

# Bankruptcy Law in China: Lessons of the Past Twelve Years

Contributed by Li Shuguang

In this article, Professor Li examines the current state of bankruptcy law in China. He outlines the problems in the enforcement of the current Bankruptcy Law and suggests how these problems can be remedied.

Dr. Shuguang Li is an associate professor at China University of Politics and Law and is currently a visiting professor at Harvard Law School. Dr. Li formerly served as an expert advisor on bankruptcy and de-organization in China State Economic and Trade Committee and as an expert advisor on enterprise merger and bankruptcy for World Bank and Asian Development Bank. Dr. Li also participated in the drafting of new Bankruptcy Law and the drafting of a series of governmental policies regarding the reforms of state-owned-enterprises. *The Historical Background of the Insolvency Legislation and Practice in China* Despite the long history of the Chinese legal system and its influence on much of East Asia, the concept of "bankruptcy" was not formally recognized in Chinese law until the first bankruptcy law was introduced in 1906, during the late Qing Dynasty. Until that time, the role of bankruptcy law was filled by the legal and ethical tradition that "The son pays for the debts of his father." In 1906, the Qing government followed the civil law system, especially the law of China's neighbor, Japan, and enacted bankruptcy law. It was later annulled in 1908 by Emperor Guang Xu due to difficulties in implementation. In 1915, during the era of the Republic of China, the then Northern Warlords Government drafted a bankruptcy law. In 1935, the Nationalist Government published and implemented a bankruptcy law that is still in force in Taiwan today.<sup>1</sup> After the founding of the People's Republic of China in 1949, the new government abolished all the laws the Nationalist Government had enacted. As a consequence, China did not have an insolvency law for more than 30 years. During this period, the Chinese government practiced a uniform policy of centralized assumption of profits and losses of state-owned enterprises under the planned economic system. The system was characterized by centralized financial revenue and expenditures, planned coordination of supply and demand in commercial distribution, and government-controlled labor supply and placement. Enterprise profits were turned over to the state and all losses were subsidized by the state. Enterprises with chronic and serious deficits either were "closed, suspended, consolidated or [had their] production changed" by administrative orders, or went bankrupt automatically without going through any legal procedure. The facts of bankruptcies had always been kept secret. In the early 1980s, Chinese economists, legal experts, and government officials began to realize the drawbacks in the way that the planned economic system dealt with insolvent enterprises, and advocated the promulgation of a law of enterprise insolvency. After the promotion of bankruptcy law by experts and scholars and fierce debates in the Standing Committee of the National People's Congress (NPC), the Law of the People's Republic of China on Enterprise Bankruptcy (LEB) was finally promulgated by the 18th Session of the Standing Committee of the 6th NPC on December 2, 1986. *Twelve Years after the Enactment of the Bankruptcy Law: the Law in Practice* It has been over twelve years since the bankruptcy law first came into effect on November 1, 1988. The Law comprises six chapters, including General Principles, Proposal and Acceptance of Bankruptcy Applications, Creditor's Meetings, Conciliation and Consolidation, Bankruptcy Declaration and Liquidation. There are a total of 5400 words in 43 articles. According to Article 2, the Law applies to enterprises wholly owned by the people, namely, state owned enterprises (SOEs), shattering the traditional view that SOEs would not and could not go bankrupt.

## 1. The Bankruptcy Law as one of several bases for enterprise bankruptcies

However, the Bankruptcy Law is not the only basis for bankruptcy practice in China. After the Law was promulgated, the NPC issued the amended 19th chapter of the Code of Civil Procedure on April 9, 1991: Debt Repayment Order in Legal Entity Bankruptcy. The chapter, covering 8 articles (Articles 199 to 206), provides a direct basis for handling the bankruptcies of non-state-owned enterprises and brought the bankruptcies of all legal entities (enterprises with legal person status) in China into the legal system. It has also promoted the market competition mechanism of survival of the fittest. Although the Code does not specify the debt repayment procedure for bankruptcies of non-state-owned enterprises, it provides that the repayment procedures specified in the Bankruptcy Law are applicable to all legal entities.

Therefore, in practice, many bankruptcy cases involving SOEs and non-SOEs follow the procedures. Judicial interpretations of the Bankruptcy Law issued by the Supreme People's Court on November 7, 1991 and a series of policies and other regulations implemented by the State Council also regulate and promote bankruptcy practice in China. Some localities have promulgated their own regional bankruptcy laws to promote bankruptcy work. For example, in August 1993, the Guangdong Provincial People's Congress issued a series of regulations on company bankruptcy. In November 1993, the Shenzhen municipal people's congress issued Regulations on Company Bankruptcy in the Shenzhen Special Economic Zone.

## 2. A major increase in enterprise bankruptcy cases

Many Chinese and foreign scholars as well as members of the business community share the common misconception that there are only few enterprise bankruptcies in China. In reality, since the Bankruptcy Law came into effect in November 1988, the law has been invoked to close more than 16,000 enterprises. After a slow start, the rate of bankruptcies has accelerated rapidly, particularly in the last several years (see table below). Bankruptcy has not been limited to ailing state firms, but rather has applied to all types of enterprises. In 1994, only 395 of the total 1,624 bankrupt enterprises were state firms. Among the 5,396 bankruptcies in 1997, 3,060-plus were SOEs (675 in the 111 experimental cities);<sup>2</sup> the rest were private, collectively owned or Sino-

foreign joint ventures. Bankruptcies Per Year:3

- 98
- 32
- 117
- 428
- 710
- 1,625
- 2,583
- 5,875
- 5,396

3. Types of bankruptcy Because the only bankruptcy law in China was designed for SOEs, and because of the influence of the deep-rooted central control economic system on domestic perceptions, there is a general belief that bankruptcies are only limited to SOEs. In fact, as noted above, there has been a large number of non-SOE bankruptcies in recent years. Among the 11 bankruptcies in Zhanjiang, Guangdong Province in 1996, five were sino-foreign joint ventures. Among the 5,396 bankruptcy cases in the entire country in 1997, 3,735 concerned SOEs, and most of the rest concerned private, collectively owned or sino-foreign joint ventures. Since 1992, there has been a number of bankruptcy cases involving other countries. During the Asian financial crisis, difficulties in several Asian countries (such as Japan, South Korea, and Hong Kong) caused their investments in China to fail. For instance, the bankruptcy of the International Commercial Credit Bank (BCCI) led to the bankruptcy of its branch in Shenzhen. Nonetheless, the serious bankruptcies (in terms of scale, amounts of debt, numbers of unemployed workers involved and overall impact) have involved SOEs. The biggest case to date is the closure of state-owned Shanxi Textile Dyeing Plant in September 1996. In 1993, the plant of 18,000-worker was one of China's 500 largest enterprises. Three years later it was insolvent with a total of 640 creditors and debts of RMB880 million (US\$106 million).<sup>4</sup>

4. Implementation of the Chinese bankruptcy policy in recent years Despite the fact that reforming SOEs has been the main focus of the Chinese economic reform in the last twenty years, they remain a hard nut to crack. Since 1994, the central government has changed its approach to reforming SOEs from attempting to revitalize every single SOE to saving only the viable ones and preserving the overall sector. One principal experiment in this area has been a policy aimed at strengthening enterprises through the improvement of capital structures by encouraging mergers, restructuring, bankruptcies, asset sales, and the spin-off of non-productive units such as schools and hospitals. This experiment was first carried out in 18 cities, subsequently expanded to 56 cities, including every provincial capital, and is currently being run in 111 cities. Together with this experiment, policies outlined in two State Council documents on mergers and bankruptcies (No. 59 issued in 1994 and No. 10 in 1997), and other policies issued by government departments, constitute a key driving force behind the increase in bankruptcies. Some progress has been made since the start of the experiment in 1994. According to the State Economic and Trade Commission, some 1,192 enterprises merged and 1,099 went through bankruptcy in the original 56 experimental cities in 1996. These enterprises employed 680,000 workers and amassed a combined capital of RMB25 billion (US\$3 billion) and total debts of RMB43 billion (US\$5.2 billion), with a debt-to-assets ratio of 172%. Altogether 5,908 non-productive units were separated from their parent organizations, diverting 1.23 million people to other areas. In 1997, with the total number of experimental cities increased to 111 cities, 1,509 enterprises were merged and 675 went through bankruptcy, affecting more than one million workers. It is estimated that more than 2,000 enterprises either merged or declared bankruptcy in 1998, mainly in hugely unprofitable sectors such as textiles, machinery, light industry, defense industry, chemicals and coal. Despite the progress, two main obstacles have prevented further increase of the bankruptcy rate. They are China's already substantial unemployment problem and the fragility of the financial system. Official statistics state that China had 5.76 million unemployed workers in urban areas in 1997, giving rise to an unemployment rate of 3.1%. This figure, however, hides at least another 10 million urban workers who are *xiangang*-a new term used to describe people who got laid off from their employment but are nominally paid (if they are lucky) a subsistence wage by their previous working unit. A steep rise in the number of bankruptcies would exacerbate the unemployment problem, threatening widespread social unrest. A more immediate problem, especially in light of the Asian economic crisis, is the effect widespread bankruptcies could have on China's rickety financial system. A multiplication of the loss of debt rights on the part of the state banks could make financial institutions, the largest creditors of SOEs, technically bankrupt, and thus trigger a financial crisis. In 1996, of the above-mentioned total debts of RMB43 billion, RMB26.1 billion (60%) was in the form of bank loans. As a result of liquidations and mergers, the banks recovered only 10.1% of their loans, half in cash and half in goods and debt rights.<sup>5</sup> Of the bankruptcy cases alone, the banks wrote off RMB11.4 billion, 43% of the total RMB26.1 billion. Aware of the problems associated with bankruptcies, the government has adopted a policy of promoting mergers over bankruptcies. This new policy accounted for the sharp decrease in the number of bankruptcies in the experimental cities in 1997 compared to 1996. While this approach may prove to be a palliative in the short term, in the long run, it raises the question of who will merge with a bankrupt SOE. In addition, in the area of SOE bankruptcies, there are further obstacles such as an imperfect legal system, excessive administrative intervention, disordered guarantee arrangements, fraudulent bankruptcies, low benefits of liquidation, a shortage of bankruptcy professionals, local protectionism, and difficulties in selling assets for cash. The perplexing auction of the government-owned Shanxi Textile Dyeing Plant serves as a good example. In that case, the government initially attempted to force a merger by auctioning off the plant. But no buyer was willing to pay the RMB550 million price set by the government. Eventually, the government had to set up a textile company for the sole purpose of taking over the plant. The new government-owned company bought the plant for RMB 486 million. Recognizing the inefficiency of this approach, which results in mere shifting of problems from one enterprise to another, I proposed in 1998 that bankruptcy be adopted as the preferred solution for insolvent SOEs. Only bankruptcy, rather than merger, can provide a complete cure. Indeed, in 2000, the central government began a new policy of "more

bankruptcies, less mergers". Key Issues in Chinese Bankruptcies

- The government's role in bankruptcies The Chinese government plays a special role in enterprise bankruptcies in China. The government's role is both dominant and multi-faceted in SOE bankruptcies. It initiates these bankruptcies, yet at the same time, is the policymaker, the leader, and the direct operator in them. The government not only controls their number, scale, and speed, but also decides what industries and trades are covered under the bankruptcy law. It also covers the costs of SOE bankruptcies. It should be noted that the central and local governments play different roles in bankruptcies, some of which are conducted under, and some outside, the government's planned program. In contrast, the government has little influence in the area of non-SOE bankruptcies since it is not the legal owner of these companies. The courts' role in SOE bankruptcies is derived from the power of the government and is thus limited in many aspects. Since the government appoints judges and allocates budgets for courts, Chinese courts are hardly independent of the government. Chinese courts are divided into four levels: the Supreme Court, High Court, Intermediate Court and Local Court. Unlike the American system, in which bankruptcy courts have exclusive jurisdiction over bankruptcy cases, there is no unified provision in China specifying which court (i.e. the court of which level) has jurisdiction over bankruptcy cases. Most of these cases are conducted by the Economic Trial Branch of Local Courts and Intermediate Courts. Absent approval by the government, courts are often hesitant to accept and hear bankruptcy cases. Judges are supposed to apply the existing bankruptcy law when handling these cases. They are, however, restrained by bankruptcy policies of governments of different levels, which at times conflict with the bankruptcy law. Moreover, the majority of Chinese judges are not experienced in dealing with bankruptcy cases because Chinese courts had never dealt with a single bankruptcy case prior to the implementation of the Bankruptcy Law in 1988.6

- Who's the real debtor? One complication in the current Chinese bankruptcy regime is that the ownership structure of SOEs is not clear, making it difficult to identify the real debtor. SOEs are technically "own by the state". However, it is unclear as to who represents the state in exercising its ownership, who has the authority to grant approval and make decisions for an enterprise facing bankruptcy, who can apply for bankruptcy, and who takes the economic risk and bear the losses. Legal owners should theoretically bear all losses. Yet in reality in China, SOEs are often owned by multiple governmental entities that frequently evade their responsibilities when a SOE is faced with bankruptcy. An effective mechanism is needed to establish clear ownership of SOEs. Parent-subsidiary relationships add additional complexity. When a SOE is bankrupt, should its subsidiary enterprise bear joint liability? Conversely, when a subsidiary enterprise is bankrupt, should its parent enterprise bear joint liability? In practice, many SOEs are not independent legal persons even though they are powerful enterprises. It is often the case that an SOE and its subsidiaries have business relationships without ever establishing any clear legal relationships. The absence of clear legal relationships makes it easier for parent enterprises or subsidiaries to evade their financial responsibilities. Other hotly debated bankruptcy issues arise from the current transition from a planned economy to a market economy. For instance, what does the bankruptcy property of a bankrupt SOE encompass? Does it include land, hospital, school and employees' living quarters, as well as assets of the party committee and labor union of the SOE?

- The anti-bankruptcy stance of creditors Creditors often have difficulty recovering debts from bankrupt SOEs. Current policy requires that money recovered from a bankrupt SOE be used to settle employees first. And bank creditors have priority over non-bank creditors for the remaining money, if any. As there is often little money left after employee settlement, state-owned banks, which are the main creditors of SOEs, are often hit hard by SOE bankruptcies. These banks therefore often oppose SOEs' efforts to file for bankruptcy or will only accept bankruptcy under the government's planned program. Even for enterprises whose financial situation warrants an application for bankruptcy, it is rare for banks or other creditors to initiate such an application. For non-bank creditors, the difficulties are even more daunting. In many SOE bankruptcies, the rights of these creditors are completely cancelled to allow for settlement of employees. Other creditors fortunate enough may recover their debt at a very low rate. Legal mechanisms to guarantee creditor's interests are weak at best.

- Difficulties in settling employees Employee settlement is the most difficult and thorny issue in SOE bankruptcies. The problem is manifold. First, SOE employees are reluctant to accept bankruptcy because bankruptcy means that they lose their identity as state employees. This identity is so important because there is a Chinese tradition that a state employee is guaranteed an "Iron Rice Bowl", or lifetime employment. Second, when an enterprise is bankrupt, laid-off employees become a serious potential source of social instability. This is further exacerbated by the lack of government funding for employee settlement and the inadequacies of the social welfare system. Third, questions remain concerning the logistics and terms of settlement. How should employees be settled? Where does the money for employee settlement come from? Should the government be responsible for the settlement or should the employees find their own way out? Fourth, the legal rights and interest of employees of the bankrupt enterprises are not protected due to the lack of contract enforcement mechanisms. The government frequently uses boilerplate employee settlement plans, which place employees from bankrupt SOEs into a second enterprise (either state owned or privately owned). These employees often are forced to enter into labor contracts that infringe upon their rights as guaranteed by the employee settlement plans. Such arrangements are fraught with legal problems.

- Only a few professional intermediary service organizations involved in bankruptcy cases Professional services for handling bankruptcy cases are uncommon and rudimentary in China. The majority of Chinese liquidation professionals lack experience in handling complicated bankruptcies, resulting in low efficiency and high cost for their work. Only a few law firms and accounting firms have been involved in bankruptcy cases. Moreover, there is no trustee system for handling bankruptcies.

- The Bankruptcy Law and policies are inadequate The existing Bankruptcy Law is hard to implement. Much of its content does not adequately address the complex economic realities of China. SOE bankruptcy procedures are vague and those governing non-SOE bankruptcies are deficient. There is no legal basis for filing bankruptcy for a natural

person, partnership, or corporation. Since there is no reorganization procedure for insolvent enterprises, it is difficult to determine where the responsibility of the managers of the bankrupt enterprises lies. In addition, there are conflicts and inconsistencies between the Bankruptcy Law and existing government policies.

- Fake bankruptcy cases Some enterprises dodge their liabilities by declaring bankruptcy after dividing their businesses and changing licenses. Such practices are often supported by local protectionism. A large number of enterprises practice ill-will bankruptcy-a "disappearance act from an entangled situation"-they shift their assets and repudiate their debts by taking advantage of the bankruptcy procedure.
- Confusing guarantee relations In China, enterprises often give unsubstantiated guarantees to each other, resulting in duplicate pledges of the same asset. Guarantees are often given without careful documentation, creating hidden liabilities that lead to chain reaction bankruptcies. One reason for such confusing guarantee relations is that governmental administrative agencies designate guarantees. Guarantee relations are also affected by the policy that any proceeds from bankruptcy proceedings must be used for employee settlement first. For example, proceeds from transferring land-use-rights, no matter whether the right has been given out in pledge or not, must first be used for settling employee. The mortgagors are thus unable to enjoy their rightful repayment priority.
- Creditor's rights and liabilities are difficult to evaluate The unsound accounting system for SOEs makes it difficult to evaluate creditor's rights and liabilities accurately. Because enterprises often keep two books-their own accounting books and their "official" books, it is extremely burdensome for creditors to produce concrete evidence from accounting records to substantiate their claims. Furthermore, there is a two-year statute of limitation for asserting creditor rights in courts. Unaware of their legal rights, creditors often either miss the two-year time limit or fail to produce evidence that tolls the statute of limitations. To complicate things further, government funding to SOEs could be converted into debt upon the occurrence of certain triggering events. The nature of liabilities is often unclear.
- The difficulty of converting bankruptcy assets to cash There is often a discrepancy between the appraisal value of bankruptcy property and its market value. Property values are currently determined by governmental assessment agencies, often at levels substantially higher than market values. It is thus difficult to sell bankrupt property to settle employee and creditor claims. To solve this problem, bankruptcy property should be assessed by experts in line with its real value, and sold through auctions to realize their market values.
- Bankruptcy concerning enterprises with foreign participation Myriad problems arise in the bankruptcy of Sino-foreign joint ventures. It is unclear who bears the responsibility after the bankruptcy of such joint ventures because there is no adequate bankruptcy procedure for enterprises with foreign investment or participation. The current bankruptcy law does not provide sufficient protections for foreign investors. This lack of protection partly stems from the fact that detailed provisions regarding foreign creditors are missing from the existing bankruptcy law. The 1999 bankruptcy case of Guangdong International Trust and Investment Company (GITIC) illustrates this problem. Foreign investors made loans to GITIC, on which GITIC defaulted when it declared bankruptcy. In the bankruptcy proceeding, it became apparent that the existing bankruptcy law provided little guidance on these foreign creditors' rights and how these foreign investors should proceed.
- Unfair preferential policies on bankruptcy Only SOEs in the 111 pilot cities (out of 665 cities nationwide) that are covered by the government's experimental program can benefit from preferential bankruptcy policies, such as the ability to write off bad debts. All enterprises in non-pilot cities and non-SOEs in pilot cities are denied such preferential treatment. Future Prospects for the Application of Bankruptcy Law in China China has encountered numerous difficulties in carrying out SOE bankruptcies because the existing bankruptcy law is fraught with ambiguities and deficiencies. However, after twelve years of practice and experimentation, especially after the establishment of a framework for market economic reform in China in 1993, a macro environment for broadening bankruptcy practice has emerged.
- China needs a bankruptcy system Some scholars argue that bankruptcy law is not suitable for the national conditions in China. Nevertheless, twelve years of practice with bankruptcy law, combined with the deepening of the SOE reform and the development of the market economy, have persuaded many Chinese of the country's need for a new bankruptcy law. Bankruptcies have become an inevitable economic reality. Recently, many scholars and entrepreneurs, particularly creditors, have advocated the replacement of the existing bankruptcy law with a new bankruptcy law that is more suitable for the new market economy. The original bankruptcy law is out of date with current realities. First, a large number of companies not owned by the government have been established under the rules of the new market economy in the twenty years since economic reforms began. These companies expect to operate within a legal framework more suited for a market economy. Clearly, the original bankruptcy law cannot apply to these companies. Second, even for money-losing SOEs that still carry the inertia of the planned economic system, the inevitable transition to market economy has made the existing bankruptcy law inadequate.
- Great attention paid by the top Chinese leadership to the implementation of a bankruptcy system In the report of the 15th Party Congress of Autumn 1997 and by the central government led by Premier Zhu Rongji, much emphasis was placed on "well-regulated bankruptcies, implementation of the re-employment program and improving the work on the SOE bankruptcy experiment". The central government has also decided to set aside more than RMB100 billion (US\$12 billion) in bad-loan deposit funds for state banks to write off losses caused by mergers and bankruptcies from 1997 to 2000. The government has issued a series of specific bankruptcy policies in 111 pilot cities. In 2000, the application of these new bankruptcy policies has been extended to all cities.
- A legal system relevant to the bankruptcy law is gradually improving In recent years, China has issued a number of new laws and regulations such as the Corporation Law, the Partnership Law, the Labor Law, the Commercial Banking Law, the Guarantee Law, the Insurance Law, the Regulations on the Unemployment Insurance of SOE Employees and the Securities Law. These laws provide new legal bases for creditors and debtors to file for bankruptcy. The Chinese

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government has also sped up reform in the social security system for unemployment, health, housing, and seniors. However, these new laws often conflict with the existing Bankruptcy Law because it was enacted earlier and lacks corresponding provisions.

- A new bankruptcy legislation has been drafted and placed on the legislation agenda of the Chinese legislature. Drawing on the experience of developed countries and incorporating global trends in bankruptcy law, the draft of the new bankruptcy legislation is intended to adapt to the new market economy in China. It contains detailed provisions that broaden the scope of bankruptcy application, set up simple and streamlined bankruptcy procedures, improve the court's standing in bankruptcy case hearings, better protect the creditors' interests, establish a trustee system, re-create a reorganization mechanism, and establish a special procedure for SOE bankruptcies.<sup>6</sup> After twelve years, a new stage in bankruptcy practice has arrived. It will have far-reaching impact on the deepening of China's economic reforms, in particular SOE reform, and on the establishment of an improved market economy. There is every reason to believe that the future of the enforcement of a bankruptcy law is bright, despite the challenges that lie ahead. (Translated by Yuhua Chen)

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