Venture of People's Republic of China (1988), art. 10; The

partner whereas the former is not subject to this requirement. The rationale behind this distinction is to protect the Chinese partner against unwanted loss owing to the foreign partner's bankruptcy.²⁸ In addition, share transfer must receive the necessary sanction from the local Municipal People's Government. Proceeds from the share transfer must not be transferred out of the SEZ until the liquidation expenses, taxation and other local liabilities had been repaid.²⁹

These provisions were designed to meet the requirements that combine fixity with flexibility. On the one hand, the bankruptcy of a debtor in its foreign jurisdiction does not deprive it of the capability of disposing of its own assets located in China. On the other hand, permitting the debtor to retract his assets in China by way of share transfer and then to incorporate them into the bankruptcy estate does not affect the business operation, thereby protecting the interests of the Chinese partner. But in practice, it is very difficult to keep absolutely the foreign-related enterprise from adverse effects once the investors failed in foreign jurisdictions. Furthermore, these provisions drew lots of criticism from foreign creditors towards the administrative intervention in the process of assets disposal.

B. Judicial Practice Concerning Cross-Border Insolvencies

The issues associated with cross-border bankruptcy do exist in Chinese economy life irrespective of the present legal void. In particular, various foreign-related enterprises in China are often affected by foreign bankruptcy declaration. In the event that the foreign investor (whether individual or corporation) has been declared bankrupt in a foreign jurisdiction, the status of his assets situated in China will inevitably become a tough issue. The legal blank on cross-border insolvency gives rise to various difficulties in judicial practice. There are several cases here indicating incoherent attitudes of Chinese courts towards solving these problems.

1. The LMK Nam Sang Dyeing Case

The first failure of a foreign-related enterprise took place in Shenzhen when LMK

Implementation Rules for the Law of Sino-Foreign Contractual Joint Venture of People's Republic of China (1995), art 23; The Law on Sino-Foreign Equity Joint Venture of People's Republic of China (1979, amended in 1990), art.4; The Implementation Rules for the Law on Sino-Foreign Equity Joint Venture of People's Republic of China (1983), art. 23, 24; The Law on Wholly Foreign-Owned Enterprises of People's Republic of China (1986), art. 5; The Implementation Rules for the Law on Wholly Foreign-Owned Enterprises of People's Republic of China (1990), art. 23, 24.

²⁸ Guangdong Regulations, *supra note* 22, art. 44. This article provided that the disposal of the assets, which was to take the form of share transfers or the assignment of rights and interests, was not to be made if the transfer would have had any adverse effect on the normal production and operation activities of the company.

²⁹ Guangdong Regulations, *supra note* 22, art. 41.

Nam Sang Dyeing Factory (hereinafter ‘LMK’) collapsed.³⁰ LMK, operated by a Hong Kong company, was a wholly-owned foreign enterprise. In 1983, LMK was insolvent when its controlling parent company was being wound up by a Hong Kong court.³¹ The Peat Marwick Accounting Firm, as the receiver appointed in the Hong Kong proceeding, approached the Chinese authorities to claim the control of LMK’s assets in Shenzhen. Without legal authority at that time as regards the recognition of such insolvency proceeding, this case was not coped with as a formalized bankruptcy proceeding.³² The court simply allowed Peat Marwick to negotiate with the local government. Peat Marwick succeeded in gaining control of LMK’s assets and then distributed them in the Hong Kong proceedings.³³ The LMK case illustrated the need for a bankruptcy law to deal with the legal proceedings surrounding the failure of foreign-related enterprises, and induced to some degree the generation of the Shenzhen Rules.³⁴

2. Liwan District Construction Company Case

In the case of Liwan District Construction Company v. Euro-America China Property Limited, the defendant was a company registered in Hong Kong and entered into several contracts with the plaintiff. The plaintiff lodged a complaint in Guangzhou Intermediate People’s Court due to the defendant’s breach of contract. This case became more complex when the defendant was wound up by a Hong Kong court.³⁵ In this case, the decision was mainly produced in accordance with contract law principles, paying little attention to the bankruptcy issues.³⁶ But in any case, the People’s court applied a territoriality approach to resolve cross-border insolvency issues.³⁷ In its decision, the People’s Court did not recognize the appointment of the Hong Kong representative, furtherly holding that he lacked the authority to represent the defendant in the Chinese litigation. Therefore, the Hong Kong representative could not exercise the power that was granted to the liquidation committee under the EBL.³⁸ The court’s primary intention appears to protect the Chinese party’s rights and

³⁰ See Steven L. Toronto, *supra note* 6, at 277.

³¹ Under British Insolvency laws, “winding up a company” is equivalent to liquidation of a company, *ibid*.

³² See Steven L. Seebach, *supra note* 17, at 353.

³³ See Steven L. Toronto, *supra note* 6, at 280-81.

³⁴ As far as the author is aware, it is not clear whether there were Chinese creditors or not and how were their claims dealt with in this case. But given the fact that LMK case happened at the early stage of Chinese “open door policy” and the pressing needs for China to attract foreign capital to accelerate its economic development, it was likely that the foreign creditors were in fact given priority in this case.

³⁵ With respect to the details of this case, See Donald J. Lewis & Charles D. Booth, ‘Case Comment, Liwan District Construction Company v. Euro-America China Property Limited’, 6 *China L. & Prac.*, at 27 (1990).

³⁶ See Charles D. Booth, ‘The Transnational Aspects of Hong Kong Insolvency Law’, 2 *Sw. J. L. & Trade Am.*, at 71 (1995).

³⁷ *Ibid*, at 72-73.

³⁸ For further analysis of this problem, See Donald J. Lewis & Charles D. Booth, *supra note* 35, at 33-34.

interests. Certain principles embraced in the Guangdong Regulations then in effect supported the approach adopted by the court as well.

3. BCCI (Shenzhen Branch) Case

BCCI was a banking group headquartered in Luxembourg and with numerous subsidiaries and branches in the world. BCCI also did business in China, by setting up a branch in Shenzhen. In the early 1990s, BCCI was declared bankrupt by the courts in more than 70 jurisdictions.³⁹ Shenzhen Branch of Bank of China, as the biggest creditors of BCCI Shenzhen Branch, applied to Shenzhen Intermediate Court (hereinafter 'SIC') for the bankruptcy declaration of BCCI Shenzhen Branch and commencement of debt repayment. SIC accepted and heard this case in 1992. In response to the application from Chinese creditors, SIC froze the assets of BCCI Shenzhen Branch within China in a short time. Pursuant to article 5 of Shenzhen Rules⁴⁰ and articles 243 of CPL,⁴¹ SIC appointed the liquidation committee to take charge of the liquidation of BCCI Shenzhen Branch. Accordingly, the Chinese creditors only participated in the proceeding opened by SIC, not being involved in global liquidation of BCCI. The report of liquidation committee indicated the total assets of BCCI in China amounted to \$20bn, but with nearly \$80bn liabilities. Chinese creditors obtained about 23% repayment for their respective claim in this proceeding.⁴² This case could serve as a typical exemplification on China's adherence to the territoriality principle in dealing with cross-border bankruptcy cases.

It is difficult to draw a comprehensive conclusion about Chinese cross-border insolvencies from very few cases. Nonetheless, it has been observed that there is an absence of clear legislative guide for Chinese courts to cope with these problems. Protection of local creditors has been considered as an important factor⁴³ although it is not easy to succeed due to the innocence of current international practice. More importantly, the notion of international cooperation on cross-border insolvency is still a rather new thing to Chinese courts, which constitutes a self-blockade harmful to

³⁹ With regard to the overview of the BCCI insolvency proceeding at a global level, see Christopher K. Grieson, 'Shareholder Liability, Consolidation and Pooling', in *Current Issues in Cross-Border Insolvency and Reorganization*, E. Bruce Leonard and Christopher W. Besant (edited), at 220-225 (1994); see also Christopher K. Grieson, 'Insolvency of Financial Institutions', *5 Int'l Bus. Lawyer*, at 213 (1996).

⁴⁰ See *supra* note 24, 25 and accompanying text.

⁴¹ This article provides for jurisdictional basis of Chinese courts on foreign-related civil procedures, including bankruptcy proceedings. By this article, SIC may exercise jurisdiction against the BCCI Shenzhen Branch on the basis of assets-presence, the location of representative office, etc.

⁴² See Shi Jingxia, *Legal Issues in Cross-Border Insolvency* (China), at 70 (1999).

⁴³ As a matter of fact, the concern for the protection of local creditors is blameless since it is a standard that is fairly and widely accepted as a legitimate criterion on which to base any use of its discretionary powers by the national courts in an international context. See e.g., U.S. Bankruptcy Code, section 304 (c) (2).

China's climate of investment and trade.

III. GITIC Bankruptcy Case

On January 16 1999, Guangdong International Trust and Investment Company (hereinafter "GITIC")⁴⁴ was, under the EBL, declared bankrupt by the Guangdong People's High Court⁴⁵ because of its inability to pay maturing debts.⁴⁶ A creditors' committee was set up at the first creditors' meeting in April 1999 to oversee the disposal of the GITIC's assets.⁴⁷ By far, the work of claims confirmation has been basically completed.⁴⁸ In order to protect lawful rights and interests of GITIC's creditors, Guangdong provincial government took the unprecedented step of calling together municipal and county government officials to urge them to force local debtors to pay back what was owned to the GITIC. The courts at all levels in Guangdong issued announcements to all debtors and guarantors that outstanding funds must be paid.⁴⁹ The courts tried to get back the debts by freezing, confiscating and auctioning the assets of debtors.⁵⁰

⁴⁴ GITIC, as one of a select group of "champions of economic reform", was established in July 1980 and later became the second largest foreign debenture issuer in China and a fund-raising arm for the Guangdong provincial government as well. GITIC had spectacular rise and fall in the business history of China. See, e.g., 'The Spectacular Rise and Fall of GITIC' (May 18, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_b2_99051423.html.

⁴⁵ GITIC registered with the Guangdong Administration on Industry and Commerce and had its domicile in Guangdong. Pursuant to Art. 5 of the EBL, bankruptcy cases shall be subject to the jurisdiction of the People's Courts in the location of the debtor.

⁴⁶ China originally intended to close GITIC under the administrative procedures that had been employed to cope with ailing financial institutions. In fact, the GITIC was shut down initially by People's Bank of China (PBOC) on Oct. 6, 1998, without any reference to the EBL. See e.g., Kyne, James & Harding, 'China Suffers Biggest Financial Failure', *Fin. Times* (October 7, 1998).

(The Bank of China, one of the four largest state-owned banks, was appointed as an administrator to take charge of the GITIC liquidation. The three-month liquidation, however, found GITIC was insolvent seriously. GITIC and three of its subsidiaries—GITIC Shenzhen Company, Guangdong International Leasing Company and Guangxin Development Enterprise—had to apply for bankruptcy protection. See, e.g., 'Chinese Court Declares GITIC Bankrupt', available at http://www.chinaonline.com/top_stories/today_b2_99011803.html).

China's approval of GITIC's bankruptcy was the outcome of painful choices. See, e.g., 'Q&A: Guangdong Deputy Governor Speaks on GITIC and Guangdong Enterprise', available at http://www.chinaonline.com/top_stories/breakingnews_b2-99031516.html; see also 'China's Central Banker Speaks out about GITIC Bankruptcy Proceedings' (February 11, 1999), available at http://www.chinaonline.com/top_stories/today_b2-99020110.html; Zhu Jun, 'Closure of Financial Institutions in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, at 313 (October 1999).

⁴⁷ See, e.g., Jacob, Rahul & Lucas, Louise, 'China: Government Details GITIC Assets', *Fin. Times* (April 23, 1999).

⁴⁸ Debts owed by 422 Guangdong-based units account for 95% of total outstanding debts to GITIC and subsidiaries. A total of 134 government bodies have outstanding guarantees on loans made by GITIC, accounting for 73% of total amount. See e.g., 'GITIC Loans to Guangdong-based Units Worth 18.8 bln yuan', (March 31, 2000), available at '2000 WL 16717065'.

⁴⁹ See Matthew Miller and William Kazer, 'The Loans That Went Too Far', *S. China Morning Post*, (March 30, 2000), available at '2000 WL 14847902'.

⁵⁰ For example, Guangdong People's High Court froze RMB 800 million (US\$96.64) in assets of GITIC's debtors. After freezing the assets, the court notified the relevant local governmental authorities that the businesses are forbidden from transferring, leasing or using as collateral any of their land, property, vehicles, stock rights and registered capital. See e.g., 'Chinese Court Freezes US\$97 Million in Assets of GITIC's Debtors', *Nanfang Daily (China)*, May 12, 1999.

As the first case concerning the bankruptcy of leading state-owned financial institution in China,⁵¹ the GITIC case involves the largest-ever amount of assets and foreign debts in China,⁵² drawing international-wide attention in short time. This case has raised several noteworthy legal issues. Given its unprecedented nature and historic importance, it seems worthwhile to examine the GITIC case here in some detail.

A. Equitable Treatment for Creditors and Registration of Foreign Debts

The equitable treatment for all creditors is recognized as one of core principles of insolvency and bankruptcy laws worldwide. But it is not an easy task for Chinese courts to put this principle in operation. The creditors of GITIC come from many different jurisdictions. Besides, the requirements of Chinese laws that foreign debts should be registered make this issue more complicated.

1. *Foreign Creditors v. Domestic Creditors*

GITIC had over 240 creditors from Mainland China, Hong Kong, Macao, the United States, Japan, Thailand and Australia other than individual depositors.⁵³ In China, previous liquidation of insolvent financial institutions had been carried out under central bank's administration, in which foreign creditors were paid in full.⁵⁴ But following the collapse of GITIC, PBOC announcement on the closure of GITIC dated on October 6, 1998 only stated that overseas liabilities registered with the State Administration of Foreign Exchange (hereinafter "SAFE", China's foreign exchange control authority) and principal and interest of individual depositors shall have priority in repayment.⁵⁵ The announcement actually indicated China had taken a clear stance that it was under no obligation to bail out GITIC and foreign creditors should not anticipate full repayment as ever.⁵⁶ Afterwards, the decision of putting GITIC into bankruptcy went further to strip foreign creditors of their priority, even though their loans had been registered with the SAFE. Creditors, whether foreign or domestic,

⁵¹ Until the GITIC case, the EBL had been used mostly for the bankruptcies of small state-owned enterprises, and had never been used in the case of a large financial institution, or for a debtor which had significant foreign indebtedness. See T K Chang, 'The East Is in the Red', *IFLR*, at 43 (March 1999).

⁵² When it went bust, GITIC had assets of US\$2.58 billion against liabilities of US\$4.35 billion.

⁵³ The foreign currency obligations of GITIC are estimated to be in excess of \$4 billion, about half of its loans and balance in guarantees.

⁵⁴ For example, in the administrative closure of Hainan Development Bank (21/06/98) and China Agriculture Trust and Investment Corporation, CATIC (04/01/97), overseas debts obtained full repayment. See Liu Shiyu, 'China's Experience in Small and Medium Financial Institutions Resolution', in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, at 299 (October 1999).

⁵⁵ See, e.g., T K Chang, *supra* note 51, at 44.

⁵⁶ See A V Rajwade, 'Investing in the Chinese Puzzle', *Business Standard* (March 15, 1999), available at '1999 WL 5943936'.

were required to undertake their lending responsibility without exception⁵⁷ This drew strong criticism from foreign banks and other creditors, who insisted on priority in repayment.

But as far as the principle of bankruptcy laws is concerned, a Chinese court is on the right track for treating all creditors equally in this regard. Under the EBL, the order for the distribution of unsecured assets is, firstly to wages and labor insurance benefit owed by the debtor to its workers and staff, then second-rank priority is given to taxation obligations, and lastly to general claims.⁵⁸ Thus, there is no legal basis on which foreign creditors could obtain priority. Moreover, if foreign creditors were granted priority in repayment, domestic creditors would actually be put in more miserable circumstances.⁵⁹ At the same time, from an international perspective, all creditors that belong to the same rank shall be treated impartially regardless of their nationality. There is no insolvency law granting foreign debts priority over domestic debts.

2. Registered Foreign Debts v. Unregistered Foreign Debts

Another problem relating to the treatment of creditors stems from the existing Chinese laws that require all indebtedness within China to foreign lenders to be approved and register with the SAFE.⁶⁰ Unregistered foreign debts, that is, foreign debts which are not on file at the SAFE, are unrecognizable and unenforceable.⁶¹ At the second creditors' meeting held on October 22, 1999, the liquidation committee informed creditors of that only RMB24.33bn worth of claims from a total of RMB38.9bn would be recognized. The reduction totaling RMB14.57bn (\$1.75bn) consisted mainly of unregistered overseas debts. The Guangdong People's High Court announced the refusal and gave creditors 15 days to object.⁶²

⁵⁷ See e.g., 'Reexamination of GITIC Bankruptcy Case', *Special Information(China)*, at 2 (1999); See also 'Analysis - China Plans Public Fund Injection for ITICs', *Asia Pulse* (January 11, 2000), available at '2000 WL 2676073'.

⁵⁸ Enterprise Bankruptcy Law, art.37(2).

⁵⁹ Recovery from the assets of GITIC would be virtually impossible for many Chinese creditors, including foreign-funded banks; joint ventures and state-owned enterprises.

⁶⁰ Foreign Exchange Control Regulation of the People's Republic of China (adopted at the 41st meeting of standing committee of State Council, effective as of April 1, 1996, amended on January 14, 1997), art. 24. This article provides that China shall implement a system for registration of foreign debt. All organizations within China shall carry out registration of foreign debt in accordance with the State Council Regulations Concerning Monitoring and Collecting of Data on Foreign Debt.

⁶¹ Similarly, in connection with the way derivative-related debts arising from the collapse of GITIC are settled, unless these transactions with GITIC were individually registered, they should be placed in subordination to other debts arising out of GITIC's failure. See e.g., 'PBC Said to Clam Up on GITIC', *Derivatives Week* (March 2000), available at '2000 WL 11658639'.

⁶² See Lin Ho Swee, 'GITIC: Payout Blow for Creditors', *Fin. Times* (October 23, 1999); See also 'Creditors of China's GITIC Object to Plan' (November 9, 1999), available at '<http://www.chinaonline.com/topstories/C9110807.asp>'; 'GITIC Debts Lower, Liquidators Say', *Hong Kong Ming Bao*, October 23, 1999.

One of objections concerns the guarantees granted by GITIC to its Hong Kong subsidiary. Creditors insisted that this kind of guarantee should not be regarded as overseas indebtedness and formal registration with the SAFE was not required.⁶³ But in accordance with Chinese laws regarding foreign debt guarantees, the guarantee refers to domestic enterprises in China, foreign-related enterprises, 100% subsidiaries of institutions within China and enterprises registered out of China but with shares purchased by Chinese parties.⁶⁴ Hence, the said guarantee provided by GITIC shall fall into the scope of foreign debts and registration with the SAFE shall be compulsory.

It should be pointed out that there exists a misunderstanding regarding the requirements of registration of foreign debts in that it is sometimes supposed that foreign lenders obtain guarantees from Chinese government once foreign debt has been registered with the SAFE. But in fact, the purpose of registration of foreign debts with the SAFE is to monitor and collect data on overseas indebtedness of China.⁶⁵ In the meantime, this registration also enables the borrower to gain authorization to use Renminbi, China's currency, for buying foreign currency so as to repay the foreign creditors.⁶⁶ Accordingly, this registration by all means should only be viewed as a means of tracking capital inflows and outflows instead of guarantee for foreign currency loans or debt provided by Chinese government.⁶⁷ In other words, registered foreign debts could not constitute sovereignty debts which Chinese government should take the responsibility of repayment.

3. Individual Depositors v. Corporate Creditors

Apart from numerous corporate creditors, GITIC had 25,000 individual depositors. PBOC announcement once mentioned that priority in repayment should be given to the overseas lenders and individual creditors. As a matter of fact, GITIC's individual depositors were repaid in full on their principal, but not on their interest outside the

⁶³ See T K Chang, *supra* note 51, at 45.

⁶⁴ Rules for Implementation of Administrative Measures for Foreign Guarantee by the Institutions within China (promulgated on September 26, 1991 by the People's Bank of China), Art. 6. These Rules are substituted by 'Administration Regulations on Foreign Guarantee Provided by Domestic Institutions' (promulgated on August 21, 1996 by the People's Bank of China, effective as of October 1, 1996). The new Regulations contain similar provisions in its article 2.

⁶⁵ Interim Regulations Concerning Monitoring and Collecting of Data on Foreign Debts (approved by State Council of P. R. of China on June 17, 1987, promulgated by the SAFE on August 27, 1987), art. 1.

⁶⁶ As is commonly known, China has been implementing the policy of foreign exchange control. Renminbi (Chinese currency) can not be converted freely. Therefore, the Chinese borrower needs to convert its own Renminbi capital into relevant foreign exchange in order to pay the overdue principal and interests of foreign debts once the borrower itself has not enough foreign exchange to do so.

⁶⁷ See, e.g., 'Q&A: Guangdong Deputy Governor Speaks on GITIC and Guangdong Enterprise', *supra* note 46; See also 'GITIC Interest Taxes Add Insult to Injury', *S. China Morning Post* (March 31, 2000), available at '2000 WL 14847846'.

bankruptcy proceeding⁶⁸ This drew strong criticism from foreign creditors⁶⁹ though individual depositors were paid out of provincial money rather than from the bankruptcy estate.⁷⁰

These criticisms to some extent are justifiable in view of the non-observance of the principle of equal treatment for all creditors. Besides, it was unlawful for GITIC to accept savings from natural persons as GITIC in nature is not a deposit-taking institution.⁷¹ Consequently, 'illegal' depositors, who were attracted by illegally high interest rates, should not have been protected.⁷² None the less, it should be acknowledged that there exists an unwritten, but deep-rooted, consideration for the Guangdong provincial government to pay individual depositors. Considering that China now lacks a deposit insurance system, it will inevitably lead to huge social unrest due to the failure to repay for individual depositors, which is undesirable for China's stability and solidarity.⁷³

B. Letters of Comfort

In many of the GITIC's borrowings and capital market transactions, foreign lenders were provided with so-called comfort letters by the Guangdong provincial government. In such letters, the Guangdong provincial government typically stated that it would supply all necessary support with respect to the repayment of principal and interests of loans.⁷⁴ Thereupon, it is not surprisingly that many foreign bankers,

⁶⁸ See e.g., 'Declared Bankruptcy: GITIC Cast Off Eventually', *Special Information (China)*, at 6 (1999).

⁶⁹ They insisted that since some parts of the announcement concerning the repayment in full (at least of principal) of individual depositors had already been honored, the rest of the promise should also be carried out. See Mark Landlers, 'China Gives Foreign Creditors A Rude 1999 Awakening', *N. Y. Times*, at 4 (January 12, 1999); See also T K Chang, *supra* note 51, at 44.

⁷⁰ *Supra* note 68.

⁷¹ See generally, Interim Regulations on Administration of Trust and Investment Institutions (promulgated by People's Bank of China in 1986).

See also Regulations on Saving Management of People's Republic of China (promulgated on Dec. 11, 1992 by the State Council of PRC (Order No.107), effective as of March 1, 1993), art. 8. This article stipulates that any units and individual shall not carry out the savings operation except the savings institutions'. Pursuant to art.4 of this Regulation, 'savings institutions' refer to various banks, credit cooperatives and postal units carrying on the savings business under the approval of the People's Bank of China and its branch. Therefore, GITIC should not belong to these categories of savings institutions.

Furtherly, Punishments for Financial Unlawful Dealings of People's Republic of China (promulgated on Feb. 22, 1999 by State Council of PRC, effective as of the same date), art. 28. (Providing that International Trust and Investment Companies (ITICs) shall not accept individual deposits and issue loans.)

⁷² Regulations on Savings Management of People's Republic of China, *supra* note 71, art. 5. This article provides that ownership and all other legal interests of individual depositors shall be protected. Inference from this article should be that 'illegal interests' should not be protected.

⁷³ Commercial Banking Law of People's Republic of China (adopted at the 13th. Meeting of Standing Committee of 8th. National People's Congress on May 10, 1995) has similar provisions on preferential rights of individual depositors. Art. 71(2) says that in the case of bankruptcy liquidation of commercial banks, after the payment of liquidation expenses, wages and labor insurance fees, principal and interests of individual savings shall be given priority.

⁷⁴ See 'Reexamination if GITIC Bankruptcy Case', *Supra* note 57, at 3 (1999); See also T K Chang, *supra* note 51, at 46.

who believed they were lending to the government other than commercial enterprise, reacted with such vehemence to the bankruptcy of GITIC.

Nevertheless, letters of comfort are not of the binding force that had been anticipated by foreign creditors in the legal sense, even though they morally bear effects to urge debtors to pay. More significantly, Chinese relevant laws and regulations have already prohibited government departments from providing guarantees on foreign debts for many years.⁷⁵ Thus, it was not easy for foreign creditors to claim on the basis of commitments indicated in these letters of comfort. This unsatisfactory situation results in part from non-normative conducts of local governments. At the same time, foreign creditors would have to pay the price for their unawareness of Chinese laws.⁷⁶

On the other hand, when GITIC borrowed money, it was billed as a company, which had close connections to Guangdong provincial government, key credentials in China where the government had not quite separated itself from its dominant economic role.⁷⁷ But now the situation has changed a lot.⁷⁸ China is becoming an economy that is run on market principles and even a company with a strong government linkage could collapse.⁷⁹ 'Too big to fail' has become a fairy tale in Chinese business history.⁸⁰ In this sense, there would be many positive implications from GITIC bankruptcy.⁸¹ At least, those investors often relying on undocumented guarantees from quasi-government sources should undoubtedly be wary after GITIC case.⁸²

⁷⁵ In accordance with the Notice of the State Council Regarding the Strengthening of Control over the Borrowing and Using of International Commercial Loans, issued on January 12, 1989, no governmental agency or institution shall provide foreign exchange guarantees to any foreign party. Moreover, pursuant to art. 8 of the Security Law of People's Republic of China (adopted at the 14 th. Meeting of 8 th. Standing Committee of National People's Congress, effective as of Oct.1, 1995), governmental units shall not provide guarantee for economic activities.

⁷⁶ In fact, China's central government never provided any explicit guarantees for GITIC, although local government in China in the past often interfered in the financial arena. See 'Nothing Could Help GITIC But Bankruptcy', *Special Information (China)*, at 6 (1999).

⁷⁷ The bankers felt specially comfortable with GITIC, where the ultimate borrower was a big provincial government, Guangdong no less, with its proximity to Hong Kong and its breakneck growth rate. See e.g., 'The Spectacular Rise and Fall of GITIC', *supra* note 44.

⁷⁸ See e.g., Jiang Zemin, 'Hold High the Great Banner of Deng Xiaoping Theory for an All-Round Advancement of the Cause of Building Socialism with Chinese Characteristics to the 21st Century' (Report Delivered at the Fifteenth National Congress of the Communist Party of China on Sep. 12, 1997), Part V, 'Economic Restructuring and Economic Development Strategy'.

⁷⁹ The Chinese government's current major reform move to allow bankruptcy of enterprises that fail to restructure, is proof that the government is standing by its policy. See e.g., 'What did GITIC Bankruptcy Signify?', *Special Information (China)*, at 7-8 (1999); See also 'Q&A: Guangdong Deputy Governor Speaks on GITIC and Guangdong Enterprise', *supra* note 46.

⁸⁰ Though it has not been widely published inside and outside China, but in the long term, China has clearly established that it will not fall into the moral hazard trap of rescuing badly run companies just because they are too big to fail. Chinese companies will no longer be able to obtain easy credit on the basis of opaque financial statements, personal connections (Guanxi) and vague comfort letters from their parent governmental authorities. See T K Chang, *supra* note 51, at 43; See also 'What did GITIC Bankruptcy Signify?', *ibid*.

⁸¹ See Vivian Chu, 'China Starts Long March to Securitization', *Emerging Market Debt Report*, March 6, 2000, available at '2000 WL 3958353'.

⁸² See Stephen H. Willard & Jr. Bonnie Weinstein, 'International Legal developments in Review: 1998 Business Regulation – International Investment, Development and Privatization', 33 *Int'l Law*, at 232-33 (1999).

C. Liquidation Committee and Avoidable Transaction

Under the EBL, the liquidation committee has broad powers in connection with the keeping, appraisal, disposition and distribution of the debtor's property in bankruptcy proceedings.⁸³ In terms of the composition of liquidation committee, the People's Court shall designate its members from among the superior departments in charge, government finance departments, other relevant departments and professional personnel.⁸⁴ In the GITIC case, the liquidation committee appointed by the Guangdong People's High Court was made up of representatives from PBOC, GITIC, the Guangdong provincial government, the Bank of China, GuangFa Securities, Peat Marwick Huazen and a PRC law firm as well.⁸⁵ But this composition produces such problems as possible conflicts of interest and fairness of liquidation procedure.⁸⁶

For instance, PBOC announcement ordered that the securities trading business of GITIC be transferred to GuangFa Securities, one of the leading securities firms in China.⁸⁷ But whether such transfer impaired the interests of whole creditors and then should be considered as an avoidable transaction or not remains an issue. According to the EBL, certain actions carried out during the six months period prior to bankruptcy will be deemed null and void, including private distribution or gratuitous transfer of property, irregular underselling of property and repayment of unmatured liabilities.⁸⁸ Accordingly, creditors might be able to lodge challenges against such transfer. However, given the fact that a representative of GuangFa Securities is on the liquidation committee, it was unlikely that such a challenge would be successful.⁸⁹

In addition to GuangFa Securities, another member of the liquidation committee came from the Bank of China, one of the largest creditors of GITIC, reportedly with total loans to GITIC of over \$50 million. Furthermore, the liquidation committee also includes officials from Guangdong provincial government, which is technically the owner of GITIC, as well as members of the former management of GITIC, all of whom arguably have conflicts of interest in getting repayment. This, together with the dominant role that is played by the liquidation committee, makes potential conflicts very likely to occur between the liquidation committee and the creditors' committee.⁹⁰

⁸³ Enterprise Bankruptcy Law, art. 24 (1).

⁸⁴ Enterprise Bankruptcy Law, art. 24 (2).

⁸⁵ See, e.g., Chang, TK, *supra* note 51, at 45.

⁸⁶ *Ibid.*

⁸⁷ See 'Commentary Analysis: China's Task Is Economic', *The Straits Times (Singapore)*, January 25, 1999, 'available at: 1999 WL 8244807'.

⁸⁸ Enterprise Bankruptcy Law, art. 35(1).

⁸⁹ Pursuant to 35(2) of the EBL, should bankruptcy enterprises have committed voidable transactions listed in the 35(1), the liquidation committee has the right to apply to the people's court to recover the property, which shall be added to the bankruptcy property.

⁹⁰ The Supreme Court Bankruptcy Opinions, *supra* note 12. These Opinions set forth many details on bankruptcy procedures and was explicitly cited by the chief judge in his statement that there would be conflicts between the

It is fair to say these latent unfair consequences are mainly attributable to the relevant provisions of the EBL, which bear the obvious imprints of a command economy and pay little attention to the requisite neutrality of the liquidation committee.

In addition, the GITIC case poses questions over how to maximize the assets of GITIC and improve recovery for the whole body of creditors⁹¹ These relate to the auction of GITIC assets, maintaining the GITIC as a going-concern, even substantive consolidation of the whole case.⁹² But these important issues go unanswered by the EBL, which leaves the Chinese courts at a loose end.

To include, the GITIC case demonstrates once more that Chinese bankruptcy systems are very ill-equipped and unprepared for market economy. Trial implementation is clearly no longer adequate. Chinese bankruptcy regime must keep abreast of international standards. In particular, the core issue, that is, how to realize real equality for whole creditors in bankruptcy proceedings must be considered and well dealt with. Hopefully, GITIC case could act as a catalyst for accelerating the reforms of Chinese bankruptcy systems.

IV. Future Developments: Reform and Cooperation

A. Reform of Chinese Bankruptcy Laws

1. *Necessity of reform*

As mentioned above, China is devoid of a cross-border system for the time being, which is unfitting for its economic role in the international community. But in fact, the reform of bankruptcy laws has been put on the national schedule for many years with China's transition from command economy to market economy.⁹³ China tried to

liquidation committee and the creditors' committee. For example, according to article 31 of the Opinion, should the plan for the distribution of assets proposed by the liquidation committee is not approved by the creditors' committee, the matter would be decided by the people's court.

⁹¹ As far as the methods of realizing assets are concerned, whether through auction on the open market or maintaining GITIC as a going-concern, difficulties would raise due to the restriction or prohibition of foreign ownership of GITIC's assets and shares because GITIC was a state-owned enterprise. GITIC held shares in numerous Chinese companies in the form of state or legal person shares, which generally may not be transferred to foreign parties. Under the existing regulations, it is also generally not possible for foreign parties to hold GITIC shares, because the state must hold an absolute majority or relative majority in all state-owned companies. See Peter P Farkas, 'Discipline in the marketplace', *CA Magazine*, (October 1, 1999), 'available at 1999 WL 13692026'; See also T K Chang, *supra* note 51, at 46.

⁹² GITIC headquarter and its three subsidiaries had been carried out by four bankruptcy proceedings separately. At a practical level, it is likely that substantive consolidation might be able to benefit the whole creditors since it removes all inter-company claims. For the elaboration of substantive consolidation in insolvency proceedings, See Christopher K. Grieson, 'Shareholder Liability, Consolidation and Pooling', in *Current Issues in Cross-Border Insolvency and Reorganization*, *supra* note 39, at 217-24, 1994.

⁹³ See e.g., Jiang Zemin, *supra* note 78, part V. 'Economic Restructuring and Economic Development Strategy'

constitute a new bankruptcy law since early 1994 and completed its draft in late 1995⁹⁴, but without passage by the National People's Congress until now. In March 1999, the PRC Constitution was amended to incorporate the rule of law as a guiding principle for governance of the country.⁹⁵ In support of the Government's economic reform policy, one of the objectives of the Chinese legislative program is to enact a new bankruptcy law, which will be appropriate for a market economy and essential to ensure the efficient and productive use of resources. The new bankruptcy law has been given priority for adoption in 1999-2001.⁹⁶

The scope of proposed new law covers consumers and all business entities, including state, private and foreign-related enterprises.⁹⁷ Many of its articles are drawn directly from foreign advanced bankruptcy system, with an attempt to bring China's bankruptcy legislation in line with international standards.⁹⁸ But regrettably, cross-border bankruptcy issues are still ill-considered in this proposed new law even if it is much more comprehensive and well thought-out. It is inadvisable for China to continue to neglect this important field. In order to attract more foreign investment and accelerate economic growth, China wishes to maintain a favorable image in the eyes of the international community. When foreign investors decide whether or not to invest in the potentially lucrative Chinese market, it is necessary for them to analyze Chinese legal system, which to a large extent determines attractiveness of an investment market.⁹⁹ One of such considerations entails the protections offered to debtors and creditors by bankruptcy systems.¹⁰⁰ It is, therefore, critical for China to develop relevant laws, which are both adequate and able to deal effectively with cross-border insolvency problems for the interests of all parties involved.¹⁰¹

2. Reference for Reform

It should be helpful for China to use successful international experience for reference in preparing its cross-border bankruptcy legislation. The UNCITRAL Model Law and EU Regulation could provide fertile examples in this respect.

(standardizing the bankruptcy procedure).

⁹⁴ See Josephine Ma, 'Revised Bankruptcy Law Closer to Reality', *S. China Morning Post*, Nov. 2, 1995, at 12.

⁹⁵ The Constitution Law of the People's Republic of China (adopted on December 4, 1982, amended on March 15, 1999), art. 5 (1). This article provides that the People's Republic of China implements the rule of law and builds socialism democracy.

⁹⁶ As for the overall economic legislation reform for market economy in China, See e.g., 'Law and Policy Reform at the Asian Development Bank', 2000 Edition, Vol. I, at 4 (April 2000).

⁹⁷ See Josephine Ma, 'New Bankruptcy Law Seen as a Bold Reform', *S. China Morning Post*, Nov. 3, 1995, at 5.

⁹⁸ Vivien Pik-Kwan Chan, 'NPC Date for Bankruptcy Legislation', *S. China Morning Post*, Oct. 11, 1995, at 10.

⁹⁹ See Richard C. Breeden, 'The Globalization of Law and Business in the 1990's', *28 Wake Forest L. REV.*, at 515(1993).

¹⁰⁰ *Ibid.*

¹⁰¹ See Ronald Winston Harmer, 'Insolvency Law and Reform in the People's Republic of China', *64 Fordham L. Rev.*, at 2574 (1996).

As the product of a negotiation process involving more than 40 countries that represent a wide spectrum of varying legal traditions,¹⁰² The Model Law¹⁰³ comprises a well-balanced set of rules, thereby offering the best prospects of solution to the cross-border insolvency fiasco.¹⁰⁴ With the essential purpose of producing a uniform standard for recognizing foreign insolvency proceedings and facilitating cooperation across the borders,¹⁰⁵ the Model Law aspires to give rise to uniformity of approach in a range of key matters concerned with cross-border insolvency cases.¹⁰⁶ Enacting the Model Law by many States will greatly facilitate international trade and investment as doing so leads to more confidence among investors, traders and bankers.¹⁰⁷ Thus far, the Model Law is adopted in Mexico¹⁰⁸ and Eritrea and enjoyed widespread support in several states, including USA,¹⁰⁹ UK,¹¹⁰ Australia,¹¹¹ New Zealand,¹¹² South Africa,¹¹³ etc. In support of this effort, many jurists and attorneys have participated in the development of new bankruptcy laws and procedures, especially in Eastern Europe and the Pacific Rim.¹¹⁴

In addition to the Model Law, the EU Regulation is an important attribution for the harmonization of cross-border insolvency irrespective of its regional limitation. The predecessor of EU Regulation is EU Convention on Insolvency Proceedings,¹¹⁵

¹⁰² World Bank Consultation Draft, 'Effective Insolvency Systems: Principles and Guideline', Part III: International Considerations, at 127.

¹⁰³ The United National Commission on International Trade Law adopted the Model Law on Cross-Border Insolvency on May 30, 1997, after spending lots of time in debating and refining the draft produced by the Working Group. See e.g., 'Report of the United Nations Commission on International Trade Law on the Work of Its Thirtieth Session', *U. N. Gaor*, 52nd Sess., Supp. No. 17, at 5.

¹⁰⁴ See Ian F. Fletcher, *Insolvency in Private International Law*, at 369 (1999); See also Claudia Tobler, 'Managing Failure in the New Global Economy: The UNCITRAL Model Law on Cross-Border Insolvency', 22 *B. C. Int'l & Comp. L. Rev.*, at 384 (1999).

¹⁰⁵ See UNCITRAL Model Law on Cross-Border Insolvency: Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency' (hereinafter 'Guide to Enactment of Model Law'), 1997 XXVII UNCITRAL Y.B. pt. 3, 2, UN Doc. A/CN. 9/442, available at <http://www.uncitral.org/english/texts/insolven/ml+guide.htm>; See also Andre J. Berends, 'The UNCITRAL Model Law on Cross-Border Insolvency: A Comprehensive Overview', 6 *Tul. J. Int'l & Comp. L.*, at 311(1998).

¹⁰⁶ See Ian F. Fletcher, *supra* note 104, at 330.

¹⁰⁷ See Andre J. Berends, *supra* note 105, at 399.

¹⁰⁸ On 26 April 2000, Mexico adopted the new Bankruptcy Law in which enacts the UNCITRAL Model Law.

¹⁰⁹ In the USA, the text of enacting the Model Law has been proposed as a new chapter, Chapter 6 to the Bankruptcy Code. The bill containing these changes is the "Bankruptcy Reform Act", which failed to be passed in 1998 and 2000 by the Congress. Now, it is more likely that the enactment of the Model Law will be submitted as a separate bill to the Congress for passage in the near future.

¹¹⁰ In the UK, the Insolvency-Bill 2000 includes an enabling clause to authorize the Lord Chancellor, by means of a statutory instrument, to give effect to the Model Law. For this purpose, the application of insolvency law and any provision of Section 426 Insolvency Act 1986 should be amended. See Insolvency Bill [H.L.], available at <<http://www.parliament.the-stationery-off/pa>>.

¹¹¹ Australia has contributed to the relevant UNCITRAL deliberations and is considering possible adoption of the Model Law. See Rosalind Mason, 'Implications of the UNCITRAL Model Law for Australian Cross-Border Insolvencies', *Int. Insol. Rev.*, Vol. 8: 83-108, at 83 (1999).

¹¹² The Model Law has already been adopted by New Zealand (although not implemented).

¹¹³ South Africa Law Commission drew out the Interim Report on Review of the Law of Insolvency (The Enactment in South Africa of UNCITRAL Model Law on Cross-Border Insolvency) for the legislative consideration of adoption. See South Africa Law Commission, project 63, June 1999, ISBN: 0-621-29300-8.

¹¹⁴ See Christopher J. Redmond, 'Offshore Estate Planning: Haven for International Insolvency Litigation', 17-OCT *Am. Bankr. Inst. J.*, at 12 (1998).

¹¹⁵ The European Union Council of Ministers established a working group to propose an insolvency Convention in

which is widely viewed as a milestone of four decades' efforts in Europe to harmonize cross-border insolvency.¹¹⁶ Though stalled on the non-cooperation with Europe from UK,¹¹⁷ EU Convention has recently been resurrected as a Regulation and adopted by the EU Council of Ministers on 29 May 2000 with entry into force on 31 May 2002.¹¹⁸

The Model Law was designed not only for jurisdictions that currently have to deal with numerous cross-border insolvency cases, but also those that desire to be well prepared for the increasing possibility of such cases.¹¹⁹ China has played a role in the negotiation of the Model Law. Although there may be a long way to go before China enacts it, it is strongly recommended that China should take the Model Law earnestly into account in preparing laws and procedures for cross-border bankruptcy. Besides, it is worthwhile to pay suitable attention to the EU Regulation since the Model Law does not purport to provide a comprehensive solution to all – or even most – of the problems encountered in this context.¹²⁰

B. Enhancement of International Cooperation

As is commonly stated, international cooperation in cross-border insolvency is indispensable with successful solution to these cases. Such cooperation should be of paramount significance to prevent dissipation of assets and maximize the value of assets.¹²¹ It has been observed from several cases discussed in part II, Chinese courts are currently unprepared for the consciousness of cooperation, not to mention the practice and experience in this field. Thereby, in its efforts to develop bankruptcy law infrastructure, as a critical tache, China needs to foster the spirit of cooperation with foreign courts, which has been driven by general trends in international practice. There are several basic issues regarding international cooperation in cross-border

1989. As the production of this group, EU Convention opened for signature on Nov. 23, 1995. The text of EU Convention can be found at 35 *I. L. M.* 1223 (1996). EU Convention has been considered as a continuation of the earlier EEC Draft Convention. See, e.g., Ian F. Fletcher, 'International Insolvency: A Case for Study and Treatment', 27 *Int'l Law.*, at 439 (1993).

¹¹⁶ In fact, various European countries have been struggling for more than 40 years to establish an insolvency treaty. See Leslie A. Burton, 'Toward An-International Bankruptcy Policy in Europe: Four Decades in Search for of A Treaty', 5 *Ann. Surv. Int'l & Comp. L.*, at 217 (1999).

¹¹⁷ The reason for the UK's rejection to be member state of EU Convention mainly exists in two aspects: one is "Mad Cow Disease", the other is the debate between Spain and UK about the public authority in Gibraltar. See generally, Andre J. Berends, *supra note* 105, at 317-18; See also Bob Wessels, 'Primer on the New European Insolvency Framework', 17-*AUG Am. Bankr. Inst. J.*, at 12 (1998). For more details about the Gibraltar syndrome, See Ian F. Fletcher, *supra note* 104, at 298-300.

¹¹⁸ See Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, Official Journal of the European Communities, L 160, available at <http://europa.eu.int/eur-lex/en/dat/2000/l-160/l-16020000630en/00010018.pdf>.

¹¹⁹ See Guide to Enactment of Model Law, *supra note* 105, para. 3.

¹²⁰ World Bank Consultation Draft, *supra note* 102, at 125.

¹²¹ Today, there are not many legislative systems that provide legal bases for cooperation. The aim of Chapter IV is to fill this gap. See Andre J. Berends, *supra note* 105, at 378.

insolvency cases to be discussed here.

1. Universality versus Territoriality

Universality and territoriality are two principal viewpoints as regards the effective way to handle cross-border insolvencies.¹²² In general terms, the universality upholds that one central forum globally administers the bankruptcy of a debtor with the assistance and cooperation of foreign courts.¹²³ The contrasting territoriality principle, associated with the “grab rule”,¹²⁴ stresses the rights of local, creditors and follows the strict rule of sovereignty.¹²⁵ Although modern cases indicate a strong and growing advocacy towards universality,¹²⁶ territoriality is historically the predominant philosophy endorsed by many States.¹²⁷

So far as theoretical bases are concerned, the Model Law has a goal based on universality by promoting the recognition, assistance and co-operation between states with no reciprocity requirement.¹²⁸ But it does not strive to create a pure universality regime in which in which one insolvency proceeding necessarily dominates.¹²⁹ The Model Law can be correctly characterized as an example of “modified

¹²² See e.g., Ian F. Fletcher, *supra* note 104, at 10; See also Blom-Cooper, *Bankruptcy in Private International Law*, 11-12, 14-17 (1954); John D. Honsberger, ‘Conflict of Laws and the Bankruptcy Reform Act of 1978’, *30 Case W. Res. L. Rev.*, at 633-35 (1980); Timothy E. Powers & Rona R. Mears, ‘Protecting a Debtor’s Assets in International Bankruptcy: A Survey and Proposal for Reciprocity’, *10 N. C. J. Int’l & Com. Reg.*, at 305-07(1985); Barbara K. Unger, ‘United States Recognition of Foreign Bankruptcies’, *19 Int’l Law*, at 1154-55(1985); Jay L. Westbrook, ‘Choice of Avoidance Law in Global Insolvency’, *17 Brook. J. Int’l L.*, at 512-19 (1991); Jay L. Westbrook & Emmanuel Gaillard, ‘Four Models for International Bankruptcy’, *41 Am. J. Comp. L.*, at 573 (1994).

¹²³ See e.g., The American Law Institute, *Transnational Insolvency Project: Principles of Cooperation in Transnational Insolvency Cases Among the Members of the North American Free Trade Agreement*, Tentative Draft, at 11 (2000).

¹²⁴ The principle of territoriality might motivate “diligent” creditors to grab the debtor’s assets situated in foreign countries. See Junichi Matsushita, ‘Present and Future of Japanese International Insolvency Law’, *33 Tex. Int’l L. J.*, at 75 (1998); See also Barbara K. Unger, *supra* note 122, at 1155; John D. Honsberger, *supra* note 122, at 634-35.

¹²⁵ See Harold S. Burman, ‘Harmonization of International Bankruptcy Law: A United States Perspective’, *64 Fordham L. Rev.*, at 2552 (1996); See also Daniel M. Glosband & Christopher T. Katucki, ‘Claims and Priorities in Ancillary Proceedings under Section 304’, *17 Brook. J. Int’l L.*, at 480.

¹²⁶ See Jay Lawrence Westbrook, *supra* note 3, at 750-51.

¹²⁷ See Harold S. Burman, *supra* note 125, at 2551-52; See also Jay Lawrence Westbrook, *supra* note 3, at 748. There is a recent vigorous defense of a cooperative form of territoriality as well. See Lucian Arye Bebchuk & Andrew T. Guzman, ‘An Economical Analysis of Transnational Bankruptcies’, *42 J. L. & Econ.*, at 806 (1999). This paper has identified the winners and losers from territoriality. The author came to the conclusion that even though territoriality reduces overall global welfare, a country may benefit from territoriality at the expense of foreign firms. In another article, the author examined five kinds of system for international insolvency cooperation and concluded that universalism is unworkable. Rather, territorialism provides the best foundation for international cooperation. See Lynn M. LoPucki, ‘Cooperation in International Bankruptcy: A Post-Universalist Approach’, *84 Cornell L. Rev.*, at 696 (1999).

¹²⁸ See New Zealand Law Commission (NZLC) Report 52, ‘Cross-Border Insolvency: Should New Zealand Adopt the UNCITRAL Model Law on Cross-Border Insolvency?’ Part 1: Para.8, available at <<http://www.lawcom.govt.nz/CrossBorder/R52con.htm>>.

¹²⁹ This deference to local proceedings was a political necessity. See New Zealand Law Commission (NZLC) Report 52, *supra* note 128, Part 1: Para.27; See also Glosband and Tobler, ‘Cross-Border Insolvencies’, in *Bankruptcy Court Judicial Forum '98* (Massachusetts Continuing Legal Education), at 12 (1998).

universalism”¹³⁰ or “cooperative territoriality”.¹³¹ Similarly, the EU Regulation establishes a modified rather than pure universality theory, blending a “framework of member state cooperation” with recognition of the “unique aspects of member state’s laws”¹³² These two instruments conform to a recent trend, which began to emerge in the theory and practice of cross-border insolvency and could be termed ‘new pragmatism’ mainly because it has been developed from the practical insights into cross-border insolvency.¹³³

Following the traditional way of thinking, it is also necessary to determine whether Chinese bankruptcy legislation adheres to the principle of territoriality, or to the principle of universality. This distinction seems so important that it is commonly considered to reflect the basic attitudes towards cross-border insolvency.¹³⁴ There are varying theoretical arguments in China, such as territoriality,¹³⁵ restricted territoriality,¹³⁶ mutual recognition,¹³⁷ and universality,¹³⁸ with a particular focus on the extraterritorial effects of bankruptcy proceedings. Chinese current legislation remains unanswered to this issue but territoriality seems to be the dominant consideration in judicial practice. According to the Draft Bankruptcy Law of the P. R. of China, the bankruptcy, reconciliation and reorganization proceedings commenced outside China shall be no effect against the debtor’s assets located within China.¹³⁹ With respect to the effect of bankruptcy proceedings opened by Chinese courts against debtor’s assets located in foreign jurisdiction, this draft remains silent.

On the whole, this kind of self-closure runs counter to the cooperation trend of modern cross-border insolvency. In devising its principle, with an eye to the disparity between idealism and realism, the new pragmatism seems calculated best to satisfy the main purpose of cross-border insolvency proceedings although the universality should ideally be the preferred solution to these cases. Indeed, for any insolvency law to function, a suitable blend of principle and pragmatism is always workable. The same degree of pragmatism should be alive and well for China. This pragmatism should lay emphasis especially on the need to facilitate the most efficient and

¹³⁰ See New Zealand Law Commission (NZLC) Report 52, *supra* note 128, Part 1: Para.17.

¹³¹ See Matthew T. Gronin, ‘UNCITRAL Model Law on Cross-Border Insolvency: Procedural Approach to A Substantive Problem’, 24 *J. Corp. L.*, at 711 (1999).

¹³² See Leslie A. Burton, *supra* note 116, at 217-19; See also Bernard Schollmeyer, ‘The New European Convention on International Insolvency’, 13 *Bankr. Dev. J.*, at 437(1997).

¹³³ World Bank Consultation Draft, *supra* note 102, at 126.

¹³⁴ See Manfredi Burgio, ‘Cross-Border Insolvency – An Italian Approach’, *Int’l Insol. Rev.*, Vol. 8: 39-47, at 40 (1999).

¹³⁵ See Zhang Weiping, *Introduction to Bankruptcy Proceedings* (Chinese), China Politics and Law University Press, at 189 (1993).

¹³⁶ See Hu Zeen, ‘Bankruptcy Legislation for Foreign-Related Enterprises and Extraterritoriality Effect of Bankruptcy Declaration’, *Legal World* (China), No. 2, 1989, at 23 (1989).

¹³⁷ See Tang Weijian, ‘On Cross-Border Insolvency’, *Journal of Comparative Law* (China), Vol.2, 1995, at 124.

¹³⁸ See Ke Shanfang, *Introduction to Bankruptcy Law* (Chinese), Higher Education Press, at 167 (1988).

¹³⁹ The Draft Bankruptcy Law of the People’s Republic of China (the second edition), article 8.

cost-effective administration of the debtor's estate,¹⁴⁰ which is most concerned by all parties in insolvency proceedings.¹⁴¹ From a practical view, the notion of pragmatism offers a bridge between the competing doctrinal schools of territoriality and universality and strikes a balance between the protection of Chinese national interests and international economic cooperation. Seen from the current legislation, there should be no legal conflicts and barriers for China's adopting this approach.

2. Jurisdiction to Open Insolvency Proceedings

Jurisdiction is a very sensitive and complex issue since it is so easy to generate positive conflicts of jurisdiction in cross-border insolvency cases. Accordingly, it is a precondition of international cooperation to determine which courts and to which extent has jurisdiction to insolvency cases.

As is commonly pointed out, in the modern era of cross-border insolvency, there has been a consistent tendency favoring the grant of primary jurisdictional competence to the courts of the state where the debtor's center of main interests is located.¹⁴² Both the Model Law and EU Regulation establish a powerful demonstration of this worldwide trend,¹⁴³ furtherly distinguishing between main and non-main insolvency proceedings.¹⁴⁴ A main proceeding takes place where the debtor has the center of its main interests.¹⁴⁵ There being no explicit definition as to 'center of main interests', the Model Law and EU Regulation employ a rebuttable presumption that for a company or legal person/entity, the center of its main interests shall be the place of its registered office.¹⁴⁶

Under the EBL, the people's court where the registered office of the debtor is located shall have jurisdiction to open the bankruptcy proceeding.¹⁴⁷ But this jurisdiction can be exercised only against the SOEs. With respect to other enterprises, including foreign-related enterprises, the CPL empowers the people's court where the debtor is domiciled to exercise jurisdiction.¹⁴⁸ Pursuant to article 39 of the General

¹⁴⁰ World Bank Consultation Draft, *supra* note 97, at 127.

¹⁴¹ See Thomas M. Gaa & Paula E. Garzon, 'International Creditor's Rights and Bankruptcy', 31 *Int'l Law*, at 273 (1997); See also Charles D. Booth, 'A History of the Transnational Aspects of United States Bankruptcy Law Prior to the Bankruptcy Reform Act of 1978', 9 *B. U. Int'l J.*, at 36-37 (1991).

¹⁴² World Bank Consultation Draft, *supra* note 102, at 128.

¹⁴³ See Ian Fletcher & Hamish Anderson, 'Cross-border Security and Insolvency: The Insolvency Issues', unpublished paper presented at *The Oxford Law Colloquium* 4-6 April 2000, at N18.

¹⁴⁴ See UNCITRAL Model Law, art 2 (c) ("foreign non-main proceeding"); art 2 (b) ("foreign main proceeding"). This distinction reflects the underlying goal of resolving cross-border insolvency by establishing one primary proceeding that is accompanied by various secondary, or ancillary, proceedings in other jurisdictions. See also Guide to Enactment of Model Law, *supra* note 105.

¹⁴⁵ UNCITRAL Model Law, art 2 (b).

¹⁴⁶ UNCITRAL Model Law, art. 16 (3); EU Regulation (draft), art. 3 (1).

¹⁴⁷ Enterprise Bankruptcy Law, art. 5.

¹⁴⁸ Civil Procedure Law, *supra* note 11, art. 205.

Principle of Civil Law of P R of China,¹⁴⁹ the domicile of a legal person shall be the location of its main office. Therefore, the basic notion of insolvency jurisdiction in Chinese laws is consistent with the Model Law and EU Regulation though the concept of main interest center has not been established in China.

However, the most important and difficult thing lies mainly in the determination of real center of debtor's main interests, especially when the debtor is transnational corporation that invests in many jurisdictions. The registered office may be located in a sunny tax haven where the debtor has only a postbox and nothing else. The debtor's actual center of interests may locate within other state so as to generate relevant interests and expectations wherein based upon the local law.¹⁵⁰ China particularly concerns about this situation. The main interest center of transnational corporation is often considered to situate in other jurisdictions but it carries on business in China. The Model Law and EU Regulation introduce the concept of establishment to solve this problem.¹⁵¹ The jurisdiction to open non-main proceedings should be exercised on the basis of establishment owned by debtor.¹⁵² The effect of the non-main proceeding is restricted to the assets of the debtor situated within local territory. This deference to local proceedings accommodates China's concern about potentially over-intrusive foreign proceedings dominating local bankruptcy system.

Another issue may be resulted from the virtually broad jurisdiction of Chinese courts to commence bankruptcy cases. For example, the enterprises without domicile in China shall also be subject to the jurisdiction of Chinese courts on the basis of presence of assets, representative office and subject matter in China.¹⁵³ It is, therefore, relatively easy for Chinese court to exercise jurisdiction on the bankruptcy of foreign-related enterprises. But to put it in the context of cross-border insolvency, it is likely to give rise to conflicts between this broad jurisdiction and the widely recognized principles of international jurisdiction. It seems that suitable jurisdictional self-restrictions are necessary to facilitate the cooperation between Chinese and foreign courts in solving cross-border insolvency cases.

¹⁴⁹ The General Principles of Civil Law of P. R. of China was adopted by the National People's Congress on April 12, 1986, effective as of January 1, 1987. China now is on the way of preparing a new Code of Civil Law.

¹⁵⁰ See Andre J. Berends, *supra note* 105, at 330.

¹⁵¹ UNCITRAL Model Law, art. 2 (f) (definition of "establishment"); art. 17(2) (b) (stating that the foreign proceeding shall be recognized as a foreign non-main proceeding if the debtor has an establishment in the foreign state).

EU Regulation (draft), art. 2 (h) (definition of "establishment"), art. 3 (2) (stating that the courts of another Member States shall have jurisdiction to open insolvency proceedings against that debtor only if he possesses an establishment within the territory of that other Member State).

¹⁵² UNCITRAL Model Law, art. 17(2)(b).

¹⁵³ Civil Procedure Law, *supra note* 11, art. 243.

3. Recognition and Assistance in Insolvency Proceedings

Given the Model Law and EU Regulation do not adopt pure universality, it is essential to devise a framework under which cooperation among different proceedings could be run well. The Model Law seeks to achieve this purpose mainly by focusing on procedural matters such as recognition, access and cooperation between courts and representatives but no reciprocity requirements.¹⁵⁴ In particular, The ease of court access by both foreign representatives and creditors constitutes a commendable aspect of the Model Law.¹⁵⁵

The Model Law provides under which circumstances a foreign proceeding shall be recognized.¹⁵⁶ Accordingly, it comprises two types of effects upon recognition. The first type is automatic from recognition itself,¹⁵⁷ which is necessary to organize an ordered and fair cross-border insolvency proceeding. The second type of effect only occurs upon court order.¹⁵⁸ When concurrent, fully-fledged local insolvency proceedings exist,¹⁵⁹ the Model Law mandates judicial cooperation rather than merely encourages it.¹⁶⁰ The Model Law addresses cooperation of courts of the enacting State with foreign courts or foreign representatives,¹⁶¹ the cooperation of domestic representatives with foreign courts and foreign representatives,¹⁶² and the forms through which cooperation can be implemented.¹⁶³

When a cross-border insolvency involving China arises, there are at least two probabilities concerning recognition and cooperation. Firstly, a Chinese court may seek assistance from a foreign court for the purpose of enabling the liquidation committee to fulfil duties under Chinese laws. Secondly, a foreign court might request assistance from a Chinese court with similar purposes. Once China enacts the Model Law, Chinese courts will be required to recognize and --subject to their discretion-- to give assistance to a foreign representative, with a number of significant effects following automatically upon such recognition.¹⁶⁴

¹⁵⁴ See Guide to Enactment of Model Law, *supra* note 105. (stating that the Model Law does not attempt a substantive unification of insolvency law); See also Matthew T. Cronin, *supra* note 131, at 710; Andre J. Berends, *supra* note 105, at 321-22.

¹⁵⁵ The Model Law allows a foreign representative to directly apply for recognition of a foreign insolvency proceeding. UNCITRAL Model Law, art. 15 (1). See Thomas M. Gaa & Paula E. Garzon, 'International Creditors' Rights and Bankruptcy', 31 *Int'L Law*, at 275 (1997); see also Claudia Tobler, *supra* note 104, at 421-22 (1998).

¹⁵⁶ UNCITRAL Model Law, art. 17 ("decision to recognize a foreign proceeding").

¹⁵⁷ UNCITRAL Model Law, art. 20 (1).

¹⁵⁸ See Andre J. Berends, *supra* note 105, at 350.

¹⁵⁹ Concurrent proceedings can have many forms. For a list of various types of concurrent proceedings, See Andre J. Berends, *supra* note 105, at 385-87.

¹⁶⁰ See Guide to Enactment of the Model Law, *supra* note 105, at para. 173-74.

¹⁶¹ UNCITRAL Model Law, art. 25.

¹⁶² UNCITRAL Model Law, art. 26.

¹⁶³ UNCITRAL Model Law, art. 27.

¹⁶⁴ UNCITRAL Model Law, art. 17, art. 20-24.

This recognition and assistance relates to the basic attitudes of China towards foreign-related civil procedures. The 1991 Civil Procedure Law and accompanying judicial interpretation devote several provisions to this issue¹⁶⁵ According to relevant provisions, Chinese current civil procedures actually interpose some obstacles in respect of the cooperation between courts at home and abroad For instance, when there exists an effective bankruptcy judgment made by a foreign court, but without judicial assistance agreement and reciprocity relations among the said foreign States and China, the foreign liquidator should approach a competent Chinese court and file a separate case. Chinese courts shall then review and examine the foreign judgments in order to decide whether it is contrary to Chinese public interests or not to recognize its effects. Strictly speaking, this is a sort of separate adjudgment made by Chinese courts, not involving recognition foreign proceedings. The foreign bankruptcy judgment actually plays a role as a cause of action for the lawsuit of a foreign liquidator before the Chinese courts.¹⁶⁶

In addition, it should be noted that the principle, which shall be abided by the Chinese courts for its examination of foreign judgment, involves reciprocity requirements. In the event that a court of a foreign state which has no relation with China based on treaties of judicial assistance involving, reciprocity, requires direct assistance and cooperation from a Chinese court, it shall not be sanctioned unless these requirements are conducted by suitable diplomatic measures.¹⁶⁷ These provisions show unarguable disparities between Chinese current legislation and the framework of the Model Law. There should be necessary revision to be made correspondingly so as to adapt Chinese domestic laws to the Model Law.

V. Conclusion

As the largest emerging market in the world, China has attracted numerous investors from many developed countries.¹⁶⁸ Consequently, at a practical level, it is more likely that Chinese entities become more and more embroiled in cross-border insolvencies with a robust growth of foreign-related enterprises in China, especially in southern China. The Chinese bankruptcy laws in their current state, however, are vague and underutilized, so are cross-border bankruptcy aspects. Historically, the EBL and relevant regulations were tailored exclusively for the requirements of a command economy instead of a market economy. None the less, it is necessary that bankruptcy

¹⁶⁵ Civil Procedure Law, *supra* note 11, art. 268; The Supreme Court CPL Opinions, *supra* note 12, art. 318.

¹⁶⁶ See Shi Jingxia, *supra* note 41, at 122.

¹⁶⁷ The Supreme Court CPL Opinions, *supra* note 12, art. 319.

¹⁶⁸ See Steven L. Seebach, *supra* note 17, at 351(1995).

legislation shall be at the forefront of the change, given that China now continues on a path toward deepening economic reform and marketization.¹⁶⁹

Internationally accepted cross-border insolvency norms by all means should be needed urgently in China. Moreover, it is preferable for China to enact modern cross-border insolvency laws before major problems occur. But in any case, it is also very crucial to strike a necessary balance between the need for China to regulate economic activity within its territorial boundaries and the need to create a positive environment in which international trade and investment can operate. Or else, a modern bankruptcy law may be just nominal presence and will not work well in actual cases.

The golden ages come with the increasing popularity of current initiatives on cross-border insolvency, especially the Model Law and EU Regulation. The Model Law and EU Regulation are designed to serve separate but compatible objectives,¹⁷⁰ reflecting the modern trend on the cross-border insolvency. They deserve to be employed as helpful reference for China to prepare its own bankruptcy law. Firstly, it is recommended that China should give every consideration to the possibility of incorporating the provisions contained within the Model Law into its future bankruptcy law. Secondly, regards may be given to the suitability of the provisions found within the EU Regulation, to serve as a basis for possible adaptation into Chinese framework of rules for use.¹⁷¹ More importantly, China should be aware of the potential problems and ensure the Model Law has the maximum effect in China's context. In achieving this goal, it is necessary for China to examine closely its existing bankruptcy-related legislation so as to eliminate potential conflicts with the Model Law.

¹⁶⁹ See Shirley S. Cho, *supra* note 15, at 762.

¹⁷⁰ See Ian F. Fletcher, *supra* note 104, at 370.

¹⁷¹ Although the EU Regulation is regionally-based instrument, it is intended to operate in a cross-border environment between jurisdictions which belong to different legal traditions, and which quite possibly subscribe to different philosophical and policy approaches to matters of insolvency.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

Practical Issues Arising from Hong Kong SAR Insolvency Proceedings of Companies with Assets in Mainland China

Mark Hyde

UNIVERSITY OF HONG KONG FACULTY OF LAW &
THE ASIAN INSTITUTE OF INTERNATIONAL FINANCIAL LAW

CHINESE INSOLVENCY LAW SYMPOSIUM

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Mark Hyde, Partner,
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- The winding-up of Hong Kong incorporated companies
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The GITIC HK experience

- two separate legal entities
- the rationale for the establishment of GITIC Hong Kong
- the lack of substantive consolidation
- particular issues for creditors
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 - attempts to steal a march by taking court action in Hong Kong against GITIC



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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Commentator

**A Commentary on Cross-Border
Insolvency Issues**

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CHINESE INSOLVENCY LAW SYMPOSIUM:

DEVELOPING AN INSOLVENCY INFRASTRUCTURE

A Commentary on Cross-Border Insolvency Issues

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A Commentary on Cross-Border Insolvency Issues¹

Introduction

The New Zealand Law Commission² is currently involved in the review of New Zealand's insolvency law. To date, two substantive reports have been presented by the Commission: first, *Cross-Border Insolvency: Should New Zealand Adopt the UNCITRAL Model Law on Cross-Border Insolvency?*³; second, *Priority Debts in the Distribution of Insolvent Estates*⁴. The latter was an advisory report prepared for the Ministry of Commerce (as the Ministry of Economic Development was then known). The Ministry of Economic Development is the lead Ministry for insolvency law in New Zealand.

As part of the Commission's involvement with the reform of New Zealand insolvency law, I had the privilege of attending the December 1999 session of the United Nations Commission on International Trade Law's [UNCITRAL] Working Group on Insolvency Law as a New Zealand delegate. I draw on that experience when discussing one of the topics upon which I have chosen to comment; viz the direction of UNCITRAL's future work on UNCITRAL law.

¹ By Paul Heath QC, Hamilton, New Zealand; Commissioner, New Zealand Law Commission, Wellington, New Zealand. The views expressed do not necessarily reflect the views of the Commission.

² The Law Commission was established by the Law Commission Act 1985. Deliberately the word "reform" was omitted from its name. The functions of the Commission are set out in s 5(1); the principal functions are (a) to take and keep under review in a systematic way the law of New Zealand; (b) to make recommendations for the reform and development of the law of New Zealand; (c) to advise on the review of any aspect of the law of New Zealand conducted by any Government department or organisation and on proposals made as a result of the review; (d) to advise the Minister of Justice on ways in which the law of New Zealand can be made as understandable and accessible as is practicable. In making its recommendations the Commission is obliged to take into account te ao Maori (the Maori dimension) and to give consideration to the multi-cultural character of New Zealand society; in addition, the Commission must have regard to the desirability of simplifying the expression and content of the law, so far as that is practicable: s 5(2). Unlike many other similar bodies, the Commission can self-refer projects: under s 6(2)(a) and (b) the Commission has power to initiate proposals for the review, reform or development of any aspect of the law of New Zealand and to receive and consider proposals made or referred to it by any person. It may also initiate sponsor and carry out such studies and research as it thinks expedient for the proper discharge of its functions.

³ NZLC R 52, February 1999. This report is available on the Commission's website <http://www.lawcom.govt.nz> under the heading "Publications".

⁴ NZLC SP 2, October 1999; this Study Paper is available on the Commission's website <http://www.lawcom.govt.nz> under the heading "Publications".

This Symposium addresses cross-border insolvency issues at two quite distinct levels. First, there are the particular issues of cross-border insolvency involving the Hong Kong Special Administrative Region and the People's Republic of China. When addressing that issue it is necessary to have regard to matters which would affect an approach to domestic insolvency law reform. The second issue, however, is wider in its scope. It concerns the direction of future international work about to be undertaken by UNCITRAL on insolvency law and the factors to which reference should be made when considering insolvency law from an international perspective.

It is helpful to consider the two issues together because the factors which are relevant to domestic insolvency law reform can be compared to the factors which should be taken into account at an international level. A joint consideration of the issues also tends to focus upon common goals and the need for domestic laws to work adequately within what has become a truly global market place.

This commentary addresses two issues: viz

- A. An approach which could be taken by UNCITRAL in its future work on insolvency law which would both encourage greater harmonisation in the use of insolvency regimes yet assist States to tailor domestic insolvency laws to meet their own economic, legal, commercial, social and cultural needs.⁵
- B. Whether there are any lessons to be learnt from the recent judgments of the Courts of the Hong Kong Special Administrative Region in the *Chen Li Hung*⁶ litigation which involved an attempt by trustees in bankruptcy appointed by the District Court in Taipei to gain access to assets of the bankrupt in the Hong Kong Special Administrative Region. These decisions will be noted because

⁵ See also Asian Development Bank, Office of the General Counsel, *Law and Policy Reform at the Asian Development Bank: Report on RETA 5795: Insolvency Law Reforms in the Asian and Pacific Region* (April 2000), para 22 at p 13

⁶ See, *Ting Lei Miao v. Chen Li Hung* [1997] 2 HKC 779 (Patrick Chan J); *Ku Chia Chun v. Ting Lei Miao* [1998] 3 HKC 119; [1999] 1 HKLRD 123 (CA) and *Chen Li Hung v. Ting Lei Miao* [2000] 1 HKC 461 (CFA)

they raise an unusual issue in the context of cross-border insolvency law. My questions are: (a) Have the Hong Kong courts resolved the issue adequately? and (b) what lessons can be learnt from the litigation?

Future UNCITRAL Work

Background

On 15 December 1997, the General Assembly of the United Nations passed a resolution (inter alia) recommending that all States review their legislation on cross-border aspects of insolvency to determine whether the legislation met the objectives of a modern and efficient insolvency system. The resolution went on to ask that States give favourable consideration to enacting the Model Law on Cross-Border Insolvency which had been developed by the Working Group on Insolvency Law and adopted by UNCITRAL,

...bearing in mind the need for an internationally harmonised legislation governing instances of cross-border insolvency;...⁷

The Model Law did not attempt any substantive harmonisation of insolvency law. Indeed, it was recognised in the course of the Working Group meetings that, in some cases, it was necessary to defer to national laws (for example on the questions of priority debts) in order to achieve agreement on processes which would enable the efficient and effective resolution of cross-border insolvency cases.

The Guide to Enactment of the Model Law noted that while the increasing incidence of cross-border insolvencies reflected continuing global expansion of trade and investment, national insolvency laws had not kept pace with that trend and were often ill-equipped to deal with cases of a cross-border nature. The Guide went on to

⁷ General Assembly Resolution 52/158 of 15 December 1997 is set out as an Annex to the *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment* (United Nations, New York 1999) at pp 93-94

note a number of consequences flowing from this: i.e. inadequate and inharmonious legal approaches which -

- (a) hampered the rescue of financially troubled businesses;
- (b) were not conducive to a fair and efficient administration of cross-border insolvencies;
- (c) impeded the protection of the assets of the insolvent debtor against dissipation;
- (d) hindered maximisation of the value of the assets of the insolvent debtor.⁸

Further, it was noted that the absence of predictability in the way in which cross-border insolvency cases were administered both (i) impeded capital flows and (ii) acted as a disincentive to cross-border investment.⁹

Another problem was the increase in fraud by insolvent debtors and the increasing ability (and ease) for fraudsters to conceal assets or to transfer them to foreign jurisdictions. The Guide to Enactment noted that this was an increasing problem both in terms of frequency and magnitude. The Guide continued:

The modern, interconnected world makes such fraud easier to conceive and carry out. The cross-border co-operation mechanisms established by the Model Law are designed to confront such international fraud.¹⁰

In order to deal with these difficulties, the Model Law provided better access for foreign insolvency representatives to the courts of the State in which assets were located.¹¹ It also devised processes designed to recognise foreign insolvency proceedings and to give effect to them within the State in which assets were located.¹² These processes included the ability for the courts of the States in which

⁸ *Guide to Enactment of Model Law on Cross-Border Insolvency* para 13, pp 23-24

⁹ *Ibid*

¹⁰ *Ibid* para 14; see also Millett, *Tracing the Proceeds of Fraud* (1991) 107 LQR 71.

¹¹ Generally, Articles 9-14 of the Model Law.

¹² Generally, Articles 15 - 24 of the Model Law.

application was made to grant relief on the application of the foreign insolvency representative.¹³

Another (and important) element of the Model Law was the emphasis placed upon co-operation between courts in different jurisdictions and the insolvency representatives themselves.¹⁴ The whole topic of direct communication and co-operation is one on which a lengthy article or commentary could be written but it is sufficient for my present purposes to note that the Model Law has acted as an impetus to the holding of joint audio and video conferences among courts in different jurisdictions in an endeavour to deal in a pragmatic way with the difficult issues which arise in cross-border insolvency cases. In particular, these rules assist in the expeditious completion of an insolvency regime and facilitate early payment of dividends to creditors. A good deal of work has already been done to build upon this aspect of the Model Law: in particular I refer to American Law Institute's Transnational Insolvency Project which, in Appendix 2 sets out suggested guidelines applicable to Court-to-Court communications in cross-border cases.¹⁵

The Next Phase of UNCITRAL Work

The UNCITRAL Working Group on Insolvency Law met in Vienna between 6 and 17 December 1999. In its report the Group made the following recommendation to UNCITRAL:

The Working Group recommends that the Commission give it the mandate to prepare: a comprehensive statement of key objectives and core features for strong insolvency, debtor-creditor regime, including consideration of out-of-court restructuring; a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches. A legislative guide similar to that being prepared by the

¹³ Articles 19 and 21 of the Model Law.

¹⁴ Generally, Articles 25 – 27 of the Model Law.

¹⁵ American Law Institute, Transnational Insolvency Project: *Principles of Co-Operation in Transnational Insolvencies Cases Among the Members of the North American Free Trade Agreement* (2000)

Commission for privately financed infrastructure projects would be useful and could contain model legislative provisions, where appropriate.

Should the Commission decide to undertake such a project, the Working Group should be mindful in carrying out this task of the work underway or already completed by other organizations, including the International Monetary Fund, the World Bank, the Asian Development Bank, the International Bar Association and INSOL International. The Working Group should seek their collaboration in order to benefit from the expertise these organizations can provide and to build on their efforts and should commence its work after receipt of the reports currently being prepared by the World Bank and the Asian Development Bank.¹⁶

That recommendation was received by UNCITRAL at its plenary session held in June and July 2000 in New York. There was general agreement in the Commission that a single model law on insolvency was neither feasible nor necessary. Nevertheless, it was accepted that a legislative guide similar to that adopted by UNCITRAL for privately financed infrastructure projects would be useful and could contain model legislative provisions, where appropriate. Further, the Working Group was directed to be mindful of the work underway or already completed by other organisations, including the International Monetary Fund [IMF], the World Bank, the Asian Development Bank [ADB], INSOL International and the International Bar Association. The Secretariat was asked to organise a colloquium before the next session of the Working Group¹⁷ in co-operation with INSOL International and the International Bar Association.¹⁸

A number of the reports to which UNCITRAL referred, stress the need for strong insolvency systems to act as important pillars of support for the financial system as a whole and the efficient flow of international capital in particular. By way of example, in the report by the Legal Department of the IMF, *Orderly and Effective Insolvency Procedures: Key Issues* it was said:

¹⁶ *Report of the Working Group on Insolvency Law on the Work of its 22nd Session* (Vienna, 6 – 17 December 1999), para 140 (p 33).

¹⁷ The next Working Group session is to be held in New York from 26 March to 6 April 2001. The Colloquium is being held in Vienna from 4 – 6 December 2000.

¹⁸ A/55/17 Report of the United Nations Commission on International Trade Law on the work of its 33rd session (New York, 12 June 2000 – 7 July 2000), para 409

Over the years, the IMF has become increasingly involved in the promotion of orderly and effective insolvency systems among its members. Experience has demonstrated that reform in this area can play a major role in strengthening a country's economic and financial system....Insolvency reform can be particularly relevant for economies in transition, where it can play a critical role in addressing the problems of insolvent State-owned enterprises. In the context of financial crises, an orderly and effective insolvency system can provide an important means of ensuring adequate private sector contribution to the resolution of such crises. Finally, although insolvency procedures are implemented through the courts, the very existence of an orderly and effective insolvency system establishes incentives for negotiations between debtors and their creditors, which may led to out of court agreement being reached "in the shadow" of the law.¹⁹

In the New Zealand Law Commission's report on *Cross-Border Insolvency*²⁰ we, in an endeavour to add value to the Model Law, sought to identify factors in favour and against reform of the law by adoption of the UNCITRAL Model Law. We identified three factors in favour of reform: viz

- *Globalisation Factors*: these factors arise from the desirability to synthesise international commercial law given the nature of the global markets in which trading entities operate;
- *Fiscal Factors*: these factors impinge upon policy reasons for not discriminating against foreign investors or lenders. In particular, we referred to analysis by economists stressing the need for fair treatment of foreign creditors.²¹
- *Efficiency and Fairness Factors*: these factors go to the process by which relief can be sought when cross-border insolvent issues arise.

Two factors were identified which militated against reform: viz

¹⁹ Legal Department of IMF, *Orderly and Effective Insolvency Procedures: Key Issues* (1999) Foreword at p vii

²⁰ NZLC R 52, February 1999. This report is available on the Commission's website <http://www.lawcom.govt.nz> under the heading "Publications".

²¹ For example, Bebchuk & Guzman, *An Economic Analysis of Transnational Bankruptcies* (National Bureau of Economic Research, Working Paper 6521, Cambridge, 1998) at pp 19 - 23

- *Adequacy of Existing Legislation*: plainly, if existing legislation was adequate there is unlikely to be a need to reform the law;
- *Sovereignty Factor*: this factor goes to the question whether it is appropriate for a particular country to adopt an international regime rather than a domestic regime which may better suit or protect its citizens.²²

Building on the Model Law

The report of the UNCITRAL Working Group on Insolvency Law's December 1999 meeting concentrated on two distinct issues: viz identification of –

- key objectives for insolvency law²³ and
- core features of an efficient and effective insolvency law.²⁴

The Working Group Report makes it clear that objectives of insolvency law should not be treated as polarising insolvency laws into liquidation (on the one hand) and rehabilitation procedures (on the other). What was more important was –

...a more broadly phrased 'arrangement' or 'method' which was aimed at maximising the return and minimising the effects of insolvency and [which] would include the range of possible insolvency techniques.²⁵

And, to emphasise the point, the Working Group later noted, in the context of discussing the relationship between liquidation and rehabilitation procedures, that:

²² These factors are summarised in the Executive Summary to Cross-Border Insolvency *Should New Zealand Adopt the UNCITRAL Model Law on Cross-Border Insolvency?* (NZLC R 52) at paras E3 and E4; see also the discussion of these factors in chapter 3.

²³ A/CN.9/469, Report of the Working Group on Insolvency Law on the Work of its Twenty Second Session [Working Group Report] at paras 21 - 31

²⁴ Working Group Report, paras 32 - 124

²⁵ Working Group Report, para 21

...what was required was a balance between different insolvency procedures, however they may be arranged in the insolvency law (such as unitary proceedings or otherwise). As noted in the discussion on key objectives, there should not be a polarisation of proceedings into liquidation on the one hand and rehabilitation on the other, but inclusion of a range of possible insolvency techniques that could be used to achieve the objective of maximising the value of the assets.²⁶

I interpolate some comments about terminology. The literature refers to "reorganisation", "rehabilitation" and "rescue" procedures almost interchangeably. Indeed, there is some inconsistency in the UNCITRAL material in that Article 2(a) of the Model Law on Cross-Border Insolvency (which defines the term "foreign proceeding") refers to the notion of "reorganisation" whereas the Working Group discussion in December 1999 focused upon "rehabilitation". Whichever term is used, it is necessary to focus attention on the business of the entity rather than on the entity itself. In truth, it is more likely that the business operated by the entity can be saved by utilising a procedure which enables it to be sold as a going concern. It is important not to fudge the distinction between salvaging a business (which may involve sale of the business by the insolvent entity as a going concern with resulting liquidation of the entity) and resuscitation of the insolvent entity itself. For consistency, I use the term "rehabilitation".

There was general agreement at the UNCITRAL Working Group on Insolvency Law as to the core features of a liquidation regime.²⁷ Thus, I propose to leave those matters to one side. I do that because, in my view, it is far more important for UNCITRAL to debate and reach conclusions on the essential nature of a rehabilitation regime both to assist States in developing their domestic rehabilitation regimes and also to ensure that those States which adopt the Model Law on Cross-Border Insolvency have laws in place which will be effective when one comes to deal with them under the Model Law.

²⁶ Working Group Report, para 38

²⁷ Working Group Report, paras 39 - 62

It is the collective nature of an insolvency procedure which is the cornerstone on which the Model Law on Cross-Border Insolvency is built. Foreign insolvency proceedings will only be recognised if they fall within the definition of the term "foreign proceeding" set out in Article 2(a) of the Model Law. Use of the term "collective" distinguishes between a regime operating for the benefit of creditors as a whole and a regime which operates for the benefit of a particular creditor. An example of the latter is a floating charge debenture pursuant to which a secured creditor may appoint a receiver and manager over the undertaking of the debtor business. Such a security, while well known in insolvency systems based on the United Kingdom model, is not a creature known to United States' law.

The definition of the term "foreign proceeding" is:

A collective judicial or administrative proceeding in a foreign State, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganisation or liquidation:...

The elements of the definition (in the context of a rehabilitation regime) can be summarised as follows:

- The proceeding must be a collective proceeding in nature; such a proceeding is designed to give effect to what has been called the "creditors' bargain" - the implicit agreement between creditors that there are economies of scale in having one office to administer the proceeding and pay creditors according to a set statutory schedule of priority.²⁸
- The collective proceeding must arise out of a law relating to insolvency;

²⁸ See generally, M J Ross, *Political Expediency and Misguided Insolvency Reform - The New Zealand Experience with the Corporations (Investigation and Management) Act 1989* (1994) 2 Insolvency LJ 25 at 27.

- Pursuant to that law, the assets and affairs of the debtor must be subject to control or supervision by a court for the purpose of a rehabilitation regime.

The different constituent elements of a rehabilitation procedure were emphasised recently in the ADB report²⁹. I retain the references in paras 37 – 39 of that report to “rescue” rather than “rehabilitation”:

37. In the context of this report “rescue” means any form of process, by whatever name called, which provides for the continuation (and not the liquidation) of an insolvent corporate debtor. This may take the form of a composition, by which the debtor and creditors agree to a simple compounding of debts. For example, the creditors agree to receive a percentage of the debts they are owed in full, complete and final satisfaction of those debts. The debts of the corporation are thus reduced or satisfied, it becomes solvent and may continue on.
38. A rescue might also take the form of a complex reorganisation under which, for example, the debts of the debtor are restructured (extended length of loan, extended period in which to make payment, deferral of payment of interest, possible change in the identity of lenders and so forth); the possible conversion of some debts to equity together with a reduction (or, even, extinguishment) of existing equities; the sale of some of its non-core assets; and the closure of non profitable business activities.
39. However, rescue does not imply that the corporation, its creditors and its shareholders are or will be completely restored. Nor does rescue necessarily mean that ownership and management of an insolvency corporation will maintain and preserve their respective position. In general, however, rescue does imply that under whatever form of plan, scheme, or arrangement is agreed, the creditors will eventually receive more than if the corporation was immediately or soon liquidated.

The ADB report acknowledges that a rehabilitation process is not as universal as that of liquidation and, therefore, does not follow a common pattern or process. Nevertheless, the authors suggest that “key or essential elements” include:

²⁹ *Law and Policy Reform at the Asian Development Bank: Report on RETA 5795: Insolvency Law Reforms in the Asian and Pacific Region* (April 2000)

- the voluntary submission by a corporation to the process (which may or may not involve judicial proceedings and thereafter judicial control or supervision);
- an automatic stay or suspension of actions and proceedings against the property of the debtor affecting all creditors for a limited period of time;
- the continuation of the business of the debtor either by the existing management, an independent manager or a combination of both;
- the formulation of a plan which proposes the manner in which creditors, equity holders and the debtor itself (including its business and assets) will be treated;
- the consideration of and voting on acceptance of the plan by creditors;
- possibly, the judicial sanction of an accepted plan; and
- the implementation of the plan.³⁰

At para 43 of the ADB report it is suggested that legal theory maintains that rehabilitation procedures require laws which:

- permit quick and easy access to the process;
- provide sufficient protection for all of those involved in the process (which primarily includes the corporation and its property and the various ranks and classes of creditors);
- provide a structure which permits the negotiation of a commercial plan;
- enables a majority of creditors in favour of a plan or other course of action to find all other creditors by the democratic exercise of voting rights; and
- provide for judicial or other supervision to ensure that the process is not subject to unfair manipulation or abuse.

In paras 44 and 46 of the ADB report there are three propositions put forward:

³⁰ Ibid at para 41.

1. It is of critical importance to the rehabilitation process that the opportunity, whether prompted by possible sanction or encouraged by possible benefit, should be available to a debtor in financial difficulty to commence the process before it is too late.³¹
2. It is critical to the modern rehabilitation process that attempts by creditors, whether secured or otherwise, to intervene upon the process and pursue their independent individual rights should be restrained, by automatic operation of the legislation, as far as possible.
3. While, in a market based economy, liquidation and rehabilitation should not be the subject of political or government influence or intervention, the presence of some exceptional economic, social or other such circumstance might sometimes justify a special process and the involvement or intervention of Government; e.g. where the banking sector is itself in financial difficulty.

It is helpful to have these three propositions as a starting point and the work of the ADB should be applauded for providing a platform from which further analysis can be undertaken.

In my view, the primary task of UNCITRAL in its future work will be to determine whether the three ADB propositions to which I have referred have sufficient support to justify acceptance as core (or minimum) features of a rehabilitation process.

There is no doubt that a number of countries operate collective rehabilitation procedures which fall squarely within the propositions put forward in the ADB report. Nevertheless, there are also countries which operate rehabilitation procedures which do not fall within those criteria. New Zealand is one.

³¹ In this paper I propose to refer to the term “debtor” although the ADB paper is restricted to “corporations”.

Yet, I would argue that New Zealand, while needing improvements to its insolvency law, has a sound structure in place which, generally meets the needs of those doing business in the country.³² There is no provision under New Zealand's insolvency law, whether for individuals or companies, for either an administrative or judicial collective process which would create an automatic stay so far as secured creditors are concerned. The New Zealand approach has always been to regard secured creditors as falling outside of the insolvency law framework as they, in effect, contract out of insolvency laws by taking security and reserving to themselves the right to take action against some or all of the assets of the debtor should the debt not be repaid on due date or should there be some other default under the security arrangement. There are, I accept, two exceptions to that general proposition in New Zealand. Both are termed "statutory management" but fall to be determined under different statutes. The first is the statute designed to prevent systemic failure (the Reserve Bank of New Zealand Act 1989); the second, and more problematic, is the Corporations (Investigation and Management) Act 1989 which is more wide ranging in its nature. Both statutes permit Government intervention by the making of an Order-in-Council placing an entity under statutory management and, once that is done, mandatory stays arise both in respect of secured and unsecured debts.³³

I do not propose to proffer an answer to the question whether the ADB propositions are correct. Rather, I prefer to raise questions about the ways in which rehabilitation regimes might be viewed from both a domestic and an international perspective. The answers to those questions (and, in particular, the differences highlighted by the answers) should help shape a statement of the minimum elements required for a rehabilitation process to be effective both domestically and internationally.

Questions from Domestic Perspective

³² Provisions for corporate rehabilitation can be found in Parts XIV and XV of the Companies Act 1993 (New Zealand) – neither of which allow for automatic stays in respect of secured debt.

³³ I do not debate the appropriateness of those procedures; they are being considered at present as part of work on rehabilitation procedures which is being undertaken by the Law Commission at the request of the Ministry of Economic Development: the Law Commission is to report to the Ministry of Economic

- (a) *How should a particular State view its insolvency law and consider reform?*

If the State has no insolvency law traditions or infrastructure, it may well be possible to start from scratch with no adverse consequences. If, however, that State has a sound insolvency system which has worked well, there is a risk that domestic financiers used to operating under existing laws might increase the cost of credit should new laws be enacted which would restrict the circumstances in which securities could be readily enforced.

There is also the risk that foreign investors would see inexperience in operating a new regime as a reason for increasing the interest rate of return sought. This may lead to a question of confidence in the necessary infrastructures. Countries such as the United States of America which have well developed rehabilitation laws also have the advantage of having worked under those laws for a long time and having specialised courts with a specialist bar to service the courts. The same cannot be said in developing or small States. For example, in a State the size of New Zealand (population approximately 3.6 million) it would be impossible to develop the type of specialist bar or bench which operates in the United States. Each State must tailor its insolvency laws to fit, primarily, its own needs while, of course, paying heed to standards required in the international arena.

- (b) *To what extent are States likely to take account of competitive advantages to be derived from the way in which their rehabilitation laws are expressed?*

On this point it is important to bear in mind that if a particular State sees that it can gain a competitive advantage in attracting investment due to the way in which it organises its domestic law (e.g. tax havens) it is likely to do so. State X may see it as advantageous to have rehabilitation regimes which are

particularly advantageous to debtors (for cultural or social policy reasons) while State Y may frame its insolvency laws with a bias towards secured creditors by omitting mandatory stays from the regime as it affects secured debt.

There is also a respectable argument that the absence of an automatic stay in respect of secured debt will encourage more realistic rehabilitation plans because proponents are aware that they must pass muster with secured creditors in order to proceed.

If the absence of an automatic stay for secured creditors can be supported as a proper choice at a domestic level, how can a mandatory stay in respect of secured debt be regarded as a core or minimum element of a rehabilitation procedure at an international level?

- (c) *How can proper incentives be provided for debtors to take advantage of rehabilitation processes?*

In Australia, abolition of the taxation debt priorities was followed by statutory requirements for directors to place companies into a form of insolvency regime if tax debts could not be met within particular times; if advantage was not taken to use an insolvency regime, the director could find himself or herself liable personally for the taxation debt. This proved to be a good incentive.

But there is a wider question. Outside of insolvency processes creditors are encouraged to act quickly so that they may gain the fruits of a judgment before other creditors. Yet, once collective procedures are put in place there are often disincentives to those who seek early payment; i.e. the use of voidable transaction legislation.

A policy question is whether it is more desirable to encourage debtors to face *all* creditors at the earliest possible time (through use of collective insolvency procedures) or to encourage creditors to obtain payment if they move quickly and efficiently. That is a major policy choice. If policy shifted towards the former, one way of achieving change would be to ensure that an examination

as to means took place immediately upon a judgment being entered with the possible consequence of a collective insolvency regime being imposed if the debtor was plainly insolvent.

- (d) *To what extent should political or Government involvement in insolvency processes be permitted?*

Different cultures and different social systems will place greater or lesser emphasis on the need for political or Government influence or intervention – even in a market based economy.

Consideration needs to be given to what constitutes a sufficient reason for Governments to intervene to prevent a collective insolvency procedure from taking effect. Examples might be protection of the financial system or other essential industries. In that regard, the UNCITRAL Model Law on Cross-Border Insolvency expressly contemplates banks or insurance companies as the types of business which may fall outside the scope of the Model Law³⁴. However, how far can this be taken? Can it legitimately apply to companies which manage funds in which people may invest for their retirement? Should it extend to essential industries? What about hospitals, schools and other community services? And, does it matter whether the businesses are run by the public or private sector?

Questions from an International Perspective

From an international perspective, the questions become slightly different. For example,

- (a) *What should be the minimum requirements for a rehabilitation regime to be given effect under the UNCITRAL Model Law on Cross-Border Insolvency?*

³⁴ See Article 1(2) of the Model Law

From an international perspective one can put to one side purely domestic considerations and consider what types of proceedings should be enforced throughout the world if minimum criteria are met.

- (b) *How, from an international perspective, should one deal with extraordinary remedies which permit political or Government influence or intervention upon the insolvency of a debtor due to domestic circumstances in a particular State?*

That question was avoided in the Model Law: for good reason because the Model Law was not an attempt to harmonise substantive law. There are plainly cases in which the Law was not intended to apply.³⁵ I query whether the question can properly be avoided in UNCITRAL's future work.

Looking at the issues from an international perspective, it would seem appropriate for UNCITRAL to address those two questions early in its work on insolvency law. They are difficult questions but, to a large extent, individual States may find it easier to answer questions from a domestic perspective once the international solution becomes clearer. And, equally, they are questions which may be more readily answered at an international rather than a domestic level.

The *Chen Li Hung* Litigation

Chen Li Hung was an unusual case in the context of cross-border insolvency. It started life in the High Court of Hong Kong prior to resumption of sovereignty by the People's Republic of China over Hong Kong on 1 July 1997. Appeals to the Court of Appeal and the Court of Final Appeal of the Hong Kong Special Administrative Region were both heard and determined after resumption of sovereignty.

The facts were relatively simple. There was a bankruptcy order made by the Taipei District Court. A trustee in bankruptcy was appointed in Taiwan. The bankrupt had assets in Hong Kong. The trustee sought recourse to those assets through the Hong Kong so that the assets could be realised and distributed among creditors of the

³⁵ Ibid

bankrupt. The question which arose in the proceedings was whether it was appropriate for the courts in Hong Kong to recognise and give effect to the bankruptcy order made in Taipei given that -

- (a) prior to 1 July 1997 the United Kingdom Government did not recognise authorities in Taiwan either as a *de jure* or *de facto* Government; and
- (b) after 1 July 1997 the authorities in Taiwan, in the eyes of a Chinese court, should be regarded as nothing more than rebel authorities having regard to the terms of the Constitution of the People's Republic of China.

In the High Court, Patrick Chan J held that because the United Kingdom Government did not recognise the authorities in Taiwan as a *de jure* or *de facto* Government, the courts in Hong Kong should not recognise the acts of the Taiwanese courts which were not considered as lawfully and properly constituted.³⁶ After resumption of sovereignty over Hong Kong by the People's Republic of China in July 1997, the case came before the Court of Appeal of Hong Kong. Both Mortimer VP and Godfrey JA were of the view that the appeal should be allowed because, while the Constitution of the People's Republic of China asserted sovereignty over Taiwan³⁷ the case fell within the principles enunciated by the House of Lords, in *Carl Zeiss Stiftung v. Rayner and Keeler (No 2)* [1964] 1 AC 853. In that case the House of Lords made it plain that even though Government X may not recognise Government Y the Courts of X should strive to give effect to the laws of Y where failure to do so would affect private rights and to give effect to such laws would not be inimical to the interests of the State claiming sovereignty or otherwise contrary to its public policy. Rogers JA took a different view which is encapsulated in the following passage from his judgment:³⁸

...it would in my view be open to the Court to recognise the existing state of affairs even in that part of the sovereign territory where the authority of the sovereign is disputed. This would include recognition of marriages, divorces and the transfer of property. However, as I have already pointed out that is not the question which arises on the first preliminary issue in this case. The draft

³⁶ (1997) 2 HKC 779 at 792

³⁷ Preamble to the Constitution of the People's Republic of China.

³⁸ [1999] 1 HKLRD 123 at 146-147

Statement of Claim does not rely upon an allegation that any right of property vests in the trustees but rather having referred to the Order of the Taiwan Court on 20 October 1990 the claim is that the trustees have the right and capacity to bring legal proceedings for the purpose of recovering the assets of the bankrupt. *If the court were to accede to this application, it seems to me, that the court in Hong Kong would be assisting in the distribution of assets of Mr Ting being undertaken by a Government which is not merely an unrecognised Government but is exercising power in the Republic of China contrary to the wishes and intent of the sovereign Government. If the court were so to act, it seems to me, it would unwittingly become part of the judicial process of Taiwan, namely the process of administration of assets and what is, in effect, a rebel territory under the control of a court of the rebel Government.* [my emphasis]

The Court of Final Appeal unanimously upheld the majority decision of the Court of Appeal for substantially the same reasons given by the majority in the Court of Appeal. The Final Court of Appeal relied upon the *Carl Zeiss Stiftung* case in holding that it was appropriate for the Hong Kong courts to give effect to the orders made by the Taiwanese court. In the leading judgment, Bokhary PJ held that courts in Hong Kong would give effect to the orders of non recognised courts where –

- the rights conferred by those orders were private rights;
- giving effect to such orders accorded with the interests of justice, the dictates of common sense and the needs of law and order; and
- giving them effect would not be inimical to the sovereign's interests or otherwise contrary to public policy.

In a separate judgment Lord Cooke of Thorndon NPJ, while agreeing with the judgment of Bokhary PJ, made two observations of importance in relation to trans-national insolvency cases. First, His Lordship noted (in relation to Articles 2, 8, 82 and 159 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China) that the common law was to be maintained in Hong Kong except to the extent that it contravened the Basic Law and was not amended by the legislature of the Special Administrative Region. Lord Cooke then said:

Having regard to those provisions and to the purposes of the Basic Law as a whole, I think that it may be inferred that, in appropriate cases, a function of a judge from other common law jurisdictions is to give particular consideration to whether a proposed decision of this court is in accord with generally accepted principles of the common law.

In the present case I have no hesitation in answering that question affirmatively together with my colleague. At international level, the relevant principle goes back at least to the 17th century and Grotius. It is sometimes described as the principle of implied mandate, but that is perhaps not a happy description, because the application of the principle does not depend on interpreting anything that the lawful sovereign says or does.

Second, Lord Cooke of Thorndon said:

Viewing the case from a different perspective, the issue is essentially between the Taiwan creditors on the one hand and Mr Ting, Madame Chen and Mr Chan on the other. It is not an issue with which national politics had any natural connection. They should not be allowed to intrude into or overshadow a question of the private rights and day to day affairs of ordinary people. The ordinary principles of private international law should be applied without importing extraneous high level public controversy.

I suggest that the Court of Final Appeal's judgment in *Chen Li Hung* is both sensible and in accordance with the expectations of those who invest and trade internationally. Because the case involves a balancing of competing public policy factors, it is an interesting case study in the application of both domestic and international policy factors discussed earlier in this paper in the context of insolvency law reform.

Viewed from a domestic perspective, there are three competing public policy factors at work in a case such as this. The first involves fiscal factors, including the need to encourage capital flows³⁹; the second involves the need to give effect to organs of a *de facto* regime in order to ensure that business and family life can go on without concern about over-riding political considerations;⁴⁰ the third is the sovereignty factor

³⁹ See the discussion of fiscal factors in *Cross-Border Insolvency* (NZLC R52) at paras E3 and E4 and 76-100.

⁴⁰ In the Court of Final Appeal, Bokhary PJ put it this way: "When the doctrine of public policy is raised in the courts, it is usually in regard to whether a contract should be refused effect on public policy grounds.

to which Rogers JA referred in his dissent in the Court of Appeal and to which both the majority in the Court of Appeal and the Court of Final Appeal itself addressed by holding that there was nothing “inimical to the interest of the sovereign power” in giving effect to the Taiwanese order.⁴¹ There are also international public policy considerations at work. From an international perspective the focus shifts to the factors discussed in paras 13 and 14 of UNCITRAL’s Guide to Enactment of the Model Law⁴²; i.e. in general terms, the need for efficient international processes (a) to resolve cross-border insolvency issues (b) to secure prompt distributions to creditors and (c) to confront increasing cross-border fraud.

The real difference between the majority and minority in the Court of Appeal in *Chen Li Hung* was that Rogers JA (in his dissent) placed greater emphasis on the sovereignty factor. In Rogers JA’s view if the Hong Kong courts were “to recognise” the Taiwanese order they would become “unwitting” accessories to the judicial organs of the “rebel” Taiwanese Government to an extent inconsistent with the Constitution of the People’s Republic of China. On the other hand, both the majority in the Court of Appeal and the Court of Final Appeal itself placed emphasis on the need to provide mechanisms to assist cross-border claimants to recover their money.

Looking at the case from an international perspective, it would seem that the ultimate decision in the Court of Final Appeal reflected an appropriate balancing of policy factors. In effect, the decision took account of both domestic and international policy concerns. I offer no opinion as to whether that decision represented an appropriate

The contractual objects which invalidate contracts on those grounds, include (as the learned editors of ‘Chitty on Contracts’, 28th ed (1999) put it in Vol 1, p 838, para 17-005) ‘Objects injurious to good Government either in the field of domestic or foreign affairs’. This goes to show that Mortimer VP was proceeding in conformity with established principles when he addressed the question of whether ‘recognition of the rights of the trustees in bankruptcy to sue in Hong Kong [would be] in any way inimical to the interests of the sovereign power’. If I may say so, the learned Vice President’s terminology expresses very neatly one of the public policy considerations which arise in situations like the present; and I gratefully adopt his terminology”.

⁴¹ Ibid; see also, the observations of Lord Cooke of Thorndon cited at p 21 supra. In addition, in the New Zealand context, see the discussion of the sovereignty factor in *Cross-Border Insolvency* (NZLC R52) at paras E3, E4 and 104-105.

⁴² Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency at pp 23-24; see also the discussion at pp 3-4 supra.

weighing of domestic policy factors; nor do I offer any view as to whether the decision was right or wrong as a matter of Hong Kong law. I am plainly not qualified to comment on such matters. Neither is it my place to do so.

What lessons, if any, can be learnt from the decisions of the Hong Kong courts in the *Chen Li Hung* litigation? May I offer the following tentative suggestions:

- (a) Although the case may be regarded as addressing an unusual issue, recent developments in the former Yugoslavia and in Indonesia (with East Timor) suggest that fragmentation of Nation States could provide more cases in which the issue will be raised. As mentioned earlier in this commentary, cross-border mechanisms are needed to ensure fair and efficient administration of cross-border insolvencies and to maximise the value of the assets of the insolvent debtor so that those assets can be realised and distributed among all creditors. The solution offered in the *Chen Li Hung* litigation through the ultimate decision of the Court of Final Appeal applies a principle which recognises the need for pragmatism in dealing with cross-border insolvency cases. That, I suggest, is the right emphasis.
- (b) Looking at the issue from an international perspective, the judgment of the Court of Final Appeal, in placing emphasis on the rights of creditors to gain access to assets of the debtor in a different location, applied the principles which underpin the Model Law on cross-border insolvency without, in the particular case, referring to them either expressly or by necessary implication.
- (c) The case demonstrates that cross-border insolvency problems arise not only in a truly international context but also in the context of cross-border claims within either a Federal jurisdiction (where insolvency jurisdiction is exercised by member States) or where rebel Governments exist. There is no reason in principle why the same principles should not be applied equally in all circumstances.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Commentator

Japanese Points of View to the Draft Chinese Insolvency Law

Shinjiro Takagi

Japanese Points of View to the Draft Chinese Bankruptcy Law
Professor Shinjiro Takagi (Former Justice of Tokyo Court of Appeals)

1 Composition

(1) Restriction on Secured Rights Might Be Needed

Article 70 of the Draft Bankruptcy Law provides that secured rights shall not be bound by Article 20 of the Law from the day when the people's court decides to approve the commencement of composition proceedings.

However, it is important to restrict foreclosure of secured rights to some extent even in composition proceedings.

Collaterals are often assets that are very important for the continuation of the debtor's business such as machinery, equipment, inventories, buildings and factory sites. The debtor, therefore, may not survive without the collaterals.

Moreover, most secured claims are of large amounts usually.

It may be difficult to negotiate with secured creditors holding large claims if they are free to enforce their secured rights.

While secured creditors' rights must be protected even in the course of insolvency proceedings, some restrictions should be imposed on the secured rights.

For example, the people's court should be able to issue a temporary restraining order prohibiting foreclosure under secured rights upon request made by the debtor. Of course, the secured creditors whose foreclosure has been suspended will be entitled to request adequate protection to compensate the possible harm caused by the restraining order.

Japanese Civil Rehabilitation Law which has been effective since April 2000 provides that a debtor can apply for a temporary restraining order to stay realization proceedings of a secured right if the secured creditor is stubborn and refuses to negotiate. Under the new Law, the debtor is also entitled to request extinction of a secured right by paying off an amount equal to the liquidation value of the collateral even if the amount of the secured claim is larger than the value of the collateral. These two weapons may be helpful to negotiate with strong secured creditors.

(2) Composition Plan Should Be Proposed Later

Article 67 of the Draft Bankruptcy Law provides that a debtor applying for composition shall submit to the people's court a petition for composition and a draft composition agreement. A draft agreement may be equivalent to a reorganization plan under Chapter 11 of United States Bankruptcy Code or a rehabilitation plan under Japanese Civil Rehabilitation Law which provides for the impairment of creditors' claims including partial discharge and extension of due date.

It may be very difficult, if not impossible, for a debtor to draft a feasible plan before it files for composition with the people's court. However, Article 67 requires a plan to be submitted at the time of filing the petition. After filing the petition, the debtor must restructure its business to restore its profitability. Only then can the debtor make a plan as to how much and when it can pay old debts. Then the debtor has to negotiate with creditors and/or creditors' committees repeatedly regarding the contents of the proposed plan.

Should a debtor submit a plan upon filing of the petition to commence composition proceedings, the debtor will propose a "milky" plan which will be accepted by creditors easily without any negotiation. A "milky" plan means a plan which provides little impairment so that it is easily acceptable by creditors. Such a

plan providing for payment beyond the debtor's ability might result in a second bankruptcy and the composition may lose its reliability in public.

It is recommended, therefore, that a draft plan be proposed by a debtor at least a few or six months after the filing of the petition to commence composition proceedings.

2 Cross-Border Insolvency

Article 8 of the Draft Bankruptcy Law provides that no procedure of bankruptcy, composition or reorganization that begins outside the domain of the People's Republic of China has force upon a debtor's assets that are located within the territory of the People's Republic of China. This draft Article 8, providing for territorialism, must be eliminated. Territorialism may be harmful because foreign courts may refuse to acknowledge the effect of judgments, adjudication, decisions and orders rendered by the people's court due to reciprocity.

At least the following three provisions are necessary:

- (1) Judgments, adjudications, decisions and orders rendered by the people's court under the Bankruptcy Law are effective over the debtors' assets located outside the territory of the People's Republic of China.
- (2) Foreigners hold the same status as Chinese in bankruptcy and insolvency proceedings commenced under the Bankruptcy Law.
- (3) Bankruptcy or insolvency proceedings can be commenced over a foreigner's assets located in the territory of the People's Republic of China.

By the way, Japanese Ministry of Justice has completed drafting a new law entitled "The Law Regarding Recognition And Aid to Foreign Bankruptcy And Insolvency Proceedings." The new law is expected to be enacted before the end of this year. The law will abolish Japan's territorialism which has been notorious all over the world and provides for recognition of and assistance to foreign bankruptcy and insolvency proceedings commenced outside Japan. The law has adopted many of the UNCITRAL Model Law provisions except provisions regarding direct court-to-court communications and avoiding powers.

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INTERNATIONAL DEVELOPMENTS; LESSONS FOR THE HKSAR AND MAINLAND CHINA?

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1. Current Position

- No 'constitutional' assistance to cross-border issues in private international law generally and none for insolvency in particular
- No bi-lateral agreements in the insolvency arena (cf arbitral awards, service of civil process)
- No specific statutory assistance provision for international insolvencies in HK law
- Hence, the 'common law' position continues to apply in the HKSAR:
 - *Re China Tianjin* [1994] 2 HKLR 327 (noted by Booth and Smart [1996] J.I.B.L. 216), winding up petition in relation to SOE
 - *Chen Li Hung v Ting Lei Miao* [2000] 1 HKC 461, CFA (Taiwanese bankruptcy – rebel province, rather than a recognised State)
 - Hong Kong's insolvency legislation increasingly extra-territorial in its scope (Booth and Smart, 34:1 Int Lawyer 255 (2000)), so more scope for potential conflict

2. EU Regulation on Insolvency Proceedings

Council Regulation (EC) No 1346/2000 of 29th May 2000 on Insolvency Proceedings, *Official Journal* L 160 , 30/06/2000, p.1.

If an agreement can be reached between so many different countries within Europe, then perhaps the EU Regulation might seem a useful starting point when trying to come up with proposals for a few different law districts within the **one country**?

Not realistic in current HKSAR/Mainland context.

The Regulation has as a focus the concept of Main and Secondary insolvency proceedings. The Main proceedings can only be conducted in the place where the insolvent has its 'home' base. Main proceedings are extraterritorial – so as to take effect throughout the EU member States – and a number of issues have a 'binding' effect in all the other EU jurisdictions. To some extent this binding effect can be lessened if Secondary proceedings (which are strictly territorial) are commenced in another EU country. Secondary proceedings can only be commenced where there is an establishment in that place.

As Main proceedings are intended to be the core of the insolvency process, it follows that the Regulation requires that all creditors of whatever nationality can enter claims without discrimination **and** that revenue and social security and other public claims from any EU country can be proven in the Main insolvency.

At present, it would appear that there is insufficient familiarity, and confidence, between the HK and Mainland insolvency systems to enable the relatively strict EU model to have much chance of being actively pursued here.

Cf Bayers Polymers Co Ltd v Industrial and Commercial Bank of China, Hong Kong Branch [2000] 1 HKC 805 – lack of substantial justice if civil proceedings were to take place on the Mainland.

3. UNCITRAL Model Law

More flexible approach under the Model Law has greater potential. As the basis for an ‘Arrangement’ to become part of the law of both jurisdictions.

Many of the provisions of the Model Law are already part of HK law, by virtue of the common law rules; e.g.

- Foreign creditors are not discriminated against, but may claim equally with HK creditors.
- A foreign representative may apply directly to the HK court, e.g. to sue to recover debts owing to the insolvent.
- A foreign insolvency proceeding may be recognised by the HK courts with a number of consequences (e.g. no subsequent attachment of assets will confer a priority on the attaching creditor).

But the Model Law goes further in some areas, e.g. examination of witnesses and right to apply for a stay of local creditor actions, than the common law rules. More importantly, the Model Law is set out clearly and concisely – whereas the common law rules are often rather hidden away in (sometimes ancient) cases. The Model Law provisions might, perhaps, be more radical in the context of Mainland Law.

Flexibility of Model Law – ‘starter pack’ approach possible; so that when experience is gained and mutual confidence builds up, more co-operation can be added.



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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Speaker

**AMCs and Debt-Equity Swaps in China,
Can They Really Solve the State
Commercial Bank NPL Problem?**

Lou Jianbo

AMCs and Debt-Equity Swaps in China, Can They Really Solve the State Commercial Bank NPL Problem?

Jianbo Lou

Outline

I. INTRODUCTION

II. WHY AMCS AND DEBT EQUITY SWAPS IN CHINA?

A. THE SERIOUSNESS OF THE NPL PROBLEM

1. The Seriousness: Large Amount of Existing NPLs and Increasing New NPLs
2. Negative Effects of Bank NPLs
3. Summary

B. THE ASIAN FINANCIAL CRISIS: SIMILARITIES BETWEEN CHINA AND ASIAN CRISIS COUNTRIES

1. The Asian Financial Crisis and Its Origins
2. Similarities Between China and Asian Crisis Countries

C. THE UNSUCCESSFUL RMB 270 BILLION RECAPITALIZATION IN 1998

1. Official Reaction in China After the Asian Financial Crisis
2. Ex-ante Recapitalization Vs. Ex-post Recapitalization
3. The RMB270bn Recapitalization in 1998

D. TURNING TO AMCS AND DEBT-EQUITY SWAPS

E. SUMMARY

III. AMCS FOR THE FOUR LARGEST STATE COMMERCIAL BANKS

A. CHINA'S PRACTICES OF AMCS

B. CHARACTERISTICS OF CHINA'S AMCS

1. Bank- Specific AMCs
2. State Ownership and Heavy Administrative Color
3. Wide Business Scope and Powers

C. PROBLEMS WITH THE AMC PRACTICES IN CHINA AND RECOMMENDED SOLUTION

1. The Dilemma Faced by Chinese AMCs
2. The Dependence of AMCs on Their Banks
3. The Funding Problem
4. The Lack of Expertise and Experience
5. Difficulties in Evaluating Assets

D. IMMEDIATE LEGAL ISSUES RELATED TO AMC PRACTICES IN CHINA

1. The Notification Obligation Under the Contract Law
2. Accomplishing Legal Procedures for the Transfer of Security Interests
3. AMCs' Liabilities to Debtors

IV. CHINA'S DEBT-EQUITY SWAP SCHEME

A. THE DEVELOPMENT OF DEBT-EQUITY SWAPS IN CHINA

1. The Main Policies of the SETC Debt-Equity Scheme
2. The Implementation of the SETC Scheme

B. POLICIES BEHIND THE SETC DEBT-EQUITY SWAP SCHEME

1. The Debt-Equity Swap Scheme as Part of the Government's Anti-Depreciation Policies
2. The Micro-Economic Effects: A Win-Win Situation For SOEs and Banks
3. Justification for Converting SOEs' Debts into Equity

C. PROBLEMS WITH THE CURRENT DEBT-EQUITY SWAP SCHEME AND RECOMMENDED SOLUTIONS

1. Moral Hazard Problem
2. Lack of Workable Reorganization Plan

D. AMCS' EXIT PROBLEM

1. The Importance of AMCs' Timely Exit
2. Probable Routes for AMCs to Dispose Equity Acquired from Debt-Equity Swaps

E. Summary

V. CONCLUDING OBSERVATION

I. INTRODUCTION

Two events marked China's on-going financial reform¹ in 1999: the establishment of the four bank-specific Asset Management Companies (AMCs) and the carrying out of debt-equity swap scheme by the newly established AMCs and the State Development Bank (SDB),² aiming at solving the state commercial banks'³ non-performing loan (NPL) problem and achieving the government's goal of having SOEs out of difficulties during the three-year-period from 1998 to 2000.⁴ But can AMCs and debt-equity-swaps really help? This monograph intends to answer this question by analyzing the AMC practices and debt-equity swap scheme in China.

The rest of the paper will be organized in four sections. Section II explores the policies behind the Chinese government's decision to have AMCs and carry out debt-equity swaps. In Section III, we will analyze the characteristics of China's four AMCs; problems with China's AMC practices will be identified as well. Section IV focuses on the debt-equity swap scheme. Concluding observation will be given as Section V.

Because of the shortness of empirical evidences in China—the AMCs and debt-equity swap scheme were only launched in 1999, lessons and experience of other countries will have to be drawn here and there in this paper to help understand and analyze the practices in China.

II. WHY AMCS AND DEBT EQUITY SWAPS IN CHINA?

¹ China's current financial reform was initiated in 1993. In November 1993, the 3rd Plenum of the Fourteenth National Congress of the Communist Party of China set the future course of financial sector development in China as part of its socialist market economy strategy. The State Council adopted Resolution on Financial System Reform accordingly in the same year, which drew blueprint for overhauling China's financial system, including the commercialization of state banks.

² The SDB, along with the other two state policy banks (the Agricultural Development Bank and China Export-Import Bank) were established in 1994 to free state commercial banks from policy loans for development purpose. Three policy banks were established since January 1994: State Development Bank (SDB). The SDB is mandated with general responsibilities for infrastructure lending. *See*, Circular of the State Council On Establishing State Development Bank, No. 22, (1994).

³ State commercial banks denotes special the Industrial and Commercial Bank of China (ICBC), China Construct Bank (CCB), the Agricultural Bank of China (ABC) and the Bank of China (BOC). Because they are the four largest banks in China, they are also referred to as the "big four" in this thesis.

⁴ The three-year-goal was pledged by Premier Zhu Rongji at the March 19, 1998 press conference of the First Session of Ninth National People's Congress. Premier Zhu said that the problems of the state-owned enterprises (SOEs), as well as those within the banking sector, should be resolved within three years. *See*, e.g., Historical Research Unit of the Central Committee of the Communist Party of China, 'Major Events after the Third Session of the Eleventh Central Committee of the Communist Party of China (III) (*zhonggong shiyijie sanzongquanhui yilei dashiji-xia*)', *People's Daily (Overseas Edition)*, 3 (December 16, 1999).

Policies behind the establishment of four AMC's and debt-equity swaps in China are quite complicated. Externally, the severity of Asian financial crisis taught the Chinese government the importance of having a health financial system. What directly led to the decision to establish four AMC's and carry out debt-equity swaps, however, is that other policy initiatives failed to solve the problem.

A. THE SERIOUSNESS OF THE NPL PROBLEM

1. The Seriousness: Large Amount of Existing NPLs and Increasing New NPLs

The seriousness of China's bank NPL problem can hardly be overweighed. Chinese Scholars' estimation about the proportion of NPLs in the whole bank assets has varied from 10 % to 40 %.⁵ "Two reasons contribute to the various estimations of scholars: one is that different asset classification standards are applied; the other is that most of the estimation are based on samples rather than on comprehensive statistics. What can be said without doubt, however, is that the huge amount of bad assets accumulated on [state] banks' balance sheet may have very serious consequences and must be paid close attention to."⁶

The best data available to outside observers are for the big four, based on China's former loan classification system.⁷ Central bank governor Dai Xianglong and other high ranking officials in China's financial system have stated that NPL, as a share of their total outstanding loans, increased from 20% at year-end 1994 to 22 at year-end 1995, and then to 25% at year-end 1997.⁸ Some foreign economists believe much higher ratios, however. According to investment bank Goldman Sachs, for example, a more stringent and internationally accepted classification would show that the mainland's banking sector had

⁵ Different estimations of the proportion of NPLs to the total state commercial banks' asset can be in the following publications—10%: Pan, Yue (ed.), *Policies and Procedures for Asset Restructuring*, 31 (Beijing: 1997); 20%: Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring* (Beijing 1995); 22.3%: Yi, Gang, 'The Asset Structure of China's Financial Institutions and Its Policy Implication', *Jingji Yanjiu* No. 12 (1996); 20-30%: Huang, Yuncheng, 'Bank Reform and Debt Restructuring', *Beijing. Guanli Shijie* No. 6 (1996); 30%: Xv, Jingyong, 'Causes to the Deterioration of the Asset Quality of State Specialized Banks', *Dangdai Jingji Yanjiu* No. 1 (1996); 25-40%: Lu, Xianxiang, 'Problems with the Three Lending Models of China's Commercial Banks', *Guoji Jingrong Yanjiu* No. 12 (1996).

⁶ See, Qing, Chi-jiang, 'Bank NPL Problem in China' in Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 20, at 21 (Beijing 1995). Qing is the head of the Finance Research Institute of the PBOC.

⁷ For the details of China's former loan classification system before 1998 and its shortcomings, please see relevant discussion in Chapter 3.

⁸ The total figure for NPLs include those that were overdue for less than one year and might be recovered, there is also a core of bad and doubtful loans that would have to be written off. These amounted to between 7 and 10 per cent of total lending. See, e.g., Montagnon, Peter & Harding, James, 'China: Bank Cut Non-performing Loans', *Fin. Times* (September 13, 1999); Faison, S., 'Inflation Curbed but Not Growth, China Asserts', *New York Times* (July 16, 1996); and Lardy, Nicholas R., 'The Challenge of Bank Restructuring in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 26 (October 1999).

one of the highest NPL level in Asia, ranging from 30 to 60 per cent.⁹ Taking into account the leniency of China's loan classification system compared with standard international practices, Goldman's estimation might not be an exaggeration.

Before 1998, the loan classification system in China classified loans into normal, overdue, dead and loss, while the last three were all included in the NPLs. The released official date did not make distinction of the three types of NPLs in 1997. What we have now is the date for the year 1996, then the PBOC governor Dai Xianglong said 8% of outstanding loans at state banks are more than three years overdue and another 12% are less than three years overdue.¹⁰ The majority of NPLs then were dead loans or loss according to Dai's statement. Another source is an article based on an extensive interview with Dai Xianglong, which revealed that the sum of the share of loans that are outstanding to firms that have already gone through bankruptcy and been liquidated without the banks recovering any of their outstanding loans, so-called loss, and loans that are two years or more overdue, so-called "dead loans", increased by at least half between year-end 1994 and year-end 1997.¹¹ The amount of irrecoverable loans of commercial banks in China reached RMB865bn as of the end of 1998, accounting for 10% of the RMB8.65trillion outstanding loans.¹²

The situation of some individual bank branches is even worse than the average situation. In accordance with a research program of the Metropolitan Finance Society of Hunan Province, for example, the bad assets in a state specialized bank branch totaled RMB 117.184 m, accounted for 56.6% of its outstanding loans in 1995.¹³ The China Investment Bank, which was acquired by the Everbright Bank of China, had accumulated a bad asset ratio of about 50% through lending to troubled sectors of the slowing economy before the acquisition.¹⁴

⁹ The outstanding loans amounted to 9.6 trillion yuan at March 31, 1999, 110% of the GDP this year. See, Wang, Xiangwei, 'Goldman Puts Loan Clean-up Bill at US\$272bn', *South China Morning Post*, 4 (September 24, 1999).

¹⁰ See, e.g., Faison, S., 'Inflation Curbed but Not Growth, China Asserts', *New York Times* (July 16, 1996).

¹¹ See, Ye, Hongyan, 'Recognizing the Current Crisis of Bad Loans in China's Financial Structure', *Ta Kung Pao (Hong Kong)* (January 20, 1998).

¹² Calculated according to Dai's speech at the annual session of National People's Congress in March 1999, Dai suggested a huge improvement in the health of the banks' balance sheets. He said that China's NPLs, those that have already been written off, were just 2.9% of total assets at the end of 1998 and total irrecoverable loans were less than 10%. Quoted in Harding James, 'China: Banks to Be Allowed to Price Risks', *Fin. Times* (March 12, 1999). Foreign commentators always criticized that this figure conflicted with the earlier revelation. Dai, however, actually only referred to irrecoverable loans, when he gave the 10% estimation. See, Pu, Yonghao, 'Why China Won't Be Asia's Next Basket Case Economy', available at 'http://www.chinaonline.com/top_stories/breakingnews_c9041941.html'.

¹³ See, the Metropolitan Finance Society of Hunan Province, 'The Situation of Bad Assets in Specialized State Banks', *Jingji Yanjiu Zhiliao* No. 1 (1995).

¹⁴ See, e.g., Macmahon, William J., 'Everbright and CIB Merge in a Strong Bank-Weak Bank Rescue', available at 'http://www.chinaonline.com/top_stories/breakingnews_b9031915.html'; Kyngge, James, 'China: Everbright Acquires State Bank', *Fin. Times* (March 19, 1999); Wang Xiaowei, 'Huge Credit Risks Seen in CIB Acquisition Everbright Takes Over NPLs', *South China Morning Post* (March 19, 1999); and Wang, Xiaowei, 'Everbright to Double Assets CIB Branches Changing Hands', *South China Morning Post* (March 18, 1999).

Moreover, despite the large write-offs of NPLs in recent years,¹⁵ Chinese banks' non-performing loans level have been rising steadily.¹⁶ It was estimated that new NPLs are being increasingly created on state banks' balance sheet at an annual rate of 2%.¹⁷ A PBOC report released on April 16, 1999 stated that NPLs rose sharply in the first three months of 1999 in Shenzhen.¹⁸ Dai Xianglong, the Governor of the People's Bank of China, admitted in his speech at the annual session of the National People's Congress on March 11, 1999 that "owing to the unsatisfactory performance of state-owned enterprises the trend of increasingly non-performing loans has yet to be checked".¹⁹

2. Negative Effects of Bank NPLs

a. Negative Effects on State Banks

The NPL problem has been a major obstacle for state commercial banks to become genuine commercial banks. Huge amount of bad assets are damaging the profitability and competitive capacity of state commercial banks, and impeding state commercial banks from improving its economic efficiency. If the increasingly creation of bad assets cannot be curbed effectively, NPL problem will eventually lead to the collapse of state banks and consequently the whole banking system.

(i) *The decreasing efficiency and profitability of state commercial banks.* The high proportion of bad assets accounting to the total bank assets has seriously affected

¹⁵ It is reported that China wrote off RMB 30bn (US \$ 3.62bn) in bad debts in 1997 and RMB 40bn (US \$ 4.83bn) in 1998. See, e.g., 'China Wrote Off US \$ 3.62 Billion in Bad Debts in 1997, US \$ 4.83 Billion in 1998', available at 'http://www.chinaonline.com/top_stories/breakingnews_c9022405.html'. These two years writing off was on the basis of a RMB 23.8bn writing off in 1996. See, The People's Bank of China, *China Financial Outlook 1998*, 20 (Beijing: 1998).

¹⁶ China's banking sector has been increasing loans to inefficient state-owned enterprises at a rate that outstrips output growth, thereby heaping new non-performing loans on old-ones. See, e.g., Harding, James, 'China: Market Differences Emphasized', *Fin Times* (January 28, 1999). Standard & Poor gave this comment to all the five Chinese financial institutions (Bank of China, Bank of Communication, China Construction Bank, China International Trust & Investment Corp. and Industrial & Commercial Bank of China) downgraded on March 1, 1999 this comment. See, Standard & Poor's CreditWire, 'Ratings Lowered on Five Chinese Financial Institutions; Removed from CreditWatch Negative', available at '<http://www.ratings.standardpoor.com/news/newsrelease.htm>'.

¹⁷ An article based on an interview with Dai Xianglong, then vice-governor of the central bank, states that the proportion of non-performing loans of China's large state-owned banks "has been rising by 2 percentage points per annum in recent years." See, Zhao Yining, 'The Financial Situation and Financial Reform', *Liangwang (Outlook)*, 12-3 (May 15, 1995).

¹⁸ It is reported that overdue loans rose by RMB 2.23 bn in the first three months of 1999, an increase of just over 22% since the end of December last year; bad debts rose by 1.5%. The report on the Shenzhen banks by the central bank is an unusual activity for the PBOC, which tends to offer only the minimum of detail on the NPL problem in the financial sector. See, e.g., Harding, James, 'China: NPLs Soar in Shenzhen', *Fin Times* (April 17, 1999).

¹⁹ See Harding, James, 'China: Banks to Be Allowed to Price Risks', *Fin. Times* (March 12, 1999). But, Cf., Chinaonline, 'Dai Xianglong Says RMB Will Be Stable, Beijing to Help Banks' (January 20, 2000), available at '<http://www.chinaonline.com/topstories/000120/c00012052.asp>'. Dai was reported to announce at a central bank news conference on January 20 that efforts to reform the banking system had pushed the ratio of bad loans on new loans to just two or three percent in recent years. *Id.*

state banks' efficiency of capital. This was evidenced by the chronologically prolonged average turnover period of state bank loans. The average loan circulation ratio of state banks was 1.25 in 1991, which decreased to 1.08 in 1993, to 0.8 in 1995; the average loan circulation period was prolonged respectively from 307 days in 1991 to 386 days in 1994 to 456 days in 1995.²⁰

The lowering efficiency logically leads to lowering profitability of state commercial banks. Actually, NPLs have direct decreasing effects on bank profits: banks have to write off and provision for NPLs, which decreased banks' profit substantially. As shown in Table 1, the profitability²¹ of the big four as a group was relatively stable at about 1.4% in 1985-87 but fell sharply afterwards. Over the four years from 1993 through 1996, return on assets averaged only one-fourth the average level of 1985-87. This simply reflects the fact that while loans expanded rapidly, profits grew much more slowly. This is an almost certain indicator of declining loan quality or a sharp increase in the banks' cost of loanable funds relative to interest rates they charge borrowers. The NPLs reduce banks' absolute profits as well. The China Construction Bank, for example, generated book profits of RMB 2.2bn (US \$ 266 m) in 1998. The actual profits, however, were only RMB 850 m (US \$ 102.7 m), 44% down the RMB 1.51bn in 1997.²² Zhou Xiaochuan, governor of the CCB, said the bank experienced an increase in expenditures and decrease in profits. In addition to the government's cut in interest rates, adjustments made to the bank's interest receivable, and the summer floods, he attributed this to the increase in provisions for the bank's NPLs. Provisions for NPLs rose by RMB 7.9bn (US \$ 954 m) year on year.²³ Another example is the Bank of China, the state-owned commercial bank with the broadest international exposure, which announced a 40% slide in profits to RMB 3.52bn in 1998, compared with RMB 5.87bn in 1997.²⁴

Table 1: Return on Assets of the Big Four, 1985-96

Year	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Return on assets (%)	1.4	1.3	1.4	1.1	1.1	0.9	0.9	0.7	0.4	0.3	0.3	0.3

Source: Table 3-8 in Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 100 (1998).

(ii) *The Deteriorating Creditworthiness of State Commercial Banks.* The accumulation of NPLs seriously decreases banks' credit standing. This is evidenced by the downgrading of five Chinese financial institutions by Standards and Poor on March 1,

²⁰ See, Li, Lin, 'The Survival Crisis Threatening State Commercial Banks', *Xiandai Jingrong Daokan* No. 1 (1996).

²¹ The profitability here is represented by return on assets, which is calculated as pre-tax profits divided by total assets.

²² See, e.g., Harding, James, 'China: Profits Under Pressure', *Fin. Times* (January 22, 1999).

²³ See, e.g., 'China's Top Five Commercial Banks Report 1998 Account Balances', available at 'http://www.chinaonline.com/top_stories/today_b9012040.html'.

²⁴ See, e.g., Harding, James, 'China: Profits Under Pressure', *Fin. Times* (January 22, 1999).

1999.²⁵ Standard & Poor lowered the foreign currency counterpart credit, certificate of deposit, and debt ratings on five Chinese financial institutions: Bank of China (BOC), Bank of Communications (BOCS), China Construction Bank (CCB), China International Trust & Investment Corp. (CITIC), and Industrial & Commercial Bank of China (ICBC). According to Standard & Poor CreditWire,²⁶ in addition to the adverse macro-economic environment, to various degrees, several factors limit each institution's ability to improve its credit standing: including poor asset quality and increased write-offs.

According to Moody's, China's average bank financial strength rating stood by "D", i.e., very weak, in July 1999. That was worse than most of the countries being rated, only better than Korea, Pakistan, Thailand, Indonesia and Russia.²⁷

(iii) *The Potential Failure of State Commercial Banks and the Whole Banking System.* Bank NPLs has been one of the direct causes to historical bank failure. In the US, loan losses dominated the major bank failures from 1934-1983.²⁸

The huge amount of NPLs has made China's big four state commercial banks technically insolvent.²⁹ They are running mainly on the government support and public's confidence on them.³⁰ Or, in Lardy's words, the big four are insolvent, but not illiquid.³¹

²⁵ See, e.g., Standard & Poor's CreditWire, 'Ratings Lowered on Five Chinese Financial Institutions; Removed from CreditWatch Negative', available at '<http://www.ratings.standardpoor.com/news/newsrelease.htm>'; Harding, James, 'China: Financial Institution Downgraded', *Fin. Times* (March 2, 1999); and also, 'S & P Downgrades Hit China's Big Banks When They Can Least Afford It', available at 'http://www.chinaonline.com/top_stories/top_news_story.html'.

²⁶ See, Standard & Poor's CreditWire, 'Ratings Lowered on Five Chinese Financial Institutions; Removed from CreditWatch Negative', available at '<http://www.ratings.standardpoor.com/news/newsrelease.htm>'.

²⁷ See, 'Average Bank Financial Strength Rating by Country' in *Banking System Outlook: Singapore*, 5 (Moody's Investors Service).

²⁸ See Table 9.2 of Nagle, Reid & Petersen, Bruce, 'Capitalization Problems in Perspective', in Aspinwall, Richard C. & Eisenbeis Robert A.(eds.), *Handbook for Banking Strategy* (1985). Among the 20 failure cases which the authors listed in that table, four of them are caused by loan losses.

²⁹ As of 1995, for example, it was revealed that then overdue loans, dead loans and irrecoverable constituted 12, 8 and 2%, respectively, of the combined value of the loan portfolios of the big four. See, e.g., Tang Xiong, 'How to Regard the Bank's Non-Performing Assets', *Jingrong Shibao (Financial Times)*, 5 (April 21, 1996).

Since the loans outstanding of these four institutions at year-end 1995 stood at RMB3.9bn, classified loans can be estimated at RMB860bn. Of these RMB469bn were overdue, RMB313 were dead loans, and RMB78bn were irrecoverable. The total net worth of these banks at year-end 1995, including paid-in capital, surpluses, and retained profits, stood at only RMB269bn. Deducting the value of irrecoverable loans, the net worth of these institutions would be only RMB191bn. If the ultimate recovery rate on the remaining classified loans is less than 3/4, the magnitude of loans to be written off would exceed the remaining net worth of these banks. See, Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 119 (1998).

See, also, Li Xinxin, 'Looking at China's Hidden Financial Danger from the Perspective of the East Asian Financial Crisis: An Analysis of the Utilization and Management of Assets by China's State-Owned Commercial Banks', *Gaige (Beijing)* No. 3, 32 (1998). Li Xinxin is one of the few Chinese authors who has explicitly acknowledged that the liabilities of the big four exceed their assets.

³⁰ Despite of the inefficiency of Chinese banks, the savings of the Chinese people soared with increased prosperity. It is reported that Chinese citizens in the first two months of 1999 have saved RMB 340bn (US \$ 41.1bn)—almost half of what they saved all last year. See, 'Chinese Savings Soar as Fear Grows and Economy Falter', available at 'http://www.chinaonline.com/top_stories/breakingnews_c9032601.html'.

Taking into the weight of the state commercial banks in the whole banking system,³² it will not be exaggerating to assert that if the increasingly creation of NPLs cannot be effectively curbed, the accumulating NPLs will eventually pull down the state commercial banks and even the whole banking system in China.³³

b. Negative Effects on the Economic Reform and the Growth of Real Economy

(i) *Negative Effects on the Economic Reform.* Building up a market economy requires the creation of markets, of market-oriented enterprises, and of the wide range of institutions and business practices needed to support them. For market to function well there must be robust entry into, and discipline exit from, markets to ensure that the most efficient and innovation producers are those that operate in a market.³⁴

The presence of NPLs on banks' balance sheets distorts the incentives of both banks and SOEs. It has been proved that the large amount of NPLs frequently led to adverse selection of bank's managers.³⁵ The distortion of the lending decision is most extreme if the bank is so heavily exposed to the borrower that the bank would fail if the workout loan were not made. In this case, the bank will be willing to make the loan so long as there is some chance— however negligible— the workout loan will succeed. In other words, additional lending to allow bankrupt firms to service the old loans becomes rational, as it enables banks to report the loans as formally performing, thus delayed the

³¹ See, Lardy, Nicholas R., 'The Challenge of Bank Restructuring in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 31 (October 1999). Lardy lists three factors that allowed insolvent banks to continue to operate. The first is the rising rate of national saving in the reform period. The rate was about 30% of GDP at the outset of reform but had risen to 40% or slightly more by mid-1990s. Second, the sources of savings have shifted dramatically, so that by the mid-1990s households accounted for about half of all savings, compared with their negligible share at the outset of reform. Third, given the tiny size of China's bond and equity markets and the absence of capital account convertibility, households have had little choice but to hold financial assets either in currency or bank savings deposits denominated in local currency. The combination of these three factors has meant that ever growing amounts of household savings flow into the banks each year. *Id.*, at 31-32.

³² The big four state commercial banks hold 68% of the nation's deposits, 77% of all loans, 75% of the country's total assets and employs 66% of those working in the banking sector. See, e.g., Chinaonline, 'A Look at Bank Reform in China' (April 14, 1999), available at 'http://www.chinaonline.com/top_stories/breakingnews_b2-99030914-2.html'.

³³ The logic development of a financial crisis will always include the accumulation of NPLs on banks' books. A well-accepted description of the development of Asian financial crisis is as follows: the extensive inflow of capital into these countries' fragile, bank-centered financial systems. Authorities in these systems permitted the development for serious asset-liability mismatches, with banks financing long-term domestic lending through short-term foreign currency borrowing. The financial systems were politicized, with financial decisions being influenced both by government intervention and corruption, leading to perceptions of implicit government guarantees. With economic growth weakened due to exogenous factors, the NPLs began to be created and drag the financial systems away from supplying necessary credit to the economy. See, e.g., Norton, Joseph J., 'International Financial Crises: Implications for Financial Stability in China', presented for 100th anniversary of Peking University (May, 1998).

³⁴ See, e.g., European Bank For Reconstruction and Development, *Transition Report 1998: Financial Sector in Transition*, iv (1998).

³⁵ See generally, Herring, Richard, J. 'The Economics of Workout Lending', 21 *Journal of Money, Credit, and Banking* No. 1, 1 at 5 (Feb. 1989).

day of reckoning. Firms' managers, on the other hands, are under no pressure to scrutinize their project: they know that banks have no alternatives but to keep lending.

The banks' passivity in enforcing loan contract and willingness to grant new loans to loss-making SOEs has been fostering the reliance of SOEs on state banks and reducing their willingness and ability to adjusting their production to changing demands and response to market signals.³⁶ More seriously, getting used to policy loans from banks, some state enterprises cling to the idea that they do not have a legal obligation to repay loans,³⁷ while an acute sense of trust in day-to-day business dealings is essential to business. These negatives senses and behaviors of SOEs are impeding establishing market economy in China.³⁸

(ii) *Negative Effects on the Real Economy.* It is now well accepted³⁹ that the performance of the financial sector has a major influence on the performance of the overall economy, by mobilizing domestic and foreign savings and by allocating efficiently these funds to investment opportunities in the real economy; in addition, a sound financial sector is also a source of stability, providing a mechanism for allocating risks and spreading financial losses that inevitably arise from economic activity. The financial crisis in emerging market economies showed how weak banking system can

³⁶ It is reported that 66.7% per cent of 605 key manufactured products in China were in oversupply. That is to some extent due to weak market responsiveness of SOEs. See, e.g., Kynge, James, 'China: Products in 'Oversupply'', *Fin. Times* (February 5, 1999).

³⁷ In Wuhan city, for example, 10 enterprises (most of them SOEs) were penalized by banks for default in 1998. These enterprises had the ability to pay the loan principles and interests but just refused to pay. See, e.g., Ma, Xinpin, Hong Zheng, 'Insufficient Demand, Insufficient Creditworthiness [xvqiu buzhu, xinyong youqi buzhu]', *Jingrong Shibao*, 2 (September 8, 1999). Actually, some financial institutions lack the senses themselves that debt must be served. One typical example is Hainan Huitong International Trust & Investment Corp., which owes approximately US \$ 100 m to some South Korean Creditors. When they were asked to repay the debt, they threatened to declare bankrupt. See, Miller, Matthew, 'Hainan Itic's "Arrogant" Rejection of Repayment Requests Angers Koreans', *South China Morning Post* 3 (March 30, 1999).

In 1999, the PBOC, SETC issued jointly the Report on Collecting Bank Interest Arrears According to Law, which reveals that among all the interest arrears, 20% are owed by the debtors who have the capacity to repay the interests. See, Circular of the General Office of the State Council on Issuing the Report of the PBOC and the SETC on Collecting Bank Interest Arrears According to Law, issued on January 21, 1999.

³⁸ The whole society lacks the sense of credit. People do not consider their obligation to repay debts. See, e.g., Gu, Genyun, 'On Financial Crisis and Its Legal Countermeasures', *Law Science [Fa Xue: Shanghai]* No. 12, 45, at 47 (December 1998).

³⁹ There is a lot of literature demonstrating a significant correlation between financial development and growth, just to list some of them here: King, Robert G. & Levine, Ross, 'Finance and Growth: Schumpeter Might Be Right', 53 *Quarterly Journal of Economics* 715-37 (August 1993); Pagano, Marco, 'Financial Market and Growth: An Overview', 37 *Eropean Economic Review* 613-22 (April 1993); and also Stiglitz, Joseph E., 'Financial Market and Development', 5 *Oxford Review of Economic Policy* 61 (Winter 1989). Tan Ruyong tested the relationship between financial development and economic growth in China, using statistics during the period from 1993 to 1998 and found out a positive correlation between them. See, Tan, Ruyong, 'An Empirical Study of the Relationship between China's Financial Development and Economic Growth [zhongguo jinrong fanzhang he jingji zhengzhang guanxi de shizheng yanjiu]', *Economic Research journal [jingji yanjiu]*, No. 10, 53 (October 1999).

damage the economy as a whole.⁴⁰ As the banks are the key providers of funds to industry and commerce in China, their fragility can certainly have a negative impact on the real economy.

A banking system burdened with large amount of bad assets is vulnerable to the external shock. Failures in the financial sector hurt other business and eventually the whole economy.⁴¹ This has been fully shown in the failure of the Guangdong International Trust and Investment Corporation (Gitic), which led to the liquidity crisis spreading across China's financial sector— caused by the retreat of international lenders.⁴² Some economists even asserted that the Gitic bankruptcy triggered a “partial foreign debt crisis” in China.⁴³ Moreover, the GITIC bankruptcy led directly to the downgrading of the credit ratings of the Chinese state-owned banks and investment companies— Standard and Poor's assigned a “junk” rating to China International Trust and Investment Company (CITIC), the BOC, the CCB and the ICBC.⁴⁴

Even if without external shocks, large amount of bad assets will have negative impacts on the economy.⁴⁵ The massive overhang of bad debt stifles new, higher-quality lending by the state banks and acted as a drag on new economic growth. Banks have to make provisions for these loans. High provisioning needs are pushing banks to put

⁴⁰ Around the world, emerging market economies have experienced financial crisis in the aftermath of imprudent credit policies, neglectful supervision and poor regulation of politicized financial systems. Even in those cases where problems of the financial system were not the immediate cause of the currency collapse, financial sector weakness prevented an effective defense of the exchange rate and added to the fireworks of the collapse and the depth and duration of the post-crisis distress. Conversely, in Argentina, Singapore or Hong Kong the strong financial system has made the effect of a dramatic regional crisis far more sustainable. See, Dornbusch, Rudi & Giavazzi, Francesco, 'Heading off China's Financial Crisis' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 40, at 40 (October 1999).

⁴¹ For an economic analysis, see, e.g., Kiyotaki, Nobuhiro & Moore, John, 'Credit Cycles', 105 *Journal of Political Economy* No. 2, 211 (1997).

⁴² See, e.g., Harding, James, 'China: Foreign Banks Get Tough', *Fin. Time* (February 8, 1999); 'China: Foreign Banks Look to Reduced Role', *Fin. Times* (January 27, 1999); 'China: Gitic Failure Starts to Hurt other Businesses', *Fin. Times* (January 22, 1999); and Lucas, Louise & Harding, James, 'China: Confidence Sinks With Full Gitic Debt', *Fin. Times* (January 11, 1999).

China's medium and small commercial banks suffered the most from the Gitic affair. From 1998 on, many foreign banks rejected the L/C from China's medium and small commercial banks. Almost all beneficiaries required confirmation from other well-known international banks. See, Chinaonline, 'The Prospects for China's Foreign Fund- Raising Capability' (November 8, 1999), available at '<http://www.chinaonline.com/industry/financial/currentnews/open/B2-99110326-SS.asp>'.

⁴³ See, e.g., 'China's Partial Foreign Debt Crisis', available at 'http://www.chinaonline.com/top_stories/breakingnews_b2_99030835.html'.

⁴⁴ See, e.g., Lau, Lawrence J., 'The Macro-economy and Reform of the Banking Sector in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 59, at 78 (October 1999).

⁴⁵ Some economists contribute the 1998 growth slowdown in China to excess capacity in industry, banking sector stress, low consumer confidence and lower export growth. With regards to banking sector stress, they points out the huge amount of NPLs, combined with the Asian financial crisis, caused tensions in the Chinese government and the banking sector, banks became cautious about increased lending, and many projects with uncertain returns were rejected. The tight of credit contributed to the 1998 economic growth slowdown and have negative impacts on long-term growth perspective. See, generally, Wu, Renhong, *China's Economic Outlook*, Chinaonline (1999).

available cash aside for potential losses instead of making the new loans needed for the economy.⁴⁶ There have been companies complaining that more banks are avoiding giving out loans because of rising bad debt levels.⁴⁷ Those who suffer the most, however, are the potentially good borrowers, whose projects are crowded out.

It is now well-accepted that medium-sized and small sized enterprises,⁴⁸ especially those private-owned, are fast becoming the driving force for China's economic development. By November 1999, the country had 31.75m registered private business owned by individuals that employed 62.26m people and 1.41 private enterprises employing 19m peoples.⁴⁹ Because of the under-developed capital markets, bank credits are typically their only source of outside finance. Lending to new private businesses is crowded out through two distinct channels,⁵⁰ however. The first is simply an insufficient amount of credit, as this is used to roll over bad loans due to the adverse selection of bank managers; the second is unduly expensive credit-banks in trouble tend to widen the gap between lending and deposit rates in an attempt to gradually rebuild their capital. China's small companies,⁵¹ even if high technology companies,⁵² still complain bitterly that China's state-banks do not lend to them, needless to say private enterprises⁵³—private

⁴⁶ This consequence has already been seen in countries such as Japan and Thailand. In Japan, bank lending fell some 4%, while the economy shrank 2.5%. That is largely due to the dicey state of banks. Because they're carrying a \$600bn of NPLs on their books, they are leery of lending to companies. See, e.g., Business Week, 'Why Japan is Stuck', available at '1999 WL 8226852'; Bardacke, Ted, 'Thailand: Debt Makes up 44% of Lending', *Fin. Times* (March 3, 1999).

⁴⁷ These complaints were dismissed by PBOC. According to a PBOC survey, large- and mid-sized companies with healthy profits are still getting needed loans, although credit controls are more stringent and companies are being forced to look for needed capital through other channels. The survey found out that enterprises who had been turned down largely because of their poor credit record. See, Xinhua English Newswire, 'China's Bank Loans On Target' (April 5, 1999), available at '1999 WL 7931582'.

⁴⁸ China's ten m small and medium-sized companies account for 90% of all businesses in China and 60% of the country's gross industrial output. They employ 75% of the country's working population, contribute 40% of all tax revenue, and account for 60% of China's US \$ 150bn annually in exports. See, 'Small and Medium-Sized Companies Power China's Economy', available at 'http://www.chinaonline.com/top_stories/breakingnews_c9040601.html'.

⁴⁹ See, Chinaonline, 'China Sees Private Sector Upsurge Last Year' (February 9, 2000), available at '<http://www.chinaonline.com/topstories/000209/2/C00020810.asp>'.

⁵⁰ See, Begg, David & Portes R., 'Enterprise Debt and Economic Transformation: Financial Restructuring in Central and Eastern Europe', in Mayer C and Vives X (eds.), *Capital Markets and Financial Intermediation* (1993). On the crowding-out of private firms in transition economies, see, Webster, L, *Private Manufacturing in Eastern Europe*, Mimeo (World Bank, 1992).

⁵¹ See, e.g., 'China to Guarantee Loans for Small Business', available at 'http://www.chinaonline.com/industry/fina...ive/Secure/1999/february/fn_c9020309.asp'.

⁵² See, e.g., James Kynge, 'China: Beijing Plans fresh Drive on Technology', *The Fin. Times* (January 29, 1999). Efforts are going to be made, however, to boost the high-tech companies. It is said that the China Securities Regulatory Commission (CSRC), China's stock market watchdog, was prepared to ease listing requirements for high-tech companies and to speed up their approval. *Id.*

⁵³ This has caused some obvious distortions. Companies such as Huawei, a high-tech telecoms equipment manufacturer which has seen sales double almost every year for the last four, still has trouble in securing loans from state banks. The big four banks extend loans to China Telcom, the dominant state telecoms company, to facilitate the purchase of Huawei's equipment but are reluctant to lend directly to the profitable equipment maker. Another example is Stone Rich Sight, a leading internet portal company and

entrepreneurs have long complained China's "big four" state banks, which together control as much as 90% of total banking assets, seldom lend to them. With regards to the second channel, in 1998, the PBOC granted more lending rates discretion to commercial banks for their lending to small business and agricultural loans, allowing rate fluctuation ceilings for small business loans from 10% to 20% and agricultural loans from 40% to 50%.⁵⁴ This gives commercial banks authorities to charge small business more.

The government's policy toward private sector has been changed tremendously since the economic reform. Under the 1982 Constitution,⁵⁵ private sector economy was defined as a supplementary to the socialist public economy.⁵⁶ The 1988 amendments to the Constitution declared at the first time "the State allows the existence and development of private economy within the limitation of law".⁵⁷ The official standing of private enterprise was raised drastically by the 1999 Amendments to the Constitution. The National People's Congress adopted amendments which elevate the official standing of private enterprise on March 9, 1999. The changes describe "the individual, private and other non-state sectors are an important component of the socialist market economy" rather than merely an appendage to the socialist public ownership system, as before the amendments.⁵⁸ Later, the 11th Session of the Ninth NPC Standing Committee passed the Individual and Private Business Law, to regulate the development of private and individual businesses. The Ministry of Finance began to implement the Regulations for Credit Guarantees for Small and Medium-Sized Businesses in 1999 as well.⁵⁹ Without a health banking system, the crowding-out effect on private enterprises, however, will not be able to be curbed easily.

the maker of China's top Chinese-language software, which has never received a loan from a state bank. See, e.g., Kynge, James, 'China: Beijing Fillip for Private Sector', *Fin. Times* (February 4, 1999).

⁵⁴ The interest rate floor for small business loans remains unchanged at 10%. The ceiling on rate fluctuations for medium and large businesses remains unchanged at 10% as well. See, e.g., Chinaonline, 'China's Central Bank Raises Ceiling on Small Business Loan Interest Rates' (November 4, 1998), available at 'http://www.chinaonline.com/industry/fina...ive/Secure/1998/November/fn_b8103036.asp'.

⁵⁵ The Constitution of the People's Republic of China, adopted by the Fifth National People's Congress on December 4, 1982.

⁵⁶ The 1982 Constitution, art. 11.

⁵⁷ The Amendments to the Constitution, adopted at the First Session of the Seventh National People's Congress on April 12, 1988, art. 1.

⁵⁸ Amendments to the Constitution, adopted at the Second Session of the Ninth NPC on March 15, 1999, art. 16.

⁵⁹ Efforts has been making to improve the situation. In accordance with the February 3 *Zhengquan Shibao* (Securities Times), the central government will establish a system to guarantee the credit of small and medium companies seeking bank loans. The system has been used on a trial basis in Shandong and Anhui Provinces and, based on its success there, will be expanded to the rest of the country. The country's Ministry of Finance is studying different methods for putting the guarantee system into place, which include earmarking part of the central government fiscal revenues for a loan guarantee fund and exempting loan guarantor companies from paying income taxes. See, e.g., 'China to Guarantee Loans for Small Business', available at 'http://www.chinaonline.com/industry/fina...ive/Secure/1999/february/fn_c9020309.asp'. The first loan guarantee center in China for small and medium-sized enterprises started operation in the city of Zhenjiang, Jiangsu Province in February, 1999, according to the February 22 *Jingrong Shibao* (China's Financial Times). See, 'China and United Nations Open Loan Center for Small- and Medium-sized Firms', available at 'http://www.chinaonline.com/industry/fina...ive/Secure/1999/february/fn_b9022202.asp'.

3. Summary

Although there are disagreements on the exact amount of non-performing loans accumulated on China state banks' balance sheets, it is widely accepted that NPLs have accumulated to such an extent that they are large enough to threaten the safety and soundness of China's state banks and consequently the whole banking system. China's state commercial banks are now running on the government support and public's confidence.

The existence of sky-high amount of NPLs not only impair the health of the banking system, more importantly, it impedes banks from granting new loans to the real economy, and the establishing of market economy in China. Efforts must be made to workout bank NPLs, and prevent the increasingly creation of NPLs with banks' balance sheets.

B. THE ASIAN FINANCIAL CRISIS: SIMILARITIES BETWEEN CHINA AND ASIAN CRISIS COUNTRIES⁶⁰

1. The Asian Financial Crisis and Its Origins

The Asian financial crisis involved several mutually reinforcing events, starting with the devaluation of the Thai baht in July 1997, and followed by devaluation of other currencies, the attack on the Hong Kong dollar in October 1997, a rapid withdrawal of foreign private capital, bank runs, sovereign downgrades, and a dramatic decline in real economic activity. The crisis was felt particularly severely in Indonesia, Korea, and Thailand. There was a \$17.2bn rescue for Thailand, and a \$42bn package for Indonesia. South Korea got a whopping \$58.4bn when it was on the verge of bankruptcy.⁶¹ Other countries in the region also experienced some of the effects of the financial turmoil, such as Malaysia and the Philippines, although they did not suffer a full-blown crisis.

It is widely accepted that the Asian crisis originated in financial and corporate sector weakness combined with macroeconomics vulnerabilities. Weakness in bank and corporate governance and lack of market discipline allowed excessive risk-taking, as prudential regulations were weak or poorly enforced. Close relationships between governments, financial institutions and borrowers worsened the problems, particularly in Indonesia and Korea. More generally, weak accounting standards, especially for loan valuation, and disclosure practices helped hide the growing weaknesses from policy-makers and supervisors, market participants and international financial institutions—while those indicators of trouble that were available seem to have been largely ignored.⁶² These weaknesses increased the vulnerability of financial institutions to deterioration in

⁶⁰ In this paper, the term "Asian crisis countries" refer to Thailand, Indonesia, South Korea, Malaysia and Philippines.

⁶¹ For a sequenced description of the development of the current financial crisis, see, e.g., Philips, Michael M., 'One by One: A Look at How the Global Finance Crisis Began', *Asian Wall St. J.*, S2 (May 3, 1999).

⁶² See, Balino, Tomas J. T., Enoch Charles *et. al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 5 (IMF, September 1999).

the external environment, declines in asset values, market contagion, speculative attacks, exchange rate devaluation, and a reversal of capital flows. In turn, problems in financial institutions and corporations worsened capital flight and disrupted credit allocation, thereby further deepening the crisis.⁶³

2. Similarities Between China and Asian Crisis Countries

Although China has until now succeeded in immunizing itself from the contagion of the crisis, concerns have arisen about the stability of China's financial system, with its banks burdened with sky-high amount of NPLs. China shares all the fundamental weaknesses with those countries suffering from crises.⁶⁴ Five fundamental similarities can be identified between China and the crisis countries.

First, the rate of increase in bank credit since reform began in China is similar to that experienced in other countries before the emergence of major banking crisis. In Thailand, for example, there was a five-year period in which bank lending expanded at an annual rate of 25%, three times the rate of real economic growth.⁶⁵ The run-up in credit by financial institutions in China, more than 21% a year since 1978, has been almost as fast. Moreover, this expansion has been sustained for decades.⁶⁶ In both China and Thailand, excessive bank lending had financed excess investment across a broad range of industries. In China, for example, these industries ranged from home appliances to beer, property, and automobiles. Firms in these and other sectors have borrowed excessively to finance rates of expansion that are not sustainable. Moreover, in both countries, these over lending were encouraged by the government.⁶⁷

Second, a common feature shared by China's financial system and that of Asian crisis countries was that their financial systems are heavily bank dominated. In China, bank lending accounts for about 90% of the whole finance in China.⁶⁸ To be worse, China's financial sector is dominated by state commercial banks. Although a variety of institutions are populating China's financial sector, and there is now a nucleus of potential competition between commercial banks. State commercial banks, especially the

⁶³ Detailed expositions on the causes of the crisis can be found in Lane, Timothy *et. al*, *IMF-Supported Programs in Indonesia, Korea and Thailand. A Preliminary Assessment*, IMF Occasional Paper No. 178 (1998).

⁶⁴ In terms of fundamentals, a clear lesson of the Asian crisis is that it is dangerous for a country to have weak, poorly regulated banks, making policy loans to inefficient, over-leveraged state enterprises— a reasonable description of China. See, Fernald, John G. & Babson, Oliver D., 'Why China Survived the Asian Crisis So Well? What Risks Remain?', 1, *Board of Fed. Internal Finance Discussion Papers* No. 633 (February 1999).

⁶⁵ See, Sapsford, Jathon, 'The Outlook: What Asia May Need Is Far Slower Growth', *Wall Street Journal*, A1 (November 3, 1997).

⁶⁶ See, Dai Xianglong, 'Improve Financial Services to Assist Reform and Progress of SOEs in Accordance with the Guideline of 4th Plenary of the 15th Central Committee of CPC', *China Finance*, No. 11, 4, at 5 (November 1999). During the period from 1978 to September 1999, the outstanding loans of financial institutions in China increased from RMB189.5bn to RMB9339bn. *Id.*

⁶⁷ See, Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 203 (1998).

⁶⁸ See, e.g., Jiang, Xuejun & Liu, Yan, 'China's Financial Structures', *China Finance (Beijing)* No. 6, 43 (1998).

big four,⁶⁹ are still dominating the banking sector. The profits of the “big four” account for 50% of the profits in China’s banking system in 1998.⁷⁰ They hold 68% of the nation’s deposits, 77% of all loans, 75% of the country’s total assets and employs 66% of those working in the banking sector.⁷¹ China appears to be an-extreme example of the Asian pattern where a few banks loom very large on the financial landscape and competition is thus somewhat very limited.⁷²

Third, central banks are weak in China and Asian crisis countries. Their weaknesses seriously obstruct them from exercising adequate prudential supervision over commercial lending. For example, Chinese banks and other financial institutions appear to be heavily exposed to real estate lending. Although no disclosure has been made by Chinese banks about their exposure to real estate industry, the exposure is estimated to be significant.⁷³ Once the real estate market collapse, banks will certainly loss their money.

The fourth similarity is pervasiveness of NPL problem with Chinese banks and banks in Asian crisis countries. As shown above, above 20% of the loans of China’s largest banks were classified as NPLs since mid-1990s on. This percentage is higher than in Korea or Thailand just before the onset of their financial crises.⁷⁴

C. THE UNSUCCESSFUL RMB 270 BILLION RECAPITALIZATION IN 1998

1. Official Reaction in China After the Asian Financial Crisis

The severity of Asian financial crisis taught Chinese government. On November 17-19, 1997, the Central Committee of the Communist Party of China and the State Council held the National Financial Working Conference in Beijing.⁷⁵ The conference was held against

⁶⁹ They are: The Construction Bank of China, Bank of China, the Agricultural Bank of China and the Industrial and Commercial Bank of China.

⁷⁰ See, e.g., ‘S & P Downgrades Hit China’s Big Banks When They Can Least Afford It’, available at http://www.chinaonline.com/top_stories/top_news_story.html.

⁷¹ See, e.g., Chinaonline, ‘A Look at Bank Reform in China’ (April 14, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_b2-99030914-2.html.

⁷² In all Asian crisis countries, commercial banks dominated the financial system. At the end-1996, total assets of the Indonesian financial system were equivalent to about 90% of GDP, with commercial banks held 84% of total assets; in South Korea, Total assets of the system were close to 300% of GDP, with commercial banks alone accounted for 52% total assets, while specialized and development banks accounted for 17%; in Malaysia, total assets of the system were equivalent to 300% of GDP, with commercial banks accounted for 70% of total assets of the banking system (comprising the commercial banks, finance companies and merchant banks); in Thailand, total assets of the system amounted to the equivalent of 190% of GDP, with commercial banks alone accounted for 64% of total assets. See, ‘Box 1. Structure of the Financial System at End-1996’ in Balino, Tomas J. T., Enoch Charles et. al., *Financial Sector Crisis and Restructuring Lessons from Asia*, 19 (IMF, September 1999).

⁷³ An investment banker based in Singapore estimates that real estate loans account for 20% to 25% of total domestic credit. See, Lo, Chi, ‘Despite Big Bad Loans, China Can Avert a Financial Crisis’, *Asian Wall Street Journal*, 16 (Weekly Edition, January 5, 1998).

⁷⁴ In Korea the level of NPLs officially acknowledged by the Ministry of Finance in November 1997 constituted 18.5% of total loans outstanding. See, e.g., Montagnon, Peter & Ridding, John, ‘Banks “Face Years of Losses and Cuts”’, *Fin. Times* (November 25, 1997).

⁷⁵ The Conference was an usual high-level national finance work conference. The meeting was addressed by President Jiang Zemin, Premier Li Peng and Vice Premier Zhu Rongji. Several other members of the

the backdrop of financial crises in three Asian countries— Thailand, Indonesia, and Korea— that had sought massive international financial assistance coordinated by the IMF.⁷⁶ The meeting focused on similarities between the financial sector in China and those elsewhere in Asia and called to establish a financial system compatible to the socialist market economy and to strengthen the risk management capacity of financial institutions in about three years.⁷⁷ This three-year goal was later reiterated by Premier Zhu Rongji at the March 19, 1998 press conference of the First Session of Ninth National People's Congress. At the press conference, Premier Zhu said that the problems of the state-owned enterprises (SOEs),⁷⁸ as well as those within the banking sector, should be resolved within three years.⁷⁹

In the wake of the November 1997 financial conference, the government announced important steps to reduce the risks that the Asian financial contagion would spread to China, with the RMB 270bn capital injection at the core of these measures.⁸⁰

Standing Committee of the Politburo of the Central Committee of the Chinese Communist Party also were present. Other participants in the Beijing meeting included not only central bank officials at the national and provincial level, officials from the headquarters and major provincial branches of China's state-owned banks, insurance companies, and many non-bank financial institutions, but also provincial governors and provincial-level finance officials. All these show the importance of the meeting. See, Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 202-3 (1998).

⁷⁶ Indeed, in an unprecedented move, China contributed US\$1bn to the IMF-led bailout of Thailand in 1997.

⁷⁷ Historical Research Unit of the Central Committee of the Communist Party of China, 'Major Events after the Third Session of the Eleventh Central Committee of the Communist Party of China (III) (*zhonggong shiyijie sanzongquanhui yilei dashiji-xia*)', *People's Daily (Overseas Edition)*, 3 (December 16, 1999).

⁷⁸ This is limited to medium- and large-sized SOEs. According to Chen, Qingtai, Vice-Director of State Commission of Economy and Trade, the promise was limited to about 6,000 loss-making SOEs out of the then 16,000 large and medium-sized enterprises. See, Gong Wen & Huang, Rifei, 'The First Session of the Ninth National People's Congress Held Press Conference on SOE Reform and Re-employment (*Du Gouda Gaihe he Thai Juice Deng Went Juice Rend Yacht Hue Juexing Jizhe Jiadaihui*)', *People's Daily (Overseas Edition)*, 4 (March 9, 1998). The task was further limited by Liu, Hong, head of the State Statistics Bureau. In an article published in the *People's Daily*, Liu said China would be able to reduce the proportion of large and medium-sized SOEs which are loss-making to below 30% by the end of 2000. According to Liu, this would mean the government achieved its target of bringing most SOEs out of difficulty in a three-year period ending at the end of 2000. Liu said it is wrong to consider returning enterprises to profit as the only standard for judging whether enterprises are out of difficulty. See, AFX, 'China to Cut Proportion of Loss-making State Firms to Under 30% by End-2000' (December 7, 1999), available at '1999 WL 25421431'.

⁷⁹ See, e.g., Historical Research Unit of the Central Committee of the Communist Party of China, 'Major Events after the Third Session of the Eleventh Central Committee of the Communist Party of China (III) (*zhonggong shiyijie sanzongquanhui yilei dashiji-xia*)', *People's Daily (Overseas Edition)*, 3 (December 16, 1999).

⁸⁰ The other steps include but not limited: the reorganization of the local branches of the PBOC along the regional lines in order to reduce political interference in lending decisions at the local level, with purposes of ending the common practice of provincial governors and party officials influencing the flow of lending in their regions; the write-off of enterprise bad debts; policies encouraging banks to take risk into account when they set interest rates for specific borrowers; the introduction of asset-to-liability ratios and the removal of the credit ceiling on banks; the introduction of the new loan classification and provisioning system more closely aligned with international standards; and enhancing controls on international borrowings.

2. Ex-ante Recapitalization Vs. Ex-post Recapitalization⁸¹

Ex ante recapitalization and ex post recapitalization denotes whether to recapitalize banks before, or after corporate restructuring. Under an ex ante recapitalization, with appropriate burden sharing, the government recapitalize banks based upon an assessment of probable losses (determined by outside audits and independent portfolio reviews). Some loans may be transferred, at the time of recapitalization or afterwards, to AMCs. The banks are left to deal with the major part of the NPLs themselves. Poland carried out this ex ante recapitalization, with a one-time recapitalization of the banks, designed to be large enough to ensure adequate capital and make credible the “one-time-only” promise. The amount of each bank’s recapitalization was based on the value of its portfolio of bad debts at year-end 1991, as identified in audits conducted in 1992 by international accounting firms. The first set of audits by international auditing firms was carried out for all nine state banks in the summer of 1991. The audits were repeated in mid-summer 1992 and (for the seven banks still in the state hands) again in 1994. The recapitalization was based on the status of loan portfolio as of end-1991, as measured in the 1992 audit.⁸² After the recapitalization, a bank-led debt restructuring was carried out in Poland.⁸³

Ex ante recapitalization can be fast and signal to the market that problems are being resolved. It also formalizes government guarantees of bank liabilities. And, provided it is accompanied by substantive improvements in corporate governance and bank operations and is well monitored, it can be an up-front investment that leads to lower ultimate costs. But ex ante recapitalization has also carried great risks. First of all, it will be hard to assess probable losses in countries with under-developed accounting practices, while it is important for the government to inject sufficient money into banks to avoid further bailout. Second, in most cases, governments routinely respond to such systemic bank solvency problems by injecting capital into insolvent banks, without change in governance and bank operations, and recapitalization is wasted. Banks will have better capacity to work out loans and take losses when recapitalized, but they may still delay restructuring and roll over NPLs since they are able to attract new funds anyhow.⁸⁴ And, likewise, corporations may have little incentive to undertake necessary operational restructuring, if they have access to new funds anyway.

The risks are very real for many developing countries or transitional economies due to their under-developed accounting practices, the banks’ lack of skills, technical capacity, and the underdeveloped legal infrastructure. All these cannot be remedied

⁸¹ The discussion under this title relies heavily on Claessens, Stijin, ‘Experiences of Resolution of Banking Crises’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 275, at 293-4 (October 1999).

⁸² See, note 20 in Gray, Cheryl W. & Holle, Arnold, *Bank-Led Restructuring in Poland (I): An Empirical Look at the Bank Conciliation Process*, 5 (World Bank, September 1996).

⁸³ See, relevant discussion in ?

⁸⁴ Banks in Japan, for example, have shown no inclination to undertake corporate restructuring, as they can continue to carry NPLs at low costs. See, Claessens, Stijin, ‘Experiences of Resolution of Banking Crises’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 275, at 294 (October 1999).

overnight. The failed RMB270bn recapitalization of the big four in 1998 provides a good example for that.

Contrast to the ex ante recapitalization, the ex-post recapitalization denotes that banks receive public funds as, and when they provide financial relief to corporations. This model provides more time to undertake the necessary fundamental reforms and maintains pressures on banks and corporations to agree quickly on realistic financial and operational restructuring. The main drawback is uncertainty, as depositors and other creditors can be uncertain about the quality of their claims.

In between the ex ante and ex post recapitalization, the government may choose to set up AMCAs to take over NPLs from banks, so that banks are recapitalized by the consideration paid by the AMCAs for the NPLs. The AMCAs, rather than the banks are mandated to carry out corporate debt restructuring. As will be shown below, China actually is carrying on this in-between model to recapitalize the big four after the failure of the RMB270bn ex ante recapitalization.

3. The RMB270bn Recapitalization in 1998

In March 1998, the Ninth National People's Congress examined and passed a resolution allowing the Ministry of Finance to issue special bonds totaling RMB270bn to replenish the capital of the big four.⁸⁵ This recapitalization was implemented in three steps in conjunction with the reduction in the deposit reserve requirement: (1) The PBOC lowered the legal reserve requirement from 13% to 8%,⁸⁶ freeing up about RMB377bn of bank liquidity.⁸⁷ (2) In August 1998, the Ministry of Finance issued 30-year bonds to the big four, with an annual coupon rate of 7.2%.⁸⁸ The bonds were purchased by the big four themselves, with funds freed up by a lowering of the required reserve ratio from 13% to 8%. (3) The MOF injected the entire proceeds into the state-owned banks to strengthen their equity capital.⁸⁹

The recapitalization plan raised the capital of the big four to RMB478bn from RMB208bn. After the capital injection, the size of the aggregate balance sheet of the state-owned banks remained unchanged. The balance sheet of the central bank contracted

⁸⁵ See, e.g., Chinaonline, 'China's Central Bank Governor on Financial Situation' (March 7, 1998), available at 'http://www.chinaonline.com/industry/fina...1/News_Archive/Secure/1998/May/fn_002.asp'. The NPC authorized the Ministry of Finance to decide the term and interest rate of the bonds. *Id.*

⁸⁶ See, e.g., Xie, Ping, 'Bank Restructuring in China' in *Bank Restructuring in Practices*, 124, at 124-5 BIS Policy Papers No. 6 (August 1999).

⁸⁷ Roughly RMB270bn from the state-owned banks and RMB107bn from other financial institutions. The PBOC recalled part of its loans to the state-owned banks to offset the inflationary impact of the reduction in the reserve requirements. See, e.g., Mo YK, 'A Review of Recent Banking Reforms in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 90, at 93 (October 1999).

⁸⁸ See, e.g., Lau, Lawrence J., 'The Macro-economy and Reform of the Banking Sector in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 59, at 73 (October 1999).

⁸⁹ See, e.g., Mo YK, 'A Review of Recent Banking Reforms in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 90, at 93 (October 1999).

but this was offset by a similar expansion in the balance sheet of the MOF.⁹⁰ The recapitalization plan not only strengthened the capital of the big four but also positive implications for their future income streams:⁹¹ First, the big four will benefit from the yields arising from investment in the bonds. This amounted to RMB19.4bn a year before additional dividend payments to the MOF because of the government's increase in equity holdings. Second, in paying off some central bank credits, the big four will also reduce their interest costs.⁹²

It was expected then that after the RMB270bn injection, the risk-weighted capital adequacy of the big four could have reached the 8% standard set by the Basle Capital Accord and the Commercial Banking Law;⁹³ and the big four will consequently have incentives to lend on commercial basis. These expectations proved unrealistic. According to Lardy, this recapitalization scheme was neither good timed nor in the right size.⁹⁴

With regard to the time, Lardy's main criticism is that the recapitalization was such timed that it foster the expectation that having bailed out troubled banks once, the government would do so again: Although there was some evidence, particularly after mid-1993, that banks were beginning to curtail the flow of new lending to money-losing SOEs. This policy was reinforced in the spring of 1998 when the NPC endorsed the goal of encouraging commercial behavior on the part of state-owned banks. But by mid-year this policy appeared to have been significantly modified when the central bank directed these banks to continue to extend additional loans to money-losing SOEs.⁹⁵ Shortly thereafter, the government completed the RMB270bn injection of capital into the big four. Requiring banks to lend additional funds to firms that have only limited prospects of amortizing their loans creates the expectation on the part of banks that additional recapitalization funds will inevitably be forthcoming. That expectation seriously undermines the prospect for a fundamental change in bank lending behavior.

⁹⁰ For details of the changes in the aggregate balance sheet of the state-owned banks, the balance sheet of the PBOC, see, 'Annex 2, state-owned commercial bank recapitalization plan' of Mo YK, 'A Review of Recent Banking Reforms in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 90, at 106-108 (October 1999).

⁹¹ See, Mo YK, 'A Review of Recent Banking Reforms in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 90, at 94 (October 1999).

⁹² YK MO of the BIS Hong Kong Office did a calculation and estimated that the reduction in interest cost could amount to RMB4-5bn a year. This, totaled with the yields from the bonds, would mean RMB23-24bn increase in the big four's profits annually, almost as much as their aggregate profits in 1997. See, Mo YK, 'A Review of Recent Banking Reforms in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 90, at 94 (October 1999).

⁹³ See, Xinhua News Agency, 'The Ministry of Finance is to Issue Special Treasury Bonds Worth RMB270 to Enhance the Capital of State Owned Commercial Banks (*Buchong Guoyou duzi Shangye Yinghang Zibenjing, Caizhengbu Faxing 2700yi Tebie Guozhai*)', *People's Daily (Overseas Edition)*, 1 (March 2, 1998).

⁹⁴ See, Lardy, Nicholas R., 'The Challenge of Bank Restructuring in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 32-3 (October 1999).

⁹⁵ Notice Concerning Further supporting State-Owned Industrial Enterprises that Are Losing Money which Have Salable and Efficiently Produced Products [Guanyu Jingyibu Zhichi Guoyou Kuisun Gongye Qiye youxiaolu, youxiaoyi Chanpin Shengchan de Tongzhi], issued jointly by the PBOC, State Economic and Trade Commission, State Bureau of Taxation, in June 1998.

Compared to huge amount of NPLs accumulated on the big four's balance sheets, that was estimated to be RMB1trillion,⁹⁶ RMB270bn recapitalization of the big four undertaken in August 1998 fell far short of the recapitalization amount that they will ultimately require.⁹⁷ Some might argue that China follow the Polish approach and have internationally recognized accounting firms audit the financial situation of the big four before decide the size of the recapitalization. This proves unrealistic at least at this moment, however, because China cannot afford losing the public confidence on the big four.⁹⁸

D. TURNING TO AMCS AND DEBT-EQUITY SWAPS

The failure of RMB270bn ex ante recapitalization led authorities in China turns to AMCs and debt-equity swaps. As mentioned before, that is something in-between ex ante recapitalization and ex post recapitalization.

In 1999, four AMCs were established to take over NPLs from the big four. The AMCs, each with a registered capital of RMB10bn from the Ministry of Finance, issued bonds guaranteed by the Ministry of Finance to their respective banks in exchange for NPLs at the paper value of the loans.⁹⁹ Because the bonds issued to the banks in exchange of the NPLs are Treasury-back bonds, this transaction is in essence an injection of capital to the big four.

Compared to the Special Treasury Bonds injection in 1998. Setting up AMCs to take over NPLs from the big four bears some merits. Most importantly, the approach can avoid the potential costs to succumbing to the natural tendency of reducing the cost of bank recapitalization by underestimating the magnitude of NPLs or by overestimating the amount that ultimately can be recovered from borrowers. Lardy identified these costs

⁹⁶ See, Chinaonline, 'China's Bank Clean-up to Take Three Years- Official' (October 25, 1999), available at '<http://www.chinaonline.com/topstories/C9102114.asp>'.

⁹⁷ YK Mo of the BIS Hong Kong Office conducted a sensitivity test on the provisions required by the big four against their classified loans. The test was conducted on the assumption that the NPLs were 20% of total loans extended by the big four, or which 6% were irrecoverable loans and the remaining 14% and doubtful and substandard loans. The following provision requirements applied in the analysis: 100% for irrecoverable loans, 75% for doubtful loans and 15% for substandard loans. The results showed that the required amount of provision was RMB480-979bn as of end-1997. Taking the 25th and 75th percentiles, a reasonable amount would be RMB600-850bn, roughly 1.3-1.8 times the entire amount of the post-injection aggregate paid-in equity capital of the big four. The big four would probably need such amounts of additional fund injection to recapitalize in order to maintain an 8% capital adequacy ratio. See, 'Annex Sensitivity analysis on provisions for classified loans in the four state-owned banks' of Mo YK, 'A Review of Recent Banking Reforms in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 90, at 109 (October 1999).

⁹⁸ Xie, Ping, a senior official of the PBOC, for example, when talked about the feasibility of the establishment of mandatory requirements on disclosure for financial institutions, cautioned that such requirements would jeopardize public confidence since all financial institutions have serious problems and wondered how long it would take to get ready to be able to implement disclosure requirements. See, *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 331 (October 1999).

⁹⁹ See, Zhang, Chunlin, 'How to Appraise the Sustainability of Government Debt in China? [ruhe pinggu woguo zhenfu zhaiwu de ke chixxing]', *Economic Research Journal (jingji yanjiu)* No. 2, 66, at 66 (February 2000).

based on Eastern Europe experiences:¹⁰⁰ The key pitfall of recapitalization is the failure to recapitalize adequately. When recapitalization is inadequate to restore banks to financial health it can erode the credibility of the government's claim that there will be no further bailout.¹⁰¹ Partial recapitalization, as in the Hungarian case, could have undermined the incentive for a change in bank behavior going forward by increasing the possibility of future recapitalization.

Given the under-developed loan classification criteria in China and poor disclosure practices, it is hard to make a proper capital injection once-and-for-all, whether in cash or in bonds. While to establish AMCs to issue bonds in exchange of NPLs of the big four at face value to some extent has avoided the difficulties in valuation.

Setting up AMCs to take over NPLs from banks is only the first step, however. Just as US Treasury Secretary Lawrence Summers said during a joint press conference with China Minister of Finance Xiang Huaicheng— Creation AMCs and having AMCs take over NPLs from banks “[are not a total step] because [this] does not ensure that assets will be recycled or restructured or managed rather than warehoused”.¹⁰² Therefore, immediately after the Setting up of the first AMC for CCB, the China Cinda AMC, debt-equity swap scheme was introduced as a win-win solution to China's bank problem and SOE problem.

E. SUMMARY

To sum up, the seriousness of China state commercial banks' NPL problem cannot be exaggerated. If it cannot be solved properly on time, the accumulating NPLs might lead to the collapse of China's state commercial banks, and consequently the whole financial system and the whole economy. It was until the Asian financial crisis that substantial steps started being taken by Chinese authorities to deal with the NPL problem. The government first chose to recapitalize the big four ex ante in 1998, hoping that the RMB270bn capital injection could raise the capital level of the big four to international standard, and that the big four would started lending on real commercial basis. The recapitalization, however, was neither rightly timed nor in the right size.

The failure of the ex ante recapitalization led to the decision to setting up four AMCs, and the debt-equity swap schemes. The AMCs issued treasury-guaranteed bonds to their respective banks, in exchange of the NPLs at face value. By this bond-bad-debt swaps, the big four are actually recapitalized. The debt-equity swap scheme is in the intention of solving bank problem and SOE problem simultaneously.

III. AMCS FOR THE FOUR LARGEST STATE COMMERCIAL BANKS

A. CHINA'S PRACTICES OF AMCS

¹⁰⁰ See, Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 159 (1998).

¹⁰¹ See, Begg, David K. H., *Monetary Policy in Central and Eastern Europe: Lessons after Half a Decade of Transition*, IMF working paper No. 108, 37 (1996).

¹⁰² See, Chinaonline, 'US Treas Sec Comments on China's Asset Mgmt Cos.' (October 27, 1999), available at '<http://chinaonline.com/topstories/c9102731.asp>'.

In China, using intermediaries such as AMC's to solve the state commercial banks' NPL problem was recommended as early as 1993.¹⁰³ Liu, Zhunyi and Qian, Yinyi proposed the establishment of an Enterprise-Bank Restructuring Fund to take over NPLs from banks and subsidize enterprises in difficulties for a fixed period of time.¹⁰⁴ Li, Daokui and Li Shan later on proposed to establish an Enterprise Restructuring Center to compensate banks suffering loss in enterprise restructuring.¹⁰⁵ Zhang Chunlin suggested a division between NPLs of state commercial banks, with banks taking care of those granted after 1996 and special intermediaries taking care of older NPLs and deciding the fate of debtor enterprises.¹⁰⁶

These proposals, however, were not applied until 1999. In January 1999, the State Council and the People's Bank of China authorized the state commercial banks to establish separate accounts for bad loans and form asset management companies to sell part of the bad loans as a discount, or to restructure the loans.¹⁰⁷ Following this authorization, four separate AMC's were established within a span of six months (April-October) in 1999 to handle NPLs of the big four state commercial banks respectively. They are: the Cinda AMC for the CCB, the Dongfang (Orient) AMC for the BOC, China Great Wall AMC for the ABC, and China Huarong AMC for the ICBC (Table 2). In addition to these four AMC's, there are AMC's run by local government. The city of Shanghai, for example, has launched its own AMC as part of SOE reform.¹⁰⁸

Table 2: A brief Description of China's four AMC's

Name of the AMC	Date of Establishment	Registered Capital	Main Mission	President
China Cinda AMC	April 20, 1999	RMB10bn from the MOF	To take over and manage CCB's NPLs	Zhu Dengshan
China Dongfang (Orient) AMC	October 15, 1999	RMB10bn from the MOF (Comprising RMB6bn and US\$500m)	To take on the debts of the BOC issued before the end of 1996	Sun Changji

¹⁰³ See, e.g., Zhou Xiaochuan, 'The Restructuring of Bank-Enterprise Relationships [qiye yu yinhang guanxi de chongjian]', *Gaige [Reform]* No. 6 (June 1993).

¹⁰⁴ See, Liu, Zhunyi & Qian, Yinyi, 'Proposals for Bank/Enterprise Financial Restructuring [guanyu zhongou de yinhang yu qiye caiwu chongzhu de jianyi]', *Jingji yu Shehui Tizhi Bijiao* No. 5 (1994).

¹⁰⁵ See, Li, Daokui & Li, Shan, 'A New Idea for SOEs' Debt Restructuring [guoyou qiye zhaiwu chongzhu de yige xin shilu] in Wu, Tianlin (ed.), *Theory and Practices of State Sector Debt Restructuring [guoyou jingji zhaiwu chongzhu lilun yu shiwu]*, 77 (1997).

¹⁰⁶ See, Zhang, Chunlin, 'On SOEs' Debt Problem', in Wu, Tianlin (ed.), *Theory and Practices of State Sector Debt Restructuring [guoyou jingji zhaiwu chongzhu lilun yu shiwu]*, 96 (1997).

¹⁰⁷ See, e.g., Chinaonline, 'China's Troubled Financial Health Reflected in State Commercial Banks' (February 5, 1999), available at 'http://www.chinaonline.com/top_stories/industry_b2_99020516.html'; and 'China's State-Owned Banks to Sell Bad Loans; Establish Asset Management Companies' (January 19), available at 'http://www.chinaonline.com/top_stories/today_b2_99011911.html'.

¹⁰⁸ See, e.g., Dichie, Mure, 'China: Government Launches Fresh Drive on Bad Loans', *Fin. Times* (October 18, 1999).

		US\$500m)		
China Great Wall AMC	October 18, 1999	RMB10bn from the MOF	To buy, restructure, and recover the bad debts of the ABC	Wang Xingyi
China Huarong AMC	October 19, 1999	RMB10bn from the MOF	To handle the bad debt of the ICBC	Yang Kai Sheng

Sources: Xinhua News Agency, 'China Opens First Asset Management Company' (April 21, 1999), available at '1999 WL 7303136'; China Daily, 'China: Firm Set up to Manage Assets' (April 21, 1999), available at '1999 WL 5969010'; Harding, James, 'Banking Reforms Part of China WTO Bid', *Fin. Times* (April 21, 1999). The CCB was chosen to do the pilot trial is partly because of its high proportion of property loans, which are believed easier to sell, since a building is a single asset and the value can be reduced. See, e.g., O'Neill, Mark, 'Asset Manager Launch Hailed But Buyers May not Come Running', *South China Morning Post* 4 (April 21, 1999).

Chinaonline, 'China Gets Second Asset Mgmt Co., Two More this Week' (October 18, 1999), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C9101508.asp>'; Agence France-Presse, 'China Steps up Number of Asset Management Companies to Manage Bad Debts' (October 16, 1999), available at '1999 WL25125484'; and Dickie, Mure, 'China: Government Launches Fresh Drive on Bad Loans', *Fin. Times* (October 18, 1999).

Chinaonline, 'China Gets Third Asset Management Co., Another Wednesday' (October 18, 1999), available at '<http://www.chinaonline.com/topstories/B2-99101805.asp>'; China Daily, 'China: New Company to Handle Assets' (October 19, 1999), available at '1999 WL 17782977'.

Chinaonline, 'China's Fourth Asset Management Company Ready to Roll' (October 20, 1999), available at '<http://www.chinaonline.com/topstories/C9101903.asp>'; China Daily, 'China: Asset Company to Manage Bad ICBC Loans' (October 20, 1999), available at '1999 WL 17782996'; and Xinhua News Agency, 'China Wages Full War on Bad Assets of Banking Sector' (October 20, 1999), available at '1999 WL 7308529'.

AMCs in China are mandated to handle NPLs of the banks respectively. There is a cutoff, however. AMCs in China only deals with the NPLs issued before 1996. Bad loans scheduled to be written off and, however, are excluded from the purchasing.¹⁰⁹ NPLs granted after the beginning of 1996 will have to be tackled by the banks themselves. Besides, because the new loan classification criteria only started its application in 1998.¹¹⁰ Thus, the NPLs that the AMCs take over from the big four are NPLs under the old loan classification system. By the end of 1999, the big four had transferred RMB350bn in NPLs to the four AMCs.¹¹¹

¹⁰⁹ The Proposal of the PBOC, Ministry of Finance and Securities Regulatory Commission on the Establishment of the China Cinda Assets Management Corporation (issued by the General Office of the State Council on April 4, 1999), section 4; and also, O'Neill, Mark, 'Asset Manager Launch Hailed But Buyers May not Come Running', *South China Morning Post* 4 (April 21, 1999); China Daily, 'China: Firm Set up to Manage Assets' (April 21, 1999), available at '1999 WL 5969010'.

¹¹⁰ See, Guidelines for Loan Classification, issued by the PBOC in 1998.

¹¹¹ See, e.g., Chinaonline, 'Dai Xianglong: China's Commercial Banks Should Write Off 9% of Loans' (January 24, 2000), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C00012004.asp>'.

The AMCs set branches in main cities. By end-February 2000, for example, Cinda,¹¹² Great Wall had set branches in Wuhan, and the two other AMCs was reported to establish their presence in Wuhan in the year 2000.¹¹³

AMCs in China are under the supervision of the MOF, the PBOC and the CSRC. The MOF carry out supervisions over AMCs' financial situation.¹¹⁴ With regards to their businesses, they are supervised mainly by the PBOC, with its securities business supervised by the CSRC.¹¹⁵

B. CHARACTERISTICS OF CHINA'S AMCS

1. Bank- Specific AMCs

China's AMC program bears some unique features in the sense that state-owned AMCs independent of banks are established to deal with NPLs of respective banks. This distinguished China from the RTC practices in the US, and AMC practices in South Korea and Malaysia, where a state-owned centralized AMC is established to tackle the NPLs for the whole system.¹¹⁶ China's AMC practices are also quite different from the practices in Thailand and Poland, where banks are left to deal with their NPLs themselves.

This quasi-decentralized approach based on the primary role of state-owned AMCs makes sense in China for many reasons. First, bank-specific structure guarantees that NPLs in each of the big four would be tackled without delay, given the huge amount of NPLs accumulated in China's big four state commercial banks and the urgency to release the banks of these burdens. Second, bank-specified structure can to some extent avoid one disadvantage of centralized structure: lack of knowledge of the borrowers. The bank-specific structure should allow AMC to make good use of banks' information about the debtors.¹¹⁷ Moreover, because the AMCs are bank-specific, and most of their staffs are recruited within banks. These staff members, when finish their task at the AMCs, will

¹¹² On September 6, 1999, Cinda set up an office in Urumqi. That was the first office of the AMC outside Beijing. See, Shi, Runmei, 'Cinda AMC Set up Office in Urumqi[xinda zichan guanli gongshi urumuqi bangshichu chengli]', *Jingrong Shibao*, 12 (September 9, 1999).

¹¹³ See, e.g., Chinaonline, 'Four Asset Management Firms Open Shop in China's Wuhan' (February 18, 2000), available at '<http://www.chinaonline.com/topstories/000218/2/C00021706.asp>'. The four AMCs' Wuhan branches each takes on the delinquent assets from the provincial branch of their respective state commercial banks. *Id.*

¹¹⁴ To supervise AMCs more efficiently, the MOF set up a financial supervisory and inspection office in each city where there is an AMC outlet to oversee their financial situation. See, China Daily, 'China: AMCs Enhance Financial System' (October 24, 1999).

¹¹⁵ See, e.g., Chinaonline, 'China Get Second Asset Mgmt Co., Two More This Week' (October 18, 1999), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C9101508.asp>'; Chinaonline, 'China Gets Third Asset Management Co., Another Wednesday' (October 18, 1999), available at '<http://www.chinaonline.com/topstories/B2-99101805.asp>'.

¹¹⁶ See, e.g., Hawkins, John & Turner Philip, 'Bank Restructuring in Practice: An Overview' in *Bank Restructuring in Practice*, 6, at 68 -69, BIS Policy Papers No. 6 (August 1999).

¹¹⁷ This advantage, which is strong in market economies, might be mitigated in China and other transition economies where the information system is weaker and informative asymmetries more severe.

bring back their banks their experiences and skills retained from their posts at the AMC's.¹¹⁸

This bank-specific structure, however, raised concerns about the independence of AMC's (see discussion below).

2. State Ownership and Heavy Administrative Color

AMC's in China are owned by the State. The MOF capitalized them with RMB10bn each.¹¹⁹ AMC's in China also bear heavy administrative color. They are put at the same level at PBOC on the "administrative ladder". The board members of AMC's are mostly government officials, rather than expertise in law, accounting and finance.¹²⁰

The state ownership of AMC's and their administrative color rise questions about their capacity of dealing with the NPLs any better than state-owned banks.¹²¹ Like the big four, the four AMC's in China are vulnerable to government interference. The Hualu deal conducted by the Great Wall, for example, was totally a government decision. The Great Wall was asked by the government one week before the deal to take over debt from Hualu.¹²² The problem of administrative intervention was so serious that Zeng Peiyan, chairman of State Development Planning Commission had to call in the People's Daily that authorities must tighten the screening of firms eligible for debt-equity swaps and curb "administrative intervention" in the selecting process.¹²³

Furthermore, the state-ownership means that the state will eventually have to take care of NPLs that the AMC's fail to workout or recover. The state-ownership in this sense creates de-incentives for AMC's to do their best to avoid unloading debt into the government.

3. Wide Business Scope and Powers

AMC's in China are granted wide business scope and powers. The business scope of them cover both commercial and investment banks. In addition to handling NPLs sliced off

¹¹⁸ See, e.g., Zhu Ming & Huang Jinlao, 'On China's Assets Management Corporations [lun zhongguo de zichan guanli gongsi]', *Economic Research Journal* No. 12, 3, at 5 (December 1999).

¹¹⁹ See, e.g., China Daily, 'China: AMC's Enhance Financial System' (October 24, 1999); and Harding, James, 'Banking Reforms Part of China WTO Bid', *Fin. Times* (April 21, 1999). The RMB10bn is not necessary in RMB. The Dongfang AMC for the BOC, for example, received 6 bn in RMB and 500m in US\$ for the RMB10bn registered capital. See, Agence France-Presse, 'China Steps up Number of Asset Management Companies to Manage Bad Debt' (October 16, 1999), available at '1999 WL 25125484'.

¹²⁰ See, e.g., Zhu Ming & Huang Jinlao, 'On China's Assets Management Corporations [lun zhongguo de zichan guanli gongsi]', *Economic Research Journal* No. 12, 3, at 4 (December 1999).

¹²¹ See, e.g., Chinaonline, 'Economist Examine China's Potential Debt-to-Equity Conversion' (September 21, 1999), available at '<http://www.chinaonline.com/industry/fina.../currentnews/open/B2-99090711-SS.doc.asp>'. That article questions that from a systemic perspective, what difference there is between these AMC's and SOEs or state-owned commercial banks that will allow these companies to solve the debt problems while SOEs and commercial banks have failed. *Id.*

¹²² See, Johnson, Ian, 'Asset Managers in China Strain to Save Banks', *Wall St. J.*, A33 (November 8, 1999).

¹²³ See, Reuters English News Service, 'China: China Planner Seeks to Cool Fever on D/E Swaps' (November 5, 1999).

from the bank. They can also dabble in direct investment, project evaluation, bond issues, auditing and liquidation, investment, financial and legal consulting.¹²⁴

The four AMC's have great discretion in managing NPLs. They can do debt-equity swap, debt and enterprise restructuring, capital securitization, listing recommendation. In addition, they are authorized to sell the debts to foreign investors according to related regulations.¹²⁵

To facilitate their operation, AMC's enjoy several preferential policies given by the State, including an exemption of registration fees and purchase and transaction taxes.¹²⁶

C. PROBLEMS WITH THE AMC PRACTICES IN CHINA AND RECOMMENDED SOLUTION

The AMC's in China are modeled on the US Resolution Trust Corp., which successfully solved the S & L crisis in early 1990s.¹²⁷ Dai Xianglong, the governor of the PBOC, said that the objective of the plan is "to make bank officers accountable for their practices...to deal with non-performing assets in a clear, specific manner [and] to improve the balance sheets of the state-owned banks."¹²⁸ Whether the AMC's in China can achieve these goals, however, remain doubtful,¹²⁹ if the problems listed below cannot be solved properly.

1. The Dilemma Faced by Chinese AMC's

¹²⁴ See, China Daily, 'China: New Company to Handle Assets' (October 19, 1999); 'China: Asset Company to Manage Bad ICBC Loans' (October 20, 1999); Xinhua News Agency, 'China Wages Full War on Bad Assets of Banking Sector' (October 20, 1999), available at '1999 WL 7308529'; and Xinhua News Agency, 'China Opens First Asset Management Company' (April 21, 1999), available at '1999 WL 7303136'.

¹²⁵ See, China Daily, 'China: New Company to Handle Assets' (October 19, 1999); 'China: Asset Company to Manage Bad ICBC Loans' (October 20, 1999); Xinhua News Agency, 'China Wages Full War on Bad Assets of Banking Sector' (October 20, 1999), available at '1999 WL 7308529'; and Xinhua News Agency, 'China Opens First Asset Management Company' (April 21, 1999), available at '1999 WL 7303136'.

¹²⁶ See, China Daily, 'China: New Company to Handle Assets' (October 19, 1999); and Xinhua News Agency, 'China Opens First Asset Management Company' (April 21, 1999), available at '1999 WL 7303136'.

¹²⁷ This is admitted by China's Premier Zhu Rongji. See, Associate Press Newswires, 'Clinton Zhu Text By the Associated Press' (April 9, 1999). RTC's former chairman, L. William Seidman, is now advising the Chinese government for the program. See, Pornfret, John, 'China Set to Tackle Economic Woes; Government Plan Readied to Deal With Massive Bank Debt', *The Washington Post*, A21 (January 16, 1999). The Premier Minister might not have realized that RTC in the US was in charge of closing insolvent S & Ls rather than taking NPLs from afloat banks.

¹²⁸ Quoted in Harding, James, 'China: Market Differences Emphasized', *Fin. Times* (January 28, 1999).

¹²⁹ See, e.g., Reuters English News Service, 'China: China's WTO Deal Heralds Radical Banking Reform' (November 16, 1999). The Chinese Academy of Social Sciences released a report on the impact of China's entry into the WTO immediately after the US/China WTO deal. The academy report raised doubts over the way China is now handling the NPLs of the big four through AMC's. The AMC's are repackaging the debt in form of securities and plan to sell them to domestic and foreign investors. "It is still hard to predict whether the scheme will be successful", the report said. *Id.*

Not like the RTC in the US, AMC in China are not simply mandated to solve the bank NPL problem, but also to help SOEs get rid of their troubles as well.¹³⁰ Although AMCs in China are officially defined as non-profitable non-bank financial institutions, they have to carry out some duties that should be carried out by government agencies.¹³¹ They are mandated to rescue as many “viable” SOEs as possible. Foreclosure and bankruptcy can only be applied as last resort by AMCs in China.¹³² Thus, AMCs in China are actually facing a dilemma. On the one hand, they are creditors to SOEs with regards to the NPLs they have taken over from their banks, and should recover as much as possible from their SOE debtors. On the other hand, however, they must help SOEs out of their problems. This dilemma in some terms greatly limits AMCs’ discretion in managing bank NPLs and put doubts on whether AMCs can carry out their tasks as successful as their counterpart in the US.¹³³

It will be unrealistic to propose that China ignore SOE problem and put emphasis solely on bank NPL problem. First of all, China’s state commercial banks, although technically insolvent, are not suffering any liquidity problem. There are no bank runs or bank panic in China. The concerns of the policy-makers, therefore, are mainly on negative effects of NPL problem on the real economy. Because of the underdeveloped capital markets in China, enterprises in China have to rely on banks to finance themselves. Banks, trapped by huge amount of NPLs, are becoming cautious on granting new loans. This has greatly impeded the efficient implementation of “expanding” monetary policy.¹³⁴ Second, because both creditors and debtors are state owned, the solution to the NPL problem cannot only be based on banks’ consideration, rather, emphases should be put on reducing the SOEs’ debt burden. Third, As a matter of fact, without solving the SOE problem, the NPL problem embarrassing the state commercial banks cannot be solved really.¹³⁵

The experiences in Poland might have some relevance to policy-makers in China. To enhance market discipline on banks and enterprises, the Polish government required that financial cooperation between banks and nonviable enterprises be terminated and nonviable enterprises be liquidated, except where liquidation was considered unfeasible

¹³⁰ See, Zhu Ming & Huang Jinlao, ‘On China’s Assets Management Corporations [lun zhongguo de zichan guanli gongsi]’, *Economic Research Journal* No. 12, 3, at 3 (December 1999).

¹³¹ See, Zhu Ming & Huang Jinlao, ‘On China’s Assets Management Corporations [lun zhongguo de zichan guanli gongsi]’, *Economic Research Journal* No. 12, 3, at 4 (December 1999).

¹³² See, e.g., Foo Choy Peng, ‘China Cinda Seeks Foreign Help’, *South China Morning Post*, 8 (May 5, 1999).

¹³³ The RTC in the US carried out a strategy of disposing the impaired assets as quickly as possible and maximizing the recovery from the disposal. In its six years of existence, the RTC in the US had resolved 747 insolvent thrifts and recovered \$395bn of the \$456bn in its charge. See, Foust, Dean, ‘The RTC’s Epitaph: It Worked’, *Bus. Wk.*, 29 (January 15, 1996). The RTC had accomplished its mission so expeditiously that it shut its doors one year ahead of its December 31, 1996 sunset expiration date. See, Lim, Alvin K., ‘The S & L Crisis Revisited: Exporting An American Model to Resolve Thailand’s Banking Problems’, 9 *Duke J. Comp. & Int’l L.* 343, at 355-6 (Fall, 1998).

¹³⁴ See, Zhu Ming & Huang Jinlao, ‘On China’s Assets Management Corporations [lun zhongguo de zichan guanli gongsi]’, *Economic Research Journal* No. 12, 3, at 3 (December 1999).

¹³⁵ See, Zhu Ming & Huang Jinlao, ‘On China’s Assets Management Corporations [lun zhongguo de zichan guanli gongsi]’, *Economic Research Journal* No. 12, 3, at 3 (December 1999).

because of political or socioeconomic considerations. Such cases were treated under the terms of a decree, prepared in November 1993, and enacted in October 1995, that allowed special budgetary allocations (Industrial Development Agency (IDA)) supporting restructuring or managing the liquidation. To prevent banks from conditioning conciliation agreements on the provision of budgetary assistance, the decree stipulated that budgetary resources should support a conciliation agreement only if it is conducted by IDA.¹³⁶ The 1995 decree released commercial banks of the burden of subsidizing those “too big to fail” SOEs and facilitate their commercialization.

The current author would suggest that the government take care of those “too big to fail” SOEs itself, so that AMC in China can concentrate on solving bank NPL problem. In other words, it should be the government’s duty rather than that of the AMCs’ to bail out those economically and socially important SOEs.

2. The Dependence of AMCs on Their Banks

The independence of AMC is crucial to the success of AMC practices. One advantage of AMCs over banks themselves in managing NPLs is that AMCs will not be scared to investigate causes to NPLs. This advantage of AMC over banks will be lost, however, if AMCs are dependent to their banks.

It has been repeatedly declared that AMCs are wholly state-owned, hold independent civil liability, and operate completely independently from the banks.¹³⁷ There remain doubts, however, that the AMCs in China can be independent of the banks, as they are supposed to be. All the four AMCs are carved out of former investment and trust companies subject to respective banks.¹³⁸ Their staffs come from the banks as well.¹³⁹ The supervisory boards of the AMCs comprise officials appointed by the Ministry of Finance, the PBOC, the State General Auditing Bureau, The CSRC, and their respective banks, in addition to outside expertise, representatives of the AMC staff.¹⁴⁰ Moreover, Their

¹³⁶ See, Fernando Montes-Negret & Papi, Luca, *The Polish Experience in Bank and Enterprise Restructuring*, 10 (The World Bank, November 1996).

¹³⁷ See, e.g., Chinaonline, ‘China Gets Second Asset Mgmt Co., Two More This Week’ (October 18, 1999), available at ‘<http://www.chinaonline.com/industry/financial/currentnews/secure/C9101508.asp>’.

¹³⁸ Huarong AMC is based on Huarong Trust & Investment of the Industrial and Commercial Bank of China, China Great Wall AMC is based on the Great Wall Trust & Investment of Agricultural Bank of China, Dongfang AMC is based on Dongfang Trust & Investment of Bank of China, Cinda AMC is based on Xinda Trust & Investment of Construction Bank of China. These investment and trust subsidiaries of commercial banks were “closed” by the government by February 1999. See, Harding, James, ‘China: Five More Trust to Be Closed’, *Fin. Times* (February 3, 1999).

¹³⁹ See, e.g., The Proposal of the PBOC, Ministry of Finance and Securities Regulatory Commission on the Establishment of the China Cinda Assets Management Corporation (issued by the General Office of the State Council on April 4, 1999), section 2, which provides that staff of Cinda should be mainly selected from the existing staff in the CCB. The main staff of AMCs is recruited from the state commercial employment pool. Only a handful of expertise is recruited from outside the banks. See, e.g., Zhu Ming & Huang Jinlao, ‘On China’s Assets Management Corporations [lun zhongguo de zichan guanli gongsi]’, *Economic Research Journal* No. 12, 3, at 5 (December 1999).

¹⁴⁰ See, e.g., The Proposal of the PBOC, Ministry of Finance and Securities Regulatory Commission on the Establishment of the China Cinda Assets Management Corporation (issued by the General Office of the State Council on April 4, 1999), section 2.

leadership appears to have close ties with the banks. For example, The State Council appointed Zhu Dengshan, former vice president of the CCB as Cinda's president, with Shi chungui and Tian Guoli, former vice and assistant presidents of CCB as Cinda's vice-presidents.¹⁴¹ Huarong's Party Committee is headed by Liu Tinghua, who used to be ICBC's president and the secretary of its Party committee,¹⁴² and Huarong President Yang Kaisheng is the former vice president of ICBC.¹⁴³

The dependence of AMC's on banks is to some extent inevitable in China. The AMC's lack a network of branch organizations like banks. So when they deal with local borrowers, they will have to rely on banks' branch network. Besides, the banks have the knowledge about their borrowers, which is essential to debt recollection and debt restructuring. Lou Jiwei, vice-minister of the MOF, required when spoke at the Great Wall's opening ceremony that ABC should not completely separate itself from Great Wall, although the later stood as an independent company— "ABC should do it best to help Great Wall with its asset recovering."¹⁴⁴

What the author would like to suggest here is that emphases be placed on the accountability of AMC's. AMC's must report to the MOF, the PBOC periodically about their work. Public auditors should be employed by the MOF to audit the main transaction conducted by the AMC. More importantly, personal liabilities should be imposed on those AMC officials who fail to carry out their duty rightly.

3. The Funding Problem¹⁴⁵

Funding will be big problem for the four AMC's in China, given the fact that each AMC has RMB10bn registered capital from the MOF, while they are mandated to purchase NPLs at face value from respective banks. It is estimated that AMC's were to take NPLs worth of RMB1trillion from the big four.¹⁴⁶ Huarong AMC, which was set up to recover the NPLs owed to the ICBC, for example, was estimated to take over RMB350bn NPLs from the bank,¹⁴⁷ 35 times of its registered capital.¹⁴⁸

¹⁴¹ See, e.g., Agence France-Presse, 'China Opens First Asset Management Company for Bad Loans', (April 20, 1999), available at '1999 WL 2586720'.

¹⁴² Liu Tinghua was moved to the position of PBOC vice-governor in February 2000.

¹⁴³ See, Chinaonline, 'China's Fourth Asset Management Company Ready to Roll' (October 20, 1999), available at '<http://www.chinaonline.com/topstories/C9101903.asp>'.

¹⁴⁴ See, China Daily, 'China: New Company to Handle Assets' (October 19, 1999).

¹⁴⁵ Funding problem is not unique to AMC's in China. In South Korea, although a KAMCO-administered fund was established as early as November 1997 by contributions from financial institutions and government guaranteed bond issues, the KAMCO was restricted to purchase foreign currency denominated assets from commercial banks owing to lack of funding capacity in foreign exchange. To overcome this deficiency, KAMCO for the first time issued US dollar denominated bonds in late December 1998 for US\$513m. See, 'Box 2. Korea KAMCO Operations' in Balino, Tomas J. T., Enoch Charles *et. al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 120 (IMF, September 1999).

¹⁴⁶ See, Wong, Lana, 'New Units Confront Three-year Challenges Over Bank Bad Loans', *South China Morning Post*, 5 (October 21, 1999).

¹⁴⁷ See, Chinaonline, 'China Huarong to Relieve ICBC of Bad Loans Worth US\$42.3bn' (December 3, 1999), available at '<http://www.chinaonline.com/topstories/991203/B9120238.asp>'.

¹⁴⁸ See, China Daily, 'China: AMC's Enhance Financial System' (October 24, 1999).

Two factors can help relieve the financing burden of AMCs. First of all, the AMCs are authorized to issue government guaranteed bonds to the big four in exchange of NPLs.¹⁴⁹ Second, they do not take NPLs from their banks at once. Instead, they took NPLs piece by piece from provincial branches of their banks. Cinda, for example, acquired RMB1.7bn in NPLs from the Wuhan branch in November, RMB2bn in NPLs from the CCB Shanghai branch¹⁵⁰ and RMB16bn in NPLs from CCB's Hubei branch in December.¹⁵¹

Currently, AMCs in China rely heavily on issuing corporate bond and borrowing commercial and government-sponsored loans.¹⁵² The Great Wall, for example, financed two of the debt-equity swap deals through five-year to 10-year interest-free loans from the central bank.¹⁵³ This financial reliance further deteriorates AMC's independence. The point here, however, is not that AMCs should be more sufficiently funded by the government. But AMCs really should not just hold NPLs they collected from banks. That will definitely increase their operational costs. Instead, they should be more active in disposing and restructuring the NPLs. Otherwise, even if they can manage to finance their operation at this moment by issuing bonds or borrowing from banks, they will certainly face a debt crisis when the bonds they issued, no matter how long the terms are, become due.

4. The Lack of Expertise and Experience

Handling NPLs requires skills and experiences in various fields. The debt recovery process is quite complex, and involves the conversion of the NPLs into assets, real or financial, then the restructuring of these assets into easily sellable forms, and finally the selling process to maximize the net sale value. Expertise and experience are thus essential the success of an AMC in managing NPLs.

AMCs in China are in desperate needs of these personnel and experiences.¹⁵⁴ Cinda might be an exception.¹⁵⁵ Cinda's managers, for the most part, are sophisticated financial engineers.¹⁵⁶ But this is not the case for other three AMCs.

¹⁴⁹ Huarong, for example, is to issue bonds with an annual rate of 2.5% to the ICBC to take over the NPLs. See, Chinaonline, 'China Huarong to Relieve ICBC of Bad Loans Worth US\$42.3bn' (December 3, 1999), available at '<http://www.chinaonline.com/topstories/991203/B9120238.asp>'.

¹⁵⁰ See, e.g., Dow Jones Int'l News, 'China Cinda Takes on CNY2 Billion in Construction Bk Debt-Report' (December 2, 1999).

¹⁵¹ See, e.g., Reuters English News Service, 'China: China Cinda Takes Over \$1.93bn in Bad Loans' (December 13, 1999).

¹⁵² See, Agence France-Presse, 'China Steps up Number of Asset Management Companies to Management Bad Debt' (October 16, 1999), available at '1999 WL 25125484'; Chinaonline, 'China Cinda Asset Mgmt to Take Only 60% of CCB's Debt' (November 4, 1999), available at '<http://www.chinaonline.com/topstories/B2-99110402.asp>'.

¹⁵³ See, Johnson, Ian, 'Asset Managers in China Strain to Save Banks', *Wall St. J.*, A33 (November 8, 1999).

¹⁵⁴ Zhou Xiaochuan, chief executive and president of CCB, admitted that AMCs created to take over NPLs from banks were short of experienced and qualified personnel. See, e.g., Wang, Xiangwei, 'Debt-clearing Scheme May Face Hurdles Official Says Swaps Not "A Free Lunch"', *South China Morning Post* 3 (December 11, 1999).

In this respect, China should learn from South Korean. Where Joint venture asset management companies are setting up so as to use foreign expertise and experiences.¹⁵⁷ The State-run Korea Development Bank, for example, is reported to set up an AMC with Merrill Lynch & Co, and US private-equity fund Lone Star Fund II.¹⁵⁸ According to the report, Lone Star will take care of NPLs, while Merrill Lynch will do research work for reinvestments, including the issuance of asset-backed securities.¹⁵⁹ Actually, even the RTC in the US relied heavily on expensive consultants because its fleeting life span made it difficult to recruit quality personnel.¹⁶⁰

5. Difficulties in Evaluating Assets

Realistic valuation of bank NPLs is crucial for AMCs to take over NPLs from banks and to dispose NPLs. There is no precise method for valuing NPLs in China, however, because of the lack of market prices for NPLs. Also, it is hard to value collateral, not only because of uncertain prices and limited markets, but also because of uncertainty as to whether, and when the creditor can seize the collateral. Further, even these problems can be solved, it takes time to evaluate NPLs in such a huge amount, while NPLs need to be taken over urgently from the banks.¹⁶¹

The AMCs in china avoided the pricing problem in taking over NPLs by taking the NPLs at their face value from the big four.¹⁶² This is quite different from the practices

¹⁵⁵ At least the first deal of Cinda, the Beijing Cement Plant deal, was accompanied by substantial restructuring requirements. After the deal, the Cement factory will be converted into a limited liability company, with its non-business assets, such as logistics, hospitals and training center being coming off the company, and its current around 800 employees be reduced to around 350. According to the agreement, Cinda, as the major shareholder, will be represented in the company's board of directors. See, Li, Xia & Wang, Xing, 'Debt-Equity Swap Started in China [zhanzhuanggu jingru shizixing chaozhou]', *Jingrong Shibao*, 12 (September 15, 1999).

¹⁵⁶ Business Week, 'China's Bad-debt Cops Get Going' (October 11, 1999), available at '1999 WL 27295452'. Fang Xinghai, a general manager at CCB and one of the founders of Cinda, for example, earned a doctorate in economics at Stanford University and spent five years at the World Bank before joining CCB and overseeing Cinda's creation. Already, Cinda has solicited advice on debt-equity swaps from Goldman, Sachs & Co. and other institutional or individual expertise. *Id.*

¹⁵⁷ See Tarrant, Bill, 'South Korea: Analysis- Skorea Shifts to Tack on Asset Restructuring', Reuters English News Service (November 2, 1999).

¹⁵⁸ See, Dow Jones Newswires, 'Korean Bank to Team with Two US Firms to Manage Bad Loans', *Asian Wall St J*, 5 (December 7, 1999).

¹⁵⁹ See, The Korea Herald, 'Korea Development Bank to Set up Asset Management Unit' (December 6, 1999), available in '1999 WL 29057585'.

¹⁶⁰ See, Lim, Alvin K., 'The S & L Crisis Revisited: Exporting An American Model to Resolve Thailand's Banking Problems', 9 *Duke J. Comp. & Int'l L.* 343, at 357 (Fall, 1998). The RTC enlisted the aid of big-name consultants and investment banks to put together large deals so as to expedite the transactions and maximize value. *Id.* at 360.

¹⁶¹ See, e.g., Zhu Ming & Huang Jinlao, 'On China's Assets Management Corporations [Jun zhongguo de zichan guanli gongsi]', *Economic Research Journal* No. 12, 3, at 6 (December 1999).

¹⁶² See, e.g., Zhu Ming & Huang Jinlao, 'On China's Assets Management Corporations [Jun zhongguo de zichan guanli gongsi]', *Economic Research Journal* No. 12, 3, at 6 (December 1999).

in Asian crisis countries.¹⁶³ Because both AMC and banks are publicly owned, the moral hazard problem is not so serious. Face-value take over, however, will have some de-incentives for banks to help AMCs recover and restructure debts.¹⁶⁴ This in some extent self-defeats one of the advantages of bank-specific AMC structure. Besides, because the NPLs were taken from banks at face value. It will be harder to appraise how well the AMCs have done their job¹⁶⁵ and create de-incentives for AMCs to maximize the recovery of NPLs.¹⁶⁶

The evaluation problem is not only limited to NPL takeover. NPLs will have to be valued when they are disposal are restructured. There are already reported crosses between AMCs and enterprises on the valuation of enterprises' net asset in debt-equity swaps: The AMCs wanted a re-valuation of the net asset, while the enterprises insisted that book value be used.¹⁶⁷

D. IMMEDIATE LEGAL ISSUES RELATED TO AMC PRACTICES IN CHINA

1. The Notification Obligation Under the Contract Law

Under the current Chinese contract law,¹⁶⁸ an obligee may assign its rights under the contract in whole or in part to a third party,¹⁶⁹ the obligee, however, shall notify the

¹⁶³ In Indonesia, NPLs were taken from banks at zero value. In South Korea, the discounts are 45% of face value for secured loans, 3% for unsecured loans. In Malaysia, the average discount has been 37% (excluding one large loan, it has been 60%). See, 'Table 9. Public Asset Management Companies in the Asian Crisis Countries' in Balino, Tomas J. T., Enoch Charles *et. al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 53 (IMF, September 1999). The discounting prices in these countries were based on market prices. In South Korea, for instance, the discounted price of 45% of face for secured loans is the average price obtained in auctions of similar collateral in the market. See, 'Box 2. Korea KAMCO Operations' in Balino, Tomas J. T., Enoch Charles *et. al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 120 (IMF, September 1999).

¹⁶⁴ Proper transfer pricing is of key importance for the incentive structures for both the AMC and the banks— there is a need to set a system that provides the right balance. Excessive prices for NPLs may induce banks to reduce their recovery efforts, which could lead to a general deterioration of credit discipline and loan values throughout the banking system. See, Balino, Tomas J. T., Enoch Charles *et. al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 58 (IMF, September 1999).

¹⁶⁵ There is suggestion that an appraisal committee comprising officials from the MOF, PBOC, state commercial banks and AMCs shall be established to access approximately the value of the NPLs taken from banks. See, *e.g.*, Zhu Ming & Huang Jinlao, 'On China's Assets Management Corporations [lun zhongguo de zichan guanli gongsi]', *Economic Research Journal* No. 12, 3, at 6 (December 1999).

¹⁶⁶ See, *e.g.*, Li, Xia, "'Debt-equity Swaps Should be Carried out On the Commercial Basis [zhaizhuanggu yunzhou ying gengjia shichang hua]', *Jingrong Shibao*, 12 (September 15, 1999).

¹⁶⁷ See, *e.g.*, Chinaonline, 'China's Debt -Equity Program Has Yet to Be Implemented' (January 13, 2000), available at '<http://www.chinaonline.com/topstories/000113/C00011330.asp>'.

¹⁶⁸ Contract Law of the People's Republic of China, adopted at the Second Session of the Ninth National People's Congress on March 15, 1999 and effective as of October 1, 1999.

¹⁶⁹ Contract Law, Section 79. Section 79 reads as follows:

An obligee may assign its rights under the contract in whole or in part to a third person, except where assignment is prohibited:

- (i) in light of the nature of the contract;
- (ii) as agreed upon by the parties;
- (iii) as provided by law.

obligor, and the assignment will not be binding upon the obligor if the obligee fails to give such notice.¹⁷⁰ The relevance of these provisions with the AMC practices is that, banks must notify the borrowers when they sell NPLs to their AMCs. If banks fail to fulfill this notification obligation, when AMCs later on claim against the borrowers, the borrowers might be able to argue that AMCs do not have the authority to do that.

The absence of notice has other legal effects as well: 1) Borrowers can continue to pay the banks rather than the AMCs. This, however, is not an objection because the AMCs might wish the banks continue to collect loans principles and interests on behalf of them. 2) Borrowers without notice can continue to acquire new set-off and defenses. 3) It may be necessary for AMCs to join the banks in an action against borrowers.

Although the State Council approved that once NPLs purchased by AMCs, the AMCs become the creditors of the purchased loans and enjoy all the rights as creditors.¹⁷¹ The same document approved by the State Council further provides that AMCs must go through relevant procedures so as to enjoy the creditor's rights.¹⁷² Even if this does not mean that appropriate notification must be made to debtors, whether the State Council's regulation can supersede the legislation of the National People's Congress, remains a problem. It is therefore necessary to pass special legislation ensures that the AMCs has a clear title to asset purchased and notification to borrowers is not necessary.

2. Accomplishing Legal Procedures for the Transfer of Security Interests

Under the 1995 Security Law,¹⁷³ a lender's right can be secured by a guarantor, mortgage, pledge, lien or earnest money.¹⁷⁴ The security interests, however, will not automatically transferred with the loans. Acquiring NPLs from banks does not mean that AMCs take over the security interests as well. The AMCs must go through certain legal procedures to be the new holders of the security interests.

Under the Security Law, if the security takes the form of guarantee, the guarantee contract need not be specifically assigned for the guarantor's obligation remains unaffected by the assignment of the main right, unless the guarantee contract provides otherwise.¹⁷⁵ If the security takes the form of mortgage, however, the AMCs will need to perfect its security interests by registration since unregistered mortgages will be ineffective against third parties or ineffective to all intents.¹⁷⁶

¹⁷⁰ Contract Law, Section 80.

¹⁷¹ The Proposal of the PBOC, Ministry of Finance and Securities Regulatory Commission on the Establishment of the China Cinda Assets Management Corporation (issued by the General Office of the State Council on April 4, 1999), section 4.

¹⁷² The Proposal of the PBOC, Ministry of Finance and Securities Regulatory Commission on the Establishment of the China Cinda Assets Management Corporation (issued by the General Office of the State Council on April 4, 1999), section 4.

¹⁷³ Security Law of the People's Republic of China, adopted at the 14th Session of the Standing Committee of the 8th National People's Congress on June 30, 1995 and effective as of October 1, 1995 (hereinafter referred to as Security Law).

¹⁷⁴ Security Law, art. 2.

¹⁷⁵ Security Law, art. 22.

¹⁷⁶ Under the Security Law, a mortgage is not necessary to go through registration, although the parties may choose to have registered. Security Law, art. 43. For mortgages on real estate (including land use

3. AMC's Liabilities to Debtors

Another problem arises from art. 82 of the Contract Law. That article provides that upon receipt of the notice for assignment of obligee's rights, the obligor may assert against the assignee any of its defenses against the assignor. These provisions may prove troublesome for the AMCs. If there are no special provisions exempt AMCs from a lender's obligations. The borrowers may be able to ask AMCs to perform some obligations under original lending contracts. Because AMCs in China are now only in charge of NPLs extended by 1996, this concern, however, might only have remote theoretical significance.

IV. CHINA'S DEBT-EQUITY SWAP SCHEME

A. THE DEVELOPMENT OF DEBT-EQUITY SWAPS IN CHINA

Debt-equity swaps were used in China occasionally in 1980s. Between 1984 and 1988, loans valued at RMB66bn were converted into state investment in enterprises.¹⁷⁷ Although debt-equity swaps were proposed as early as mid-1990s as a solution to bank NPL problem,¹⁷⁸ it was until 1999, with the establishment of the four AMCs, however, that debt-equity swaps started being carried out at large scale.¹⁷⁹ The SETC announced the initiation of the debt-equity scheme on August 3, 1999.

1. The Main Policies of the SETC Debt-Equity Scheme

Under the SETC's Debt-Equity Swap Scheme—

(i) *Only the Four AMCs and SDB Can Conduct the Debt-Equity Swaps with SOEs.*¹⁸⁰ The four AMCs, together with the SDB, forgive debts owed by SOEs to them in exchange of equity stakes in the enterprises.

(ii) *Only Debts Initially Borrowed by 1997 Can Be Swapped.*

(iii) *Candidate SOEs.* With regards to candidate enterprises that can enjoy the treatment of debt-equity swaps. Authorities in China make it clear that not all SOEs are

rights, buildings and forest), aircraft, ships and vehicles, or mortgages on enterprise assets, including equipment or other movable property, registration is compulsory, however (the mortgage will not go into effect until it is registered). Security Law, arts. 41, 42. For mortgages on other properties, without registration, the mortgage can not bind third parties. Security Law, art. 43.

¹⁷⁷ See, e.g., A Ming, 'State-Owned Enterprises: How to Confront the Debt Ratio?', *Jingrong Shibao* (Beijing), 1 (October 7, 1995).

¹⁷⁸ See, e.g., Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 35-54, 82-4 (Beijing 1995).

¹⁷⁹ See, generally, World News Connection, Article by ZXS reporter Tao Guangxiong: 'Focus of State-Owned Enterprise Reform: Converting Debts into Shares Helps Ease Difficulties in State-Owned Enterprise Reform' (September 18, 1999), available at '1999 WL26443497'.

¹⁸⁰ See, Li, Xia, 'The Scope and Preconditions for Candidate Enterprises for the Debt-Equity Swap Scheme [shishi zhaizhuanggu qiye de fangwei yu tiaojian]', *Jingrong Shibao*, 12 (September 15, 1999).

eligible for this scheme. Enterprises must satisfy several conditions before their debts can be converted into equity.¹⁸¹

First of all, enterprises that can be chosen for the debt-equity swap must be: (1) industrial SOEs that were constructed during the periods of the “Seventh-Plan” (1986-1990), or the “Eighth-Plan” (1991-1995), or during the first two years of the “Ninth-Plan” (1996-1997). The construction of the enterprises must have been mainly financed by borrowing from banks in domestic or foreign currencies. And as a result, the enterprises are loss-making and have difficulties in repaying loan principles and interests. Or, (2) Industrial enterprises among the 512 key enterprises that become excessive leveraged because of expansion and turns to red. The debtor must be independent legal person. Trading enterprises can only be exceptionally chosen for this pilot trial.

Second, the candidate enterprise must have the potential to return to balance after debt-equity swaps. Detailed criteria are set to judge this potential— the enterprises must have readily marketable products, advanced and environmental-friendly technology and equipment, good management (judged on the capacity of the enterprise managers, the financial and accounting system of the enterprises, the contract relationships of which the enterprises are parties); and, most importantly, the enterprises must have a plan to restructure its operation in the line of modern enterprise system, purposing on improving the efficiency, with the redundancy plan approved by local government.

2. The Implementation of the SETC Scheme

To implement the scheme, the SETC has sent working groups to various localities to work out a list of candidate enterprises based on industries and quotas.¹⁸² According to Sheng, Huaren, the SETC director, among China’s 16,000 large and medium-sized SOEs, over 2,000 had applied for debt-equity swaps. The SETC recommended 601 SOEs for the swap worth RMB459.6bn.¹⁸³ AMCs are supposed to choose enterprises from the SETC recommended list; if they choose any enterprise out of the recommended list, an approval from the SETC is required.

A debt-equity swap leading group is established to oversee the implementation of the scheme. The leading group comprises representatives from the SETC, the PBOC, the Ministry of Finance and other relevant government agencies. All debt-equity swap agreements are subject to the approval of the debt-equity leading group.

The first debt-equity swap deal was signed on September 2, 1999 between Cinda and Beijing Building Material Group.¹⁸⁴ In September 1999 only, Cinda signed five

¹⁸¹ These preconditions are set by the State Economic and Trade Commission. See, e.g., Li, Xia, ‘The Scope and Preconditions for Candidate Enterprises for the Debt-Equity Swap Scheme [shishi zhaizhuanggu qiye de fangwei yu tiaojian]’, *Jingrong Shibao*, 12 (September 15, 1999).

¹⁸² See, e.g., Xinhua News Agency, ‘“Converting Debts into Shares”, An Important Form of SOE Reform’ (September 3, 1999), available at ‘1999 WL 7397282’.

¹⁸³ See, Chinaonline, ‘China Denies Debt-Equity Swaps Just “Word Games”’ (February 7, 2000), available at ‘<http://www.chinaonline.com/topstories/000207/2/C00012604.asp>’.

¹⁸⁴ On September 2, 1999, Cinda Assets Management Corp. signed an agreement with the Beijing Building Materials Group on the debt-to-equity swap of the Beijing Cement Plant (With a daily output of 2,000 tons of cement, the Beijing Cement Plant is one the major state-owned enterprises in China. By the end of 1998, the plant’s total debt had amounted to RMB970m, which plunged it into chaos.). According to the

deals- Beijing Cement Plant deal, Shanghai Jiaohua Plant Deal, Meishan (Group) Co. deal, Jiangxi Guixi Fertilizer Plant Deal, and a deal concerning a firm in Xinjiang that produces reeds.¹⁸⁵ The other three AMC's joined the scheme after their establishment. In addition to the four AMC's, the State Development Bank (SDB) have also participated in debt-equity swaps.¹⁸⁶ By January 24, 2000, 78 enterprises entered into debt-equity swap agreements or frame agreements with AMC's or the SDB for the swap of debts worth of RMB112.2bn.¹⁸⁷ Most of the deals involves more than one AMC's, with the biggest debt playing a leading role in joint-debt deals.¹⁸⁸

Often a more detailed agreement will be signed later based on the framework agreement. The Shougang Group (China Capital Steel), for example, signed a framework debt-equity swap agreement with all the four AMC's and the SDB on December 30, 1999,¹⁸⁹ a detailed agreement, was later on signed in April 2000.¹⁹⁰ So far, however, most of the deals remain at framework agreement stage.

B. POLICIES BEHIND THE SETC DEBT-EQUITY SWAP SCHEME

1. The Debt-Equity Swap Scheme as Part of the Government's Anti-Depreciation Policies

China has been facing depreciation for years.¹⁹¹ The debt-equity equity swap scheme to some extent is in fact part of the government's anti-depreciation policies. There have

agreement, RMB670m of Beijing Cement Plant's RMB970m debt is to be converted into equity held by Cinda, reducing the plant's asset liability ratio from 80.1% to 32.4%. As a result, the plant is transformed into a limited liability company with both Cinda (approximately 70%) and the Beijing Building Material Group (approximately 30%) as its shareholders. *See, e.g.,* Asia Pulse, 'Chinese Firms Sign Country's First Debt-to Equity Deal' (September 3, 1999), *available at* '1999 WL 18772310'.

¹⁸⁵ *See, e.g.,* O'Neill, Mark, 'Foreign Bankers Remain Skeptical as Cinda Takes Equity in Five Companies Debt-swap Deals to Test Reform Plan', *South China Morning Post*, 2 (October 14, 1999).

¹⁸⁶ *See, e.g.,* Chinaonline, 'CNPC, Sinopec to Swap US\$3.6bn in Debt for Equity' (October 27, 1999), *available at* '<http://www.chinaonline.com/topstories/c9102605.asp>'. It was reported that the SDB has already made an agreement with the State Investment Management Co. to convert RMB100bn worth of debt to equity. The first two enterprises to use these RMB100bn quotas are China Petroleum Corp. and China National Petroleum Corp.. RMB30bn of their debts are swapped into equity held by the State Investment Management Co. *Id.*

Besides, the SDB also participates in debt-equity swaps led by AMC's. On October 28, 1999, for example, the SDB, along with Dongfang, Cinda and Huarong, signed a RMB723m debt-equity swap deal with Zhejiang Synthetic United Group. *See, e.g.,* O'Neill, 'Creditors Combine in Bid to Revive Plant', *South China Morning Post*, 3 (October 30, 1999).

¹⁸⁷ *See, Luo, Lan, 'The Goal of SOEs Going out of Red in Three Years Is Expected to Be Achieved This Year [Guoqi Sannina Taikun mubiao jinjiang ke ruqi shixiang]',* *People's Daily (Overseas Edition)*, 1 (January 26, 2000).

¹⁸⁸ *See, e.g.,* Dow Jones International News, 'China Asset Management Companies, Devt Bk Sign First Joint Debt Deal' (October 29, 1999).

¹⁸⁹ *See, Chinaonline, 'China Second Auto Works to Swap Debt for Equity' (January 3, 2000), available at* '<http://www.chinaonline.com/topstories/000103/C9123004.asp>'.

¹⁹⁰ *See, Chinaonline, 'China Capital Steel Signs US\$430m Debt-for-Equity Swap' (April 5, 2000), available at* '<http://www.chinaonline.com/topstories/000405/2/C00040402.asp>'.

¹⁹¹ *See, Wu Jinglian, 'The Macro-economic Trend in 1999 and Policy Options' in* *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 116, at 116-7 (October 1999). For a detailed discussion about China's deflation, *see, generally,* Pu, Yonghao, 'China's New Challenge:

been complaints that more banks are avoiding giving out loans because of rising NPL levels.¹⁹² Two reasons can be identified for this “credit crunch”: On the enterprise side, the creditworthiness of enterprises is deteriorating sharply due to the depreciation. On the bank side, the banks’ ability to provide credits is greatly limited because of the huge amount of NPLs accumulated on their books. Debt-Equity swaps tackle these two sides simultaneously. Banks’ ability to lend will be enhanced when their NPLs are taken over by AMC, while the creditworthiness of enterprises will be enhanced when their capital structure is improved by debt-equity swaps.¹⁹³

2. The Micro-Economic Effects: A Win-Win Situation For SOEs and Banks

Some economists in China note that debt-equity swaps will lead to a “win-win” situation for banks and SOEs, as it helps SOEs solve the problem of a heavy debt burden and helps banks avoid financial risks simultaneously.¹⁹⁴

The debt-equity swap can relieve the burden on many Chinese SOEs struggling under the weight of debt and interest payments, allowing them to direct their resources on efforts to modernize and restructure. Beijing Cement Plant is a good example for that. Under the agreement with Cinda, the company’s debt falls from RMB970m to RMB300m. The plant, formerly a money-losing one, is expected to turn its loss into profit in 1999 and earn RMB20m yuan in net profit from 2000 on. The company plans to build a new production line that would double output.¹⁹⁵ A more general example is the 42 enterprises recommended by the SETC to Huarong for the debt-equity swaps. It is calculated that the swaps would reduce the companies’ annual interest payments by a total of RMB1.78bn, a figure that exceeded their aggregate book loss in 1998 of RMB1.04bn. Within a year of the swaps, the 42 SOEs are expected to report combined profits of RMB740m.¹⁹⁶ More importantly, the debt-for-equity swap could also diversify

Deflation’, *Chinaonline* (May 11, 1999), available at http://www.chinaonline.com/CSubs/econ_news/en_c81102Pu.asp.

The deflation proves long-term. The deflationary trend entered its 24th month in September 1999. Deflation has hit corporate profit margins and created hesitancy among consumers. See, Kyngé, James, ‘China’s Falling Prices Put Curb on Growth’, *Fin. Times* (October 20, 1999).

¹⁹² These complaints were dismissed by PBOC. According to a PBOC survey, large- and mid-sized companies with healthy profits are still getting needed loans, although credit controls are more stringent and companies are being forced to look for needed capital through other channels. The survey found out that enterprises had been turned down largely because of their poor credit record. See, Xinhua English Newswire, ‘China’s Bank Loans On Target’ (April 5, 1999), available at ‘1999 WL 7931582’.

¹⁹³ See, Wu, Youchang, Zhao Xiao, ‘Debt-to-Equity Swap: A Theoretical and Policy Analysis Based on Corporate Governance [zhaozhuan: jiyu qiye zhili jiegou de lilun yu zhenche fengxi]’, *Economic Research Journal (jingji yanjiu)* No. 2, 26, at 30 (Feb. 2000).

¹⁹⁴ See, e.g., CBN, ‘China: Debt-to-equity Swaps: A “Win-Win” Choice for Banks and Firms’ (October 20, 1999), available at ‘1999 WL 17731561’.

¹⁹⁵ See, South China Morning Post, ‘Cement Plant Finds Life After Debt’ (October 25, 1999); and also CBN, ‘China: Debt-to-equity Swaps: A “Win-Win” Choice for Banks and Firms’ (October 20, 1999), available at ‘1999 WL 17731561’.

¹⁹⁶ See, Chinaonline, ‘China Huarong to Relieve ICBC of Bad Loans Worth US\$42.3bn’ (December 3, 1999), available at <http://www.chinaonline.com/topstories/991203/B9120238.asp>.

the ownership of SOEs¹⁹⁷ and improve the corporate governance of SOEs because they have to give board representation to AMCAs and tailor business decisions to meet investor demands. Therefore, in the short term, converting debts into shares will help China attain the goal of freeing its SOEs from difficulties in three years;¹⁹⁸ and in the long run, converting debts into shares will serve as a booster enabling SOEs to establish a modern enterprise system. The achievements of these goals, however, depends on AMCAs' capacity to run industrial businesses, and whether the restructured companies can find strategic investors¹⁹⁹ who became involved in the management of the enterprises and placed the enterprises under pressure to become profitable.²⁰⁰

Because the swaps are carried out by AMCAs rather than the state commercial banks, the swaps will not have direct impacts on banks' balance sheets.²⁰¹ However, the improvement in SOEs profitability will certainly increase the enterprises' capacity in repaying loan principals and interests and thus help improve banks' profitability and avoid potential financial risks.

3. Justification for Converting SOEs' Debts into Equity

The current debt-equity swap scheme limits the debt-equity swap scheme to release SOEs' debt burden. Some scholars argue that the current debt-equity swap scheme gives SOEs unfair market advantages.²⁰²

¹⁹⁷ In Shanghai, for example, dozens of SOEs plan to swap debts totaling RMB 20-30bn into equity by the end of 1999. That is estimated to decrease the proportion of state shares in the city's state-owned enterprises from 65% to 50%. See, Chinaonline, 'Dozens of Shanghai SOEs Plan Debt-for-Equity Swaps' (October 4, 1999), available at '<http://www.chinaonline.com/topstories/C9092909.asp>'.

¹⁹⁸ The three-year goal was initiated by Zhu Rongji in early 1998 when he was appointed China's Premier. This goal was reiterated at the Fourth Plenum of the 15th Central Committee of the Chinese Communist Party held in September 1999. See, e.g., Chinaonline, 'China Reiterates Goal to Make SOEs Profitable in Three Years' (September 24, 1999), available at '<http://www.chinaonline.com/topstories/C9092211.asp>'.

By the end of 1997, a total of 6,599 medium to large-sized SOEs were in red. The government's goal is to reduce the number of companies in debt by one third in three years by push them into mergers, bankruptcy, reorganization, regrouping and management restructuring, and other means. See, e.g., Chinaonline, 'China SOEs Must Turnaround By Next Year- Official' (November 24, 1999), available at '<http://www.chinaonline.com/topstories/991124/b9112320.asp>'.

¹⁹⁹ In China, a strategic investor is defined as a legal person closely associated with the issuing firm and intending to hold issued stocks for a long term. See, e.g., Circular on Improving Stock Issuance, issued by China Securities Regulatory Committee in October 1999.

²⁰⁰ According to Zhang Chunlin, a delegate for the World Bank in Beijing, investors who purchased state firms might face difficulties freeing the companies from the control of local governments, making it difficult to return companies to profit. Thus, if the AMC cannot resist the interference from government, it will not make sense whether it holds shares or debts in the company. See, e.g., AFX (AP), 'Interview' (September 6, 1999), available at '[1999 WL 25400825](http://www.chinaonline.com/industry/fina.../currentnews/open/B2-99090711-SS.doc.asp)'.

²⁰¹ Many Chinese scholars ignore the fact that AMCAs are legally independent from the banks by arguing that debt-equity swaps reduces the NPL level of banks. See, e.g., Zhou Tianyong, 'The Transfer Mechanism of Debt-to-Equity Swap Program and the Operation Risk [zhaizhuanggu de liucheng jili yu yunxing fengxian]', *Jingji Yanjiu (Economic Research Journal)* No. 1, 22, at 22 (January 2000).

²⁰² See, e.g., Chinaonline, 'Economist Examine China's Potential Debt-to-Equity Conversion' (September 21, 1999), available at '<http://www.chinaonline.com/industry/fina.../currentnews/open/B2-99090711-SS.doc.asp>'.

If we look back at how SOEs have developed high debt-asset ratios, however, we might be able to accept a different answer.²⁰³ With the deepening of the economic reform, SOEs have been forced to rely more and more heavily on bank loans.

It is a common practice that enterprise owners should provide their enterprises with sufficient capital. This rule, however, was not obeyed by the Chinese government, the owner of SOEs. Starting in 1980, working capitals were partially provided in bank loans at a monthly rate of 2.1%.²⁰⁴ In July 1983, a circular was issued by the State Council to put all SOEs' working capital under the management of the banks, with different interests rates charged on working capital loans according to their terms.²⁰⁵ With regards to the financing of fixed asset investment, a pilot trial started in 1979 to issue loans for fixed-asset investments. By the end of 1980, 619 loan contracts had been signed for fixed-asset investments.²⁰⁶ The trial continued and extended from 1980 on. In 1984, budget financing for fixed-asset investment was completely replaced by fixed-asset loans.²⁰⁷ It was from 1996 on that minimum capital requirements were set for fixed-asset investment.²⁰⁸ In other words, the government as the owner of SOEs, had stopped provides SOEs with sufficient capital for a period of times. That explains to some extent why SOEs in China have such high leverage ratios.²⁰⁹ Anecdotal evidences support this assertion as well. Beijing Cement Plant, the first SOE selected for the debt-equity swap,

²⁰³ The discussion in the paragraph and the following paragraphs draws heavily from Wu, Xiaolin, Xiepin, 'Some Ideas about SOE's Debt Restructuring' in Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 2-3 (Beijing 1995). Ms. Wu and Mr. Xie are the heads of the PBOC Policy Study Office.

²⁰⁴ See, Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 104 (Beijing 1995).

²⁰⁵ See, Circular of the State Council Approving and Promulgating the Report of the People's Bank of China on PBOC's Unified-Management of State-Operated Enterprises' Working Capital, issued by the State Council on June 25, 1983.

²⁰⁶ See, Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 104 (Beijing 1995).

²⁰⁷ See, *generally*, Interim Provisions Converting All State Budgetary Capital Construction Investment from Appropriations to Loans, adopted by the Ministry of Finance on December 14, 1984. The budget financing for fixed-asset investment started again in 1985 when the budget financed 10 construction projects. From 1988 on, a Central Basic Construction Fund was established to finance state construction projects. See, Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 104 (Beijing 1995).

²⁰⁸ Circular of the State Council on Implementing on a Trial Basis the System of Capital Funds in Projects which Involve Investment in Fixed Assets [guowuyuan guanyu shixing guding zichan touzi xiangmu shixing zibenjin zhidu de tongzhi], issued on August 23, 1996. The Chinese Version of the Circular is available at State Council Gazette [guowuyuan gongbao], No. 27, 1074-1077 (September 27, 1996). The Circular requires that the owner of a fixed-investment project must have invested a certain amount (varies for projects in different industrial lines and regions) of capital funds.

²⁰⁹ See, Chinaonline, 'Economist Examines China's Potential Debt-to-Equity Conversion' (September 21, 1999), available in '<http://www.chinaonline.com/industry/fina.../currentnews/open/B2-99090711-SS.doc.asp>'. That article claims that since reform, the state has "blackmailed" SOEs, burdening them with debt economics, thus "stabbing" the state-owned economy seven times. In addition to the change from allocations to loans and the cutting off of SOE working capital investment, and the cutting of investment in technological transformation, the other four are the change from loan repayment before taxes to loan repayment after taxes, interest reform tax, heavier turnover tax burdens, and heavier social welfare burdens. *Id.*

was built between March 1993 and mid-1995. The initial budget was RMB393m. Due to a sharp rise in the cost of steel and cement, however, the final cost reached RMB818m and the balance was totally financed by CCB loans.²¹⁰

The application of this argument is not limited to SOEs established after mid-1980s, but also applies to SOEs built before then. These SOEs, having handed most of their profits to the government, had to borrow from banks to update themselves, resulting in their high debt-asset ratios. Jiangxi Phoenix Optical Instrument Group, which signed a deal with Dongfang on October 25, 1999, tells the story:²¹¹ The Jiangxi firm was set up in 1969 in caves in the mountains of northern Jiangxi to produce precision machines and optical equipment for military uses. The factory then located 100 kilometers from the nearest city, Shangrao. In 1987, after fear of the war had receded, the firm moved to Shangrao, where it could more easily sell its products to domestic and foreign markets. Originally the cost for the move and rebuilding of the plant, about RMB200m, was to be paid for by a government grant but the policy changed and this became a loan. That is why the company's debt-asset ratio reached 69%.

To conclude, SOEs should not be blamed solely for their high debt-asset ratios. And the government should at least to some extent bear the responsibility for that. Debt-Equity Swaps at least can give some SOEs an opportunity to restart.²¹²

C. PROBLEMS WITH THE CURRENT DEBT-EQUITY SWAP SCHEME AND RECOMMENDED SOLUTIONS

1. Moral Hazard Problem

Moral hazards are the biggest risks that need to be on guard against to implement the debt-equity conversion scheme.²¹³ There are moral hazards of debtor enterprises and of local governments.²¹⁴

²¹⁰ South China Morning Post, 'Cement Plant Finds Life After Debt' (October 25, 1999). The company had owed the CCB RMB553m ever since its establishment. An amount so large that it could not pay the interest, let alone the principal, and keep running. *Id.*

²¹¹ See, O'Neill, 'Debt Deal Boost Ex-military Firm', *South China Morning Post*, 4 (October 27, 1999).

²¹² Compared to closure & liquidation, or keeping the enterprise floating without tacking their extensive debt-asset ratio, debt-equity swaps might be an optimal option. Closure and liquidation cannot be applied ubiquitously, given the important role SOEs play in the economy. Second, if the enterprise debt-asset ratio remains at unreasonably high level, most of the SOEs will not have chance to return to black. Moreover, there will be moral hazard problem with over-leveraged enterprises. See, Wu, Youchang, Zhao Xiao, 'Debt-to-Equity Swap: A Theoretical and Policy Analysis Based on Corporate Governance [zhaozhuangu: jiyu qiye zhili jiegou de lilun yu zhenche fengxi]', *Economic Research Journal (jingji yanjiu)* No. 2, 26, at 30 (Feb. 2000).

²¹³ *C.f.*, Stiglitz, Joseph E., 'Second-Generation Strategies for Reform for China (zhongguo dierbu gaige zhanlue)', *People's Daily (Overseas Edition)*, 2 & 3 (November 13, 1998). An English version is available at '<http://www.worldbank.org/html/extdr/extme/jssp072098.htm>'. Stiglitz, the Chief Economist of the World Bank, when spoke at Peking University on July 20, 1998, argued that the fact that in China the government is both the owner and the lender (indirectly) provides an easy way for SOEs to get out of their high debt burdens: debt-equity swap. These swaps need to be carried out early, and should be one of the main tasks given to AMCs. *Id.*

Debt-Equity swaps are de facto a gambling, the central government, AMCAs as a party to gamble with debtor enterprises and local governments. The central government and AMCAs want to mitigate financial risks via debt-equity swaps and recover more from the NPLs when the financial situation of their debtors improves. The debtor enterprises and local governments, however, aim at releasing themselves of the debt burdens by debt-equity swaps and paying as less dividends as possible to AMCAs.

Theoretically, SOEs in China fall into three categories: Enterprises in the first category are those who can pay their debts on time. Enterprises in the third category are those who have no potential to return to profit. Enterprises between them, i.e., those who have difficulties in paying bank loan principals and interests because of their irrational capital structure fall into the second category. If the criteria set by the SETC can be strictly applied, debt-equity swaps will only be applied to the second category enterprises.

The real picture is much more complicated, however. There are de-incentives for enterprises of the first category. Because they are in better financial situation, they are not qualified for debt-equity swaps and thus have to pay their debts in full; while the debts of those enterprises who are not doing as well as them can enjoy the debt forgiveness (Although they will have to pay dividends to AMCAs later, the payment of dividends are not compulsory.). Enterprises of the first category therefore may choose to “downgrade” themselves to qualify for debt-equity swaps. In other words, they have incentives to not work as hard as before. Enterprises in the third category will have incentives to “qualify” themselves for debt equity swaps by polishing their accounting reports and providing incorrect information about their potentials in returning to profit. The enterprises in the second category, while they are qualified for debt-equity swaps, might have the expectation to be bailed-out by the government in the future and lack incentives to improve their management and operation after their debt burdens are mitigated. To be worse, enterprises will be often countenanced or even helped by local governments to “qualify” themselves for the debt-equity swap scheme. In this way, local governments are competing for resources. It is therefore no wonder that more than 500 of SOEs with assets of RMB358.5bn applied to the SETC to join the swap scheme in a month after the scheme was initiated.²¹⁵

The problem is so serious that Shen Huaren, the SETC director, stated at the Working Conference of State Economy and Trade in Beijing in later November 1999²¹⁶ that only those deals authorized by SETC are valid. All unauthorized deals are void— “[d]ebt-for-equity swaps should be conducted within a proposed name list recommended by the SETC”, “[a]ny unauthorized swap is not permitted.”²¹⁷ To punish local

²¹⁴ The discussion in the section draw heavily from Zhou Tianyong, ‘The Transfer Mechanism of Debt-to-Equity Swap Program and the Operation Risk [zhaizhuanggu de liucheng jili yu yunxing fengxian]’, *Jingji Yanjiu (Economic Research Journal)* No. 1, 22 (January 2000).

²¹⁵ These enterprises had an average debt-asset ratio of 80.3%, and RMB188.2bn in long-term liability. See, World News Connection, Article by ZXS Reporter Tao Guangxiong: ‘Focus of State-Owned Enterprise Reform: Converting Debts into Shares Helps Ease Difficulties in State-Owned Enterprise Reform’ (September 18, 1999), available at ‘1999 WL26443497’.

²¹⁶ See, Chinaonline, ‘Unauthorized Debt-equity Swaps Are Void- Beijing’ (November 23, 1999), available at ‘<http://www.chinaonline.com/topstories/991123/b9112231.asp>’.

²¹⁷ See, Chinaonline, ‘Unauthorized Debt-equity Swaps Are Void- Beijing’ (November 23, 1999), available at ‘<http://www.chinaonline.com/topstories/991123/b9112231.asp>’.

governments that impose their enterprises to AMCs for debt-equity swap, Mr. Shen stressed that supervision of debt-equity swaps and indicated that if fraud is discovered, such deals would be canceled “and debt-for-equity swaps for enterprises in the entire province will be suspended.”²¹⁸ The announcement had a retrospective effect. According to Mr. Shen, Those debt-equity swap deals unauthorized by the SETC “already completed are considered no longer effective, otherwise no new programs will be approved”.²¹⁹

This strict restriction on candidate enterprises can surely to some extent solve the problem. There are new concerns, however. First of all, whether the SETC can carry out the criteria completely remains doubtful. Because of the information in-symmetry between the SETC and the local governments (and enterprises), the SETC has to rely on information provided by enterprises and local governments to make the selection. And, because the SETC does not bear the cost and responsibilities for debt-equity swaps, they have all the reasons to bend to pressures from local governments and enterprises.²²⁰ Although most of the enterprises recommended by the SETC are good enterprises,²²¹ at least one of the five announced deals signed by Cinda— with a Xinjiang company that is the largest reed producer in the mainland’s northwest — raises concerns. The company— part of the military-owned Construction and Engineering Group (Bingtuan), one of the biggest industrial and agricultural entities in the border region — has an asset-debt ratio of 62.39%, with debts of RMB145.37m, of which 133.51m is owed to CCB. The deal appears to flaunt the SETC swap guidelines because reed cannot be considered a priority product.²²² Second, because all the transactions are subject to the approval of the SETC, there are de-incentives on AMCs as well: Since the final decisions are not made by AMCs but by the SETC, AMCs will have an excuse when a deal proves unsuccessful later on.

²¹⁸ See, Chinaonline, ‘Unauthorized Debt-equity Swaps Are Void- Beijing’ (November 23, 1999), available at ‘<http://www.chinaonline.com/topstories/991123/b9112231.asp>’.

²¹⁹ See, Chinaonline, ‘Unauthorized Debt-equity Swaps Are Void- Beijing’ (November 23, 1999), available at ‘<http://www.chinaonline.com/topstories/991123/b9112231.asp>’.

²²⁰ Both the SETC and local governments are obligated by the promise have SOEs return to profits in three years (with the 2000 the last year).

²²¹ Beijing Cement Plant, the first SOE selected for the debt-equity swap scheme, is among the most modern in the mainland, with Swiss and German equipment, selling everything it can produce and environmentally sound since it filters its dust, produces no smoke and recycle all its water. Output doubled from 220,00 tons in 1995 to 460,000 in 1996 and 780,000 in 1999, with its cement used in many of Beijing’s best-known construction projects. See, South China Morning Post, ‘Cement Plant Finds Life after Debt’ (October 25, 1999). Jiangxi Phoenix Optical Instrument Group, which signed the debt-equity swap deal with Dongfang, the AMC of the BOC on October 25, 1999, for example, is an enterprise which employs 4,300 people, including 600 technical staff, and produces cameras, mirrors, binoculars and other optical equipment. The company’s annual exports are worth US\$10m. Group revenue, including the listed vehicle (The group owns a 60% share of Phoenix Optical that listed RMB37.4m A shares on the Shanghai market in May 1997), was RMB430m in 1998, up from RMB340m in 1997. See, O’Neill, ‘Debt Deal Boost Ex-military Firm’, *South China Morning Post*, 4 (October 27, 1999).

²²² See, O’Neill, Mark, ‘Foreign Bankers Remain Skeptical as Cinda Takes Equity in Five Companies Debt-swap Deals to Test Reform Plan’, *South China Morning Post*, 2 (October 14, 1999). There is suspicion that Cinda was forced into the deal by the political lobbying power of the Bingtuan and Beijing’s preferential policies for border regions, which are less developed than the east coast. *Id.*

In selecting candidate enterprises, the author here would suggest that AMCs be granted discretion not to carry out debt-equity swaps with recommended enterprises so that they can double check the financial situation and potentiality of the enterprises.

2. Lack of Workable Reorganization Plan

The success of the debt-equity swap scheme cannot be taken for granted. The win-win situation of SOEs and banks cannot be achieved simply by converting enterprise debts into equity. If the enterprise cannot be effectively restructured, if the enterprise governance structure cannot be improved, the debt-equity swaps—the increase in enterprise book profits by reducing in interest payment means no benefit to the society,²²³ and the financial risks will by no means be reduced.²²⁴ It is therefore essential that a workable reorganization plan can be agreed and enforced in debt-equity swap transactions.

China's AMCs are now in a hurry to conclude debt-equity swap agreements with SOEs recommended by the SETC, mainly because of the requirement of the SETC that framework agreements for debt-equity swaps must be research by mid 2000.²²⁵ To catch up with the deadline, the AMCs have been signing agreements in a hurry. By the end of 1999, the four AMCs had reached debt-to-equity swap agreements or framework agreements with 66 SOEs for debt equivalent to RMB83.463bn.²²⁶ On December 28, 1999 only, for example, the nation's four AMCs signed debt-to-equity swaps with ten SOEs to swap RMB4.13bn of their aggregate debt.²²⁷ That made debt-equity swaps look like debt Amnesty in China.²²⁸

It seems that emphases have mainly been put on improving enterprises' book profits by reducing their interest expenditures, rather than on improving SOEs' real

²²³ This can be proved by a simple calculation. Let us assume an enterprise has a debt-asset ratio of 50% and pays interest at the rate of 10%, the enterprise will obviously lose money if the enterprise return on asset is 2% before tax. Now assume that all the debt are converted into equity, the enterprise would be able to have a profit equivalent to 2% of the total assets before tax. This conversion, however, has no benefit to the society. See, Wu, Youchang, Zhao Xiao, 'Debt-to-Equity Swap: A Theoretical and Policy Analysis Based on Corporate Governance [zhaozhuangu: jiyu qiye zhili jiegou de lilun yu zhenche fengxi]', *Economic Research Journal (jingji yanjiu)* No. 2, 26, at 29 (Feb. 2000).

²²⁴ If the profitability of the enterprise sector has not been improved, then although the banks are released of the NPLs, the government will have to bail out the AMCs sooner or later; moreover, new loans to the enterprise sector will become NPLs again and new financial risks will be accumulated in the banking sector. See, Wu, Youchang, Zhao Xiao, 'Debt-to-Equity Swap: A Theoretical and Policy Analysis Based on Corporate Governance [zhaozhuangu: jiyu qiye zhili jiegou de lilun yu zhenche fengxi]', *Economic Research Journal (jingji yanjiu)* No. 2, 26, at 30 (Feb. 2000).

²²⁵ See, Chinaonline, 'China's Debt -Equity Program Has Yet to Be Implemented' (January 13, 2000), available at '<http://www.chinaonline.com/topstories/000113/C00011330.asp>'. The existence of a deadline was very important as to spur AMCs to finish the process so that NPLs will not stay with them too long.

²²⁶ See, 'The Four AMCs Has Reached Debt-Equity Swap Agreements Worth of RMB83.4bn', *People's Daily*, 5 (January 8, 2000).

²²⁷ See, Chinaonline, 'Ten SOEs Signed Debt-to-equity Swaps in China' (December 30, 1999), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C9122903c.asp>'.

²²⁸ See, Chinaonline, 'Debt-Equity Can Mean Debt Amnesty in China, Expert' (January 6, 2000), available at '<http://www.chinaonline.com/topstories/000106/C00010630b.asp>'.

profit-earning capability in most of the reported deals.²²⁹ Except in few cases, most of the reported deals do not include substantial reorganization plan. Presumably, this is because that most of the agreements so far reached are only framework agreements and need to be detailed by further negotiation.

The current author, however, doubts whether there can be substantial reorganization plans later on. First of all, the governments at various levels are reluctant in pushing rigorous reorganization plans. Even the SETC itself provides that enterprises involved in debt-equity swaps are not permitted to mergers or declare bankruptcy.²³⁰ The local governments, concerning about their local welfare, are not willing to support reorganization plans including large layoffs.²³¹ And they are in the right position to kill such kind of reorganization plans.²³²

Second, the AMCs do not have sufficient incentives and expertise to impose reorganization plan on SOEs. In many deals, AMCs only hold a minority stake and cannot carry out their influences efficiently. Besides, most deals bear a buy-back provision, the parent company of the enterprise promised to purchase back equity held by AMCs during a certain period of time,²³³ that creates a de-incentives for AMCs to act positively in improving SOEs' profitability and operation. Moreover, even if AMCs are willing and allowed to make the intervention, whether they have the capacity of doing so is another problem.²³⁴

There are suggestions that compulsory dividend distribution be provided in debt-equity swap deals so that AMCs and their debtor enterprises will have incentives to

²²⁹ See, Dow Jones International News, 'China Govt Paper Warns of Moral Risk in Debt-Equity Plan' (December 6, 1999).

²³⁰ See, Chinaonline, 'Unauthorized Debt-equity Swaps Are Void- Beijing' (November 23, 1999), available at '<http://www.chinaonline.com/topstories/991123/b9112231.asp>'.

²³¹ See, Chinaonline, 'China's Debt -Equity Program Has Yet to Be Implemented' (January 13, 2000), available at '<http://www.chinaonline.com/topstories/000113/C00011330.asp>'. All across the country there are regular reports of demonstrations by retired workers, unable to draw their pensions, and the jobless, protesting at the lack of welfare. In February 1999, for example, the country suffered its worst outbreak of industrial unrest in several years in a blighted northeastern mining town, where more than 20,000 people smashed windows, blocked traffic, burned car and fought with armed police for many days. See, Kynge, James, 'Riots in Chinese Mining Town', *Fin. Times*(April 3, 2000).

²³² See, Li, Xia, 'The Scope and Preconditions for Candidate Enterprises for the Debt-Equity Swap Scheme [shishi zhaizhuanggu qiye de fangwei yu tiaojian]', *Jingrong Shibao*, 12 (September 15, 1999). According to the SETC guidelines, a restructuring plan involving large layoffs must be approved by relevant local governments. *Id.*

²³³ In the Beijing Cement Plant Deal, for example, although Cinda became the controlling shareholder under the agreement. The original parent company, are entitled to buy out Cinda's share in three years. The same provisions can also be found in the Metallurgy Group Co. (Ye Gang) deal. According to the agreement, Cinda would only temporarily hold Yegang Steel's shares, which would eventually be sold or transferred back to Yegang. See, Chinaonline, 'Xinda Asset Mgmt Lightens China Yegang Steel's Debt Load' (November 11, 1999), available at '<http://www.chinaonline.com/topstories/991111/c9111003.asp>'.

²³⁴ See, e.g., Wu, Youchang, Zhao Xiao, 'Debt-to-Equity Swap: A Theoretical an Policy Analysis Based on Corporate Governance [zhaozhuanggu: jiyu qiye zhili jieou de lilun yu zhenche fengxi]', *Economic Research Journal (jingji yanjiu)* No. 2, 26, at 31 (Feb. 2000).

improve enterprises' management and operation.²³⁵ The current author, however, would argue that attentions be paid to include outsider investors in the debt-equity swap, breaking the circle among banks, AMCAs and enterprises. Only if AMCAs can transfer parts of the equity they acquired from the swaps to the society, the corporate governance of the enterprises can be improved. The arguments are simple, first, there is no reason to expect that AMCAs, state-owned as well, can do better than other government agency in manage state assets. Second, the AMCAs will not have sufficient resources to do their job.

D. AMCS' EXIT PROBLEM

1. The Importance of AMCAs' Timely Exit

AMCAs are not NPL warehouses. They should only hold equities converted from debts temporarily.²³⁶ The exit of AMCAs' is essential to the success of debt-equity swap scheme.

First of all, to the managers of an enterprise, debt constraints are harder than equity. In a mature market economy, an insolvent enterprise will be forced to go bankrupt, resulting in the unemployment of enterprise managers. To avoid this, the managers will have to work harder and ensure that the enterprise has the ability to repay loan principles and interests.²³⁷ With regards to SOEs in China, although debt constraints are not really hard budget constraints, compared to the owner of SOEs—the State represented by various government agencies, banks as creditors are putting more constraints on enterprise borrowers. The debt-equity swaps are actually removing the constraints from SOEs.²³⁸ Second, as mentioned before, the AMCAs lack the incentives and capacity to restructure enterprises and monitor their operations. It is therefore important for AMCAs to dispose the equity they acquired timely to those domestic or overseas investors who has the ability to restructure the enterprises and monitor their operation.

Moreover, at the end of the day, AMCAs must cash banks in return for the NPLs (which they currently paid in bonds). If AMCAs can neither receive dividends from SOEs or cash in the equity they acquired via the debt-equity swaps, they will have no resources to pay the banks. Consequently, banks will have no way to repay depositors, and the government will ultimately have to take responsibility for repayment.²³⁹

2. Probable Routes for AMCAs to Dispose Equity Acquired from Debt-Equity Swaps

²³⁵ See, e.g., Zhou Tianyong, 'The Transfer Mechanism of Debt-to-Equity Swap Program and the Operation Risk [zhaizhuanggu de liucheng jili yu yunxing fengxian]', *Jingji Yanjiu (Economic Research Journal)* No. 1, 22, at 27 (January 2000).

²³⁶ See, e.g., Zhu Ming & Huang Jinlao, 'On China's Assets Management Corporations [lun zhongguo de zichan guanli gongsi]', *Economic Research Journal* No. 12, 3, at 8 (December 1999).

²³⁷ See, e.g., Wu, Youchang, Zhao Xiao, 'Debt-to-Equity Swap: A Theoretical and Policy Analysis Based on Corporate Governance [zhaozhuanggu: jiyu qiye zhili jiegou de lilun yu zhenche fengxi]', *Economic Research Journal (jingji yanjiu)* No. 2, 26, at 31 (Feb. 2000).

²³⁸ See, e.g., Wu, Youchang, Zhao Xiao, 'Debt-to-Equity Swap: A Theoretical and Policy Analysis Based on Corporate Governance [zhaozhuanggu: jiyu qiye zhili jiegou de lilun yu zhenche fengxi]', *Economic Research Journal (jingji yanjiu)* No. 2, 26, at 32 (Feb. 2000).

²³⁹ See, AFX, 'China Debt Disposal Via AMCAs Seen "Worse than Imaginable' (December 8, 1999), available at '1999 WL 25421659'.

The government's idea behind the debt-equity swap scheme is that by converting SOE loans into stock, these SOEs, and particularly enterprises in highly competitive industries, can be gradually introduced to society, making them truly public companies. In this way the AMC's can dispose their stocks to the public.²⁴⁰ There are other possible exits as well, such as selling equities privately to domestic or foreign investors, selling the equities back to the enterprise.²⁴¹ Whether AMC's can exit through these routines, however, remains doubtful.

a. Difficulties in Disposing Stocks By Selling them to the Public

To list the enterprises and sell shares to the public is what considered the optimal routine for AMC's to dispose the shares they acquired from the debt-equity swaps. There are at least three obstacles, however.

One are the listing criteria, including rules that require firms to have three consecutive years of profits before they can sell shares to the public.²⁴² Since SOEs must be in the red to be chosen for the swaps, it will definitely take a certain period, at least three years after the swap, before the enterprises can be listed.

Second, although there are now pilot trials to dispose state shares of joint stock companies, state-owned shares, including those hold by state-owned units,²⁴³ are not allowed to circulate freely in the stock exchange due to historical reasons.²⁴⁴ If this rule cannot be changed, the shares held by AMC's, that are all wholly state-owned, will not be tradable even if the enterprises succeeded in listing eventually.

Third, even if these two rules can be changed or zigzagged. Disposing equity via stock markets will need a very long period of time. The debts in the 601 SOEs recommended by the SETC for debt-equity swap amounted to RMB459.6bn.²⁴⁵ The total market value on the Shenzhen and Shanghai stock markets is about RMB2.8trillion, only one-third of which consists of traded shares, and the total amount of funds raised via the

²⁴⁰ See, e.g., Chinaonline, 'Economist Examine China's Potential Debt-to-Equity Conversion' (September 21, 1999), available at <http://www.chinaonline.com/industry/fina.../currentnews/open/B2-99090711-SS.doc.asp>.

²⁴¹ See, Liu, Min, 'The Operation of "Debt-equity Swaps": the Exit of AMC's [zhaizhuanggu shishi ji tuichu fangshi chutuan]', *Jingrong Shibao*, 12 (September 15, 1999).

²⁴² According to the Company Law of the People's Republic of China, a company that wishes to issue new stocks must have earned profits in each of the last three years and is able to pay dividends to its shareholders, the company's anticipated profit rate must at least meet the interest rate on bank deposits, in addition to other conditions. See, the Company Law, art. 137.

²⁴³ In China, shares issued by a joint stock company have been specially divided into state shares [guojiagu], legal person shares, [farengu] (including state-owned legal person shares, collective enterprise legal person shares, institutional legal person shares); individual shares [gerengu] and foreign capital shares [waizigu]. State shares and state-owned legal persons shares are called state-owned shares. See, e.g., Gu, Minkang, 'Acquisition of State-owned Shares through Chinese Securities Markets: A Way of Privatization?', *International Business Lawyer*, 386, at 386 (October 1999).

²⁴⁴ See, e.g., Gu, Minkang, 'Acquisition of State-owned Shares through Chinese Securities Markets: A Way of Privatization?', *International Business Lawyer*, 386, at 386 (October 1999).

²⁴⁵ See, Chinaonline, 'China Denies Debt-Equity Swaps Just "Word Games"' (February 7, 2000), available at <http://www.chinaonline.com/topstories/000207/2/C00012604.asp>.

markets was RMB70bn in 1997, RMB43bn in 1998.²⁴⁶ It is obvious that it will take a while for the domestic stock exchanges to digest the equity acquired by AMCs via debt-equity swaps.

Listing abroad might be another choice. But there are problems as well. First of all, according to the 1994 State Council Special Regulations on Limited Stock Companies Issuing Stock and Listing Abroad, the dividends of a company listed abroad should be declared in RMB but paid in foreign currency in accordance with foreign exchange regulations.²⁴⁷ Given the capital account control in China, few SOEs can be listed abroad. Second, according to updated requirements and procedures for Chinese enterprises applying for an overseas stock market listing issued by China Securities Regulatory Commission (CSRC) in 1999, any Chinese enterprise wishing to list overseas must have net assets of more than RMB400m. The company's after-tax profits from the previous year should be no less than RMB60m. And, calculated according to a reasonably expected price-earning ratio, the financing should be no less than US\$50m.²⁴⁸ Third, there will be requirement from the host securities exchange commission as well.²⁴⁹ Even if these regulations were to be eliminated, it seems unlikely that the foreign investors would be willing to invest in firms with uncertain future.²⁵⁰

b. Difficulties in Selling Shares to Strategic Investors

Another way for the AMCs to dispose their stock-holdings is to sell them to domestic and overseas strategic investors. While there are not many domestic investors, foreign investors are expected to be the main purchaser. In 1997, foreign direct investment reached a historic high of \$45bn, but it remains a question whether foreign investors would be prepared to buy shares in state-run companies.²⁵¹

²⁴⁶ See, AFX, 'China Debt Disposal Via AMCs Seen "Worse than Imaginable' (December 8, 1999), available at '1999 WL 25421659'.

²⁴⁷ Special Regulations on Limited Stock Companies Issuing Stock and Listing Abroad, art. 27.

²⁴⁸ See, Chinaonline, 'China Updates Overseas Listing Rules' (July 20, 1999), available at 'http://www.chinaonline.com/industry/fina.. Archive/Secure/1999/july/fn_c9071916.asp'.

²⁴⁹ The IPO of China National Petroleum Corporation (CNPC), for example, was held up by extensive scrutiny from the US securities regulator in February 2000. The delay was holding up a number of other Chinese listing hopefuls. See, Lin, Ho Swee, 'CNPC: IPO Delayed by US Regulator' *Fin. Times* (February 2, 2000).

²⁵⁰ The IPO of Beijing Capital International Airport in January 2000 served a good example for this assertion. The public portion of the BCIA equity offering on 28 January was under-subscribed and was expected to be priced at the lower end as underwriters struggled to place the paper. According to analysts, this issue is overshadowed by a domination of high-growth stocks. The SOEs are being overshadowed by the technology sector. Because China's state-run companies are perceived to have excessive production capacity, huge work-forces, heavy debts and be loss-making, there is a lot of skepticisms about any Chinese stock which does not have a clear growth potential. BCIA is China's first IPO attempt since China National Offshore Oil Corporation, the country's third largest oil company, pulled its offer last October. That offer was abandoned after the share price was heavily cut back. See, Lin, Ho Swee & Ostrovsky, Arkady, 'Beijing: Airport IPO Short of Full Take-up', *Fin. Times* (January 28, 2000).

²⁵¹ There are report, though, that dozens of well-known foreign investment companies have had extensive contacts with the Cinda AMC, and both sides have reached substantial agreement on their intention for future cooperation. See, Chinaonline, 'China Asset-Management Firms Offer Shares to Foreign Firms' (April 20, 2000), available at '<http://www.chinaonline.com/topstories/000420/2/C00041910.asp>'.

Besides, the sale of state-owned shares in Chinese companies to foreign investors would prove difficult. In 1994, the Administration of State-Owned Assets and the State Commission for Restructuring the Economy jointly issued the Interim Provisions on the Management of State-Owned Shares in Joint-Stock Companies. According to the Interim Provisions, holders of state-owned shares intending to transfer state-owned shares to foreign investors should apply to the Administration of State-Owned Assets for examination and approval; when the transfer of state-owned shares involves huge amount or may result in changes in absolute or relative holding rights, the transferor must apply for examination and approval of the Administration of State-Owned Assets, the State Commission for Restructuring the Economy and other related departments.

c. Difficulties in Selling Back the Shares to the Debtor Companies or Their Parent Institutions

Buying-back clause are not uncommon in debt-equity swap deals in China.²⁵² But this would also require that the AMCs hold their shares for a long time, restructure the enterprises, establish a new management system and bring the companies back to profit. Otherwise, the companies cannot buy back the shares. Or even they managed to buy back the shares, the companies will remained unchanged, self-defeating the purpose of debt-equity swap.

E. Summary

It is not surprising that debt equity swaps are chosen as the main strategy for AMCs to deal with the NPLs they collected from banks. AMCs in China are not only mandated to improve banks' financial condition, but also to save SOEs in China. Macro-economically, the debt-equity swap scheme is part of the government's anti-deflation policy. And, for some SOEs, if their excessive debt-asset ratios can be reduced to a reasonable level, they can hopefully go out of difficulties. Some economists in China yell that debt-equity swaps are win-win solution to both SOEs and banks.

There are problems with the implementation of the scheme, however. First of all, although criteria have been set by the SETC on what enterprises are qualified for the scheme, it is doubtful that these criteria can be carried out completely. Second, most of the deals signed so far do not contain substantial enterprise reorganization plan, putting doubt on whether the enterprise will improve their performance after the deal. Third, it is important for AMCs to be able to dispose the equities they have acquired from the swaps timely. There are difficulties, both legally and economically, however, for the achievements of this goal.

²⁵² In the Beijing Cement Plant deal, for example, Beijing Building Material Group has to rights to purchase back the shares held by Cinda in three years after the agreement. See, Li, Xia & Wang, Xing, 'Debt-Equity Swap Started in China [zhanzhuanggu jingru shizixing chaozhou]', *Jingrong Shibao*, 12 (September 15, 1999). There was report, however, that enterprises were unwilling to make purchase-back promises. See, Chinaonline, 'China's Debt -Equity Program Has Yet to Be Implemented' (January 13, 2000), available at '<http://www.chinaonline.com/topstories/000113/C00011330.asp>'.

V. CONCLUDING OBSERVATION

It is not surprising that China chooses AMC and debt-equity swaps to solve the bank NPL problems. The seriousness of bank NPL in China cannot be exaggerated, given the large amount of existing NPLs and the continuous accumulation of new NPLs on state commercial banks' balance sheet. It is widely recognized that NPLs have accumulated to such an extent that they are large enough to threaten the safety and soundness of China's state banks and consequently the whole banking system. Moreover, the existence of sky-high amount of NPLs impedes banks from granting new loans to the real economy, and the establishing of market economy in China.

The severity of Asian financial crisis taught the Chinese government the importance of having a health financial system. What directly led to the decision to establish four AMCs and carry out debt-equity swaps, however, is that other policy initiatives failed to solve the problem. In the wake of the Asian financial crisis, the Chinese government announced important steps to reduce the risks that the Asian financial contagion would spread to China, with the RMB 270bn capital injection at the core of these measures. The government then expected that the ex ante RMB270bn recapitalization would bring the risk-weighted capital adequacy of the big four to the 8% standard set by the Basle Capital Accord and the Commercial Banking Law; and the big four would consequently have incentives to lend on commercial basis. The recapitalization was neither good timed nor at the right size. The failure of RMB270bn ex ante recapitalization led authorities in China turns to AMCs and debt-equity swaps.

In 1999, four AMCs were established to take over NPLs from the big four. The AMCs, each with a registered capital of RMB10bn from the Ministry of Finance, issued bonds guaranteed by the Ministry of Finance to their respective banks in exchange for NPLs at the paper value of the loans. Because the bonds issued to the banks in exchange of the NPLs are Treasury-back bonds, this transaction is in essence an injection of capital to the big four.

Compared to the Special Treasury Bonds injection in 1998. Setting up AMCs to take over NPLs from the big four bears some merits. Most importantly, the approach can avoid the potential costs to succumbing to the natural tendency of reducing the cost of bank recapitalization by underestimating the magnitude of NPLs or by overestimating the amount that ultimately can be recovered from borrowers.

The root of bank NPL problem not only lies with China's banking system, but the loss-making SOEs as well. In an intention to solve the bank problem and SOE problem simultaneously, authorities in China initiated the debt-equity swap scheme immediately after the establishment of the four AMCs.

The operation of AMCs is problematic, however. First of all, AMCs in China are not simply mandated to solve the bank NPL problem, but also to help SOEs grow out of their difficulties. This in some terms greatly limits AMCs' discretion in managing bank NPLs and put doubts on whether AMCs can carry out their tasks as successful as their counterpart in the US. Second, AMCs in China are heavily dependent on their banks, although it has been repeatedly declared that AMCs are wholly state-owned, hold independent civil liability, and operate completely independently from the banks. This

cast doubts on whether they could carry out thorough investigation about the causes to NPLs. Third, AMCs in China have to rely on issuing corporate bond and borrowing commercial and government-sponsored loans. This financial reliance further deteriorates AMC's independence. Fourth, AMCs in China are in short of experience and expertise in managing NPLs. Last but not least, there are legal obstacles to AMCs' smooth operation in China: (1) It is not clear whether the borrowers must be notified of AMCs' take-over of the loans from the banks, as required by China's contract law. (2) AMCs must take cautions to accomplish legal procedures for the transfer of security interests on the loans. (3) The borrowers' right to assert against AMCs their defenses against banks may prove troublesome.

The debt-equity swap scheme, yelled by some economists in China as a win-win solution to banks and SOEs, has problem in its operation as well. The debt-equity scheme bears moral hazards of debtor enterprises and of local governments. They are struggling for "tickets" of converting debts into equity. Second, so far, most the debt-equity swap agreements reached don't contains substantial reorganization plan for the enterprises, rather, emphases have mainly been put on improving enterprises' book profits by reducing their interest expenditures. Last but not least, it seems that AMCs will have difficulties in disposing the equity they acquired from debt-equity swaps later on, while this is essential for the success of the whole AMC practices in China.

Until these problems can be solved properly, whether the AMCs and debt-equity swap scheme can really solve bank NPL problem in China remains doubtful. Moreover, taking over NPLs from banks only releases banks of their NPL stock. If new NPLs continue to accumulate on their books, it will not be pessimistic to predict that the state commercial banks will have to be bailed out by the government soon. To check the increasing accumulation of NPLs, efforts should be taken to enhance banking prudential regulation and supervision in China, promoting internal controls of state commercial banks.

To conclude, AMCs and debt-equity swaps are solid steps to solve the NPL Problem in China. The operation of AMCs and the carrying out of debt-equity swaps, however, are not problemless. These problems must be solved properly. The AMCs and debt-equity swaps are mainly steps to solve the stock side of NPL problem. Without tackling the flow side of NPL problem, the state commercial banks will have to be bailed out again. Efforts, therefore, should be taken to tackle the flow side of NPL problem as well.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Commentator

**Mainland China's Accounting
Standards for Debt Structure**

Liu Yan

會計準則如何影響債務重組？

——一個初步的分析

一、問題的提出

債務重組，即在債務人發生財務困難的情況下，債權人按照其與債務人達成的協定或者法院的裁定作出讓步，調整其原有債權債務關係的活動，在當下的中國經濟生活中具有顯著的意義，它對於改善我國企業不合理的債務結構，減輕企業，特別是國有企業的債務負擔有積極的作用，同時又避免了破產程式費時耗資，容易引起社會震蕩等消極因素。

債務重組涉及到市場、會計與法律的制度配置，其中會計準則具有特別重要的意義。這是因為：

第一，會計準則具有經濟後果是一個不爭之事實；

第二，儘管從本質上說，債務重組是一項法律活動，旨在改變債權人與債務人之間原有合同關係的過程，但是債務重組的核心是雙方間重新進行的利益分配。會計準則對當事人重組過程中的利益得失以及重組後債權價值的處理，構成債務重組必不可少的技術支撐。

第三，與同樣具有消滅債權債務關係功能的破產程式相比，債務重組體現為雙方當事人之間的談判與協定的過程，法律干預程度較低。在這種情形下，債務重組的會計準則客觀上成為當事人之間進行債務重組過程中最主要的，也是最重要的法律依據。它不僅為當事人計量有關的權利義務提供了技術方法，而且對當事人感受並確定其權利義務有一種誘導性的效應，並在一定程度上約束著重組債務的當事人設定他們之間權利義務關係的自由度。

或許是基於上述考慮，1998年，財政部頒佈了《企業會計準則--債務重組》，對於債務重組中新債權的計量以及重組損益的確定等問題作出了規定。這幾乎是迄今為止關於債務重組的唯一的制度規範。然而，這一會計準則的實踐效果似乎不盡如人意。一方面，上市公司的債務重組幾近成為公司逃避債務、操縱利潤的手段；另一方面，當政府力圖推進規範化的債務重組時，債權人卻難以接受，轉而尋求破產。近年來的一系列債權重組導甚至引起人們對原本就缺乏市場經濟基本要素--“信用”的中國經濟滑向“賴賬經濟”的擔憂。¹這其中當然有諸多原因，但會計準則恐怕也難咎其責。²

¹ 參見 北京大學中國經濟研究中心宏觀組，“債轉股：走在信用經濟與‘賴賬經濟’的十字路口”，《國際經濟評論》1999年第9期。

² 人們將產生上述問題的原因歸結於“中國的法律系統、會計制度和資本市場都不成熟”，認為債務重組的制度配置尚未建立。上述評價或許反映了與債務重組相關的法律要素與市場要素的現狀，但它顯然忽略了

債務重組以債權人作出讓步為前提，但其核心是債權人與債務人之間利益的相對均衡。如果債務重組會計準則導致債權人遭受比破產程式下的損失還要高的損失，這對債權人是不公平的。債權人不會願意進行債務重組，從而挫敗政府推動債務重組的政策意圖。那麼現行《企業會計準則—債務重組》是否體現了債權人與債務人之間利益的均衡配置？它對債務重組的實踐可能產生什麼樣的影響？

在下文中，筆者將考察債務重組會計準則對兩個問題——修改債務條件下重組新債權的計量方法，債轉股下重組損益的確認——的處理方法，分析其對債權人和債務人利益的不同影響。筆者的初步結論是：現行債務重組會計準則給債務人以債務重組的利益驅動，但是未能對債權人的利益給予足夠的關注。

二、在修改債務條件的重組方式下，重組債權入賬價值應如何確定？

1、現行會計準則的規定及其效果

以修改債務條件方式進行的債務重組，包括延長債務償還期限，降低債務的利息率，豁免原債務的累計利息，豁免部分債務，或者上述方式的組合。《企業會計準則—債務重組》第 8 項規定：“以修改其他債務條件進行債務重組的，債務人應將重組債務的賬面價值減記至將來應付金額，減記的金額作為債務重組收益，計入當期損益”。財政部發佈的《企業會計準則—債務重組》指南將“將來應付金額”解釋為包括將來應付債務的面值和利息。³ 相應地，在這種債務重組方式中，債權人應將債權的賬面餘額減記至將來應收金額，減記的金額作為債務重組損失，計入當期損益。⁴ 將來應收金額包括重組後債權的面值與利息。

由此可見，現行會計準則對於新債權的入賬價值的規定主要是兩點：第一，重組後債權的入賬價值是將來支付總額，不折合為現值；第二，將來支付總額包括未來應計利息。

下面舉例說明如下：

A 公司欠 B 銀行三年期貸款 100 萬元，年利率 10%。由於 A 公司陷入財務困難，到期本息 130 萬元均不能償還。雙方達成延期還款，降低利率的債務重組安排，B 銀行同意給予 A 公司兩年的寬限期，利率降為 5%（同期市場利率為 8%），並豁免原貸款的累計利息。按照會計準則的規定，對於 A 公司來說，重組後債務的入賬價值為將來應付總額 110 萬元，即 100 萬元本金與兩年利息 10 萬元，與原債務的賬面價值 130 萬元相比，債務人實現重

我國近年來悄然進行的會計準則制訂工作已經提供了債務重組的會計基礎——《企業會計準則—債務重組》頒佈已近兩年時間。這也在一定程度上意味著債務重組的會計制度與人們的期望不一致。參見“債轉股仍屬紙上談兵，業內人指仍有難解問題”，載《羊城晚報》2000.1.19，轉引自 <http://www.listcom.com.cn/>

³ 具體地說，在應付賬款情形下，僅涉及將來應付債務面值(或本金，原值)；在計息債券或者其他有利利息的情形下，還應加上將來應付利息。參見：中華人民共和國財政部制定，企業會計準則 1999，北京：經濟科學出版社，1999 年第 1 版，頁 208。

⁴ 《企業會計準則—債務重組》第 14 項。

組收益 20 萬元；另一方面，B 銀行將將來應收總額 110 萬元作為重組後債權入賬，其與原債權的賬面價值 130 萬元之差 20 萬元確認為重組損失。

上例顯示，在現行會計準則下，銀行的兩項損失未能得到充分確認：

第一，所豁免的債務人原三年貸款利息 30 萬元的一部分（即 10 萬元）。導致這一結果的原因是重組後債權的入賬價值被規定為“將來支付總額”，包括“將來應計利息”。由於原貸款的利息損失與新貸款安排下的應計利息相互抵消，因此只有兩項利息的差額部分被確認。

第二，新的貸款安排下協定利率 5%與現行市場利率 8%之間的利差所隱含的市場利率損失。導致這一結果的原因是重組後債權的入賬價值是將來支付總額，不折合為現值。

2、未來應付利息入賬對當事人利益的影響

以修改債務條件為形式進行的重組債務，是債權債務關係當事人變更其原有合同關係，確立新債權債務關係的活動。重組後形成的新債權(債務)的入賬價值，一方面以貨幣的方式揭示了債權人所作的讓步，另一方面也是雙方當事人預期未來可得利益或者付出的座標。它應當準確地反映在重組後雙方之間存在的新的合同關係，並為會計上進一步確認重組債務對雙方財務狀況以及經營成果的影響奠定可靠的基礎。然而，未來應付利息計入重組後新債務價值的規定顯然與這一思路相背離。

從債權人一方來看，重組後債務的未來利息實際上是新的合同關係下，債權人可以預期取得的未來收益。將這筆未來應付利息計入重組後債務的賬面價值，虛增了債權人在債務重組中實際獲得的利益對價，減少了債權人應確認的重組損失的數額，未能充分反映債權人所作的讓步。另一方面，當債權人日後實際收到利息時，直接沖減債權賬面價值，不能反映債權人的利息收入，歪曲了債權人的財務狀況。

從債務人一方來看，將重組後債務的未來應付利息計入賬面價值，債務人減少了重組收益的確認，減輕了相關的稅負。同時，債務人日後支付利息時，直接沖減債務面值，不會發生利息等財務費用，未能真實反映債務人的籌資成本。

由此可見，將重組後新債務的未來利息計入債務的賬面價值，一方面掩蓋了債權人讓步的幅度，另一方面，也使債權人/債務人未來的融資關係未能得到真實而公允的反映。

3、對折現問題的再思考

未來利息應否入賬，與折現因素相關。以修改債務條件為形式進行的債務重組，客觀上隱含著“以合同修改之時作為損益計算的時點”這一前提。此時，原有債務終止，新債務承接。在新債務有面值並計息的情況下（如老貸款延長還款期並計息的情形），會計準則的制訂者實際上面臨兩種選擇：（1）考慮折現因素；這意味著新債務按現值入賬，新債務現值與原債務賬面價值之間的差額則反映當事人之間的損益分擔。在計算現值時，新債務的面值與未來應付利息都包括之內。因此，在考慮折現因素的前提下，未來利息應當入賬，不過應按照一定的貼現率進行折現。（2）不考慮折現因素，即按照合同修改時點新債務的面值入賬，

並依據新債務的面值與原債務的賬面價值之間的差額確認損益，此時，未來利息部分就不應當入賬，也不能參與損益計算，否則就會虛增新債務的入賬價值，也未能充分反映債務人實際獲得的重組利益以及債權人實際讓步的程度。

現行債務重組會計準則沒有考慮折現因素，主要是基於現階段我國會計資訊的提供者與需求方的實際狀況。⁵ 但是，會計準則一方面將折現因素剔除在外，另一方面卻將未來應付利息入賬，未能保持其邏輯上的一致性，必然導致債務人與債權人“一家歡喜一家愁”的結果。

三 債轉股方式下應否確認重組損益？

1、現行準則的規定及其效果

以債權轉股權方式進行的債務重組，其核心是如何確定股權的價值並在財務報表中反映，這個問題又與是否確認重組損益密切相關。

現行《企業會計準則--債務重組》採用以股權的公允價值入賬並確認重組損益的處理方式，其具體規則是：債務人應將債權人因放棄債權而享有的股份的面值總額（或股權份額）確認為股本（或實收資本）；股份的公允價值與股本（或實收資本）之間的差額確認為資本公積。重組債務的賬面價值與股份的公允價值總額之間的差額，作為債務人的重組收益計入當期損益。⁶ 相應地，《企業會計準則--債務重組》第 13 項要求債權人將債轉股後享有的股權的公允價值確認為長期投資；重組債權的賬面餘額與股權的公允價值之間的差額，作為重組損失確認。

上述規則舉例說明如下：

A 公司銷售一批材料給 B 公司，取得後者簽發的半年期帶息商業承兌票據一張。由於 B 公司發生財務困難，到期無法兌現票據。雙方達成債轉股的債務重組安排：B 公司以本公司的普通股 1 萬股置換了其原簽發的商業匯票。在重組日，該匯票的本息和為 10.4 萬元，B 公司普通股面值為 1 元，股票市價為每股 9.6 元，稅費不計。對於該項債務重組，B 公司確認重組收益 0.8 萬元（債務賬面價值 10.4 萬元-股權公允價值 9.6 萬元），同時確認股本 1 萬元，資本公積 8.6 萬元。A 公司則確認其股權投資 9.6 萬元，重組損失 0.8 萬元。⁷

2、確認重組損益對債權人的影響

從會計原理的角度看，確認債轉股中的重組損益的理由似乎非常充分。⁸ 然而，如果我

⁵ 根據財政部的解釋，剔除折現因素主要是因為它與我國目前的市場環境尚不相容，複利未成為主要的時間價值指標，經濟分析很少考慮折現因素，會計人員的素質也不適應折現反映的要求。參見上注，頁 227-228。

⁶ 《企業會計準則--債務重組》第 7 項。

⁷ 案例來源：《企業會計準則--債務重組》指南例 4，同上注，頁 384。

⁸ 採用股權公允價值入賬並確認損益的會計上的理由可以歸納為以下幾點：一是以重組債務的賬面價值而非公允價值入賬，沒有反映這項交易的經濟意義；其二，以賬面價值入賬無法單獨確認重組收益，致使這項有價值的資訊無法得到反映；其三，如果以重組債務的賬面價值入賬，與一般股票發行的核算原則就不一

們暫且跳出會計技術問題的框架，從公平的視角來看待這一規定，不免產生另一番感覺，即對債權人來說，債權轉股權的代價似乎大得令人難以接受。

現行會計準則處理隱含的一個前提是 在債權轉股權方式下，原債權的賬面價值必然大於轉股後股權的公允價值，即債權人在債權轉股權的同時，遭受了“重組損失”；相應地，債務人則增加了股本與資本公積，並實現了重組損益。然而，對債務人“重組收益”的正當性以及相應地債權人“重組損失”的必然性，我們有必要打一個問號。試想，如果債權人不同意讓步並進行債務重組，而是強行要求債務清償，債務人可能被迫進入破產清算。在這種情形下，債權人完全可能獲得現有股東更有利的地位，因為其全部債權都可以列為破產債權在股東之前獲得清償。然而，按照現行會計準則進行重組後，債權人的債權一部分被放棄，一部分轉化為資本公積，剩餘的部分方轉化股本或實收資本，與其他股東一起分享企業淨資產，而陷於財務困境的企業的淨資產通常並不是一個令人振奮的數位。兩相比較，債轉股與債權即時實現兩種方式對債權人利益的影響有如天壤之別，不禁令人對這種債務重組的可行性產生疑問。

中國信達資產管理公司在承接了中國建設銀行對鄭州百文股份有限公司的債權後，拒絕轉股而向法院申請鄭百文破產，似乎可以給上述疑問提供一個旁證。

3、對確認重組損益的幾項理由的分析

有幾個方面的理由似乎可以用來支援會計準則確認重組損益的做法：第一，既然債務重組意味著債權人的讓步，其放棄一部分債權是難免的，出現重組損失是必然的；⁹ 第二，股權以賬面價值入賬，不單獨確認重組收益，致使這項交易的經濟性質未能得到反映，債務人實際獲得了好處這一有價值的資訊也未能傳遞給外界；¹⁰ 第三，股權按照公允價值入賬，以股份的面值或股權份額作為實收資本，而將股本或實收資本與股權的公允價值之間的差額作為資本公積，符合一般股票發行的核算原則。¹¹ 第四，會計準則只不過是記錄交易的技術規範。債權賬面價值是否大於股權的公允價值，是否出現重組損益，是當事人之間談判的結果，會計僅僅是被動地將現實中產生的重組損益記錄下來而已。

筆者以為，上述四個方面的理由都難以成立。

(1) 何謂“債權人作出讓步”？

當債務人陷入財務困境，債權人將債權轉化為股權，本身就是對債務人的讓步，至少減輕了其利息負擔以及還債的壓力，降低了其財務杠杆比率，改善了其財務結構。何況，我國現行的《企業會計準則--債務重組》在衡量債權人的讓步時，沒有將折現因素考慮在內，已經在確認債權人讓步程度方面打了折扣。因此，考慮到債權人成為股東的特殊時點，那種強

致了，而二者的本質是一樣的；其四，債務轉為資本實際上也可以看作是兩項交易，即債務人首先償還債務，債權人獲得現金或其他資產，然後又將這些獲得的資產投給債務人作為長期投資。參見上注，頁 233-234。

⁹ 見《企業會計準則--債務重組》第 3 項關於債務重組的定義。

¹⁰ 見注 9 所引述的第一與第二項理由。

¹¹ 見注 9 所引述的第三項理由。

求債權人再犧牲一部分債權以換取股權的債務重組，實際上是對債權人合法權益的剝奪。其實質結果是債權人被迫進行了雙重讓步：首先是被迫接受債轉股方案，其次是所轉換成的股權的公允價值低於債權賬面價值。

(2) 什麼是“債務重組中有價值的資訊”?

債務重組是否為債務人帶來實質意義上的“重組收益”，歷來是一個仁智互見的問題。從實際情況來看，如果債權人的債權是沒有抵押擔保的，債權人通常不到竭盡債務人的可變現資產的程度就不會作出讓步。在這種情形下，耗盡了可變現資產的債務人在賬面上顯現“重組收益”，並沒有多大實際意義。如果債權人的債權是有抵押擔保的，債權人沒有必要作出讓步，除非抵押品的可變現淨值下降。如果債權人在抵押品貶值的情形下作出讓步，雖然債務人的債務減少了，但他並沒有因此而盈利，因為作為抵押品的資產的價值與債務額同時下降了。在債權轉股權的情形下，是否存在會計上可計量的“重組收益，則是一個爭議更大的問題。¹²

因此，如果僅僅為了傳遞“債務重組”(而不是重組損益)這個有價值的資訊，資訊披露似乎比確認重組損益更好的選擇。它不僅能達到向外界傳遞資訊的目的，而且還避免了因重組收益計入債務人的損益表所可能產生的誤導效果。

(3) 一般股票發行下如何確認股權的入賬價值?

在會計上，所有者權益的入賬價值按照實際成本原則確定。不論是一般的股票發行還是債轉股，股權的入賬價值都是發行股票公司所實際收到的對價，在債轉股中，這種對價表現為債權的賬面價值，它代表著債權人/新股東對公司的實際投入。按照實際成本計量，是公司法的註冊資本制度對會計計量的客觀要求。實踐中，股票發行時，股權的入賬價值以公司實際收到的對價為入賬標準；當公司經營期間進行配股時，不論配股價與股票市價(如果該公司股票有市價的話)之間關係如何，公司仍然按照配股價而非股權的公允價值來確定股權的入賬價值。普通可轉換債券的會計實務也傾向於以債務的賬面價值入賬，¹³ 不確認轉股收益。因此，如果是為了求得與一般股票發行的會計處理一致，債務重組中的股權理應以債權的賬面價值入賬，不確認重組損益才是。

(4) 債務重組會計準則是否僅僅是消極的反映工具?

會計技術性或者會計工具論的觀點，似乎完全可以拒絕對現行會計準則提出的批評。然而，在當下我國的企業債務重組進程中，會計準則並不僅僅是消極的、被動的記賬規則，

¹² 我國債務重組準則的制訂過程中，對於債權轉股權下股權的會計計量存在著三種意見。一是以股權的公允價值入賬並確認損益；二是以股權的公允價值入賬，但債務人不確認重組損益，而是將股權的公允價值與重組債務的賬面價值之間的差額確認為所有者權益；三是主張將債權的賬面價值直接作為所有者權益加以反映，既不以股權的公允價值作為入賬標準，也不確認重組損益。財政部最終採納了第一種意見，理由見前注 10。

¹³ 我國財政部在《企業會計準則第 x 項——應付項(徵求意見稿)》中採用的就是賬面價值法，其中的第 22 段規定：“在債權人行使轉換權利，將持有的可轉換債券轉換為股票時，應按股票面值記作股本，可轉換債券的賬面價值與股票值之間的差額記作資本公積”。在西方國家債轉股的會計處理中，儘管賬面價值法與市價法都被認可，但是前者更受推崇。

它同時也是設權規則。有關債務重組制度配置的缺損，特別其中法律規則的缺乏，使得債務重組會計準則客觀上具有一般法律規範的示範與導向效應。它在一定程度上設定了債權人與債務人談判的路徑，奠定了他們之間權利義務配置的基本框架。現行會計準則所採用的“債權=股本+資本公積+重組損益”的會計模式，將債權人放棄一部分債權，承擔重組損失視為當然的結果，不可避免地對債務重組的實踐產生消極的影響。

這是因為，債權人與債務人的注意力首先集中到債權人應放棄多少債權這個敏感的問題上，而債權人所感受到的不公平待遇，勢必增加其對債務重組的對抗情緒，延長債務重組的進程。通常認為，高效率與低成本為債務人帶來的利益，是債務人尋求債務重組而不是破產的最直接的動力。¹⁴ 從這個意義上說，確認債轉股中的重組損益，表面上看是對債務人有利，實際上拖延了債務重組的過程，最終也損害了債務人的利益。

相反，如果債務重組會計準則不確認重組損益，而是要求全部債權都按照股權的公允價值折合股份入賬，債權人與債務人關注的焦點就會轉移到對股權的公允價值的確定上，這個問題相對於“放棄債權”來說更多地具有客觀性色彩，通過評估機構或者其他仲介機構的參與，債權人與債務人比較容易達成一致的意見，從而可以加快債務重組的進程。

綜上所述，不論是遵循一般會計原理，還是著眼于均衡債權人與債務人利益的法律機制，會計準則都不應當確認債務人在債轉股中的“重組收益”與債權人“重組損失”。債權人的全部債權應當按照其賬面價值與股權公允價值之間的比例折合成股份，這是債權人所具有的合法權益。會計上不應承認這種情形下的“重組損益”，其原因並不在於債權人未作出讓步，而是因為債權人的讓步，即在債務人陷入財務困難的情況下將債權轉換為股權，與債務人同舟共濟，是無法（或者說在現行會計技術手段下很難）用會計的方法來進行確認和計量的。

四、需要關注債權人利益嗎？

1、一個上市公司債務豁免的例子

前面關於債務重組會計準則的理論分析，基本上可以推導出其未能允當界定債權人利益的結論。然而，從我國企業、特別是上市公司的實踐來看，債權人對會計準則的關注點似乎與我們所設想的利益導向背道而馳，他們似乎並不關心重組對自身利益的不利影響。一些陷入財務困難的上市公司，輕而易舉地獲得了債務人對其債務的豁免，或者債權人同意將其債權轉化為股份。

這裏舉一個典型的例子。如意集團股份有限公司在 1999 年進行了五項債務重組，確認重組收益 1639 萬元，占當年利潤總額的 49%。五項債務重組形式各異：（1）如意股份的

¹⁴ Lawrence E. Mitchell, Lawrence A. Cunningham, Lewis D. Solomon, Corporate Finance and Governance: Cases, Materials, and Problems for an Advanced Course in Corporations, Durham, N.C.: Carolina Academic Press, 1996, 第 386 頁。

關聯公司——中國遠大集團公司、遠大房地產開發公司分別豁免如意公司所欠的 840 萬元和 260 萬元的債務；(2) 如意公司以價值不足 10 萬元的種苗，抵欠他人的原料款 43 萬元；(3) 接受關聯企業 404 萬元資產抵償所欠如意公司債務 378 萬元，差額部分 26 萬元作為如意公司債務重組收益；同時如意公司以上述資產 404 萬元抵償所欠中國遠大集團公司債務 766 萬元，差額部分 362 萬元再次作為公司債務重組收益。(4) 直接承接連雲港金禾食品有限公司所欠遠大房地產開發公司 100 萬元債務，同時遠大房地產開發公司將此債務豁免，使如意股份獲得收益 100 萬元。在上面的安排中，如意集團的債權人絞盡腦汁的似乎不是收回債權，而是放棄權利，頗與常理相背。

應當如何解釋這一現象？它是否意味著要求會計準則關注債權人利益純屬多餘？

筆者以為，我國上市公司債務重組中債權人利益主體的缺失，根源在於當下我國證券市場運作的特殊機理。上市公司“殼”資源的珍貴，導致其主要的債權人——通常也是其大股東——對上市公司債務人的價值另有一番度量。因此，以豁免債權方式為上市公司輸血，儘管它導致了債權人遭受了債務重組損失，¹⁵ 但是由於債權人本身的財務報告並不對外披露，這種損失的負面效應並不會立即顯現出來。相反，債務人由於債務重組而取得的重組收益則立竿見影：上市公司淨資產利潤率大幅度提高，從而可獲得配股資格；¹⁶ 有的 ST 公司則依此扭虧為盈，不僅擺脫了因連續三年虧損而滑入 PT 深淵的夢魘，而且因出現賬面盈利而一舉摘掉 ST 帽子，至少在此後三年內無被摘牌之虞。¹⁷ 債權人——大股東從此也可以安享三年上市資源。由此可見，以大規模豁免債務方式表現出來的債權人對自身利益的漠視，實質上是我國當下市場機制中債權人保護其利益的特殊方式，只不過它以扭曲的形式表現出來。

從這個意義上看，我國上市公司中大規模債務豁免的存在，並沒有證明債權人利益主體的缺位，恰恰相反，它展現了債權人利益在債務重組會計準則中凸現的具體方式。更準確地說，現行會計準則對於債務重組損益的確認，恰恰迎合了目前條件下債權人的特殊需要。

¹⁸

還需要指出的一點是，近年來我國進行的債務重組更多地體現了國家干預的特點，並非嚴格意義上的市場行為。因此，債權人缺乏對直接影響其切身利益的債務重組會計準則的關注，也實非出人意料。隨著債務重組進入規範化的市場運作軌道，當事人之間權利義務的均衡必然成為雙方關注的焦點。當前我國債轉股實踐的膠著狀態以及圍繞著債轉股而引發的

¹⁵ 目前尚未見到對有關債務重組的實證研究，因此無法判斷在這些債務重組方案中，債權人的讓步對其自身財務狀況的影響。

¹⁶ 例如，如意集團借助此次債務重組，不僅 1999 年淨利潤比上年大增 6 倍有餘，而且淨資產收益率達到 16.43%。這樣一來，近三年淨資產收益率的平均值為 9.43%。

¹⁷ 債務重組為“保牌”的一個例子是 ST 石勸業。在石勸業戴上 ST 帽子近兩年的 1999 年初，其主營的商場陷入完全停業的困境，因而當年營業利潤虧損 1880 萬元。如果沒有 1999 年底大股東河南思達科技（集團）股份有限公司將石勸業所欠鉅額債務全部豁免，以及公司所在轄區石家莊市橋東區財政局豁免公司向財政局借款的全部利息形成的 2092 萬元債務重組收益，公司將淨虧 1911 萬元，無疑要淪為 PT 一族。而如今，石勸業借助債務重組完成了“驚險的跳躍”，在連續虧損兩年後扭虧為盈。

¹⁸ 但是，上市公司通過關聯企業輸血終究不是長久之計，關聯企業與大股東的財力也是有限的。隨著證券市場的規範化以及我國企業經營機制的完善，債權人漠視其正當權益的情形必然改變，他們將開始關注會

理論論爭，充分反映了這一點。從這個意義上看，中國信達資產管理公司拒絕債轉股而要求債務人破產，可以被視為一個象徵，它昭示了債務重組中債權人意識的覺醒，也對債務重組的制度建設發出一個強烈的信號。

五、結語

完善的市場、會計與法律規則，是債務重組順利進行所必不可少的制度配置。在上述三個方面，我國目前僅會計準則初見端倪。理論分析表明，現行債務重組的會計準則未能對債權人的利益給予必要的關注，可能在一定程度上強化了債務人尋求債務重組的利益驅動。然而，缺乏對債權人利益的必要關注的會計準則，必然給力圖規範化運作的債務重組設置無形的障礙。

強調會計準則應兼顧債權人與債務人之間的利益均衡，似乎更多地體現了一種法律的視角。這並不是希望將一個職業的觀點強加另一個職業身上，而是考慮到債務重組會計制度對當事人之間的權利義務以及利益配置的設定效果。儘管會計作為一種“通用的商業語言”，具有較強的技術性、中立性，但是會計準則的經濟後果要求準則制定者關注其所描述、反映的物件，特別是其中凸現的利益關係。特定國家、特定時期、特定社會經濟文化背景中發生的債務危機類型，構成了債務重組的特定背景，它可能對債務重組會計準則提出與會計理論上的預設完全不同的要求。順應這種要求的制度配置，似乎是一個必然的選擇。債務重組會計準則作為債務重組的技術支撐，儘管其本身就是近年來改革的產物，但是基於本身存在的缺陷，恐怕也無法置身於這一制度建設或者重構的進程之外。



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Supplementary Materials

Business Reorganization in Bankruptcy

Mark Scarberry

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Chapter One

Introduction to Chapter 11 Business Reorganizations

Chapter 11 of the federal Bankruptcy Code¹ gives financially distressed businesses an opportunity to reorganize and to avoid liquidation. Liquidation of a business's assets can be very costly to the persons directly involved and to society. “The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.” *National Labor Relations Board v. Bildisco and Bildisco*, 465 U.S. 513, 528, 104 S. Ct. 1188, 1197, 79 L. Ed. 2d 482 (1984).

A. THE BENEFITS OF REORGANIZATION

Creating a business is costly. It takes time and money to create the business entity (typically by forming a corporation, partnership, or limited liability company), to obtain the necessary start-up financing, to purchase or lease the necessary tangible assets, to integrate those physical assets together into a productive plant, to recruit and train a work force, to build relationships with customers and suppliers, and to build name recognition.

If the business is liquidated piecemeal, the assets and the work force will be dispersed; whatever value was created by bringing them together and forging them into a productive whole will be lost. The value of the relationships and name recognition will also be destroyed. The value of other intangible assets will be diminished; for example, it is generally much more difficult to collect the accounts receivable of a business that is in liquidation than of one that is a going concern. The liquidation sale price of tangible assets is often very low compared to the value they would have as part of a productive whole.

The cost to society of business liquidations is high. The destruction of value caused by business liquidations reduces the total wealth of our society. The loss of jobs causes additional social costs, such as increased unemployment insurance payments, increased use of other social welfare programs, and decreased tax revenues. Increased unemployment may have other social costs, such as an increase in poverty and crime. If overall demand for the products of the kind made by a liquidated business does not decrease, many of the workers and managers may eventually be hired by other firms for similar positions, but this does not happen quickly, and it is not cost-free. It does not happen at all if jobs are lost to foreign competition. Society pays a price for the liquidation of businesses.

1. The Bankruptcy Code itself is *title 11 of the United States Code*; *chapter 11 of the Bankruptcy Code* is the 1100 series of sections in the Bankruptcy Code.

For the workers, the managers, the creditors, and the owners of a liquidated business, the effect is more direct and, in some cases, devastating. The workers and managers lose their jobs, with the accompanying financial and emotional stress on them and their families.² On liquidation the assets may be insufficient to repay creditors more than a small fraction of their debts; unsecured creditors (those who do not have liens on any particular assets of the debtor) often will receive nothing. If creditors are not paid in full in the liquidation, then the stockholders, partners or other owners of the business will receive nothing.

Keeping the business in operation will therefore often be much more desirable than liquidating it. The fundamental premise of chapter 11 of the Bankruptcy Code is that reorganization is desirable.³

However, not all distressed businesses should be kept in operation; sometimes a business has no going concern value or a going concern value less than its liquidation value. In such cases, the creditors will be harmed by the continuation of the business.

Later in this chapter we will consider the example of a financially distressed shoe manufacturer (Acme, Inc.), which manufactures shoes worth \$9.50 per pair and which uses up \$10 in resources for every pair of shoes it manufactures. Thus Acme has a 50 cent per pair “negative cash flow from operations.” Such a business is worth nothing as a going concern, unless its operating costs can be cut or the value of its products can be increased. A business that creates less value than it consumes diminishes the wealth of society and of the business’s owners. A business sometimes can survive negative cash flow in the short run, but not in the long run. Unless a business can be turned around so that it has sustainable “positive cash flow from operations,” it has no going concern value and should be liquidated.

Even if the business has some going concern value because it can be turned around so that it has positive cash flow from operations, its value as a going concern may still be less than its liquidation

2. There is, however, the possibility that a purchaser of some or all of the assets in the liquidation may hire them.

3. In this book (1) the term “liquidation” generally means the sale of the business’s assets in such a way that the business ceases to operate; and (2) the terms “reorganization” and “rehabilitation” generally are used synonymously to mean the restructuring of the debtor and its debts so that the business can continue in operation under the ownership of its creditors or former owners. Writers do not always use these terms in exactly these ways. For example, a sale of the business’s assets as a whole to a buyer who will continue to operate the business is a kind of “liquidation”—it turns the assets into liquid funds which can be paid to creditors. Some writers would call such a sale a kind of “reorganization,” because it allows the business operations to continue. A few writers might even call it a “rehabilitation” because it keeps the business going despite past difficulties. Indeed, it is even possible (just barely) to call a piecemeal liquidation a “reorganization;” after all, chapter 11, which is entitled “Reorganization,” permits confirmation of a plan providing for sale of the business as a going concern or even for its piecemeal liquidation. See § 1123(a)(5)(D). We will try to use the terms as we have defined them, and we hope that any deviation from such usage will be made clear by context.

Sale of the business as a going concern does not disperse the assets or necessarily cost workers their jobs. Unless the identity of the business’s owner is important—as with a dentist’s or accountant’s professional practice, for example—the going concern value of the business may be preserved. Such a sale may yield many of the benefits that a true reorganization would yield. State law makes sale of a distressed business as a going concern difficult outside of bankruptcy for the same reasons that it makes true reorganization difficult. (We detail those reasons later in this chapter of the book.) Thus it may be much easier to accomplish such a sale in a chapter 11 plan under § 1123(a)(5)(D) than outside of bankruptcy. Many courts will allow such a sale in chapter 11 under the procedurally much easier § 363(b)(1), if there are good reasons for doing so. See Chapter Four, section B.2. below.

Congress could have required that a business in chapter 11 be sold quickly as a going concern, so as to avoid many of the complexities discussed in this book. But Congress did not do so, probably for good reason. There could be severe practical problems with requiring a sale of the assets, especially a quick sale. The owners or managers of a distressed business would probably wait longer than they do now before filing a chapter 11 bankruptcy petition, if they knew that the business would be sold out from under them in bankruptcy. If so, the going concern value of the debtor could be diminished substantially before the filing of a petition as employees, customers, and suppliers abandon the distressed business and as its productive assets become depleted. The distress nature of a quick sale of the assets in bankruptcy might lead to a low price being paid for the assets. Even if a quick sale were not required, the debtor’s managers would have little incentive to be diligent or loyal during the bankruptcy case; they would know that a sale was in prospect and that they had little prospect of long term employment with the debtor.

value. Should Acme be reorganized or, on the other hand, liquidated if (1) its positive cash flow from operations will be \$3,000 per year for the foreseeable future, and (2) its assets could be sold in a piecemeal liquidation for \$150,000? No one would pay \$150,000 for the right to get \$3,000 per year; even in a very safe investment like U.S. treasury notes, a \$150,000 investment will yield more than \$3,000 per year. Thus Acme's going concern value would be less than its liquidation value. If it were kept in operation there would be only \$3,000 per year that could be distributed to the creditors on account of their prepetition debts, even if all the positive cash flow were distributed to the creditors and none to the present stockholders.

That represents much less than \$150,000 in total "present value" for the creditors, in fact, less than \$100,000, as the following analysis shows. If the creditors were given \$100,000 in cash they could buy U.S. treasury bonds or even deposit the money at a bank and earn more than \$3,000 per year;⁴ thus they would prefer to have \$100,000 cash rather than the \$3,000 per year from the shoe manufacturer; and thus the right to get the \$3,000 per year from Acme is worth less than \$100,000. Since the creditors as a group could receive \$150,000 cash if Acme were liquidated, the creditors will lose more than \$50,000 in present value if Acme is reorganized rather than liquidated. Whether such a business should be reorganized or liquidated involves a choice between maximizing the economic return for creditors and saving the jobs of the workers and managers.

Generally, a chapter 11 plan of reorganization cannot be confirmed over the objection of even one creditor unless that creditor will receive at least as much value under the plan as it would receive in a liquidation. See § 1129(a)(7).⁵ Thus most businesses for whom liquidation value exceeds going concern value cannot successfully reorganize under chapter 11.

[Problem 1-1 omitted.]

B. THE MAJOR OBSTACLES TO REORGANIZATION OUTSIDE OF CHAPTER 11

A financially distressed business can be reorganized outside of chapter 11, in what is called an "out-of-court workout" or simply a "workout." In a workout, the creditors typically agree to a moratorium on debt collection activities while a workout agreement is negotiated. The workout agreement may give the debtor extra time to pay its debts (an "extension" agreement), may provide that each creditor's debt is reduced by a certain percent (a "composition" agreement), or may provide for both an extension and a composition. If the creditors forgive debt, they are sometimes given shares of the debtor's stock in exchange, so that they become equity owners in the debtor.

However, three major obstacles stand in the way of successful reorganization outside of chapter 11. First, the state law of creditors' rights puts a premium on diligent collection activity. The first

4. Currently, 10 year U.S. Treasury bonds yield about 6%; the annual yield on them (and also on 6 month certificates of deposit—based on dealer rates in the secondary market) has exceeded 3% every year at least since 1962. See www.bog.frb.fed.us/releases/h15/current/; www.bog.frb.fed.us/releases/h15/data/a/tcm10y.txt; www.bog.frb.fed.us/releases/h15/data/a/cd6m.txt (visited 7/28/00). As of mid-July 2000, the national average rate for negotiable 6 month CD's in the secondary market was 6.83%. See www.bog.frb.fed.us/releases/h15/data/b/cd6m.txt (visited 7/28/00).

5. As noted in section C.2. of this chapter, the liquidation value for purposes of § 1129(a)(7) is determined as of the effective date of a proposed plan of reorganization. That may be less than the liquidation value on the date the petition was filed; thus creditors are not assured of getting value equal to the liquidation value that the debtor's assets had on the petition date. Of course, even a liquidation takes time; creditors are not assured even in a chapter 7 case that the assets will not depreciate before liquidation is completed.

creditor to obtain a lien on an asset will typically have priority in that asset over the other creditors.⁶ When the debtor fails to pay a debt, the creditor will therefore have a strong incentive to obtain a lien on some or all of the debtor's assets, if the creditor does not already have a lien. Thus, if a creditor, Finance Co., can obtain an attachment or execution lien on the debtor's punch press before any other creditors obtain a lien on it, then whatever value can be obtained from liquidation of the punch press will go first to Finance Co.; other creditors will not receive any of that value unless there is a surplus left over after Finance Co.'s debt is fully paid. State law therefore encourages a race of diligence to obtain liens on the debtor's assets by judicial process. State law makes it dangerous for creditors to wait while the debtor attempts to reorganize.

Second, the obtaining of a judicial lien on an asset other than real estate typically involves a seizure of the asset, so that the debtor no longer has the use of it. After obtaining a judgment for the debt, the creditor will obtain as a matter of right a writ of execution authorizing the sheriff or some other governmental officer to seize specific assets belonging to the debtor.⁷ That seizure (called a "levy") creates a judicial lien (called an "execution lien") in favor of the creditor on whatever assets were seized. Real estate is typically only "constructively" seized; to levy, the sheriff simply records the appropriate notice in the county real estate records.⁸ Tangible personal property, however, usually is physically seized.

Whether the asset is real or tangible personal property, the *enforcement* of the execution lien typically results in the execution sale of the asset, which makes it permanently unavailable to the debtor (absent a right of redemption). Intangible personal property, such as debts owed to the debtor by the debtor's customers for goods sold or services rendered ("accounts receivable") effectively will be seized when they are "garnished." Garnishment is accomplished under the writ of execution or under other procedures depending on the jurisdiction. Garnishment occurs when the sheriff or other officer serves appropriate papers on the persons who owe the money to the debtor. Those persons then must pay the debts to the sheriff rather than the debtor, thus diverting cash that would otherwise have gone to the debtor.

The debtor cannot stay in business for very long if it has no inventory to sell (because its inventory was seized), or if its production equipment cannot be used (because its equipment was seized), or if it has no cash to pay wages and other expenses (because its bank accounts and accounts receivable were garnished). Once the business ceases operations, much of its going concern value will quickly evaporate; workers will leave, customers will find other companies to supply their needs, and the goodwill of the business will erode. Thus, state law not only makes it dangerous for creditors to wait but also encourages creditor activity that as a practical matter will bring the debtor's business to a halt and destroy its going concern value.

Third, outside chapter 11 the creditors as a group may not be able to give the debtor the chance it needs to reorganize, even if most of the creditors want to give the debtor that chance. Dissenting creditors, those who oppose the reorganization, generally cannot be forced to cooperate. The existence of even a few dissenters may doom the workout for the following reasons.

6. For an introduction to liens and to the general law of debtor-creditor relations, go to <http://law.pepperdine.edu/scarberry> and click on "Introduction to Liens and Debtor-Creditor Law."

7. In some cases it is possible for a creditor to obtain a prejudgment writ of attachment, which will authorize the sheriff to seize assets of the debtor and hold them as security for any judgment that may ultimately be obtained.

8. In most states a creditor who has obtained a judgment can obtain a judicial lien on whatever real property the debtor may own in a particular county by recording the appropriate notice of the judgment in the county real estate records. The lien is called a judgment lien. Levy under a writ of execution is not therefore needed for the judgment creditor to obtain a lien on real property, but it still is used in some states as one step in foreclosure of the judgment lien. In a few states, filing of a notice of judgment lien in the appropriate personal property records creates a judgment lien on certain personal property.

Out-of-court workouts are entirely voluntary from the creditors' point of view and require almost unanimous creditor support to succeed. Only creditors who agree to the workout agreement are bound by it; even if 99 out of 100 creditors agree to it, the one dissenting creditor can demand full payment and pursue legal remedies. The debtor will typically pay that dissenting creditor to avoid the disruption that would be caused if the dissenter exercised its state law creditor's rights. The 99 creditors may be willing to give the debtor concessions even if the other creditor is immediately paid in full, but, depending on the size of the debt owed to the dissenter, the lack of equal treatment may be troubling to them. Creditors will not give concessions to the debtor unless substantially all the other similarly situated creditors also give concessions; no one wants to bear much more than a fair share of the burden. Thus most workout agreements expressly require a very high degree of participation by creditors (e.g., 95% in dollar amount) before becoming effective. If there is too much dissent to obtain that high degree of participation, then the workout will fail. *Outside of chapter 11, a few dissenting creditors can prevent reorganization.*

The question is not only whether enough creditors will eventually sign a workout agreement for it to become effective, but whether the moratorium on debt collection activity will hold while the debtor is trying to obtain those signatures. Usually creditors agree to forebear from pursuing or enforcing their state law remedies for a limited time period only, and only on condition that other creditors not receive preferred treatment. There typically will not be a binding agreement to abide by the moratorium; creditors who abide by it do so because they believe that immediate payment is not attainable, because they believe the workout may succeed, because they believe they will receive more in a successful workout than in a liquidation, and because they believe that the workout agreement will treat them fairly as compared with other creditors.⁹ If any of those beliefs are shaken, the moratorium will fall apart.

The beliefs that underlie the moratorium will be shaken if there is significant dissent. Creditors can dissent not only by refusing to agree to a proposed workout agreement but also by refusing to abide by the moratorium. If, to avoid disruption of the business, the debtor pays even a few dissenters who refuse to abide by the moratorium, then other creditors will decide that dissent pays; they may abandon the moratorium, hoping to be paid off. And dissent by even a few creditors, who either show an unwillingness to agree to a workout agreement or who go further and abandon the moratorium, may convince other creditors that too few creditors will participate in the workout agreement for it to succeed; those other creditors may then abandon the moratorium. Finally, immediate payment to even a few dissenters will undermine the other creditors' belief that they will be treated fairly in the workout. If that belief is shaken, then more creditors will abandon the moratorium. Each additional dissenter created in one of these ways will further shake the beliefs that underlie the moratorium, thus potentially creating more dissent. The chain reaction of shaken belief and resulting dissent will destroy the moratorium.

9. Trade creditors—those whom the debtor owes for goods or services—have an additional interest in seeing a workout succeed; a rehabilitated debtor probably will buy goods and services from them in the future. The workout will save a customer for them. They will generally not, however, provide goods or services to the debtor on credit during the moratorium; the debtor *at ready* has announced its inability to pay unsecured debts. Instead, they will require “cash on delivery” or even prepayment. (They are also likely to try to raise the prices they charge the debtor, so as to obtain, in effect, some repayment of the existing debt.) If, as is often the case, there is an existing Article 9 secured party whose security agreement extends to the debtor's present and after-acquired inventory and accounts receivable, the debtor may be unwilling to buy inventory from trade creditors on purchase money secured credit. The granting of such a security interest in the inventory is a default under most well-drafted security agreements. And to obtain purchase money priority a trade creditor would generally need to notify the existing secured party of the proposed purchase money financing. See U.C.C. § 9-312(3); Revised U.C.C. § 9-324. All of this would alienate further the existing secured party, who is counting on having priority in new inventory, and would provide an additional basis for accelerating the debt and moving against the collateral. Even if the debtor is willing to take that risk, a trade creditor often still cannot safely sell inventory to the debtor on purchase money secured credit; the purchase money priority will not extend to any accounts receivable generated when the debtor resells the inventory to its customers on unsecured credit. *Id.*

Without the moratorium to protect the debtor, there will be little chance of a workout succeeding; engaging in the state law race of diligence, the creditors will have the debtor's tangible assets seized (under writs of execution or attachment) and will eliminate the debtor's sources of cash by garnishing the debtor's bank accounts and accounts receivable. The debtor's business will not be able to survive the disruption.

This picture is not entirely realistic, because it ignores the secured creditors. In many cases, all or nearly all the debtor's assets are subject to consensual liens securing debts. By agreement, the debtor will have given liens ("security interests") on personal property and fixtures to one or more creditors under U.C.C. Article 9. By agreement, the debtor will also have given liens on its real estate to one or more creditors by executing mortgages or deeds of trust. The debts secured by the liens typically will exceed the liquidation value of the assets. If so, the unsecured creditors will have little incentive to seek judicial liens; there is no available value in the assets, at least not if the debtor's assets are liquidated. The only real hope the unsecured creditors have is for the debtor to continue in business and earn enough money to pay something on their debts. Thus, beyond the question whether unsecured creditors will abide by the moratorium is another question: whether the secured creditors—especially the Article 9 secured parties—will abide by the moratorium.¹⁰

The effect on the debtor if Article 9 secured parties do not abide by the moratorium may be immediate. The secured party is entitled to take possession of tangible collateral if the debtor is in default. U.C.C. § 9-503; Revised U.C.C. § 9-609. The secured party can take possession using self-help without even going to court if the repossession can be accomplished without a breach of the peace. *Id.* Even if court action is needed, provisional relief under a writ of replevin (or "claim and delivery") will often result in immediate seizure of the collateral. If the collateral is intangible, like accounts receivable, the secured party may not need to go to court to realize on the collateral; the secured party can demand payment from the "account debtors" who owe the accounts receivable. U.C.C. § 9-502(1); Revised U.C.C. § 9-607. Any of these actions will quickly destroy the business.¹¹

[Problem 1-2 omitted.]

C. THE CHAPTER 11 SOLUTION

The problems, then, are (1) that state law gives each creditor an incentive to attack the debtor's assets diligently, (2) that the use of state law creditors' rights against the debtor—including U.C.C. Article 9 default rights of secured parties—will disrupt and destroy the debtor's business, and (3) that a few dissenting creditors can prevent a reorganization from occurring outside of bankruptcy. How does the Bankruptcy Code deal with these problems?

First, the Bankruptcy Code mildly discourages creditors from pressuring the debtor and from engaging in the race of diligence. Unsecured creditors who pressured an insolvent¹² debtor for

10. Indeed, if secured creditors support the work out attempt, they may be able to assert "third party" claims and defeat attempts by unsecured creditors to execute upon or attach the assets.

11. By contrast, unless an unsecured creditor can obtain an attachment lien, the unsecured creditor must obtain a judgment before obtaining a judicial lien. Even if the debtor permits a default judgment to be entered, there will be at least several weeks between filing of the complaint and the obtaining of such a post-judgment judicial lien. Unfortunately for debtors, in many states pre-judgment attachment liens can often be obtained for business debts.

12. There are two kinds of insolvency, "balance sheet" insolvency and "equity" insolvency. Usually the term insolvency refers to balance sheet insolvency. A debtor is insolvent in the balance sheet sense if the sum of the debtor's debts exceeds the value of the debtor's assets. "Insolvent on a liquidation basis" means that the debtor's debts exceed the value that would be obtained in liquidation of the assets; "insolvent on a going concern basis" means that the debtor's debts exceed the value of the business as a going concern. For debtors other than municipalities, the Bankruptcy Code defines insolvency in the balance sheet sense, section 101(32), and requires use of a "fair valuation," which at least in some circumstances means going concern value. See *In re Taxman Clothing Co.*, 905 F.2d 166 (7th Cir.1990). Also under the Bankruptcy Code definition, the value of any assets that are exempt is

payment or obtained payment through judicial action usually must return any payments made within 90 days before the filing of the bankruptcy petition; the payments will be “avoidable preferences.” See § 547 (especially § 547(c)(2), which permits many creditors to keep payments made by the debtor in the “ordinary course” rather than in response to pressure). Section 547 also avoids (eliminates) most liens obtained by unsecured creditors within 90 days before the date the bankruptcy petition is filed. Section 542 (the “turnover” section) permits the debtor to recover possession of its property that is held by others, including property seized under writs of attachment or execution and property seized by Article 9 secured parties. These provisions provide some incentive for the creditors not to take actions that will simply be reversed if the debtor files a bankruptcy petition. In addition, by reversing the actions, the provisions return resources to the debtor that may be needed for the reorganization. The provisions also further the bankruptcy policy of equality of distribution among general unsecured creditors.

Second, the Bankruptcy Code provides a much stronger substitute for the fragile workout moratorium. The filing of a bankruptcy petition creates an automatic stay of almost all creditor actions to collect prepetition debts. Section 362(a). Creditors are prohibited from trying to obtain judicial liens, from trying to take possession of property away from the debtor, and from engaging in any other collection activity; they cannot even send letters to the debtor demanding payment. The debtor is permitted to retain possession of and use its property,¹³ subject to the need to provide adequate protection of the property interests of others, such as secured creditors. See §§ 362(a) and (d), 363(c)(1) and (e).

Third, the Bankruptcy Code (specifically chapter 11) provides a more workable substitute for the workout agreement. Dissenting creditors cannot be bound in a workout, but they can be bound in chapter 11. Chapter 11 permits a plan of reorganization to be confirmed even if some creditors oppose it. The debtor, its stockholders (or other owners), and all the creditors will then be bound to the terms of the confirmed plan. Chapter 11 thus imposes a collective solution.

The effect of chapter 11 extends beyond the cases in which a chapter 11 petition is actually filed. Creditors know that the debtor can file a chapter 11 petition if necessary; that strongly affects the negotiations in out-of-court workouts. Because creditors know that chapter 11 is an option, they often give concessions in out-of-court workouts that they would not give if chapter 11 did not exist. The threat, implicit or explicit, is always there; if the creditors do not cooperate, the debtor can file a chapter 11 petition. That gives the debtor considerable leverage in workout negotiations.

If the leverage given by the existence of chapter 11 permits the reorganization to occur out of court, that usually will be preferable to reorganizing in chapter 11. The advantages of an out-of-court workout (if one can be accomplished) are considerable:

1. Attorneys’ fees and other professionals’ fees will usually be much lower in a workout than in a chapter 11 case.
2. Workouts usually can be accomplished and consummated much faster than the more formal chapter 11 reorganizations.

not counted in determining whether the debtor is insolvent. (Only human beings have exemptions; corporations, partnerships, and other artificial persons do not. See § 522.) The Bankruptcy Code definition is not as important as it might seem. A debtor (other than a municipality) need not be insolvent to file a petition in bankruptcy. See § 109.

A debtor is insolvent in the “equity” sense if the debtor is unable to pay debts as they become due. Regardless of the debtor’s ability to pay, if the debtor generally fails to pay debts as they become due, creditors can commence and maintain an involuntary bankruptcy case against the debtor. See § 303(h)(1). In this book, the terms “insolvent” or “insolvency” refer to balance sheet insolvency, unless otherwise specified.

13. It is not quite accurate to say that the property is the debtor’s. The filing of the bankruptcy petition creates an “estate.” See § 541(a). The debtor’s property becomes property of that estate. Unless the court orders appointment of a trustee, the debtor in a chapter 11 case is thus permitted to re-tain and use the property of the estate as the “debtor in possession.” See §§ 1101(1), 1107 and 1108.

3. Workouts minimize some of the pressures that are present in a chapter 11 case. The very commencement of a chapter 11 case may create additional pressures on a debtor that is undergoing financial difficulties. Often, customers will find reasons to avoid paying for products or services supplied by the debtor or to cease dealing with the debtor. They may fear or claim to fear that the debtor will not be able to honor warranties or service contracts. They may believe that the debtor will not have the resources to pursue uncollected accounts. They may question whether the debtor will survive and may simply prefer to pay accounts owed to those with whom they believe they will be continuing to transact business. Suppliers may stop supplying goods on credit and insist that the debtor pay cash on delivery or before delivery. These problems usually are less intense in workouts than in chapter 11.
4. Workouts usually also cause much less damage than the filing of a chapter 11 petition to the debtor's general reputation.

As a result, most reorganizations are accomplished in out-of-court workouts. Creditors often recognize that it is not in their best interest to force the debtor to file in chapter 11; the debtor can use the explicit or implicit threat of chapter 11 as leverage to negotiate a workout agreement.

However, there are situations in which the mere threat of chapter 11 is not sufficient to allow a workout to be accomplished out-of-court:

1. Creditors may have taken actions that, if not reversed, would disrupt or destroy the debtor's business, such as having the debtor's assets seized or garnished.
2. One or more creditors may have obtained an advantage over the other creditors by obtaining liens on the debtor's assets; the other creditors may refuse to agree to a workout that leaves that advantage in place. In bankruptcy it may be possible to eliminate that advantage as a preference under section 547.
3. Outside bankruptcy, the debtor may not be able to borrow the funds needed for the business to stay afloat. Lenders will want assurances that the new loans will be repaid, even if the debtor cannot pay its old debts; in chapter 11 the lenders can obtain (at a minimum) an administrative priority over the prepetition creditors. See § 364. Likewise, trade creditors may not ship needed goods on credit unless they receive the chapter 11 administrative priority or other protection available only in bankruptcy. *Id.*
4. The debtor may also need the power that bankruptcy law gives to deal with executory contracts and with leases. See § 365. For example, if the debtor has failed to pay rent on its business premises, the debtor in possession may need more time to cure the default than nonbankruptcy law would provide.
5. The debtor may need the special tax treatment that is given to debtors only in bankruptcy. One of the debtor's major "assets" may be its "net operating loss" from past years, which can save the debtor huge amounts of taxes on income from future profitable years. Special tax law provisions applicable only in bankruptcy cases may help the debtor to preserve the benefit of its past net operating loss.
6. The debtor may need the special securities law exemption provided in chapter 11. As part of its reorganization, the debtor may need to issue new securities that could not be issued (or could be issued only at a prohibitive cost) under the securities laws outside chapter 11. See §§ 1125(d) and 1145.
7. Most importantly, the mere threat of a chapter 11 filing may not be enough for the debtor to obtain the unanimous or near unanimous support needed for an out-of-court workout to succeed. The debtor may need the protection of the automatic stay during negotiation of the reorganization plan. See § 362. The debtor may also need to be able to bind dissenting creditors to the terms of the plan; confirmation of the chapter 11 plan will bind all the creditors, including dissenters. See § 1141(a). That power to bind dissenting creditors generally is available only in bankruptcy.¹⁴

14. There is a possible exception to this rule. It may be possible to bind dissenting public bondholders or tort claimants to a workout outside of bankruptcy. If the bondholders or tort claimants are made part of a class in a class action under Federal Rule of Civil Procedure 23(b)(1), it may be possible to bind dissenters to a settlement of the class action as part of a workout. Class members do not have the right to "opt out" of a class if it is certified under Rule 23(b)(1). See Issacharoff, *Class Action Conflicts* 30 U.C. DAVIS L. REV. 805 (1997); Spiotto, *Exchange Offers, THE PROBLEMS OF INDENTURE TRUSTEES AND BONDHOLDERS*, 409 PLL/Real 759, 770-76 (Westlaw) (1995); Kraemer & Paige, *Consensual Workouts—Bankruptcy Alternative for the 1990s?* BANKING AND COMMERCIAL LENDING LAW, R182 ALI-ABA 419, 443-45 (Westlaw) (1994); Edwards, Herbst, and Hewitt, *Mandatory Class Action Lawsuits As a Restructuring Technique* 19 PEPP. L. REV. 875 (1992). The Supreme Court recently held that class certification under Rule 23(b)(1) was

In such cases, the benefits of chapter 11 may outweigh the burdens, from the standpoint of the debtor; thus the debtor may choose to file in chapter 11.

[Problem 1-3 omitted.]

D. THE BENEFITS OF REORGANIZATION VERSUS THE BURDENS ON CREDITORS AND OTHERS

Of course, chapter 11 does not impose burdens only on the debtor. There is a question in many cases whether the burdens imposed by chapter 11 on creditors (or others) are justified by its benefits. There are several kinds of burdens imposed by chapter 11. The automatic stay forces creditors to use the collective bankruptcy process to collect their debts rather than the state law race of diligence; some creditors may see this as a burden, although others will welcome the equality provided by bankruptcy law. Property interests are also affected by the stay; the secured creditor who is prevented from foreclosing, or the landlord who is prevented from evicting the delinquent debtor, suffer a burden on their property rights. In this section we discuss two additional effects of bankruptcy, one that creditors may perceive as a burden even though it is not, and one that may create an actual burden.

1. Recognition of Existing Loss

Most people do not like to be forced to face the fact that they have lost money. Creditors are no exception. Chapter 11 (and other forms of bankruptcy) may force them to face that fact, and they may see that as a burden. Assume a corporation owes \$1,000,000 in debts, all unsecured. Assume the corporation's assets are worth \$300,000 on a going concern basis and \$200,000 on a liquidation basis. The creditors have already lost at least \$700,000. If the corporation is not reorganized successfully, it will not continue as a going concern and creditors will have lost \$800,000. Suppose the corporation files a chapter 11 petition, and creditors end up receiving \$300,000 in cash or other forms of value in the reorganization, with the remainder of their debts (\$700,000) discharged. The creditors may feel that bankruptcy law cost them \$700,000; but that money was lost with or without bankruptcy. In fact, it is difficult to say that chapter 11 created a burden on the creditors as long as they receive at least \$200,000, the amount they would have received if there had been a liquidation.

2. Risk of Further Losses To Creditors

The creditors could more justifiably complain of a burden if they ultimately received less than \$200,000 in value as a result of the attempt to reorganize. That may indeed happen if the debtor suffers further losses.

If the debtor continues to lose money after filing its chapter 11 petition, it may use up much of its assets and incur additional business debts as administrative expenses of the reorganization. Attorneys' fees and other professional fees in a chapter 11 case will also be considered administrative expenses and may consume a substantial part of the value of the debtor. If the debtor manages to

not proper in an asbestos injury action filed for settlement purposes where the traditional features of a "common fund" case were not present. *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 119 S. Ct. 2295, 144 L. Ed. 2d 715 (1999). The court did not hold that such a mass tort class could never be certified under Rule 23(b)(1). But the Court did (1) catalogue numerous obstacles to such certification, (2) question whether Rule 23(b)(1) should ever be so used, and (3) note that settlement of monetary claims in a mandatory non-opt-out class action in federal court may violate the Seventh Amendment right to jury trial.

reorganize, the value of the business may be less than \$300,000 due to the using up of assets. Further, the administrative expense claims will have to be paid in full, thus reducing the value available for the unsecured creditors. They may end up with much less than the \$200,000 they could have had in a prompt liquidation.

Some reorganization attempts fail. If the debtor's property ultimately is liquidated after a failed reorganization attempt, there may be few remaining assets to liquidate. Administrative expenses from the failed reorganization will be paid ahead of the prepetition unsecured debts, so there may be little or nothing left for the prepetition unsecured creditors.

The delay in payment in a chapter 11 case also causes further losses. A chapter 11 reorganization usually takes much longer to consummate than does a workout. (The procedures in chapter 11 are much more formal—and thus time-consuming—and the automatic stay reduces the debtor's sense of urgency.) The value of whatever the creditors ultimately receive will be diminished by the delay in receiving it; that diminishment is a further loss imposed by chapter 11. In our example, a liquidation would yield \$200,000 for creditors. Creditors could insist on at least that much value in a quick out-of-court workout. During the time spent in a chapter 11 reorganization, they lose the interest or other return they could have earned on the \$200,000. If the creditors have to wait a year or two or three during a chapter 11 case before receiving value, they thus will have to receive more than \$200,000 to be even. The delay in receiving payment may cause some creditors to be unable to pay their own obligations, which may cause serious loss to them. (Note, however, that even chapter 7 liquidations often do not produce quick cash for creditors; a chapter 7 trustee might several months or more to sell the assets in an orderly way and make distributions to creditors.)

Chapter 11 therefore creates a serious risk of loss to the creditors. Chapter 11 prevents creditors from forcing the liquidation of the debtor's property, thus preventing them from receiving the liquidation value of the assets. Chapter 11 allows the debtor to risk that liquidation value in an attempt to reorganize. In a sense then, chapter 11 forces the creditors to finance the reorganization venture and to bear the risk of losses from it. It might be said that the debtor is gambling with the creditors' money.¹⁵

Because the creditors in a sense provide the financing for the attempted reorganization, the following key questions demand answers. Should the creditors or at least someone other than the debtor's managers control whether and how an attempt to reorganize is made? How can the danger of further losses be balanced against the potential benefits of reorganization? How much support from creditors should be required before a plan of reorganization can be confirmed?

Chapter 11 answers those questions in a way that does not give great comfort to creditors:

- No creditor consent is needed for the filing of a chapter 11 petition; even if none of the creditors believes the debtor can successfully reorganize, the debtor can still file a chapter 11 petition and continue to operate its business.
- The debtor's management typically continues to operate its business during the reorganization, even if it is the same management whose mismanagement caused the debtor's financial distress; the debtor is called the "debtor in possession" because the debtor stays in possession of the property of the estate unless the court orders appointment of a trustee. See §§ 1101(1), 1104(a) (including "gross mismanagement" but not simple mismanagement as a cause for appointment of a trustee), 1107(a), and 1108.
- Indeed, even if the debtor continues to lose money during the chapter 11 case, that by itself is not a ground for dismissal of the case or for conversion to a chapter 7 liquidation as long as there is a reasonable likelihood that the business can be rehabilitated. See § 1112(b)(1).

15. Note, however, that a creditor ordinarily is not considered to have any interest in the debtor's property until and unless it obtains a lien. See *Grupo Mexicano de Desarrollo v. Alliance Bond Fund*, 527 U.S. 308, 119 S. Ct. 1961, 144 L. Ed. 2d 319 (1999).

- Some creditor support is needed for confirmation of a plan of reorganization, but unanimity is not needed; in some cases a plan can be confirmed over the objection of most of the creditors. See §§ 1126(c) and 1129(b).
- The plan generally must give a dissenting creditor at least as much value as it would receive in a chapter 7 liquidation as of the effective date of the reorganization plan. See § 1129(a)(7)(A). That provides small comfort. The debtor may have suffered losses and piled up large administrative expenses during the reorganization. Thus the creditor's share of liquidation value as of the effective date of the plan may be much less than it would have been before the attempted reorganization.
- Further, the creditors may not receive what the plan provides; if the reorganized debtor again falls into financial distress, it may be unable to make the payments required by the plan, and any stock or other securities given to the creditors under the plan may turn out to be worth little or nothing. (Under section 1129(a)(11) the plan cannot be confirmed unless the court determines under a preponderance of the evidence standard that confirmation is not likely to be followed by an unplanned liquidation or the need for further financial reorganization; but the court is sometimes wrong.)

On the other hand most creditors voluntarily chose to extend credit to the debtor knowing that the debtor could someday utilize chapter 11. Most creditors chose to do so on an unsecured basis under nonbankruptcy law that affords them no rights other than the right to sue for nonpayment. They did so to make a profit. Perhaps the bankruptcy law should require them to bear some risk in an attempt to preserve jobs and rehabilitate the business. In a more realistic case there will be not only unsecured creditors but also secured creditors. Secured creditors who are prevented from foreclosing on their collateral during an attempted reorganization also run several risks of loss. See Section E.1.a. immediately below.

E. THE FOUR INGREDIENTS FOR A SUCCESSFUL REORGANIZATION IN CHAPTER 11

There are usually four ingredients needed for a chapter 11 reorganization to be successful. This book is organized around those four ingredients. Following this introductory Part I, the book is divided into four Parts:

Part II: Keeping the Ship Afloat

Part III: Turning the Business Around

Part IV: Determining Claims by and Against the Estate

Part V: Restructuring the Debts and Dividing the Enterprise's Value

Chapter 11 helps to provide each of those ingredients, but at the cost of denying various persons the rights they would have had outside of bankruptcy. In each case there is a question whether chapter 11 strikes an appropriate balance between the benefits and burdens of reorganization.

It is important for the student to keep the larger picture in mind during the course. To help the student do that, we provide the following overview of Parts II through V of this text. * * *

1. Keeping the Ship Afloat

The first ingredient is keeping the ship afloat—keeping the business in operation. If the business ceases operations, even for a short time, key employees will be lost, and relationships with customers and suppliers will be damaged severely.

a. Preventing Disruptive Interference

To keep the ship afloat, the debtor in possession will need protection from disruptive interference with its business. Most importantly, the debtor needs protection from having its assets seized. * * *

Even if the automatic stay initially provides sufficient protection to the debtor, creditors can seek relief from the automatic stay. See § 362(d). Secured creditors often seek relief from the stay so that they can foreclose on their collateral; approximately half of the litigation in the bankruptcy courts consists of such motions for relief from the automatic stay. In many cases the reorganization will be doomed if the court grants relief. On the other hand, if relief is not granted, the secured creditor's nonbankruptcy property rights may be damaged.

* * *

The risks and costs imposed on secured creditors must be balanced against the policy of facilitating reorganization. We will see that the Code and the courts balance them by demanding good faith on the part of the debtor, by demanding (as we have seen) "adequate protection" of the secured creditor's property interest, and demanding (in some cases) that there be a reasonable possibility of a successful reorganization within a reasonable time.

[Problem 1-4 omitted.]

b. Finding the Cash To Continue Operations

There is one other major factor that is needed to keep the ship afloat beyond prevention of interference with the business: the business will need cash to operate. Businesses cannot be operated without cash. If workers are not paid for their continuing services, they will strike or simply leave. If raw materials or inventory cannot be purchased, the business cannot continue for long. Without access to cash, the debtor cannot continue in business.

The debtor's business operations will generate some cash,¹⁶ but there may be an obstacle in the way of the debtor using the cash. The cash will often be subject to a lien;¹⁷ if so, it will be "cash collateral," and the debtor will not be permitted to use it unless the lienholder consents or the court authorizes its use. See § 363(a) and (c)(2).

If the court does not authorize use of cash collateral, the business will probably not be able to continue in operation, and the reorganization will fail. If the court does authorize use of the cash collateral, the debtor in possession will spend the cash, and the business's operations might not generate enough new cash to replace it. That may result in losses to the lienholder. The question will be to what extent the law should place that risk on the lienholder in order to facilitate reorganization.

[Problem 1-5 omitted.]

16. This is not to say that the debtor's operations will generate enough cash to pay all the expenses of operations; many chapter 11 debtors do not have net positive cash flow from operations, at least not at first. However, some cash should come in that can at least be used to pay part of the postpetition expenses of operations.

17. An Article 9 secured party who has a security interest in the debtor's accounts receivable and inventory will claim a lien on the cash collections from the accounts receivable and on the proceeds of sale of inventory; the cash will be "proceeds" of the accounts or of the inventory, and Article 9 gives the secured party a lien on "proceeds" of its collateral. See U.C.C. § 9-306(1) and (2); Revised U.C.C. § 9-315. Similarly, real estate mortgagees with mortgages on rental property (such as apartments and office buildings) will typically claim a lien on the rents under provisions in the mortgages. Section 552(b) protects these liens on proceeds and rents except to the extent the "equities of the case" otherwise require.

Scarberry, Klee, Newton & Nickles, *BUSINESS REORGANIZATION IN BANKRUPTCY*, 2d ed., page 13

Access to cash collateral may be enough to keep the business operating, but in many cases the debtor needs to borrow additional cash or obtain additional credit for purchases of goods and services. No one will extend credit to a financially distressed business on a nonpriority, unsecured basis. In most cases the debtor in possession will not be able to pay prepetition creditors in full; if the new, postpetition creditors were placed on an equal footing with the prepetition creditors, then they would not be repaid in full, either. No one would willingly extend credit knowing that full repayment will not occur. Special protection for the new creditors is essential.¹⁸ Outside of bankruptcy, the debtor could give the new creditors a security interest in unencumbered assets, or junior liens on assets that were already encumbered,¹⁹ but there usually is not enough unencumbered asset value to secure the needed credit. A subordination agreement by some of the existing creditors might suffice; so might a guarantee of the new credit by a financially sound person (such as the debtor's principal stockholder). In many cases none of these is available, and the debtor cannot obtain the needed credit outside of chapter 11.

In chapter 11, if new credit is obtained properly, it will be considered an administrative expense (an expense of reorganizing the debtor) and will have priority over the prepetition unsecured debts owed to the other creditors. See § 364(a) and (b). * * *

In effect, the prepetition unsecured creditors are involuntarily subordinated to the postpetition creditors. This helps create an incentive for the new creditors to extend credit, but it carries great risks for the prepetition creditors. The new credit may merely permit the debtor to operate at a loss for a longer time and lose even more money. Then, when the debtor's assets are finally liquidated, the new credit and all the other administrative expenses built up during that longer period of time will have to be paid in full before the prepetition unsecured creditors receive anything.²⁰

If needed credit cannot be obtained by offering the new lender an administrative priority the debtor in possession can seek court approval to give the postpetition creditor a superadministrative priority over all the other administrative claims. See § 364(c)(1). The debtor can also seek court approval to offer liens on unencumbered property or junior liens on already encumbered property. See § 364(c)(2) and (c)(3). If even that is not enough to induce the potential postpetition creditor to extend credit, the debtor in possession can seek court approval to give the postpetition creditor a senior "priming" lien on property on which prepetition creditors already have liens. See § 364(d). The subordination of existing liens by a "priming" lien given to the new lender creates a grave danger that the existing

18. In many cases one or more of the old creditors will be the best source of new credit. To the extent that they extend new credit, the discussion here applies to them as if they were "new creditors."

19. This would often be an event of default under existing security agreements, which would entitle the existing secured party to accelerate its debt and move against the collateral. See footnote 9, *supra*, this Chapter.

20. Eastern Airlines suffered operating losses of more than \$1.5 billion from the time it filed its chapter 11 petition—in March 1989—up to the time it stopped flying—in January 1991. More than a billion dollars generated from asset sales were set aside initially in an escrow account to pay unsecured creditors, who were owed about a billion dollars. During a long and unsuccessful attempt to turn the business around, the court allowed Eastern to spend about \$900 million from the escrow account to fund its continued operations. A liquidating plan was confirmed in late 1994. See O'Brian & Pae, *Judge Rebuffs Call to Liquidate Eastern Airlines* WALL ST. J., Nov. 15, 1990; O'Brian & Pae, *Eastern Air Bid For \$135 Million Cleared by Court* WALL ST. J., Nov. 28, 1990; *In re Ionosphere Clubs, Inc.*, 113 B.R. 164 (Bankr. S.D.N.Y. 1990); *Abel v. Shugrue* (In re Ionosphere Clubs, Inc.), 184 B.R. 648 (S.D.N.Y. 1995). Under the plan, holders of smaller unsecured claims received 11% of their claims in cash. Holders of larger unsecured claims were to receive between 9% and 16% over time from sale of remaining assets. *Business Brief: Eastern Air Lines: Some Creditors' Settlements Are Planned for 1st Quarter* WALL ST. J., Dec. 23, 1994. Holders of smaller unsecured claims were paid their 11% in early 1995. As of late 1998 the liquidation process was still continuing. Holders of larger unsecured claims had been paid 9% with some possibility of ultimately recovering another 7% or 8%. See *Eastern Airlines Distributes Another \$5.6 Million to Large Creditors* BUS. WIRE, Nov. 6, 1997; Paiva, *Miami-Based Eastern Airlines Pays Some Creditors After Bankruptcy* MIAMI HERALD, Nov. 13, 1998 (1998 WL 16348289).

lienholders' property interests will be damaged. Again there is a question of the extent to which this risk should be placed on the existing lienholders in order to facilitate reorganization.

2. Turning the Business Around

A business "turn around" is a necessary part of most chapter 11 cases. Management must try to cut costs, increase revenues, and otherwise deal with the problems that led to financial distress. Unprofitable divisions or product lines must be made profitable, sold, or shut down. As we have seen, if the business cannot be turned around so that there is a "positive cash flow from operations," there will be no point in trying to reorganize the debtor. The debtor's revenues from its business operations (typically the amount of its sales) must exceed what it costs the debtor to generate those revenues (not including interest or principal payments on prepetition debts). If the debtor cannot generate any extra cash even when it is not paying its debts, then there is no earning power in the business, and it is worthless as a going concern. As low as liquidation value might be, it would be more than the zero reorganization value. Reorganization would not make sense.

Some of the steps in the business turn around may require cash outlays, such as payments to purchase new, efficient manufacturing equipment to replace old, failing, inefficient equipment, or to purchase more inventory for the debtor's stores so that there will be something to draw customers to the stores. The cash to take those steps will need to be found. Again, the debtor in possession will look to cash collateral, and if necessary to new credit, as discussed above. If the reorganization ultimately fails, the expenditures may add little to the liquidation value of the debtor's assets, but the new debts will be paid ahead of the prepetition unsecured creditors.

As we have seen, the creditors are in effect forced to finance the reorganization attempt, because chapter 11 places on them the risk of further losses during the reorganization. Normally, the owners of an enterprise put at least some resources into the enterprise as equity capital. Creditors are protected to some extent by that equity capital, in that the enterprise will not become insolvent until it has lost all of the equity capital that the owners contributed. In effect the owners lose their equity capital before the creditors lose what they have lent. In chapter 11, at least if the debtor is insolvent, every dollar of further loss will be at the expense of the creditors. In a sense they are thus providing the "equity capital" for the enterprise as it attempts to reorganize. Outside bankruptcy, those who provide the equity capital—the owners—typically have the right to control the enterprise, or at least to choose whether to contribute the equity capital. Should the unsecured creditors thus have some control over the reorganization, including some control over whether non-ordinary course expenditures are made in the chapter 11 case?

* * *

If creditors believe the reorganization will be unsuccessful, and if the debtor is continuing to lose money, they can move to have the case dismissed or converted to a chapter 7 liquidation case. See § 1112. As a less drastic step, the creditors can ask the court to order appointment of a trustee to oust the debtor's management, which the creditors may believe is incompetent or dishonest. See § 1104(a). Creditors may prefer to have an independent trustee running the business, supervising the attempt to turn it around, and making the decision as to whether it is worth the risk to attempt to rehabilitate the business.

* * *

[Problem 1-6 omitted.]

3. Determining Claims By and Against the Debtor

The starting point for determining claims by and against the debtor will be nonbankruptcy law. Nonbankruptcy law determines property interests and the general, substantive rights of the parties—such as whether a creditor has a lien or whether a person owes money to the debtor. See *Raleigh v. Illinois Dept. of Revenue*, ___ U.S. ___, 120 S. Ct. 1951, 147 L. Ed. 2d 13 (2000) (recognizing that nonbankruptcy law creates a substantive right in favor of taxing authorities when it places the burden of proof on taxpayers in tax claim disputes, and thus holding that taxpayer retains the burden of proof even when disputing a tax claim in the taxpayer's bankruptcy). However, bankruptcy changes the procedures used to enforce those property interests and other rights, and sometimes it even changes their substance. In some cases, the litigation costs of determining the claims against the debtor are a major factor in the debtor's financial distress; the question is whether those claims can be determined efficiently in a chapter 11 case. If not, then the process of determining them may use up much of the value that otherwise could go to pay them. * * *

4. The Restructuring of the Debts and the Division of the Enterprise's Value

The final ingredient for a successful reorganization is that the debts must be restructured so that the debtor will be able to pay them, and the value of the reorganized debtor must be divided among the creditors and the stockholders (or other owners).

a. The Need for Restructuring of the Debts

The debtor will need to have the debts that it owes reduced or the time for payment extended, or more likely both. It will do no one any good if the debtor finishes the reorganization still owing debts that it cannot pay. In fact, it will often be to the creditors' advantage to agree to reduce their debts enough so that the debtor is in a good, solvent financial position; as a result, the debtor will very likely be able to pay the reduced debts as they come due. If the debts are reduced that much, the shares of stock (or other ownership interests) in the now solvent debtor will have value. The question then will be who will get those valuable shares, which will represent part of the value of the reorganized debtor.

b. How Value Can Be Given to Creditors in the Plan of Reorganization

Creditors can receive value in an out-of-court workout or a chapter 11 reorganization in three ways. First, any cash or other property that is not needed for continuing operations can be distributed immediately to creditors when the reorganization or workout agreement is consummated. Surprisingly, debtors often are able to build up cash. Because of the moratorium or the automatic stay, the debtor will not be making payments on at least some, and perhaps most, of its prepetition debts; if the debtor has positive cash flow from operations, cash may build up. In fact, in chapter 11 a substantial amount of cash may be needed in order to put the plan of reorganization into effect; unpaid administrative expenses of the reorganization, including attorneys' and accountants' fees, will have to be paid in full on the effective date of the reorganization or shortly afterwards. However, there may still be excess cash that can be used to make some immediate payments to prepetition creditors on the effective date.

Second, the workout agreement or chapter 11 plan will not completely wipe out the debts owed to the creditors; the agreement or plan will provide for debts to be owed to the creditors by the reorganized debtor, though typically in a reduced amount and with a longer time for payment. Those debts will be valuable assets owned by the creditors. The debts will represent a commitment of part

of the value of the debtor's business to the creditors, since cash generated from the operations of the business will have to be used to pay interest and principal on the debts. The value of the debts to the creditors will depend on the amount of interest and principal to be paid, the payment schedule, the risk that the debtor may fail to make the payments, and whether the debts are secured. The concept of the time value of money requires that the future payments be discounted by an appropriate yearly discount rate. For example, if in the reorganization or workout a particular creditor receives a promissory note for \$1000 all payable in thirty years, with 2% interest paid each year, the debt's value will much less than its face value, because the appropriate discount rate will be much more than the note's 2% interest rate. If in addition the debtor is not financially sound even after the reorganization, the value of the debt will be even less, because the risk of non-payment will increase the appropriate discount rate.

Third, the creditors can be given shares of stock (or other kinds of ownership interests) in the reorganized debtor, which will have value, assuming the debts were reduced enough to make the debtor solvent.²¹ The question of how the value of the shares can be determined is discussed below, near the end of this introductory chapter.

c. Determining the Value to which Creditors Are Entitled—Liquidation Value vs. Reorganization Value

When value is given out in the plan of reorganization, a key question will be how much of the debtor's reorganization (going concern) value the creditors are entitled to receive. Chapter 11's approach to this question is based to some extent on the nonbankruptcy rights of the parties and on the way those rights could be exercised in an out-of-court workout.

As we have seen, dissenting creditors generally cannot be bound against their will to take less than full cash payment in satisfaction of their debts outside of bankruptcy. If some creditors refuse to take less than full cash payment, then the other creditors will likely refuse, as well, being unwilling to make sacrifices for the reorganization unless all or almost all creditors share the burden. The dissenting creditors are entitled to demand full payment, even if that prevents out-of-court reorganization. If there were no chapter 11, liquidation would result. In liquidation, creditors would receive payment ahead of stockholders (or other owners) out of the value of the debtor's assets. That follows from a basic corporation law principle: creditors are entitled to the value of a company ahead of owners, such as stockholders.²² The creditors have first claim to the liquidation value of a corporation's assets, ahead of the stockholders, who, as equity owners, have the residual rights to the corporation's liquidation value if it exceeds the creditors' claims.

On the other hand, if in a workout the creditors refuse to agree to reduce the debts sufficiently or demand too much of the stock of the debtor in exchange for reducing their debts, then the debtor's management, acting on behalf of the existing stockholders, can refuse to consent to an out-of-court workout agreement. (The stockholders themselves may even have the right to vote on whether stock will be issued to the creditors.) Thus either dissenting creditors or dissenting stockholders may be able to prevent a workout from succeeding and therefore force a liquidation of the business. In fact, the debtor's managers—with approval of the shareholders—usually can choose to liquidate the debtor.

21. A plan that would leave the reorganized debtor insolvent is not feasible and should not be confirmed, because there would likely be need for further reorganization. See § 1129(a)(11).

22. For simplicity, we refer simply to stockholders in the remainder of this section 4.c. A similar analysis would apply to partners (as owners of a partnership) and to "members" (as owners of a limited liability company).

Apart from the bankruptcy laws,²³ the creditors cannot prevent a liquidation. (However, if a corporate debtor is insolvent, its officers and directors may owe fiduciary duties to the creditors, which would prevent them from liquidating the debtor simply to spite the creditors.)

Outside of bankruptcy, then, neither the creditors nor the stockholders nor the debtor's management are absolutely entitled to keep the business in operation and preserve the going concern value of the debtor. Creditors are entitled to the entire value that can be obtained from the debtor's assets in a liquidation (if all of it is needed to pay their claims), so they are entitled to the full liquidation value of the debtor. However, if the debtor is reorganized, and if the reorganization value exceeds the liquidation value, then what should happen to the excess value? In other words, the creditors should at least get the liquidation value (if all of it is needed to pay their claims), but who should get the rest, the difference between the liquidation value and the reorganization value? Neither creditors alone nor stockholders alone have any entitlement to that excess value outside of chapter 11, so who should get it in chapter 11? Further, how does chapter 11 assure that creditors receive at least the liquidation value they could obtain outside bankruptcy?

Initially, at least, chapter 11 leaves the result up to negotiations among the parties. The negotiations occur under ground rules for the eventual confirmation of the plan that are designed to give creditors and stockholders (directly and through the debtor's management) appropriate bargaining power. How the debtor's value is divided is determined in the first instance by negotiations. Typically the debtor's management negotiates with a committee made up of unsecured creditors, see §§ 1102 and 1103, and with the major secured creditors; sometimes there are several committees of unsecured creditors, and sometimes there are one or more committees of stockholders (or other owners, such as limited partners).

Under chapter 11, a plan of reorganization can be confirmed without unanimous creditor or stockholder support, and the confirmed plan will bind all the creditors and stockholders, including those who opposed it. The debtor can file a plan without negotiating with creditors, but some creditor support generally will be needed for confirmation. Thus chapter 11 plans are usually the result of negotiations; to that extent the process of formulating the chapter 11 plan is like the formulation of an out-of-court workout agreement. The dynamics of the negotiations are, however, very different. The negotiations will likely result in the successful confirmation of the plan in chapter 11 if *most* of the interested parties can come to agreement, since neither unanimous creditor support nor, in many cases, substantial stockholder support is needed. That makes the negotiations much easier to conclude and takes away much of the leverage that assertive individual creditors would have in an out-of-court workout.

A key factor in the negotiations is that, for a period of time (usually at least 120 days), the debtor has the exclusive right to file a proposed plan of reorganization. See § 1121. This "exclusivity" gives the debtor some leverage in negotiations, since the creditors must either come to agreement with the debtor or face delay. The automatic stay protects the debtor during the negotiations, so the debtor does not have the fear that is always present during workout negotiations, that the moratorium will break down if negotiations do not proceed swiftly. However, at some point "exclusivity" is supposed to end, so that any party can file a plan; the debtor is not supposed to be able to say to creditors, "Accept this plan or there will be no reorganization." Thus, at least in theory, the debtor's leverage is limited.

23. If the debtor attempts to liquidate outside bankruptcy, the creditors could try to prevent the liquidation by filing an involuntary chapter 11 petition against the debtor. See § 303. If the debtor files a chapter 7 petition seeking liquidation in bankruptcy, the creditors could move to convert the case to chapter 11. See § 706(b).

Any plan that is proposed must place the creditors' claims into classes and state what the creditors in each class will receive. See § 1123(a)(1)-(3). Similarly, the proposed plan must place stockholders or other owners (who are all "interest holders" in the language of the Bankruptcy Code) into classes of "interests," and state what, if anything, they will receive. *Id.* No creditor or interest holder can be put into a class with anyone else whose claim or interest is not substantially similar, see § 1122(a),²⁴ because the creditors and stockholders will vote on the plan by classes; the vote of a class should represent the collective decision of a group of creditors or stockholders with a similar interest. However, the statute does not require that all substantially similar claims be put in the same class; most courts give the drafter of the plan some discretion to separate substantially similar claims into two or more classes if there is a legitimate business reason for doing so.

A class of creditors' claims accepts a plan if the holders of two thirds in amount and over one half in number of the claims (out of the claims that are voted) vote to accept the plan. See § 1126(c). A class of stockholders' interests accepts a plan if holders of two thirds in amount (out of the stock that is voted) vote to accept the plan. See § 1126(d).

It is easiest to have the plan confirmed if all classes accept the plan; it will be a "consensual plan," which needs to meet the requirements only of section 1129(a). If not all classes accept, the plan may still be confirmed in a "cramdown" if the requirements of both section 1129(a)—except for 1129(a)(8)—and section 1129(b) are met. Generally, in either case, the plan cannot be confirmed unless at least one class of claims accepts the plan *not counting the acceptances of "insiders"* such as directors, officers, controlling stockholders, their relatives, and affiliated corporations who may hold claims against the debtor. See §§ 101(31) and 1129(a)(10).²⁵ This last requirement is designed to ensure that the plan has at least some support from "disinterested" creditors, by which we mean creditors who will likely accept or reject the plan on the basis of what is best for them as creditors. An insider, such as a major stockholder in the debtor who also lent money to the debtor, may vote the resulting claim in favor of the plan not because the plan is in the best interest of the insider as a creditor, but because it is in the insiders' best interest as a stockholder.

The debtor might be tempted to engage in "gerrymandering" of the classes created by its plan. The debtor will try to place the claims in classes in such a way that a sufficient majority in each class will support the plan; the debtor will want to be sure, however, that there is a sufficient non-insider majority in at least one class of claims. Most courts restrict such gerrymandering, at least if it obviously is done for the purpose of affecting the outcome. Debtors usually are able to give other reasons for their classification schemes, which will often be accepted by the courts. The requirement that at least one class of claims accept the plan *not counting the acceptances of insiders* places some limit on the most effective form of gerrymandering: the strategic placement of insiders' claims in classes. Insiders' claims can still be placed strategically in various classes to affect the outcome in each class, so long as one class of claims can be constructed that will accept the plan not counting insiders' acceptances.

The debtor's ability to gerrymander the classes adds to the negotiating leverage that the exclusivity period gives the debtor. Obviously, it reduces to some extent the negotiating leverage of

24. Section 1122(b) provides an exception to this rule; it permits small claims to be classified together for administrative convenience even if they are dissimilar.

25. The class that accepts not counting acceptances by insiders must be an "impaired" class of claims, if there is at least one "impaired" class of claims. As we discuss more fully in Chapter Eleven of this text, a class is impaired unless the rights of holders of claims in the class are left untouched or nearly untouched. See § 1124. Of course, if no class of claims is impaired, then there is no need to obtain acceptance of an impaired class of claims. See § 1129(a)(10).

creditors; their threats to vote against the plan have reduced force due to the debtor's ability to construct the classes in the plan proposed by the debtor.

Of course chapter 11 provides protections for dissenting creditors and interest holders beyond merely their right to engage in negotiations over the plan. In fact, the negotiating leverage of creditors and interest holders comes in large part from the protections they receive if they dissent. Thus, even if a plan ultimately may be confirmed with little or no dissent, the negotiations over the terms of the plan will be dominated by the rights that the parties are guaranteed if they dissent.

The extent of the protections for dissenters depends on the breadth of the dissent. If a dissenter votes against the plan, but the dissenter's class accepts the plan, then confirmation of the plan rather than liquidation is probably in the economic interest of all the class members; at least, most of the class members think so. As added insurance, however, chapter 11 imposes what is called the "best interests" test: the value to be received by a dissenter (with a claim in an impaired class²⁶) under the plan must at least equal what the dissenter would receive if the debtor were liquidated in a chapter 7 case on the effective date of the plan. See § 1129(a)(7). If the test is met, then the plan can be confirmed despite the dissenter's objection. The dissenter will then be at least no worse off under the plan than the dissenter would be if reorganization were blocked and the debtor were liquidated.²⁷ If the "best interests" test is not met, then the plan cannot be confirmed even if there is only one dissenter. This guarantees at least that the bankruptcy judge believes dissenters will obtain the liquidation value that is their right.

On the other hand, if an impaired *class* does not accept the plan, then there is either significant collective dissent or dissent by a holder of a major claim or interest. Then it is not a case of a few obstructive dissenters with relatively small claims or interests trying to block a reorganization that similarly situated creditors or interest holders in general find acceptable. A forced reorganization under the proposed plan (a "cramdown") may then do too much violence to the rights that the dissenting class would have outside of bankruptcy. Chapter 11 therefore sets two requirements (in addition to the "best interests" test) that must then be met for the plan to be confirmed in a cramdown. First, the plan must be "fair and equitable" with respect to the dissenting class or classes. Second, the plan must not "unfairly discriminate" against the dissenting class or classes in favor of other classes. See § 1129(b).

The requirement that the plan not unfairly discriminate against the dissenting class probably means that the dissenting class must receive value approximately equal to the same percentage of its claims as other classes whose claims have equal priority. Whether deviation from that principle of equality can ever be justified, and thus not be "unfair" discrimination, is the subject of some controversy. See Chapter Fifteen below, and Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227 (1998).

26. See footnote 28, *supra*, and Chapter Eleven of this text for the meaning of "impaired."

27. This is not to say that the dissenting creditor must receive an amount equal to what it would have received had the debtor's assets been liquidated promptly at the beginning of the case. See section C.2. of this chapter. Note also that the best interests test does not require that the plan be the best one possible from the dissenter's point of view or require that the dissenter receive full value equal to the amount of the debt. The major reason for reorganizing a debtor is to avoid the diminution in value of its assets that would occur in a liquidation. Because only the debtor can propose a plan during the exclusivity period, creditors may be faced with voting for a plan that is better than liquidation would be, but that is not as good for them as some other plan might be. Creditors may decide to vote for the debtor's plan rather than wait and hope that eventually a better plan might be brought forward. This is part of the leverage that exclusivity gives to the debtor.

However, it is in the “fair and equitable” requirement that chapter 11 answers the large question left unanswered above: if negotiations fail to allocate it, who will receive the excess of the going concern value of the reorganized debtor over its liquidation value? Here chapter 11 comes down on the side of the dissenting classes of creditors. In the end, when negotiations fail, the theory of chapter 11 is that dissenting classes of creditors are entitled to the full going concern value of the debtor company ahead of the stockholders (or other interest holders), including the excess of reorganization value over liquidation value, if that much is needed to provide them with full repayment. Thus chapter 11’s “fair and equitable” standard is an absolute priority rule in favor of dissenting classes.

Section 1129(b)(2)(B) explains the treatment that a dissenting class of unsecured claims must receive under the fair and equitable requirement. The plan must treat the class in one of two ways. The plan can give the holders of claims in the dissenting class property (which can include stock in the reorganized debtor) with a present value equal to the full amount of their claims—a kind of full payment. If that is not done, the plan *must* provide that holders of claims in classes “junior” to the dissenting class neither retain nor receive anything at all—no cash, no promissory notes, no stock—on account of their claims or interests. Those junior classes would include any classes of creditors who agreed to subordinate their debt to the dissenting class’s debt (e.g., subordinated notes or debentures), any classes of preferred stockholders’ interests, and the class of common stockholders’ interests.

One important result is that if there is a dissenting class of unsecured claims that will not receive value equal to 100% of its claims, then the debtor’s stockholders will receive nothing on account of their stock; their stock will be canceled, and they will cease to have any interest in the company. As we will see, however, some courts have permitted stockholders in such cases to receive some or all of the stock of the reorganized debtor not “on account of” their stock but on account of a contribution of new value. The Supreme Court has hinted that this is permissible, but only under strict conditions, and the law on this matter is still unclear. See *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607 (1999), reprinted and discussed in Chapter Fifteen, section B, below.

Section 1129(b)(2)(A)(i) explains the treatment that a dissenting class of *secured* claims usually must receive under the fair and equitable requirement if the debtor retains the collateral. The plan must let the holders of claims in the dissenting class keep their liens for the amount of their secured claims and must provide for them to receive payments that have a present value equal (in the usual case) to the amount of the secured claims.²⁸ Note that under section 1129(b)(2)(A)(i) a dissenting class of secured claims is entitled to monetary payment and cannot be forced to take stock in the debtor or other property as part of the value received for purposes of the fair and equitable requirement. However, under section 1129(b)(2)(A)(iii) there is an alternative way to satisfy the fair and equitable standard with respect to a class of secured claims: the plan may provide for the “realization” by the secured claim holders of the “indubitable equivalent” of their claims. As strong as that language sounds, its vagueness creates uncertainty in the rights of secured creditors. See Chapter Fifteen, section A.2.a.(2).

28. The language of section 1129(b)(2)(A)(i)(II) is complex because of the possibility that the class will make the election permitted by section 1111(b)(2). If the class makes the section 1111(b)(2) election then a holder of an undersecured claim in the class will be considered to have an allowed secured claim for the entire amount of its debt, rather than just for the value of its collateral, which is the usual allowed amount under section 506(a). In a cramdown, despite the election, the secured creditor is still only entitled to present value equal to the value of its collateral; it is, however, entitled to receive payments over time totaling at least the amount of its debt. The section 1111(b)(2) election is discussed in Chapter Fifteen of this text.

d. Determining the Value of the Debtor and of Property Distributed Under the Plan

(1) *Why Valuation Is Critical*

Valuation issues are critically important in chapter 11. Suppose that, under the proposed plan of reorganization for a debtor, creditors with unsecured claims in a certain class (say, Class V) are to receive the following property for each \$100 of claims: \$10 cash, a \$20 five-year promissory note, and one share of common stock in the reorganized debtor. Suppose creditors with unsecured claims in Class VI are to receive \$5 cash and a \$30 ten-year promissory note, but no stock, for each \$100 of claims. Consider the number of valuation questions that may have to be answered.

First, suppose a creditor with a claim in Class V dissents. The “best interests” test will require the court to determine how much value the creditor would receive on account of the claim in a liquidation, determine how much value the creditor will receive on account of the claim under the plan, and compare the two values to ensure that the creditor receives at least as much under the plan as in a liquidation. To determine what the creditor would receive in a liquidation for each \$100 of claim, the court will have to determine the liquidation value of the debtor’s assets, subtract the amount of any priority claims, and divide the remaining amount by the total amount of unsecured claims. That will yield a percentage that would be paid on unsecured claims in a liquidation. (If, for example, the liquidation value minus priority claims is \$250,000, and total general unsecured claims are \$1,000,000, then dividing the two yields a payment percentage of 25%. The creditor would therefore receive \$25 in a liquidation for each \$100 of claim.) To determine how much value the creditor will receive under the plan for each \$100 of claim, the court will have to determine what the \$20 promissory note is worth and what the share of stock is worth.

Second, suppose Class V rejects the plan, but Class VI accepts it. The plan can be confirmed only if it does not unfairly discriminate against Class V. Assuming the two classes are of equal priority (neither one sub-ordinate to the other) that probably means that holders of claims in Class V must at least receive approximately the same percentage repayment that holders of claims in Class VI will receive. To determine whether that standard is met, the court will have to determine the value of the \$20 five-year promissory notes, the value of the \$30 ten-year promissory notes, and the value of the shares of common stock. As we explain below, in order to determine the value of one share of common stock, the court will need to determine the reorganization value (also called the going concern value) of the debtor, then subtract the present value of all of the debt that the reorganized debtor will have, and then divide by the total number of shares that will be outstanding.

Third, suppose again that Class V rejects the plan and that Class VI accepts it, but now suppose that Class V is senior to Class VI. (For example, the holders of claims in Class VI may be the owners of “subordinated debentures”—long term unsecured debt securities issued by the debtor, which, according to their terms, are subordinated to some or all of the debtor’s other debts. Debentures often are subordinate to “institutional debt” but not to trade debt. In this case we assume the Class V claims are claims of institutional creditors such as banks and finance companies, and that the Class VI claims of the debentureholders are thus subordinated to the Class V claims by agreement between the debtor and the debentureholders.) Now, under the fair and equitable standard, the plan cannot be confirmed unless the plan either (1) gives holders of claims in Class V value equal to 100% of their claims, or else (2) gives the holders of claims in Class VI (and holders of claims in all other junior classes) nothing. Here the plan gives something to the junior Class VI, and thus the plan cannot be confirmed unless the property received by holders of claims in Class V for each \$100 of claim—the \$10 cash, the \$20 promissory note, and the share of stock—is worth at least \$100. Once again the court will have to determine the value of the promissory note and of the common stock to determine whether the plan can

be confirmed.²⁹

Of course the negotiations of the parties will be influenced by the power of the debtor to have a plan confirmed over the dissent of creditors, just as it will be influenced by the creditors' ability to block a plan that does not meet the legal standards. Thus the parties will need the best valuation information they can get to help them determine their negotiating positions. Beyond the question of legal requirements, the creditors need valuation information to decide whether to accept or reject a proposed plan. A creditor with a claim in Class V will need to know what the share of common stock will be worth to know how much value it will receive under the plan. Obviously the creditor will be more likely to accept the plan if the share of stock will be worth \$50 than if it will be worth only \$2. The creditor will also want to know what it would get in a liquidation of the debtor's assets; if liquidation would give the creditor as much or nearly as much value as the plan would give, then the creditor will likely prefer to receive cash in a liquidation rather than be subject to the delays and future uncertainties involved in owning a five year promissory note and common stock. Finally, the creditor will want to know what the reorganization value of the debtor is. If the reorganization value is \$80 million and the total debts are \$100 million, all unsecured, the creditor might well support a plan that gave it and other creditors value equal to 75% of their claims (thus leaving something, but not too much, for the old stockholders). The creditor would probably balk at a plan that gave it only a 50% recovery.

Thus valuation issues are critically important.³⁰

(2) *The Valuation Process*

The basic principle of valuation is that the reorganization value of the debtor's business depends on its earning power, on the amount of cash that it will be able to generate in excess of its operating expenses. To the extent the debtor can generate such excess cash, there will be value that can be given out to the parties.

An analogy to liquidation value is helpful. It is easy to see how the liquidation value of a debtor's assets can be determined and then distributed in a chapter 7 liquidation; the liquidation creates a one-time pool of money (received from sale of the debtor's assets) that is simply used to pay the costs of administration of the chapter 7 case and then divided among the creditors, all by application of the rules in section 726. In the beginning it may be harder for the student to see how the reorganization value of a going business can be determined and distributed, but it is actually fairly simple. If the debtor's assets are not going to be sold, then the debtor will use its assets to make money year after year. Instead of a one-time pool of money, a pool of money is created each year, which can be

29. We must defer until Chapter Fifteen below the question whether holders of claims in Class V are entitled under the fair and equitable requirement or under section 510(b) to receive full payment *including postpetition interest* before the holders of claims in Class VI are entitled to receive anything. Another serious question is whether, under the terms of the plan, the senior class (Class V) is treated fairly and equitably where it is forced to take the risk of owning common stock but the junior class (Class VI) is not forced to take that risk. The stock to be received by holders of claims in Class V would be junior to the \$30 promissory notes to be received by the holders of claims in Class VI. Section 1129(b)(2) does not expressly prohibit this arrangement, but that does not mean that it is fair and equitable. The fair and equitable requirement "includes" the requirements of section 1129(b)(2) but is not limited to them. See §§ 102(3); 1129(b)(1)-(2).

We must also defer the question whether the plan could provide less than 100% value to Class V claimholders and still be fair and equitable, if the Class V claimholders retain their state law rights to sue the Class VI claimholders under the subordination agreement.

30. It is also often critically important to be able to determine a value for an individual asset, when the asset is subject to a lien. As noted above, under section 506(a) a secured creditor ordinarily has an allowable secured claim to the extent of the lesser of the amount of the debt or the value of the collateral, and an allowable unsecured claim for the rest of the debt. Thus, the valuation of the collateral determines the amount of secured and unsecured claims.

distributed;³¹ the reorganization value of the debtor lies precisely in those yearly pools of available cash. In order to distribute the reorganization value of the debtor, we simply need to find a way to allocate that future cash among the existing creditors and stockholders. To determine the reorganization value, we must find a way to determine the total value of a series of yearly cash amounts.

Allocation of the future cash is handled by the chapter 11 plan of reorganization. Most plans allocate the cash in two ways. First, they provide that the creditors will receive scheduled payments in the future; often this is done by providing that the creditors will receive promissory notes payable by the reorganized debtor. As a result, the creditors who were owed money before the reorganization will end up again as creditors of the reorganized debtor (although typically with a reduced amount owed to them). Second, the plan of reorganization typically will provide that the creditors will receive shares of stock (or other ownership interests) in the debtor. The plan may also allocate some of the future cash to the existing stockholders of the debtor by providing for them to receive shares in the reorganized debtor. Through dividends, or in other ways, the owners of the stock in the reorganized debtor will share in the future cash flows.

To determine the value of the yearly cash flows, it may be helpful to think about the assets of an operating business as the contents of a sealed box. Imagine a box that has two slots, one marked "cash in," and one marked "cash out." Consider Acme, Inc., a shoe manufacturer that pays out \$10 per pair of shoes for the raw materials, labor, rent, utilities, and other expenses necessary to make and sell a pair of shoes. Assume Acme has enough cash at present to operate its business, but no excess cash and no other excess assets. Acme's assets can be considered as the contents of a box with the following characteristics: (1) when you put \$10 in the "in" slot, a certain amount of money comes out of the "out" slot; (2) the box is capable of being operated a certain number of times each year, so that the cycle of putting the \$10 in and getting some cash out can occur that many times each year; and (3) a few \$10 bills are in an envelope attached to the box.

What is the value of the box? In other words, what would an investor pay for the box? That depends on how much money comes out of the "out" slot for each \$10 put in the "in" slot and on how many times per year the box can be operated—how many times per year it can go through the cycle of taking in a \$10 bill and ejecting cash.

Suppose the best price Acme can get on sale of its shoes is \$9.50 per pair, and that Acme can make 10,000 pairs per year. What would an investor pay for a box that takes in and consumes \$10 and in return ejects \$9.50 for the investor 10,000 times during the year? An investor would pay nothing if the investor had to leave the box sealed and had to operate it. Every cycle of the box would use up 50 cents of the money in the envelope. Soon that money would be gone, and the owner would have to use other money to keep the box operating. The only value of the box would be for the investor to open it quickly, sell off its contents, and pocket any money that might still be in the envelope. Similarly, Acme's assets would be worthless as a going concern, and would have no reorganization value (at least no positive value).³² Of course the equipment and raw materials and

31. Instead of being distributed directly, some of the excess cash may be reinvested in the business so that the business will generate more cash in the future than previously projected. The expectation of future cash flow will make the shares of stock more valuable. That will increase the wealth of whoever owns the stock, without any cash being given directly to the owners. Thus, the cash flow does not have to be distributed directly for its value to be given to the stockholders.

32. The owner of a business that efficiently produced leather and other shoe manufacturing raw materials, and that could thus provide the needed resources for Acme's business at a cost of less than \$9.50 per pair, might, however, be interested in acquiring Acme as a going concern. That would give the new owner a "captive market" for its products and would create a vertically integrated manufacturing enterprise.

other assets could be sold off for some amount of money; if there were any cash in Acme's bank account (the "envelope" attached to the box), that would add to the total in the liquidation. Thus the only value of the assets would be their liquidation value. It would make no sense to try to reorganize Acme, since the only valuable use of its assets is in a liquidation. In fact, a business cannot be successfully reorganized if it cannot bring in enough revenues to pay for its operating costs. Even if the business is relieved of all of its debts it will eventually run up more debts, and be unable to pay them.

It may be that with better management or with an infusion of cash, Acme can take steps to cut its costs or to increase the price it receives for its product, so that its revenues will more than cover its operating costs. If Acme may succeed in such a business "turn around," the assets may have a going concern value, and an attempt to reorganize may make sense.

Suppose that Acme cuts its costs of operation to \$8.50 per pair of shoes, based upon manufacture and sale of 10,000 pairs per year, which it can sell for \$9.50 per pair. Suppose that will likely continue for the foreseeable future, although with some "ups" and some "downs." Acme's average cash flow from operations will be a dollar per pair of shoes, for a total of \$10,000 per year (\$1 times 10,000 pairs of shoes).³³

Think of Acme's assets again as a sealed box. What would you pay for a box that, on average, would give you \$10,000 per year?

The amount you would pay for the box would depend on the rate of return that you would demand on your investment. Assume you can get at least a 5% return on money in the bank, a much safer investment than money invested in a shoe manufacturer. (After all, you do not *know* that you will receive \$10,000 each year if you buy the shoe manufacturer's assets, although that is your expectation for an average year. You might do better and you might do worse; typically investors demand a higher rate of return when the outcome is less predictable, because most investors are *risk averse*.) Thus you will ask for more than a 5% return. You will compare the investment in the shoe manufacturer's assets with other investments you could make, and you will not settle for a lower rate of return than what you could get from other investments that involve a similar risk.

Suppose you decide that you will not settle for less than a 20% return (before taxes) each year on your investment in Acme's assets; what would you be willing to pay for those assets? If you believe that the assets will give you average net cash flow of \$10,000 per year for the foreseeable future, then you would be willing to pay \$50,000 for the assets. Then you would expect to make an average of \$10,000 per year on your \$50,000 investment, which is the 20% return (before taxes) that you demanded.³⁴

33. Of course the shoe stitching machinery and the other equipment will eventually wear out and have to be replaced. Each year, therefore, to maintain its capacity and efficiency, Acme will probably have to replace some of its equipment. Therefore some amount of the cash generated from sale of the shoes will have to go to equipment replacement to maintain Acme's cash generating abilities. That amount of "capital expenditure" will have to be subtracted from the \$10,000 per year to determine how much net cash is actually available to be paid out to the investor. For simplicity, the example in the text assumes that no capital expenditures will be needed.

In the real world, businesses start with what they paid for an item of equipment and allocate part of that amount each year as an "expense" of using the equipment. That expense is called "depreciation." For purposes of figuring out the business's profits for a year, depreciation is treated as an expense, just as payment of wages to employees is treated as a expense; all the business's expenses are subtracted from its revenues to come up with a profit figure. Depreciation expense does not require the business to expend any more cash; all the cash needed to buy the equipment was spent when it was first purchased. Eventually, though, the equipment will have to be replaced (unless the business reduces its operations), which will use up cash. A buyer of the business would take into account that need to spend cash in the future in deciding how much the business is worth.

34. In the example, it is possible to "eyeball" the problem and figure out that a 20% return is one fifth per year, so the value of the business must be five times the yearly payout, or \$50,000. In other cases a formula is helpful. In general, if an investment will pay P dollars per year in perpetuity, and if the investor demands a return of r percent per year on the investment, then the investment

Note that this assumes that Acme will continue to have the same cash flow year after year. However, a debtor coming out of chapter 11 may be able to do better each year for the first few years after confirmation of the plan. As time goes on, the debtor will regain more and more of the confidence of its customers, and the “stain” of having been in chapter 11 will fade. Thus we need more sophisticated methods of giving a value to the cash that the debtor will generate, methods that can take into account the projected increase in cash flows over the first few years. Earlier years may be more important, because the longer the investor will have to wait to receive cash, the greater the discount due to the time value of money. However, larger cash flows in later years can have a substantial effect on the value of the business. We discuss more sophisticated methods of valuation below in Chapter Twelve.

Now we can compare the liquidation value to going concern value. As a going concern, the assets are worth \$50,000, if investors will demand a 20% rate of return. Suppose an appraisal shows that the assets would probably sell in a liquidation for \$30,000. The going concern value would then be greater than the liquidation value. (Presumably this would be due to the time and money Acme’s owners put into assembling the assets, training the workers, building good relations with customers and suppliers, and developing a good reputation for the company’s shoes.) It would make no sense to liquidate the company, when that would destroy \$20,000 of the assets’ value along with the employees’ jobs.

If the value of the cash that will be generated by the debtor is \$50,000, then that is the value of the debtor’s assets as a going concern, and that is the total amount of value that can be given out in the plan in the form of stock in the reorganized debtor and debts to be owed by the reorganized debtor.³⁵ You can see why that is true if you consider that the value of the stock in the reorganized debtor and the value of the debts to be owed by the reorganized debtor depend on the amount of cash Acme can generate in the future. Acme’s future cash flows will be used to make interest and principal payments on debts of the reorganized debtor and to pay dividends or in some other way give value to the reorganized debtor’s stockholders. Imagine that a person bought all the debts of the reorganized Acme and all its stock; that person would then get all of Acme’s future cash flows. Since those cash flows are worth \$50,000, the person would likely pay \$50,000 for all the debts and stock of the debtor. *That means that the total value of all the debts and stock of the debtor equals \$50,000, the value of the cash flows.*³⁶

Using that principle, we can determine the value of Acme’s stock. If the reorganized Acme will end up owing \$35,000 in debts, then the stock will be worth \$15,000, because the value of the debts

is worth P divided by r and then multiplied by 100. In the example, X is \$10,000, and r is 20; thus the value of the business to the investor is \$10,000 divided by 20 and then multiplied times 100, which equals 500 times 100, which equals \$50,000.

35. If the debtor has built up surplus cash during the reorganization—cash beyond the amount needed to run its business and beyond the amount that must be paid to holders of administrative expense claims on the effective date of the plan—then the debtor can give out some cash to creditors in its plan of reorganization. Similarly, if the debtor has surplus assets—such as equipment that it does not need—the assets can be sold to generate cash to give to creditors.

36. We make the assumption that the total value of the debts and the stock is the same whether they are all owned by the same person or are owned by many different people. Thus, we assume that if an investor would pay \$50,000 for all of the debt and stock, the total value of the debt and stock is \$50,000, whether or not it is all owned by one person.

Consider the result if the total value of the debt and stock were less than \$50,000 simply because many different people owned the debts and the stock. A smart investor would buy all the debts and all the stock, paying less than \$50,000, would end up with \$50,000 in value, and would have made a profit. We do not observe many cases in which investors buy up all the stock and all the debts of companies. That is some indication that they are not worth less simply because they are not all owned by the same person. There have been many leveraged buyouts, especially in the 1980’s, in which investors purchased all the stock of companies—but not all the debts. Presumably the investors *thought* the stock would be worth more if it was all owned by a single investor (or group of investors). The failure of many of the companies after the leveraged buyouts provided a bonanza for bankruptcy attorneys and may make us question whether the investors were right.

and the value of the stock must total \$50,000. That does assume something; it assumes that the \$35,000 in debts is worth \$35,000. (Remember we have determined that an investor would pay a total of \$50,000 for all of the stock and all of the debts; if an investor would pay less than \$35,000 for the debts alone, then the stock is worth more than \$15,000.) If the interest rate on the debts is lower than a fair market rate, given the risk and the length of time before payment, then the debts will not be worth \$35,000. Suppose the interest rate is so low that an investor would only pay \$33,000 for the \$35,000 in face amount of the debts; if so, the stock in the debtor should be worth \$17,000, because the value of the stock and debts together should be \$50,000. If the interest rate is an above-market rate, so that the debts are worth \$40,000 instead of their face amount of \$35,000, the stock will be worth \$10,000.

This is just common sense. A company that pays a higher rate of interest on its debts has less cash left to benefit the stockholders. Thus the stock is not as valuable. A company that pays a lower interest rate on its debts has more cash for the stockholders. Thus the stock is more valuable.³⁷

Therefore, if we can determine Acme's total reorganization value, and if we can determine the value of the debt that Acme will have after reorganization, we can determine the value of Acme's stock—the total value of all the shares of stock in the reorganized debtor. If we divide that value by the number of shares of stock that will be outstanding in the reorganized Acme, we will get the value of each share. For example, if the total value of Acme's stock is \$37,000, and if there will be 1,000 shares of stock outstanding after the reorganization, then each share will be worth \$37.³⁸ That then allows us to determine how much value a proposed plan of reorganization will give to each party. In turn, that will allow the parties to decide whether they wish to accept or reject the plan. It will also then allow the court to decide whether the "best interests" test has been satisfied, and, if a cramdown is necessary, to decide whether the plan is "fair and equitable" and whether it "unfairly discriminates."

[Problem 1-7 omitted.]

37. Note that if the required debt payments are too high, then the overall value of the reorganized company may suffer. If the company has to pay so much on its debts that a downturn in business will cause the company to default on its debts, then there is a risk of another bankruptcy. The risky nature of the business then would lead investors to demand a higher rate of return. That would cause the value of the company's projected future cash flows to be reduced. As we have seen, the business is worth \$50,000 if investors demand a 20% return. If investors demand a 25% return, then the same expected \$10,000 per year cash flows are worth only \$40,000 total, because a buyer who paid \$40,000 for the business would receive a 25% per year return on the investment. Thus it is in everyone's interest to leave the reorganized debtor in a strong financial position, not with too much debt, so that its value will not be diminished by the risk of future financial distress. But if the amount of debt is very low, the company may be forgoing tax advantages. Interest payments are usually tax deductible, but dividends paid to stockholders are not. The company may reduce its taxes by paying out some of its cash flows in the form of interest on debts.

38. For the sake of simplicity we assume the reorganized Acme will have only one class of stock, rather than a complex financial structure with different classes of common and preferred shares. We also ignore control premiums and minority share discounts.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Supplementary Materials

Chinese Bankruptcy Law for State-Owned Enterprises (1986)

中华人民共和国企业破产法（试行）

PRC, State Enterprise Insolvency Law (Trial)

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第一章 总则

PART ONE: GENERAL PRINCIPLES

第一条 为了适应社会主义有计划的商品经济发展和经济体制改革的需要，促进全民所有制企业自主经营，加强经济责任制和民主管理，改善经营状况，提高经济效益，保护债权人、债务人的合法权益，特制定本法。

Article 1: This Law is specially formulated in order to satisfy the needs of the planned development of a socialist commodity economy and of the reforms of the economic system; to promote initiative in the operation of state enterprises; to strengthen the economic responsibility system and democratic management; to improve the general state of management, increase economic benefits and to protect the legitimate rights and interests of creditors and debtors.

第二条 本法适用于全民所有制企业。

Article 2: This law applies to State-owned enterprises.

第三条 企业因经营管理不善造成严重亏损，不能清偿到期债务的，依照本法规定宣告破产。

Article 3: Enterprises will be declared insolvent according to this law where serious losses are caused by mismanagement and where enterprises cannot repay their debts on time.

企业由债权人申请破产，有下列情形之一的，不予宣告破产：

Enterprises which have been petitioned for insolvency by creditors will not be declared insolvent in the following situations:

(一) 公用企业和与国计民生有重大关系的企业，政府有关部门给予资助或者采取其他措施帮助清偿债务的；

(1) public enterprises and enterprises which have an important relationship to the national economy and to the people's livelihood and where the relevant government department provides financial assistance or adopts other measures to assist the enterprise in repaying its debts, and

(二) 取得担保，自破产申请之日起六个月内清偿债务的。

(2) where the enterprise has obtained a guarantee and repays its debts within six months from the date of the petition for insolvency

企业由债权人申请破产，上级主管部门申请整顿并且经企业与债权人会议达成和解协议的，中止破产程序。

Where an enterprise has been petitioned for insolvency by creditors, winding up will be stayed where the superior department in charge applies for reorganization and where the creditor's meeting reaches a reconciliation agreement.

第四条 国家通过各种途径妥善安置破产企业职工重新就业，并保障他们重新就业前的基本生活需要，具体办法由国务院另行规定。

Article 4: The state has adopted various means to arrange for the workers of insolvent enterprises to obtain new employment and assures their basic living needs prior to their reemployment. Specific procedures will be stipulated separately by the State Council.

第五条 破产案件由债权人所在地人民法院管辖。

第六条 破产案件的诉讼程序，本法没有规定的，适用民事诉讼法程序的法律规定。

第二章 破产申请的提出和受理

第七条 债务人不能清偿到期债务，债权人可以申请宣告债务人破产。

债权人提出破产申请时，应当提供关于债权数额、有无财产担保以及债务人不能清偿到期债务的有关证据。

第八条 债务人经其上级主管部门同意后，可以申请宣告破产。

债务人提出破产申请时，应当说明企业亏损的情况，提交有关的会计报表、债务清册和债权清册。

第九条 人民法院受理破产案件后，应当在十日内通知债务人并且发布公告。人民法院在收到债务人提交的债务清册后十日内，应当通知已知的债权人。

公告和通知中应当规定第一次债权人会议召开的日期。

债权人应当在收到通知后一个月内，未收到通知的债权人应当自公告之日起三个月内，向人民法院申报债权，说明债权的数额和有无财产担保，并且提交有关证明材料。

逾期未申报债权的，视为自动放弃债权。

人民法院对有财产担保债权和无财产担保债权的申报，应当分别登记。

第十条 债权人提出破产申请的，债务人应当在收到人民法院通知后十五日内，向人民法院提交本法第八条第二款所列有关材料。

Article 5: People's Courts in the region of the debtor will have jurisdiction over insolvency.

Article 6: Where this law does not provide civil procedure, the law and regulations for civil law litigation will apply.

PART TWO: PRESENTATION AND ACCEPTANCE OF INSOLVENCY PETITIONS

Article 7: A creditor may petition for the insolvency of its debtor where the debtor is unable to repay its debts on time Note that this term is not defined.

At the time of presenting its petition for insolvency, the creditor must provide evidence of the amount of the debt; of whether or not the debt is secured and evidence of the fact that the debtor is unable to repay on time.

Article 8: After receiving the consent of its superior department in charge, a debtor may itself petition to be declared insolvent.

At the time of presenting its petition for insolvency, the debtor must explain the circumstances of the enterprise's losses and submit the relevant accountant's report and a register of debts and credits.

Article 9: Within ten days of accepting a petition for insolvency, the People's Court shall notify the debtor and publish a notice. Within ten days of accepting the submission of a register of creditors from a debtor, the People's Court shall notify such listed creditors.

Notices and public notices shall indicate the date of the first creditors' meeting.

Creditors shall register their claims with the People's Court within one month of receiving notice. Creditors who have not received notice must register within three months of the publication of the public notice. Creditors must specify the amount of the debt, whether or not it is secured and must provide relevant certification.

Creditors who do not register within the specified period will be deemed to have abandoned their rights as creditors.

The People's Courts shall separately register claims for credit which are secured from those which are not secured.

Article 10: Where a petition for insolvency is presented by a creditor, within fifteen days of receiving notice from the People's Courts, the debtor shall submit to the People's Court such relevant material as is listed in Article eight paragraph 2 of this Law

债务人或者其他单位担任保证人的，应当在收到人民法院通知后五日内转告有关当事人。

第十一条 人民法院受理破产案件后，对债务人财产的其他民事执行程序必须中止。

第十二条 人民法院受理破产案件后，债务人对部分债权人的清偿无效，但是债务人正常生产经营所必需的除外。

第三章 债权人会议

第十三条 所有债权人均为债权人会议成员。债权人会议成员享有表决权，但是有财产担保的债权人未放弃优先受偿权利的除外。债务人的保证人，在代替债务人清偿债务后可以作为债权人，享有表决权。

债权人会议主席由人民法院从有表决权的债权人中指定。

债务人的法定代表人必须列席债权人会议，回答债权人的询问。

第十四条 第一次债权人会议由人民法院召集，应当在债权申报期限届满后十五日内召开。以后的债权人会议在人民法院或者会议主席认为必要时召开，也可以在清算组或者占无财产担保债权总额的四分之一以上的债权人要求时召开。

第十五条 债权人会议的职权是：

- (一) 审查有关债权的证明材料，确认债权有无财产担保及其数额；
- (二) 讨论通过和解协议草案；
- (三) 讨论通过破产财产的处理和分配方案。

第十六条 债权人会议的决议，由出席会议的有表决权的债权人的过半数通过，并且其所代表的债权额，必须占无财产担保债权总额的半数以上，

Where a debtor has undertaken to act as a guarantor for another unit, it shall notify such relevant parties. Probably the guaranteed and the creditor of the guaranteed within five days of receiving a notice from the People's Courts.

Article 11: After the People's Courts have accepted an insolvency case, the court must stay the execution of civil procedures relating to the property of the debtor.

Article 12: After the People's Courts have accepted the insolvency case, except insofar as is necessary for its normal operation and production, partial repayments to creditors by the debtor are invalid.

PART THREE: CREDITORS' MEETINGS

Article 13: All creditors shall be members of the creditors' meeting. Members of the creditors' meeting shall all enjoy voting rights except for those secured creditors who have not abandoned their right of priority. Guarantors who have repayed the debts of the debtor may be act as creditors and may enjoy the right to vote at creditors' meetings.

The chairman of the creditor's meeting shall be selected by the People's Court from the voting members.

The legal representatives of the debtor must attend the creditors' meeting as non-voting participants and must respond to creditors' queries

Article 14: The first creditors' meeting will be convened by the People's Court and shall be fifteen days after the expiry of the period for registration of creditors. Further meetings will be convened when considered necessary by the People's Court or by the chairman of the creditors' meeting. They may also be convened when requested by the liquidating committee or by twenty five percent or more of unsecured creditors.

Article 15: The authority of the creditor's meeting is as follows:

- (1) examine the relevant documentation of creditors and confirm their amounts and whether or not the creditors are secured or unsecured
- (2) discuss the passing of a "draft reconciliation agreement";
- (3) discuss the adoption of a plan for the distribution and disposition of the assets available for distribution

Article 16: Resolutions of creditor's meetings must be passed by half of the voting members in attendance and fifty percent or more of the total amount of claims; for unsecured claims must be represented in such resolution

但是通过和解协议草案的决议，必须占无财产担保债权总额的三分之二以上。

债权人会议的决议，对于全体债权人均有约束力。

债权人认为债权人会议的决议违反法律规定的，可以在债权人会议作出决议后七日内提请人民法院裁定。

第四章 和解和整顿

第十七条 企业由债权人申请破产的，在人民法院受理案件后三个月内，被申请破产的企业的高级主管部门可以申请对该企业进行整顿，整顿的期限不超过两年。

第十八条 整顿申请提出后，企业应当向债权人会议提出和解协议草案。

和解协议应当规定企业清偿债务的期限。

第十九条 企业和债权人会议达成和解协议，经人民法院认可后，由人民法院发布公告，中止破产程序。

和解协议自公告之日起具有法律效力。

第二十条 企业的整顿由其上级主管部门负责主持。

企业整顿方案应当经过企业职工代表大会讨论，企业整顿的情况应当向企业职工代表大会报告，并听取意见。

企业整顿的情况应当定期向债权人会议报告。

第二十一条 整顿期间，企业有下列情形之一的，经人民法院裁定，终结该企业的整顿，宣告其破产：

However, in order to pass a resolution for a draft reconciliation plan, two thirds or more of the total amount of claims for unsecured credit must be represented.

Resolutions of the creditors' meetings have binding force on all of the creditors.

Where a creditor considers that a resolution of the creditors' meeting is unlawful he may seek an order from the People's Courts within seven days from the passage of such resolution.

PART FOUR: RECONCILIATION AND REORGANIZATION

Article 17: Where an enterprise has been petitioned for insolvency by its creditors, the superior department in charge of the enterprise may apply to the People's Court which has accepted the case within three months of such acceptance to conduct reorganization. The period for reorganization may not exceed two years.

Article 18: After presenting an application for reorganization, the enterprise shall submit a draft reconciliation agreement to the creditors' meeting.

The draft reconciliation agreement shall stipulate the period within which the enterprise must repay its debts.

Article 19: Where the enterprise and the creditors reach a reconciliation agreement, after approval and publication of a notice by the People's Court, the winding up will be stayed.

The reconciliation agreement will have legal effect from the date of publication of the notice.

Article 20: The superior department in charge of the enterprise will be responsible for directing the reorganization.

The enterprise reorganization plan shall be passed to a meeting of employee representatives for discussion. The circumstances of reorganising the enterprise shall be reported to the employees' meeting and the opinions of the its members shall be solicited

The circumstances of the enterprises' reorganization shall be reported periodically to the creditors' meeting.

Article 21: Where any one of the following situations occur during the period of reorganization, pursuant to an order of the People's Court, the enterprise reorganization process will terminate and the enterprise will be declared insolvent

- (1) the reconciliation agreement is not implemented;
- (2) The financial situation continues to deteriorate and the creditors' meeting applies for the termination of reorganization proceedings; or
- (3) one of the categories of conduct referred to in Article 35 of this law occurs, seriously damaging the interests of the creditors.

Article 22: Where during the course of reorganization, the enterprise is able to repay its debts in accordance with the reconciliation agreement, the People's Court shall terminate the enterprise's insolvency proceedings and shall publish a notice to this effect.

Where the period for reorganization has expired and the enterprise is unable to repay its debts in accordance with the reconciliation agreement, the People's Court shall declare the enterprise insolvent and in accordance with the provisions of Article 9 of this law, it shall reregister creditors.

PART FIVE: DECLARATION OF INSOLVENCY AND LIQUIDATION

Article 23: In any one of the following situations, the People's Court will declare an enterprise insolvent:

- (1) where insolvency should be declared in accordance with the provisions of Article 3 of this law; or
- (2) where reorganization has been terminated in accordance with Article twenty one of this law;
- (3) where the period for reorganization has expired and the enterprise is unable to repay its debts in accordance with the reconciliation agreement in accordance with Article 22 para. 2.

Article 24: Within fifteen days of declaring the enterprise insolvent, the People's Court shall appoint a liquidating committee to take over the affairs of the insolvent enterprise.

The liquidating committee is responsible for the safe custody, organization, valuation, disposal and distribution of the insolvent assets.

The liquidating committee can legitimately conduct necessary civil law activities.

The liquidating committee shall be selected by the People's Court from the supervisors or department in charge of the enterprise, relevant government officials,

- (一) 不执行和解协议的；
- (二) 财务状况继续恶化，债权人会议申请终结整顿的；
- (三) 有本法第三十五条所列行为之一，严重损害债权人利益的。

第二十二條 经过整顿，企业能够按照和解协议清偿债务的，人民法院应当终结对该企业的破产程序并且予以公告。

整顿期满，企业不能按照和解协议清偿债务的，人民法院应当宣告该企业破产，并且按照本法第九条的规定重新登记债权。

第五章 破产宣告和破产清算

第二十三條 有下列情形之一的，由人民法院裁定，宣告企业破产：

- (一) 依照本法第三条的规定应当宣告破产的；
- (二) 依照本法第二十一条的规定终结整顿的；
- (三) 整顿期满，不能按照和解协议清偿债务的。

第二十四條 人民法院应当自宣告企业破产之日起十五日内成立清算组，接管破产企业。

清算组负责破产财产的保管、清理、估价、处理和分配。

清算组可以依法进行必要的民事活动。

清算组成员由人民法院从企业上级主管部门、政府财政部门等有关部门和专业人员中指定。清算组可以聘任必要的工作人员。

清算组对人民法院负责并且报告工作。

第二十五条 任何单位和个人不得非法处理破产企业的财产、帐册、文书、资料 and 印章等。破产企业的债务人和财产持有人，只能向清算组清偿债务或者交付财产。

第二十六条 对破产企业未履行的合同，清算组可以决定解除或者继续履行。

清算组决定解除合同，另一方当事人因合同解除受到损害的，其损害赔偿作为破产债权。

第二十七条 破产企业的法定代表人在向清算组办理移交手续前，负责保管本企业的财产、帐册、文书、资料 and 印章等。

破产企业的法定代表人在破产程序终结以前，根据人民法院或者清算组的要求进行工作，不得擅离职守。

第二十八条 破产财产由下列财产构成：

- (一) 宣告破产时破产企业经营管理的全部财产；
- (二) 破产企业在破产宣告后至破产程序终结前所取得的财产；
- (三) 应当由破产企业行使的其他财产权利。

已作为担保物的财产不属于破产财产；担保物的价款超过其所担保的债务数额的，超过部分属于破产财产。

第二十九条 破产企业内属于他人的财产，由该财产的权利人通过清算组取回。

The liquidating committee is answerable to the People's Court and shall report its work to the court.

Article 25: No unit or individual may illicitly deal with the property, account books, documents, seal or other materials of the insolvent enterprise. The debtors and property holders of the insolvent enterprise may only repay debts or deliver possession of such property to the liquidating committee.

Article 26: The liquidating committee may decide whether to rescind or continue to perform undischarged contracts.

Where the liquidating committee decides to rescind a contract and where the other party to the contract suffers losses, the amount of such losses shall be taken as insolvency claims.

Article 27: The legal representatives of the insolvent enterprise shall be responsible for the safe custody of the assets, account books, documents, seal and other such materials for the period before the transferral of formalities to the liquidating committee.

The legal representatives of the insolvent enterprise shall continue to work according to the requirements of the People's Court or the liquidating committee until the conclusion of the winding up. They may not leave their work without authorisation.

Article 28: The assets available for distribution shall consist of the following:

- (1) all of the property of the enterprise which is being operated and managed at the time of the declaration of insolvency;
- (2) such property as is acquired by the enterprise as from the time of the declaration of insolvency up until the termination of winding up; and
- (3) other proprietary interests as shall be exercised by the insolvent enterprise.

Such items as have been already encumbered as security shall not constitute assets available for distribution. However where the value of the secured item surpasses the amount of the secured debt, such excess portion shall constitute assets available for distribution.

Article 29: Property within the insolvent enterprise which belongs to third persons may be reappropriated through the liquidating committee by persons who have an interest in such property

第三十条 破产宣告前成立的无财产担保的债权和放弃优先受偿权利的有财产担保的债权为破产债权。

债权人参加破产程序的费用不得作为破产债权。

第三十一条 破产宣告时未到期的债权，视为已到期债权，但是应当减去未到期利息。

第三十二条 破产宣告前成立的有财产担保的债权，债权人享有就该担保物优先受偿的权利。

有财产担保的债权，其数额超过担保物的价款的，未受清偿的部分，作为破产债权，依照破产程序受偿。

第三十三条 债权人对破产企业负有债务的，可以在破产清算前抵销。

第三十四条 下列破产费用，应当从破产财产中优先拨付：

- (一) 破产财产的管理、变卖和分配所需要的费用，包括聘任工作人员的费用；
- (二) 破产案件的诉讼费用；
- (三) 为债权人的共同利益而在破产程序中支付的其他费用。

破产财产不足以支付破产费用的，人民法院应当宣告破产程序终结。

第三十五条 人民法院受理破产案件前六个月至破产宣告之日的期间内，破产企业的下列行为无效：

- (一) 隐匿、私分或者无偿转让财产；
- (二) 非正常压价出售财产；

Article 30: Insolvency claims shall comprise unsecured credit extant before the declaration of insolvency and secured credit for which the right of priority has been abandoned.

The expenses of creditors who participate in winding up shall not constitute insolvency claims. Priority for repayment of such expenses is provided in Article 34 (1).

Article 31: Credit which is not due at the time of the declaration of insolvency shall be deemed due. However unaccrued interest shall not be included.

Article 32: Creditors whose credit was secured before the declaration of insolvency shall enjoy a right of priority to receive compensation in respect of the item secured.

Where the amount of the secured credit exceeds the value of the item secured, such unrecovered portion shall be taken as an insolvency claim and shall be recovered according to the winding up.

Article 33: Where a creditor is also in debt to the insolvent enterprise, the enterprise may set off such debt against its credit before the commencement of the liquidation proceedings.

Article 34: The following expenses of insolvency shall be paid in priority from the assets available for distribution:

- (1) expenses incurred in administration, liquidation and distribution of the assets available for distribution;
- (2) legal expenses incurred in the insolvency case; and
- (3) other expenses incurred for the joint benefit of the creditors and defrayed during the course of the winding up.

Where the assets available for distribution are insufficient to defray the expenses of the winding up, the People's Court shall declare the winding up terminated.

Article 35: The following acts of an insolvent enterprise are invalid where they occur within the period commencing six months prior to the acceptance of the case by the People's Court until the date of the declaration of insolvency:

- (1) concealment, illicit distribution or gratuitous transfer of property
- (2) underselling property

- (3) providing security to creditors whose credit was originally unsecured;
- (4) repayment of debts not due as at the time of repayment; and
- (5) abandoning one's own credit

Where the insolvent enterprise has committed any of the acts listed above, the liquidating committee has authority to apply to the People's Court for recovery of the property. Recovered property shall form part of the assets available for distribution.

Article 36: Where the assets available for distribution include equipment which forms sets, such sets shall be sold in their entirety. Where they cannot be sold in entirety, they may be sold separately.

Article 37: The liquidating committee shall propose an assets available for distribution plan which shall be implemented pursuant to being discussed and passed by the creditors' meeting and after obtaining an order from the People's Court.

After defraying the expenses of the winding up, repayments will be made from the assets available for distribution in the following sequence.

- (1) employees' wages and labour insurance expenses owed by the insolvent enterprise;
- (2) taxes owed by the insolvent enterprise; and
- (3) insolvency claims.

Where the assets available for distribution are insufficient to satisfy the claims of the same ranking, the property will be distributed proportionally within that ranking.

Article 38: When distribution of the assets available for distribution is complete, the liquidating committee shall apply to the People's Court to terminate the winding up. When the winding up has been terminated, such claims as have not been satisfied shall be extinguished.

Article 39: After the termination of the winding up, the liquidating committee shall arrange for cancellation of registration of the insolvent enterprise at its original registration office. The enterprise is probably dissolved at the time of cancellation of its registration. No provision otherwise exists for an order for dissolution.

Article 40: Where any of the acts mentioned in Article 35 of the Insolvency Law

- (三) 对原来没有财产担保的债务提供财产担保;
- (四) 对未到期的债务提前清偿;
- (五) 放弃自己的债权。

破产企业有前款所列行为的,清算组有权向人民法院申请追回财产,并入破产财产。

第三十六条 破产财产中的成套设备,应当整体出售;不能整体出售的,可以分散出售。

第三十七条 清算组提出破产财产分配方案,经债权人会议讨论通过,报请人民法院裁定后执行。

破产财产优先拨付破产费用后,按照下列顺序清偿:

- (一) 破产企业所欠职工工资和劳动保险费用;
- (二) 破产企业所欠税款;
- (三) 破产债权。

破产财产不足清偿同一顺序的清偿要求的,按照比例分配。

第三十八条 破产财产分配完毕,由清算组提请人民法院终结破产程序。破产程序终结后,未得到清偿的债权不再清偿。

第三十九条 破产程序终结后,由清算组向破产企业原登记机关办理注销登记。

第四十条 破产企业有本法第三十五条所列行为之一,自破产程序终结之日

起一年內被重查的，由人民法院追回財產，依照本法第三十七條的規定執行。

第四十一條 破產企業有本法第三十五條所列行為之一的，對破產企業的法定代表人和直接責任人員給予行政處分：

破產企業的法定代表人和直接責任人員的行為構成犯罪的，依法追究刑事責任。

第四十二條 企業被宣告破產後，由政府監察部門和審計部門負責查明企業破產的責任。

破產企業的法定代表人對企業破產負有主要責任的，給予行政處分。

破產企業的上級主管部門對企業破產負有主要責任的，對該上級主管部門的領導人，給予行政處分。

破產企業的法定代表人和破產企業的上級主管部門的領導人，因疏忽職守造成企業破產，致使國家財產遭受重大損失的，依照《中華人民共和國刑法》第一百八十七條的規定追究刑事責任。

第六章 附則

第四十三條 本法自全民所有制工業企業法實施滿三個月之日起施行，試行的具體部署和步驟由國務院規定。

relation to an insolvent enterprise, the People's Court may recover the assets discovered within one year of the conclusion of the winding up and make repayments in accordance with Article 37 of this law.

Article 41: Where any of the acts mentioned in Article 35 of this law occur in relation to an insolvent enterprise, the legal representatives of the enterprise and the personnel directly responsible shall be punished administratively.

Where the acts of the legal representatives of the enterprise and the personnel directly responsible constitute a crime they will be prosecuted according to the law.

Article 42: After the enterprise has been declared insolvent, government supervisory departments and auditing departments will investigate the personal responsibility for the insolvency of the enterprise

The legal representatives of the insolvent enterprise who are principally responsible for the insolvency shall be punished administratively.

The leaders in the superior departments in charge of the insolvent enterprise who are principally responsible for the insolvency will be punished administratively.

Legal representatives of the insolvent enterprise and leaders of the superior departments in charge of the enterprise that have caused the insolvency of the enterprise through dereliction of duty, resulting in great losses to the nation, shall be prosecuted according to the provisions of Article 187 of the PRC Criminal Law.

PART SIX: SUPPLEMENTARY

Article 43: This Law will take effect three months after the implementation of *Ownership of the Whole People Industrial Enterprise Law*. Specific measures for the implementation and deployment of the Law will be provided by the State Council.

最高人民法院贯彻执行《中华人民共和国企业破产法（试行）》若干问题的意见

Ref no: 2500/91.11.07

(1991年11月7日发布。)

为了正确贯彻执行《中华人民共和国企业破产法（试行）》（以下简称企业破产法），根据企业破产法和审判实践经验，现就破产诉讼中的若干问题提出如下意见：

一、管辖

1、企业破产案件由债务人所在地人民法院管辖。债务人所在地是指企业主要办事机构所在地。

2、基层人民法院一般管辖县、县级市或区的工商行政管理机关核准登记企业的破产案件；

中级人民法院一般管辖地区、地级市（含本级）以上工商行政管理机关核准登记企业的破产案件；

个别案件的级别管辖，可以依照《中华人民共和国民事诉讼法》（以下简称民事诉讼法）第三十九条第一款和第二款的规定办理。

二、破产申请

3、提出破产申请，应当采用书面形式。

4、债权人提出破产申请，应当向人民法院提供下列材料：

- (1) 债权发生事实及有关证据；
- (2) 债权性质、数额；
- (3) 债权有无财产担保、有财产担保的，应当提供证据；

Supreme People's Court, Questions on the
<<People's Republic of China, Enterprise
Insolvency Law (Trial Implementation)>> Opinion

Ref no: 2500/91.11.07

(Promulgated on 7 November 1991)

In accordance with the Enterprise Insolvency Law, actual judicial experience, and in order to correctly implement the PRC, State Enterprise Insolvency Law (Trial) (hereafter, "Enterprise Insolvency Law"), the following Opinion regarding several questions on insolvency litigation is now issued:

PART ONE: JURISDICTION

1: Enterprise insolvency cases shall be under the jurisdiction of the People's Court where the debtor is located. "Where the debtor is located" shall refer to where the main administrative organization of an enterprise is located.

2: Basic-level People's Courts shall generally have jurisdiction over the insolvency cases of enterprises examined and approved by and registered with county, county-level municipality or district industrial and commercial administrative authorities.

Intermediary People's Courts shall generally have jurisdiction over cases of insolvency involving enterprises examined and approved by and registered with regional, regional-level municipality or higher level industrial and commercial administrative authorities.

Jurisdiction for individual insolvency cases may be handled in accordance with Paragraphs 1 and 2 of Article 39 of the PRC, Civil Procedure Law (hereafter, "Civil Procedure Law").

PART TWO : APPLICATION FOR INSOLVENCY

3. Applications for insolvency must be in written form

4. Where an application for insolvency is submitted by a creditor, the following materials must be submitted to a People's Court

- (1) the facts of the loan and relevant evidence;
- (2) the nature and amount of the loan;
- (3) whether or not the loan is secured by property and if it is, whether of such property and

(4) 债务人不能清偿到期债务的有关证据。

5、债务人提出破产申请，应当向人民法院提供下列材料：

- (1) 企业亏损情况的说明；
- (2) 会计报表；
- (3) 企业财产状况明细表和有形财产的处所；
- (4) 债权清册和债务清册（包括债权人、债务人名单、住所、开户银行、债权债务发生的时间、债权债务数额，有无争议等）；
- (5) 破产企业上级主管部门或者政府授权部门同意其申请破产的意见；
- (6) 人民法院认为依法应当提供的其他材料。

三、破产案件的受理

6、人民法院收到破产申请后，应当依照企业破产法第七条、第八条和第三条的规定进行审查，并在七日内决定是否立案。

人民法院经审查认为破产申请需要更正、补充材料的，可以责令申请人限期更正、补充。按期更正、补充材料的，自收到更正补充材料的次日起七日内决定是否立案；逾期不予更正、补充的，视为撤回申请。

7、申请人不服人民法院驳回破产申请裁定的，有权向上一级人民法院提起上诉。上诉的期限为十日。

(4) evidence that the debtor is unable to repay the loan on time

5. Where an application for insolvency is submitted by a debtor, the following materials must be submitted to a People's Court:

- (1) an explanation of the circumstances regarding losses incurred by the enterprise;
- (2) an accounting statement;
- (3) a report detailing the enterprise's assets and the location of tangible assets;
- (4) a detailed list of creditors and debtors (including the names and domiciles of creditors and debtors, banks at which they have accounts, time during which the loan took place, amount of the loan, whether or not disputes exist, etc);
- (5) the consent to the application for insolvency of the superior department in charge of the insolvent enterprise or a department authorized by the government; and
- (6) other materials that a People's Court considers must be provided in accordance with the law.

PART THREE : ACCEPTANCE OF INSOLVENCY CASES

6: After receiving an application for insolvency, a People's Court shall conduct an investigation in accordance with Articles 3, 7 and 8 of the Enterprise Insolvency Law, and within seven days, shall decide whether or not to place the case on file.

Where a People's Court, after investigation, considers that an application for insolvency requires corrected or supplementary materials, it may order the applicant to provide corrected or supplementary materials within a set time period. Where corrected or supplementary materials are provided on time, within seven days of the receipt of such materials, a People's Court shall decide whether or not to place the case on file. Where corrected or supplementary materials are not provided on time, the application shall be deemed' have been withdrawn.

7: Where an applicant does not agree with the decision of a People's Court to

8、企业破产法第三条第一款中的“不能清偿到期债务”，是指：

- (1) 债务的清偿期限已经届满；
- (2) 债权人已要求清偿；
- (3) 债务人明显缺乏清偿能力。

债务人停止支付到期债务并呈连续状态，如无相反证据，可推定为“不能清偿到期债务”。

9、人民法院受理破产案件后，应当组成合议庭进行审理。

10、人民法院受理破产案件后，应当在十日内发布公告。公告除了在受理破产案件的人民法院公告栏内张贴外，还应根据具体情况（如债权人所分布的区域、破产财产所在的区域等）在地方或全国性报刊上登载。公告应包括下列内容：

- (1) 立案时间；
- (2) 破产案件的债务人；
- (3) 申报债权的期限、地点和逾期未报的法律后果；
- (4) 第一次债权人会议召开的日期、地点等。

11、人民法院受理破产案件后，应当在十日内通知债务人，在收到债务人提交的债务清册后十日内通知已知的债权人。

通知已知债权人的通知书应包括本意见第10条第(3)、(4)项内容。

12、人民法院受理破产案件后，以破产企业为债务人的其他经济纠纷案件，根据下列不同情况分别处理：

8: The phrase "inability to repay the loan on time" in Paragraph 1 of Article 3 of the Enterprise Insolvency Law shall refer to:

- (1) the term of repayment of the loan has already expired;
- (2) the creditor has already requested repayment; and
- (3) the debtor clearly lacks the ability to repay the loan.

Where the debtor stops payments on a loan that has fallen due and continues not to pay, and if there is no evidence to the contrary, such debtor may be deemed "unable to repay the loan on time".

9: After a People's Court accepts an insolvency case, it shall organize a collegiate bench to conduct a hearing.

10: Within ten days of accepting an insolvency case, a People's Court shall issue a public notice. Such public notice, in addition to being posted within the public notice railings of the People's Court that has accepted the insolvency case, shall be published in local or national periodicals in accordance with the details of the case (such as the districts or cities over which the creditors are distributed, the districts or cities in which the assets available for distribution are located, etc). Public notices shall include the following information:

- (1) when the case was placed on file;
- (2) the debtor(s) involved in the insolvency case;
- (3) time limit in which and location at which to lodge claims, and the legal consequences of failure to lodge claims on time; and
- (4) the time and location of the first creditors' meeting

11: Within ten days of accepting an insolvency case, a People's Court shall notify the debtor, and within 10 days of accepting a detailed list of debts submitted by the debtor, such court shall notify known creditors

The notice to known creditors shall include the information specified in Items 3 and 4 of Article 10 of this Opinion.

12: After a People's Court accepts an insolvency case, cases of other economic disputes involving the insolvent enterprise as a debtor shall be handled in accordance with their different circumstances as follows:

(1) 已经审结但未执行的，应当中止执行，由债权人凭生效的法律文书向受理破产案件的人民法院申报债务；

(2) 尚未审结且另无连带责任人，应当终结诉讼，由债权人向受理破产案件的人民法院申报债权；

(3) 尚未审结且另有连带责任人，应当中止诉讼，由债权人向受理破产案件的人民法院申报债权。待破产程序终结后，恢复审理。

13、 人民法院受理破产案件后，以破产企业为债权人的其他经济纠纷案件，受诉人民法院不能在三个月以内结案时，应当移送受理破产案件的人人民法院，由受理破产案件的人民法院按照本意见第45条、第46条的规定办理。

14、 人民法院受理破产案件后，发现破产企业作为债权人的案件在其他人民法院并且三个月以内难以审结的，应通知该人人民法院移送。

15、 在民事诉讼执行程序或民事执行程序进行中，人民法院获悉债务人不能清偿到期债务时，应当告知债务人可以向其所在地人民法院申请破产。

申请破产的，债务人所在地的人民法院应当依法宣告债务人破产。

不申请破产的，不依职权宣告债务人破产，原诉讼程序或执行程序可继续进行。

16、 依照企业破产法第十条第二款的规定，债务人为其他单位担任保证人的，应当在收到人民法院破产立案通知后五日内将告知当事人，债权人得知保证人（债务人）破产的情况后，享有是否将其债权作为破产债权的选择权。债权人既不参加破产程序又不告知保证人的，保证人（债务人）的保证义务即自此终止；债权人参加破产程序的，债权人应在破产宣告时所享有的债权申报即为破产债权，参加分配后仍然可就其未受清偿的债权向该保证人求偿。

(1) enforcement shall be suspended on cases that have already been decided but have not been enforced, and claims shall be lodged by the creditor on the strength of valid legal documents with the People's Court that accepted the insolvency case;

(2) litigation shall be suspended on cases that have not yet been decided and in which there are no other parties jointly liable, and claims shall be lodged by the creditor with the People's Court that accepted the insolvency case; and

(3) litigation shall be suspended on cases that have not yet been decided and in which there are other parties jointly and severally liable, and claims shall be lodged by the creditor with the People's Court that accepted the insolvency case. After the insolvency process is completed, the hearing shall continue.

13: After a People's Court accepts an insolvency case, other economic dispute cases involving the insolvent enterprise as a creditor that cannot be settled within 3 months of being accepted by a People's Court shall be transferred to the People's Court that accepted the insolvency case and shall be handled by such People's Court in accordance with Articles 45 and 46 of this Opinion.

14: Where, after a People's Court accepts an insolvency case, it is discovered that a case involving the insolvent enterprise as a creditor exists with another People's Court and is not likely to be decided within 3 months, such People's Court shall be ordered to transfer the case.

15: Where, during civil proceedings or civil enforcement, a People's Court learns that a debtor is unable to repay a debt on time, such court shall notify such debtor that it may apply for insolvency with the People's Court where it is located.

Where an application for insolvency is submitted, the People's Court where the debtor is located shall declare the debtor insolvent in accordance with the law.

Where an application for insolvency is not submitted, such court shall not exercise its powers to declare the debtor insolvent. The original proceedings or enforcement process may continue.

16: Where a debtor has undertaken to act as a guarantor for another work unit in accordance with Paragraph 2 of Article 10 of the Enterprises Insolvency Law, such debtor must inform the relevant parties within 5 days of receipt of a notice that a People's Court has placed the insolvency case on file. After a creditor has been informed of the details of a guarantor's (debtor's) insolvency, such creditor has the right to choose whether or not to include the debt owed to it in the insolvency claims. Where the creditor does not participate in the insolvency process and does not notify the guarantor, the obligations of a guarantor (debtor) to guarantee the debt are terminated. Where the creditor does participate in the insolvency process, the amount of the debt owed to the creditor at the time of the declaration of insolvency shall be the insolvency claim. After participation in the liquidation of funds, the creditor may seek repayment from the guarantor (debtor).

17、人民法院发布立案公告后，债权人只能申报债权，不能向受理破产案件的人民法院提起新的诉讼。申报书应具有本意见第4条所列前三项内容。

18、人民法院对于申报的债权，应当指派专人负责登记造册。

19、人民法院受理破产案件后，应当立即通知债务人自收到通知之日起，停止清偿债务。债务人正常生产经营活动所必须清偿的，在清算组成立前应当经人民法院审查批准。

债务人收到人民法院关于停止清偿债务的通知后，仍然对部分债权人清偿债务或者企业破产法第三十五条第一款所列行为者，人民法院应当裁定无效，追回该项财产，并可依照民事诉讼法第一百零二条、第一百零四条的规定对法定代表人、上级主管部门负责人以及其他直接责任者进行处罚。

20、人民法院受理破产案件后，应当及时通知债务人的开户银行停止办理债务人清偿债务的结算业务；开户银行支付维持债务人正常生产经营所必需的费用，需经人民法院许可。

21、债务人的开户银行收到人民法院的通知后，不得扣划债务人的既存款和汇入款抵还贷款。扣回的无效，应当退回扣划的款项。拒不退回的，人民法院应当裁定其退回并向其开户银行制发协助执行通知书，并可依照民事诉讼法第一百零二条、第一百零四条的规定对有关人员和直接责任者予以处罚。

22、人民法院受理破产案件后，应向企业全体职工发布布告，要求他们保护好企业财产，不得非法处理企业的帐册、文书、资料 and 印章，不得隐匿、私分、无偿转让、非正常压价出售企业的财产。

17: After a People's Court has published a public notice regarding its placing of a case on file, a creditor may only lodge claims and may not initiate new proceedings with the People's Court that has accepted the insolvency case. An application to lodge a claim shall contain the information listed in Items 1 to 3 of Article 4 of this Opinion.

18: The People's Court shall assign a particular individual to be responsible for the registration and recording of claims that are lodged.

19: After accepting an insolvency case, a People's Court shall promptly notify the debtor that it must immediately cease repayment of debts upon receipt of such notice. Payments that must be made for the normal production and operation of the debtor must be investigated and approved by the People's Court before the establishment of the liquidation committee.

Where debtors, upon receipt of a notice from a People's Court regarding the cessation of repayment of debts, continue to repay some creditors, and actions that are among those listed in Paragraph 1 of Article 35 of the Enterprise Insolvency Law, shall be ruled void by the People's Courts. The People's Courts shall recover such property and may penalize the legal representative, the person responsible at the superior department in charge or any other directly responsible parties in accordance with Articles 102 and 104 of the Civil Procedure Law.

20: After accepting an insolvency case, a People's Court must promptly notify the bank at which the debtor has an account that such bank must cease the handling of settlement business for the debtors' repayment of debts. The payment of expenses by such bank required to maintain the normal production and operation of the debtor must be approved by a People's Court.

21: After a bank at which a debtor has an account receives notice from the People's Court, it may not deduct or transfer funds from deposits that the debtor has already made or from remittances received to repay loans. Deductions or transferrals shall be void, and funds deducted or transferred must be returned. If a bank refuses to return such funds, the People's Court shall order that they be returned and shall formulate and issue an enforcement assistance notice to such bank, and may penalize relevant personnel and directly responsible parties in accordance with the provisions in Articles 102 and 104 of the Civil Procedure Law.

22: After accepting an insolvency case, a People's Court shall issue a public notice to all staff and workers of the enterprise requesting them to protect the property of the enterprise and not to allow illegal disposal of account books, documents, materials or seals of the enterprise, or concealment, illicit distribution, gratuitous transfer or underselling of the property of the enterprise.

破产企业的法定代表人或主要负责人在破产程序终结以前，擅离职守或以其他方式逃避的，或者拒绝向清算组办理交接手续的，或者有其他妨碍清算行为的，人民法院可以根据情节轻重，予以罚款、拘留；构成犯罪的，依法追究刑事责任。

四、 债权人会议

23、第一次债权人会议由人民法院主持，以后的债权人会议由会议主席主持。

24、人民法院召集第一次债权人会议时，应当宣布债权人资格审查结果，并指定并宣布债权人会议主席，宣布债权人会议的职权及其他有关事项，并通报债务人的生产、经营、财产、债务的基本情况。

25、债权人会议主席召开债权人会议，应在发出通知前三日报告人民法院。

26、债权人可以委托代理人出席债权人会议，行使表决权。代理人应向人民法院或债权人会议主席提交由委托人签名盖章的授权委托书。

27、召开债权人会议，召集人应在开会前七日（外地应为二十日）将会议的时间、地点、内容、目的等事項通知债权人。

28、债权人会议决议的表决，以出席会议的有表决权的债权人计算票数，以其代表的债权额计算表决的债权额。

29、企业破产法第十六条第一款的“半数以上”、“三分之二以上”均包括本数，“过半数”不包括本数。

30、行使表决权的债权人所代表的债权额，按债权人会议确定的债权额计算。对债权人会议确定的债权额有争议的，由人民法院审查后裁定，并按裁定所确认的债权额计算。

Where, prior to the conclusion of the insolvency process, the legal representative of the insolvent enterprise leaves his post without authorization or otherwise evades his responsibilities, or refuses to handle handover procedures for the liquidation committee, or engages in any of the actions listed in Article 102 of the Civil Procedure Law, a People's Court may impose fines or detention in accordance with the seriousness of the case. If the matter constitutes a crime, criminal liability shall be pursued.

PART FOUR : CREDITORS' MEETINGS

23: The first creditors' meeting shall be presided over by a People's Court. Succeeding creditors' meetings shall be presided over by the chairman of the creditors' meetings.

24: When convening the first creditors' meeting, the People's Court shall announce the results of the investigation of the qualifications of creditors, and shall appoint and announce the chairman of the creditors' meetings, the authority of the creditors' meetings and other relevant matters. Such court shall also circulate a notice concerning the basic condition of the production, operation, assets and liabilities of the debtor.

25: Where the chairman of the creditors' meetings convenes a creditors' meeting, he shall notify the People's Court three days prior to issuing a notice to convene a meeting.

26: Creditors may commission an agent to attend creditors' meetings and exercise such creditors right to vote. The agent shall submit to the People's Court or to the chairman of the creditors' meetings, power of attorney signed and sealed by the commissioning creditor.

27: Seven days before the convening of a creditors's meeting (20 days if in another area), the convener shall notify creditors of such matters as the time, place, content and purpose of the meeting.

28: For votes on resolutions at a creditors' meeting, the number of votes shall be calculated on the basis of the number of creditors attending the meeting that have the right to vote, and the quantity of creditors' rights represented by the votes shall be calculated on the basis of the quantity of creditors' rights held by the creditors

29: In Paragraph 1 of Article 16 of the Enterprise Insolvency Law, the phrases "at least half" and "at least two-thirds" shall include half and two thirds respectively, but the phrase "more than half" shall not include half.

30: The quantity of creditors' rights represented by a creditor that exercises its right to vote shall be calculated on the basis of the quantity of its creditors' rights determined by the creditors' meeting. If disputes arise concerning the quantity of creditors' rights determined by the creditors' meeting, a People's Court shall make a ruling after investigation and shall calculate such right, on the basis of the creditors' rights confirmed by such ruling.

31、清算组提出破产财产分配方案，经债权人会议多次讨论仍未通过的，人民法院应根据具体情况及时作出裁定。

32、债务人的上级主管部门可以派员列席债权人会议。债务人的法定代表人必须列席债权人会议并有义务回答债权人的询问，拒绝列席的，人民法院可以依照民事诉讼法第一百零六条的规定拘传。

五、和解和整顿

33、企业由债权人申请破产，其上级主管部门申请对该企业进行整顿的，应向人民法院、债权人会议提交整顿方案。整顿方案应当具有下列内容：

- (1) 对企业达到破产界限的原因的分析；
- (2) 调整或组建企业新的领导班子的计划；
- (3) 改善经营管理的措施和改进、转产措施的可行性；
- (4) 扭亏增盈的办法；
- (5) 整顿的期限（不得超过两年）和目标等。

34、被申请整顿的企业应当向债权人会议提交和解协议草案，和解协议草案应具有下列内容：

- (1) 清偿债务的财产来源；
- (2) 清偿债务的办法；
- (3) 清偿债务的期限等。

31: Where an assets available for distribution plan submitted by a liquidation committee has still not been passed after being discussed several times by creditors' meetings, a People's Court shall make a ruling based on the specific details of the case in a timely manner.

32: The superior department in charge of the debtor may assign someone to attend creditors' meetings as a non-voting participant. The legal representative of the debtor must attend creditors' meetings as a non-voting participant and has an obligation to respond to the queries of creditors. Where such legal representative refuses to attend meetings as a non-voting participant, the People's Court may subpoena him in accordance with Article 100 of the Civil Procedure Law.

PART FIVE : RECONCILIATION AND REORGANIZATION

33: Where an enterprise has been petitioned for insolvency by its creditors, and the superior department in charge of it applies for such enterprise to undergo reorganization, a reorganization plan shall be submitted to a People's Court or to a creditors' meeting. The reorganization plan shall include the following:

- (1) analysis of the reasons for the enterprise having reached the edge of insolvency;
- (2) plan for the adjustment or establishment of a new leading group for the enterprise;
- (3) feasibility concerning measures and reforms to be taken for the improvement of business management and measures to be taken for changes in production;
- (4) methods of reducing losses and increasing profits; and
- (5) term of reorganization (not to exceed two years) and objectives, etc

34: Where an application for reorganization of an enterprise is made, a draft reconciliation agreement shall be submitted to a creditors' meeting. The draft reconciliation agreement shall include the following:

- (1) sources of capital for debt repayment;
- (2) method of debt repayment; and
- (3) term of debt repayment

被申请整顿的企业如果要求减少债务的，还应写明请求减少的数额。

35、企业与债权人会议达成和解协议，经人民法院认可后，由人民法院发布公告，中止破产程序；企业与债权人达不成和解协议的，由人民法院裁定宣告企业破产。

36、企业整顿期间，企业的上级主管部门应当定期向债权人会议和人民法院报告整顿情况、和解协议执行情况。

37、企业整顿期间，企业有企业破产法第二十一条第一款和第三项所列情形之一的，部分债权人或债权人会议均有权申请终结整顿。

38、企业整顿期间，人民法院发现债务人企业破产法第二十一条所列情形之一的，应当裁定终结该企业的整顿，宣告其破产。

39、经过整顿，企业能够偿还到期债务的，只能按照和解协议规定的期限、数额清偿。但是，有财产担保并且没有放弃优先权的债权，不在此限。

担保债权人在破产案件受理后至破产宣告前非经人民法院同意，不得行使优先权。

40、人民法院受理破产案件后，企业的上级主管部门不申请整顿的，即依法宣告其破产。

六、破产宣告

41、人民法院宣告企业破产，应当公开进行。

42、人民法院宣告企业破产，应当通知债权人、债务人到庭。当庭宣布裁定。拒不到庭的，不影响裁定的效力。

If enterprises that apply for reorganization require a reduction of debts, the application shall also clearly state the amount of reduction requested.

35: Where the enterprise and the creditors reach a reconciliation agreement, after approval and publication of a notice by a People's Court, the insolvency process shall be suspended. Where an enterprise is unable to reach a reconciliation agreement with its creditors, a People's Court shall declare the enterprise insolvent.

36: During the reorganization period of an enterprise, the superior department in charge of the enterprise shall report the circumstances of the reorganization and the implementation of the reconciliation agreement periodically to creditors' meetings or to a People's Court

37: During the reorganization period of an enterprise, where one of the conditions listed in Items 1 and 3 of Article 21 of the Enterprise Insolvency Law pertains to the enterprise, a portion of the creditors or all the creditors in the creditors' meetings have the right to apply for termination of reorganization.

38: During the reorganization period of an enterprise, where a People's Court discovers that one of the conditions listed in Article 21 of the Enterprise Insolvency Law pertains to the enterprise, such court shall rule to terminate reorganization of the enterprise and declare such enterprise insolvent.

39: After reorganization, where an enterprise is able to repay debts on time, it may only repay them in accordance with the term and amounts in the reconciliation agreement. However, the repayment of debts that are secured with property and for which priority rights have not been renounced shall not be so restricted.

During the time after an insolvency case has been accepted by the court but before insolvency has been declared without the consent of the People's Court, the creditor of a loan secured may not exercise priority rights.

40: After a People's Court has accepted an insolvency case, where the superior department in charge of an enterprise does not apply for reorganization, the People's Court may declare the enterprise insolvent in accordance with the law.

PART SIX : DECLARATION OF INSOLVENCY

41: A People's Court shall publicly declare an enterprise insolvent

42: Where a People's Court declares an enterprise insolvent, it shall order the creditors and the debtors to come to the court, where a ruling shall be issued. Where a party refuses to come to the court, the validity of the ruling shall not

43、人民法院宣告企业破产的裁定自宣告之日起发生法律效力，破产企业自即日起应当停止生产经营活动，但人民法院或清算组认为确有必要继续生产经营的除外。

44、人民法院裁定宣告企业破产的同时可发布公告。公告应具有下列内容：

- (1) 企业亏损、资产负债状况；
- (2) 宣告企业破产的理由和法律根据；
- (3) 宣告企业破产的日期；
- (4) 宣告企业破产后破产企业的财产、帐册、文书、资料 and 印章等的保护；

公告应加盖人民法院印章。

45、人民法院宣告企业破产后，应通知破产企业的债务人或财产持有人向清算组清偿债务或交付财产。

46、破产企业的债务人或财产持有人收到人民法院的上述通知后，应当按通知的数额、时间向清算组清偿债务或交付财产；对通知的债务数额或财产的品种、数量等有异议的，可在七日内请求人民法院予以裁定；逾期既不清偿或交付又未提出异议的，由清算组申请人民法院裁定后强制执行。

47、人民法院宣告企业破产后，应通知（附宣告企业破产的裁定书副本）破产企业的开户银行，限定其银行账户只能供清算组使用。

48、人民法院宣告企业破产后，可将宣告企业破产的裁定书副本抄送有关政府监察部门和审计部门。

43: The ruling of a People's Court declaring the insolvency of the enterprise shall be legally valid from the date of its issue. From this date the insolvent enterprise shall cease production and operation activities, unless the People's Court or the liquidation committee considers it necessary for production and operation to continue.

44: When a People's Court rules to declare an enterprise insolvent, it may at the same time issue a public notice. The public notice shall include the following:

- (1) the enterprise's losses, assets and liabilities;
- (2) reasons for and legal basis of the declaration of insolvency of the enterprise;
- (3) date of the declaration of insolvency of the enterprise; and
- (4) protection of the insolvent enterprise's property, account books, documents, materials and seals, etc. after the declaration of its insolvency.

The public notice shall be sealed with the seal of the People's Court.

45: After declaring an enterprise insolvent, a People's Court shall order the debtor of the insolvent enterprise or the party in possession of the property to repay the debts or deliver the property to the liquidation committee.

46: After the debtor of the insolvent enterprise or the party in possession of the property receives the above notice from the People's Court, it shall repay the debts or deliver the property to the liquidation committee in accordance with the amounts and times specified in the notice. If there are any objections concerning the amount of debts or the type and quantity of property, or other matters specified in the notice, within seven days, a request may be made to the People's Court to issue a ruling. Where the term expires and repayment or delivery has not been made or any objections raised, enforcement may be taken after the liquidation committee applies for and the People's Court issues a ruling.

47: After a People's Court declares an enterprise insolvent, it shall order (with a copy of the ruling declaring the enterprise insolvent) the bank at which the enterprise has an account to restrict access to such bank account to sole use by the liquidation committee

48: After a People's Court declares an enterprise to be insolvent, it may send copies of the ruling declaring the enterprise insolvent to relevant supervisory departments auditing departments of the government

49、企业被宣告破产后，人民法院应当指定必要的留守人员。破产企业的法定代表人和财会、统计、保管、保卫人员必须留守，其他需要留守的人员及留守人数由清算组决定。

七、破产清算

50、成立清算组以前，人民法院商同级人民政府从企业上级主管部门、政府财政、工商行政管理、计委、审计、税务、物价、劳动、人事等部门和专业人员中用公函指定清算组成员。一经指定，有关单位和有关人员不得借故推托或擅离职守。确因客观情况不能执行职务的，人民法院可以另行指定。

清算组组长由人民法院指定。

51、清算组可以聘任会计师事务所一定数量的会计师及其他工作人员。

52、清算组对人民法院负责并且报告工作，接受人民法院监督。清算组有损害债权人利益的行为或其他违法行为，人民法院应当纠正，并可以解除不称职的清算组成员的职务，另行指定新的成员。

53、清算组应当列席债权人会议并受债权人会议监督。清算组的决定违背债权人利益的，债权人可以申请人民法院裁定撤销。

54、宣告企业破产后，破产企业的原法定代表人应当组织企业财会人员做好财务决算工作，保管人员编制好财产清单，业务人员做好购销等业务清结工作。清算组接管破产企业时，由破产企业的原法定代表人向清算组移交。

49: After an enterprise is declared insolvent, a People's Court shall appoint the necessary personnel that must be retained. The legal representative of the insolvent enterprise, together with finance and accounting, statistical, maintenance and security personnel must be retained. Other personnel required to be retained and the number of personnel to be retained shall be determined by the liquidation committee.

PART SEVEN : INSOLVENCY LIQUIDATION

50: Before a liquidation committee is established, a People's Court in consultation with the people's government of the same level shall, through official letters, appoint members to a liquidation committee from among professional personnel and departments such as the superior department in charge of the enterprise and the government departments in charge of public finance, industry and commerce, planning, auditing, taxation, commodity prices, labour and personnel. Once appointed, relevant work units and relevant personnel may not make excuses to evade their duties or leave their work without authorization. Where there is a true, objective reason that they may not continue their work, the People's Court may make a new appointment.

The head of the liquidation committee shall be appointed by the People's Court.

51: The liquidation committee may appoint a certain number of accountants from an accountancy firm and other personnel.

52: The liquidation committee is responsible to the People's Court, shall report its work to it, and shall accept the supervision of the People's Court. Where the actions of the liquidation committee damage the interests of creditors or are in violation of the law, the People's Court shall redress the matter, and may dismiss members of the liquidation committee that are not competent and appoint new members.

53: The liquidation committee shall attend creditors' meetings as non-voting participants and accept the supervision of the creditors' meeting. Where a decision of the liquidation committee violates the interests of creditors, creditors may apply to a People's Court for a ruling cancelling such decision.

54: After an enterprise is declared insolvent, the former legal representative of the insolvent enterprise shall organize finance and accounting personnel to complete the final financial accounting, maintenance personnel to draft a detailed list of assets, and business personnel to complete the settlement of purchases and sales. When the liquidation committee takes over the insolvent enterprise, the former legal representative of the insolvent enterprise shall conduct the handover to the liquidation committee.

55、清算组决定解除合同，另一方当事人因合同解除受到损害而发生的损害赔偿争议，由人民法院裁定解决。裁定书所确定的赔偿数额列入破产债权。

56、清算组接管破产企业后，应组织企业留守人员和清算组的工作人员，对破产企业的全部财产清点、登记造册，查明企业实有财产总额。

57、清算组对破产财产应当重新估价，已经折旧完毕的固定资产，应对其残值重新估价，残次变质财产应当变价计算，不需要变价的，按原值计价。

58、清算组分配破产企业的财产，以金钱分配为原则，也可以采用实物方式，或者兼用两种方式；破产企业的债权在分配时仍未得到清偿的，也可以将该债权按比例分配给破产企业的债权人，同时通知破产企业的债权人。

59、清算组处理破产企业的财产，可以将实物合理作价后分配给债权人，也可以变卖出售。变卖应公开进行，如采用公开拍卖方式。破产财产属于限制流转物的，由国家指定的部门收购。

60、破产企业与其他人组成法人型或合伙型联合体的，破产企业作为出资投入的财产和应得收益应当收回；不能收回的可以转让，对方当事人同等条件下享有优先购买权。破产企业作为合伙型联合体的，一方应对退出前联合体的全部债务承担连带责任，联合体的债权人可作为债权人参加破产程序。清算组收回破产企业投入的财产和应得收益给对方当事人造成损害的，按照本意见第55条处理。

55: Where the liquidation committee decides to cancel a contract and the other party to the contract suffers losses as a result of such cancellation that lead to disputes over compensation, the matter shall be settled through a ruling by a People's Court. The amount of compensation determined by the ruling shall be entered into insolvency claims.

56: After the liquidation committee takes over the insolvent enterprise, it shall organize the retained personnel of the enterprise and the liquidation committee personnel to conduct an account of the total property of the insolvent enterprise, list and register such property, and ascertain the total value of the actual assets of the enterprise.

57: The liquidation committee shall conduct a new appraisal of the assets available for distribution. New appraisal shall be conducted on the remaining value of fixed assets after depreciation. Defective or damaged property shall be re-valued. If re-valuation is not necessary, such property may be included at its original value.

58: When the liquidation committee distributes the property of the insolvent enterprise, the principle of cash distribution shall be used. Object distribution may also be used, or both methods may be used together. When claims of the insolvent enterprise are not compensated in the distribution, such claims may be distributed proportionately to the creditors of the insolvent enterprise. At the same time, debtors of the insolvent enterprise shall be notified.

59: When the liquidation committee disposes of the property of the insolvent enterprise, after reasonable appraisal such property may be distributed to creditors. It may also sell such property. Sale shall be conducted openly through such means as public auction. Where the circulation of assets available for distribution is restricted, such assets shall be purchased by a department designated by the state.

60: Where the insolvent enterprise is part of a legal person style or partnership style cooperative unit formed with other parties, assets invested by the insolvent enterprise as initial capital contribution and profit pertaining to such assets shall be recovered. What cannot be recovered may be assigned. The partner of the cooperation unit shall have a priority right of purchase under equal conditions. Where an insolvent enterprise is a partner of a partnership style cooperative unit, it shall be jointly and severally liable for the entire debts of the cooperative unit incurred before it withdrew from partnership. The creditors of the cooperative unit may participate in the insolvency process as creditors. Where the other party to the cooperative unit suffers losses due to recovery by the liquidation committee of the assets invested by the insolvent enterprise and profit pertaining to such assets, the matter shall be handled in accordance with Article 55 of this Opinion.

61、依照民法通则第八十九条和企业破产法第十三条第一款的规定，凡被保证人被宣告破产前，保证人代替被保证人清偿债务的，保证人有权以其清偿数额作为破产债权申报并参加分配；凡被保证人被宣告破产前，保证人未代替被保证人清偿债务的，分以下两种情况：

- (1) 债权人可以作为破产债权人参加破产程序，以其全部债权额作为破产债权申报并参加分配，还可就不足受偿部分向保证人追偿；
- (2) 保证人在申报债权的期限届满以前得知债权人不参加破产程序的情况下，可以其保证的债务数额作为破产债权申报并参加分配。

62、票据（汇票、本票、支票）发票人或背书人被宣告破产，而付款人或承兑人不知其事实而付款或承兑，因此所产生的债权为破产债权，付款人或承兑人为债权人。

63、破产企业的抵押物或者其他担保物的价款，不足其所担保的债务数额的，其差额应列入破产债权。

64、计息的破产债权，计算到破产宣告之日止。

65、破产宣告时破产企业未到期的债权，以到期债权列入破产财产，但是应当减去未到期的利息及其他损失。确实无法收回的破产企业的财产，不列为破产财产进行分配。

66、企业破产法第三十四条第一款第（一）项中的“费用”，包括破产企业留守人员的工资和劳动保险费用以及清算组的必需费用。

67、清算组应当根据清算结果制作破产财产明细表、资产负债表，并提出破产财产的配置方案。

61: In accordance with Article 89 of the General Principles of Civil Law and Item 1 of Article 13 of Enterprise Insolvency Law, whenever a guarantor has paid debts on behalf of a debtor, before the debtor is declared insolvent, the guarantor has the right to apply to the People's Court to participate in the distribution with the amount of the repayment as an insolvency claim. Whenever the guarantor has not repaid the debt on behalf of the debtor before the debtor has been declared insolvent, the matter shall be handled as follows:

- (1) the creditor may participate in the insolvency process as a creditor and participate in the distribution with the total repayment for the debts as an insolvency claim. The creditor may also pursue claims against the guarantor for the balance that is not repaid; or
- (2) where the guarantor learns that a creditor will not participate in the insolvency process before the expiration date of the guarantor's claims, such guarantor may participate in the distribution with the amount of the debt that is guaranteed by him as an insolvency claim.

62: Where the issuer or the endorser of negotiable instruments (money orders, cashier's cheques and cheques) is declared insolvent, and the payer or acceptor is not aware of this situation and pays or accepts such cheques, the debts incurred shall be insolvency claims, and the payers or acceptors shall be creditors.

63: Where the value of the security or other objects used as a guarantee by the insolvent enterprise are insufficient for the amount of debt secured, the balance shall be taken as insolvency claims.

64: For insolvency claims with interest, interest accumulation shall cease on the date of the declaration of insolvency.

65: Claims that have not matured at the time when the enterprise is declared insolvent shall be included in the assets available for distribution as matured claims, but interest that has not matured and other losses shall be deducted. Assets of the insolvent enterprise that are truly not recoverable, shall not be included in the assets available for distribution.

66: "Expenses" referred to in Paragraph 1 of Item 1 of Article 34 of the Enterprise Insolvency Law shall include the insolvent enterprise's salary and labour insurance expenses of the retained personnel and necessary expenses of the liquidation committee.

67: The liquidation committee shall formulate a detailed list of assets available for distribution and a balance sheet in accordance with the results of the liquidation, and issue an assets available for distribution plan.

68、破产财产的分配方案经债权人会议讨论通过、人民法院裁定认可后，清算组应立即通知债权人限期领取财产，逾期不领取的，可以提存。

69、债权人领取财产时，应当出具注明债权人具体地址、开户银行帐号的证明。

70、破产财产分配完毕，清算组提请人民法院终结破产程序后，人民法院应当在七日内裁定终结破产程序。

71、破产程序终结后，清算组应当向破产企业原登记机关办理破产企业注销登记，并将办理情况及时告知人民法院。

72、破产企业注销登记后，人民法院应宣布清算组撤销。

73、破产程序终结后发现的破产企业的财产请求权，由破产企业的上级主管部门行使，追回财产，由人民法院依照企业破产法第三十七条的规定清偿。如财产较少，人民法院认为无再行分配的必要时，可归破产企业的上级主管部门。

八、其他

74、非全民所有制企业法人的破产还债程序，适用民事诉讼法的规定。

75、人民法院对破产案件作出的裁定，除驳回破产申请的裁定外，一律不准上诉。当事人对裁定有异议的，可以向做出裁定的原审人民法院申请复议。但是，复议期间不停止裁定的执行。

76、破产企业的债务人或财产持有人对人民法院通知清偿的债务数额或交付的财产数量有异议，经人民法院审查被驳回的，应当按照《人民法院诉讼收费办法》第五条第（四）项规定的标准交纳案件受理费。⁸³

68: After the assets available for distribution plan is discussed and passed by a creditors' meeting and approved by a People's Court, the liquidation committee shall promptly notify creditors to collect the property within a set time period. Property that is not collected within the given time period may be deposited.

69: When a creditor collects property, it shall provide proof of its address and its bank account number.

70: After distribution of the assets available for distribution, and the liquidation committee's application to a People's Court for termination of the insolvency process, the People's Court shall make a ruling regarding termination of the insolvency process within seven days.

71: After the termination of the insolvency process, the liquidation committee shall handle cancellation of the registration of the insolvent enterprise with original registration authority of the insolvent enterprise, and promptly report such matter to a People's Court.

72: After the registration of the insolvent enterprise has been cancelled, the People's Court shall declare the dissolution of the liquidation committee.

73: Property claims on the insolvent enterprise discovered after the termination of the insolvency process shall be handled by the superior department in charge of the insolvent enterprise. Property that has been recovered shall be distributed by a People's Court in accordance with Article 37 of the Enterprise Insolvency Law. If the property is of too little value and the People's Court considers that a new distribution is not necessary, such property may be turned over to the superior department in charge of the insolvent enterprise.

PART EIGHT: SUPPLEMENTARY

74: Insolvency repayment procedures for non state enterprise legal persons shall be handled in accordance with the provisions of the Civil Procedure Law.

75: Rulings of a People's Court on insolvency cases may not be appealed, with the exception of rulings to reject applications for insolvency. If a party involved objects to a ruling, it may apply for review to the People's Court that originally issued such ruling. However, the enforcement of the ruling shall not be suspended during the review period.

76: Where debtors and property holders of the insolvent enterprise object to the amount of debts to be repaid or the amount of property to be handed over, as instructed by a People's Court, and where such objection is rejected by the People's Court after investigation, they shall pay case handling charges in accordance with the standards stipulated in Item 4 of Article 5 of the People's Court Lit Non Fee Collection Procedures.⁸⁴

接到通知书之日起三十日内，未接到通知书的自第一次公告之日起九十日内，有权要求公司清偿债务或者提供相应的担保。

公司减少资本后的注册资本不得低于法定的最低限额。

第一百八十七条 有限责任公司增加注册资本时，股

中华人民共和国公司法

(1993年12月29日第八届全国人民代表大会常务委
第五次会通过 1993年12月29日中华人民共和国
主席令第十六号公布 自1994年7月1日起施行)

第八章 公司破产、解散和清算

第一百八十九条 公司因不能清偿到期债务，被依法宣告破产的，由人民法院依照有关法律的规定，组织股东、有关机关及有关专业人员成立清算组，对公司进行破产清算。

第一百九十条 公司有下例情形之一的，可以解散：
(一) 公司章程规定的营业期限届满或者公司章程规

The various creditors shall, within 30 days of the receipt of notice or within 90 days of the first announcement where the creditors have not received notice, have the right to request the company to settle its debts payable or provide relevant guarantee.

The registered capital remaining after the reduction shall not be less than the legal minimum amount.

Article 187. When a limited liability company increases its registered capital, the contribution of newly increased capital by shareholders...

Company Law of the People's Republic of China

Enacted at the Fifth Session of the Standing Committee of the Eighth National People's Congress of China on 29 December 1993 and promulgated on the same day by the President of China

CHAPTER VIII — COMPANY BANKRUPTCY, DISSOLUTION AND LIQUIDATION

Article 189. When a company has been declared bankrupt, in accordance with the law, due to it being unable to repay its due debts, a People's Court shall organise a liquidation committee composed of shareholders, relevant authorities and professional personnel, in accordance with the provisions of relevant laws, in order to implement bankruptcy liquidation procedures

Article 190. A company may be dissolved in any of the following situations:

(1) expiry of the company's term of operations or the occurrence of a reason

定的其他解散事由出现时；

(二) 股东会决议解散；

(三) 因公司合并或者分立需要解散的。

第一百九十一条 公司依照前条第(一)项、第(二)项规定解散的，应当在十五日内成立清算组，有限责任公司由清算组由股东组成，股份有限公司的清算组由股东大会确定其人选；逾期不成立清算组进行清算的，债权人可以申请人民法院指定有关人员组成清算组，进行清算。人民法院应当受理该申请，并及时指定清算组成员，进行清算。

第一百九十二条 公司违反法律、行政法规被依法责令关闭的，应当解散，由有关主管机关组织股东、有关机关及有关专业人员成立清算组，进行清算。

第一百九十三条 清算组在清算期间行使下列职权：

- (一) 清理公司财产，分别编制资产负债表和财产清单；
- (二) 通知或者公告债权人；
- (三) 处理与清算有关的公司未了结的业务；
- (四) 清缴所欠税款；
- (五) 清理债权、债务；
- (六) 处理公司清偿债务后的剩余财产；
- (七) 代表公司参与民事诉讼活动。

第一百九十四条 清算组应当自成立之日起十日内通知债权人，并于六十日内在报纸上至少公告三次。债权人应当自接到通知书之日起三十日内，未接到通知书的自第一次公告之日起九十日内，向清算组申报其债权。

债权人申报其债权，应当说明债权的有关事项，并提

for liquidation as stipulated in its articles of association;

(2) a shareholders' meeting decides on the dissolution;

(3) dissolution becomes necessary because of company merger or division.

Article 191. In the case of a company being dissolved in accordance with the provisions of items (1) and (2) of the preceding Article, the company shall, within 15 days, establish a liquidation committee. The liquidation committee for liquidation of a limited liability company shall consist of shareholders; the members of the liquidation of a company limited by shares shall be determined by the shareholders' meeting. If a company fails to establish a liquidation committee to carry out liquidation within the prescribed time limit, creditors may apply to a People's Court to appoint relevant personnel to form a liquidation committee to conduct the liquidation. The People's Court shall accept such application and shall promptly appoint members of the liquidation committee to conduct the liquidation.

Article 192. A company shall be dissolved if it has been ordered to close down as a result of violation of the law and statutory regulations, and the relevant authority in charge shall organise shareholders, relevant authorities and relevant professional personnel to form a liquidation committee to conduct the liquidation.

Article 193. A liquidation committee shall exercise the following powers of office during the period of liquidation:

- (1) perform a stocktake of the company's property and formulate a balance sheet and property inventory;
- (2) notify creditors and make a public announcement concerning the liquidation;
- (3) handle and finalise matters in relation to the unfinished business affairs of the company;
- (4) pay overdue taxes;
- (5) clear debts receivable and debts payable;
- (6) dispose of the remaining assets after all of the debts have been paid;
- (7) participate in civil proceedings on behalf of the company.

Article 194. A liquidation committee shall, within 10 days of its establishment, notify the various creditors and make a public announcement in the newspapers at least three times within 60 days. The various creditors shall declare their claims to the liquidation committee within 30 days of receipt of notice, or within 90 days of the first announcement where the creditors have not received notice.

When declaring claims, creditors shall specify the relevant matters concerning their claims and shall provide evidentiary documents. The

供证明材料。清算组应当对债权进行登记

第一百九十五条 清算组在清算公司财产、编制资产负债表和财产清单后，应当制定清算方案，并报股东会或者有关主管机关确认。

公司财产能够清偿公司债务的，分别支付清算费用、职工工资和劳动保险费用，缴纳所欠税款，清偿公司债务。

公司财产按前款规定清偿后的剩余财产，有限责任公司按照股东的出资比例分配，股份有限公司按照股东持有的股份比例分配。

清算期间，公司不得开展新的经营活动。公司财产在未按第二款的规定清偿前，不得分配给股东。

第一百九十六条 因公司解散而清算，清算组在清理公司财产、编制资产负债表和财产清单后，发现公司财产不足清偿债务的，应当立即向人民法院申请宣告破产。

公司经人民法院裁定宣告破产后，清算组应当将清算事务移交人民法院。

第一百九十七条 公司清算结束后，清算组应当制作清算报告，报股东会或者有关主管机关确认，并报送公司登记机关，申请注销公司登记，公告公司终止。不申请注销公司登记的，由公司登记机关吊销其公司营业执照，并予以公告。

第一百九十八条 清算组成员应当忠于职守，依法履行清算义务。

清算组成员不得利用职权收受贿赂或者其他非法收入，不得侵占公司财产。

清算组成员因故意或者重大过失给公司或者债权人造成损失的，应当承担赔偿责任。

liquidation committee shall register their claims.

Article 195. A liquidation plan shall be formulated by the liquidation committee after the stocktake of the company property has been performed and the balance sheet and property inventory have been compiled, and this shall be submitted to the shareholders' meeting or to relevant authorities in charge for confirmation.

If a company's property is adequate to repay its debts, that property shall be used, in order, to pay liquidation expenses, employee wages and labour insurance expenses, overdue taxes and to clear the debts of the company.

The assets remaining after the company has settled its debts pursuant to the preceding paragraph shall be distributed to the various shareholders according to the percentages of their capital contributions in the case of limited liability companies, or according to their percentages of shares held in the case of companies limited by shares.

During the period of liquidation, a company shall not be permitted to develop new operating activities. The company's property shall not be distributed to the various shareholders before settlement of the company's debts pursuant to the provisions of paragraph two of this Article.

Article 196. Where a liquidation is carried out as a result of a resolution of the company, upon discovering, after a stocktake of the company's assets and compilation of a balance sheet and property inventory, that the assets are insufficient to settle its debts, the liquidation committee shall promptly apply to a People's Court for a declaration of bankruptcy.

If a company has been declared bankrupt by a People's Court, the liquidation committee shall hand over the liquidation matters to the People's Court.

Article 197. After the conclusion of liquidation proceedings, the liquidation committee shall compile a liquidation report and submit it to the shareholders' meeting or relevant authority in charge for confirmation, apply to the company registration authority to register the cancellation and make a public announcement concerning the termination of the company's business operations. Where a company fails to apply for registration of cancellation, its company business licence shall be revoked by the company registration authority and a public announcement shall be made.

Article 198. Members of a liquidation committee shall be devoted to their duties and perform liquidation duties in accordance with the law.

Members of a liquidation committee shall not be permitted to use their powers to accept bribes or other illicit gains and shall not be permitted to seize the company's property.

Members of the liquidation committee shall bear liability for compensation for losses incurred during the liquidation of the company or to creditors as a result of deliberate acts or serious mistakes.



The University of Hong Kong Faculty of Law
Asian Institute of International Financial Law



**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Supplementary Materials

Chinese restructurings

Many cases expected to follow big three

RESTRUCTURINGS

Eric Ng

China will have many more big corporate restructuring cases to tackle following the resolution of three of its most high-profile cases, according to Pricewaterhouse Coopers (PWC)

The liquidation of Guangdong International Trust and Investment Corp (Gitic) and the restructurings of Guangdong Enterprises (Holdings) (GDE) and Guangzhou International Trust and Investment Corp have reached their final stages.

However, the landmark cases mark the end of the beginning rather than the beginning of the end, according to senior managers of the accountancy and corporate advisory giant

They called on Beijing to take advantage of the “good timing” and build on the momentum of its restructuring effort.

PWC, which is the financial adviser for at least five Chinese government-backed investment companies and fund-raising vehicles, expects more restructurings to take place in the next few years.

“It’s not the end of the story,” said partner David Brown. “In fact, in many ways it’s just the end of the first chapter. We think there will be many more large cases in China waiting to be resolved.”

He saw opportunities for China to clean up the bad debts of its investment arms once and for all, in the same way down the value of assets during recessions.

“PRC Inc has already taken its hit on its reputation, so it might as well clean up the bad debts,” he said.

Mr Brown is an adviser to bank creditors in GDE’s restructuring.

China has gone through a tough learning process in dealing with corporate failures involving foreign creditors since it ordered the closure of Gitic about two years ago.

Gitic, the flagship financing arm of the Guangdong provincial government, was forced to file for bankruptcy three months after it closed down, in China’s largest corporate failure. It was followed by the collapses of a number of other “itics” and government-backed investment arms.

The heavy-handed approach to resolving the case of Gitic, once China’s second-largest trust and investment company, sparked uproar among foreign creditors.

They were caught by surprise by the company’s seeming overnight deterioration in financial health, as well as China’s lack of an established corporate restructuring system.

Ted Osborne, also a partner with PWC, said there was a world of difference in the expectations of the Chinese government and the creditors at the start of the restructuring process

Mr Osborne is an adviser to the Guangzhou municipal government on the Gzitic restructuring “The biggest challenge is getting everyone’s expectations to meet,” he said “In China, things take a lot longer than elsewhere to decide because of government involvement.”

It took a long time for the advisers to introduce the foreign concepts of corporate restructuring to the government, he said

The two years it had taken to restructure the companies was within their expectations “Personally I expected at least a year, if not one and a half to two, but never, say, three,” Mr Osborne said.

China’s demonstration of its “political will to do it properly” had helped speed up “the most complex corporate restructuring probably anywhere in the world”, according to Mr Brown

Malcolm Macdonald, a PWC partner who is also an adviser to GDE’s bank creditors, said China needed to revamp its commercial laws to give investors protection in cases of insolvency.

Under China’s existing bankruptcy law, it is very difficult for creditors to put a state-owned enterprise (SOE) into bankruptcy. Gitic is the first and only SOE bankruptcy to be declared in China.

On October 31, Gitic’s 200 creditors won their first payout of 731 million yuan (about HK\$685.02 million), about 34 per cent of the debt recognized by Gitic’s liquidation committee.

A day later, GDE’s 135 creditors were given a one-month deadline to approve or reject a restructuring proposal that would see bank creditors get securities and cash with a total face value of about US\$65 for every US\$100 of debt owed.

A few days afterwards, Gzitic’s more than 130 foreign creditors were offered the option to either accept an immediate one-time cash handout covering 50 per cent of outstanding principal, or a 100 per cent settlement that could extend 10 years or beyond.



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Supplementary Materials

Cross-Border Insolvency Articles

Case Digest

Liwan District Construction Company v. Euro-America China Property Limited

A Court in Guangdong

(Reported February 9, 1990)

[Breach of contract - transnational bankruptcy - loss of civil capacity]

This case is a suit for breach of contract that was complicated because the defendant had been declared bankrupt in Hongkong and had lost capacity to participate in a civil action in the PRC.

On March 31, 1987, Euro-America Construction Company of Hongkong ("Euro-America") signed an agreement with the Guangzhou Liwan District Headquarters for Construction with Foreign Investment (HCFI) in Guangzhou entitled "Xiguan New Town and Lizhiwan New Town Construction Agreement". The agreement provided for the development of Xiguan New Town and Lizhiwan New Town on a total area of 87,000 sq.m. Euro-America would be responsible for raising capital for the project, which was to be completed within 5 years. The residential flats of the project would be divided between Euro-America and the HCFI at a ratio of 36% to 64%. The agreement provided for separate appendices to be concluded later to cover the issues of sale of the residential flats in Hongkong and financing.

After the agreement was signed, the chairman of Euro-America issued shares and formed a new company in Hongkong in order to raise capital for the project. With the approval of the HCFI, the Hongkong party to the agreement was changed to Hongkong Euro-America China Property Limited Company ("Euro-America China"). Also, after approval by the relevant authorities, the

Chinese party to the agreement was changed to the Guangzhou City Liwan District Construction Company (the "construction company"). All terms and contents of the agreement and all dates mentioned remained unchanged.

Meanwhile, the parties to the contract agreed to build a temporary office building at Longjin Road West in Guangzhou using funds provided by Euro-America China. The temporary office building would serve as the administrative office for the project and provide accommodation for the staff of Euro-America China during trips to Guangzhou. The temporary office would be transferred to the construction company after the project was completed.

While the construction company was building the temporary office, it also conducted studies as to the scale and design of the two New Town residential projects, and began preparatory work for their construction. The parties were still negotiating the terms of the appendices to the agreement. At this stage, Euro-America China, without the approval of the construction company, took out advertisements in the *Hong Kong Daily News* and the *Journal on Banking and Property* to publicize the sale of the residential flats. Euro-America China sold the residential flats in Lizhiwan New Town to Mei Bong Development Company Ltd. ("Mei Bong") of Hongkong and received HK\$2 million in deposits.

The parties completed the temporary office at a total construction cost of Rmb 238,560. Expenditure on infrastructure and preparation of Lizhiwan New Town amounted to Rmb 90,535. Euro-America China remitted a total of Rmb 240,640 towards these costs, and the construction company paid the remaining Rmb 88,455 on the behalf of Euro-America China. In the meantime, the parties were still negotiating

the appendices to the agreement with the assistance of government authorities. However, because Euro-America China could not provide assurance of credit no agreement was reached, and the appendices were not signed.

A second round of consultative negotiations was held on February 10, 1989. Again no agreement was reached. The parties agreed to resort to litigation, and the construction company commenced proceedings in the People's Court.

At this time, a dispute occurred between the shareholders of Euro-America China. Pursuant to an application by Mei Bong, the Supreme Court of Hong Kong issued a liquidation order for Euro-America China and assigned a liquidator for the company.)

After the People's Court accepted the case, the court found that since Euro-America China was being liquidated, its chairman could not represent it. The liquidator also lacked authority to represent the new company in legal proceedings outside Hongkong. Accordingly, the People's Court adjudicated the case pursuant to PRC law based on the facts which had already been established.)

The court found that the agreement was valid and the costs incurred during preparatory work, infrastructure development and construction of the temporary office should be borne by the Euro-America China. The court further found that the agreement was not implemented because Euro-America China had been unable to provide sufficient funds. Euro-America China had also breached the terms of the agreement by selling the residential premises and receiving deposits prematurely without the approval of the other side. The agreement was also frustrated by the loss of legal capacity of Euro-America China following its winding up.

The temporary office was the only property

derived from performing the agreement. Since the agreement had been frustrated, the temporary office could not be put into use in accordance with the agreed terms of the parties and should be disposed of by the court. Since the temporary office was located on a road that was part of an urban plan, its residual value should be determined according to the rules of the town planning departments.

The People's Court held as follows:

- i. that the agreement be set aside;
- ii. that the costs of the preparatory works and infrastructure for Lizhiwan New Town and construction of the temporary office be borne by Euro-America China;
- iii. that the residual value of the temporary office, as determined by the relevant authorities, be awarded to Euro-America China;
- iv. that Euro-America China compensate the construction company for breach of the agreement;
- v. that after the accounts above had been set off with each other, the balance attributable to Euro-America China be remitted to and held in an account of the People's Court.

This case highlights the inadequacy of Chinese law on matters concerning foreign-related insolvency. The case involved an alleged breach of contract by a Hong Kong company, Euro-America China Property Co. Ltd ("Euro-America China"), which was put into liquidation in Hong Kong after proceedings had been commenced on the contract action in the Guangzhou People's Courts. The case raises troubling questions about the way that the Chinese courts deal with Hong Kong insolvencies in a legal environment devoid of regulation. In the instant case, the Guangzhou court conveniently skirted the insolvency issues raised by the facts and

proceeded to resolve the dispute simply on the basis of contract law.

The Guangzhou court determined that Euro-America China had breached the terms of a construction contract with the Guangzhou City Liwan District Construction Company (the "Liwan Construction Company"). The court found that the Hong Kong company had breached the contract by selling residential flats in Hongkong without the prior approval of the Liwan Construction Company.

However, the sale of the residential flats in Hong Kong does not appear to be a breach of the construction contract. In this regard, it seems clear that the construction contract contained no provision for prior approval of the Chinese party in order for the Hongkong party to sell the flats in Hongkong. Indeed, the facts indicate that the parties were unable to reach agreement on this issue as well as on the issue of financing by the Hongkong company, both of which were to be agreed upon in appendices to the construction contract. Given this situation, it is difficult to ascertain how the Guangzhou court could have awarded damages to the Liwan Construction Company for breach of contract.

The Guangzhou court also held that the construction contract in question was "discharged" on account of Euro-America China's loss of legal capacity which was brought about by the liquidation of that company in Hongkong. As a result, so said the court, the construction contract had been "frustrated". It is clear that the court was not using the term, "frustrated", in the sense ordinarily appreciated at common law. It is well-established at common law that a contract cannot be frustrated or rendered impossible of performance on account of the insolvency of one of the parties. This is because the financial difficulties of such a party cannot be said to arise from events beyond the control of that party; in other words, such cases involve

personal, not objective, impossibility of performance. Such a conclusion would also be tenable at Chinese law. According to Article 24 of the PRC Foreign Economic Contracts Law, force majeure may only excuse non-performance of a contract where the event in question, in this case, insolvency, cannot be objectively avoided.

By what device, then, did the Guangzhou court conclude that the contract between Euro-America China and the Liwan Construction Company was "discharged"? The Court states that it applied PRC law to decide this dispute. According to Article 45 of the PRC Civil Law General Principles ("CLGP") an enterprise legal person is terminated, where inter alia, it is declared insolvent in accordance with the law. From a Chinese law perspective, the winding-up order of the Hongkong court would constitute such a lawful declaration of insolvency, the effect of which would be to terminate the legal existence of Euro-America China. Moreover, Article 36 of the CLGP provides that the civil capacity of a legal person ceases when the legal person terminates. Thus, as a matter of Chinese law, the Guangzhou court would be correct in concluding that Euro-America China lost its civil capacity when it was declared insolvent by the Hongkong court.

Still, does a loss of civil capacity by an enterprise or company on account of insolvency necessarily lead to the discharge or cancellation of a pre-existing, executory contract, such as the construction contract in this case? Article 36 of the CLGP sheds some light on this issue by providing that, upon termination, a legal person not only loses its civil capacity but also its competence to perform civil acts (including contractual duties). Thus, at Chinese law, the declaration of insolvency renders an enterprise unable to perform executory contracts.

However, there appears to be no provision in Chinese law regarding the legal

consequences for the parties or the contract where one of the parties cannot perform an executory contract and the time for performance has not as yet arrived. In this regard, Chinese law does not recognize the common law doctrine of anticipatory breach.

Nonetheless, the Guangzhou court forged ahead into this untrammelled thicket and declared the contract discharged: a very dubious conclusion. Perhaps what the court had secretly in mind was the proposition that, on account of Euro-America China's prospective inability to perform, Liwan Construction Company (not the contract) was discharged from its contractual duty to perform - a result which would be consonant with the common law given Euro-America China's apparent anticipatory repudiation of the contract. But if that was the intent of the court, then Liwan Construction company should have had a claim for damages for total breach of contract against Euro-America China - a possibility never even considered in the report of the case.

The conclusion of the Guangzhou court that the construction contract was discharged or frustrated could have been entirely avoided if the liquidator for the insolvent Euro-America China (the "HK Liquidator") had been allowed to represent the Hongkong company in the court proceedings. As it was, the court averred that the HK Liquidator lacked authority to represent Euro-America in China. Had the HK Liquidator been recognized by the Guangzhou court, no question would have arisen about the prospective inability to perform the contract by the insolvent enterprise, because the HK Liquidator, under both PRC and Hongkong Law, has the power to perform executory contracts on behalf of an insolvent company.

Under Hongkong law, the liquidator steps into the shoes of the liquidated company. In a winding-up by the court, section 199

(1)(b) of the Companies Ordinance, Chapter 32 of the Laws of Hongkong (the "HK Companies Ordinance"), confers upon a liquidator the power, with the sanction of the court or the committee of inspection, "to carry on the business of the company, as far as may be necessary for the beneficial winding up thereof". A liquidator may be able to perform the liquidated party's contractual duties for this purpose. Similarly, section 199 (1)(a) of the HK Companies Ordinance confers upon a liquidator the power, with the sanction of the court or the committee of inspection, "to carry on business of the company, so far as may be necessary for the beneficial winding up thereof". A liquidator may be able to perform the liquidated party's contractual duties for this purpose. Similarly, section 199 (1)(a) of the HK Companies Ordinance confers upon a liquidator the power "to bring or defend any action or other legal proceeding in the name and on behalf of the company". This power extends to bringing or defending actions abroad. For instance, when Axona International Credit & Commerce Ltd. ("Axona") was wound up in Hongkong in 1983, the Supreme Court of Hongkong authorized the liquidators for Axona ("Axona's Liquidators") to file an involuntary bankruptcy petition against Axona in the United States Bankruptcy Code to protect and preserve for the benefit of all creditors the assets of Axona located in the United States case (the "U.S. Trustee"), and then later Axona's Liquidators and the U.S. Trustee jointly made application to the United States Bankruptcy Court to suspend the U.S. bankruptcy case and turn over all assets in the United States estate of Axona to Axona's Liquidators to be distributed in Hongkong to all creditors of the company. The United States Bankruptcy court granted this application in *In Re Axona International Credit & Commerce Ltd.*, 88 B.R. 597 (Bankr. S.D.N.Y. 1988), *aff'd*, No. 88 Civ. 5518 (S.D.N.Y. May 11, 1990).

It is interesting to note that if the Liwan

Construction Company had been liquidated under PRC, State Enterprise Bankruptcy Law (Trial Implementation) NPC 12/2/86 / 1 CLP 30 (the PRC Bankruptcy Law), pursuant to Article 24 of that law, the People's Court would have established a liquidation panel to assume control of the debtor and that panel would have been entitled to engage in all necessary civil activities in accordance with law; and, moreover, under Article 26, the liquidation panel would have had the power to reject or assume the executory contracts of the debtor, such as the one in this case. In other words, under the PRC Bankruptcy Law, the liquidation panel would have had the authority to represent the company in legal proceedings within China. Thus, in the instant case, the Guangzhou court has adopted an approach regarding the authority of a Hongkong liquidator that is antithetical to its approach regarding domestic liquidators.

It is also troubling to see the Guangzhou court applying a "territoriality" approach, rather than a "universality" approach, to the transnational insolvency issues (i.e., the recognition of the HK Liquidator) involved in this case. Under the "universality" approach, a single primary administration of the debtor's assets occurs in the jurisdiction where the debtor is domiciled or where the debtor's principal place of business is located. Other jurisdictions recognize and act in aid of the primary administration through ancillary administrations (in which the law of the jurisdiction of the primary administration is applied) and assist the liquidator appointed in the primary administration - often by turning the debtor's assets over to it for distribution to all creditors worldwide. At the same time, bankruptcy courts in different jurisdictions act in cooperation with each other. Such an arrangement leads to a more efficient administration of the debtor's assets.

In contrast, under the "territoriality"

approach, each jurisdiction protects the interests of local creditors, adjudicates assets within its own borders and refuses to recognize the adjudications of liquidation or the appointment of liquidators in foreign jurisdictions. Under this approach, a wasteful liquidation proceeding occurs in each jurisdiction where the debtor's assets are located.

If the Guangzhou court had followed the "universality" approach, it would have recognized the winding-up adjudication in Hongkong. The court would allow Euro-America China to petition for ancillary relief in aid of the Hongkong winding-up, and then order that all assets (or the proceeds from the sale thereof) of Euro-America China in the PRC be turned over to the HK Liquidator. These assets (or proceeds) would then have been distributed in the winding-up proceeding in Hongkong for the benefit of all the creditors of the debtor, including the Liwan Construction Company, which would have been encouraged to file a claim in the Hongkong proceeding.

Instead, the court applied the "territoriality" approach and protected the local Chinese party. It is implicit in the court's analysis that the Hongkong court's winding-up order had effect only within Hongkong. The assets of Euro-America China, most importantly the temporary office building in Guangzhou (which had not yet been transferred to the Liwan Construction Company), were to be adjudicated under the laws of the PRC and any claims made by the HK liquidator would not be recognized. The court held that the residual value of the building "should be determined according to the rules of the town planning departments" (query whether this computation of value might be lower than market value) and that the Hongkong company should be awarded the balance of the residual value of the building, after satisfying the Liwan Construction Company's claims for the costs of the preparatory works and infrastructure for the

Lizhiwan New Town, the costs of the temporary office building, and damages for breach of the agreement. In short, the Guangzhou court chose to protect the interests of the PRC enterprise at the expense of furthering cooperation with Hongkong.

The court may well have reached this result because of the inadequacy of extant PRC insolvency law to resolve transnational insolvency matters in general, and this matter in particular. In the Summer of 1988, the consensus among the bankruptcy experts in the PRC was that since business was booming, there was no need to be concerned with problems regarding the adjudication of assets in the PRC of a foreign debtor undergoing liquidation elsewhere. One expert responded that if the foreign partner in a joint venture filed for liquidation abroad, the issue in the PRC would not be a bankruptcy problem, but rather a joint venture problem requiring the assignment of the foreign partner's interest in the joint venture. Another PRC lawyer added that any PRC bankruptcy law was "medicine" before the "illness".

But two years later much has changed and the illness has arrived - many of the joint ventures in China are encountering financial problems and the first bankruptcies have been filed. It may be asked how effective is the "medicine" currently available in the PRC?

The principal PRC enactments on insolvency presently consist of the PRC Bankruptcy Law, the Shenyang Municipality, Dealing With the Insolvency and Closure of Urban Collective Industrial Enterprises Provisional Regulations, the Guangdong SEZs, Foreign-Related Companies Regulations Guangdong PC 9/28/86 (the "Guangdong Foreign Companies Regulations), and the Shenzhen Special Economic Zone, Foreign Company Bankruptcy Regulations Guangdong PC 11/29/86 | 1 CLP 37 (the

"Shenzhen Bankruptcy Regulations"). One of the problems that arises under current PRC insolvency law is the lack of any provision which allows for the commencement of an ancillary proceeding in the PRC in aid of a primary liquidation proceeding abroad. In addition, present law does not even provide for the commencement of liquidation proceedings against companies such as Euro-America China. Since Euro-America China is not a state-owned enterprise, it is not eligible for bankruptcy under the PRC Bankruptcy law, and since the company is not a foreign investment enterprise and is not located in the Guangdong Special Economic Zones, it is not eligible under either the Guangdong Foreign Companies Regulations or the Shenzhen Bankruptcy Regulations.

Although the PRC Bankruptcy Law is silent as to what effect should be given to the recognition of a foreign liquidation and of a foreign liquidator, Article 5 of the Shenzhen Bankruptcy Regulations states that, "Bankruptcy declared in accordance with the bankruptcy laws of foreign countries does not automatically become effective on the assets of the company concerned in the Special Zone". In addition, Article 44 of the Guangdong Foreign Companies Regulations states that the assets in China of a foreign debtor cannot be transferred from China if such a transfer would "have any adverse effect on the production and operation activities of the company". Article 41 of the Guangdong regulations also provides that all such transfers are subject to approval of the local municipal People's Government.

Both of these two regulations thus assert "territoriality" principles in transnational insolvency. It is surprising that the Guangzhou court does not explicitly refer to these principles in its decision since it is clearly motivated by them. Instead, the People's Court further entrenches the "territoriality" approach in PRC jurisprudence without offering any

explanation for doing so. This is particularly discouraging and, indeed, inappropriate in cases involving the recognition of liquidators from Hongkong. One would have thought that the PRC courts would begin to treat Hongkong liquidators on a friendlier ("one country") basis given that China and Hongkong will soon share a common future.

As a matter of PRC civil procedure law, it may be argued that the HK Liquidator in the instant case should have been allowed to represent Euro-America China in the Guangzhou proceedings. According to the facts in the case, once the Guangzhou court was apprised of the winding-up order against Euro-America China in Hongkong, it apparently assumed that from that point in time the Hongkong company had lost all legal capacity. What should the People's Court have done under the PRC Civil Procedure Law ("Civil Procedure Law") given this situation?

It could be argued that the Guangzhou court should have discontinued the action in accordance with Article 118 of the Civil Procedure Law which provides that if one party loses his capacity for litigation, and a legally appointed agent has not yet been ascertained, the suit should be discontinued. However, it appears that this provision in Article 118 was originally intended to apply only to natural persons, not to legal persons such as Euro-America China.

It is unclear whether the HK Liquidator attempted to join the litigation on behalf of the Euro-America China. As previously mentioned, the Guangzhou court was of the opinion that the liquidator lacked the authority to represent the Hongkong company in PRC proceedings. However, Article 90 of the Civil Procedure Law provides that if a party responding to the suit does not meet the qualifications of a party, the People's Court should notify another qualified party to participate in the

lawsuit instead. Since it appears that the Guangzhou court concluded that Euro-America China lacked legal capacity, it could be argued that if the action were to continue the HK Liquidator should have been notified to join the action.

This conclusion is bolstered by the Supreme People's Court's Enforcement of the Civil Procedure Law in the Course of Economic Trial Work Opinion. Although this Opinion is an interpretation of the Civil Procedure Law with respect to the handling of domestic economic disputes involving Chinese enterprises, the procedural matters discussed in this Opinion could apply by analogy to economic cases involving Hongkong parties.

The Supreme People's Court Opinion provides in Part II, paragraph 1 (entitled "Parties"), that, if in the course of litigation proceedings, an enterprise is closed down, then the court should change the parties in good time. Where an enterprise is closed down, the litigation should be conducted by the liquidator on behalf of the liquidated party. Thus, in a domestic context, a PRC liquidator, or liquidation panel, has a procedural right to represent the insolvent Chinese enterprise as a party in any on-going litigation before the People's Courts. It is submitted that this procedural right should also be extended to a Hongkong liquidator. The support for this position is to be found in Article 5 of the Civil Procedure Law which provides that parties to a lawsuit before the People's Courts are equal as far as the application of the law is concerned; and such parties are guaranteed equal litigation rights. As the Supreme People's Court has made clear, a liquidator, as a matter of law, becomes the insolvent Chinese enterprise as a party in trial proceedings before the People's Courts, which is clearly the case, then an identical procedural right should be accorded to a Hongkong liquidator if the assertions about the equal litigation rights of parties in Article 5 are to have any

Vol IV, 6 CLP, July 16, 1990

meaning. To deny a Hongkong liquidator this procedural right, as unfortunately the Guangzhou court appears to have done, denies Hongkong parties, in circumstances similar to those of Euro-America China, any meaningful representation in litigation in the PRC.

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PRC Corporations, Garnishee Orders and Transnational Insolvency

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Recent litigation before the courts in England and Hong Kong involving a PRC state-owned enterprise highlights the practical benefits of utilising insolvency proceedings as a means of international debt enforcement.

Readers will recall Michael Cohn's article in 1994 that dealt with the failure of an English judgment creditor to obtain a garnishee order absolute against the London branch of the Bank of China, the creditor having previously brought an action in the High Court against its joint venture partner – a PRC state-owned enterprise – and obtained a default judgment for a little under £2 million.¹ However, following the discharge of the garnishee order *nisi* by the court in London, the English creditor has pursued other avenues of redress: most notably by putting the PRC state-owned enterprise into liquidation in Hong Kong. The Hong Kong winding up proceedings appear to have produced at least some results for the creditor, since a settlement was subsequently reached and the winding up stayed, although, in an intriguing final twist to an exceptional case, the judge in Hong Kong who ordered the stay expressed concern as to whether the draft settlement agreement (which remained confidential) was a 'proper commercially moral agreement'.²

In 1992 an English company ('Zoneheath') obtained a default judgment in London against China Tianjin International Economic and Technical Co-operative Corp. ('CTIETCC'), a corporation formed in accordance with the law of the People's Republic of China pursuant to an order of the Ministry of Foreign Trade and Economic Cooperation and the People's Government of the Municipality of Tianjin. In April 1993 in England, Zoneheath obtained from a master a garnishee order *nisi* against the Bank of China in London in respect of the judgment debtor's accounts held with the bank in the People's Republic of China. In March 1994 the Bank of China applied to have the garnishee order *nisi* set aside.³ Although the English court had jurisdiction over the Bank of China (because it had a branch in London) and over the debts (even though they were situated in the People's Republic of China),⁴ the court exercised

its discretion in favour of the Bank of China and set aside the garnishee order. The court found that it was improper to 'impose the remedy of the English court on a commercial entity unconnected with the subject-matter of the litigation and only drawn in because it happens to have a branch office in the City of London'.⁵ The court was influenced, *inter alia*, by the consideration that were an order made it might expose the Bank of China to the real risk of having to pay the debt twice over; and, moreover, that it was open to Zoneheath to enforce its judgment by bringing proceedings in the People's Republic of China under Articles 267 and 268 of the PRC Civil Procedure Code. It was stated by the judge that so to do was the 'proper procedure which could and should be followed'.

After the garnishee order *nisi* was discharged, Zoneheath registered the English default judgment in Hong Kong.⁶ In September 1994, relying on the registration of its judgment in Hong Kong, Zoneheath petitioned the Hong Kong High Court to wind up CTIETCC as an 'unregistered company' under sections 326 and 327 of the Companies Ordinance (Chapter 32, Laws of Hong Kong). Sections 326 and 327 of the Hong Kong legislation are, for present purposes, identical to sections 220 and 221 of the Insolvency Act 1986; and in both jurisdictions foreign corporations may be wound up as unregistered companies. In *Re China Tianjin International Economic and Technical Co-operative Corporation* Rogers J held that CTIETCC had a 'sufficiently close connection' to Hong Kong to justify making a winding up order, on the basis that CTIETCC had assets in Hong Kong (namely one share in a Hong Kong registered company) and that CTIETCC had claimed in certain published materials that it had established offices and joint ventures in many countries worldwide, including Hong Kong. In so holding, Rogers J relied on *Re A Company (No. 00359 of 1987)* and *Re Real Estate Development Co.*⁷

At the time of making the winding up order in Hong Kong, Rogers J expressed the hope that by doing so the chances of a settlement of the underlying dispute between Zoneheath and CTIETCC might be advanced.⁸ The chances of a settlement were increased by the fact that Zoneheath was apparently the only known creditor of CTIETCC. By early September 1995, newspapers in Hong Kong were reporting that a compromise had been reached, and, on 16 October 1995, Zoneheath applied for a stay of all further proceedings in the winding up (*Re China Tianjin International Economic and Technical Co-operative Corp., Winding Up 438 of 1994*,

1. 'Garnishee Strikes Back to Avoid Double Jeopardy' [1994] 7 JIBL 284, commenting on *Zoneheath Associates Ltd v China Tianjin International Economic and Technical Co-operative Corp.*, *The Times*, 8 April 1994.

2. Note 10 below.

3. Note 1 above.

4. See *Deutsche Schachtbau v Shell International Petroleum Ltd* [1990] AC 295.

5. Note 1 above.

6. UK judgments may be registered in Hong Kong pursuant to the judgments (Facilities for Enforcement) Ordinance (Chapter 9, LHK). Zoneheath was also reported to have registered its judgment in Singapore and Canada.

7. [1994] 2 HKLR 327, at 328 ([1995] 1 HKC 720, at 721 to 722).

8. [1988] Ch. 210 and [1991] BCLC 210, respectively.

9. Note 7 above, at 329.

High Court, 16 October 1995, unreported). The terms of the draft settlement agreement remained confidential and were not divulged in the court. So one can only speculate as to what prompted Rogers J to observe:

That is a confidential agreement and its terms are not to be disclosed. I will, therefore, not refer to the details of it but I have to say that I find it very difficult to say that I am satisfied as to commercial morality. The decision in this case should not therefore be taken as any precedent in the future. In my view it may well be necessary in any future case for evidence to be filed to show that the agreement between the parties does reflect a proper commercially moral agreement and not an agreement to which one of the parties has been forced.¹⁰

Nevertheless, Rogers J did exercise his discretion to order a stay. The court noted, first, that the default judgment obtained by Zoneheath in England in 1992 had been set aside, with the consequence that the judgment could no longer be registered in Hong Kong and form the basis of the winding up petition; and, secondly, that since it had become clear that the liquidator was not in any event going to recover any substantial or worthwhile assets in Hong Kong, no one would benefit from the continuation of the winding up proceedings.¹¹

Comment

The practical significance of the Hong Kong proceedings is that this is the very first time a PRC corporation – let alone a PRC state-owned corporation – has been put into liquidation in Hong Kong. Moreover, the facts of the underlying dispute had no connection whatsoever with Hong Kong. Obviously, therefore, the *CTIETCC* case serves as a useful reminder to practitioners whose clients have joint venture interests in the People's Republic of China (or who trade with PRC corporations generally) that resorting to winding up proceedings in Hong Kong can be a useful tactical option. Additionally, of

course, once a liquidator has been appointed, the investigatory powers that are available under the winding up legislation may reveal the whereabouts of valuable assets.

Two final points must be made. First, traditionally the jurisdiction of the courts (in Hong Kong as in England) to wind up a foreign company has been founded on the presence of assets alone (*Re Compania Merabello San Nicholas SA*).¹² However, in the *CTIETCC* case, Rogers J held that the fact that there were assets in Hong Kong was relevant in considering whether there was a 'sufficient connection' to Hong Kong. On the facts, Rogers J found such a sufficient connection. In making these findings, a certain amount of confusion appears to have crept into the judgment. The English cases that refer to a 'sufficient connection'¹³ have involved situations where there were *no assets* in England – so that another jurisdictional basis had to be found. But if, as in the *CTIETCC* case, there are assets in Hong Kong, then that is in itself enough to found jurisdiction to wind up a foreign company. And, secondly, it must always be remembered that the making of a winding up order against a foreign corporation is a matter of discretion: an order does not have to be made. The court (in Hong Kong as in England) may decline to make a winding up order on the basis that there is a clearly more appropriate forum in which proceedings should be instituted.¹⁴ It is unfortunate that the question of discretion was not raised by the corporation in the *CTIETCC* case. However, it can be stated with some certainty that a winding up order *will* be made if the court finds that a debtor corporation is simply trying to avoid paying a debt owed to one particular creditor, rather than that the corporation is genuinely insolvent and is seeking to make proper arrangements in its home state for reconstruction or liquidation for the benefit of all its creditors.

12. [1973] Ch. 75.

13. See, for example *Re A Company (No. 00359 of 1987)*, Note 8 above.

14. See Smart, *Cross-Border Insolvency*, 1991, at 74 to 76 and Booth, 'Living in Uncertain Times: The Need to Strengthen Hong Kong Transnational Insolvency Law' (1996) 34(2) *Columbia Jo. of Trans. L.*, at Part III B 2(d).

10. Judgment, at 3.

11. *Ibid.*, at 3 to 4.

ARTICLE

**LIVING IN UNCERTAIN TIMES: THE NEED TO
STRENGTHEN HONG KONG TRANSNATIONAL
INSOLVENCY LAW**

CHARLES D. BOOTH

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Living in Uncertain Times: The Need to Strengthen Hong Kong Transnational Insolvency Law

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The author, an American academic in Hong Kong, argues that Hong Kong should reform its transnational insolvency law before 1997. He first examines the options available under Hong Kong law for protecting the assets of a foreign debtor and for obtaining cross-border assistance from Hong Kong courts, including non-insolvency options, the winding up of foreign companies, and the bankruptcy of individuals. He also summarizes the position in England, the United States, and China regarding the granting of recognition and assistance to Hong Kong insolvencies. He then discusses economic, political, and legal developments that will affect the post-1997 evolution of Hong Kong transnational insolvency law and the treatment of Hong Kong insolvencies by foreign courts. The author critiques recent law reform proposals, highlights weaknesses in the existing legislative and case law framework, and proposes many amendments to Hong Kong transnational insolvency law. He also calls on Hong Kong and China to enter into a bilateral cross-border insolvency agreement and to take steps to maintain confidence in the administration and adjudication of Hong Kong insolvencies after 1997.

I.	INTRODUCTION	391
II.	INTRODUCTION TO TRANSNATIONAL INSOLVENCY LAW	393
III.	THE OPTIONS AVAILABLE UNDER HONG KONG LAW FOR PROTECTING THE ASSETS OF A FOREIGN DEBTOR IN HONG KONG AND FOR OBTAINING CROSS-BORDER ASSISTANCE FROM HONG KONG COURTS	396

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A.	<i>Recognition of Foreign Insolvencies</i>	396
B.	<i>The Options Available for Protecting the Assets of a Foreign Debtor in Hong Kong and for Obtaining Cross-Border Assistance from Hong Kong Courts</i>	400
1.	Non-Insolvency Options	400
2.	Winding Up	402
a.	<i>Introduction</i>	402
b.	<i>Sections 326, 327, and 327A of the Companies Ordinance</i>	405
c.	<i>Jurisdiction</i>	415
d.	<i>Discretion to Order Relief and the Types of Relief</i>	420
3.	Bankruptcy	422
a.	<i>Introduction</i>	422
b.	<i>Jurisdiction</i>	425
c.	<i>Discretion to Order Relief and the Types of Relief</i>	429
IV.	THE TREATMENT OF HONG KONG INSOLVENCIES BY COURTS IN ENGLAND, THE UNITED STATES, AND CHINA	430
A.	<i>English Law</i>	430
B.	<i>United States Law</i>	431
C.	<i>Chinese Law</i>	434
V.	THE POST-1997 EVOLUTION OF HONG KONG TRANSNATIONAL INSOLVENCY LAW AND THE TREATMENT OF HONG KONG INSOLVENCIES BY FOREIGN COURTS	435
A.	<i>Factors Likely to Increase the Number of Insolvencies in Hong Kong</i>	435
B.	<i>Factors Likely to Increase the Number of Liquidations of Chinese Enterprises in Hong Kong</i>	438
C.	<i>Political and Legal Factors Likely to Affect the Post-1997 Evolution of Hong Kong Transnational Insolvency Law and the Treatment of Hong Kong Insolvencies by Foreign Courts</i>	441
1.	Extent to which China Honors the Terms of the Joint Declaration and the Basic Law	441
2.	Repercussions of Winding Up More Chinese State Enterprises in Hong Kong	443
3.	Impact of the Law Reform Commission's Recommendations Regarding the Official Receiver's Powers	444
VI.	CONCLUSION	446

I. INTRODUCTION

One of the important ramifications of the approach of 1997 is the flurry of law reform in Hong Kong. The law of insolvency has been no exception. In 1990, the Law Reform Commission of Hong Kong (the "Law Reform Commission") appointed a Subcommittee on Insolvency (the "Subcommittee on Insolvency") to review the law and practice relating to the bankruptcy of individuals and the liquidation of companies.¹ In mid-1993, the Subcommittee on Insolvency issued its first interim report, the Consultative Document on Bankruptcy,² in which it proposed a broad range of changes to the Hong Kong Bankruptcy Ordinance (the "Bankruptcy Ordinance").³ Most of its proposals, with a few important exceptions, were adopted by the Law Reform Commission in its Report on Bankruptcy,⁴ issued in May 1995. It is anticipated that the Law Reform Commission's bankruptcy proposals will be enacted in May 1996.

Meanwhile, in June 1995, the Subcommittee on Insolvency issued its second interim report, addressing corporate rescue and insolvent trading (the "Corporate Rescue and Insolvent Trading Consultation Paper").⁵ The Subcommittee has now turned its attention to a consideration of the overall context of insolvency law, which will form the basis for the Subcommittee's final report. In addition, the Hong Kong Government has appointed Mr. Ermanno

1. In Hong Kong, the insolvency law of individuals is separate from that of companies. The former is called bankruptcy law and is contained in the Bankruptcy Ordinance, cap. 6, Laws of Hong Kong [hereinafter L.H.K.] (1995) and the latter is called liquidation law and is contained in the Companies Ordinance, cap. 32, L.H.K. (1995). In Hong Kong, the term "winding up" is synonymous with "liquidation." The insolvency of a partnership is usually administered under the Bankruptcy Ordinance, but administration under the liquidation procedures for unregistered companies may be possible in some instances. See *infra* note 80. Provisions for restructuring (reorganizing) insolvent companies are also contained in the Companies Ordinance, but they are rarely used. See Companies Ordinance § 166, Booth, *supra* note *, at 48-49.

In this article, the terms "bankruptcy," "liquidation," and "winding up" retain their Hong Kong meanings. The term "insolvency" refers to the broad variety of insolvency proceedings noted above.

2. THE LAW REFORM COMMISSION OF HONG KONG SUBCOMMITTEE ON INSOLVENCY, CONSULTATIVE DOCUMENT ON BANKRUPTCY (July 1993) [hereinafter CONSULTATIVE DOCUMENT ON BANKRUPTCY].

3. Cap. 6, L.H.K. (1995).

4. THE LAW REFORM COMMISSION OF HONG KONG, REPORT ON BANKRUPTCY (May 1995) [hereinafter REPORT ON BANKRUPTCY].

5. THE LAW REFORM COMMISSION OF HONG KONG SUBCOMMITTEE ON INSOLVENCY, CORPORATE RESCUE AND INSOLVENT TRADING CONSULTATION PAPER (June 1995) [hereinafter CORPORATE RESCUE AND INSOLVENT TRADING CONSULTATION PAPER].

Pascutto, the former Deputy Chairman of the Hong Kong Securities and Futures Commission, to conduct a separate overview of the Hong Kong Companies Ordinance (the "Companies Ordinance").⁶ This review might also lead to recommendations regarding insolvency law.

To date, the Subcommittee on Insolvency and the Law Reform Commission have addressed only a few transnational insolvency issues, although the Subcommittee intends to discuss cross-border insolvency more fully in its final report. Cross-border insolvency is of growing importance in Hong Kong. Hong Kong's transnational insolvency law is also of interest to the international legal and business community, as it attempts to assess the effect of 1997 on trade and investment in Hong Kong.

This article focuses on the need to reform Hong Kong transnational insolvency law before 1997 and puts forward many recommendations for the Subcommittee on Insolvency to consider in its final report. Part I offers an introduction to transnational insolvency law and sets out general paradigms for resolving transnational insolvency issues. Part II examines the options available under Hong Kong law for protecting the assets of a foreign debtor in Hong Kong and for obtaining cross-border assistance from Hong Kong courts. First, this part sets out Hong Kong (and relevant English) rules regarding the recognition of foreign insolvencies. A summary follows of the options for gaining cross-border assistance in Hong Kong, which include the following: non-insolvency options, the liquidation (or winding up)⁷ of foreign companies under the Companies Ordinance, and the bankruptcy of foreign individuals under the Bankruptcy Ordinance. This section also discusses recent Hong Kong case law and law reform proposals, highlights serious weaknesses and omissions in the existing legislative and case law framework, and proposes relevant amendments to Hong Kong's cross-border insolvency law. Part III briefly summarizes the position in England, the United States, and China regarding the granting of recognition and assistance to Hong Kong insolvencies. Recent cases are noted. Part IV examines economic, political, and other legal developments in Hong Kong and China (many of which are directly related to 1997), which will have repercussions for the post-1997 evolution of Hong Kong's transnational insolvency law. Also discussed are those factors that will affect whether foreign courts will recognize and assist Hong Kong insolvencies after 1997. This part proposes other recommenda-

6. Cap. 32, L.H.K. (1995).

7. See *supra* note 1.

tions to strengthen Hong Kong's law relating to cross-border insolvency and to increase the likelihood that overseas courts will continue to recognize and assist Hong Kong insolvencies.

II. INTRODUCTION TO TRANSNATIONAL INSOLVENCY LAW

Transnational insolvency law is founded largely on private international law.⁸ In a typical case involving the insolvency of a company incorporated in and with its primary place of business in Country A, but with assets in Country B, the issues arise whether the liquidator or trustee (the "foreign representative")⁹ from Country A will be able to protect the company's assets in Country B from the actions of creditors and whether the Country B court will order the return of the assets to Country A for distribution there to all of the company's creditors. In resolving these issues, two important questions arise under the law of country B: (1) What effect does the declaration of insolvency in Country A have on the property in Country B?¹⁰ and (2) May a second insolvency be commenced in Country B pursuant to which Country B's insolvency law will be applied to resolve matters involving the foreign company's assets in Country B?¹¹

With respect to the first question, assume that Country A's law extends to property in Country B, that is, that property abroad is part of the insolvency estate in Country A and that the foreign representative from Country A is entitled to go abroad and claim the property in Country B. If Country B's transnational insolvency law recognizes the extraterritorial scope of Country A's law and allows the foreign

8. Although much effort has been exerted in negotiating multilateral transnational insolvency treaties, most efforts have proved unsuccessful. See, e.g., Kurt H. Nadelmann, *Discrimination in Foreign Bankruptcy Laws Against Non-Domestic Claims*, 47 AM. BANKR. L.J. 147, 147-48 (1973). Perhaps the E.C. Convention on Insolvency Proceedings, recently opened for signature, will prove to be a welcome exception to this trend.

9. Different countries use different terminology. In the United States, the representative of an estate in a liquidation is called a "trustee," 11 U.S.C.A. §§ 701, 702 (1995), and in a reorganization is called either a "debtor in possession," 11 U.S.C.A. §§ 1101(1), 1107, or a "trustee," 11 U.S.C.A. § 1104. In Hong Kong, the representative of a bankrupt's estate is called a "trustee." Bankruptcy Ordinance § 23. Technically, there is no estate created in a liquidation in Hong Kong. Therefore, in a company's liquidation the representative belongs to the company and its creditors and is called a "liquidator." Companies Ordinance §§ 193, 194. For the purposes of this article, a trustee or liquidator may also be referred to as a "foreign representative."

10. See LOUIS JACQUES BLOM-COOPER, *BANKRUPTCY IN PRIVATE INTERNATIONAL LAW* 14-18 (1954).

11. This question is often phrased as a matter of jurisdiction. See *id.* at 14-15.

representative from Country A to claim the property in Country B, Country B is said to have adopted the "universality" approach to transnational insolvency law. In contrast, if Country B's law does not recognize the extraterritorial scope of Country A's law and does not allow the foreign representative from Country A to claim the assets in Country B, Country B is said to have adopted the "territoriality" approach to transnational insolvency law.

With respect to the second question, if Country B's law does not permit a separate insolvency proceeding to be commenced in Country B, and Country B defers to the application of Country A's insolvency law with respect to the company's assets in Country B, Country B is said to have adopted the "unity" approach. On the other hand, if Country B's law permits the commencement of a separate liquidation proceeding in Country B to adjudicate claims to the company's assets in Country B under Country B's insolvency law, Country B is said to have adopted the "plurality" approach.¹²

Although it is true that the universality approach is distinct from the unity approach, "[t]he most comprehensive way to conceive of universality is the idea of 'unity' of bankruptcy."¹³ Thus, it is helpful to combine these two questions when addressing transnational insolvency problems. One could envision a universality continuum that runs from a "universality/unity" approach to a "universality/plurality" approach.¹⁴ An example of the universality/unity approach would be where Country B (1) recognizes and gives effect to the insolvency proceedings in Country A, (2) assists the foreign representative from Country A, (3) applies the substantive insolvency law of Country A (such as avoidance powers, if so applicable), and (4) orders that the foreign debtor's assets in Country B be turned over to Country A. An independent insolvency proceeding would not be commenced under the law of Country B. However, an "ancillary"

12. For further discussion of these various approaches, see BLOM-COOPER, *supra* note 10, at 11-17; JOSEPH STORY, COMMENTARIES ON THE CONFLICT OF LAWS, §§ 403-09, at 565-72 (8th ed. 1883); John D. Honsberger, *Conflict of Laws and the Bankruptcy Reform Act of 1978*, 30 CASE W. RES. L. REV. 631, 633-35 (1980); Barbara K. Unger, *United States Recognition of Foreign Bankruptcies*, 19 INT'L LAW. 1153, 1154-55 (1985); Jay L. Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499, 512-19 (1991).

13. Hans Hanisch, "Universality" versus Secondary Bankruptcy: A European Debate, 2 INT'L INSOLVENCY REV. 151, 151-52 (1993).

14. See *id.* at 152.

proceeding¹⁵ might be needed in Country B to assist the proceeding in Country A. All creditors from Country B who intend to share in the distribution of the debtor's assets would be required to submit claims in the insolvency proceeding in Country A.¹⁶

Under a universality/plurality approach, Country B would also recognize and give effect to the insolvency proceedings in Country A and assist the foreign representative from Country A with respect to certain assets, such as movable property not subject to prior attachment. However, Country B's law would permit the commencement of an independent insolvency proceeding in Country B in which Country B's substantive insolvency law (e.g., regarding priorities and the avoidance of local attachments) would be applied. At that point, depending on how much cooperation Country B wants to offer, the court in Country B could act in an ancillary capacity and order the turnover of local assets to Country A,¹⁷ permit a scheme of arrangement to be negotiated with Country A for the worldwide distribution of assets, or make a distribution to creditors under local law.

Lastly, under a territoriality/plurality approach, Country B would neither recognize nor assist the insolvency proceedings in Country A. A separate insolvency proceeding would be commenced in Country B to adjudicate all claims to the debtor's assets located there.

Cross-border cooperation is most extensive under a universality/unity approach, which is premised on the notion of equality of distribution to creditors worldwide. The administration of all claims in a single insolvency proceeding minimizes expenses, although it may at times cause inconvenience or hardship for individual creditors who must travel abroad to participate in the primary insolvency proceeding.¹⁸ Cross-border cooperation is less frequent when countries adopt a territoriality approach, which often leads to a full-scale insolvency proceeding in each jurisdiction in which a debtor's assets are located. Expenses are, therefore, greatest under the

15. The term "ancillary" proceeding is used in § 304 of the U.S. Bankruptcy Code 11 U.S.C.A. § 304 (1995). See generally Charles D. Booth, *Recognition of Foreign Bankruptcies: An Analysis and Critique of the Inconsistent Approaches of United States Courts*, 66 AM. BANKR. L.J. 135, 148-217 (1992) [hereinafter *Recognition of Foreign Bankruptcies*]. The term has a different meaning under Hong Kong law not intended here. See *infra* note 17.

16. See Unger, *supra* note 12, at 1154.

17. In a Hong Kong corporate insolvency, this proceeding would be called an "ancillary winding up." See *Re Irish Shipping Ltd.*, [1985] H.K.L.R. 437. See also PHILIP ST J. SMART, CROSS-BORDER INSOLVENCY 233-52 (1991).

18. See Unger, *supra* note 12, at 1154-55.

territoriality approach.

III. THE OPTIONS AVAILABLE UNDER HONG KONG LAW FOR PROTECTING THE ASSETS OF A FOREIGN DEBTOR IN HONG KONG AND FOR OBTAINING CROSS-BORDER ASSISTANCE FROM HONG KONG COURTS¹⁹

A. *Recognition of Foreign Insolvencies*

Under Hong Kong law, no statutory provision governs the recognition of foreign insolvencies;²⁰ rather, case law provides the guiding principles regarding recognition. Only a few reported Hong Kong cases exist concerning this topic, but Hong Kong courts also follow applicable English cases. These Hong Kong and English cases, and the writings of English law commentators, are discussed below.²¹

Inasmuch as Hong Kong draws a distinction between bankruptcy law and corporate liquidation law,²² it also draws a distinction between the recognition of foreign bankruptcies and the recognition of foreign liquidations. In short, foreign bankruptcies are recognized under Hong Kong law when (1) declared by a court in the jurisdiction in which the debtor was domiciled at the commencement of the bankruptcy²³ or (2) the debtor submits to the jurisdiction of the foreign court.²⁴ Some commentators support the proposition that a foreign bankruptcy should also be recognized when the debtor carries

19. Parts of this section have been condensed from Booth, *supra* note *, at 13-57.

20. However, prior to its repeal in 1985, the United Kingdom Bankruptcy Act, 1914, 4 & 5 Geo. 5, ch. 59, §122 [hereinafter the U.K. Bankruptcy Act 1914], which provided for cooperation among bankruptcy courts throughout the Commonwealth, was applicable in Hong Kong. See Booth, *supra* note *, at 17 n.82.

21. For a discussion of the application of English law in Hong Kong and the effect of English judicial decisions on Hong Kong courts, see Booth, *supra* note *, at 13-16. For a more detailed analysis of this, at times, complex topic see Peter Wesley-Smith, *The Reception of English Law in Hong Kong*, 18 H.K.L.J. 183 (1988); Peter Wesley-Smith, *The Effect of 'De Lasala' in Hong Kong*, 28 MALAYA L.R. 50 (1986).

22. See *supra* note 1.

23. *Modern Terminals (Berth 5) Ltd. v. States S.S. Co.*, [1979] H.K.L.R. 512, 513 (citing the English case, *Re Blithman*, (1866) L.R. 2 Eq. 23). See also the following commentators, who discuss English law and cite *Re Blithman*: 2 DICEY & MORRIS ON THE CONFLICT OF LAWS, Rule 167(2)(a) and accompanying Comment, at 1172-74 (12th ed. 1993) [hereinafter 2 DICEY & MORRIS]; SMART, *supra* note 17, at 83.

24. *Modern Terminals* 1979 H.K.L.R. at 513 (1979) (citing the English case, *Re Anderson* (1911) 1 K.B. 896). See also 2 DICEY AND MORRIS, *supra* note 23, Rule 167(2)(b) and accompanying Comment, at 1172-74; SMART, *supra* note 17, at 85-86.

on business within the jurisdiction of the foreign court.²⁵

With respect to foreign liquidations, Hong Kong courts will as a rule recognize a foreign liquidation that is granted under the law of the place of the company's incorporation.²⁶ However, other grounds exist upon which recognition may be based,²⁷ including the following: (1) that the company carries on business within the jurisdiction of the foreign court;²⁸ (2) that the company submits to the insolvency jurisdiction of the foreign court;²⁹ or (3) that a liquidation is unlikely to take place in the jurisdiction in which a company is incorporated.³⁰

Hong Kong courts must sometimes decide whether to apply the rules regarding the recognition of foreign bankruptcies or the rules regarding the recognition of foreign liquidations. In *Modern Terminals (Berth 5) Ltd. v. States Steamship Co.*,³¹ this issue arose in the context of whether to recognize the rehabilitation of a U.S. company under Chapter XI of the United States Bankruptcy Act of 1898 (the "U.S. Bankruptcy Act of 1898").³² The Hong Kong court noted that the U.S. Bankruptcy Act of 1898 dealt with corporate liquidations, which in Hong Kong are governed by the Companies Ordinance, but the court nevertheless relied exclusively on bankruptcy rather than companies law precedent in deciding whether to recognize

25. IAN F. FLETCHER, *THE LAW OF INSOLVENCY* 574 (1990); SMART, *supra* note 17, at 86-92. Some commentators propose that a foreign bankruptcy should also be recognized on the basis of the residence of the bankrupt within the jurisdiction of the foreign court. See FLETCHER, *supra*; SMART, *supra* note 17, at 95-96.

26. See *Re Irish Shipping* 1985 H.K.L.R. at 439 (1985); 2 DICEY AND MORRIS, *supra* note 23, Rule 160 and accompanying Comment, at 1137-39, and SECOND SUPPLEMENT TO THE TWELFTH EDITION 99 (1995) [hereinafter SECOND SUPPLEMENT]; SMART, *supra* note 17, at 102-03.

27. But see J.W. Wolonieccki, *Co-operation Between National Courts in International Insolvencies: Recent United Kingdom Legislation*, 35 INT'L & COMP. L.Q. 644, 656 (1986) (asserting that "[i]t is not clear whether the English court will recognize the jurisdiction of a foreign court to wind up a company in any case where the company is not incorporated under the law of that court").

28. SMART, *supra* note 17, at 107-08 (but noting that there might be limits to the consequences of such recognition); 2 DICEY AND MORRIS, *supra* note 23, Comment to Rule 160, at 1138.

29. SMART, *supra* note 17, at 108-09.

30. 2 DICEY AND MORRIS, *supra* note 23, Comment to Rule 160, at 1138-39; SMART, *supra* note 17, at 106-07. See also *Re Russo-Asiatic Bank*, 24 H.K.L.R. 16 (1930), *appeal dismissed*, 24 H.K.L.R. 100 (1930).

31. [1979] H.K.L.R. 512.

32. *Id.* at 513. United States Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898) (repealed 1978) [hereinafter the U.S. Bankruptcy Act of 1898].

the U.S. rehabilitation proceedings.³³

The approach of the English case of *Felixstowe Dock and Railway Co. v. United States Lines Inc.*,³⁴ offers an alternative to the *Modern Terminals* approach.³⁵ This case involved the recognition of insolvency proceedings in which a U.S. company was reorganizing under Chapter 11 of the United States Bankruptcy Code (the "U.S. Bankruptcy Code").³⁶ The court treated the case as one involving the recognition of a foreign liquidation³⁷ and its approach is thus preferable to that employed in *Modern Terminals*.³⁸

Even if a foreign debtor fulfills the above criteria for the recognition of a foreign bankruptcy or liquidation, recognition may nevertheless not be forthcoming. A Hong Kong court may refuse to grant recognition (1) where the recognition of the foreign insolvency would be contrary to Hong Kong public policy,³⁹ (2) where the foreign insolvency decree was made as a result of fraud or is in breach of the rules of natural justice,⁴⁰ or (3) where the foreign insolvency proceedings are an attempt to enforce a foreign penal or revenue law.⁴¹

A serious weakness in both the Bankruptcy Ordinance and the Companies Ordinance is the failure to include provisions regarding the recognition of foreign insolvencies. In this area of the law, especially with 1997 fast approaching, it would be best for the common law approach to be supplanted by detailed statutory guidelines. Ideally, these guidelines should also expand the existing recognition criteria. Definitions of the terms "foreign representative" and "foreign proceeding" should be enacted, perhaps by adapting the definitions currently included in the U.S. Bankruptcy Code.⁴²

For example, "foreign representative" could be defined as a

33. *Modern Terminals*, [1979] H.K.L.R. at 514-21.

34. *Felixstowe Dock and Railway Co. v. United States Lines Inc.*, [1989] Q.B. 360.

35. See SMART, *supra* note 17, at 114-15.

36. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in 11 U.S.C.A. (1995), in scattered sections of 28 U.S.C.A. (1995), and in scattered sections of other titles).

37. SMART, *supra* note 17, at 114. *Felixstowe Dock*, [1989] Q.B. 360.

38. SMART, *supra* note 17, at 114-15.

39. *Id.* at 117-18.

40. *Id.* at 118-23.

41. *Id.* at 125-31. In cases involving the enforcement of foreign revenue laws, it is generally accepted that this exception to recognition should apply only where the sole object of the foreign proceedings is to enforce foreign revenue laws. *Id.*

42. See 11 U.S.C.A. §101(23), (24) (West 1995).

“duly selected trustee, liquidator, receiver, receiver and manager, administrator, or other representative of an estate or company in a foreign proceeding.” “Foreign proceeding,” in turn, could be defined as follows:

a proceeding, whether judicial or administrative and whether or not under bankruptcy, liquidation, or other insolvency law, in a foreign country in which:

- (a) in a case involving an individual or partnership
 - (1) the debtor's domicile, residence, or principal assets were located at the commencement of such proceeding;
 - (2) the debtor carried on business at the commencement of such proceeding; or
 - (3) the debtor submitted to the jurisdiction of the court; and
- (b) in a case involving a company
 - (1) the company was incorporated at the commencement of such proceeding;
 - (2) the company carried on business at the commencement of such proceeding;
 - (3) the company's principal assets were located at the commencement of such proceeding; or
 - (4) the company submitted to the jurisdiction of the court

as the case may be, for the purpose of liquidating an estate or winding up a company, adjusting debts by composition, extension, or discharge, or effecting a reorganization or restructuring.

The term “foreign proceeding” is especially important and, as can be seen above, should set forth the required jurisdictional connection between the foreign debtor and the foreign jurisdiction that would justify the granting of recognition by a Hong Kong court to a foreign bankruptcy or liquidation. Attention should also be given to resolving cases in which a Hong Kong court is confronted with requests for recognition and assistance by foreign representatives from two or more jurisdictions. In my view, as a general rule, preference should be given in bankruptcy to the jurisdiction in which the debtor was domiciled at the commencement of the insolvency, and in liquidation, to the jurisdiction in which the foreign corporation had its

primary place of business.⁴³

B. The Options Available for Protecting the Assets of a Foreign Debtor in Hong Kong and for Obtaining Cross-Border Assistance from Hong Kong Courts

1. Non-Insolvency Options

Under Hong Kong law, once recognition is granted, the next issue that arises concerns the types of assistance that may be forthcoming.⁴⁴ It is clear that Hong Kong courts have the inherent jurisdiction to assist a foreign representative from any jurisdiction.⁴⁵ A variety of options may be pursued to protect the assets of a foreign debtor in Hong Kong and to obtain cross-border assistance from the Hong Kong courts.

The English case of *Galbraith v. Grimshaw*,⁴⁶ decided in 1910, remains applicable in Hong Kong to this day.⁴⁷ This case stands for the principle that a foreign order vesting title in a foreign trustee operates to vest in the foreign trustee movable (personal) property in Hong Kong that is not subject to prior attachment, execution, or valid charge—provided the foreign law extends to movable property in Hong Kong.⁴⁸ Thus, a foreign trustee will be able to claim such

43. Given that many Hong Kong companies have "redomiciled" overseas, adoption of this test would be consistent with a related principle that should be adopted, namely, that, as a general rule the primary liquidation of any former Hong Kong company that has reincorporated elsewhere, but has retained its primary place of business in Hong Kong, should take place in Hong Kong. See *infra* notes 123-24 (noting the number of overseas companies that are listed on the Hong Kong Stock Exchange and the number of local companies that have redomiciled overseas).

However, preferring the jurisdiction in which the foreign company was incorporated would be more consistent with existing case law.

44. SMART, *supra* note 17, at 79, 135.

45. See *id.* at 259. See also the English case of *In re Kooperman*, 1928 W.N. 101 (discussed in *id.* at 98). Prior to its repeal in 1985, § 122 of the U.K. Bankruptcy Act 1914 provided statutory authorization for granting assistance to bankruptcy trustees from Commonwealth jurisdictions.

46. *Galbraith v. Grimshaw*, [1910] App. Cas. 508.

47. See *Modern Terminals*, [1979] H.K.L.R. at 517, 523, 525.

48. See 2 DICEY & MORRIS, *supra* note 23, Rule 169 & accompanying Comment, at 1175-77, and SECOND SUPPLEMENT, *supra* note 26, at 102; SMART, *supra* note 17, at 140. See also P.M. NORTH & J.J. FAWCETT, CHESHIRE AND NORTH'S PRIVATE INTERNATIONAL LAW 912 (12th ed. 1992) [hereinafter CHESHIRE & NORTH] (noting that "[t]he English courts have consistently applied the doctrine of *universality*, according to which they hold that all *movable* property, no matter where it may be situated at the time of the assignment by the foreign law, passes to the trustee.") (emphasis in original). But see Kurt H. Nadelmann, *Solomons v. Ross and International Bankruptcy Law*, 9 MOD. L. REV. 154, 163 (1946)

property in Hong Kong without seeking the assistance of the Hong Kong courts.⁴⁹ The same is true in the case of a foreign liquidator vested under foreign law with title to the company's assets.⁵⁰

Although title usually does not vest in a liquidator, Hong Kong law would most likely allow a foreign liquidator to represent a foreign corporation in Hong Kong and deal with its movable assets there, subject to any pre-existing attachment, execution, or charge,⁵¹ provided the foreign law extends to property in Hong Kong.

To gain control over a foreign debtor's immovable property in Hong Kong (as such property does not vest in the foreign representative), a foreign representative may seek to be appointed as the receiver of the foreign debtor's property in Hong Kong, with the power to sell the property and distribute the proceeds to the debtor's creditors after satisfying prior encumbrances.⁵²

Hong Kong law would also allow a foreign representative to commence civil proceedings, to seek declarations regarding the effect of foreign insolvency proceedings, and to recover debts.⁵³ The remedies available for debt collection in Hong Kong include the following: interim attachment of the debtor's property;⁵⁴ a writ of execution;⁵⁵ garnishee proceedings;⁵⁶ a charging order or stop order;⁵⁷ and an examination of a judgment debtor.⁵⁸ Hong Kong

(claiming that "[o]ne may wonder whether the theory of universality is part of English law" and concluding that whether a foreign trustee is entitled to collect local assets in England is a matter of discretion). See also *id.* at 161-62.

The foreign trustee's title may extend to after-acquired property in Hong Kong. See SMART, *supra* note 17, at 141-45. In addition, the English/Hong Kong rule has been to uphold the title of the foreign assignee over attachments made after the commencement of the foreign bankruptcy. CHESHIRE & NORTH, *supra*.

49. See SMART, *supra* note 17, at 140, 147-48; 2 DICEY & MORRIS, *supra* note 23, Rules 169, 170 and accompanying Comments, at 1175-79, and SECOND SUPPLEMENT, *supra* note 26, at 102.

50. See *Modern Terminals*, [1979] H.K.L.R. 512.

51. SMART, *supra* note 17, at 217. See also *id.* at 141, 149 n.17.

52. See 2 DICEY & MORRIS, *supra* note 23, Rule 170 & accompanying Comment, at 1178-79, and SECOND SUPPLEMENT, *supra* note 26, at 102; SMART, *supra* note 17, at 140-41. See The Rules of the Supreme Court, O. 30, cap. 4, sub. leg. A, L.H.K. (1995); Supreme Court Ordinance § 21L, cap. 4, L.H.K. (1995). The foreign representative should seek such relief through an application for an order in aid.

53. SMART, *supra* note 17, at 135.

54. The Rules of the Supreme Court, O. 44A, r. 7.

55. *Id.* O. 46, O. 47.

56. *Id.* O. 49.

57. *Id.* O. 50.

58. *Id.* O. 48.

law also provides for a variety of harsh legal methods for collecting debts, including the issuance of an order prohibiting a debtor from leaving Hong Kong⁵⁹ and the execution and enforcement of a judgment for money by imprisonment.⁶⁰ To pursue any of these options, the foreign representative must first prove that the foreign law permits him or her to commence the proceedings in Hong Kong.⁶¹

Hong Kong law also permits a foreign representative to submit a proof of debt in a Hong Kong insolvency. However, to claim her share of a distribution, a foreign representative must first comply with Hong Kong law.⁶² Under Hong Kong law, a foreign representative may also seek injunctive relief, including the entry of a stay of Hong Kong proceedings or execution,⁶³ or the entry of a Mareva injunction.⁶⁴

2. Winding Up

a. Introduction

Section 176 of the Companies Ordinance provides the Hong Kong High Court with the jurisdiction to wind up (or liquidate) any "company," which is defined in Section 2 of the Companies Ordinance.

59. *Id.* O. 44A, r. 2; Supreme Court Ordinance § 21B; District Court Ordinance § 52E(1)(a), cap. 336, L.H.K. (1995). See *Tam Hing-ye v. Wu Tai-wai*, 1 H.K.P.L.R. 261 (1991) (upholding the issuance of a prohibition order by the Hong Kong District Court under § 52E(1)(a) of the District Court Ordinance as not violating the Hong Kong Bill of Rights). For a discussion of this case, see 1(2) H.K. BILL OF RTS. BULL. 13-14 (Dec. 1991).

60. Rules of the Supreme Court, O. 49B; Supreme Court Ordinance § 21A.

61. SMART, *supra* note 17, at 139.

62. See *Re Kowloon Container Warehouse Co. Ltd.*, [1981] H.K.L.R. 210 (holding that a foreign creditor could not receive a distribution in a members' voluntary winding up until first paying a debt owed to the company being wound up).

63. See, e.g., *Modern Terminals*, [1979] H.K.L.R. 512 (refusing to order the stay of proceedings against a U.S. corporation undergoing rehabilitation under Chapter XI of the U.S. Bankruptcy Act, but granting a stay of execution). *But see Mobil Sales and Supply Corp. v. Owners of "Pacific Bear"*, [1979] H.K.L.R. 125 (refusing to order the stay of proceedings against a U.S. corporation undergoing rehabilitation under Chapter XI of the U.S. Bankruptcy Act of 1898).

64. A Mareva injunction is an interlocutory order sought to prevent a defendant from dealing with his assets and removing them from the jurisdiction in which they are located. Mark Gross, *Foreign Creditor Rights: Recognition of Foreign Bankruptcy Adjudications in the United States and the Republic of Singapore*, 12 U. PA. J. INT'L BUS. L. 125, 141-42 (1991); J. David Murphy, *Mareva Injunctions: Recent Developments*, in LAW LECTURES FOR PRACTITIONERS 1990 19 (J. David Murphy ed. 1990). However, the assets subject to a Mareva injunction are to be made available to creditors generally and are not security for the petitioner. Gross, *supra*, at 142; Murphy, *supra*, at 20.

nance as a Hong Kong company.⁶⁵ Foreign companies are wound up pursuant to provisions in Part X of the Companies Ordinance.⁶⁶ A foreign company in Hong Kong is called an "unregistered company;"⁶⁷ it is also called an "oversea company" if it has established a place of business in Hong Kong.⁶⁸ Although a foreign company is generally not considered to be a "company" as that term is defined in Section 2 of the Companies Ordinance,⁶⁹ it may be deemed to be a "company" to the extent provided by Part X of the Companies Ordinance.⁷⁰

It is often not necessary to commence a winding up to reach a foreign company's assets in Hong Kong. For instance, to the extent that movable assets in Hong Kong are not subject to any pre-existing attachment, execution, or charge, the foreign liquidator should be able to have the assets transferred to him as the representative of the foreign company or estate.⁷¹ Similarly, a foreign liquidator may attempt to be appointed as receiver of the foreign company's immovable property with the power to sell the property and distribute the proceeds to creditors.⁷² However, if these collection attempts prove unsuccessful, the foreign liquidator should consider commencing a liquidation of the foreign company.⁷³ Filing a petition for liquidation would also be advisable where unsecured creditors would benefit from some of the other advantages of liquidation, including the exercise of a liquidator's avoidance powers⁷⁴ (which are general-

65. Section 2 of the Companies Ordinance defines "company" as a "company formed and registered under this Ordinance or an existing company." An "existing company," in turn, is defined as a company formed and registered under earlier Hong Kong companies ordinances. Companies Ordinance § 2.

66. Companies Ordinance §§ 326-331A.

67. *Id.* § 326. See also *infra* text accompanying note 80.

68. *Id.* § 332. See also Securities and Futures Commission v. MKI Corp. Ltd., [1995] 2 H.K.C. 79 (holding that an "oversea company" may be wound up as an "unregistered company"), discussed *infra* in text accompanying notes 89-122.

69. See Insurance Co. of Pa. v. Grand Union Insurance Co., [1988] H.K.L.R. 541, 544 (dealing with an oversea company).

70. See Companies Ordinance § 331, discussed *infra* in note 88.

71. See *supra* note 51. Of course, the foreign law would have to extend to the property in Hong Kong.

72. See *supra* note 52.

73. See FLETCHER, *supra* note 25, at 615.

74. See Companies Ordinance § 269(1) (providing for the avoidance of attachments or executions that have not been completed prior to the commencement of a winding up), *id.* § 269(2) (providing how to complete an execution against goods, an attachment of a debt, and an execution against land); *id.* § 267 (providing for the avoidance of any floating charge granted by an insolvent company within twelve months of the commencement of the winding

ly not very extensive) or investigatory powers⁷⁵ or the application of the stay.⁷⁶ If a winding up order is made, the foreign liquidator may request the Hong Kong court to order the turnover of Hong Kong assets to the foreign liquidation for distribution abroad.⁷⁷

No provision in the Companies Ordinance expressly authorizes a foreign representative to commence a winding-up in Hong Kong of the foreign company that she represents, or whose estate she represents, in the foreign insolvency. Thus, if a foreign representative would like to commence a winding-up proceeding against the foreign company, she must either convince one of the foreign company's creditors to file the petition or file the petition herself on behalf of the foreign company.⁷⁸ Part X of the Companies Ordinance should be amended to provide explicitly that a foreign representative may petition in Hong Kong for the liquidation of the foreign company, or the estate of the foreign company, that she represents in the foreign proceeding.⁷⁹

up, except to the amount of any cash advanced to the company at the time of or after the creation of the charge, together with interest); *id.* § 266 (providing for the avoidance of any fraudulent preference made by or against the company within six months of the commencement of the liquidation).

75. See *id.* §§ 221-22.

76. A stay commences upon the making of the winding up order, or earlier upon the appointment of a provisional liquidator and prevents actions or proceedings from being continued or commenced against the company, except with the leave of court. *Id.* § 186. The stay, however, does not prevent secured creditors from exercising their rights in respect of their security. ROY M. GOODE, *COMMERCIAL LAW* 850-51 (2d ed. 1995). After the presentation of a winding up petition, but before the making of a winding up order or the appointment of a provisional liquidator, pending actions or proceedings against the company may be stayed or restrained. Companies Ordinance § 181.

77. A turnover order was made in the liquidation involving Irish Shipping Ltd. *Re Irish Shipping Ltd.*, Companies Winding Up No. 408 of 1984 (June 7, 1985).

78. The latter approach was used in *Irish Shipping Ltd.* [1985] H.K.L.R. at 439. The foreign representative would be able to make the filing pursuant to Companies Ordinance § 179(1), which provides that a winding up petition may be presented, *inter alia*, by the company itself or by any creditor or creditors. Companies Ordinance § 179(1). This section is applicable to the winding up of a foreign company pursuant to §§ 327(1) and 331 of the Companies Ordinance. *Id.* §§ 327(1), 331; see also *infra* note 88 and accompanying text.

79. Such a provision is currently contained in § 303(b)(4) of the U.S. Bankruptcy Code, which provides that an involuntary bankruptcy case may be commenced against a person "by a foreign representative of the estate in a foreign proceeding concerning such person." 11 U.S.C.A. § 303(b)(4) (West 1995). The Bankruptcy Code also defines "person" to include an individual, a partnership, and a corporation. 11 U.S.C.A. § 101(a)(41). Of course, the foreign representative should have to demonstrate that she was authorized under foreign law to commence the winding up in Hong Kong. See *Irish Shipping*, [1985] H.K.L.R. at 441-42.

b. *Sections 326, 327, and 327A of the Companies Ordinance*

Part X of the Companies Ordinance, entitled "Winding Up Of Unregistered Companies," contains the relevant sections for winding up foreign companies. Section 326 defines "unregistered company" to include any partnership, limited partnership, association, and company, except for the following:

- (a) a company registered under the Companies Ordinance 1865 (1 of 1865), or under the Companies Ordinance 1911 (58 of 1911), or under this Ordinance;
- (b) a partnership, association or company which consists of less than eight members and is not a foreign partnership, association, or company;
- (c) a partnership registered in Hong Kong under the Limited Partnership Ordinance (Cap. 37).⁸⁰

Section 327(1), in turn, provides that, subject to the provisions of Part X of the Companies Ordinance, any unregistered company may be wound up under the Companies Ordinance. Under Section 327(3), an unregistered company may be wound up under the following circumstances:

- (a) if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs;
- (b) if the company is unable to pay its debts;
- (c) if the court is of opinion that it is just and equitable that the company should be wound up.⁸¹

Most foreign companies in Hong Kong are wound up as "unregistered companies" under Section 327.⁸² Foreign companies may also be

80. Companies Ordinance § 326. Interestingly, although a "partnership" is not a "company" under § 2 of the Companies Ordinance, a Hong Kong partnership with eight or more partners and a foreign partnership are both defined as an "unregistered company" and may therefore be wound up under Part X of the Companies Ordinance. Bankruptcy proceedings may also be commenced against a partnership carrying on business in Hong Kong. Bankruptcy Ordinance § 7(1); *see also* Bankruptcy Ordinance § 109.

Amendments should be made to current law mandating that the insolvencies of partnerships be administered under either companies or bankruptcy law.

81. Companies Ordinance § 327(3). The Companies Ordinance defines the circumstances in which an unregistered company shall be deemed unable to pay its debts *id.* § 327(4). These criteria are somewhat broader than the criteria applicable to the winding up of Hong Kong companies. *Id.* § 178.

82. Philip Smart, *Cross-Border Insolvency*, in *LAW LECTURES FOR PRACTITIONERS 1991* 139, 142 (Jill Cottrell ed., 1991).

wound up under Section 327A of the Companies Ordinance,⁸³ although in practice this section is rarely used.⁸⁴ Section 327A, which is oddly entitled "Oversea companies may be wound up although dissolved," provides as follows:

Where a company incorporated outside Hong Kong which has been carrying on business in Hong Kong ceases to carry on business in Hong Kong, it may be wound up as an unregistered company under this Part [X of the Companies Ordinance], notwithstanding that it has been dissolved or otherwise ceased to exist as a company under or by virtue of the laws of the place of its incorporation.

Philip Smart has noted, in reference to the English equivalent to the title of Section 327A of the Companies Ordinance, that the use of the term "oversea company" is inappropriate.⁸⁵ The same is true with respect to the use of the term "oversea companies" in the title to Section 327A; this term generally refers to a foreign company that has established a place of business in Hong Kong,⁸⁶ but a company incorporated outside Hong Kong need not have an established place of business to carry on business in Hong Kong.⁸⁷ This inaccuracy in the existing title of Section 327A should be corrected; the reference to "oversea companies" could be replaced with a reference to "foreign companies carrying on business in Hong Kong."

Pursuant to Sections 327(1) and 331 of the Companies Ordinance, in the winding up of unregistered companies, the provisions in Part X of the Companies Ordinance are supposed to supplement the other winding-up provisions contained in the Companies Ordinance.⁸⁸ However, Sections 327(1) and 331 are somewhat inelegant-

83. See *Dairen Kisen Kabushiki Kaisha v. Shiang Kee*, [1941] App. Cas. 373 (P.C. 1941) (appeal taken from the Sup. Ct. of H.K.) (involving the liquidation in Hong Kong of the Hong Kong branch of a company incorporated and dissolved in the Republic of China (under § 313(2) of the Companies Ordinance (cap. 32, L.H.K., 1932), re-enacted with minor changes as § 327A of the Companies Ordinance)).

84. Smart, *supra* note 82, at 142. However, a filing under § 327A was fairly recently made in *Macau-Mokes Group Ltd.*, Companies Winding Up No. 62 of 1994 (Feb. 3, 1994).

85. SMART, *supra* note 17, at 68.

86. See *supra* note 68 and accompanying text.

87. SMART, *supra* note 17, at 68.

88. Section 327(1) provides as follows:

Subject to the provisions of this Part [X of the Companies Ordinance], any unregistered company may be wound up under this Ordinance, and all the provisions of this Ordinance with respect to winding up shall apply to an unregistered company, with the exceptions and additions mentioned in this section.

ly drafted, and they overlap and even conflict in scope. Section 327(1) provides that the general winding-up provisions in the Companies Ordinance are subject to the "exceptions and additions" of Section 327; in contrast, Section 331 provides that the winding-up provisions elsewhere in the ordinance are to be supplemented, but not restricted, by the provisions in Part X. These sections should be redrafted to eliminate the overlap and confusion.

The poor drafting of other provisions in Part X of the Companies Ordinance causes ambiguity in resolving even more fundamental issues, notably, the need (1) to resolve the confusing relationship among Sections 326, 327, and 327A and (2) to determine whether these sections are applicable to the winding up of oversea companies. These two issues were only recently resolved in the Hong Kong High Court case, *Securities and Futures Commission v. MKI Corp. Ltd.*,⁸⁹ in which the court held that the power to wind up an unregistered company under Section 327 extends to oversea companies registered under Part XI of the Companies Ordinance.

MKI Corporation Limited ("MKI") was incorporated under the laws of Bermuda. It established a place of business in Hong Kong and registered under Part XI of the Companies Ordinance as an oversea company. Its shares were listed on the Hong Kong Stock Exchange. In 1993, MKI's management entered into deals that led to a decrease in the company's assets from HK\$160.7 million to HK\$7.7 million.⁹⁰ Nevertheless, in the following year, during a one-month period ending on June 5, 1994, MKI's shares doubled in value

Section 331 provides as follows:

The provisions of this Part [X of the Companies Ordinance] with respect to unregistered companies shall be in addition to and not in restriction of any provisions hereinbefore in this Ordinance contained with respect to winding up companies by the court, and the court or liquidator may exercise any powers or do any act in the case of unregistered companies which might be exercised or done by it or him in winding up companies formed and registered under this Ordinance:

Provided that an unregistered company shall not, except in the event of its being wound up, be deemed to be a company under this Ordinance, and then only to the extent provided by this Part [X of the Companies Ordinance].

89. *MKI*, [1995] 2 H.K.C. 79.

90. Ada Yuen, *MKI Corp saved from liquidation*, S. CHINA MORNING POST, Sept. 28, 1995 (Business Post), at 3. In a later decision involving an application in respect of costs, the Hong Kong High Court noted that with respect to MKI's dealings relating to land in China, "either there was deliberate dissipation of the Company's money to persons connected with the management and others or else the management of the Company was so culpably inept that large amounts of money were lost." *Re MKI Corp.*, Companies Winding Up No 562 of 1994 (C. 25, 1995) (unrep.), at 3 [hereinafter *MKI II*].

from HK\$.31 to HK\$.61.⁹¹ The Securities and Futures Commission ("SFC")⁹² quickly intervened and, on June 6, 1994, suspended trading in MKI shares on the ground that the company had issued press releases that they had failed to clear with regulators.⁹³

Suspecting that the directors of MKI had misled its shareholders and committed fraud,⁹⁴ the SFC petitioned to wind up the company,⁹⁵ relying on Section 45 of the Securities and Futures Commission Ordinance.⁹⁶ This was the first time that the SFC petitioned to wind up a listed company in Hong Kong. The SFC asserted that the Hong Kong High Court had the power to wind up MKI under Section 327 of the Companies Ordinance.

MKI disputed this assertion and moved to strike out the petition. It argued that the power to wind up a company under Section 327 is limited to unregistered companies, which are defined in Section 326. Section 326(a) provides that an unregistered company does not include a company registered under the Companies Ordinance.

91. Kerry Wong, *A white knight in sullied armour*, S. CHINA SUNDAY MORNING POST, May 7, 1995 (Money), at 3.

92. The Securities and Futures Commission was established in 1989 to be responsible for a variety of functions with respect to the enforcement of Hong Kong laws that relate to securities, futures contracts, and property investment arrangements. Securities and Futures Commission Ordinance § 4 (cap. 24, L.H.K.) (1995).

93. Wong, *supra* note 91.

94. Bruce Gilley, *Top cadre 'tricked' into joining MKI*, EASTERN EXPRESS, Dec. 15, 1994, at 1. The High Court later noted that MKI:

had been used to dupe the public. The shares had been artificially boosted with false information and at the same time money was at best frittered away in imprudent deals and more likely siphoned out of the Company with unscrupulous deals and all the time the Company was giving the impression it was being run by its directors but in truth and in fact they were acting as fronts for a person who had good reason to distance himself and be seen to distance himself from the Company.

MKI II, *supra* note 90 at 13.

95. The colorful story surrounding MKI also exemplifies the growing ties between Hong Kong companies and Mainland Chinese interests. In November 1994, Yao Mingwei, a son of the retired Chinese Communist Party leader Yao Yilin (or a "Red Prince," as a son of a high ranking Chinese leader is called) became non-executive chairman of MKI. Mr. Yao claims that he was "tricked" into becoming the chairman and that MKI "used him" to get money out of China, but never told him about the background to the company's business. Gilley, *supra* note 94.

96. (Cap. 24, L.H.K.) (1995). This section provides as follows:

If, in the case of a company which may be wound up by the court under the Companies Ordinance (Cap. 32), it appears to the Commission that it is expedient in the public interest that the company should be wound up, the Commission may, subject to subsection (2), present a petition for it to be wound up under that Ordinance on the ground that it is just and equitable that it should be so wound up.

However, MKI argued that Part XI of the Ordinance (unlike corresponding provisions in the United Kingdom legislation) provides that an oversea company *is* registered and, more particularly, that Section 333(3) of the Companies Ordinance "makes clear that a company in respect of which the appropriate steps have been taken is registered."⁹⁷ Lastly, the company asserted that Section 326(a) makes clear that registration under Part XI is registration under the Companies Ordinance.⁹⁸

The High Court, however, found that MKI had misconstrued the Hong Kong legislation, and it dismissed the company's application.⁹⁹ The court's discussion both of the relationship among Sections 326, 327, and 327A of the Companies Ordinance and of the scope of these provisions is instructive. To resolve these issues, the court reviewed the history of the provisions in Part XI of the Companies Ordinance relating to oversea companies. The court noted that provisions requiring oversea companies to register certain documents¹⁰⁰ were enacted in Hong Kong in Ordinance 58 of 1911 (the "Companies Ordinance 1911"), having earlier been enacted in the United Kingdom.¹⁰¹ In 1973, the Companies Law Revision Committee proposed a number of recommendations, including a recommendation that a company should register itself in addition to its documents.¹⁰² This recommendation was finally enacted as part of the 1984 amendments to the Companies Ordinance, and a companies register was established.¹⁰³

The court then turned to the power of the court to wind up an unregistered company under Section 327 of the Companies Ordinance

97. *MKI*, [1995] 2 H.K.C. at 82.

98. *Id.*

99. The High Court had intended to order that MKI be liquidated. However, on September 27, 1995, shareholders avoided liquidation by voting in support of a takeover proposal of the Singapore company, Winfoong Investment ("Winfoong"). Ada Yuen, *supra* note 90. The shareholders preferred Winfoong's proposal to that of China-backed Wing Hing Holdings. On October 9, 1995, the SFC withdrew its petition. Three days later, when trading in the reconstituted company's shares was resumed, MKI's share price soared more than 100%, from HK\$0.80 to HK\$1.68. Lorraine Chan, *MKI soars as trading resumes*, EASTERN EXPRESS, Oct. 13, 1995 (Business), at 19.

100. Including the company's charter, a list of directors, and the name and address of an individual in Hong Kong who was authorized to accept service and notices on behalf of the company. *MKI*, [1995] 2 H.K.C. at 83.

101. *Id.*

102. *Id.* See SECOND REPORT OF THE COMPANIES LAW REVISION COMMITTEE: COMPANY LAW ¶ 10.16, at 297 (April 1973) [hereinafter the 1973 REPORT OF THE COMPANIES LAW REVISION COMMITTEE].

103. See Companies Ordinance § 333(3).

and reviewed the jurisdictional requirements as espoused by English courts under the equivalent United Kingdom provision.¹⁰⁴ The court concluded that companies incorporated overseas may be wound up under the United Kingdom equivalent to Section 327 irrespective of whether the companies have registered documents as overseas companies under United Kingdom law.¹⁰⁵ The court noted that at least prior to the enactment of the 1984 amendments in Hong Kong, the same was true of Hong Kong law.

The court then turned to the effect of the 1984 amendments and considered whether the language in Section 326 "registered . . . under this Ordinance" should be construed as including or excluding companies registered under Part XI of the Companies Ordinance. To gain a better understanding of Section 326, the court first considered the application of Section 327A to companies registered under Part XI. This section provides that the court may wind up a company "which has ceased to carry on business in Hong Kong *notwithstanding* that it has been dissolved or otherwise ceased to exist."¹⁰⁶ The court pointed out that although it may well be the case that a company carrying on business may not have established a place of business in Hong Kong,¹⁰⁷ in practice, a company being wound up pursuant to Section 327A would quite likely be a company that is registered under Part XI of the Companies Ordinance.¹⁰⁸

The court also discussed the origins of Section 327A, noting that the section was enacted in Hong Kong in Ordinance No. 39 of 1932 and was based on earlier enactments in the United Kingdom.¹⁰⁹ The court accepted the reasoning of an earlier English decision that the United Kingdom equivalent of Section 327A "did not confer any

104. *MKI*, [1995] H.K.C. at 84 (1995) (citing *Re A Company No. 00359 of 1987 Ch. 210* (1988) [hereinafter *Okeanos Maritime Corp.*] (noting "that the jurisdiction to wind up a foreign company is flexible, that there is a sufficiently close connection with the jurisdiction, and that there is a reasonable possibility that creditors will benefit from the winding up")); *Re Real Estate Development Co.*, [1991] B.C.L.C. 210 ("that the court must be able to exercise jurisdiction over one or more persons interested in the distribution of the company's assets"). The court also noted that United Kingdom Courts were originally given the power to wind up companies in 1862, but that this power was not extended to Hong Kong until 1911. *Id.* at 83.

105. *Id.* at 83-84. Companies that have not established a place of business may not register documents.

106. *Id.* at 85 (emphasis supplied).

107. See *supra* notes 85-87 and accompanying text.

108. *MKI*, [1995] H.K.C. at 10.

109. *Id.* (citing United Kingdom Companies Act, 1928, 18 & 19 Geo. 5, ch. 45, §91, and United Kingdom Companies Act, 1929, 19 & 20 Geo. 5, ch. 23, §338).

new power to wind up companies.”¹¹⁰ Rather, this section was intended to “remove a doubt as to the court’s jurisdiction which arose in connection with the dissolution of Russian banks following the revolution in 1917.”¹¹¹ The court thus noted that Section 327A “harks back to Section 327(3)(a)”¹¹² and “is predicated upon the basis that there is power to wind up if the company has not been dissolved or otherwise ceased to exist in the country of its incorporation.”¹¹³ Thus, in the court’s view, since oversea companies may be wound up under Section 327A and since the power to wind up foreign companies under Section 327A has its origins in Section 327(3)(a), “the presence of Section 327A alone makes it difficult to construe Section 326 as excluding companies registered under Part XI from inclusion within the meaning of unregistered companies as used in that section. Such a construction would render Section 327A largely ineffective.”¹¹⁴ Furthermore, the court noted that the fact that Section 327A was expressly re-enacted by the 1984 legislation demonstrated that the Hong Kong legislature had not intended that the changes in the registration mechanics for oversea companies was to have any impact on the scope of companies covered by the phrase “a company registered . . . under this Ordinance” in Section 326.¹¹⁵

The court’s interpretation of the relevant statutory language is sound. Moreover, a review of predecessor provisions in the Companies Ordinance 1911¹¹⁶ further assists in interpreting Section 326. The confusing manner in which the term “unregistered company” is defined lies at the heart of the debate about the scope of Section 326(a). As noted above, this section exempts “a company registered . . . under this Ordinance” from the definition of an “unregistered company.” This phrase first appeared in Hong Kong law (in a slightly different form) in Section 245 of the Companies Ordinance 1911. Like Section 2 of the current Companies Ordinance, Section 261 of the 1911 legislation defined the term “company” as a “company formed and registered under this Ordinance or an existing company.”¹¹⁷ Section 1(2), in turn, provided that the 1911 ordi-

110. *Id.*, at 85 (quoting *Re A Company* (No. 007946 of 1993) 1 B.C.L.C. 565, 570 (1994)).

111. *Id.* (quoting 1 B.C.L.C. at 570 (1994)).

112. *Id.* at 86.

113. *Id.*

114. *Id.*

115. *Id.*

116. No. 58 of 1911, L.H.K.

117. Comp’ Ordinance 1911, §261.

nance "applie[d] to every company registered" in Hong Kong¹¹⁸. Part IX of the 1911 legislation dealt with Companies Established Outside the Colony, and Section 252(1) of Part IX included the provision referred to by the *MKI* court that required every company which established a place of business in Hong Kong to register certain documents with the Companies Registrar.¹¹⁹

It is unfortunate that the definition of "unregistered company" in Section 245 of the Companies Ordinance 1911 failed to track the "formed and registered" language in Section 261. However, at that time and until the enactment of the 1984 amendments to Hong Kong companies law, this omission made no difference, because any company registered under Hong Kong companies legislation would also have been formed under Hong Kong companies law; there were no companies that were "registered" but not "formed" under Hong Kong companies law. Thus, the effect of Section 245 of the Companies Ordinance 1911 would have been to exclude Hong Kong companies, that is, companies "formed and registered" under Hong Kong companies law, from the definition of an unregistered company. The same is true of the effect of Section 326(a) the Companies Ordinance, at least until 1984.¹²⁰

With the enactment of the 1984 amendments to Part XI of the Companies Ordinance, the interpretation of Section 326(a) became more complicated. These changes mandated for the first time that an

118. *Id.* at §1(2).

119. The Companies Ordinance 1911 was the first Hong Kong companies ordinance that required foreign companies to register documents. A similar requirement had been enacted in the United Kingdom in the 1907 and 1908 companies legislation. *MKI*, [1995] 2 H.K.C. at 83. Thus, prior to the enactment of § 252(1) in the Companies Ordinance 1911, foreign companies were not required to register any documents with the Hong Kong government.

120. The *MKI* court noted that "the phrase 'registered under this Ordinance' was not and never had been used in respect of Part XI companies." *MKI*, [1995] 2 H.K.C. at 87. That is correct, but there would have been no reason for the issue to have arisen, because Part XI companies were not registered under the Companies Ordinance prior to 1984.

Further support for the interpretation urged above can be gleaned from existing United Kingdom legislation, which reflects the pre-1984 Hong Kong situation in that overseas companies in the United Kingdom continue to register documents rather than the companies themselves. Although the United Kingdom Companies Act, 1985, ch. 6, §735, defines a "company" as a company "formed and registered" under that act, United Kingdom companies are wound up under Part IV of the United Kingdom Insolvency Act, 1986, ch. 45 [hereinafter U.K. Insolvency Act 1986], which is titled "Winding Up Of Companies Registered Under the Companies Acts" (and not "Winding Up Of Companies Formed and Registered . . ."). "Unregistered companies" are wound up under Part V of the U.K. Insolvency Act 1986, which is entitled "Winding Up Of Unregistered Companies." It should also be noted that the U.K. Insolvency Act 1986, §220, which defines an "unregistered company", also retains the reference to a company "registered" (rather than "formed and registered") under United Kingdom companies law.

oversea company must register itself, and not just its documents, with the Companies Registrar. The 1984 amendments, however, did not amend the definition of "unregistered company" in Section 326 to track the "formed and registered" language in Section 2 of the Companies Ordinance. This legislative oversight is what led to the dispute in *MKI*, for after 1984 it was possible to have a company that could be "registered," though not "formed," under the Companies Ordinance.

There is no evidence that the enactment of the 1984 amendments to Part XI of the Companies Ordinance was intended to have any effect on the interpretation of the exception contained in Section 326(a). To interpret Section 326(a)'s exemption of "a company registered . . . under this Ordinance" as exempting an "oversea company" registered under Part XI would be inconsistent with the intended application of Section 326(a) and its 1911 predecessor provision, namely, that the exemption of companies "registered" under Hong Kong companies law extends only to companies that are "formed and registered" under the applicable Hong Kong companies ordinance.¹²¹

Thus, one can see from the above analysis and from the opinion of the court in *MKI* that since the exemption in Section 326(a) does not apply to Part XI companies, it is appropriate to wind up oversea companies under Section 327 of the Companies Ordinance. Important policy considerations also support this result. As the *MKI* court noted, acceptance of *MKI*'s argument would have led to the anomaly that a company incorporated overseas that properly registers under Part XI could not be wound up by the Hong Kong courts, but a company incorporated overseas that fails to register or that carries on business in Hong Kong but has not established a place of business there could be wound up.¹²² Such an anomaly would create a big gap in the Hong Kong court's winding-up jurisdiction, because, at present, more than sixty percent of the companies listed on the Hong Kong Stock Exchange are oversea companies.¹²³ This high percent-

121. See the Australian case, *In Re Harry Rickards Tivoli Theatres Ltd.* (1931) V.L.R. 305 (supporting the argument in the text).

122. *MKI*, [1995] H.K.C. at 88.

123. As at the end of March 1995, 327 (61.7%) of the 530 companies listed on the Hong Kong Stock Exchange were overseas companies. SECURITIES AND FUTURES COMMISSION ANNUAL REPORT 1994/1995 § 3, Annex III, at 40 (1995). Both the number and the percentage of oversea companies listed on the Hong Kong Stock Exchange have been increasing. For example, the comparable numbers for earlier years are as follows: as at the end of March 1994, 297 (59.9%) of the 496 companies were oversea companies, SECURITIES AND FUTURES COMMISSION ANNUAL REPORT 1993/94 § 3, Annex III, at 42 (1994), and at

age of oversea companies reflects, in part, the recent trend among Hong Kong companies in favor of redomiciling overseas.¹²⁴

Interestingly, as far back as 1973, the Companies Law Revision Committee proposed that Hong Kong adopt the equivalent of a proposal made by the Jenkins Committee in the United Kingdom, namely, that Hong Kong law be amended to provide expressly that a company incorporated outside Hong Kong could be wound up in Hong Kong if the company had assets in Hong Kong.¹²⁵ This report noted the assertion by the Jenkins Committee that this jurisdiction should exist "irrespective of whether [the foreign company] has had a place of business in Great Britain or has carried on business there so long as one or other of the conditions specified in [the United Kingdom equivalent to Section 327(1)(b) of the Companies Ordinance] is satisfied."¹²⁶ The court in *MKI* noted that such an amendment was unnecessary¹²⁷, but the fact that the issue arose in *MKI* in the context of whether an oversea company could be wound up as an unregistered company demonstrates that such an amendment would have been helpful. Part X of the Companies Ordinance should now be written to incorporate the *MKI* holding in order to avoid further confusion. Section 326(a) should be amended to exclude a company "formed and registered" under the Companies Ordinance from the definition of "unregistered company." For further clarification, the title of Part X of the Companies Ordinance should be amended to refer to foreign companies. A definition of "foreign company" should therefore be included in Part X, either as a subdivision of the definition of "unregistered company" or as a separate term. A jurisdictional test based on the presence of assets should be enacted in Part X, as is mentioned below in Part III.B.2.c.

In addition, Section 327A should be amended or deleted. As

the end of March 1992, 155 (44.4%) of the 349 companies were oversea companies, SECURITIES AND FUTURES COMMISSION ANNUAL REPORT 1991/92 § 5, Annex III, at 54 (1992).

124. See SECURITIES AND FUTURES COMMISSION ANNUAL REPORT 1991/92, *supra* note 123, § 5.31, at 46. As at the end of March 1992, 80 Hong Kong companies had redomiciled overseas. *Id.* § 5, Annex III, at 54. In 1992-93, 12 more companies redomiciled overseas; in 1993-94, 4 companies; and in 1994-95, 1 company. SECURITIES AND FUTURES COMMISSION ANNUAL REPORT 1993/94, *supra* note 123, § 3, Annex II, at 41; SECURITIES AND FUTURES COMMISSION ANNUAL REPORT 1994/95, *supra* note 123, § 3, Annex II, at 39.

125. 1973 REPORT OF THE COMPANIES LAW REVISION COMMITTEE, *supra* note 102, ¶ 10.44, at 306.

126. *Id.* ¶ 10.43, at 306.

127. *MKI*, [1995] 2 H.K.C. at 87-88.

noted above, this section provides that if certain criteria are met, a foreign company "may be wound up as an unregistered company" under Part X of the Companies Ordinance. This phrase "may be wound up as an unregistered company" is a curious one, because it implies that the foreign company may not satisfy the definition of an unregistered company. Yet, as noted by the court in *MKI*, it is clear that Section 327A does not offer an independent basis for winding up a foreign company.¹²⁸ Thus, a company that may be wound up under Section 327A must be an "unregistered company" that may also be wound up under Section 327. Therefore, there is no need to retain Section 327A as an independent provision. Instead, it should be incorporated into a new sub-section in Section 327(3). However, if Section 327A is retained, it should be rewritten as follows:

[Where an unregistered company incorporated outside Hong Kong or a foreign company] which has been carrying on business in Hong Kong ceases to carry on business in Hong Kong, it may be wound up under this section, notwithstanding that it has been dissolved or otherwise ceased to exist as a company under or by virtue of the laws of the place of its incorporation.

Lastly, as noted earlier, if Section 327A is retained, the section should be retitled, "Foreign companies may be wound up although dissolved."

c. *Jurisdiction*

Except for Section 327A's application to situations where a foreign company "which has been carrying on business in Hong Kong ceases to carry on business in Hong Kong," the Companies Ordinance is silent regarding the jurisdictional connection that must exist between a foreign company and Hong Kong to enable the foreign company to be wound up in Hong Kong. Despite the failure to enact the amendment proposed in 1973 regarding the presence of assets,¹²⁹ it is clear from the case law that a foreign company with assets in Hong Kong may be wound up there.¹³⁰ Over the years, the presence-of-assets test has been modified and now includes the following:

- (1) A proper connection with the jurisdiction must be

128. *MKI*, [1995] H.K.C. at 86.

129. See *supra* notes 125-27 and accompanying text.

130. *Hong Kong v. Shau* follows the English position, which has its origins in *Banque des Marchands de M. Shau v. Kindersley*, [1951] Ch. 112. See Smart, *supra* note 82, at 143

established by sufficient evidence to show (a) that the company has some asset or assets within the jurisdiction, and (b) that there are one or more persons concerned in the proper distribution of the assets over whom the jurisdiction is exercisable.¹³¹

- (2) It suffices if the assets of the company within the jurisdiction are of any nature; they need not be "commercial" assets, or assets which indicate that the company formerly carried on business there.¹³²
- (3) The assets need not be assets which will be distributable to creditors by the liquidator in the winding up: it suffices if by the making of the winding up order they will be of benefit to a creditor or creditors in some other way.¹³³
- (4) If it is shown that there is no reasonable possibility of benefit accruing to creditors from making the winding up order, the jurisdiction is excluded.¹³⁴
- (5) The presence of assets includes a right of action that has a reasonable possibility of success.¹³⁵
- (6) The assets upon which to find jurisdiction need not belong to the company, but may belong to an outside source.¹³⁶

The 1985 Hong Kong case of *Re Irish Shipping Ltd.* ("*Irish Shipping*")¹³⁷ further expanded the presence-of-assets test. In this case, the Irish liquidator claimed jurisdiction to wind up an unregistered company under Section 327 of the Companies Ordinance on the basis of the "imminent arrival" in Hong Kong of a ship owned by the unregistered company.¹³⁸ As it so happened, the company had other assets in Hong Kong at the time the winding-up petition was

131. *Re Compania Merabello San Nicholas S.A.*, [1973] Ch. 75, 91-92.

132. *Id.* at 92.

133. *Id.*

134. *Id.*

135. *Re Allobrogia S.S. Corp.*, [1978] 3 All E.R. 423.

136. *Re Eloc Electro-Optieck & Communicatie B.V.*, [1982] Ch. 43. For example, in Hong Kong the assets could include the Protection of Wages on Insolvency Fund, which is administered pursuant to the Protection of Wages on Insolvency Ordinance, cap. 380, L.H.K. (1995).

137. *Irish Shipping Ltd.*, [1985] H.K.L.R. 437.

138. *Id.* at 439.

presented and at the date of the hearing.¹³⁹ Nevertheless, *in obiter*, the court in *Irish Shipping* stated that "the liquidator is not precluded from presenting a petition before the asset is within the jurisdiction. It is sufficient to found jurisdiction if there are assets here when the petition is heard."¹⁴⁰ This assertion is troubling. As Philip Smart states: "Either the court has jurisdiction when the petition is presented or it does not."¹⁴¹ This is surely correct. The date for determining jurisdiction should be the date that the winding-up petition is presented.

Since the decision by the English court in *Okeanos Maritime Corp.*,¹⁴² the existence of an independent assets-based test has been called into question. In this case, the court stated that "provided a sufficient connection with the jurisdiction is shown, and there is a reasonable possibility of benefit for the creditors from the winding-up, the court has jurisdiction to wind up the foreign company."¹⁴³ The court found that a sufficient connection existed because, *inter alia*, the debt owed by the foreign company to the petitioner was incurred in England under an English loan agreement and the foreign company had carried on business in England through its agents.¹⁴⁴ On the basis of the adoption of the "sufficient connection" test in other English cases,¹⁴⁵ some commentators have argued that the presence of assets might be regarded as a factor to be considered under a "sufficient connection" analysis.¹⁴⁶ The Law Reform Commission also sets forth this interpretation in its Report on Bankruptcy.¹⁴⁷

The Hong Kong courts have only recently begun to address the "sufficient connection" test. In *MKI*, the High Court briefly noted the

139. *Id.* at 444.

140. *Id.*

141. SMART, *supra* note 17, at 62 n.14. See also Smart, *supra* note 82, at 143-44; *Re Real Estate Development Co.* [1991] B.C.L.C. at 217 (stating that "it seems ... to be necessary, where there is no asset within the jurisdiction at the presentation of a petition, to establish a link of genuine substance between the company and this country").

142. *Re A Company* (No. 00359 of 1987) Ch. 210 (1988).

143. *Id.* at 225-26.

144. *Id.* at 226.

145. See *Re A Company* (No. 003102 of 1991), *Ex parte Nyckeln Finance Co.* [1991] B.C.L.C. 539, 540 (finding a sufficient connection); *Re Real Estate Development Co.* [1991] B.C.L.C. at 217 (not finding a sufficient connection and also requiring that the court be able to exercise jurisdiction over one or more persons who will benefit from the making of the winding up order).

146. See 2 DICEY & MORRIS, *supra* note 23, Comment to Rule 157, at 1121-23, SECOND SUPPLEMENT, *supra* note 26, at 96-97.

147. See REPORT ON BANKRUPTCY, *supra* note 4, ¶ 2.40, at 30.

applicability of the test but offered no concrete analysis as to the factors at bar that would have satisfied the test.¹⁴⁸ The discussion in *Re China Tianjin International Economic and Technical Co-operative Corp.*¹⁴⁹ ("CTIETCC") was more detailed.¹⁵⁰ In deciding to exercise its winding-up jurisdiction, the court noted the principle from *Okeanos Maritime Corp.* that the "jurisdiction to wind-up a foreign company is flexible" and repeated the requirements that "there is a sufficiently close connection with the jurisdiction and that there is a reasonable possibility of benefit for the creditors from the winding up."¹⁵¹ Among the factors discussed by the court were the following: that the China Tianjin International Economic and Technical Co-operative Corp. ("CTIETCC") had one share in the Hong Kong company Tsinlien Economic Cooperation Co. Ltd. and that CTIETCC claimed in some published materials to have set up its own office or offices in Hong Kong and to have established throughout the world, including in Hong Kong, more than "twenty joint-ventures, cooperative business operations, and enterprises with exclusive Chinese investment."¹⁵² Before making the winding-up order, the court noted that the existence of these factors gave rise to the "prima facie presumption" that CTIETCC had assets in Hong Kong and that "there must . . . be a reasonable prospect of there being substantial assets which are liable to be recovered should a

148. *MKI*, [1995] 2 H.K.C. at 84 (also noting the requirement of *Re Real Estate Development Co.*, [1991] B.C.L.C. at 210, "that the court must be able to exercise jurisdiction over one or more persons interested in the distribution of the company's assets").

149. *Re China Tianjin International Economic and Technical Co-operative Corp.* [1994] 2 H.K.L.R. 327 [hereinafter *CTIETCC*].

150. This case involved a petition brought under Section 327 of the Companies Ordinance to wind up a Chinese state enterprise, China Tianjin International Economic and Technical Cooperative Corp. ("CTIETCC"), a company established pursuant to an Order of the Ministry of Foreign Trade and Economic Cooperation and the People's Government of the Municipality of Tianjin. The petitioner was an English creditor, Zoneheath Associates Ltd. ("Zoneheath"), which petitioned in Hong Kong on the ground that CTIETCC was unable to pay its debts, as it had failed to pay the petitioner's U.S. \$4.6 million debt that was based on a default judgment that had been entered in the Queen's Bench Division in England in 1992 and later registered in Hong Kong. 2 H.K.L.R. at 328. Zoneheath decided to petition to wind up CTIETCC in Hong Kong only after failing to locate assets belonging to CTIETCC in the United Kingdom that could be used to satisfy the English judgment. *PRC State-Owned Company to Liquidate in Hong Kong*, H.K. LAW., Feb. 1995, at 8. It is claimed that Zoneheath chose Hong Kong as the winding-up forum after discovering that CTIETCC's own literature stated that the company had a share in a Hong Kong company. *Id.*

151. *CTIETCC* [1994] 2 H.K.L.R. at 328 (also noting the requirement from *Re Real Estate Development Co.* [1991] B.C.L.C. 210 "that the court must be able to exercise jurisdiction over one or more persons interested in the distribution of the company's assets").

152. *Id.* (emphasis in original).

winding-up order be made."¹⁵³

It can be seen from the court's analysis in *CTIETCC* that the court adopts the view that the presence of assets should be a factor taken into consideration under the sufficient connection test. The gaining popularity of the sufficient connection test is worrisome, because it has the potential to lead to unnecessary confusion in determining whether there is proper jurisdiction to liquidate a foreign company. Jurisdictional factors should be clear cut to make it easier for creditors, foreign representatives, and foreign companies to understand under what conditions a foreign company may be wound-up in Hong Kong. Philip Smart espouses similar concerns in his criticism of the vagueness of the sufficient connection test.¹⁵⁴ He rightly proposes that there should be two independent jurisdictional tests: one based on the presence of assets and another based on the carrying on of business "either directly or through an agent."¹⁵⁵ These tests should be incorporated into Part X of the Companies Ordinance. The variety of other factors that the courts currently discuss under a sufficient connection test should relate to the discretion of the court when determining whether to exercise its jurisdiction.

Okeanos Maritime Corp. also provides that when a court is deciding whether jurisdiction exists, "[i]t is also appropriate for the court to consider whether any other jurisdiction is more appropriate for the winding up . . ."¹⁵⁶ This test was adopted by the court in *Ex parte Nyckeln Finance Co.*¹⁵⁷ and by the Law Reform Commission in its Report on Bankruptcy.¹⁵⁸ Nevertheless, as has been noted in a later case¹⁵⁹ and by some commentators,¹⁶⁰ courts should consider this factor only when exercising their discretion. To hold otherwise would make it impossible for the Hong Kong courts to order an ancillary or concurrent winding up in Hong Kong¹⁶¹ that

153. *Id.*

154. SMART, *supra* note 17, at 64-65.

155. *Id.* at 65 (also rightly retaining the requirement "that there is a reasonable possibility of benefit accruing to creditors from the making of a winding up order").

156. *Okeanos Maritime Corp.* [1995] Ch. at 226.

157. *Nyckeln Finance*, [1991] B.C.L.C. at 540.

158. REPORT ON BANKRUPTCY, *supra* note 4, ¶ 2.40, at 30.

159. *Re Wallace Smith & Co.* 1992 B.C.L.C. 970, 985.

160. Smart, *supra* note 17, at 64, n.5; 2 DICEY & MORRIS, *supra* note 23, Comment to Rule 157, at 1123; and SECOND SUPPLEMENT, *supra* note 26, at 96-97.

161. *See Re V Wallace Smith & Co.* [1992] B.C.L.C. at 985. For a discussion of ancillary and concurrent liquidations. see *infra* Part II.B.2.d.

would enable a foreign company's general creditors to reach the foreign company's assets in Hong Kong.

d. Discretion to Order Relief and the Types of Relief

Satisfaction of the jurisdictional criteria does not necessarily lead a court to make a winding-up order. Pursuant to the court's inherent jurisdiction and to Section 180 of the Companies Ordinance, the court has the discretion to dismiss a winding-up petition and thereby not make a winding-up order.¹⁶² Before a court decides to make a winding-up order, the court should consider, as noted by the court in *Okeanos Maritime Corp.*, whether it is more appropriate for the winding-up to occur elsewhere.¹⁶³ Consideration of this factor is especially important in those instances in which the underlying dispute between a foreign company and its petitioner does not involve Hong Kong and in which the foreign company has not been wound up elsewhere. This was the very fact situation that arose in the recent liquidation of CTIETCC. Surprisingly, the company failed to raise this issue. One would have thought that CTIETCC would have argued, first, that the proper place to wind up CTIETCC was in China—the company's place of incorporation and principal place of business—rather than in Hong Kong and, second, that it was improper for the petitioner to try to enforce its judgment by petitioning for the company's liquidation in Hong Kong when other remedies were available.¹⁶⁴

More frequent than the *CTIETCC* situation, however, are cases in which a foreign representative petitions in Hong Kong to wind up the foreign company, or the estate of the foreign company, that she

162. Under § 209 of the Companies Ordinance, the court also has the discretion to stay winding up proceedings at any time after the winding up order has been made. Furthermore, in the recent case of *Bicoastal Corp. v. Shinwa Co.*, [1994] 1 H.K.L.R. 65, a Hong Kong court took the unusual action of staying winding up proceedings before a winding up order had even been made.

163. *Okeanos Maritime Corp.* [1988] Ch. at 226. See *supra* notes 156-60 and accompanying text.

164. Regarding the first point, the petitioner could have stated that it had not attempted to enforce its judgment in China—either by relying on China's law of civil procedure or by commencing a liquidation of CTIETCC under Chinese insolvency law—because it doubted that its claim would have received just treatment in the Chinese courts, and it therefore believed that no benefits would have resulted from pursuing either strategy. See, e.g., *infra* Part IV.C. It could also have argued that these concerns justified the application of the principle that there are times when it is inappropriate to require a liquidation of a company in its place of incorporation. Regarding the second point, the petitioner could have noted that it commenced a liquidation to benefit from the liquidator's investigatory powers which it deemed essential for tracking down CTIETCC's assets in Hong Kong. Had these arguments been put forth, they would have made for a very interesting decision.

represents abroad. In such cases, the Hong Kong court often focuses, not on whether a winding-up order should be made, but rather on the type of cooperation that the Hong Kong court should provide to the foreign liquidation in the concurrent insolvency proceeding in Hong Kong. The court can adopt a very cooperative attitude and order an ancillary winding up, as did the court in *Irish Shipping* when it stated: "The jurisdiction of this court in the liquidation [will] be ancillary as far as possible to the winding-up in Ireland and [will] provide assistance to the official liquidator in the collection and preservation of the assets within Hong Kong."¹⁶⁵

In an ancillary winding up under Hong Kong law, the primary aim of the Hong Kong proceeding is to assist the foreign proceeding.¹⁶⁶ *Irish Shipping* is the only reported Hong Kong case that discusses the common law conditions that must be satisfied before an ancillary winding-up order may be made. First, creditors who oppose the making of a winding-up order must give "satisfactory reasons" to support their position.¹⁶⁷ Second, the court should consider the interests of unsecured creditors (e.g., equality of distribution) and of the public.¹⁶⁸ Third, the court should consider the "comity of nations whereby it is desirable that the court should assist the liquidator in another jurisdiction to carry out his duties unless good reasons to the contrary have been put forward."¹⁶⁹

Although not addressed by the court in *Irish Shipping*, "good reasons to the contrary" would arise in a case in which the connections between the foreign company and the country in which the primary liquidation occurs are not substantial enough to justify the granting of ancillary assistance by the Hong Kong court. In such a case, it would be more appropriate for the Hong Kong court to order a concurrent liquidation in which the Hong Kong liquidator and foreign representative would act on equal footing. One possibility would be for all local assets to be distributed to creditors in a full-

165. *Irish Shipping Ltd.*, [1985] H.K.L.R. at 445.

166. A liquidator is appointed, a stay comes into effect, and the Hong Kong avoidance powers are applicable. The Hong Kong court may also order that the foreign company's assets in Hong Kong be turned over to the foreign liquidator to be distributed in the foreign proceeding. See, e.g., *Re Irish Shipping, Companies Winding Up No. 408 of 1984, Order* (1985). If a turnover order is made, the Hong Kong court would most likely require that the costs of liquidation, priorities (called preferential debts in Hong Kong), and secured creditors' claims be satisfied before sending the surplus abroad. See Smart, *supra* note 17, at 248-50.

167. 1985 H.K.L.R. at 444.

168. *Id.*

169. *Id.* at 445. Cf. Smart, *supra* note 17, at 236-37 (proposing a more general test of whether ordering an ancillary winding up would be in "the interests of all the parties")

scale liquidation in Hong Kong. Another possibility would be for the Hong Kong liquidator and the foreign representative to agree upon a scheme of arrangement regarding distributions to creditors worldwide. Such a scheme would require the approval of the Hong Kong court and compliance with the law of the jurisdiction in which the debtor is incorporated.¹⁷⁰ Cooperation might also be achieved among concurrent insolvencies of various members of one corporate family when the representatives of the respective debtors negotiate settlement agreements, as occurred in the insolvency proceedings involving the Deak-Perera group of companies.¹⁷¹

Since Hong Kong law does not provide for the application of foreign insolvency law in ancillary liquidation proceedings, it does not allow for the development of what may be called the universality/unity approach. However, cross-border cooperation is still possible under what may best be characterized as a universality/plurality approach—through either an ancillary winding-up or a concurrent insolvency. Additional provisions should be enacted that include criteria for courts to consider when deciding whether to grant ancillary assistance to foreign liquidations, as well as examples of the types of assistance that may be granted. Section 304 of the U.S. Bankruptcy Code might prove helpful in this respect (as the Subcommittee of Insolvency has noted).¹⁷²

3. Bankruptcy

a. Introduction

Since Hong Kong courts do not recognize the principle of the “unity of bankruptcy,” Hong Kong courts have jurisdiction to adjudge a debtor bankrupt in Hong Kong even though the debtor has already been adjudicated bankrupt abroad.¹⁷³ However, since a vesting order operates to vest movable property in Hong Kong in the foreign trustee (provided the foreign law extends to movable property in Hong Kong),¹⁷⁴ a foreign trustee will often not need to commence

170. See Smart, *supra* note 17, at 214-15.

171. See *R. Leslie Deak v. Deak Perera Far East Ltd.* (in liq.) [1991] 1 H.K.L.R. 551, 555; *Deak Perera (Far East) Ltd. (in liq.) v. R. Leslie Deak* [1995] 1 H.K.L.R. 145. For a discussion of these cases, see Booth, *supra* note *, at 44-47.

172. CORPORATE RESCUE AND INSOLVENT TRADING CONSULTATION PAPER, *supra* note 5, ¶ 1.40 at 15.

173. 2 DICEY AND MORRIS, *supra* note 23, Rule 163 & accompanying Comment, at 1161-62.

174. See *supra* notes 47-49.

a bankruptcy against a foreign debtor to reach movable property. The same is true in cases involving immovable property, because a foreign trustee may be able to be appointed as receiver of the debtor's immovable property in Hong Kong.¹⁷⁵

Nevertheless, situations might arise in which it would be advantageous to commence a bankruptcy proceeding against a foreign debtor. For example, a foreign representative may want (1) to reach immovable property not otherwise obtainable, (2) to avoid uncompleted attachments or executions,¹⁷⁶ certain settlements,¹⁷⁷ or fraudulent preferences,¹⁷⁸ (3) to gain the application of broad investigatory powers,¹⁷⁹ or (4) to benefit from the stay.¹⁸⁰ (However, as in liquidation, the stay does not prevent secured creditors from realizing or otherwise dealing with their security).¹⁸¹ Commencement of a bankruptcy proceeding would also allow creditors to benefit from the relation back doctrine.¹⁸²

Hong Kong bankruptcy law still adopts the notion that before a bankruptcy proceeding may be commenced, a debtor must first commit an "act of bankruptcy."¹⁸³ This notion is premised on the belief that certain types of wrongful conduct by the debtor (e.g., unjustly defeating or delaying one's creditors), rather than the debtor's mere "financial embarrassment," should trigger a bankruptcy proceeding.¹⁸⁴ The Law Reform Commission has proposed to abolish the concept of "acts of bankruptcy" and to replace it with

175. See *supra* note 52. When seeking such relief, the foreign representative should file an application for an order in aid.

176. Bankruptcy Ordinance § 45.

177. *Id.* § 47.

178. *Id.* § 49. As in corporate insolvencies, the relevant period is six months.

179. *Id.* § 29.

180. After the presentation of a bankruptcy petition, but before the making of a receiving order, the court may stay any action, execution, or other legal process. *Id.* § 14. After the making of a receiving order, no creditor with a provable debt in the debtor's bankruptcy shall have any remedy against the debtor or the debtor's property in respect of the debt, or shall commence any action or other legal proceeding, except by leave of the court. *Id.* § 12(1)

181. See *id.* § 12(2).

182. *Id.* § 42. This doctrine "provides for the 'relation back' of the trustee's title to property of the bankrupt to the time of the act of bankruptcy on which a receiving order is made, or, if there has been more than one act of bankruptcy, the time of the first of these acts within the three months before the presentation of the bankruptcy petition." REPORT ON BANKRUPTCY, *supra* note 4, ¶14.1, at 133. See also *id.*, ch. 14, at 133-37.

183. Bankruptcy Ordinance § 3(1). The act of bankruptcy upon which the petition is grounded must occur within three months of the filing of the petition. *Id.* § 6(c)

184. DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY (2d ed. 1990).

other grounds.¹⁸⁵

Current Hong Kong law explicitly provides for a bankruptcy petition to be filed by either a creditor or the debtor.¹⁸⁶ Thus, like the Companies Ordinance, the Bankruptcy Ordinance fails to expressly provide for the filing of a petition by a foreign representative. Nevertheless, a foreign representative may commence a bankruptcy case against the person whose estate she represents abroad. According to the Official Receiver¹⁸⁷, the practice in Hong Kong is to permit a foreign trustee to file a petition as a creditor of the foreign debtor.¹⁸⁸ At present, a foreign representative may therefore commence a bankruptcy against a foreign debtor as a creditor of the debtor, or she may convince a creditor or the debtor himself to file the petition. The Bankruptcy Ordinance should be amended to authorize explicitly a foreign representative to commence a bankruptcy against the individual whose estate she represents in the foreign proceeding.

The Official Receiver plays a major role in bankruptcy cases, and the Law Reform Commission has proposed that this role be increased.¹⁸⁹ If the court makes a receiving order to protect the estate,¹⁹⁰ the Official Receiver becomes the receiver of the debtor's property,¹⁹¹ and, if an adjudication order is made¹⁹² (which occurs

185. See REPORT ON BANKRUPTCY, *supra* note 4, ch. 1, at 6-19. The four grounds are the following: (1) the failure of a debtor to comply with the terms of a bankruptcy notice; (2) the unsatisfied execution of a judgment against the property of a debtor; (3) the departure, or intention to depart, out of Hong Kong by a debtor knowing that a necessary consequence of his departure would be to defeat or delay his creditors, notwithstanding that his absence from Hong Kong had nothing to do with his debts; and (4) the default by a debtor under a form of voluntary arrangement.

186. Bankruptcy Ordinance §§ 9-10.

187. The Official Receiver's Office is responsible for the administration of insolvency matters that involve the compulsory winding up of companies and the bankruptcy of individuals or partnerships. OFFICIAL RECEIVER'S OFFICE ANNUAL DEPARTMENTAL REPORT 1994-95, ¶1.1, at 1 (Hong Kong 1995) [hereinafter OFFICIAL RECEIVER'S 1994-95 REPORT].

188. There is conflicting case law regarding the ability of a trustee to file a bankruptcy petition as a creditor of the debtor. See *Hutcheson v. Taylor* [1931] Scots. L. Times 356, 360-61 (supporting the proposition). *But see* the Canadian case, *Re Eades Estate* [1917] W.W.R. 65, 90 (rejecting the proposition).

189. See, e.g., REPORT ON BANKRUPTCY, *supra* note 4, ¶¶ 8.7-8.11, at 69-70. For a criticism of these proposals, see *infra* Part V.C.3.

190. See Bankruptcy Ordinance § 5.

191. *Id.* § 12(1). Also, the court may appoint the Official Receiver to be interim receiver of the debtor's property at any time after the presentation of the petition and before the making of a receiving order. *Id.* § 13.

192. *Id.* § 22.

in the majority of cases),¹⁹³ the Official Receiver is usually chosen by the creditors to serve as the trustee.¹⁹⁴

b. Jurisdiction

In a bankruptcy case, jurisdiction must exist at the time of the occurrence of any act of bankruptcy. In the case of a creditor's petition, jurisdiction must also exist at the time that (or within a year before the date on which) the bankruptcy petition is filed. Section 3(2) of the Bankruptcy Ordinance provides that "a debtor":

includes any person, whether a British subject or not, who at the time when any act of bankruptcy was done or suffered by him—

- (a) was personally present in Hong Kong; or
- (b) ordinarily resided or had a place of residence in Hong Kong; or
- (c) was carrying on business in Hong Kong, personally or by means of an agent or manager; or
- (d) was a member of a firm or partnership which carried on business in Hong Kong.

Section 6(1), in turn, provides that a creditor shall not be entitled to present a bankruptcy petition against a debtor unless:

- (d) the debtor is domiciled in Hong Kong, or within a year before the date of the presentation of the petition has ordinarily resided, or had a dwelling-house or place of business, in Hong Kong, or has carried on business in Hong Kong, personally or by means of an agent or manager, or is or within the said period has been a member of a firm or partnership of persons which has carried on business in Hong Kong by

193. REPORT ON BANKRUPTCY, *supra* note 4, ¶ 5.8, at 42. See also *id.* ¶ 6.2, at 46. For example, of the 294 bankruptcy cases in 1991-92 in which a receiving order was made, an adjudication order followed in 212 cases. ANNUAL DEPARTMENTAL REPORT OF THE HONG KONG REGISTRAR GENERAL, 1991-92 ¶ 108, at 40 [hereinafter REGISTRAR GENERAL'S 1991-92 REPORT].

194. For example, between 1959 and 1992, there were only four cases in which the Official Receiver has not been appointed trustee. REGISTRAR GENERAL'S 1991-92 REPORT, *supra* note 193, ¶ 108, at 40. Under the recent proposals of the Law Reform Commission, the Official Receiver will be even more likely to be the trustee. Under these proposals the two-step bankruptcy procedure comprised of the receiving order and the adjudication order will be replaced by a one-step process comprised of a bankruptcy order only and the Official Receiver will have the discretion whether to serve as the trustee. See REPORT ON BANKRUPTCY, *supra* note 4, ch. 5, at 41-45, ch. 8, at 67-72.

means of a partner or partners or an agent or manager.

The Law Reform Commission has recommended that the current jurisdictional criteria be replaced by a Hong Kong version of Section 265 of the U.K. Insolvency Act 1986. The new version is as follows:

- (1) A bankruptcy petition shall not be presented to the court . . . unless the debtor, irrespective of nationality¹⁹⁵
 - (a) is domiciled in Hong Kong,
 - (b) is personally present in Hong Kong on the day on which the petition is presented, or
 - (c) at any time in the period of three years ending with that day—
 - (i) has been ordinarily resident, or has had a place of residence, in Hong Kong, or
 - (ii) has carried on business in Hong Kong (as interpreted by Section 265(2) of the U.K. Insolvency Act 1986).¹⁹⁶

There were differences of opinion between the Subcommittee on Insolvency and the Law Reform Commission regarding whether the presence of assets should be an additional jurisdictional criterion.¹⁹⁷ The Subcommittee proposed its inclusion and recommended that jurisdiction should exist when the debtor has, will have, or is likely to have, assets within Hong Kong by the time the bankruptcy order is made.¹⁹⁸ The Law Reform Commission rightly noted that it would be unworkable to confer jurisdiction prospectively at the time the court hears the petition and decides whether to make a bankruptcy petition.¹⁹⁹ Unfortunately, the Law Reform Commission was also critical of basing jurisdiction on the presence of assets at the time of the filing of a bankruptcy petition. To use the Commission's own words:

195. The phrase "irrespective of nationality" does not appear in the United Kingdom legislation. Its addition is intended to clarify, rather than change, the current position. See REPORT ON BANKRUPTCY, *supra* note 4, ¶¶ 2.8-2.11, at 22-23.

196. *Id.* ¶ 2.11 at 23.

197. There were also disagreements about the Subcommittee's proposal that a further independent ground should be whether "there was the possibility of a benefit accruing to a creditor or creditors by the making of the order." *Id.* ¶ 2.37, at 29. The Law Reform Commission correctly rejected this proposal. See *id.* ¶¶ 2.38-42, at 29-31.

198. CONSULTATIVE DOCUMENT ON BANKRUPTCY, *supra* note 2, ¶ 3.12, at 19.

199. REPORT ON BANKRUPTCY, *supra* note 4, ¶ 2.29, at 27, ¶¶ 2.34-35, at 28. See also *supra* text accompanying notes 138-141.

it is fair to say that the proposal has not been adopted more because of difficulties in putting it into effect (illustrated, for example, by the probability that it could create difficulties for the Hong Kong courts in applying extra-territorial jurisdiction) rather than out of sympathy for a debtor whose only connection with Hong Kong was to place assets here.²⁰⁰

The Commission also stated that a jurisdictional ground based on the presence of assets "would go far beyond any recognised basis for jurisdiction to be exercised by Hong Kong courts in accordance with established conflict of law principles and with international comity."²⁰¹ Moreover, the Commission noted that if an assets-based test were enacted, no other connection between the debtor and Hong Kong would be required, and, as a result, "foreign courts are likely to perceive the jurisdiction as unreasonable and to refuse judicial recognition and support."²⁰²

The Law Reform Commission's concerns are misguided for a number of reasons. First, the notion of basing bankruptcy jurisdiction on the presence of assets is not as radical as the Law Reform Commission suggests. United States law has for many years included such a jurisdictional ground—previously in the U.S. Bankruptcy Act²⁰³ and currently in the U.S. Bankruptcy Code²⁰⁴—without adverse consequences.

Second, the Law Reform Commission's concerns to the contrary, an assets-based test would most likely foster, not hinder, cross-border cooperation. In its discussion of an assets-based test, the Law Reform commission focused on the possible negative ramifications that adoption of the test could have on foreign treatment of Hong Kong bankruptcies. In so doing, the Commission failed to see that the inclusion of the test would make it easier for Hong Kong courts to assist foreign bankruptcies. A possible reason for the Commission's errant focus was its failure to see that the petitioner most likely to rely on the new jurisdictional ground would be a foreign representative seeking the assistance of the Hong Kong courts with respect

200. *Id.* ¶ 2.19, at 25.

201. *Id.* ¶ 2.29, at 27.

202. *Id.* ¶ 2.33, at 28.

203. U.S. Bankruptcy Act of 1898, ch. 541, § 2(a)(1).

204. 11 U.S.C.A. § 109(a) (West 1995)

to a foreign debtor's Hong Kong assets.²⁰⁵

Third, the Law Reform Commission failed to consider that a court would have had the discretion not to order relief in a case commenced on the basis of the presence of assets in Hong Kong.²⁰⁶ Thus, the enactment of this additional jurisdictional criterion would not necessarily have led to bankruptcy orders being made in all cases based on the presence of assets.

Fourth, the Law Reform Commission has raised certain objections to the presence-of-assets test without acknowledging that these same concerns equally apply to other jurisdictional criteria. For example, the Law Reform Commission asserts that a presence-of-assets test might lead to a "tenuous basis for the exercise of jurisdiction [that] would probably not be accepted by the Hong Kong court in its general civil jurisdiction" because the "transaction and the debt underlying the petition . . . need have no connection whatever with Hong Kong."²⁰⁷ However, this assertion is equally true of possible cases that could be based on the personal presence test. For example, non-Hong Kong creditors could theoretically petition for the bankruptcy of a first-time tourist to Hong Kong, or even of a passenger who is stranded overnight in Hong Kong when engine difficulties force his plane to make an unscheduled stop. Thus, depending on the facts of a given case, an assets-based jurisdictional test may yield no more tenuous a connection with Hong Kong than do other jurisdictional criteria such as personal presence or any of the proposed (as well as existing) jurisdictional criteria that may be satisfied before the date of the filing of the petition.²⁰⁸ Moreover, the assertion of the Law Reform Commission that in cases based on the presence of assets "foreign courts are likely to perceive the jurisdiction as

205. As discussed above, movable assets that have not been attached or charged will vest in a foreign trustee pursuant to a forcing vesting order. Therefore, it will be rare for a foreign trustee to commence bankruptcy proceedings in Hong Kong against a foreign debtor whose estate she represents abroad. A foreign representative will commence a bankruptcy case in Hong Kong primarily to reach assets that are otherwise unobtainable. See *supra* notes 173-78 and accompanying text. In such cases, the Hong Kong proceeding would function as a secondary or concurrent bankruptcy, perhaps in an ancillary capacity, primarily to adjudicate claims to those assets that would otherwise be outside the reach of the foreign representative.

206. See *infra* part II.B.3.(c).

207. REPORT ON BANKRUPTCY, *supra* note 4, ¶ 2.33, at 28.

208. A likely response by the Law Reform Commission that can be gleaned from the Report on Bankruptcy would be that in the two examples in the text above there is at least a "personal connection between the debtor and Hong Kong." REPORT ON BANKRUPTCY, ¶2.32. at 28.

unreasonable and to refuse judicial recognition and support²⁰⁹ is equally true of cases based on these other factors.²¹⁰ In such cases, it would be best for a primary bankruptcy to be commenced abroad in the jurisdiction in which the foreign debtor is domiciled or resides, and for the Hong Kong court to offer its assistance and cooperation in facilitating the worldwide distribution of the debtor's assets.²¹¹

Finally, the failure to include an assets-based jurisdictional ground actually leaves a gap in the existing law: certain assets might be outside the reach of the foreign trustee, yet also outside the scope of Hong Kong bankruptcy law. This gap may well work to the advantage of fast-moving creditors and to the detriment of unsecured creditors generally.²¹² This is a very unsatisfactory result.

Perhaps the Law Reform Commission will reconsider its decision to omit the presence of assets as a jurisdictional criterion.

c. Discretion to Order Relief and the Types of Relief

Under its inherent jurisdiction, the court has the discretion to dismiss any bankruptcy petition and, under Section 9(3) of the Bankruptcy Ordinance, the discretion to dismiss a creditor's petition. The court also has the discretion under Section 10(1) of the Bankruptcy Ordinance not to make a receiving order in a case commenced by a debtor's petition, under Section 100(2) to adjourn any proceedings before it, and under Section 104 to stay bankruptcy proceedings permanently or for a limited time. The power to stay proceedings is rarely exercised.²¹³ When a bankruptcy petition is filed in Hong Kong against a debtor who has previously been adjudicated bankrupt abroad, the more likely scenario is for a concurrent bankruptcy to occur in Hong Kong. The Hong Kong court may then choose among the following: entering a turnover order, settling all claims in the Hong Kong proceeding, or approving a scheme of arrangement agreed

209. *Id.* ¶2.33, at 28.

210. The same is true of a case based on the ground of a debtor's departure from Hong Kong.

211. For further discussion, see Booth, *supra* note *, at 78-79.

212. For example, assume that a fast-moving creditor attaches a foreign debtor's asset in Hong Kong before that asset vests in a foreign trustee who is appointed trustee of the foreign debtor's estate. Also assume that the attachment would be avoidable under Hong Kong bankruptcy law. The foreign representative would be unable to claim the asset, and, under the Law Reform Commission's proposals, if none of the proposed jurisdictional criteria for petitioning for bankruptcy could be satisfied, the fast-moving creditor would also be immune from possible attack in a Hong Kong bankruptcy proceeding. The same result would occur in a case in which the foreign bankruptcy law was territorial in scope and did not extend to the Hong Kong asset.

213. SMART, *supra* note 17, at 34, 43-55.

upon by the Hong Kong bankruptcy trustee and the foreign representative for a pooling of the debtor's assets and a pro rata distribution among creditors.²¹⁴ In concurrent bankruptcies, as in concurrent and ancillary liquidations, Hong Kong adopts the universality/plurality approach. The current situation would be improved, however, if statutory criteria were enacted to assist courts in deciding how best to cooperate with foreign bankruptcies. These new provisions should explicitly provide that ancillary relief may be granted.

IV. THE TREATMENT OF HONG KONG INSOLVENCIES BY COURTS IN ENGLAND, THE UNITED STATES, AND CHINA²¹⁵

Hong Kong law provides that the title of a bankruptcy trustee extends to property abroad²¹⁶ and that a trustee may seek judicial assistance abroad with respect to a Hong Kong bankruptcy. Similarly, Hong Kong law provides that a liquidator may seek judicial assistance abroad with respect to a company being wound up in Hong Kong.²¹⁷ Since Hong Kong is not a party to any transnational insolvency treaties, the question of whether a foreign court will recognize a Hong Kong insolvency and provide assistance must be resolved by the law of the foreign jurisdiction. Following is a brief summary of the positions of English, United States, and Chinese law regarding these issues. These summaries are included to demonstrate some of the various ways in which foreign countries currently treat Hong Kong insolvencies. Part V below, in turn, discusses developments in Hong Kong and China that will affect whether foreign countries will continue to recognize, and offer assistance to, Hong Kong insolvencies.

A. *English Law*

Although Hong Kong and England do not have a reciprocal agreement, England has unilaterally provided for the recognition of Hong Kong insolvencies through the enactment of Section 426(4) of the U.K. Insolvency Act 1986 (co-operation between courts exercising jurisdiction in relation to insolvency). Section 426(4) states that "[t]he courts having jurisdiction in relation to insolvency law in any part of the United Kingdom shall assist the courts having the

214. *See id.* at 214-15, 220.

215. This section has been condensed from Booth, *supra* note *, at 58-74.

216. Bankruptcy Ordinance §§ 2, 43(i), 58.

217. *American Express Int'l Banking Corp. v. Johnson* [1984] H.L. ¶. 372.

corresponding jurisdiction in any other part of the United Kingdom or any relevant country or territory."²¹⁸ Section 426(11)(b) of the U.K. Insolvency Act 1986, in turn, specifies that "relevant country or territory means any country or territory designated for the purposes of this section by the Secretary of State by order made by statutory instrument."²¹⁹ In 1986, the Secretary of State of England specified that Hong Kong is a relevant territory.²²⁰ Thus, in a case involving a request made to a court in the United Kingdom by a Hong Kong liquidator or trustee, the United Kingdom court "shall" assist the Hong Kong court.²²¹ It is hoped that Hong Kong will remain a relevant territory after 1997.

B. *United States Law*²²²

The U.S. Bankruptcy Code expressly provides the following three options for a foreign representative who wants a U.S. court to recognize, and provide assistance to, a foreign insolvency, including the following: (1) filing a petition under Section 303(b)(4) to commence an involuntary Chapter 7 (liquidation) or Chapter 11 (reorganization) case against a foreign debtor; (2) filing a petition under Section 304 to commence a case ancillary to a foreign proceeding; and (3) seeking dismissal of a case or suspension of all proceedings under Section 305(a)(2). A recent case demonstrates that a foreign representative may also file a petition on behalf of a debtor under Section 301 to commence a voluntary case under Chapter 7 or Chapter 11.²²³ In addition, the foreign representative may recover assets or vacate local attachments under state law by seeking the granting of comity.

In most cases, the foreign representative's choice will be

218. U.K. Insolvency Act 1986 § 426(4). For further analysis of § 426, see SMART, *supra* note 17, at 259-64. See also FLETCHER, *supra* note 25.

219. U.K. Insolvency Act 1986 § 426(11)(b).

220. United Kingdom Co-operation of Insolvency Courts (Designation of Relevant Countries and Territories) Order (No. 2123) (1986).

221. An example of such assistance is a 1992 case in which the English High Court of Justice, Chancery Division, granted the relief requested by the Hong Kong Official Receiver under § 426, namely, the appointment of the Official Receiver as receiver of a Hong Kong bankrupt's real property in England, with the power to sell and deal with the proceeds of sale. *Official Receiver of Hong Kong v. Keith Thomas Philcox*, Ch. 1992 O 6052, (Order, High Court of Justice, Chancery Division, Aug 13, 1992)

222. For a detailed discussion of the issues summarized below, see Charles D Booth, *supra* note 15.

223. See *In re* aruko, Inc No. SD 91-12303-A11 (Bankr S D Cal Oct 30, 1991)

between the first two options above—petitioning for a liquidation under U.S. law or petitioning for ancillary assistance. In a liquidation commenced under Section 303(b)(4) or Section 301, a trustee is appointed,²²⁴ an estate is created,²²⁵ the automatic stay comes into effect,²²⁶ and U.S. avoidance powers are applicable.²²⁷ Such a case exemplifies the universality/plurality approach and is analogous to a concurrent insolvency, including an ancillary winding up, under Hong Kong law. An ancillary case, in comparison, is an innovation of U.S. law that permits the application of foreign law in the U.S. proceeding²²⁸ and therefore allows for the development of the universality/unity approach. An ancillary case is usually limited to the foreign debtor's property in the United States. A trustee is not appointed, the automatic stay does not come into operation, and an estate is not created. The foreign representative usually seeks injunctive relief to protect the foreign debtor's property in the United States and often seeks a turnover order.

To date, there have been two reported U.S. cases involving the recognition of Hong Kong insolvencies by U.S. courts: *In re Axona International Credit & Commerce Ltd.* ("Axona"),²²⁹ which was a Chapter 7 case commenced under Section 303(b)(4) of the U.S. Bankruptcy Code, and *In re Chingman Chan*,²³⁰ which was a Section 304 case. However, only *Axona* includes a detailed discussion of why Hong Kong insolvencies should be recognized and assisted by U.S. courts.²³¹ In this case, the bankruptcy court for the Southern District of New York granted the relief requested by the Hong Kong liquidators and the U.S. trustee, namely, the suspension of the U.S. liquidation and an order to transfer the U.S. assets to the

224. 11 U.S.C.A. §§ 701, 702 (West 1995).

225. *Id.* § 541.

226. *Id.* § 362.

227. For example, the strong arm powers, *id.* § 544, the ability to avoid preferences, *id.* § 547, and fraudulent transfers, *id.* § 548.

228. See *In re Metzeler*, 78 B.R. 674 (Bankr. S.D.N.Y. 1987).

229. *In re Axona International Credit & Commerce Ltd.*, 88 B.R. 597 (Bankr. S.D.N.Y. 1988), *aff'd*, 115 B.R. 442 (S.D.N.Y. 1990), *appeal dismissed*, 924 F.2d 31 (2d Cir. 1991) [hereinafter *Axona*].

230. *In re Chingman Chan*, 1993 U.S. Dist. LEXIS 7864 (S.D.N.Y. June 9, 1993). See also *Scientex Corp. v. Harry Kay*, Memorandum of Decision and Order, No. CV82-0410-RJK (C.D. Cal., July 28, 1986) (dismissing for reasons of comity a cross-claim against a company that was in the midst of liquidation in Hong Kong).

231. For a more detailed analysis of *Axona*, see Booth, *supra* note 15, at 220-29, and Booth, Case Comment, *Transnational Insolvency: Cross-Border Co-operation Between the United States and Hong Kong—In re Axona International Credit and Commerce Limited*, 23 H.K.L.J. 131 (1993).

Hong Kong liquidators to be administered in the Hong Kong proceedings under Hong Kong law. In determining whether to order the relief requested under Section 305 of the U.S. Bankruptcy Code, the court had to consider the application of the criteria in Section 304(c). (These criteria must also be considered by a court in determining whether to grant relief in a Section 304 case). Section 304(c) provides as follows:

In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditious administration of such estate, consistent with—

- (1) just treatment of all holders of claims against or interests in such estate;
- (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
- (3) prevention of preferential or fraudulent dispositions of property of such estate;
- (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;
- (5) comity; and
- (6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.²³²

In explaining how Hong Kong law and procedures satisfy the Section 304(c) criteria, the court first focused on the fifth factor, comity, and emphasized that comity should be granted to the Hong Kong insolvency because Hong Kong is a sister common law jurisdiction whose company law is “derived from the British Companies Act.”²³³ This finding is especially important in the context of Hong Kong’s upcoming transition to Chinese rule; only time will tell whether Hong Kong remains a sister common law jurisdiction.

In discussing the other Section 304(c) criteria, the court also noted the following factors: that the Companies Ordinance “is strikingly similar” to U.S. bankruptcy law “and provides a comprehensive procedure for the orderly and equitable distribution of

232. 11 U.S.C.A. § 304 (West 1995).

233. *Axona*, 88 B.R. at 610.

assets;²³⁴ that Hong Kong law does not discriminate against foreign creditors;²³⁵ that Hong Kong law prevents preferential or fraudulent dispositions of property;²³⁶ and that the Hong Kong distribution scheme is substantially in accordance with the order prescribed by U.S. law.²³⁷

C. Chinese Law

In contrast to the cooperative approach demonstrated by England and the United States toward Hong Kong insolvencies, China adopts a territorial position and does not provide cross-border assistance. The case of *Liwan District Construction Company v. Euro-America China Property Limited*²³⁸ exemplifies the Chinese approach and is the only reported Chinese case involving the recognition of a foreign insolvency. The case involved a suit between a Chinese company, Guangzhou City Liwan District Construction Company, and a Hong Kong company, Hong Kong Euro-America China Property Co. Ltd. for breach of contract. The Chinese litigation was complicated by the fact that the Hong Kong defendant was in the process of being wound up in Hong Kong. The People's Court in Guangdong Province found that the liquidator who had been appointed in the Hong Kong liquidation lacked the authority to represent the Hong Kong party in the Chinese litigation. Ultimately, the People's Court protected the interests of the Chinese party, by, in effect, awarding it a "lien" on property in China that had been primarily financed by the Hong Kong defendant and had not yet been transferred to the plaintiff.

With 1997 approaching, bilateral cross-border insolvency matters involving Hong Kong and China have been the subject of increasing attention in both jurisdictions, both of which are in the process of reforming their respective insolvency law. It is understood that the Subcommittee on Insolvency intends to address these issues in its final report on Hong Kong insolvency law reform. The Chinese have also been considering these matters, and, as noted by a member of China's National Insolvency Law Drafting Team, China is ready to

234. *Id.*

235. *Id.* at 612.

236. *Id.* at 613.

237. *Id.*

238. *Liwan District Construction Company v. Euro-America China Property Limited*, A People's Court in Guangdong Province, reported Feb. 9, 1990, reprinted in Donald J. Lewis & Charles D. Booth, Case Comment, *Liwan District Construction Company v. Euro-America China Property Limited*, 6 CHINA L. & PRAC. 27 (1990). For a more detailed analysis of this case, see *id.*

take steps to cooperate with Hong Kong in cross-border insolvencies.²³⁹ However, this same member acknowledged that, at least in the near future, China will continue to adopt the territoriality approach.²⁴⁰

V. THE POST-1997 EVOLUTION OF HONG KONG'S TRANSNATIONAL INSOLVENCY LAW AND THE TREATMENT OF HONG KONG INSOLVENCIES BY FOREIGN COURTS

The continuing evolution of Hong Kong's transnational insolvency law after 1997 depends upon a variety of economic, political, and legal developments in both Hong Kong and China. Part A below discusses a variety of factors that will quite likely lead to an increase in the number of Hong Kong insolvencies, many of which will have cross-border implications. Part B explains why more Chinese enterprises²⁴¹ are likely to be wound up in backdoor liquidations in Hong Kong. Part C then discusses a variety of political and legal factors that will have further ramifications for the development of Hong Kong's transnational insolvency law, as well as affect whether foreign countries will continue to grant recognition and provide assistance to Hong Kong insolvencies. Additional recommendations to Hong Kong insolvency law are also proposed.

A. *Factors Likely to Increase the Number of Insolvencies in Hong Kong*

Hong Kong has historically had a low rate of insolvency, both in absolute terms²⁴² and as compared to rates elsewhere.²⁴³

239. Wang Wei Guo, Member of the National Insolvency Law Drafting Team, Chasing the Dragons: Business Protection in China and the New Asia, Remarks at the INSOL Conference Asia Pacific (Nov. 2, 1995) (on file with author).

240. *Id.*

241. In China, the term "enterprise" includes a broad variety of business entities. See GUIGUO WANG, BUSINESS LAW OF CHINA: CASES, TEXTS, AND COMMENTARY 145-46 (1993).

242. For example, in 1993-94, receiving orders were made in 318 bankruptcies and winding-up orders were made in 433 compulsory liquidations. OFFICIAL RECEIVER'S OFFICE ANNUAL DEPARTMENT REPORT, 1993-94, ¶ 3.6.2, at 5 (Hong Kong 1994) [hereinafter OFFICIAL RECEIVER'S 1993-94 REPORT]. In 1994-95, the number of bankruptcy cases in which receiving orders were made increased to 325 and the number of compulsory liquidations in which winding-up orders were made declined to 429. OFFICIAL RECEIVER'S 1994-95 REPORT, *supra* note 187, ¶ 3.7.2, at 5 (1995).

Recently, however, the number of insolvencies in Hong Kong has been increasing, and it is likely that this trend will continue.²⁴⁴ Many of these insolvencies will have transnational implications, and as the number of transnational insolvencies increases, the current weaknesses and ambiguities in Hong Kong's transnational insolvency law will become more apparent.

Many factors will likely cause an increase in the number of insolvencies in Hong Kong. First, the Hong Kong economy appears to be slowing down. This led some analysts to claim that "Hong Kong's economic growth has peaked and is in danger of stalling, judging by the latest economic data."²⁴⁵ Many commentators predict that this trend will continue throughout 1996.²⁴⁶ Meanwhile, frequent articles in the local press lament the sluggish property market, the decline in retail sales, and the increase in Hong Kong's unemployment rate.²⁴⁷

Second, poor economic conditions in many countries abroad may, in turn, lead to an increase in the number of insolvencies commenced in Hong Kong. For example, it was recently reported that insolvency is increasing among buyers from Hong Kong exporters; in particular, buyers from the United States are increasingly filing voluntary petitions under Chapter 11 of the U.S. Bankruptcy Code.²⁴⁸ It is possible that the foreign representatives in some of

243. For example, the average annual corporate failure rate in Hong Kong between 1985-86 and 1994-95 was 0.93%. OFFICIAL RECEIVER'S 1994-95 REPORT, *supra* note 187, Annex 6. In contrast, the annual failure rate in the United Kingdom between 1986 and 1988 was 2.27%. Edward L.G. Tyler, *Current Issues in Insolvency*, in COMMERCIAL LAW 17, 20 (Caroline Hague ed. 1991).

244. In 1992-93 there were 640 new insolvency cases in which either a receiving order or a winding up order was made. In 1993-94, this number increased to 751, and in 1994-95 to 754. This total of 754 new insolvencies marked an increase of 17.8% over the number of insolvencies in 1992-93 and .4% over the number in 1993-94, and is the highest number of insolvencies over the past decade. See OFFICIAL RECEIVER'S 1994-95 REPORT, *supra* note 187, ¶ 3.6.2, at 5, and Annex 5.

245. Simon Fluendy, *Party is over for HK, say analysts*, S. CHINA MORNING POST, Feb. 10, 1995 (Business Post), at 1.

246. See, e.g. Noel Fung, *Hang Seng Bearish on 1996*, S. CHINA MORNING POST, Dec. 1, 1995 (Business Post), at 3; Francine Brevetti, *Economic Woes Cloud Outlook*, ASIAN BUS., Nov. 1995, at 34.

247. See, e.g. Jonathan Braude, *Polls shows people fear ravages of unemployment; Pessimism reigns on the economy; Polls shows pessimism*, S. CHINA MORNING POST, Oct. 23, 1995, at 1; Ken Lee and Raymond Wang, *Land sale slump continues*, EASTERN EXPRESS, Oct. 18, 1995 (Business), at 17; Brevetti, *supra* note 246; Fung, *supra* note 246. For a more optimistic interpretation of this data, see Caspar W. Weinberger, *Hong Kong—Why All the Pessimism?*, FORBES, Nov. 20, 1995, at 33.

248. *Bankruptcies on Rise*, EASTERN EXPRESS, Dec. 1, 1995, at 19.

these cases may petition in Hong Kong under Part X of the Companies Ordinance to wind up the foreign buyers whose estates they represent in the U.S.. Such proceedings could enable the foreign representatives to secure the foreign debtors' Hong Kong assets for distribution to creditors in the United States. This scenario is also likely to arise with respect to Chinese enterprises. The poor state of the Chinese economy, which is discussed below in Part V.B, will most likely lead to the insolvency of more Chinese enterprises in the near future.²⁴⁹ In cases in which these enterprises have assets in Hong Kong, the foreign representatives from China will very likely be petitioning to have these enterprises wound up in Hong Kong.

Third, the enactment of the Law Reform Commission's bankruptcy recommendations will most likely lead to a dramatic increase in the number of bankruptcy cases. Currently, it is difficult, and often impossible, for a Hong Kong debtor to receive a discharge from bankruptcy.²⁵⁰ The existing discharge provisions are thus a disincentive to debtors who might otherwise petition for bankruptcy as a way to resolve their financial problems. In contrast, the proposed amendments to the discharge provisions are more debtor-friendly and provide for automatic discharge in most cases.²⁵¹ Once these proposals come into effect, many more debtors will likely file voluntary bankruptcy petitions to gain the benefits of a "fresh start."

Fourth, a related factor is that the increase in the use of credit cards by consumers in Hong Kong will also eventually cause an increase in personal bankruptcy. Recent statistics show that the amount charged on Visa and MasterCard in Asia last year increased 49% from the previous year.²⁵² Perhaps most importantly, given that the majority of Hong Kong's credit cardholders pay 24% interest per annum,²⁵³ many cardholders might eventually be forced to resort to the new Voluntary Arrangement Procedure, which was recently proposed by the Law Reform Commission,²⁵⁴ or to bankruptcy.

249. *Instances of state-run bankruptcies to surge*, EASTERN EXPRESS, Nov. 18-19, 1995, at 18.

250. The Law Reform Commission has noted that "for the overwhelming majority of bankrupts bankruptcy is a life sentence." REPORT ON BANKRUPTCY, *supra* note 4, ¶ 171, at 156.

251. *Id.*, ch. 17, at 156-78.

252. Nisha Gopalan, *Credit cards take charge in more ways than one*, EASTERN EXPRESS, Dec. 4, 1995 (Business), at 24 (citing the Nilson Report).

253. *Id.*

254. REPORT ON BANKRUPTCY, *supra* note 4, ch. 6, at 46-59.

Fifth, of course, if China causes any major disruption to Hong Kong's economy or attempts to assert any undue influence on Hong Kong's legal system or markets, investor confidence will most certainly plummet, causing flights of capital from Hong Kong and a downward spiral in the local economy.²⁵⁵ This, in turn, would lead to an increase in the number of both personal and corporate insolvencies in Hong Kong.

Sixth, if the current peg that exists between the Hong Kong dollar and the U.S. dollar²⁵⁶ is altered or abolished, the Hong Kong dollar will most likely fall in value and cause many local insolvencies. Moreover, the fact that people fear that the Hong Kong dollar may fall in value is in itself a factor that could precipitate such a fall. This danger is exacerbated by the fact that some global banks engage in what is locally called "ring fencing." "Ring fencing" involves "global banks refusing to stand behind deposits in their local branches in case a political upheaval makes it impossible to redeem them locally."²⁵⁷ (For example, Citibank has been alerting investors in the bank's Hong Kong dollar-denominated CDs "that they're on their own if the Hong Kong dollar disappears after 1997."²⁵⁸) Therefore, if Hong Kong depositors become overly worried about the future strength of the Hong Kong dollar and about the risks caused by ring fencing, they might decide to move their bank deposits to non-Hong Kong dollar accounts located offshore. A massive exodus from Hong Kong dollar deposits, could, in turn, put pressure on the Hong Kong dollar and eventually lead to its fall. Of course, a considerable increase in the number of insolvencies would result.

B. *Factors Likely to Increase the Number of Liquidations of Chinese Enterprises in Hong Kong*

The decision by the High Court to wind up CTIETCC,²⁵⁹ the fourteenth largest state enterprise in China and the first Chinese

255. See Adrian Kennedy, *Financiers fear exodus if Beijing interferes*, EASTERN EXPRESS, May 19, 1995, at 1.

256. The peg is now set at approximately HK\$7.8=US\$1.

257. *Hong Kong Timebomb*, ASIAN WALL ST. J., Feb. 28, 1995, at 6.

258. *Id.* The Hong Kong Monetary Authority believes that these "ring fencing" clauses should be removed or simplified because they unduly confuse and worry investors. *Call for end to ring fencing*, EASTERN EXPRESS, June 6, 1995 (Business), at 25. The Authority asserts that these clauses are unnecessary because under Hong Kong law an oversea company generally would not be liable for the debt payments by its local branch in the event of an "extraordinary" event such as war, insurrection, or civil strife. *Id.*

259. See *supra* notes 148-57 and accompanying text.

enterprise to be wound up in Hong Kong since World War II, demonstrates that it is now possible in Hong Kong to commence a backdoor liquidation against a Chinese enterprise—that is, the liquidation of a Hong Kong enterprise not in the process of being wound up in China. A “backdoor” liquidation enables creditors to avoid the pitfalls that are often encountered when attempting to enforce an arbitral award or judgment in China²⁶⁰ or when resorting to Chinese insolvency law. The fact that the English petitioner and CTIETCC settled their dispute²⁶¹ not long after the winding up was ordered demonstrates that additional benefits may result from pursuing such a course of action.

As China is now the biggest investor in Hong Kong,²⁶² there are a growing number of Chinese enterprises with a presence in Hong Kong. When creditors experience difficulty in reaching the assets of these enterprises, they are increasingly likely to commence “backdoor” liquidations in Hong Kong under Part X of the Companies Ordinance. There are two categories of Chinese enterprises that are more likely to be the target of such a strategy: those that are unable to pay and those that are unwilling to pay. There are a growing number of enterprises in each category.

With respect to the first category, economic conditions in China continue to weaken the financial condition of many Chinese enterprises, and the situation is likely to deteriorate further. For example, concerns have been growing about the massive amounts of triangular debt²⁶³ in China. In 1994 it was claimed that 390,000 state enterprises had run up a triangular debt of US\$69 billion, equal to 10% of China's GDP.²⁶⁴ Over the first nine months of 1995, this problem

260. Peter Stein, *How to Win and Lose in China's Civil Courts*, ASIAN WALL ST. J., Feb. 16, 1995, at 1,7.

261. The Hong Kong High Court granted a stay of the winding-up proceedings, but only after cryptically noting the court was not satisfied as to the “commercial morality” of the parties' confidential agreement. *Re China Tianjin Int'l Economic and Technical Cooperative Corp.*, Companies Winding Up No. 438 of 1994 (Oct. 16, 1995).

262. Adrian Kennedy, *Mainland is biggest investor*, EASTERN EXPRESS, Feb. 11-12, 1995, at 27 (quoting Denise Yue, the Hong Kong government director-general of industry).

263. “Triangular debt” is the name for the situation in which Chinese enterprises make loans or extend goods and services on credit to each other with the result that each of the enterprises is owed debts at the same time it owes debts to other enterprises, with none of the parties having sufficient money to repay its debts and end the deadlock. *Debts owed to industrial firms grow to HK\$718b*, S. CHINA MORNING POST, Dec. 8, 1995 (Business Post), at 5. However, the liquidation of one of the enterprises will break the deadlock if it causes the collapse of the other enterprises to which it owes money.

264. Edward Steinfield, *China's Cash Cow Dinosaurs*, THE ASIAN WALL ST. J., Feb. 7, 1995, at 10.

eased only slightly.²⁶⁵ It was also recently reported that more than 41% of China's state enterprises lost money during this nine-month period, an increase of 1.17% over the same period in 1994,²⁶⁶ and that the total amount lost was approximately US\$5 billion, an increase of 18.8% over the comparable 1994 period.²⁶⁷ In addition, the average debt-to-assets ratio for state enterprises has reached a dangerous level of almost 80 percent,²⁶⁸ and almost one-quarter of all bank loans to China's state-sector is non-performing.²⁶⁹ Lastly, recent downgradings by Moody's Investors Service of the debt ratings of many Chinese banks and state enterprises will further hurt these institutions by raising the cost of their borrowing.²⁷⁰

With respect to the second category of enterprises, a growing number of Chinese state enterprises have been denying their liability to Western companies relating to massive losses that were allegedly incurred by the state enterprises in trading currency or a variety of financial instruments. It is interesting that many Western companies have apparently changed their debt collection strategy from one that involves quiet settlement with their Chinese partner or client to one that involves a more confrontational stance, including litigation and a publicity battle in the press.²⁷¹

265. Geoffrey Crothall, *Mainland state enterprise losses rise 20pc to \$38.75b*, S. CHINA MORNING POST, Oct. 20, 1995, at 1.

266. *Id.*

267. *Id.*

268. Shan Li and D. Daoqui Li, *Weaning China's Managers Off Easy Money*, ASIAN WALL ST. J., Dec. 4, 1995, at 6.

269. *Id.*

270. In April 1995, Moody's Investors Service downgraded the debt ratings of four major Chinese banks and downgraded or put on review the credit ratings of seven state enterprises. Erik Guyot & Kathy Chen, *Moody's Announces Downgrades Of Nonsovereign Chinese Debt*, ASIAN WALL ST. J., Apr. 20, 1995, at 1. Six months later, Moody's downgraded the long term debt of China International Trust and Investment Corp. ("CITIC"). Erik Guyot, *Moody's Downgrades Citic Beijing's Debt*, ASIAN WALL ST. J., Oct. 18, 1995, at 1.

271. The following disputes were reported earlier this year:

(1) In December 1994, Lehman Brothers filed suit in New York against China National Metals & Minerals Import & Export Corp. ("Minmetals") and its subsidiary Minmetals International Non-Ferrous Metals Trading Co. ("Minmetals Non-Ferrous") to recover US\$52.5 million and against China International United Petroleum & Chemicals Co. ("Unipecc") to recover US\$44 million that Lehman Brothers alleges was lost in foreign-exchange derivatives transactions. David Ibson, *New twist in Lehman's legal wrangle*, S. CHINA SUNDAY MORNING POST, March 26, 1995 (Money) at 1. Minmetals Non-Ferrous filed a US\$128 million counterclaim alleging that Lehman Brothers "lured a young and innocent trader into making derivatives deals he was unauthorised to conduct and unable to understand." David Ibson, *Lehman Brothers return fire in Minmetals legal battle*, S. CHINA SUNDAY MORNING POST, March 12, 1995, (Money), at 1. Lehman Brothers denied the charge and claimed that the trader was fully authorized to conduct the trading. *Id.* The U.S.

C. *Political and Legal Factors Likely to Affect the Post-1997 Evolution of Hong Kong Transnational Insolvency Law and the Treatment of Hong Kong Insolvencies by Foreign Courts*

1. Extent to which China Honors the Terms of the Joint Declaration and the Basic Law

At present, a foreign representative can come to Hong Kong and petition for the insolvency of the debtor (or the estate of the debtor that she represents) in a foreign proceeding. She can be confident that the winding-up will be administered fairly and efficiently and that the Official Receiver will operate independently when carrying out any necessary investigations. Similarly, a foreign investor or businessperson in Hong Kong can be confident that if problems arise with respect to her investment or transaction in Hong Kong, she will receive an impartial hearing in the Hong Kong courts. The future success of Hong Kong's transnational insolvency law, and of the continued recognition of Hong Kong insolvencies, depends on whether foreign representatives, investors, and businesspersons remain similarly confident after 1997, or, in other words, on whether the current legal system that is premised on the notion of the rule of law is maintained.

The most important factor that will determine whether the rule of law continues is whether China abides by the terms of the Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong (the "Sino-British

court recently denied Lehman Brothers' motion to have the Minmetals Non-Ferrous counterclaims dismissed. *Minmetals Suit Against Lehman Will Be Allowed*, ASIAN WALL ST. J., Oct 20, 1995, at 3. Unipecc has also counterclaimed, seeking US\$38 million in damages. *China's Unipecc Files Countersuit Against Lehman Over Big Losses*, ASIAN WALL ST. J., March 16, 1995, at 2. Lehman Brothers countered by claiming that Unipecc's "actions and allegations are simply a smoke screen to renege on their obligations." *Id.*

(2) Both Goldman Sachs and Bankers Trust are understood to have threatened to place stop-orders on some of their Chinese clients' accounts after their initial attempts to recover losses proved unsuccessful. David Ibison, *Banks get tough with China firms*, S. CHINA MORNING POST, Jan. 8, 1995, (Money), at 1; *Banks face snag over forex debts*, S. CHINA MORNING POST, Jan. 10, 1995, (Business Post), at 4.

(3) A group of fourteen brokers, including Lehman Brothers, Merrill Lynch & Co., and Credit Lyonnais Rouse, sued CITIC to collect more than US\$42 million following alleged losses on the London Metals Exchange from the unauthorized trading of copper futures by staff members of CITIC's Shanghai subsidiary. *CITIC Claims London Accord*, INT'L HERALD TRIB., March 20, 1995, at 11; Simon Fluendy, *Minmetals president replaced after derivatives debacle*, S. CHINA MORNING POST, Aug. 7, 1995. The dispute was eventually settled after two high-ranking officials were replaced. *See id.*

Joint Declaration")²⁷² and the terms of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (the "Basic Law").²⁷³ If China honors the terms of the Sino-British Joint Declaration and the Basic Law, the laws of Hong Kong that are in effect prior to the transfer of sovereignty on July 1, 1997 will continue to be enforced by an impartial and competent judiciary for at least the next fifty years, subject, of course, to amendment by the Hong Kong SAR legislature. If so, the transfer of sovereignty might have little effect on Hong Kong transnational insolvency law. Foreign representatives, investors, and businesspersons will retain confidence in Hong Kong's economy and legal system, and foreign jurisdictions will continue to recognize and grant assistance to Hong Kong insolvencies.

If, however, China refuses to honor the terms of the Joint Declaration, new laws will be promulgated to replace the laws currently in force. If Hong Kong were to lose its autonomy and become just another region in China, foreign investors and businesspersons might well liquidate their Hong Kong investments and assets and repatriate their funds abroad. In addition, if Hong Kong's legal system were to lose its independence, foreign jurisdictions would be less likely to recognize or assist Hong Kong insolvencies. For example, it would be more difficult for Hong Kong insolvencies to gain recognition and assistance from U.S. courts if Hong Kong were deemed to be a Chinese, rather than a sister common law, jurisdiction.

272. The Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, *reprinted in PUBLIC LAW AND HUMAN RIGHTS—A HONG KONG SOURCEBOOK* 45 (Andrew Byrnes & Johannes Chan eds. 1993) [hereinafter the Sino-British Joint Declaration]. The Sino-British Joint Declaration provides that Hong Kong will become a Special Administrative Region in the People's Republic of China (the "Hong Kong SAR") directly under the authority of the Central People's Government of the People's Republic of China and that the Hong Kong SAR is to "enjoy a high degree of autonomy." Sino-British Joint Declaration, ¶¶ 1-3(2) & (12). The Declaration also provides that the judiciary is to remain independent and that "[t]he laws currently in force in Hong Kong will remain basically unchanged." Sino-British Joint Declaration, ¶ 3(3). These latter provisions were incorporated respectively into Articles 2 and 8 of The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, ch. 1, arts. 2, 8, *reprinted in PUBLIC LAW AND HUMAN RIGHTS*, at 84-85 [hereinafter The Basic Law], which will become the constitution of the Hong Kong SAR on July 1, 1997. Article 2 provides that the Hong Kong SAR is to enjoy "independent judicial power, including that of final adjudication." Basic Law, ch.1, art. 2. Article 8 provides that the laws in force in Hong Kong prior to the transfer, other than those made in the United Kingdom, but including the common law and the rules of equity, shall be maintained unless they contravene the Basic Law, and shall be subject to amendment by the Hong Kong SAR legislature. Basic Law, ch. 1 art.8.

273. See *supra* note 272.

A third, and perhaps the most likely, scenario is that China will pursue a middle ground in which many of the laws will remain unchanged, but in which the application or enforcement of those laws might become less impartial. Moreover, China might put forth increasingly aggressive interpretations of the Sino-British Joint Declaration or the Basic Law.²⁷⁴ Under this approach, China would abide by the "letter" rather than the "spirit" of the law. The international community's response would depend on the extent to which it perceives that Hong Kong's legal system has changed.

Only time will tell which approach China will adopt. In the meantime, at least one overseas court has already voiced concern about the future of Hong Kong's legal system.²⁷⁵ In this recent case, which involved the death of an American woman who drowned in a swimming pool in a Hong Kong hotel, the Massachusetts District Court, justified, in part its exercise of personal jurisdiction over a Hong Kong defendant by noting the "uncertain future of the Hong Kong legal system, given the island's reversion to Chinese sovereignty in less than two years."²⁷⁶ This case led the Hong Kong government to appoint a top legal official to visit the United States to address lawyers, major corporations, and U.S. legal institutions in an attempt to increase confidence in the territory's legal system.²⁷⁷

2. Repercussions of Winding Up More Chinese Enterprises in Hong Kong

It will most likely become increasingly difficult to find lawyers who are willing to represent petitioners against Chinese enterprises or accountants who are willing to serve as liquidators and thoroughly investigate and gather the assets of Chinese enterprises. The latter problem was encountered in the liquidation of CTIETCC. Reports indicated that accountants from a major accounting firm withdrew from being considered for appointment because their firm was

274. Recently, the Preliminary Working Committee adopted this approach when asserting that certain aspects of the Hong Kong Bill of Rights violated the Basic Law and should be abolished. Senior Chinese officials later publicly announced that they supported the recommendations of the Preliminary Working Committee. See No Kwain-Yan & Chris Yeung, 'Bill of Rights must go': China backs proposal to remove statute's power to 'override' legislation, S. CHINA MORNING POST, Oct. 19, 1995, at 1.

275. *Nowak v. Tak How Investment Ltd.*, Civ. A. No. 94-11691-WGY (unrep.) (D Mass. 1995).

276. *Id.*

277. Ruth M^{rs} Hanson, *Law chief to take war on gloom to States*, S. CHINA MORNING POST, Sept. 17, 1995, at 3.

"concerned about its own position" in Hong Kong after 1997.²⁷⁸ In addition, if many more "backdoor" liquidations of Chinese enterprises occur in Hong Kong (and especially if they involve enterprises with ties to powerful individuals in China), China may exert pressure either to prevent such liquidations from occurring at all or to prevent the Official Receiver or other liquidators from carrying out proper investigations.

3. Impact of the Law Reform Commission's Recommendations Regarding the Official Receiver's Powers

One of the most important features of the Law Reform Commission's Report on Bankruptcy is the recommendation to enact a variety of procedures contained in the U.K. Insolvency Act of 1986 that increase the Official Receiver's powers. The Commission proposes to give the Official Receiver the discretion to choose whether to serve as trustee and therefore whether to hold the first meeting of creditors.²⁷⁹ In any case, the trustee is required to call the first meeting of the creditors' committee within three months of his appointment or of the establishment of the committee, whichever is later.²⁸⁰ However, subsequent meetings of the committee will no longer be held monthly, as is the current practice.²⁸¹ Instead, subsequent meetings will be held when determined by the trustee, when requested by a member of the creditors' committee, or when determined at a previous meeting of the creditors' committee.²⁸² Another recommendation of the Law Reform Commission reduces the quorum for all creditors' meetings to one creditor present or represented.²⁸³

These reforms streamline the bankruptcy process and thereby make it more efficient. However, there are two important disadvantages to the proposed reforms. First, since the Official Receiver has

278. *Hong Kong Timebomb*, *supra* note 257.

279. REPORT ON BANKRUPTCY, *supra* note 4, ¶¶ 8.7-11, at 69-70. However, the Official Receiver is required to hold the first meeting of creditors if so requested by not less than one-quarter, in value, of the debtor's creditors. *Id.* ¶ 8.12, at 70.

280. *Id.* ¶ 9.10, at 78. However, the Law Reform Commission did not recommend adoption of all the United Kingdom provisions that strengthen the powers of the Official Receiver. For example, the Law Reform Commission decided not to adopt the provision that provides that a creditors' committee is not established in cases in which the Official Receiver serves as the trustee. *Id.* ¶ 9.15, at 79-80.

281. See Bankruptcy Ordinance § 24(3).

282. REPORT ON BANKRUPTCY, *supra* note 4, ¶ 9.10, at 78.

283. *Id.* ¶¶ 8.14-8.15, at 70-71. At present, the quorum is three creditors, or all the creditors if there are fewer than three creditors. Meetings of Creditors Rules, Rule 24, cap. 6 sub. leg. D, L.H.K. (1995).

the discretion to decide against holding the first meeting of creditors, perhaps over the objection of minority creditors who are unable to meet the one-quarter-in-value requirement, this reform could possibly lead to difficulties in gaining the cooperation of U.S. courts that adopt the approach of the district court in *Interpool, Ltd. v. Certain Freights of M/V Venture Star* ("Interpool").²⁸⁴ In that case, the court refused to assist an Australian liquidation proceeding because it failed to provide U.S. creditors with similar substantive and procedural protection as is provided in the U.S. Bankruptcy Code. Among the factors noted by the court was that the Australian liquidator had failed to meet with creditors to discuss an important agreement that the liquidator later entered into with one of the company's creditors.²⁸⁵ The fact that Australian law provides other procedures to safeguard the interests of creditors, albeit different from those included in the U.S. Bankruptcy Code, demonstrates that this case was wrongly decided.²⁸⁶ However, to avoid the possibility that other U.S. or foreign courts might nevertheless adopt the *Interpool* approach, the Official Receiver should be required to hold the first meeting of creditors in any bankruptcy in which cross-border cooperation might become necessary.

A more fundamental objection to the new discretionary powers of the Official Receiver is that such a change is misguided in the context of the new era that will be ushered in by 1997. One of the main strengths of the current insolvency process in Hong Kong is the independence of the Official Receiver. However, given the uncertainties about the future of the civil service,²⁸⁷ one must query whether the Official Receiver will remain independent after 1997. If he

284. 102 B.R. 373 (D.N.J. 1988), *appeal dismissed*, 878 F.2d 111 (3d Cir. 1989).

285. *Id.* at 378-79.

286. See Booth, *supra* note 15, at 200-12. See also Daniel M. Glosband & Christopher T. Katucki, *Current Developments in International Insolvency Law and Practice*, 45 BUS. LAW. 2273, 2277-78 (1990); Michael R. Hughes, *An Australian Perspective on Interpool*, 2 INT'L INSOLVENCY & CREDITORS' RTS. REP. 32, 33-34 (1990); Jay L. Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457, 474-78 (1991).

287. For example, China caused a stir when it demanded that the Hong Kong government allow it to review civil servants' files before 1997. See Kevin Murphy, *China Says Hong Kong Civil Servants Can Keep Jobs After '97*, INT'L HERALD TRIB., June 26, 1995, at 4. Recently, however, China attempted to reassure Hong Kong's civil servants by announcing that they will be able to continue their employment past 1997 under existing conditions. *Id.* But it remains unclear whether civil servants will be able to retain their current positions. One member of the Hong Kong Legislative Council has questioned whether the "vetting process" for senior Hong Kong civil servants will be to ensure that all appointees "will have 'politically correct' views." Christine Loh, *The CCP and the Rule of Law in Hong Kong*, 25 H.K.L.J. 149, 151 (1995).

retains his independence, then it is possible that China will attempt to curtail his powers; if he does not, then it is likely that the Official Receiver may not exercise his responsibilities as diligently as he does at present. If foreign representatives, investors, and businesspersons perceive that the Official Receiver has lost his independence, they will rightly begin to worry about whether the interests of creditors will continue to be adequately protected in Hong Kong insolvency proceedings. Similarly, foreign courts might well be more reluctant to recognize and assist Hong Kong insolvencies.

The irony is that although the Law Reform Commission proposed to strengthen the Official Receiver's powers as a means of improving Hong Kong's insolvency procedures, these recommendations may eventually have the opposite effect. A better alternative would be to decentralize the insolvency process and to decrease the role played by the Official Receiver. A first step could be to appoint trustees and liquidators from private panels of insolvency practitioners.²⁸⁸ It is understood that the Official Receiver is not averse to such a change. Second, the role played by creditors and creditors' committees should be expanded. To ensure that creditors become more involved in the bankruptcy and liquidation process, reforms should be enacted to increase the likelihood of larger distributions being paid to creditors. One possibility would be to strengthen the avoidance powers.

VI. CONCLUSION

The common law development of Hong Kong's cross-border insolvency law has, for the most part, served Hong Kong well. But with the likelihood that many more transnational insolvencies will arise in the near future and with 1997 fast approaching, it is no longer satisfactory to refer primarily to English case law to resolve those matters of great local concern that involve transnational insolvency. Greater consistency and predictability would result if many of the applicable common law principles were incorporated (with clarification or supplementation, as need be) into the Companies Ordinance, the Bankruptcy Ordinance, and other legislation as necessary. Other amendments should be made to clarify and update the existing statutory guidelines in Part X of the Companies Ordinance and relevant sections of the Bankruptcy Ordinance. These changes would

288. The Law Reform Commission raised this possibility as one of two alternatives for choosing supervisors for the proposed voluntary arrangement procedures. **REPORT ON BANKRUPTCY**, *supra* note 4, ¶¶ 6.15-.23, at 52-53.

all facilitate greater cross-border cooperation.

If cross-border trade and investment between Hong Kong and China are to continue growing at a rapid pace, it is crucial for Hong Kong and China to reach agreement on a variety of bilateral cross-border insolvency issues, including the recognition of insolvencies and the types of assistance that Hong Kong and China may provide to each other's insolvencies. After the resumption of Chinese sovereignty over Hong Kong in 1997, it will be especially important for insolvencies in the Hong Kong SAR to be recognized elsewhere in China. To assist in implementing a cross-border insolvency agreement, Hong Kong and China could establish a cross-border insolvency panel that includes members from both Hong Kong and China.²⁸⁹

Of course, any reforms enacted during the transition period could be undermined if China fails to honor the terms of the Sino-British Joint Declaration or the Basic Law and instead imposes its own transnational cross-border approach. Likewise, any interference by China with the administration of Hong Kong insolvencies (or with Hong Kong's economy or legal system generally) could have serious ramifications for the treatment of Hong Kong insolvencies by foreign courts. Thus, Hong Kong and China should take steps to ensure that foreign representatives, investors, businesspersons, and courts worldwide all remain confident about the future independence of Hong Kong's economy and legal system.

289. This was the approach recently adopted to implement the cross-border bank accord that China and Hong Kong entered into in late 1994



The University of Hong Kong Faculty of Law
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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Supplementary Materials

**Excerpts from the Law Reform
Commission of Hong Kong's Report on
the Winding-up Provisions of The
Companies Ordinance (1999)**



**THE LAW REFORM COMMISSION
OF HONG KONG**
香港法律改革委員會

JULY 1999

Chapter 26 - Winding-up of Unregistered Companies (Cross-border Insolvency)

26.1 The treatment of cross-border insolvency is especially important in Hong Kong because of Hong Kong's status as an international business and financial centre. A large proportion of companies listed in Hong Kong are registered abroad and a large and growing number of other companies, both private and public, are also registered outside Hong Kong. It is therefore imperative that cross-border insolvency provisions should be promulgated that are both comprehensible and functional. The present provisions have presented some difficulty in terms of comprehension but have proved to be sufficiently flexible to suggest that, while they need to be clarified, the underlying intentions do not need to be greatly altered.

26.2 We received a considerable response to the proposals in the *Consultation Paper*, reflecting the need for appropriate cross-border provisions. We have taken account of the submissions and the recommendations modify the proposals as a result. We maintain the main proposal; however, that of the adoption of provisions along the lines of section 304 of the U. S. Bankruptcy Code which would provide the court with guidelines to apply to an application from a foreign insolvency proceeding.

26.3 We note that there is some strong support for adoption of the UNCITRAL Model Law of Insolvency¹, which is referred to below, but we have been unable to find any jurisdiction which has adopted the Model Law and we are hesitant about recommending that Hong Kong, which is a relatively small jurisdiction, should pioneer the Model Law. We are aware that the Model Law was before the last session of the U. S. Congress but that it lapsed and will need to be reintroduced at the next session.

Section 326 Meaning of unregistered company

26.4 The section provides that for the purposes of Part X, "*unregistered company*" includes any partnership, whether limited or not, any association and any company, with the following exceptions:

- (a) a company registered under the Companies Ordinances of 1865 and 1911 or under the present Companies Ordinance;
- (b) a partnership, association or company which consists of less than eight members and is not formed or established outside Hong Kong;

¹ "*UNCITRAL Model Law of Insolvency*": the United Nations Commission on International Trade Law Guide to Enactment of the UNCITRAL Model Law on Cross-border insolvency.

- (c) a partnership registered in Hong Kong under the Limited Partnerships Ordinance (Cap 37).

26.5 A recent amendment has added the provision that for the avoidance of doubt it is declared that "*unregistered company*" includes an oversea company which is certified under section 333(3) as being registered under Part XI.²

Section 327 Winding-up of unregistered companies

26.6 Subject to the provisions of Part X, any unregistered company may be wound-up under the Ordinance, and all provisions of the Ordinance with respect to winding-up shall apply to an unregistered company, with the exceptions and additions mentioned in this section. No unregistered company can be wound-up voluntarily under these provisions.

26.7 An unregistered company may only be wound-up under these circumstances:

- (a) if the company is dissolved or has ceased carrying on business or is carrying on business only for the purpose of winding-up its affairs; or
- (b) if the company is unable to pay its debts; or
- (c) if the court is of the opinion that it is just and equitable that the company should be wound-up.

Section 327A Oversea companies may be wound-up although dissolved

26.8 The section provides that where a company incorporated outside Hong Kong which has been carrying on business in Hong Kong ceases to carry on business in Hong Kong, it may be wound-up as an unregistered company under this Part, notwithstanding that it has been dissolved or otherwise ceased to exist as a company under or by virtue of the laws of the place of its incorporation.

26.9 The Companies Ordinance provisions relevant to the area of cross-border insolvency are undoubtedly thin. Cross-border insolvency is an area that is becoming increasingly important as companies become more internationalised, with significant numbers of companies operating in Hong Kong either being registered in other jurisdictions or being owned by or owning foreign companies.

26.10 There is a temptation to make recommendations for the introduction of legislation that would comprehensively provide for every situation envisaged at present. We do not, however, favour the introduction of comprehensive provisions as the current provisions, when considered together with common law developments, already cover many of the areas that need to be addressed. Where

² Ordinance No. 3 of 1997, section 48.

we make recommendations, they relate to weaknesses or gaps in the current provisions that could be usefully resolved through legislation. These are mainly technical matters that would make it easier, for instance, for foreign insolvency proceedings to have access to the Hong Kong court.

26.11 Comprehensive legislation can also result in an inflexible procedure which is not desirable in an area of law that is constantly developing. We prefer to make recommendations for a legislative framework that would leave considerable discretion in the hands of the court in order that the court would have the power to react to any given set of circumstances. An example of just such a situation may be found in the "*Irish Shipping*" case, where the court allowed a foreign representative to file a petition on behalf of a foreign company.³

26.12 The way in which the winding-up of foreign companies is dealt with under the Companies Ordinance is explained as follows:

"Section 176 of the Companies Ordinance provides the Hong Kong court with the jurisdiction to wind-up any 'company', which is defined in section 2 as a Hong Kong company.⁴ Foreign companies are wound-up pursuant to provisions in Part X of the Companies Ordinance. A foreign company in Hong Kong is called an 'unregistered company'; it is also called an 'oversea company' if it has established a place of business in Hong Kong. Although a foreign company is generally not considered to be a 'company' as that term is defined in section 2 of the Ordinance, it may be deemed to be a 'company' to the extent provided by Part X of the Ordinance.

... Part X of the Companies Ordinance, entitled 'Winding-up of unregistered companies' contains the relevant sections for winding-up foreign companies. Section 326 defines 'unregistered company' to include any partnership, limited partnership, and company, except for, ...[among other things] ... , a company registered ... under the Companies Ordinance.

Section 327(1), in turn, provides that, subject to the provisions of Part X of the Companies Ordinance, any unregistered company may be wound-up under the Companies Ordinance. Under section 327(3), an unregistered company may be wound-up under the following circumstances:

- (a) if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purposes of winding-up its affairs;*
- (b) if the company is unable to pay its debts;*
- (c) if the court is of the opinion that it is just and equitable that the company be wound-up."*

³ *Re Irish Shipping Ltd.* [1985] HKLR 437.

⁴ Section 2 defines "company" as a "company formed and registered under this Ordinance or an existing company". An "existing company" is, in turn, defined as a company formed and registered under earlier Hong Kong Companies Ordinances.

26.13 The recent amendment to section 326⁵ was introduced as a consequence of the decision of the court in the case of *Securities and Futures Commission v MKI Corporation*⁶, which held that an “oversea company” might be wound-up as an “unregistered company”; another example of the court exercising its discretion appropriately.

26.14 Most foreign companies in Hong Kong are wound-up under section 327 and, although a foreign company may be wound-up under section 327A, in practice the section is rarely used.

26.15 The objective of these recommendations is to achieve provisions which would have the effect of providing that:

- (a) any company which does business in Hong Kong, whether or not it is a company which can be wound-up as defined under section 177 or an “unregistered company” or “oversea company” as defined in sections 326 and 327A respectively, may be wound-up by the Hong Kong court;
- (b) foreign insolvency proceedings may be recognised in main proceedings without the need for the foreign insolvency practitioner to initiate main insolvency proceedings under the Companies Ordinance; and
- (c) such recognition would be based on the principle of reciprocity.

26.16 These recommendations would involve Hong Kong participating to some degree in what has been described as the simplification and unification of transnational insolvency proceedings.⁷ The comment continued:

“Under this approach, a primary insolvency proceeding, which is intended to resolve all claims against the debtor’s estate world-wide, occurs in the jurisdiction in which the debtor is domiciled or where the debtor’s principal place of business is located. A trustee is appointed in this primary proceeding. To collect the world-wide assets of the debtor and to seek the turnover of all such assets to the primary proceeding, the trustee travels abroad and commences ancillary proceedings in each country in which assets of the debtor are located.

In each of these ancillary proceedings the court recognises and gives effect to the declaration of insolvency in the primary proceeding, provides assistance to the trustee or foreign representative, applies the substantive insolvency law to the country in which the primary proceeding is occurring, and orders the turnover of all local assets to the primary proceeding. Because the final adjudication in the primary proceeding is respected by all jurisdictions, all creditors world-wide must submit claims in the primary proceeding or be forever barred from pursuing their claims.”

⁵ See paragraph 26.5.

⁶ [1995] 2 HKC 79.

⁷ Charles D. Booth, “*The Transnational Aspects of Hong Kong Insolvency Law*”, *Southwestern Journal of Law and Trade in the Americas*, Spring 1995, Volume 2, Number 1, page 5.

26.17 Giving effect to that intention is another matter and, although the international insolvency community is moving in the direction of the universal approach, there is probably no jurisdiction which applies the principle entirely. This does not mean that Hong Kong should not now make efforts to move in that direction as to do so would facilitate the resolution of insolvency cases expeditiously and for the benefit of all concerned. Such provisions should also enhance Hong Kong's reputation as a place to do business.

Jurisdiction of the court

26.18 In order for a company to be wound-up under the provisions of the Companies Ordinance it must be established that Hong Kong is the appropriate jurisdiction in which a particular company should be wound-up.

26.19 While companies which are incorporated in Hong Kong obviously qualify to be wound-up by the court under section 176, the situation is not so clear with regard to companies which are registered in other jurisdictions.

26.20 It was submitted that except for section 327A's application to situations where a foreign company "*which has been carrying on business in Hong Kong ceases to carry on business in Hong Kong*" the Companies Ordinance was silent as to the jurisdictional connection that had to exist between a foreign company and Hong Kong to enable the foreign company to be wound-up in Hong Kong. The submission suggested that two independent jurisdictional tests, one based on the presence of assets and another based on the carrying on of business either directly or through an agent, should be adopted into legislation.⁸

26.21 The "*assets based*" test referred to is just one example of "*sufficient connection*", with carrying on business either directly or through an agent being another test.

26.22 We do not accept that it is appropriate to incorporate specific tests into the Companies Ordinance because, as stated above, this could have the effect of limiting the discretion of the court to certain criteria that might not be appropriate to a particular set of circumstances. We recommend that the Companies Ordinance should not set out the jurisdictional requirements needed to establish a connection as we prefer to leave this to the discretion of the court in any particular case.

26.23 We received two submissions which considered that it would be better to set out specific tests for jurisdictional requirements on the basis that a list would provide certainty. It was submitted that the 'discretion' of the court could be maintained by providing a final basis along the lines of "*for any other reason as the Court thinks fit*". There is certainly merit in the submissions but we consider that the net effect would eventually be the same due to the catchall discretion suggested. In any event, if the list option is eventually adopted into legislation, we suggest that it be contained in a schedule to the Ordinance to facilitate amendments.

⁸ Submission of Mr Charles Booth and Mr Philip Smart.

Recognition of foreign proceedings

26.24 The Companies Ordinance does not make provision for recognition of foreign liquidation proceedings. Recognition of foreign proceedings would allow a foreign liquidator to apply to the court in Hong Kong for recognition of the foreign insolvency proceeding and recognition by the court would mean that the Hong Kong insolvency proceedings would be commenced as ancillary proceedings to the foreign insolvency proceedings. At present, a foreign liquidator needs to start insolvency proceedings afresh even though insolvency proceedings are under way in another jurisdiction. This is an area where we consider that the legislation should provide guidance to the court.

26.25 The Insolvency Act 1986, section 426, provides that the courts of the United Kingdom will co-operate with courts of certain designated jurisdictions, including Hong Kong. This leads to something of an anomaly as Hong Kong does not reciprocate with the United Kingdom or any other jurisdiction through legislation. We do not favour the concept of a list of jurisdictions⁹ which would automatically receive co-operation as we would prefer to leave it to the courts to decide whether a foreign proceeding should receive co-operation from the court.

26.26 It is more important to exercise great care and control over the recognition of foreign insolvency proceedings. A submission pointed out that many of those countries which the United Kingdom recognised had not enacted reciprocal provisions (including Hong Kong). We **recommend** that the policy underlying the enactment of any provisions recognising foreign insolvency proceedings should be predicated on the basis that the proceedings recognised are harmonious with our own procedures.

26.27 Using this approach, we **recommend** that consideration should be given to providing recognition on a bilateral basis. While it may well take a long time to achieve wide ranging recognition with other jurisdictions, we suggest that there is no advantage to Hong Kong in providing recognition to other jurisdictions on a unilateral basis. The pursuit of a bilateral recognition policy would mean that those jurisdictions that wanted mutual recognition with Hong Kong would need to have procedures that are harmonious with that of Hong Kong.

26.28 It is for these reasons that we favour the approach taken under section 304 of the United States Bankruptcy Code. Under this approach, the Hong Kong court would need to determine whether to allow a foreign representative to commence a proceeding ancillary to the foreign proceeding in the Hong Kong court. The foreign representative would initiate the application by filing a summary application with the court. In determining whether to grant relief, the court should be guided by what would best assure an economical and expeditious administration of the estate. The court could apply the criteria which is applied under section 304 of the Bankruptcy Code, as follows:

⁹ In this context, Hong Kong is in a unique position. The Hong Kong Special Administrative Region is now part of the Peoples' Republic of China (the PRC) but, under the concept of "One country, Two systems", Hong Kong retains a separate legal system. This means that while Hong Kong is part of the PRC, to all intents and purposes the rest of the PRC may be treated as a separate and distinct jurisdiction.

- (a) just treatment of all holders of claims against or interests in an estate that is being administered,
- (b) protection of claims holders in (Hong Kong) against prejudice and inconvenience in the processing of claims in such foreign proceeding,
- (c) prevention of preferential or fraudulent dispositions of property of an estate,
- (d) distribution of proceeds of an estate substantially in accordance with the order prescribed by (the Companies Ordinance), and
- (e) comity.¹⁰

26.29 We recommend the adoption of a provision along the lines of section 304 of the United States Bankruptcy Code as this would provide the court with guidelines to apply to any particular case while leaving the court to exercise its discretion in each application and satisfy the main requirement, as we see it, that Hong Kong interests receive fair treatment in a foreign proceeding. An appropriate amendment should also be made to the Bankruptcy Ordinance.

26.30 In making this recommendation we reluctantly acknowledge that universal harmony is not going to happen any time soon despite the UNCITRAL Model Law on Insolvency.

“Oversea” companies

26.31 The title to section 327A refers to “oversea” companies, which is, we believe, a legacy of legislative drafting that is not only curiously worded, but is plainly wrong in the physical sense as part of the territory of Hong Kong is on mainland Asia.

26.32 We recommend that the reference to “oversea” should be amended to reflect the fact that the legislation would relate to companies which are not Hong Kong companies, bearing in mind that companies incorporated in mainland China are not foreign. We suggest that it might be more appropriate to use wording such as “*non-Hong Kong Special Administrative Region incorporated companies*”.¹¹

26.33 We received a submission from the Registrar of Companies that the recommendation to amend the term “oversea” would have very significant implications throughout the Companies Ordinance, in particular Part XI, and add substantially to the work of the Law Draftsman. The Registrar also considered that the statement that “*companies incorporated in China are not foreign*” was not understood as such companies were “oversea” in the sense that they were not Hong Kong companies.

10 These criteria summarise section 304(c) of the U.S. Bankruptcy Code. The section also applies in personal bankruptcy in the United States.

11 It is understood that the Government’s legislative exercise on the adaptation of laws will address “oversea”, perhaps by amending the definition to “*outside Hong Kong*”.

26.34 The Registrar accepted, however, that the term was anomalous and archaic but would not wish to amend it until and unless an acceptable alternative was to be found. This is the nub of the issue. The term “oversea” might be well understood by those in the know but that is just not good enough for legislation, which should be clear and precise. We do not mind how “oversea” companies are defined; we would just like to have a definition that can be understood without further investigation.

Whether Hong Kong courts should apply foreign law in ancillary proceedings

26.35 The *Consultation Paper* considered whether the Hong Kong courts should be permitted to apply foreign law in ancillary liquidation proceedings but decided against making a proposal to this effect. The *Consultation Paper* noted that a provision of this nature was found under section 426(5) of the Insolvency Act and that the United Kingdom courts applied foreign provisions in appropriate cases.

26.36 The *Consultation Paper* considered that it would be inappropriate to adopt a provision of this nature in Hong Kong. Concern was expressed that Hong Kong was involved in so many multinational liquidations that the Hong Kong courts could be faced with a large number and variety of applications to apply foreign rules and that, in addition, Hong Kong insolvency practitioners would not have the practical experience to apply foreign rules.

26.37 We received three submissions, one of which stated that:

“ ... the use of some foreign provisions in an insolvency can assist with the orderly administration of the estate. Hong Kong insolvency practitioners are often partners of large international practices, or would have easy access to advice from international practitioners and advisers. To suggest they would not have the skills to deal with foreign law provisions is not a little patronising.

Furthermore, when courts direct the use of a foreign law provision, they usually monitor carefully or give detailed directions on how the law is to be applied. In cases such as the Maxwell Group insolvencies which involved companies incorporated in England coming under the bankruptcy jurisdiction of the U. S. courts, the English and U. S. courts jointly blessed a scheme for administering the companies which was based on both laws. The suggestion that there will be multiple-applications to apply foreign law seems unlikely to come to pass. The courts would only entertain such an application based on sound reason, not merely because a foreign law suited one party.

It is to be expected that Hong Kong lawyers and courts will be naturally inclined to apply Hong Kong law unless there is good reason not to do so. Hong Kong is a cosmopolitan, international trade and finance centre. In order to remain so, its laws must be seen not to be too inward looking and protectionist. A power allowing the courts to be flexible in cross-border insolvencies is one which, even if only

needed infrequently, helps to reinforce the view of Hong Kong as a place to do business for international investors."

26.38 We are persuaded by the force of the submissions received and would additionally note that the courts already apply foreign law in such questions as divorce, conflict of laws and comity of laws. We therefore **recommend** that the court should be able to apply foreign law in ancillary proceedings subject to the proviso that the court could exercise its discretion in each application and satisfy the requirement that Hong Kong interests receive fair treatment in a foreign proceeding.

UNCITRAL Model Law on Insolvency

26.39 We should refer to the United Nations Commission on International Trade Law (UNCITRAL) Model Law which has been promulgated to assist jurisdictions to formulate a modern, harmonised and fair legislative framework to address more effectively instances of cross-border insolvency. The model provisions are intended to provide jurisdictions with the opportunity to adopt certain internationally accepted practices into their law.

26.40 The Model Law is being actively considered in various jurisdictions but UNCITRAL itself has not been able to confirm to us that the Model Law has been adopted in any jurisdiction. While we welcome an initiative that encourages harmonizing the laws of insolvency internationally, we consider, for the reasons set out above, that Hong Kong should not be the first to adopt the Model Law.

26.41 We **recommend**, however, that in re-drafting the Companies Ordinance provisions on cross-border insolvency, the Law Draftsman might consider the extensive definitions that have been developed in the Model Law.

26.42 We received two submissions which encouraged the introduction of the Model Law. The Hon. Mr. Justice Rogers submitted that adoption of the Model Law would be beneficial to Hong Kong in that with time it was likely that it would be adopted in a number of jurisdictions and the absence of its provisions in Hong Kong might unduly hamper Hong Kong persons seeking redress overseas. The submission concluded that the adoption of these provisions in neighbouring countries would undoubtedly be beneficial to Hong Kong's business interests and that it would be very difficult to convince such countries to adopt them if Hong Kong did not.

26.43 We do not reject the Model Law. We are simply exercising caution and a watch and wait approach. When the Model Law is adopted by leading jurisdictions, that would be the time to consider adopting the Model Law in Hong Kong, but until that happens we consider that there is no benefit in being the first to adopt the Model Law.



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**Chinese Insolvency Law Symposium:
Developing an Insolvency Infrastructure**

Supplementary Supplement

The Draft Bankruptcy Law of the People's Republic of China

The Draft Bankruptcy Law of the People's Republic of China

(Edition submitted for consideration to the higher level by the Fiscal and Economic Committee of the National People's Congress)

CONTENTS

Chapter I	General Principles
Chapter II	Application and Acceptance of Insolvency Cases
Section 1	Application
Section 2	Acceptance
Section 3	Administrator
Section 4	Filing and Investigation of Claims
Section 5	Administration Expenses and Debts of Common Benefit
Chapter III	Creditors' Meetings
Section 1	General provisions
Section 2	Supervisors
Chapter IV	Composition
Section 1	Composition Application
Section 2	Review and Voting on Composition
Section 3	The Establishment of Composition
Chapter V	Reorganization
Section 1	General Provisions
Section 2	Business Operation in Period of Reorganization Observation
Section 3	Reorganization Plan
Chapter VI	Bankruptcy Liquidation
Section 1	Bankruptcy Adjudication
Section 2	Bankruptcy Liquidators
Section 3	Bankruptcy Property
Section 4	Bankruptcy Claims
Section 5	Set-off Right
Section 6	Right to Separate Satisfaction
Section 7	Disposition and Distribution
Section 8	The Close of Insolvency Cases
Section 9	Discharge
Chapter VII	Summary Procedure
Chapter VIII	Special Provisions for Bankruptcy of State-Owned Enterprises
Chapter IX	Legal Responsibilities
Chapter X	Supplementary Provisions

Chapter I General Principles

Article 1 The Law is enacted in order to ensure fair and open hearing of insolvency cases, to protect the legal rights and interests of creditors and debtors, to spur enterprises on to

independent operation and sole responsibility for their profits and losses, to establish a mechanism for survival of the fittest and to maintain the economic order for the purpose of fitting in with the needs of socialist market economy.

Article 2 When hearing an insolvency case, the people's court shall apply the procedure of composition or reorganization or bankruptcy liquidation provided in the Law.

Article 3 The Law applies to the following civil subjects:

- (1) Enterprise legal persons;
- (2) Partnership enterprises, with their partners involved;
- (3) Sole proprietorships, with their investors involved;
- (4) Other economic organizations established in accordance with the law.

The legal-person enterprises that have been dissolved but not completed liquidation are regarded as continuity within the procedure of the Law .

Article 4 When a debtor is unable to pay due debts, all its debts shall be liquidated in accordance with the procedures provided in the Law.

The cessation of payment by a debtor is presumed as inability of payment.

The procedure of reorganization provided in the Law is applicable to enterprise legal persons that are going to be unable to pay due debts owing to difficulties in business and finance.

Article 5 Insolvency cases shall be within the jurisdictions of the local people's courts in the domiciles of debtors.

Insolvency cases are under the jurisdiction of the intermediate people's courts, while those with a smaller sum of the debtor's assets are subject to the people's courts at grass levels, and those with a tidy sum are subject to the higher people's courts.

Article 6 A decision made by the people's court in accordance with the procedures provided in the Law shall enter into force from the day when it is made.

No appeal can be lodged against a decision of the people's court according to the Law, except in the circumstances otherwise provided in the Law.

Any decision made by the people's court in accordance with the procedures of the Law shall be promulgated, except in the circumstances otherwise provided in the Law.

Article 7 The people's court shall publish the promulgation provided in the Law by press publications designated by the Supreme Court, and by putting them on the bulletin boards of the local people's court.

The promulgation shall come into effect from the next day after the date of their last publication.

Article 8 No procedure of bankruptcy or composition or reorganization that begins outside the domain of the People's Republic of China has force upon a debtor's assets that locate within the territory of the People's Republic of China.

Article 9 The provisions of the Civil Procedure Law apply mutatis mutandis to insolvency cases wherever no provision available for the hearing can be found in the Law.

Chapter II Application and Acceptance of Insolvency Cases

Section 1 Application

Article 10 Either a debtor or a creditor may apply to the people's court for acceptance of insolvency case when the debtor has fallen into the position described in Article 4 of the Law.

If the debtor is a partnership, it shall submit a writing consensus of all its partners when it files the case .

Article 11 The applicant shall file a petition for insolvency case, along with some relevant evidences to the people's court

The petition shall state the following matters

- (1) The fundamental information concerning the applicant and the adverse party;
- (2) The purpose of the application;
- (3) The amount of claims, the availability of collateral if any, as well as the causa of its creation and the period of term of its enforceability;
- (4) The reason and grounds for the application;
- (5) Other matters that the court may deem necessary on documentation.

Where the debtor files the petition, it shall provide property statements, debt information, credit information and the relative financial statements to the people's court.

Article 12 The applicant, either creditor or debtor, may ask for withdrawal of the application after the petition has been filed and before it is accepted by the people's court. The court has the discretion to determine whether such a withdrawal is permitted.

Section 2 Acceptance

Article 13 The people's court shall decide whether to accept a petition for insolvency case within 15 days after it has received the application. If the court decides to accept the case, it shall make a decision.

Article 14 In the wake of its acceptance of the insolvency case, the people's court shall notify the debtor within 5 days starting from the day of the decision .

If a petition is filed by a creditor or creditors, the debtor shall submit to the court with property statements, debt and credit information and relevant financial statements within 15 days after the debtor has received the notice from the court.

Article 15 If people's court decides not to accept an insolvency case, it shall make a decision and list the reason.

The people's court shall inform the applicant of the above mentioned decision within 5 days starting from the day of the decision, but no promulgation is necessary.

The applicant can appeal to the upper-level people's court within 10 days starting from the day when the decision is received if it does not agree with the court's decision on not accepting the insolvency case.

Article 16 The people's court shall set up a collegiate bench to hear an insolvency case after it has accepted the case, except in the circumstances otherwise provided in the Law.

Article 17 After the people's court has accepted an insolvency case, it shall notify the creditors whose addresses are clear, and make promulgation within 30 days starting from the day of the decision.

The notice and promulgation shall state the following matters:

- (1) The gist of the decision on the court's acceptance of the insolvency case and the time of the acceptance;
- (2) The time of period for filing of claims, and issues that need to be heeded while filing;
- (3) The names of the administrator, and his business address;
- (4) Obligors to the debtor shall pay off the debts, and holders of the debtor's property, shall return the property, to the administrator.
- (5) The date and venue of the first creditors' meeting;
- (6) Other matters that the people's court deems necessary to be announced.

Article 18 If a debtor does not agree with the decision by the people's court on the acceptance of insolvency case, it may request the higher-level people's court for reconsideration. During the reconsideration, the execution of the decision shall not be suspended.

Article 19 After the acceptance of insolvency case by the people's court, all other civil execution procedures related to the debtor's property shall be suspended, except in the circumstances otherwise provided in the Law.

After the acceptance of insolvency case by the people's court, all other protective measures than provided by the Law over the debtor's property shall be stopped.

Article 20 After the acceptance of insolvency case by the people's court and prior to the bankruptcy adjudication, all the rights of mortgage, pledge and lien over the debtor's property or property rights shall stop exercise.

Article 21 After the acceptance of insolvency case by the people's court, any civil action on the debtor's property and property rights that has begun but not ended shall be suspended; the pending action is supposed to continue after administrator have taken over the control of the debtor's assets.

Article 22 Starting from the day when the people's court accepted an insolvency case, the debtor shall assume the following duties:

(1) Appropriately take care of all the properties, account books, documents, files, stamps and other objects in its possession and management;

(2) Carry out the affairs according to the order of the people's court or at the request of administrator, or reorganization executor or bankruptcy liquidators, and answer their questions truly and accurately;

(3) Be present at creditor's meeting and answer questions truly and accurately to creditors or supervisors;

(4) Not leave the domicile unless permitted by the people's court.

The preceding paragraph shall apply to representatives of enterprise legal persons, partners and leaders of partnership enterprises and leaders of other economic organizations; it shall also apply, if necessary, with decisions of the people's courts, to their personnel in charge of financial management and main business operation.

Article 23 After the acceptance of insolvency case by the people's court, the debtor shall not pay off debt to any of the creditors individually.

A creditor who has received the individual repayment from its debtor after the acceptance of insolvency case by the people's court shall have no entitlement on the received thereby to resist other creditors' claims.

Article 24 After acceptance of insolvency case by the people's court, obligors to the debtor shall pay off their debts, and holders of the debtor's property shall return the property, to administrator or reorganization executor or bankruptcy liquidators.

Article 25 Within 6 months prior to the acceptance of insolvency case by the people's court, the following acts done by the debtor related to its property and property rights shall not be so effective as to resist the creditors' claims:

(1) Unrequited transfer of property and property rights;

(2) Sale of property at abnormal lower prices;

(3) Pledging property as security for satisfaction of an unsecured debt;

(4) Paying off undue debt ahead of time;

(5) Giving up obligatory claims;

(6) Other acts to the detriment of creditors.

Where the debtor has any of the above acts, the administrator or reorganization executor or bankruptcy liquidators shall request the people's court to rescind it.

Article 26 Within 6 months prior to the acceptance of insolvency case by the people's court, if the debtor has been already aware of its inability to pay off due debts but still pays off to any individual creditor, to the detriment of other creditors, the repayment received by the individual creditor shall be subject to the other creditors' claims, except in circumstances that the individual repayment proves beneficial to the insolvent assets.

Article 27 The following acts concerning the debtor's property and property rights shall be null and void no matter when it occurs:

(1) Concealment or unlawful distribution of property;

(2) Fabrication or recognition of unauthentic debt.

Article 28 Administrator or bankruptcy liquidators is empowered to recover the debtor's property or property rights received through the acts listed in Articles 25, 26 or 27 of the Law

Article 29 After the acceptance of insolvency case by the people's court, if an investor to the insolvent enterprise legal person has not honored the obligation to inject capital, the administrator or bankruptcy liquidators shall request the investor to pay up the subscribed capital regardless of the deadline for capital payment.

Section 3 Administrator

Article 30 The people's court shall appoint an administrator when accepting insolvency case. The administrator shall take over the control of day-to-day management and operations of the debtor's property and be responsible to, and report on their works to, the people's court.

The administrator shall be one person. When the debtor has different business operating places or property locations, the people's court may appoint several administrators to carry out affairs separately and independently. The operations of the administrators shall be subject to the monitoring by the creditors' meeting. Administrator shall attend creditors' meetings, reporting the performance of his mission to the meeting and answering its questions.

Article 31 An administrator shall be the people with professional knowledge needed.

Anyone who falls in the following categories shall not serve as an administrator:

- (1) Those once given criminal punishment, during the five year period since the day of the completion of the punishment;
- (2) The notaries during the five year period since the revoke of notary certifications because of law violation;
- (3) Registered accountants during the five year period since the revoke of registered accountants licenses because of professional ethics violations;
- (4) Lawyers during the five year period since the revoke of lawyer's licenses because of violations of professional ethics;
- (5) Anyone who has interests with the case;
- (6) Other people whom the people's court may consider not qualified for administrator.

Article 32 Administrator shall assume the following functions from the day of his appointment:

- (1) Taking over the control of all the property, books, documents, files, seals and stamps and other objects of the debtor;
- (2) Investigating the property conditions and civil activities of the debtor, with the information concerning wages and salaries owed to the labors, unpaid social insurance premiums and default taxes included;
- (3) Making out a report on debtor's property situation;
- (4) Determination of the day-to-day expenditure and other necessary spending of the debtor;
- (5) Requisition for determining whether the debtor continues to operate;
- (6) Management and disposal of the property of the debtor;
- (7) Accepting payment or delivery of property to the debtor by a third party;
- (8) Determination of the internal management affairs of the debtor;
- (9) Employ management, professionals and other personnel as needed;
- (10) Request for summoning creditors' meetings;
- (11) Taking part on behalf of the debtor in proceedings or arbitration with regard to its property-related disputes;
- (12) Other functions which the people's court deems necessary for the administrator to carry out.

Article 33 Prior to the first creditors' meeting, an administrator shall solicit the approval of the people's court if he has any of the acts prescribed in Article 64 of the Law.

Article 34 The amount of remuneration for an administrator shall be determined by the people's court.

The remuneration and expenses needed for the execution of administrator's missions shall be paid from the debtor's assets.

An administrator is liable for the losses resulted in by his intention or gross negligence in performance of his functions; if there are several administrators, they shall bear joint liability

Article 35 An administrator shall not resign after he has been appointed by the people's court except for legitimate reasons approved by the court.

The people's court may dismiss and replace an administrator, either on request of interested persons or ex officio, in case he is not competent, or neglects his duty, or has other illegal acts.

Section 4 Filing and Investigation of Claims

Article 36 Claims against the insolvent creditor established prior to the acceptance of insolvency case shall not be enforced unless according to the procedures provided by the Law.

The claims described in the above paragraph are called composition claims in procedure of composition, reorganization claims in that of reorganization, and bankruptcy claims after bankruptcy adjudication.

Article 37 Undue claims are regarded as due claims at the time of the acceptance of insolvency case.

As far as he claims that become due after acceptance of the insolvency case are concerned, if they are with interests, the supposed interests shall stop calculating from the time of acceptance of the insolvency case; and if they are not with interests, excepting interest-free loans, the legal interests during the period from the acceptance of insolvency case and until their maturity date shall be deducted from the claims.

Article 38 Conditional claims may be exercised entirely.

Article 39 Creditors shall file their claims before the deadline determined by the people's court after the acceptance of insolvency case by the people's court.

The claims that are supposed to be filed as stipulated in the above paragraph refer to the obligatory claims against the debtor established prior to the acceptance of insolvency case. However, claims for wages and salaries, social insurance premiums, and tax claims, are not necessary to be filed.

Labors may file their claims for wages and salaries via their collectively authorized representatives.

Article 40 After the acceptance of insolvency case, the people's court shall determine the deadline of filing claims by creditors. The deadline shall not be shorter than 30 days but not longer than 90 days.

The deadline shall be computed from the day when the promulgation on the decision of the people's court accepting the insolvency case comes into effect.

Article 41 Creditors shall state in writing the amount of their claims, and availability of collateral if any, with the relevant evidence. If a filed claim is a joint one, such a fact shall be clearly stated.

Article 42 A creditor who has failed to file its claim within the required period of time because of force majeure may ask the people's court to extend the deadline for its filing.

If the creditor has not filed its claims before the deadline determined by the people's court, it may make a supplementary filing prior to the close of the insolvency case. The cost needed for the review and determination of the supplementarily filed claim shall be borne by the claimant.

If a creditor has failed to file its claim before the deadline determined by the people's court, the creditor shall not enforce its claim in the procedures provided by the Law, except in the circumstances described in the preceding paragraph.

Article 43 Joint and several creditors may be represented by one of them in filing their claim, or each of them may file it individually and separately.

Article 44 Debtors' guarantors or other joint and several debtors can report obligatory claims to the people's court with respect to their rights of recovery arising from their performing the joint obligations of repayment .

Article 45 If more than two joint debtors become subject to the procedures of the Law in the meantime or successively their creditor has the right to file the entire claim in each of the insolvency cases

Article 46 When the people's court has received documents for filing claims, it shall register, keep a record and compile a table of filed claims.

In compiling the claim table, the people's court shall calculate the amount of the non-money claims according to the average market price in the place where the debt should have performed and on the day when the people's court makes the decision to accept the insolvency case. For money claims denominated in foreign currency, the amount shall be calculated according to the middle price of the RMB market exchange rate on the day when the people's court makes the decision to accept the insolvency case.

The original claim table and filing documents shall be kept in the people's court, and the copy be kept by the administrator as reference for perusal by the interested persons.

Article 47 The claim table compiled according to Article 46 of the Law shall be reviewed by the first creditors' meeting. However, any claim already determined by arbitration or by judgment of people's court, and that unsettled in litigation or arbitration, shall not be investigated by the creditors' meeting.

If administrator, debtor and creditors' meeting have no objection to the claims recorded in the claim table, they shall become confirmed after the decision by the people's court .

A creditor may bring an action to the people's court that has accepted the insolvency case if its claim in the table is objected.

Section 5 Administration Expenses and Debts of Common Benefit

Article 48 The following expenses occurring after the acceptance of insolvency case by the people's court shall be administration expenses:

- (1) Cost necessary for the management, disposition and distribution of the debtor's assets;
- (2) Litigation cost in the insolvency case;
- (3) The remuneration of administrator, bankruptcy liquidators and expenses for their operations;
- (4) The remuneration of supervisors and expenses for their operations;
- (5) The payment for labors and social insurance premiums needed for the continuance of debtor's business operation after the people's court has accepted the insolvency case;
- (6) Other costs involved in insolvency procedures for the common interest of creditors.

Article 49 The following debts arising after the acceptance of insolvency case by the people's court shall be debts of common benefit:

- (1) Debts arising from the administrator or bankruptcy liquidators performing their functions, including liability for damages caused by the administrator or bankruptcy liquidators in performing their functions;
- (2) Debts arising from performance of bilateral contracts as required by the administrator or bankruptcy liquidators;
- (3) Debts arising from negotiorum gestio in favor of the debtor's assets;
- (4) Debts arising from unjust enrichment obtained by the debtor's assets.

Article 50 Administration expenses and debts of common benefit shall be paid off at any time by the debtor's assets.

If the debtor's assets are insufficient to pay off all administration expenses and debts of common benefit, administration expenses shall be paid off first.

If the debtor's assets are insufficient to pay off administration expenses or debts of common benefit , they shall be repaid on a pro rata basis.

If the debtor's assets are insufficient to pay off administration expenses or debts of common benefit, the administrator or bankruptcy liquidators shall submit a request to the people's court for a decision to close the insolvency case. The people's court shall make a decision on close of the insolvency case within 10 days after it has received the request for such a decision by the administrator or bankruptcy liquidators.

Chapter iii Creditors' Meetings

Section 1 General provisions

Article 51 All the creditors who have legally filed their claims are the members of the creditors' meeting, who have rights to participate in the creditors' meetings, voicing opinions on the subjects discussed at the meeting, and enjoy voting rights. Yet the creditors whose claims have not been confirmed shall not exercise voting rights.

The creditors secured with property, who have not given up their preferential right to be repaid, have no voting right to the resolutions stipulated in items (7) and (8), the first paragraph, Article 53 of the Law.

Article 52 A creditor may ask its proxy to appear at the creditors' meeting to exercise its voting right. The proxy present at the meeting shall submit a written entrustment of the creditor to the people's court or the chairman of the meeting.

Article 53 The creditors' meeting shall have the following functions and powers:

- (1) Elect and replace supervisors;
- (2) Investigate filed claims;
- (3) Determine the continuance or suspension of debtor's business operation;
- (4) Vote on a composition agreement;
- (5) Vote on a reorganization plan;
- (6) Vote on a scheme for management of the debtor's assets;
- (7) Vote on a scheme for disposition of bankruptcy property;
- (8) Vote on a scheme for distribution of bankruptcy property.

Written resolutions shall be adopted if the creditors' meeting exercises any of the above functions and powers.

Article 54 A creditors' meeting shall have one chairman, who shall be appointed by the people's court from the creditors enjoying voting rights .

The chairman presides over creditors' meetings.

Article 55 The first creditors' meeting shall be summoned within 15 days after the expiration of the term for filing claims.

The subsequent creditors' meetings may be summoned when the people's court deems necessary, or be summoned by determination of the court when administrator, or bankruptcy liquidators, or supervisors, or the creditors who possess not less than one-fourth of the determined claims unsecured with property, request to summon such meetings.

Article 56 The people's court shall notify the already known creditors of the summoning of a creditors' meeting 20 days in advance.

Article 57 A resolution at the creditors' meeting shall be adopted by more than one half of the creditors with voting right present at the meeting, whose amount of claims must account for not less than one half of the total amount of confirmed claims, except in circumstances otherwise provided in the Law.

Resolutions at creditors' meetings shall be binding on all the creditors.

Article 58 If a resolution at the creditors' meeting impairs the general interests of all the creditors, a creditor or a group of creditors may apply to the people's court for a decision to prohibit the implementation of the resolution within 15 days after the day when the resolution is passed.

Under the circumstance described in the preceding paragraph, the administrator, bankruptcy liquidators and supervisors may apply to the people's court for a decision to prohibit the implementation of the resolution within 15 days since the day when the resolution is passed.

The people's court shall adjudicate that a resolution is null and void by reason that it violates the law or the public interest of the society.

The people's court shall notify the already known creditors of the decisions described in the above 3 paragraphs, but no promulgation is necessary.

Article 59 If the creditors' meeting can not adopt a resolution on any of the matters listed in items (3), (6) and (7) the first paragraph Article 53 of the Law, the people's court shall make a decision on this matter.

If the creditors' meeting still cannot reach a resolution through second voting on the matters listed in item (8), the first paragraph, Article 53 of the Law, the people's court shall make a decision on this matter.

The people's court shall announce its decision made in pursuance of the preceding paragraphs at the creditors' meeting, with no need of making additional notification and promulgation.

Article 60 If a creditor do not agree with the decision made by the people's court in pursuance of Article 58 or Article 59 of the Law, it may request only once the people's court at higher level for reconsideration. During the reconsideration, the execution of the decision shall not be suspended.

Section 2 Supervisors

Article 61 A creditors' meeting may select and appoint supervisors. The supervisors shall not be more than three persons.

A resolution by the creditors' meeting on appointment of supervisors shall be approved by the people's court in written form.

The creditors' meeting may change their previous appointment through passage of a resolution; the resolution on changing the previous appointment shall be approved by the people's court in written form.

Article 34 of the Law applies mutatis mutandis to the remuneration of the supervisors.

Article 62 Article 31 of the Law applies mutatis mutandis to the appointment and change of supervisors.

Article 63 Supervisors shall execute the following functions and powers on behalf of the creditors' meeting during the adjournment of the meeting:

- (1) Monitor the management and disposition of the debtor's assets;
- (2) Monitor the execution of reorganization plan;
- (3) Monitor bankruptcy distribution.

In carrying out duties, supervisors have the right to ask administrator, or reorganization executor, or bankruptcy liquidators to make explanations and provide relevant documents on the matters within their functions and powers.

Supervisors have the right to request the people's court to make a decree on supervisory matters if the supervised reject the supervisor's monitorship; the court shall make a decree within 5 days.

Article 64 Supervisors' consent is required for the following actions performed by administrator:

- (1) Transfer of the ownership of real property;
- (2) Transfer of the such property as mining right, right to use land, patent right, copyright and right to exclusive use of trademark;
- (3) Assignment of the stock of goods or the business;
- (4) Lending money;
- (5) Pledging property as security;
- (6) Transfer of movables worth more than 1,000 RMB yuan for the purpose of continuance of the debtor's business operation;
- (7) Transfer of claims and securities portfolios;
- (8) Request for performance of executory bilateral contracts;
- (9) Engaging in composition, arbitration, litigation or other legal proceedings related to the debtor's property;
- (10) Waiver of rights;
- (11) Letting a person with right of recovery retrieve his property;
- (12) Satisfying a creditor with right to separate satisfaction.

If the meeting has not appointed supervisors, the performance of the actions provided in the preceding paragraph shall solicit the approval of the creditors' meeting.

Article 65 For the actions listed in Article 64 of the Law the creditors' meeting may directly pass resolutions or pass them in lieu of the consent of supervisors

When a supervisors' resolution is not compatible with that of the creditors' meeting, the latter shall prevail over the former.

Article 66 The supervisors shall be loyal to duty, assume functions in accordance with the law, and be responsible to all the creditors.

The supervisors shall bear the responsibility of compensation if they incur loss to the debtor or creditors intentionally or by gross negligence.

Chapter IV Composition

Section 1 Application for Composition

Article 67 Debtors in filing petition in accordance with Article 10 of the Law may apply to the people's court for composition immediately.

Debtors and creditors may apply to the people's court for composition after the acceptance of insolvency cases by people's courts and before the close of the insolvency cases.

Article 68 A debtor in applying for composition shall submit to the people's court a petition for composition and a draft composition agreement.

Where creditors apply for composition, the people's court shall notify the debtor after the petition for composition has been received. The debtor shall express whether it agrees to seeking composition within 10 days after the day when it receives the notice from the court. If the debtor agrees to seeking composition, it shall submit a draft composition agreement within the period specified by the court.

If a third party provides guarantee for the debtor's request for composition, the debtor shall submit statement related to the third party's guarantee and the documents on guarantee .

Article 69 All the composition terms put forward by the debtor shall treat all the creditors equally, except that some creditors clearly express an intention to accept unfavorable treatment.

Section 2 Review and Voting on Composition

Article 70 If the people's court, after review, deems that the debtor's composition application meets the provisions of the Law, it shall make a decision for opening of composition proceeding.

Those who hold rights of mortgage, pledge and lien to the debtor's property and property rights shall not be bound by Article 20 of the Law from the day when the people's court decides to approve the opening of composition proceeding.

Article 71 If the people's court, after review, deems that the debtor's composition application does not meet the provisions of the Law, it may order the debtors to make a correction. If the debtor refuses to make correction or the corrected version is still not compatible with the requirements, the court shall make a decision to revoke the composition application.

For the decision provided in the preceding paragraph, the people's court shall notify the applicant within 5 days after the date when the decision is made, but no promulgation is necessary.

Article 72 The people's court shall make a decision to declare a debtor bankrupt in the meantime when it decides according to the provisions of the Law to reject the composition application put forward prior to a bankruptcy adjudication. The people's court shall make a decision to continue the bankruptcy liquidation procedure in the meantime when it decides according to the provisions of the Law to reject the application put forward after a bankruptcy adjudication.

Article 73 A resolution on approval of composition agreement at the creditors' meeting shall be adopted by more than one half of the creditors with voting right presenting at the

meeting, whose amount of claims must account for not less than two-third of the total amount of confirmed claims

Article 74 The fact that the creditors' meeting has deliberated a draft composition agreement but not adopted it shall be considered as a rejection of composition by the meeting

The people's court shall make a decision to declare a debtor bankrupt when the creditors' meeting has rejected a composition before bankruptcy adjudication.

The court shall make a decision to continue the bankruptcy liquidation procedure when the creditors' meeting has rejected a composition after bankruptcy adjudication.

Article 75 If a composition agreement reached between debtor and creditors' meeting violates the law, -the people's court shall adjudicate it to be null and void. If it is prior to bankruptcy adjudication when the composition agreement is adjudicated to be null and void, the court shall in the meantime make a decision to declare the debtor bankrupt. If it is after bankruptcy adjudication when the composition agreement is adjudicated to be null and void, the court shall in the meantime make a decision to continue the bankruptcy liquidation procedure.

Section 3 The Conclusion of Composition

Article 76 A composition agreement reached between debtor and creditors' meeting shall become valid when it is confirmed by the people's court through decision.

Article 77 The following shall be included in the promulgation by which the people's court announces its confirmation of composition agreement:

- (1) The gist and date of the decision confirming the composition agreement;
- (2) The close of the insolvency case;
- (3) Other matters that the people's court deems necessary to be announced.

Article 78 When the people's court decides to confirm a composition agreement, it shall in the meantime decide to close the insolvency case.

If the court decides to close an insolvency case, it shall notify administrator or liquidators to terminate their operations. The administrator or liquidators shall hand over assets and administrative affairs to the debtor, and submit reports on their operations to the court.

Article 79 A composition agreement shall be binding on both debtor and all creditors in composition.

The creditors in composition mentioned in the preceding paragraph refer to such creditors as having enjoyed claims against a debtor at the time when the people's court accepts an insolvency case.

A claim in composition not filed in accordance with the provisions of the Law shall not be enforced during the time when a composition agreement is executed; it may however be enforced pursuant to the terms of satisfaction provided in the composition agreement after the composition agreement has been fully performed.

Article 80 The rights of creditors in composition against their debtor's guarantors and other joint debtors shall not be affected by the establishment of a composition agreement.

Article 81 A debtor shall not breach the terms of a composition agreement by giving extra interests to one or several of the creditors in composition to the detriment of others.

Article 82 A debtor shall pay its debts in accordance with the terms of the composition agreement.

Article 83 A composition agreement established on the basis of the debtor's fraud or other illegal acts shall be null and void.

In the circumstances provided in the preceding paragraph, the people's court shall declare the debtor bankrupt.

In the circumstances provided in the preceding paragraphs, the payments already accepted by the creditors in accordance with the composition agreement shall be not returnable within the limit of equal proportion.

Article 84 If a debtor breaches the terms of satisfaction provided in the composition agreement, creditors in composition may apply to the people's court for specific enforcement.

In the circumstances provided in the preceding paragraph the concessions made by the creditors in the composition agreement shall become no longer effective.

Article 85 If a debtor breaches the terms of satisfaction provided in the composition agreement, or if it can not pay off debt according to the composition agreement, creditors in composition may request the people's court to declare the debtor bankrupt.

If the debtor is declared bankrupt by the people's court, the payments accepted by the creditors in composition from the debtor's performance of the composition agreement shall be still valid; the balances of the composition claims are enforceable as bankruptcy claims.

Any of the creditors mentioned in the preceding paragraph shall not accept distribution until the payments obtained by other creditors reach the equal proportion to that it has obtained.

Article 86 In such circumstances as provided in Article 84 or Article 85, a guarantee offered by a third party for establishment and execution of the composition agreement shall continue to be enforceable.

Article 87 After the acceptance of insolvency case by the people's court, a debtor may request the people's court to approve a composition agreement reached outside court with unanimous agreement from all the creditors.

If the people's court confirms the composition agreement mentioned in the preceding paragraph, it shall make a decision to close the insolvency case.

Chapter V Reorganization

Section 1 General Provisions

Article 88 The Chapter applies to enterprise legal persons with the state described in Article 4 of the Law and however the possibility of rehabilitation.

Article 89 When filing a petition in accordance with the first paragraph, Article 10 of the Law, a debtor or a creditor or a group of creditors may apply to the people's courts for reorganization immediately.

After the acceptance of insolvency case by the people's court and prior to the bankruptcy adjudication, a debtor or a creditor or a group of creditors may apply to the court for reorganization.

Where a debtor has fallen into the state described in Article 4 of the Law, an investor or investors holding not less than one-third of the total sum of the debtor's registered capital may apply to the people's court for reorganization, either initially or after the acceptance of insolvency case by the court but prior to the bankruptcy adjudication.

Article 90 Reorganization petition shall be submitted together with relevant evidence when reorganization is applied.

Article 91 If the people's court, after review, deems that an application for reorganization meets the provisions of the Law, it shall make a decision for opening of reorganization proceeding.

Section 2 Business Operation in Period of Reorganization Observation

Article 92 A period of reorganization observation refers to that from the opening of reorganization proceeding decided by the people's court and the end with confirmation of reorganization plan or the close of reorganization procedure by the court.

The period of reorganization observation shall not exceed 12 months. If the period needs to be extended, the administrator may apply to the people's court for extension, with a statement on the supposed length of extended period and the reason. The people's court may, after review,

make a decision to approve the extension application along with a time schedule for the proceeding

As for the decisions mentioned in preceding paragraphs, no promulgation is necessary.

Article 93 In the period of reorganization observation, the administrator shall assume the functions provided in Article 32 of the Law. Administrator may however determine independently the continuance of the debtor's part or entire business.

In the period of reorganization observation, administrator shall not be bound by the provisions in Article 60 of the Law when carrying out his duties.

Article 94 In the period of reorganization observation, the administrator is entitled to appoint the debtor's existing management or other personnel, or some outsiders, with the mission of carrying out the business operation of the enterprise.

The persons appointed in accordance with the preceding paragraph shall ask for the administrator's consent when performing any of the actions listed in Article 64 of the Law.

Article 95 In the period of reorganization observation, mortgagees, pledgees and lienors to the debtor shall not exercise the right of disposal to the security collateral. However, if the movables subject to pledge or lien will possibly be damaged or devalued, the pledges or lienors may auction off or sell them and have the prices obtained thereby to be lodged.

To continue a debtor's business operation, the administrator may retrieve a movable subject to pledge or lien, with the condition of offering superseded security.

Article 96 Debts arising for the purpose of continuance of the debtor's business operation in the period of reorganization observation is regarded as debts of common benefit.

In the period of reorganization observation, the debtor may guarantee the loans borrowed for its continuance of business operation with the property not subject to any security right.

The use of the loans mentioned in the preceding paragraph shall be specified and be subject to some necessary control and supervision.

Article 97 In order to help reorganizing enterprise to be rehabilitated, the State Council and the local people's governments at provincial level may grant these enterprises' business activities tax reduction, tax exemption or interest discount in accordance with the provisions of relevant laws and statutes.

Article 98 As to the property possessed by the debtor with lawful basis, a request of the obligee to retrieve it in the period of reorganization observation in violation of the agreed terms may be refused by the administrator.

Article 99 In the period of reorganization observation, the debts that are allowed to be set off between creditors in reorganization and the debtor shall be limited to those that are same in nature and have become due at the time when the insolvency case is accepted by the people's court.

A reorganization claim obtained by an obligor to the debtor through assignment shall not be used in set-off.

Article 100 In the period of reorganization observation, an administrator has the right to decide revocation or continuance of performance of a bilateral contract established prior to the opening of reorganization proceeding but then still executory, and inform the other party in writing. If the administrator fails to inform the other party within 3 months, or fails to respond within 1 month after he receives the urge of the other party, it will be regarded as cancellation of the contract. Claims for damages arising from the cancellation may be filed as obligatory claims.

As for a bilateral contract that has been established and begun to be executed at the time of opening the reorganization proceeding, the other party shall not refuse to perform the contract, or terminate it ahead of schedule, by reason of the debtor's default prior to the opening of reorganization proceeding, if the administrator decides to continue to perform it.

Article 101 For the continuance of business operation in the period of reorganization observation, an administrator has the right to decide employment and unemployment of the

available staff and workers in the reorganizing enterprise during the period, and also to decide employment of personnel with some specialty from outside of the reorganizing enterprise.

Article 102 In the circumstances that the people's court has made a decision for opening of reorganization proceeding, investors to the debtor shall not come up with any claims for any payment to the debtor on the basis of their rights on the investment.

In the circumstances that the people's court has made a decision for opening of reorganization proceeding, directors, managers or other high-ranking personnel in the debtor shall not transfer their individual shares to third parties.

Article 103 In the period of reorganization observation, at the request of the interested persons, the people's court may make a decision on discontinuing part or entire operations of the debtor, or imposing necessary restrictions on its business activities.

Article 104 After the opening of reorganization proceeding and prior to the confirmation of reorganization plan, if any of following circumstances takes place, at the application of the interested persons, the people's court may, after review and acknowledgment, make a decision to terminate the reorganization procedure:

(1) The business and financial conditions of the debtor continue to deteriorate, showing little or no hope of rehabilitation;

(2) The debtor cheats, or reduces enterprise property in bad faith, or delays unreasonably, or has other acts obviously harmful to the interests of the creditors.

(3) The administrator is impossible to perform his missions because of the acts of the debtor's corporate organs and other personnel;

If there is no reorganization plan to be confirmed one month prior to the expiration of the period of reorganization observation, the people's court may make a decision ex officio to terminate the reorganization proceeding.

In the circumstances provided in the preceding paragraphs, if the debtor has fallen the state provided in the first paragraph, Article 4 of the Law, the people's court shall in the meantime make a decision to adjudicate the debtor to be bankrupt, except when the debtor or creditors apply to liquidate the debts by way of composition.

Section 3 Reorganization Plan

Article 105 The administrator shall be in charge of formulation of a draft reorganization plan, with the assistance of the debtor. In working out draft reorganization plan, the administrator shall listen to the creditors, investors and representatives of staff and workers.

A reorganization plan shall stipulate the following particulars:

(1) A scheme for operation of the reorganizing enterprise;

(2) A scheme for readjustment of the claims;

(3) A scheme for satisfaction of the claims;

(4) Reorganization executor;

(5) The period of time for execution of reorganization plan;

(6) Other schemes beneficial to enterprise reorganization.

Article 106 Claims in a reorganization plan shall be classified into the following categories:

(1) Claims secured with property;

(2) Labor claims;

(3) Tax claims;

(4) Ordinary claims.

Article 107 A reorganization plan may contain the following readjustment methods with regard to different categories of claims:

(1) Reduce the repayment amount of claims on a pro rata basis;

(2) Extension of payment in lump-sum or instalment;

(3) Changes in other terms or conditions;

(4) Conversion of a portion or all of the creditors' claims into equity.

Article 108 Claims in the same category in a reorganization plan shall be repaid under the same terms except that individual creditors accept voluntarily some unfavorable repayment terms.

Article 109 A reorganization plan may provide a scheme of merger or separation for the reorganizing enterprise.

Article 110 A reorganization plan may provide a scheme on raising fund for the reorganizing enterprise.

Article 111 A reorganization executor provided in a reorganization plan may be assumed by the administrator.

The provisions in Article 31 of the Law shall be applicable to the qualification of a reorganization executor.

Article 112 The administrator shall submit to the people's court a draft reorganization plan and a statement of feasibility study on reorganization within the period of time specified by the court.

Article 113 If the people's court, after review subsequent to receipt, deems that a draft reorganization plan meets the provisions of the Law, it shall summon a creditors' meeting and put the plan into voting.

The administrator shall explain the draft reorganization plan to the creditors' meeting and answer questions.

Article 114 Investors to the debtor may attend the creditors' meeting and discuss the draft reorganization plan.

Article 115 The creditors' meeting shall vote in separate voting groups in accordance with the classification provided in Article 106 of the Law for the passage of a draft reorganization plan.

A draft reorganization plan is passed in one voting group when it is adopted by more than one half of the creditors presenting at the meeting in the same group, whose amount of claims must account for not less than two-third of the total amount of confirmed claims in the group.

When all the voting groups have passed the draft, the reorganization plan is adopted.

Article 116 If the reorganization plan fails to be adopted, the administrator may negotiate with the voting group that has not passed the plan. The group may vote on the plan once again after negotiation. A compromise reached between the two sides shall not impair the interests of other voting groups.

If the voting group that has not passed the reorganization plan previously, after negotiation with administrator, fails to pass it again in the second voting, the administrator, or the local government of the municipality or county where the debtor locates, or the administrative department of the industry that the debtor belongs under, may apply to the people's court for confirmation of the plan. If the reorganization plan meets the following requirements, the people's court shall confirm the plan:

(1) According to the plan, claims secured with property will be fully satisfied, and the losses brought about by the extension will be fairly compensated, and there will be no impairment to their security rights; except the terms otherwise stipulated in the plan has been adopted by the group of claims secured with property;

(2) According to the plan, labor claims and tax claims will be fully satisfied, or otherwise the adjusted ratio of payment has been adopted by the relevant voting group;

(3) The ratio of payment obtained by unsecured claims according to the plan will not be less than that supposed to be obtained by the same claims via proceeding of bankruptcy liquidation at the time when the plan is submitted for confirmation;

(4) The order of claim satisfaction provided in the plan does not violate the provisions in Article 106 of the Law;

(5) The scheme for enterprise rehabilitation is feasible, and not inconsistent with the State industrial policy.

Article 117 If the creditors' meeting has not adopted the draft reorganization plan, and the plan has not been adopted via negotiation or submitted to the people's court for confirmation in accordance with the provisions in Article 116 of the Law, the court shall make a decision to terminate the reorganization proceeding.

Where the provision in the preceding paragraph is applied, if the debtor has fallen the state provided in the first paragraph, Article 4 of the Law, the people's court shall adjudicate the debtor to be bankrupt; if the debtor has not fallen the state provided in the first paragraph, Article 4 of the Law, the people's court shall make a decision to close the insolvency case.

Article 118 Within 5 days after the adoption of a reorganization plan, the administrator shall apply to the people's court for confirmation of the plan.

If the people's court deems, after review subsequent to receipt, the application is in keeping with the provisions of the Law, it shall make a decision to confirm the plan.

Article 119 The people's court shall open a court session to hear the statements by administrator, supervisors, parties concerned, and the opinions of the proper authorities and experts, before it makes a decision in accordance with the provisions in Article 103, or the second paragraph, Article 116, or the second paragraph, Article 118 of the Law.

Article 120 If the people's court deems that the a reorganization plan does not meet the provisions of the Law, it shall overrule the application on confirmation of the plan.

When the people's court overrules the application on confirmation of the plan, if the debtor has fallen the state provided in the first paragraph, Article 4 of the Law, it shall adjudicate the debtor to be bankrupt; if the debtor has not fallen the state provided in the first paragraph, Article 4 of the Law, it shall make a decision to close the insolvency case.

Article 121 When making a decision to confirm a reorganization plan, the people's court shall notify the administrator to hand over the debtor's assets and administrative affairs to a reorganization executor. The reorganization executor shall perform his missions from the day when the people's court makes a decision to confirm the plan; and the administrator shall end his performance of missions from the same day.

Article 122 A reorganization plan confirmed by the people's court shall have a binding force on all the reorganization claims established prior to the acceptance of insolvency case by the court.

Such reorganization claims as not having been filed in accordance with the provisions of the Law shall not be enforced until the plan has been executed; they may be enforced according to the repayment terms of the plan for the same class of claims after the execution of the plan is fulfilled.

The responsibility to pay off debts assumed by the reorganizing enterprise's guarantors and other joint debtors shall not be affected by the reorganization plan.

Article 123 A reorganization executor is in charge of execution of a reorganization plan.

Any of the resolutions made by the organ of authority in the reorganizing enterprise that violates the reorganization plan shall be subject to the reorganization executor's veto power.

The appointment of management made by the authority organ of the reorganizing enterprise shall be approved and supervised by the reorganization executor.

Article 124 If the reorganizing enterprise is unable or refuses to follow the reorganization plan, the people's court may, on the application of the interested persons, make a decision to terminate the execution of the reorganization plan.

Where the people's court decides to terminate the execution of the plan, if the debtor has fallen the state provided in the first paragraph, Article 4 of the Law, it shall adjudicate the debtor to be bankrupt.

In the circumstances provided in the first paragraph of this Article, the concessions made by the creditors in the reorganization plan shall become no longer effective. However, a guarantee offered by a third party for the execution of the reorganization plan shall continue to be enforceable within the pale of the secured amount provided in the plan.

Article 125 Upon the completion of the execution of a reorganization plan the reorganization executor shall end his performance of missions and timely submit a general execution report to the people's court. The people's court shall, after review and acknowledgment, make a decision to close the insolvency case.

Starting from the day when the people's court makes decision to close the insolvency case, the reorganized enterprise shall be relieved of its responsibility of paying off the portion of reorganization claims that are reduced under the reorganization plan.

Chapter VI Bankruptcy Liquidation

Section 1 Bankruptcy Adjudication

Article 126 When people's court adjudicates a debtor to be bankrupt in accordance with the Law, it shall make a written decision.

The court shall send such decision to the debtor within 3 days after the date of the decision.

Article 127 Where the people's court with jurisdiction over insolvency cases discovers the debtor to be under the circumstances provided in the first paragraph, Article 4 of the Law when hearing a civil case or exercising a civil execution, it may ex officio adjudicate the debtor bankrupt.

Within 3 days after the date when the decision of bankruptcy adjudication is made, the people's court shall serve the decision to the debtor.

Articles 16, 17, 19, 21, 22, 23, 40, 46 and 47 of the Law shall apply mutatis mutandis to a case of ex officio bankruptcy adjudication by the people's court.

Article 128 The people's court shall promulgate its decision on declaring the debtor bankruptcy within 10 days starting from the day when the decision is made. The promulgation shall contain the following particulars:

- (1) The gist of the decision on bankruptcy adjudication, and the date of the adjudication;
- (2) The names of appointed bankruptcy liquidators, if any, and their business address and telephone number;
- (3) Obligors to the bankrupt shall pay off the debts, and holders of the bankrupt's property shall return the property, to the administrator or bankruptcy liquidators;
- (4) Other matters the court deems necessary to promulgate.

The aforementioned promulgation shall state the matters provided for in items (2) and (5) of the second paragraph, Article 17 of the Law when the court adjudicates ex officio the debtor bankrupt.

Article 129 Before bankruptcy adjudication, the people's court shall make a decision to close a bankruptcy procedure and promulgate it, if any of the following circumstances occurs:

- (1) One or several relevant governments department finance or take other measures to assist the debtor to pay off the debts;
- (2) Other organizations or individuals provide security or assist the debtor to pay off the debts;
- (3) The debtor has paid off all the debt.

Article 130 If a partnership enterprise's assets are not sufficient to pay off its due debts, the people's court shall adjudicate all its partners to be bankrupt in the meantime when the court adjudicates the partnership enterprise bankrupt. If the partners have offered property that is enough to clear off all the partnership enterprise's debts, however, the court shall not adjudicate the partners bankrupt at the time when adjudicating the partnership enterprise bankrupt.

The provisions in the preceding paragraph shall apply mutatis mutandis to bankruptcies of sole proprietorships.

Section 2 Bankruptcy Liquidators

Article 131 After the bankruptcy adjudication, the people's court shall appoint liquidators within 7 days starting from the day of the decision. The administrator shall act on behalf of bankruptcy liquidators before they take office.

The administrator may assume a position of bankruptcy liquidator in the same insolvency case.

The office of bankruptcy liquidator may be taken by one or several but no more than five persons.

When there are several bankruptcy liquidators, they are called a liquidation team. The members of a liquidation team perform their missions commonly. A head of the team shall be appointed by the people's court.

When bankruptcy liquidators have been appointed, the people's court shall timely promulgate their names and business address.

Article 132 As to the qualification of bankruptcy liquidators, Article 31 of the Law applies mutatis mutandis.

Article 133 The people's court shall notify the administrator within 3 days starting from the day of the appointment of bankruptcy liquidators. The bankruptcy liquidators shall begin to hand over insolvency affairs to liquidators upon the receipt of the notice from the court.

Before the court appoints liquidators, if the obligors to the bankrupt or holders of the bankrupt's property pay off debts or deliver property to the administrator, it shall mean they pay off or deliver to liquidators.

Prior to the appointments of liquidators by the people's court, administrator's acts related to bankruptcy property according to law shall be regarded as acts of liquidators.

Article 134 Bankruptcy liquidators shall be responsible for the management, liquidation, assessment, disposition and distribution of the bankruptcy property, and undertake all civil activities in their own name within the scope of liquidation.

As to performance of functions by bankruptcy liquidators, Article 32 of the Law applies mutatis mutandis.

Liquidators shall report their operations to the court and accept the monitoring by creditors' meeting and supervisors.

Article 135 As to remuneration and expenses necessary for bankruptcy liquidators to operate, Article 34 applies mutatis mutandis.

Article 136 As to the duty relief of bankruptcy liquidators, Article 35 of the Law applies mutatis mutandis.

Section 3 Bankruptcy Property

Article 137 The bankruptcy property consists of the total property and property rights of all kinds that belong to the bankrupt at the time of bankruptcy adjudication, and the property and property rights of all kinds obtained by the bankrupt after the bankruptcy adjudication but prior to the close of insolvency case.

If the bankrupt is a natural person, the expenses necessary for the livelihood of the bankrupt and the people he supports, and daily necessities, do not belong to the bankruptcy property, and the bankrupt, with approval of bankruptcy liquidators, is entitled to take them back.

If there are special provisions concerning the composition of bankruptcy property in the Law or other laws, they shall apply.

Article 138 Liquidators, the bankrupt or other interested persons who have dispute on right in rem to some property involved in the bankruptcy proceeding may bring a case to the people's court by which the insolvency case is accepted.

Article 139 The proprietors of the property that does not belong to the bankrupt may get it back via bankruptcy liquidators.

Article 140 If a seller has shipped the goods that the adjudicated bankrupt has not received and has not paid the full price for, the seller may take back the goods in transit. However, the bankruptcy liquidators may pay in full and request the seller to deliver the goods.

The provisions in the preceding paragraph shall not affect the application of Article 146 of the Law.

Section 4 Bankruptcy Claims

Article 141 As far as non-money claims and claims denominated in foreign currencies are concerned, the amount of bankruptcy claims shall be assessed in keeping with their amount at the time of bankruptcy adjudication.

As to the calculation standards for the assessed amount of the claims mentioned in the preceding paragraph, the provisions in the second paragraph, Article 46 of the Law applies *mutatis mutandis*.

Article 142 If one or more of joint debtors are adjudicated to be bankrupt, their creditor may assert its claim in full to each bankrupt with the amount computed at the time of bankruptcy adjudication.

Article 143 If one or more of joint debtors are adjudicated to be bankrupt, and the rest having paid off the debt to which the bankrupt or bankrupts are responsible may have the claim for reimbursement enforced as a bankruptcy claim.

If one or more of joint debtors are adjudicated to be bankrupt, the rest may exercise as bankruptcy claims their future right to ask reimbursement for what they will pay off on behalf of the bankrupt or bankrupts in the future, except in circumstances that their creditor have exercised its right for the full amount of the claims.

Article 144 Article 143 of the law applies *mutatis mutandis* to guarantors of the bankrupt.

Article 145 If partners are adjudicated to be bankrupt in accordance with the Law, they shall be liquidated separately.

The creditors to each partner have equal status with those to the partnership enterprise.

A creditor to the partnership enterprise may enforce the part of its bankruptcy claim that cannot be covered by the enterprise's assets in each partner's bankruptcy liquidation in accordance with the provisions in Article 142 of the Law. However, the total amount gained from the distributions through enforcing the claim shall not exceed the amount in which the claim should have been repaid.

Article 146 As for a bilateral contract unperformed by the bankrupt, bankruptcy liquidators shall be entitled to decide if it will be cancelled or continue to be performed.

The counterpart in an executory contract may specify a deadline to the bankruptcy liquidators, and urge them to make a decision within this period as to whether the contract is to be cancelled or continue to be performed. The liquidators' failure to answer upon the expiration of the period shall be regarded as a cancellation of the contract.

If the liquidators decide to continue the performance of the contract, whereas the counterpart requests them to provide relevant security within an agreed or reasonable period, but the liquidators have not provided security during the period, this shall be regarded as a cancellation of the contract.

Where liquidators cancel a contract, if the counterpart has paid earnest money, the claim for return of the money shall be a bankruptcy claim limited by the amount of the earnest.

When a contract is cancelled under the provisions in the preceding four paragraphs, the counterpart's claims for damages shall be regarded as bankruptcy claims.

Article 147 A contract of mandate shall become terminated by reason of bankruptcy adjudication. However, if the mandatory continues to handle affairs under mandate in such circumstances that he has not received the notice on bankruptcy adjudication and keeps ignorant of this fact, the obligatory claims arising therefrom shall be regarded as bankruptcy claims.

Section 5 Set-off Right

Article 148 If a creditor is indebted to the bankrupt before bankruptcy adjudication, whether or not the obligations are same in nature, it may assert a set-off to liquidators before the promulgation of distribution scheme.

Article 149 The set-off provided in Article 148 of the Law shall not apply to any of the following circumstances:

- (1) A bankruptcy creditor becomes indebted to the bankrupt after bankruptcy adjudication;
- (2) The bankrupt obtains a bankruptcy claim from anyone else after bankruptcy adjudication;
- (3) A bankruptcy creditor becomes indebted to the bankrupt with knowledge of the bankrupt's cessation of payment or application for insolvency case, except in the circumstances that a creditor becomes indebted to the bankrupt because of legal provisions or some causa occurred before the application for insolvency case one year earlier;
- (4) An obligor to the bankrupt obtains an obligatory claim against the bankrupt with knowledge of the bankrupt's cessation of payment or application for insolvency case, except in circumstances that the obligor obtains the claim because of legal provisions or some causa occurred before the application for insolvency case one year earlier.

Section 6 Right to Separate Satisfaction

Article 150 Those who hold rights of mortgage, pledge and lien to the bankrupt's property and property rights are holders of rights to separate satisfaction.

Holders of rights to separate satisfaction shall enjoy the preferential rights to be satisfied from the objects of such rights.

Article 151 Holders of rights to separate satisfaction may exercise such rights without being bound by bankruptcy liquidation procedure.

If a creditor with a right to separate satisfaction has not been fully repaid from exercising such rights shall enforce his claim on the unsatisfied part through bankruptcy liquidation procedure.

Creditors with rights to separate satisfaction who have given up the preferential right in satisfaction shall have their claims satisfied according to bankruptcy liquidation procedure.

Article 152 Bankruptcy liquidators may retrieve an object of right to separate satisfaction by paying off the debt or rendering substitute security.

When paying off the debt as provided in the preceding paragraph, if the value of the object of right to separate satisfaction is lower than the amount of the secured claim, the repayment shall be limited within the market value of the object at that time.

Section 7 Disposition and Distribution

Article 153 Bankruptcy liquidators shall dispose the bankruptcy property when it is appropriate according to the disposition scheme adopted by the creditors' meeting, or otherwise with consent from the supervisors.

Article 154 Bankruptcy liquidators shall prepare a disposition scheme at appropriate time and submit it to the creditors' meeting. The scheme adopted at the meeting though discussions shall be subject to the people's court for a decision before it is executed.

Article 155 The disposition of the bankruptcy property shall be auctioned, except that the creditors' meeting has otherwise resolved.

The complete set of equipment in the bankruptcy property shall be soled as a whole; but what can not be soled as a whole may be sold in piecemeal.

A bankrupt enterprise may be soled as a whole or in portions. When an enterprise is soled as a whole, some particular items in the property may be soled separately.

The objects that are prohibited from auction or sale according to the State's regulations shall be disposed of in the ways prescribed by the State.

Article 156 After the administration expenses and debts of common benefit have been paid off preferentially, repayment shall be done in the following order:

- (1) Wages and salaries owed by the bankrupt to the labors, unpaid social insurance premiums, and other expenses that should be paid to the labors according to provisions of laws and administrative regulations;
- (2) Tax owed by the bankrupt;
- (3) Ordinary bankruptcy claims.

When bankruptcy property is not enough to pay off the claims in a same class, it shall be distributed among them on a pro rata basis

Article 157 Bankruptcy distribution shall be carried out in a monetary way, except as specially provided in the resolutions by the creditors' meeting.

Article 158 Bankruptcy liquidators shall timely prepare a distribution scheme and submit it to the creditors' meeting for discussion.

The distribution scheme provided in the preceding paragraph shall specify the following particulars:

- (1) The names and address of creditors involved in the distribution;
- (2) The amount of claims in the distribution;
- (3) The amount of the distributable assets;
- (4) The distributed classes, proportions and amount;
- (5) Methods for execution of the distribution.

When the creditors' meeting has adopted the distribution scheme, the liquidators shall submit it to the people's court for decision.

The scheme shall enter into force on the day when the court approves it through decision.

Article 159 If a distribution scheme enters into force, it shall be executed by liquidators.

Liquidators may complete the distribution in lump-sum basis or in several times according to the distribution scheme.

If liquidators carry out distribution more than one time, the amount of assets and that of claims involved in present distribution shall be promulgated at each time. The eventual distribution by the bankruptcy liquidators shall be well stated in the promulgation, which shall also specify the matters set forth in the second paragraph, Article 162 of the Law.

Article 160 A creditor with a claim subject to a condition subsequent may accept distribution under the circumstances that it renders an adequate security.

After the acceptance of distribution by the creditor as described in the preceding paragraph, if the condition subsequent is not fulfilled within 30 days after the last distribution promulgation, the responsibility for security, if already given, shall be relieved and the collateral, if delivered, shall be returned.

If the condition subsequent is fulfilled within 30 days after the last distribution promulgation, the accepted distribution shall be recovered.

Article 161 As for a claim subject to a condition precedent, liquidators shall lodge an amount for its distribution if the creditor accepts bankruptcy distribution.

The preceding paragraph applies mutatis mutandis to claims subject to a condition subsequent when no adequate security rendered.

The amount lodged by liquidators according to the preceding two paragraphs, in the circumstances that the condition precedent has unfulfilled or the condition subsequent fulfilled within 30 days after the promulgation of the last distribution, shall be distributed to other creditors; or otherwise, in circumstances that the condition precedent has fulfilled and the condition subsequent unfulfilled within 30 days after the last distribution promulgation, the lodged amount shall be given to the creditor.

Article 162 Distributed amounts that have not been accepted by creditors shall be lodged by bankruptcy liquidators.

If a creditor has not taken its distributed amount within 30 days after the last distribution promulgation, it shall be regarded as giving up right to distribution and the bankruptcy liquidators shall distribute the lodged amount to other creditors.

Article 163 In bankruptcy distribution, an amount distributed to a claim that is controversial, or is unsettled in litigation, shall be lodged by bankruptcy liquidators. However, the people's court shall distribute the lodged amount to other creditors provided that it has not been accepted two years after the close of the insolvency case.

Section 8 The Close of Insolvency Cases

Article 164 Bankruptcy liquidators may request the people's court to make a decision to close the insolvency case if the execution of the distribution scheme has become impossible

After the conclusion of the last distribution, bankruptcy liquidators shall timely submit a report to the people's court and call upon the court to make a decision to close the insolvency case.

The court shall make a decision as to whether insolvency case shall be closed, within 30 days upon the receipt of the request from bankruptcy liquidators for such a closing.

Article 165 Within 10 days after the close of insolvency case, bankruptcy liquidators shall bring the court decision on such closing to the registrar with which the bankrupt enterprise has originally registered for cancellation of registration.

Article 166 Bankruptcy liquidators shall end their operations on the next day after the date when the cancellation of registration completed.

Article 167 Within two years after the close of insolvency case in accordance with the fourth paragraph, Article 50 and Article 164 of the Law, creditors may request the people's court to carry out additional distribution according to the distribution scheme in any of the following circumstances:

(1) Any property supposed to be recovered in accordance with Articles 28 of the Law has been discovered;

(2) Other property of the bankrupt that is subject to the bankruptcy distribution has been discovered.

In spite of the above circumstances, additional distribution shall not be undertaken if the amount of the property is too limited to be distributed.

Article 168 After the close of insolvency case, the surety and the other joint debtor of the bankrupt shall continue to undertake repayment responsibility for the claims unpaid through the bankruptcy procedure.

Section 9 Discharge

Article 169 A bankrupt as one of the natural persons described in the first paragraph, Article 3 of the Law shall use all his property gained after the close of insolvency case and before he is discharged in accordance with Article 170 of the Law, deducting the expenses necessary for his basic livelihood and performance of his legal duties, to repay the unpaid part of the bankruptcy claims.

The bankrupt as provided in the preceding paragraph may make out an arrangement on the repayment of claims after the close of insolvency case, and submit it to the creditors' meeting for approval prior to the close of insolvency case. An arrangement approved by the meeting is binding on the two sides of parties.

Article 170 After the close of insolvency case, the bankrupt's responsibility of repaying the unpaid part of the ordinary bankruptcy claims, excepting compensations for damages cause by intentional violation of personal rights, shall be discharged because of any of the following reasons:

(1) In case of not less than 30% of the total bankruptcy claims having been paid off at the time of close of insolvency case, three years have passed since the day of the close of insolvency case; or

(2) In case of not less than 20% but less than 30% of the total bankruptcy claims having been paid off at the time of close of insolvency case, five years have passed since the day of the close of insolvency case; or

(3) In case of not less than 10% but less than 20% of the total bankruptcy claims having been paid off at the time of close of insolvency case, seven years have passed since the day of the close of insolvency case; or

(4) In case of less than 10% of the entire bankruptcy claims having been paid off at the time of close of insolvency case, ten year have passed since the day of the close of insolvency case.

Those who are sentenced criminal punishment because of bankruptcy crimes, or have the acts set forth in Chapter 9 or Article 27 of the Law, shall not be discharged.

If the bankrupt voluntarily pays off a relieved debt after the discharge, the benefit acquired therefrom by a creditor shall be protected by law.

Chapter VII Summary Procedure

Article 171 This Chapter shall apply where, after acceptance of an insolvency case, the people's court finds out that the total amount of the debtor's property is less than 500,000 RMB yuan, that the claims and debts are clear, and that the number of the creditors is comparatively small.

Other provisions in the Law shall apply except as provided otherwise in this Chapter.

Article 172 An insolvency case may be heard by sole judge when the people's court examines the case according to this Chapter.

Article 173 As for an insolvency case examined under this Chapter, a debtor can ask for composition only once.

Article 174 The decisions made by the people's court in an insolvency case to which this Chapter is applied shall be serviced through notice only. However, the decisions of the people's court on acceptance of insolvency case, on bankruptcy adjudication and on close of insolvency case shall promulgate in addition to notice.

Article 175 The people's court shall decide a period for filing bankruptcy claims after the acceptance of insolvency case; such a period shall not be less than 7 days, but no more than 30 days.

The first creditors' meeting shall be summoned within 5 days after the expiration of the period for filing claims.

Article 176 If this Chapter is applied by the people's court to hear an insolvency case, the deadline mentioned in Article 56 in the Law shall not apply.

Article 177 If this Chapter applies, an insolvency case shall be completed within 12 months after the people's court has accepted the case.

Chapter VIII Special Provisions for Bankruptcy of State-Owned Enterprises

Article 178 The provisions in this Chapter shall only apply to the state enterprises established prior to the effective date of the Law.

If there is no provision in this Chapter when debts of an enterprise described in the preceding paragraph are liquidated in accordance with the procedures provided by the Law, other provisions of the Law shall apply.

Article 179 If an enterprise applies to the people's court for acceptance of insolvency case, it shall submit a written approval of the department that the State authorizes to administrate the investment in, or to be responsible for, the enterprise. The authorized department that does not approve the enterprise to apply for the insolvency case shall provide financial aid, or take other measures, to help the enterprise to pay off its debts.

Article 180 When adjudicating ex officio a state-owned enterprise bankrupt, the people's court shall hear the opinion of the department that the State authorizes to administrate the investment in, or to be responsible for, the enterprise.

Article 181 The debtor's right to use land shall be assigned by auction or tender.

The income from assignment of the right to use land shall be used for settlement of the staff and workers in the bankrupt enterprise; and the surplus after the settlement, if any, shall be included in the distribution scheme together with other bankruptcy property.

Article 182 The detailed implement measures on the settlement of staff and workers by using the income from assignment of the right to use land in accordance with Article 181 of the Law shall be provided by the State Council separately.

Article 183 Public welfare utilities such as tenements for employees, schools, hospitals, kindergartens and nurseries set up by state-owned enterprises shall not be included in bankruptcy property, except those which are not necessary to continue and can be sold as a whole. These utilities shall be taken over as a whole and managed by the people's government of the municipality, or the district or county thereunder, in the domicile of the bankrupt enterprise. However, the tenements for employees newly built up after the effective date of the Law shall be included in bankruptcy property.

Chapter IX Legal Responsibilities

Article 184 - If a debtor or a debtor's representative who is bound to attend a creditors' meeting still refuses, without justifiable reasons, to appear at the meeting after a summon of the people's court, the court might summon the debtor through arrest warrant and impose a fine of 1000 to 5000 RMB yuan.

If a debtor or any other person with obligation of disclosure refuses to make a statement or an answer, or provides a false statement or answer, the people's court might impose him a fine of 1000 to 5000 RMB yuan.

If the acts mentioned above constitute crimes, criminal responsibilities shall be investigated in accordance with the law.

Article 185 If a debtor violates the Law and refuses to submit, or submits falsely, property statements, debt information, credit information or the relative financial statements to the people's court, the court might impose a fine of 2000 to 10,000 RMB yuan.

If a debtor violates the Law and refuses to transfer the property, and the books, documents, files and seals related to the property, to the administrator or bankruptcy liquidators, the people's court might impose the person or persons directly responsible a fine of 2000 to 10,000 RMB yuan.

If the acts mentioned above constitute crimes, criminal responsibilities shall be investigated in accordance with the law.

Article 186 If a debtor has any of the acts stipulated in Article 27 of the Law or any of the following within 12 months prior to the acceptance of insolvency case by the people's court, the court might impose the person or persons directly responsible a fine of 10,000 to 100,000 RMB yuan; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law:

- (1) Selling property at abnormally lower prices;
- (2) Paying off undue debt ahead of time;
- (3) Giving up obligatory claims;
- (4) Fabricate or destroy evidentiary material relevant to property, thus making the property status unclear.

Article 187 If a debtor has any of the following acts, the people's court might impose the person or persons directly responsible a fine of 5000 to 50,000 RMB yuan; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law:

- (1) Pledging property as security for satisfaction of an unsecured debt, within 12 months prior to the acceptance of insolvency case by the people's court;
- (2) Paying off an individual claim or claims even though having been aware of its inability to pay off due debts, within 6 months prior to the acceptance of insolvency case by the people's court.

Article 188 If a debtor has or should have been aware of its inability to pay off due debts but still unreasonably spends money and property or squanders the property, the people's court might impose the person or persons directly responsible a fine of 3000 to 30,000 RMB yuan; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

Article 189 If during a bankruptcy procedure any of the administrators, reorganization executors, bankruptcy liquidators, supervisors, creditors or their proxies asks for or accepts a bribe or other illegitimate interest, by taking advantage of his position, the people's court might

impose a fine of 10,000 to 100,000 RMB yuan according to the circumstances; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law

Article 190 If during bankruptcy procedure anyone offers a bribe or other illegitimate interest to any of the administrators, reorganization executors, bankruptcy liquidators, supervisors, creditors or their proxies, the people's court might impose the person or persons directly responsible a fine of 2000 to 30,000 RMB yuan; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

Article 191 If a debtor violates the provision in item (4) of the first paragraph, Article 22 of the Law, the people's court might impose an admonition or a detention, with a fine of 5000 to 50,000 RMB yuan in addition applicable.

Article 192 If any of the administrators, reorganization executors, bankruptcy liquidators, supervisors cause big losses to the creditors, the debtor or a third party, as a result of his misconduct in office or other illegal act, the people's court might impose a fine of 10,000 to 100,000 RMB yuan and a detention; and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

Chapter X Supplementary Provisions

Article 193 The Law shall come into force on the day of its promulgation. The Enterprise Bankruptcy Law of the People's Republic of China (on a trial basis) shall be abolished therewith.

(Translated by Professor Wang Weiguo)

Corporate rescue culture needed, forum told

By Don Gasper
Hong Kong iMail

DECIDING whether to restructure ailing corporations or let them die was the focus of a mainland symposium on emerging Chinese insolvency law yesterday.

"An enterprise in distress is like a sick horse," said Wang Weiguo, a member of the working group for drafting the new Enterprise Insolvency and Restructuring Law.

Prof Wang told participants that if a sick horse died one could only retrieve the value of the horse meat

— worth far less than a live horse.

"On the other hand, if we have to spend more to save the sick horse than buy a healthy one, it is not worth the effort," said Prof Wang, whose working group reports to the Fiscal and Economic Committee of the National People's Congress.

Prof Wang said standard guidelines for courts were needed in such cases. "But even scholars in the United States have not been able to suggest such a standard," he said.

Cao Shouye, a senior judge with the Supreme People's Court in Beijing, said that where the assets of

a company were less than 30,000 yuan (HK\$28,320) or 50,000 yuan, it was not worth restructuring it.

Zhang Xianzhu and Charles Booth of Hong Kong University's Faculty of Law, said that it was clear that the existing bankruptcy law regime on the mainland was based almost solely on liquidation, with little provisions made for efforts to launch corporate rescues or reorganise the ailing company.

Prof Wang, however, pointed out that any long-term success of Chinese insolvency law depended on the formation of a corporate

rescue culture. He said that despite the availability of some provisions on reorganisation in the existing Chinese Enterprise Bankruptcy Law, there had hardly been a case in 10 years in nearly 10,000 bankruptcies accepted by the People's Court in which these provisions had been invoked.

Judge Cao added that the lack of a registry of assets and of a comprehensive valuation system made it easier for debtors to conceal assets.

Mr Wang agreed.

"There is large room for a debtor to conceal, unlawfully distribute or

waste its assets," he said. Speakers at the symposium also suggested that the draft of the new Enterprise Insolvency Law should allow for a mechanism for the handling of cross-border insolvency issues.

They said that the increasing integration of the of the Shenzhen and Hong Kong economy made the establishment of a co-operative framework necessary.

Such a framework would be helpful in handling cases in which an insolvent firm in Shenzhen had assets in Hong Kong or vice versa.

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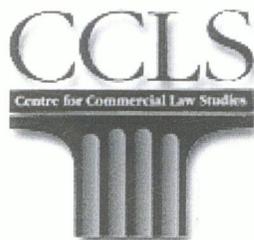
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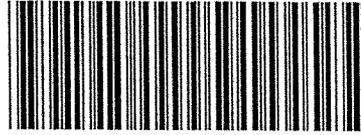
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