



**UNDERSTANDING THE CONSTRAINTS ON
THE OPERATION OF
CORPORATE INSOLVENCY LAW
IN THE ECONOMIC TRANSITION
OF DEVELOPING COUNTRIES:
THE CASE OF CHINA**

A thesis submitted for the degree of Doctor of Philosophy

by

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To my family for their support, love and inspiration.

You mean the world to me.

一不做，二不休。

Either don't do it at all, or persevere till the end.

ABSTRACT

This thesis seeks to contribute to our understanding of why creditors and debtors do not ordinarily use China's reformed Enterprise Bankruptcy Law ('EBL'), whether the low use of the EBL is problematic, and if so, what can be done to ensure a more efficient resolution of corporate insolvencies and corporate financial distress in China. The EBL has been lauded – domestically and internationally – as a major legislative success. However, despite the rapidly growing number of companies, level of corporate indebtedness and non-performing loans – which should, one might expect, lead to an increase in the use of the EBL – the number of court-run insolvency cases has in fact been decreasing since the law was implemented in 2007. The thesis draws on newly collected insights from a series of interviews in China – to supplement the scarce and often incoherent data that is available – to determine what motivates debtors and creditors not to use the EBL. The findings are presented as four complementary constraints on a more effective and efficient operation of the EBL. First two constraints relate to the low payoffs under the EBL that debtors and creditors expect to receive due to (i) flaws in the EBL itself and (ii) problems in surrounding non-bankruptcy rules and practices that reduce or prevent recoveries under the EBL. A third constraint affects those debtors and creditors who wish to use the EBL despite the low expected payoffs – for example to avoid directors' liability for corporate insolvency – but are prevented from doing so due to (iii) potential enforcers' limitations and biases. A fourth and final constraint on the use of the EBL that reinforces debtors' and creditors' unwillingness to use the EBL is (iv) the parties' (often inaccurate) perception that alternative debt enforcement mechanisms may offer comparatively higher payoffs (v. the EBL). Building on this discussion, the thesis then considers the desirability of, and options for, reform. It argues that reform and subsequent greater use of court-enforced insolvency law

are desirable in China because the (reformed) EBL has the potential to contribute to economic development through more efficient resolution of complex financial distress; better control of bad debt; easier and cheaper corporate financing; more efficient allocation of resources; and more entrepreneurial activity. However, because the necessary changes to deliver this are likely to be slow in coming, it proposes a dual-track reform encompassing (i) substantive reform of the EBL and select non-bankruptcy laws and practices; accompanied by (ii) the introduction of a new speedy, independent and confidential mechanism for insolvency resolution, 'MedArb.'

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ADR	alternative dispute resolution
AMC	asset management company
Big Four	four biggest state-owned banks in China
CBRC	the China Banking Regulatory Commission
Chapter 7	the US Bankruptcy Code, Chapter 7 (Liquidation)
Chapter 11	the US Bankruptcy Code, Chapter 11 (Reorganisation)
China	the People's Republic of China
CIETAC	the China International Economic and Trade Arbitration Commission
Constitution	the Constitution of the People's Republic of China
CPPCC	the Chinese People's Political Consultative Conferences
DDR	diversified dispute resolution (a Chinese term for alternative dispute resolution)
EBL	the Enterprise Bankruptcy Law
FDI	foreign direct investment
FT	the Financial Times (newspaper)
GDP	gross domestic product
IMF	the International Monetary Fund
JV	joint venture
Med-Arb	a combination of mediation and arbitration, very popular in China
NBS	the National Bureau of Statistics
NPC	the National People's Congress
NPL	non-performing loan
P2P	peer-to-peer lending
the Party	the Communist Party of People's Republic of China
the parties	creditors and debtors eligible to use the EBL (see Chapter 4.3.2.2)
PBoC	the People's Bank of China
RMB	Renminbi, official currency in China
SASAC	the State-owned Assets Supervision and Administration Commission of the State Council
SCMP	the South China Morning Post (newspaper)

SEZ	a special economic zone
SMEs	small and medium enterprises
SOE	a state-owned enterprise
SPC	the Supreme People's Court
SPCM	Supreme People's Court Monitor (blog)
state company	a company that belongs to the state sector (see Chapter 3.4)
UNCITRAL	the United Nations Commission on International Trade Law
WMP	wealth management product(s)
WSJ	the Wall Street Journal (newspaper)
WTO	the World Trade Organisation

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Chapter 1. INTRODUCTION

The focus of this thesis is corporate insolvency law in China. China's Enterprise Bankruptcy Law ('EBL') of 2006 has been lauded – domestically and internationally – as a major legislative success. However, it has been only rarely used. This thesis explores why creditors and debtors – i.e. the parties authorised to invoke the EBL ('the parties') – do not ordinarily use the EBL. It then considers whether the low use of the EBL is problematic, and if so, what can be done to ameliorate the problem.

The economic literature emphasises the importance of a well-functioning insolvency law for enabling a greater supply of cheaper credit and a more efficient allocation of resources.¹ China's economy is growing fast and is subject to intense demand for credit. However, formal (legal) credit is scarce and often made available according to political affiliations rather than financial performance.² In addition, many resources are still stuck in inefficient companies under state protection, shielded from market forces and hard budget constraints and so insufficiently motivated to streamline their business, increase labour productivity and follow consumer demand.

The EBL was introduced in 2006 to replace the much-criticised Insolvency Law 1986, which dated from the early stages of China's transition from plan to market and only dealt with insolvencies of state-owned enterprises ('SOEs'). But despite rapid growth in the number of companies, the level of corporate indebtedness and the frequency non-performing loans, and increasing complexity in commercial dealings – which might be

¹ See Chapter 2.2

² See Chapter 3.3

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expected to engender an increase in the use of the EBL – the number of court-run insolvency cases has actually been decreasing since the EBL was implemented in 2007.

This thesis does not seek to relate the EBL's legislative *history*. Instead, its goals are to contribute to our understanding of, first, *how* corporate insolvency law in China *functions* (and consequently, why it has been so rarely used); secondly, whether it is *desirable* for more insolvency cases to be heard in China; and thirdly, *how* Chinese insolvency law's functioning can be *improved*. The thesis draws on a combination of existing primary sources and secondary literature, as well as original qualitative empirical research. Qualitative empirical research is appropriate for exploring these questions because the existing data are often incomplete, subject to manipulation and even incoherent, and the prior literature on the subject is surprisingly limited. Interviews with parties involved in the EBL process, therefore, provide richer insights into the operation of the law.

In response to the central enquiries, identified in the previous paragraph, this thesis presents four inter-connected constraints which appear to disincentivise the parties from using the EBL to recover debts and resolve corporate financial distress.³ Building on this analysis, the thesis goes on to argue that greater use of insolvency law is desirable in China.⁴ It then proposes a dual-track reform, encompassing substantive reform of the EBL and supporting laws accompanied by the introduction of a new mechanism for corporate insolvency, 'MedArb,' which it is argued would enable faster, confidential and independent

³ See Chapter 5

⁴ See Chapter 6.1

application of the EBL to a greater number of distressed companies than the court-driven EBL as presently enforced.⁵

1.1 The scope of the thesis

This thesis focuses solely on *corporate* insolvency law in China. As China does not yet have a personal bankruptcy law, and because the term ‘bankruptcy’ is often used for corporate insolvency in China, the terms ‘bankruptcy’ and ‘insolvency’ are used interchangeably throughout as meaning corporate insolvency law. The term ‘financial distress’ is also used as a factual description of cash-flow or balance-sheet financial problems which can be resolved in court. The main focus of the discussion is on *collective* corporate insolvency procedures mediated and enforced by courts under the EBL. Other debt enforcement mechanisms – in and out of court – are only discussed by way of comparison with the operation of the EBL. Moreover, the focus of the thesis is on *formal* (law-based) collective insolvency procedures under the EBL. Non-insolvency formal enforcement mechanisms (such as court debt enforcement or the enforcement of individual security interests) and informal enforcement mechanisms (such as reputation or politically-driven bailouts) are discussed not as objects of study in their own right, but rather to enable a better understanding of the circumstances under which the parties choose (not) to use the EBL. As such, this thesis does not aim to provide exhaustive description or analysis of such mechanisms.

In seeking to understand the operation of the EBL, the thesis explores both the law ‘on the books’ (i.e. law as written) and the ‘law in practice’ (i.e. law as enforced). The discussion of how the EBL is used in practice, and in particular why the parties do not use

⁵ See Chapters 6.2 and 7

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the EBL, is informed by qualitative empirical research taking the form of open-ended interviews and, where available, existing data and secondary literature. Qualitative empirical research provides valuable insights into subjects' perceptions and the way in which processes play out in practice. As such, it helps in the thesis' presentation of a richer and more granular understanding of the operation of the EBL in China.

The thesis focuses on the period from June 2007 – when the EBL was implemented – to 2016 – when the last interviews were conducted and the last available data were provided. Some references are made to the pre-2007 period, mostly with the aim to provide historical context (Chapter 3 and Chapter 4.1) and to illustrate and enable comparison of the EBL and the Insolvency Law 1986 ('the old law').

The thesis is an *intra*-country study. It aims to examine the EBL and understand its (non-)operation in practice. A core part of the positive analysis consists of an exploration of the alternatives open to the parties to using formal insolvency proceedings and comparison of their expected payoffs under the EBL with these alternative enforcement mechanisms. For the purposes of this thesis, the relevance of corporate insolvency laws in other countries is, therefore, limited to a discussion of, firstly, the benefits of a well-functioning corporate insolvency law (in Chapter 2.2-3, and its application to China in Chapter 6.1); secondly, the solutions to particular problems in other jurisdictions which were influential when drafting the EBL (in Chapter 4); and thirdly, the number of EBL cases in China compared to other jurisdictions (in Chapters 4.3 and 6.1.1.2).

While the specific combination of institutions present in China is unlikely to be replicated elsewhere, particular aspects are likely to be shared with other emerging markets, and so aspects of the thesis' analysis may well be of broader interest.

1.2 Research design, methodology and challenges

The design of this research has developed over time in response to limited availability and quality of prior data and analysis, as well as restrictions on the access to interviewees in China.⁶ Due to the limitations of the prior data and analysis, I decided to conduct a series of interviews with those who are authorised to invoke the EBL – debtors and creditors – and those who influence whether and how the EBL is used in practice – most importantly judges, local government officials, practitioners, and other experts. I was also fortunate to be invited to take part in a commercial law reform project in China in 2016 and to host two Supreme People’s Court judges at the University of Oxford for two months in early 2017 and benefit from many insightful conversations with them, for which I am very grateful. This has enabled me to gain insights into the reasoning of the primary decision-makers and secondary influencers who, in the aggregate, determine whether and how the EBL gets used. These insights are presented and examined in Chapter 5.

During my interviews, it also became clear that describing the limitations on the effective use of the EBL only told half of the story. The other half was whether the low use of the EBL matters, and if so, what can be done about it. I decided to pursue these questions mostly because China’s official policy towards the use of the EBL started changing in late 2015 – largely in response to China’s economic slowdown. However, my discussion with policy makers and consultants revealed that they often did not understand why insolvency law matters *to China*. The reasons are discussed in Chapter 6.

⁶ The arguments in this thesis build on my earlier (2013) MSt thesis entitled “The Puzzle of Chinese Bankruptcy Law,” which explored possible reasons why the newly reformed EBL is not used in practice. However, the MSt thesis was based only on existing literature and my preliminary research during my one-year stay at the Wuhan University in China. Therefore, it lacked empirical evidence to support many of the claims. It also gave rise to many further questions which the existing data and literature had not answered.

Moreover, the proposed changes addressed only one of the four reasons that my interviewees identified as causing the low use of the EBL – the written provisions of the EBL. It, therefore, became apparent that it may be useful to explore not only the plausible causes but also possible solutions to the non-use of the EBL. These are explored in Chapter 7.

In seeking to explain the reasons why the parties do (not) use the EBL, I consider their incentives on the assumption that they behave rationally with a view to maximising their returns.⁷ A functional approach of this type is commonly relied upon in the literature regarding insolvency laws in developing and emerging markets.⁸ Although it is, of course, not the case that all parties behave rationally at all times, starting from an assumption that parties seek to maximise their returns – particularly in arms-length dealings – yields useful predictions about aggregate patterns of behaviour.⁹ A functional approach is, therefore, adopted to analyse the existing and newly collected data. This forms the basis of the positive analysis in Chapter 5 and also informs the normative analysis in Chapters 6 and 7.

The data has been collected using a mixed methods approach. Wherever possible, primary sources (most importantly legislative provisions, the Supreme People's Court's decisions and interpretation notes), statistical data and existing analysis have been included to frame the discussion. However, these materials provide numerous challenges, which make black-letter analysis and quantitative analysis problematic and unrepresentative. First, Chinese courts – like courts in many other developing countries – do not necessarily enforce

⁷ The theoretical framework is explained in Chapter 2.1

⁸ This is explained more fully in Chapter 2.2

⁹ If rationality is not assumed, it is very hard to make any predictions: irrational behaviour is by definition unpredictable, because there are many different forms it may take.

the law as written. Therefore, legislative provisions have only limited explanatory value of what happens in practice. Moreover, the Chinese legal system is an amalgamation of common and civil law tradition, and the role of previous decisions from lower courts and the Supreme People's Court statements is still unclear.¹⁰

Second, the existing data is often incomplete, manipulated and incoherent. Definitions and the calculation methods used to produce such data change from year to year, which prevents accurate comparison. In addition, data is often missing for different provinces in different years or is missing altogether for a part of the studied period. Also, national-level corporate insolvency data is not broken down to individual procedures, and data about EBL filings and their treatment is mostly unavailable. Moreover, there is evidence that some data from companies and local governments are falsified.¹¹ And finally, there is surprisingly little analysis of the EBL and its use. There are several practitioners' summaries of the EBL as written, but there is no (empirical) academic literature on the question of the (lack of) use of the EBL or its causes. What's more, a lot of background information which is necessary to support or explain my interviewees' arguments have not been discussed (nor analysed) in English-language literature and have no or only limited coverage in Chinese-language literature.¹² Part I, therefore, provides the relevant background information to enable the reader to better appreciate and understand the arguments in this thesis.

¹⁰ See Chapter 3.4

¹¹ See Chapter 4.1.3.1

¹² Examples include so-called 'ghost companies:' Chapter 4.1.3.4

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Due to these shortcomings of the existing data and literature, this thesis makes use of qualitative empirical research to provide insights into the major constraints on parties' willingness to invoke the law and what plausible reform options exist. I conducted 67 semi-structured interviews with practitioners, judges, entrepreneurs, policy-makers and experts in China and abroad. My approach to the selection of the interviewees was three-fold. Firstly, I relied on my existing contacts network consisting of my Chinese friends and colleagues from my undergraduate and postgraduate Law studies in the UK; experts I met during my academic stay in China, Australia and the US; and participants in China-related conferences and projects. Secondly, I relied on recommendations and referrals from my contacts and interviewees. And thirdly, I conducted a random search on the Internet, and in particular the Chambers and Partners database¹³ (Asia-Pacific > China > PRC Firms in the areas of Finance, Commercial dispute resolution, Corporate/Commercial, and Restructuring/Insolvency) to identify top practitioners with relevant experience and insight.

Interviewees were chosen according to their ability to provide insights about (i) what mechanisms are used by creditors to enforce their debts and by debtors to resolve their insolvency/financial distress, and why; (ii) how courts view and use the EBL, and why; and (iii) what has shaped the particular rules and policies that determine how the EBL is implemented in practice. A complete list of all 67 interviewees is provided in Appendix I. It details the region, economic sector, and level of experience and seniority of each interviewee. In order to ensure confidentiality for my interviewees (for the purpose of enabling them to speak freely), however, identities of all interviewees are coded. For the

¹³ <http://www.chambersandpartners.com/guide/asia/8/60/1>

same reason, the interviews were not recorded. Instead, I took extensive (typed and hand-written) notes and relied on documents provided by the interviewees during and after the interviews.¹⁴ Before each meeting, the relevant interviewee was informed of the broad areas of enquiry, but the exact questions were not made known to them in advance. The interviews were all structured in the same way – a list of questions is provided in Appendix II – but each interviewee was given space and time to go beyond the questions asked. This has provided further insights which, although not covered by all the interviews, offered new avenues and possible answers previously ignored in the literature and my research plan. The working languages were English and Mandarin Chinese. Most of the interviews took place in China.

While every effort has been made to ensure the integrity of the data, my empirical methodology has several limitations which may nevertheless have impacted the quality of the collected data. Firstly, the results of my interviews are not strictly comparable. Although I used the same questions as the starting point for all my interviews, often individual interviewees expanded on different points or refocused the conversation on their particular area of interest or expertise.¹⁵ Moreover, additional questions evolved over time. There were several instances in the earlier interviews which led to the identification of further, previously overlooked issues. These were, therefore, only included in later interviews.

Secondly, the views expressed by non-randomly selected interviewees do not necessarily provide an objective overview of the practices in China in general. I made an

¹⁴ Some of my interviews gave me access to internal documents. These included internal court data, internal bank analyses, and private think tank reports. These are referenced throughout the text.

¹⁵ Notwithstanding the drawbacks, allowing the interviewees to comment on issues beyond the questions and to focus on some questions more than others provided novel insights and identified many issues which had been ignored in prior literature.

effort to diversify the insights by choosing interviewees who could comment on state as well as private companies, on small as well as large players, and whose experience was focused in a single province or sector as well as those with multi-regional and multi-disciplinary focus. Nevertheless, the interviews could only share their (and, at times, their clients' or colleagues') individual experiences, which may not be shared by other practitioners and experts in China.

Thirdly, the results may also suffer from a selection bias. Of the 67 interviews, 42 were my professional contacts from conferences, projects and my academic stays abroad and 9 were randomly sampled experts who were identified through an Internet search and contacted without recommendation or referral.¹⁶ However, the remaining 16 were recommendations and referrals from my contacts and interviewees. The main problem with such method (so-called snowball sampling) is that the interconnectedness of the participants may adversely affect the representativeness of their answers.¹⁷ In this thesis, I have tried to counter this effect by including insights from both connected and randomly selected interviewees. To enable the reader to determine the level of resulting bias in any given claim, the interviewees' identities are coded to reflect how I gained access to them.¹⁸

Nevertheless, despite the limitations of the interview data, this thesis offers new and valuable in-depth process insights¹⁹ into the reasons for the low use of the EBL which would be difficult to get otherwise. This is due to the problems associated with the existing data

¹⁶ See Appendix I

¹⁷ See e.g. Biernacki and Waldorf (1981)

¹⁸ I.e. all randomly sampled interviewees are coded as 'R' plus a number; all interviews with my professional contacts are coded as 'C' plus a number; and all interviews tainted by the snowball method are coded as 'S' plus a number

¹⁹ See e.g. Elster (1989)

and research, discussed above, and because creating new qualitative and quantitative data is hindered by the language and limited access to knowledgeable and cooperative interviewees. The sampling methods used resulted from a necessary trade-off between access to data and quality of data. As a result, although the project provides plausible rather than definite answers, it enriches our understanding of how the EBL works, what may be the main constraints on its use, and what the reform options are.

1.3 Structure of the thesis

This thesis is divided into three parts. Part I consists of three chapters which explain the relevant context to the central enquiries, which are then explored in Parts II and III. Chapter 2 defines the role of corporate insolvency law and summarises the economic literature on possible contributions of a well-functioning insolvency law in economic development. This provides theoretical and empirical drive behind many national-level economic policies and legislation. Chapter 3 then provides China-related historical and socio-economic context which is necessary for a full appreciation of the arguments in Parts II and III. It draws largely on existing literature (in English and in Chinese) and my original research in China. Finally, Chapter 4 looks at the provision and enforcement of debt in China, provides an overview of the EBL, and presents the statistics on EBL's limited use. It focuses on the law on the books. It draws on primary and secondary literature (in Chinese and in English), practitioners' commentaries, and my original research.

The main findings and arguments are then presented in Parts II and III. Part II seeks to answer the first research question introduced at the beginning of this chapter, namely *why the parties so rarely use corporate insolvency law in China*. It proposes that there are four inter-linked reasons, four constraints on the use of the EBL which may disincentivise

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the parties from using it. The first constraint stems from flaws in the substance of the EBL, which reduce expected payoffs of the parties and so discourage them from using the EBL in the first place. The second constraint relates to the flaws in supporting rules and practices that reduce or prevent recoveries under the EBL. The third constraint identified in my interviews relates to the limitations in formal (court-driven) enforcement of the EBL which does not work well due to the political influence over Chinese judiciary. As a result, the parties are either excluded from using the EBL, or their EBL cases are heavily influenced by local governments. The fourth and final constraint on the use of the EBL is that the parties perceive the non-EBL alternative debt enforcement mechanisms as offering them a comparatively greater satisfaction of their financial and non-financial interests. Consequently, the parties often use them instead of the EBL.

Building on the positive analysis of these constraints on the use of the EBL, Part III then turns to the second and third research questions, which are more normative in character. They are, respectively, *whether greater use of the EBL is desirable for Chinese economy* (Chapter 6), and if so, *what are the reform options* (Chapter 7). It is argued that greater use of the EBL is desirable because it can ensure more efficient resolution of corporate financial distress and insolvency than alternative debt enforcement mechanisms. This is particularly important in insolvencies of privately-owned medium-sized companies which cannot rely on the state's help, but whose financial problems are too complex for non-EBL enforcement alternatives which are available to them. In the long term, moreover, the proposed improvements would likely benefit all companies (including those owned or controlled by the state) thanks to the comparatively greater transparency, objectivity, predictability, efficiency and fairness of the reformed EBL. Many of the regulatory and

institutional constraints, however, are firmly established and so the necessary changes are likely to be slow.

In light of these considerations, a dual-track reform is proposed that would encompass (i) substantive reform of the EBL and supporting laws and practices;²⁰ accompanied by (ii) the introduction of a new mechanism for insolvency resolution, 'MedArb,' which would combine the advantages of both mediation and arbitration to achieve speedy, discreet and independent application of the EBL according to the individual needs of the parties. The proposed mechanism has a potential to deliver improved enforcement of the EBL, as compared to existing judicial institutions. It could also provide higher payoffs than are currently available under the EBL and the non-EBL alternative enforcement mechanisms.

1.4 Contribution of the thesis

The contribution of this thesis is two-fold. Firstly, it adds granularity to our understanding and advances plausible explanations to why the EBL has been so rarely used to deal with companies' insolvencies and financial distress in China.²¹ The accompanying positive analysis offers original process insights into how the EBL is implemented. In particular, it sheds light on what factors influence debtors, creditors, courts and state vis-à-vis the EBL process. It provides further evidence for the existing claims that state-owned and state-controlled companies are treated differently from private companies.²² However, my

²⁰ This follows a similar structure as Part II: substantive reform of the EBL is discussed first (first constraint, Chapter 5.1), followed by analysis of substantive reform of supporting rules and policies (second constraint, Chapter 5.2) and of reform of the judiciary and local governments (third constraint, Chapter 5.3).

²¹ It also provides insights into what is used instead – see Chapter 5.4

²² The general literature on state ownership and state control is discussed in Chapter 3.4

research suggests that state control may be more extensive in the context of corporate insolvency than was previously thought, in that state control of non-SOEs covers not only previously state-owned and indirectly state-owned companies, but also purely private companies which are ‘economically significant’ for the local economy.²³

Secondly, the thesis contributes to the discussion of the utility of corporate insolvency law reform through a case study of China’s failed reform, examination of its consequences and a proposal for possible solutions. It argues that China should ensure a greater use of corporate insolvency law to facilitate further economic development and provides recommendations for the best way forward. It analyses the likely obstacles to the reform process but even taking these into consideration, recommends that China has much to gain from substantial reform of the EBL and surrounding laws, and from a procedural separation of the judiciary from the state. However, given the expected opposition to some of the direct reform proposals, it also proposes a new opt-in mechanism, MedArb, which would enable a greater use of the EBL for those who wish to but are debarred from using the EBL within the formal court structure.

I also hope that my findings may be of use in other developing countries which face similar challenges as those I have identified in the context of China. Chapter 8 includes an outline of such possible lessons.

²³ *Ibid.*

PART I: RELEVANT BACKGROUND

Chapter 2. ANALYTICAL FRAMEWORK FOR STUDYING THE ROLE OF INSOLVENCY LAW IN ECONOMIC TRANSITION

This chapter introduces the thesis' analytical framework. The analytic tools described below are first used in the positive analysis of Chapter 5 to interpret the collected data and existing literature about why the empowered parties – creditors and debtors – do not use the EBL to resolve debtor's financial distress. The same tools are then used in the normative analysis of Chapters 6 and 7 to evaluate whether it is desirable that the parties use the EBL more and what can be done to achieve it.

This chapter first sets out the basic theoretical framework of economic analysis of law, looking at what is meant by a *functional approach* to studying insolvency law, what analytical tools it uses, and what are its limitations (2.1). It then looks at insolvency law through the lens of economic analysis. It focuses in particular on what the literature says about the underlying goals that justify the use of insolvency law to disturb independently agreed debt contracts in case of debtor's insolvency (2.2). Finally, the chapter examines the literature about the role of insolvency law in transition to a market economy (2.3).

2.1 Theoretical framework: economic analysis of law

Economic analysis of law – that is, the use of economic methodology to analyse and evaluate law – dates back at least to the 1960s.²⁴ Its aim is to understand parties' decision-

²⁴ See e.g. The Oxford Handbook of Law and Economics (2017, OUP), Vol.1 Chapter 1

making through studying their ‘incentives’ created by the desirability of outcomes of different options that are open to them.²⁵ Standard microeconomic rational choice theory abstracts from moral and other non-legal values (including social norms), but they can be incorporated into payoff structure and taken into account when analysing parties’ decision-making.²⁶ Neo-institutional economists in the 1980s and 1990s²⁷ – most notably its founder, Douglass North – suggested that parties rely not only on written laws but on ‘any form of constraint that human beings devise to shape human interaction.’²⁸ Thus, parties are influenced in their decision-making by ‘institutions,’ that is all basic and stable mechanisms that govern players’ incentives and coordinate activities in multilateral interactions.²⁹ Informal social norms, therefore, coexist with laws and together create incentives that shape parties’ choices.³⁰

Traditionally, economic analysis of law relies on the assumption that all parties are ‘rational’ – that is, that parties always make well-informed, prudent and logical decisions based on their analysis of the costs and benefits of each option that is open to them. Once they evaluate each option from this perspective – and so determine their predicted ‘payoffs’ of each option – they choose the option that offers them the highest payoffs.³¹

²⁵ On this view, law is treated as providing parties with price-like signals that guide them toward certain behaviour

²⁶ Elster (2015); Koford and Miller (1991)

²⁷ See e.g. The Oxford Handbook (n.24), Vol.1 Chapter 22

²⁸ See North (1981) at 4. See also North (1990)

²⁹ See Xu (2011) at 1078

³⁰ For more on this co-existence, see Chapter 3.3.1

³¹ See e.g. The Oxford Handbook (n.24), Vol.1 Chapter 2

However, parties are not always rational in this way. They often rely on incomplete information, they may not know all their options, they may not know all the costs and benefits of each option, they may not be able to evaluate what payoffs to expect in each option.³² This is referred to as ‘bounded rationality.’³³ When examining parties’ decision-making in this thesis, it will be assumed that parties rely on ‘bounded rationality,’ and the influence of a wide range of ‘institutions’ – as defined above – will be considered.

Finally, three key economic concepts will be used to analyse what constraints prevent the parties from using the EBL, namely incentives, payoffs, and efficiency. ‘Incentives’ are concerned with motivating parties to act in a particular way. They can be remunerative (usually money-related); moral (e.g. guilt, admiration, social inclusion/exclusion); coercive (e.g. imprisonment, confiscation); and natural (e.g. fear, anger).³⁴ The basic incentive mechanism in economics is the price system. Economic analysis of law treats laws as conveying price-like signals; the new institutional economics extends this framework to other social institutions such as societal norms. Laws and other rules are then seen as defining a preferred type of behaviour and deterring (i.e. increasing the cost of) all other. They can function as a carrot – carrying rewards for complying – or a stick – punishing non-compliance.³⁵ In the context of insolvency law, incentives encourage preferred modes of use of the law – to restructure or liquidate under court supervision – at

³² See Simon (1979) at 502

³³ Note that an additional field of study – behavioural economics – also questions the rationality of the decision-making process. One of the issues is that real-life parties are often influenced by their inner ‘biases’ – i.e. irrational personal fears and preferences, cultural preferences, etc.: the Oxford Handbook (n.24), Vol.1 Chapter 4

³⁴ See e.g. Dalkir (2013)

³⁵ For more, see the Oxford Handbook (n.24), Vo.1 Chapter 21

a preferred point in time – once insolvent (in China) or before (other jurisdictions).³⁶ They also order courts and administrators to carry out certain powers that can increase the pool of assets that are available for redistribution in insolvency.³⁷ They also encourage debtors to cooperate and accept a collective solution. Parties rarely act in isolation, and so their incentives – and interests – may clash with those around them. Similarly, parties may be incentivised to act in more than one way, which may lead them having to consider particular ‘trade-offs.’ These trade-offs may be inherent in the nature of the options, or they may be determined by the impact of expected choices of other parties.³⁸

Another important concept in economic modelling is the idea of parties’ ‘payoffs.’ A payoff is a value – monetary or otherwise – received as a result of a party’s decision. However, because parties often consider the likely impact of their actions before making a decision (*ex ante*), this thesis mostly uses the concept of expected payoffs. This method uses backward-induction to determine the likely outcomes and payoffs of parties’ options. A party knows that they have several options for how they can act – for example, to repay a debt or not to repay. They then try to estimate what would be the outcome of these options – for example, imprisonment, a fine, other legal consequences, violence, threats, or nothing. Their payoffs are determined by the value of each action – for example, keeping all the money in case of non-repayment – in the light of the likelihood of each outcome. This payoff matrix takes into account unilateral decision-making. Often, however, parties make decisions in bilateral interactions where each party wants to maximise their own

³⁶ For more, see Chapter 4.3.2.2

³⁷ For more, see Chapters 4.3.2.6 and 5.3.2

³⁸ For more, see discussion about game theory, below

payoffs – monetary or otherwise³⁹ – while taking into account the likely decision or reaction of the other party.⁴⁰ This *strategic* interaction can be simulated, and outcomes predicted, using the game theory model.⁴¹

Finally, the quality of China’s insolvency law – on paper and in practice – will be examined against the yardstick of ‘economic efficiency.’ This will involve a procedural assessment of whether resources are optimally allocated to carry out distributional goals of insolvency law – as examined in Chapter 2.2 – with no or minimal waste. Insolvency law and practice can be said to be economically efficient where resources are allocated for the benefit of the whole and any one stakeholder’s situation cannot be improved without making another stakeholder worse off.⁴²

Economic analysis of law offers valuable insights into why parties decide to act in a particular way. In the context of this thesis, they help analyse why debtors and creditors in China tend to choose not to use the EBL. However, there are several limitations in using economic theories to explain real-life behaviour.⁴³ The first limitation is that the underlying assumptions may not hold true in all cases. The impact can be minimised by relaxing certain

³⁹ NB: players’ bounded rationality can influence this model and its inputs. See The Oxford Handbook (n.24), Vol.1 Chapter 19

⁴⁰ See von Neumann (1944) and the equilibrium analysis by Nash (1950). The strategy that is best for both players when taking into account the other player’s strategy, where neither player is better off by any other strategy – this is known as the Nash equilibrium

⁴¹ *Ibid.*

⁴² This is known as ‘Pareto efficiency.’ An extension of this concept is ‘Kaldor-Hicks efficiency.’ Kaldor-Hicks improvement is a reallocation of resources where those that are made better off could hypothetically compensate those harmed by the reallocation. Kaldor-Hicks efficiency arises where no potential Kaldor-Hicks improvements exist: see The Oxford Handbook (n.24), Vol.1 Chapter 2.3. See also Posner (1972); Posner (2007)

⁴³ For an in-depth analysis and discussion, see The Oxford Handbook (n.24), Vol.1 Chapter 15

assumptions (behavioural economics) and including a greater range of rules (neo-institutional economics). Although such models cannot fully explain and predict the behaviour of all parties, it is a good approximation and a useful starting point in the analysis. Moreover, assuming (bounded) rationality delivers more tractable theoretical predictions than assuming irrationality.

The second limitation arises from the fact that economic analysis of law offers a theory about why the EBL is so rarely used, but it cannot differentiate between multiple causes that are identified as possibly contributing to the law's low use. Similarly, observing the law's low use alone cannot tell us which of these is the principal cause. Moreover, it is difficult to design an empirical test, using available data, which will adequately identify the relevant causal mechanism in play. To ameliorate this limitation, this thesis relies on interviews with stakeholders and new data to provide more granularity and insight than prior data permits. Nevertheless, presentation of parties' views does not amount to a test of a theory, because (i) interviewees' perspective is limited to their experience, which may not be representative; because (ii) what people *say* and what they *do* are not always the same; and because (iii) sophisticated professional interviewees may present an agenda of their own.

The final limitation arises from the methodology used, namely the difficulty with drawing general representative conclusions from a sample of 67 interviews and several cases studies. Nevertheless, given the scarcity of prior literature and data, the insights drawn from the interviews and case studies add much-needed granularity to our understanding of how the EBL operates in practice and provide a platform for further study.

2.2 Functional approach to studying insolvency law and its goals

Part III,⁴⁴ below, discusses the desirability and options of corporate insolvency law reform in China. The shortcomings of the EBL and surrounding enforcement mechanisms – as identified in Chapter 5 – are evaluated and analysed using two approaches. Firstly, the thesis discusses what would increase the parties' payoffs when using the EBL (v. non-EBL alternatives) and so incentivise them to use the EBL to recover their debts.⁴⁵ In addition, however, the proposed reforms are evaluated using functional analysis which measures 'legal rules and doctrines and institutions by the extent to which they further or achieve the ends for which law exists.'⁴⁶ In the remainder of this section, therefore, the goals of insolvency law are discussed – see Table 2-1 for a summary – that enhance insolvency regime's efficiency, and justify the *ex post* re-distribution of entitlements that arise from *ex ante* independently agreed contracts and relationships.⁴⁷

Table 2-1: Summary of key efficiency-enhancing goals of insolvency law

Key efficiency-enhancing goals
(i) Differentiate between companies that should be reorganised ('saved') and companies that should be liquidated ('sold')
(ii) Discourage or prevent abuse of insolvency law regime by debtors and creditors
(iii) Enable a fair and value-maximising redistribution of assets
(iv) Increase the pool of assets by reversing vulnerable transactions
(v) Encourage timely use of insolvency law to increase payoffs

⁴⁴ i.e. Chapters 6 and 7

⁴⁵ See Chapter 2.1

⁴⁶ Pound (1954) at 42-43

⁴⁷ Commentators do not agree on a closed list of goals of insolvency laws. For an overview, see Armour (2001) For more, see e.g. Jackson (1986) Chapters 2-3; Goode (2011) at 70-79; Casey (2016)

Economists argue that it is not the role of insolvency law to *prevent* corporate risk or corporate failures.⁴⁸ Rather, they assert that insolvency law exists to offer efficient solutions to financially distressed or insolvent companies and those with an economic interest in the company.⁴⁹ In other words, an efficient insolvency law regime must be able to differentiate between which companies should be reorganised and which should be liquidated. The appropriate solution depends on why the company became financially distressed or insolvent in the first place.⁵⁰ Where the problem lies in bad management or inappropriate use of the assets that can be relatively easily fixed, it is efficient to reorganise.⁵¹ In some cases, this will lead to saving a part or whole business.⁵² On the other hand, where the problems originate in the core idea of the business – e.g. because it is unprofitable, or because the trends have changed, and there is no demand – and it would be comparatively⁵³ costly to change it, or where it is caused by external shocks⁵⁴ – e.g. a financial crisis – it is efficient to liquidate and so release the assets to their most efficient

⁴⁸ Nevertheless, it can prevent companies from excessive over-indebtedness by imposing hard-budget constraints and reducing the moral hazard that arises from state bailouts and financial support. For more, see Chapter 6.1

⁴⁹ See e.g. Goode (2011) at 57-59; Finch (2009) at 173
Cf the size of creditor group matters; where the debtor has very few creditors, private workout may be more appropriate than a full court-driven procedure under insolvency law: Kraakman et al (2017) at 142-3

⁵⁰ Coote and Schäfer (2011) at 111; Kraakman et al (2017) Chapter 5.4.2

⁵¹ See Jackson (1986) at 2; The Oxford Handbook (n.24), Vol.2 Chapter 18; Finch (2009) at 151-160

⁵² The company can retain some or all of its assets, repayment agreement under restructuring agreement with all or most of its creditors

⁵³ v. liquidate and either start afresh or transfer the assets to a better use elsewhere

⁵⁴ See Finch (2009) at 161-171

use elsewhere. A sale of the assets – either piecemeal or as a whole – generates money to repay the creditors.

Insolvency law should, therefore, seek to prevent *both* inefficient shutdowns and inefficient survival.⁵⁵ More than that, it should also disincentivise abuse of the process through, for example, strategic defaults whereby debtor company's managers try to avoid having to repay their debts by declaring insolvency, or where company's creditors use the threat of invoking insolvency law to achieve preferential repayment of debt.⁵⁶ The disincentives used – such as fines, criminal and personal liability, loss of licence, etc.⁵⁷ – must be balanced against the need to encourage the use of insolvency law where appropriate.

Moreover, corporate insolvency law sets out a distribution regime which determines who gets paid and in what proportions when a debtor company does not have enough assets to repay all of its liabilities.⁵⁸ Insolvency law employs several techniques to maximise recoveries.⁵⁹ Firstly, it imposes a compulsory and collective mechanism on all claim-holders in order to prevent asset grabbing (in a race to collect). Similarly, it often replaces the existing management or at least places a supervisor in the company to prevent asset stripping by the existing management. For the same reason, it also demands that any major transfer of debtor's property has to be approved by stakeholders or court. In addition, those

⁵⁵ The Oxford Handbook (n.24), Vol.2 Chapter 18.2.2

⁵⁶ Finch (2009) at 176-7

⁵⁷ Penalties were much harsher in the past, and included death penalty, slavery, etc.: *supra* n.54

⁵⁸ The rules about the ability to claim and order of priority differ across countries: see Chapter 4.3.2.7 for a cross-country comparison. For a theoretical discussion see Jackson (1986) Chapter 2

⁵⁹ See Jackson (1986) at 5-6 and Chapter 1

in charge try to reorganise (where efficient) or sell the business or its part(s) – as a going concern, where possible – to maximise the value of debtor's assets and so increase the recovery by claimholders.

However, insolvency law can do more than just safeguard the existing assets: it can also increase the pool of assets – and so increase the total payoffs (v. other debt recovery mechanisms) – by reversing certain 'vulnerable transactions' such as preferential payments, unfair transfers and other benefits. A court or court-empowered practitioner can claw back these assets and reverse or cancel other benefits within a defined period of time prior to the insolvency petition is accepted – so-called twilight period – which augments the total pool of assets available for redistribution to the debtor's claimholders.⁶⁰

And finally, efficient insolvency law regime also encourages a timely use of insolvency law procedures – both liquidation and reorganisation – in order to maximise recoveries. Where managers – as insiders with the best information – know that their company is insolvent or that there is little or no hope of recovery, they need to be incentivised to apply for liquidation. Where they are having problems that they are unable to resolve, or which require expertise that they do not have, managers should be incentivised to apply for reorganisation. This is, however, complicated by the fact that managers are not fully rational, and so they are likely to believe in their ability to resolve the problems and try to trade out of financial distress. Insolvency law and surrounding rules need to balance these conflicting issues.⁶¹

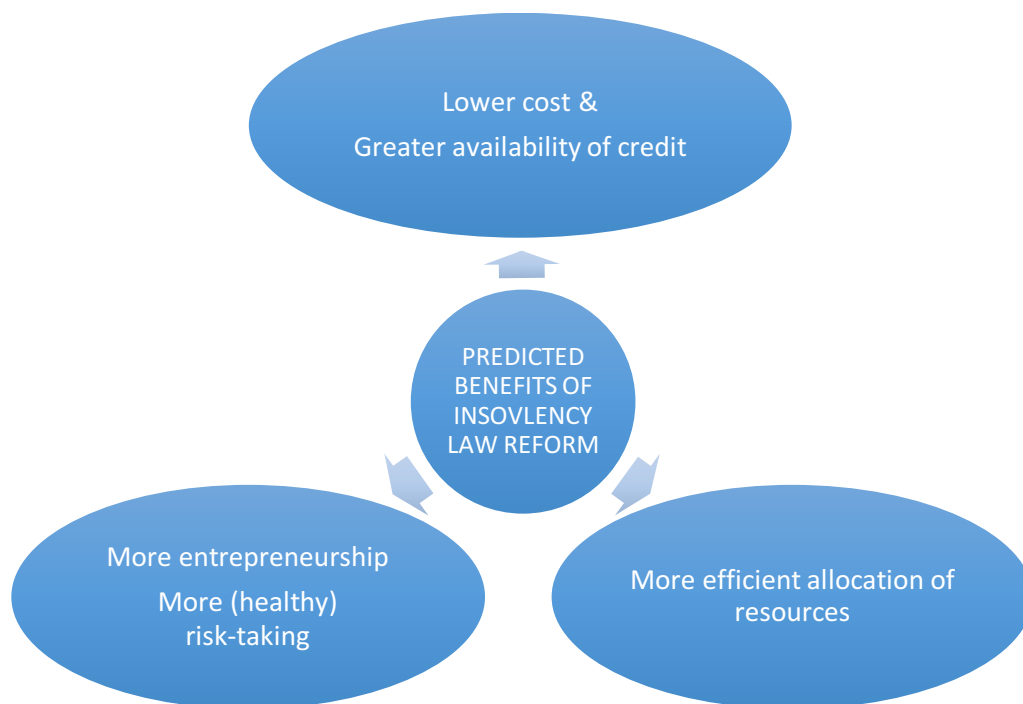
⁶⁰ For details, see e.g. Goode (2011) Chapter 13; Jackson (1986) Chapter 3

⁶¹ This is, admittedly, very difficult in practice. For more details, see Chapters 5.1.3, 6, 7.1, and 7.3

2.3 Role of insolvency law in economic development

This final section looks at what the existing literature says about the role and impact of insolvency law and its reform on economic development. In general terms, the studies suggest that improvements in insolvency law have a positive impact on debtors and creditors, and that they contribute to economic development. Three such contributions will be examined in detail below, namely easier and cheaper corporate financing (2.3.1); more efficient allocation of resources (2.3.2); and more entrepreneurial activity (2.3.3). They are summarised in Diagram 2-2.

Diagram 2-2: Summary of key benefits of insolvency law reform in transition economies, as presented in existing literature



2.3.1 Lower cost and improved access to credit

The existing literature suggests that one of the major effects of insolvency law on the economy is the increase in the availability and the decrease in the cost of credit. In the absence of effective (legal) creditor protection, banks protect themselves against the risk of no or limited recovery by adjusting their lending practices by increasing interest rates, reducing loan amounts, and shortening loan maturities.⁶² In recent studies on the effects of insolvency law reform in Italy and Brazil,⁶³ it was shown that increased creditors' recovery rates and decreased duration of insolvency can lead to a significant reduction in the cost of debt and a big increase in the aggregate level of credit.⁶⁴ More timely repayments also lead to cheaper credit.⁶⁵ Another study about the Italian reform also suggested that reducing incentives to behave opportunistically may lead to a decrease in interest rates.⁶⁶ Common to these improvements is an implied assurance that creditors will get back a larger part of the loan and these savings are passed on to the economy in the form of a greater amount of cheaper credit. Consequently, the protection of creditors' rights and the incentives at firm-level often translate into an increase of private credit to GDP at macro-level.

Literature further suggests that insolvency law can also provide credible protections and assurances to market participants (debtors, creditors, investors, shareholders), which enables even strangers and one-time business partners to transact without the need for

⁶² Davydenko and Franks (2005); Bae and Goyal (2009); Visaria (2009)

⁶³ Rodano, Serrano-Velarde and Tarantino (2012); Funchal (2008) (respectively)

⁶⁴ Gine and Love (2006)

⁶⁵ Klapper (2011); Djankov et al (2008)

⁶⁶ Rodano et al (2012)

personal trust or reputation that is otherwise built over a long period of time and which appears necessary for doing business in earlier stages of development.⁶⁷ Law can also ensure the provision of reliable information and enforcement of debtors' promises to creditors and investors (mostly contained in insolvency and investment laws), which improves the access to and the cost of credit in the economy.⁶⁸ Better creditor protection has been shown to result in a better development of debt markets and more credit available for the private sector.⁶⁹ Providing protection for shareholders, in turn, leads to a greater development of equity markets.⁷⁰

2.3.2 Allocation of resources

Another important effect of insolvency law on the economy that has been suggested in the literature is a more (economically) efficient allocation of resources through ensuring that inefficient businesses are closed, viable ones are rescued, and bankruptcy costs are reduced.

⁶⁷ See Chapter 3.3.1 for further discussion. Where the parties know each other, they are more likely to rely on less formal rules and enforcement. Dealings at arms' length are usually only possible with the support of advanced extralegal substitutes (e.g. state control) or formal law.

⁶⁸ See Coote and Schäfer (2011) at 73

⁶⁹ Levine (1998)

⁷⁰ La Porta et al (1997); Pistor (2000); Shleifer and Vishny (1997): Access to external finance is, therefore, greater in countries with strong shareholder (and creditor) protection because investors can afford to take minority positions rather than controlling stakes, and can provide finance to otherwise overly risky clients. As a result, companies in such countries have dispersed ownership, and capital markets are more liquid. By contrast, in countries with weak shareholder protection, investors tend to take controlling stakes which leads to high levels of ownership concentration and lack of finance for smaller, more risky operations. NB: this result has been doubted by Fagernas, Sarkar and Singh (2008); Sarkar and Singh (2010); and Siems and Deakin (2010) who did not find any statistically significant relationship between shareholder and creditor rights' protection and development of financial markets

One of the primary obstacles to finding an efficient solution to financial distress without using insolvency law is the so-called collective action problem.⁷¹ The goal of insolvency law is to save viable businesses and liquidate the rest,⁷² to enable smooth and efficient resolution,⁷³ and to maintain an orderly and fair distribution of the estate in order to put assets to the most (economically) efficient use⁷⁴ – all achieved for the benefit of creditors as a whole. Efficient insolvency law prevents or reverses preferential treatment – e.g. through reversal of certain unfair or preferential transactions – and allows market forces to determine which enterprises should survive and which should fail.⁷⁵ Evidence suggests that allowing assets to go to the best user leads to improved efficiency of production⁷⁶ and lower transaction costs⁷⁷ – especially in more complex transactions (through property rights and enforceable contracts).⁷⁸

⁷¹ Individual creditors have an incentive to grab and run rather than wait for an uncertain redistribution by the court or an insolvency practitioner. Especially where the creditors are a numerous and heterogeneous group, their preferences are likely to vary, and agreement is highly unlikely, even though collective redistribution is most likely to preserve maximum value for the creditors as a whole. See e.g. Armour and Cumming (2008); Klapper (2011)

⁷² Gine and Love (2006); Lim and Hahn (2003); Franks and Loran (2004)

⁷³ White (2009)

⁷⁴ Djankov, McLiesh and Schleifer (2007); Lim and Hahn (2003). This was achieved in Colombia through lowering bankruptcy costs: Gine and Love (2006)

⁷⁵ In other words, insolvency law introduces a hard budget constraint which prevents the state from propping up inefficient enterprises. For an excellent example of the extreme losses to the economy in the form of non-performing loans and lost opportunities due to inefficient allocation of resources in China, see Cho (1995-6)

⁷⁶ Aron (2000)

⁷⁷ *Ibid.*: As compared with impossible or hard-to-do enforcement of deals between strangers based solely on relationships-based reputation and social norms

⁷⁸ North (1991)

Rescuing viable firms and liquidating unviable ones is, therefore, a crucial quality of an efficient and economy-enhancing insolvency law regime. The first step is enabling the system to weed out unviable firms and release their assets to value-maximising new users. It was suggested in another study that by lowering reorganisation costs, a natural selection started to occur where most weaker firms opted for liquidation while healthier firms chose to restructure.⁷⁹ In that study, the reform of reorganisation process increased the number of firms that were able to reorganise, and reduced the length of proceedings from 34 months to 12 months. Efficient use of reorganisation and liquidation was described as having the potential to introduce greater efficiency to the allocation of resources and an increase in the total amount of available credit.⁸⁰

At the same time, evidence suggests that excessive cost of insolvency procedures likely prevents efficient allocation of assets. In a recent study it was shown that up to one third of debtors' assets are used to pay for direct costs of bankruptcy,⁸¹ and most of this goes to bankruptcy professionals.⁸² In addition, there are also indirect costs which can eat up additional portion of the assets, especially if the bankruptcy proceedings are very long and supervision-heavy.⁸³ It is, therefore, important to ensure that the costs of bankruptcy are not excessive, otherwise viable businesses are not able to reorganise and so continue without help until it is too late. In the aggregate, such cases negatively affect the economy

⁷⁹ Gine and Love (2006)

⁸⁰ Davydenko, Strebulaev and Zhao (2011); Armour, Hsu and Walters (2012)

⁸¹ Franks and Sussman (2005)

⁸² Bris, Welch and Zhu (2005)

⁸³ Ogus (2003)

as a whole. If assets are employed to highest valued use, unnecessary closure of good firms may be avoided and jobs could be saved.⁸⁴ Thus, contrary to the oft-cited argument of protectionist regimes that insolvency law increases failure rates and so endangers employment and economy's performance, the reverse is true. Evidence clearly shows that improvements in insolvency law have the potential to lead to lowered failure rates⁸⁵ and increased recovery rates⁸⁶ in the long term.

2.3.3 Entrepreneurship

The last major impact of insolvency law on the economy discussed at length in the scholarly work is the impact of insolvency law on enabling entrepreneurship. Insolvency law deeply affects entrepreneurs who are subjected to external risks when starting and running their businesses. This applies to company owners as well as managers. It has been shown that a forgiving personal bankruptcy laws (which also apply to entrepreneurs) and ready availability of limited liability can stimulate entry by 'latent' entrepreneurs who would otherwise be too risk-averse to start their own business.⁸⁷ By extension, a forgiving liability regime for managers in corporate insolvency laws is likely to have a similar effect of encouraging earlier resolution of financial distress and greater cooperation from the

⁸⁴ Berk, Stanton and Zechner (2010)

⁸⁵ E.g. in Belgium the failure rate decreased by 8.4% as a result of the reform: Dewaelheyns and Van Hulle (2006). In a Brazilian study, it was predicted that recovery rates will increase from 0.2% to 18.4% after reform: Lu and Azar (2005)

⁸⁶ In India, timely repayments increased by 28% after the reform of debt enforcement mechanisms: Visaria (2009). In Thailand, there was a substantial decrease in the level of non-performing loans. However, recoveries were highest in countries with stronger overall creditor protection: Davydenko and Franks (2005); Funchal (2008)

⁸⁷ Armour and Cumming (2008)

management in insolvency. Moreover, an effective insolvency law can provide a possibility of a ‘fresh start’ to try again if the first effort fails⁸⁸ and can limit entrepreneurs’ losses if they fail. As shown by a few studies in the US, there are more entrepreneurs in the US states with higher assets exemptions.⁸⁹ The probability of starting a business in states with higher exemptions is about 25% higher than in states with lower exemptions.⁹⁰ However, if small firms are located in states with unlimited rather than low homestead exemptions, they are more likely to be subjected to credit rationing, to be denied credit, to receive smaller loans and higher interest rates.⁹¹ At the same time, empirical studies further show that excessively strong protection of creditor rights can also be harmful to entrepreneurship because they discourage innovation⁹² and entrepreneurship itself.⁹³

Entrepreneurship can have a far-reaching impact on the whole economy since it improves the country’s volume of economic activity which can strengthen healthy competition and so introduce efficiency-inducing market competition, create value and boost the GDP. Greater entrepreneurial activity also creates new opportunities for investors and increases the inflow of non-bank funds to entrepreneurs and their projects, which, in turn, supports innovation and creativity.⁹⁴

⁸⁸ Klapper (2011)

⁸⁹ Fan and White (2002)

⁹⁰ *Ibid.* and Mathur (2009)

⁹¹ Berkowitz and White (2002)

⁹² Acharya and Subramanian (2009)

⁹³ Armour and Cumming (2008)

⁹⁴ Armour (2004)

Chapter 3. CHINESE INSTITUTIONAL BACKGROUND

This chapter aims to provide basic relevant economic, political and legal background to enable fuller appreciation of the arguments in Parts II and III. The discussion is mostly derived from existing literature, but some sections are supplemented by insights from my interviews to shed light on under-researched questions.

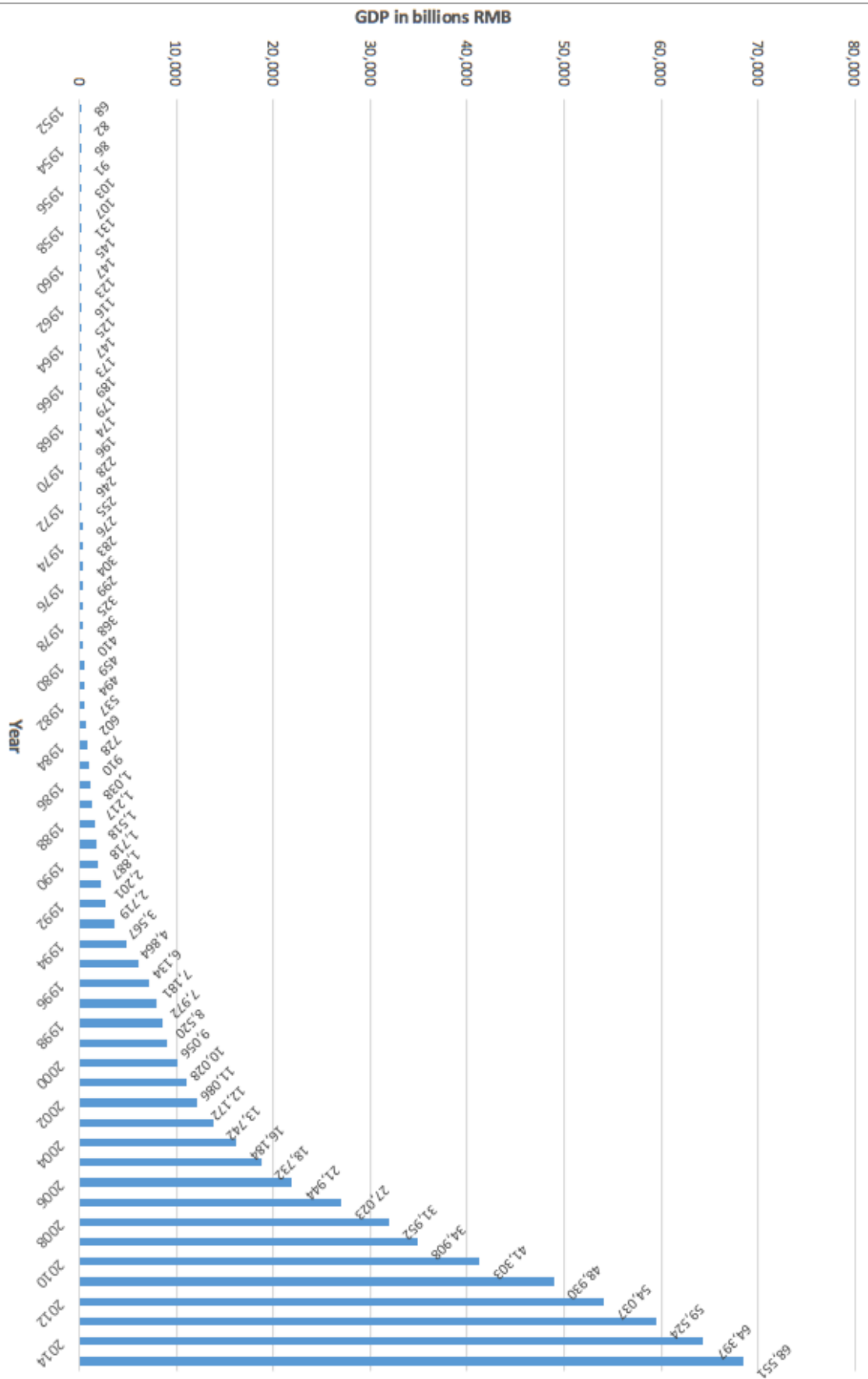
The chapter is divided into four sections. First, China's economic transformation is explored to enable a better understanding of the past and the present environment in which insolvency laws in China operate. The focus is on the period between 2007 to 2016 – same as the available data on the use of the EBL – but the discussion begins with the Mao era because many events from earlier history shaped later developments and still influence people's preferences and attitude to insolvency law (3.1). Second, the ways how power is exercised and enforced in China's political structures and processes are explored (3.2). Third, the origin and role of laws in China are examined (3.3). And fourth, several issues concerning corporate ownership and control in China and their impact on the functioning of insolvency laws are explored (3.4).

3.1 Economic and political transformation of China

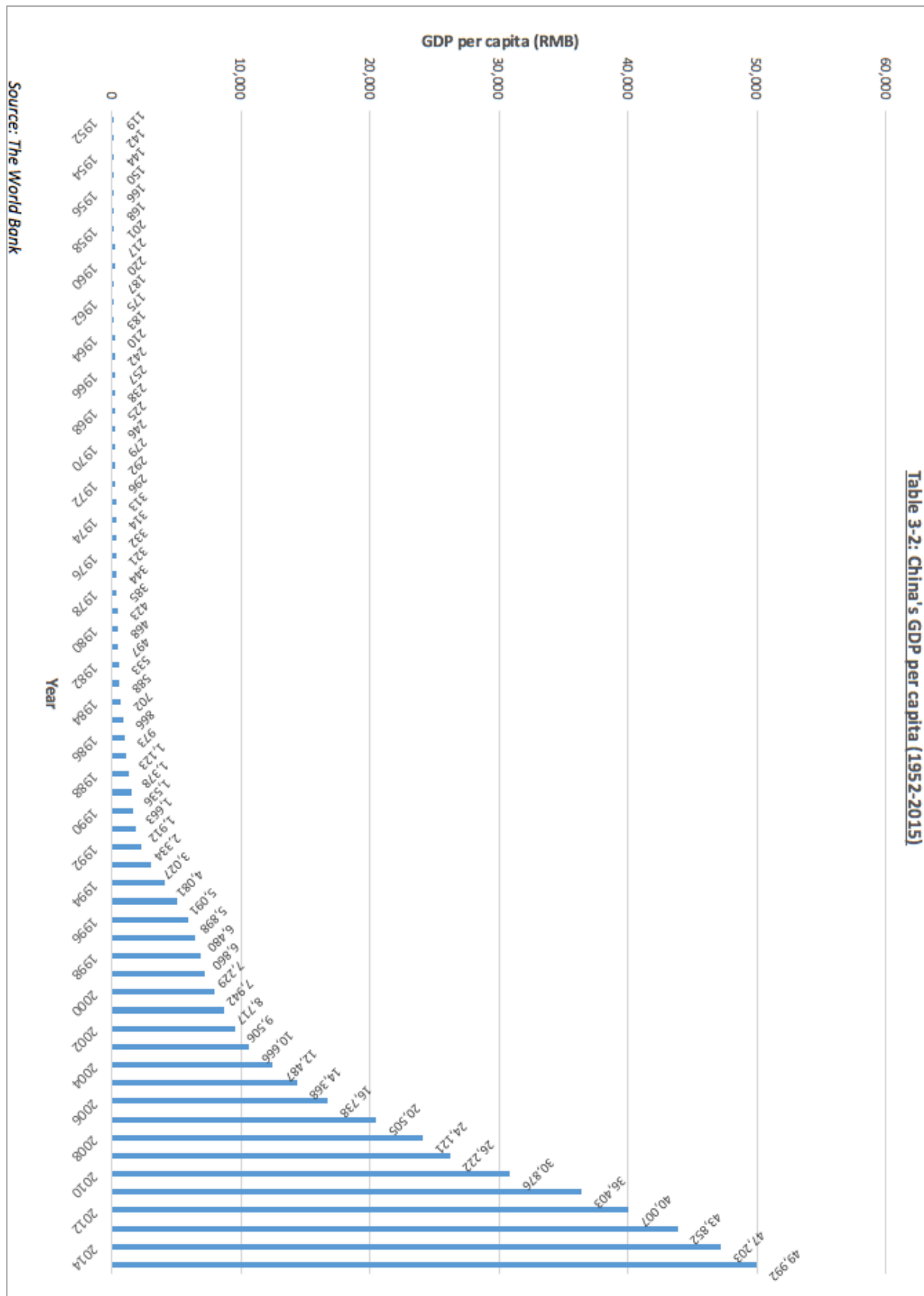
China has undergone many ups and downs since 1949 when the Communist Party won control over this vast country. Each leader brought slightly different ideology and direction which, in the aggregate, led the country from an economy based on small-scale, localised trade to one of the largest and most important economies of the early 21st century. Despite its difficult beginning, China has grown quicker than any other country we know, especially since the beginning of Deng Xiaoping's pro-market reforms in 1978. As is apparent from

Table 3-1, China's annual GDP has increased from just under RMB 68 billion in 1952 to RMB 368 billion in 1978 when the reforms started, to RMB 1.72 trillion in 1989 when the Tiananmen Massacre brought a sudden stop to the opening up which brought so much prosperity and economic growth. The growth then restarted in 1992 when Deng went around China during so-called 'Southern Tour' (*Nanxun* 南巡) and encouraged entrepreneurship. By the time China joined the World Trade Organisation ('WTO') in 2001, its GDP amounted to staggering RMB 11.1 trillion. In 2015, China's GDP stood at incredible RMB 68.6 trillion – thousand times more than in 1952. The GDP growth together with the positive *economic* impact of Deng's one-child policy – achieved by slowing down the expansion of the population, and so increasing the comparative individual living standard – has produced a steep growth of GDP per capita from RMB 119 in 1952 to RMB 49,992 in 2015. This is shown in Table 3-2.

Table 3-1: China's GDP (1952-2015)

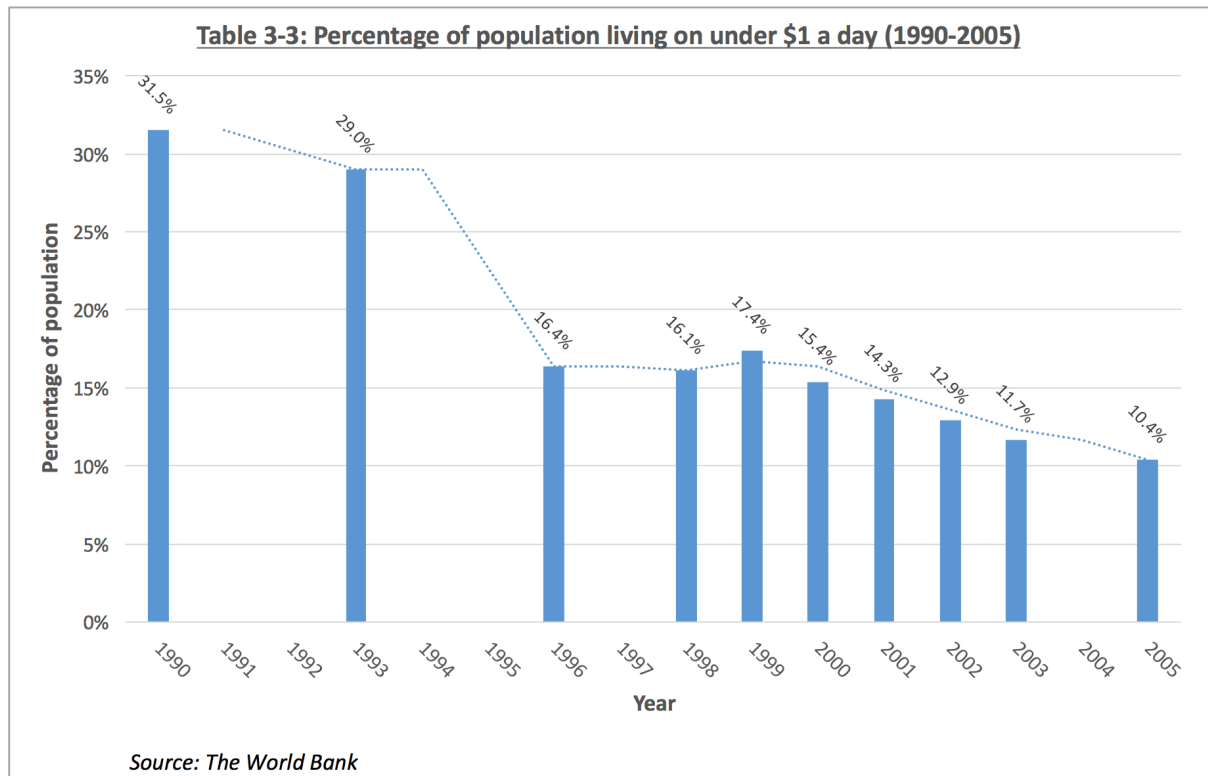


Source: The World Bank

Table 3-2: China's GDP per capita (1952-2015)

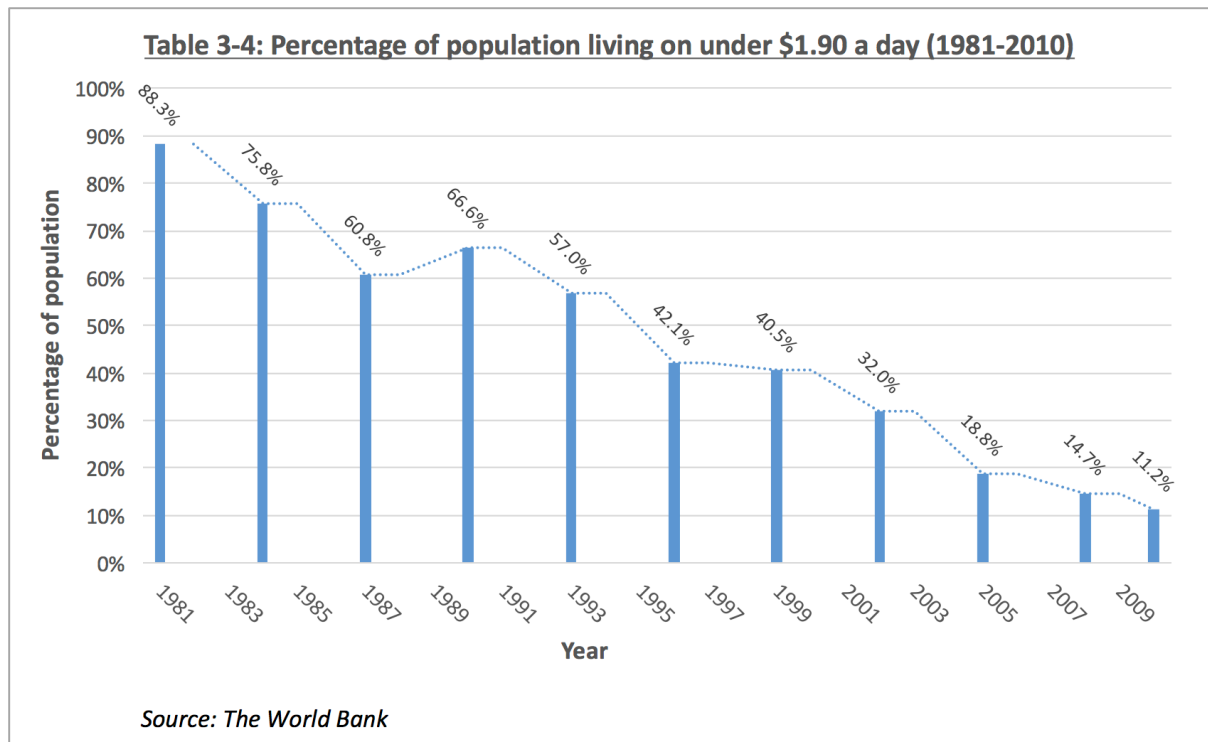
Source: The World Bank

China's fast growth lifted millions of people out of poverty. Tables 3-3 and 3-4 show the steep decline in the proportion of the population living less than 1 USD and 1.9 USD a day, respectively.



In 1981, China had over 88 percent of its population living on less than 1.9 USD a day. The number, however, declined quickly. By 1984 it dropped to 76 percent and by 1990 to 67 percent for people with less than 1.9 USD a day and 31.5 percent for people with less than 1 USD a day. By 2010, only 11.2 percent of the population was living on less than 1.90 USD per day.⁹⁵ In total, that means that between 1981 and 2010 over 70 million people were lifted from poverty.

⁹⁵ Defined as living on less than 1.9 USD a day – see Table 3-4 for details

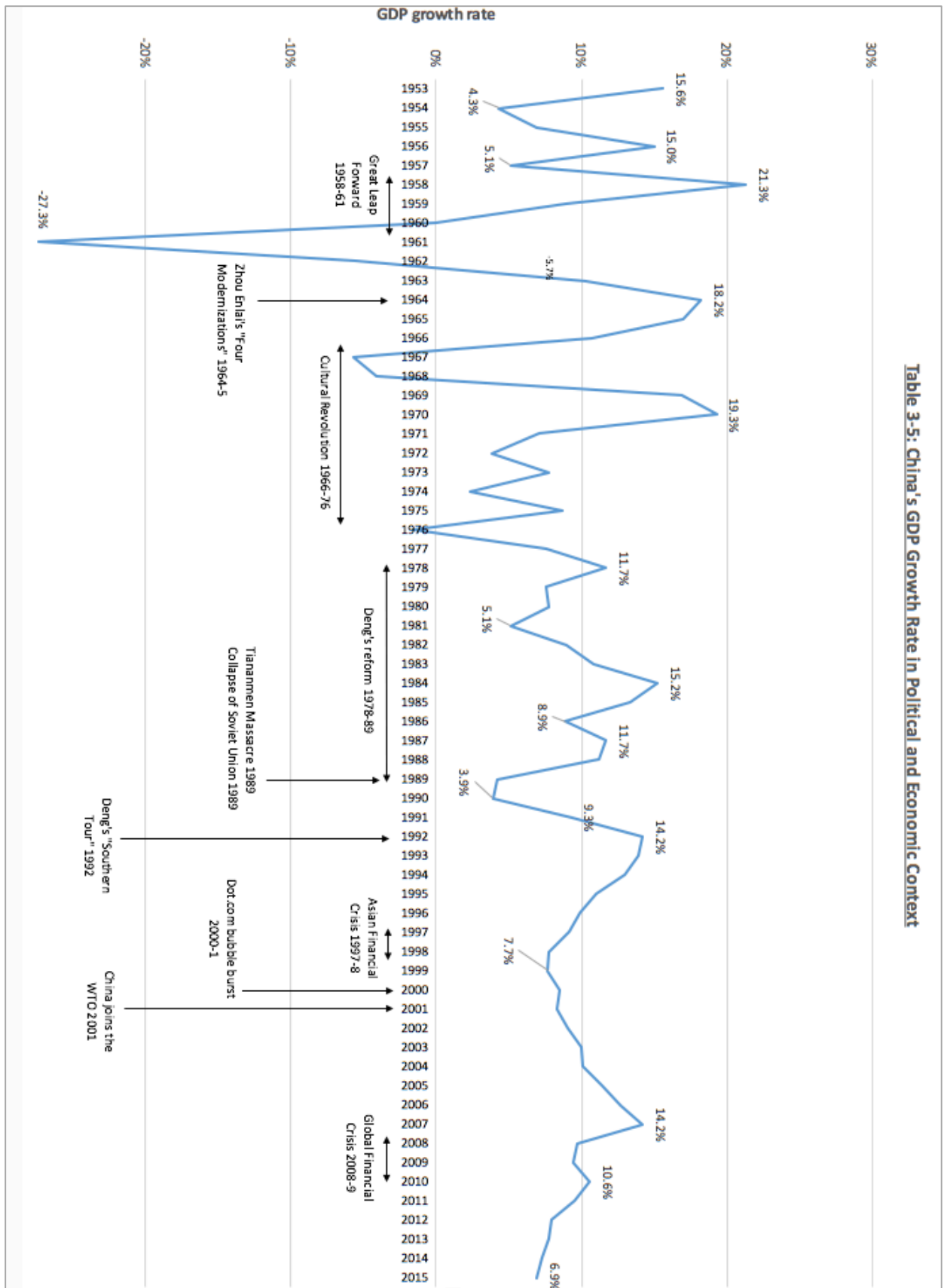


Furthermore, people's life expectancy has increased from 42.2 (45.6) years for men (women) in 1950 to 66.4 (69.4) years for men (women) in 1982 and to 74.6 (77.6) years for men (women) in 2015.⁹⁶

However, the sharp changes in the rate of GDP growth – illustrated in Table 3-5 – clearly show that China's economic transformation and growth were not always smooth. There are sharp drops and sudden increases that resulted from Mao's failed push to modernise China's economy during the Great Leap Forward movement (1958-1961), the uncertainty and destruction during civil-war-like Cultural Revolution (1966-1976), Zhou Enlai's and Deng Xiaoping's successful economic reforms (1964-1965 and 1978-1989), their abrupt end after the Tiananmen Massacre in 1989, the renewed enthusiasm and reforms after Deng's Southern Tour in 1992, and finally China's re-entry on the international market as it became a full WTO member in 2001. However, as China opened up to foreign markets

⁹⁶ Data from the World Health Organisation 1950, 1982 and 2015

Table 3-5: China's GDP Growth Rate in Political and Economic Context



and influences post-1978, it also became vulnerable to crises beyond its borders – most importantly the collapse of the Soviet Block in 1989, the Asian financial crisis in 1997-8, the dot.com bubble burst in 2000-1, and recently also the after-effect of the global financial crisis in 2009-10. These events are briefly discussed in the remainder of this chapter.

After the fall of the Qing Empire in 1911, China was engulfed in a thirty-eight-year power struggle which was eventually won by the Communists. Mao Zedong became the new Chinese emperor in all but name. With the backing of the Chinese Communist Party ('the Party'), he declared the People's Republic of China ('China') on 1 October 1949, marking the beginning of a new 'class-less' era where the Party claimed absolute power in exchange for a promise to deliver prosperity and progress to the people. The Party banned private ownership and all other capitalist concepts; all laws were abolished and replaced by high-level policies that could be easily changed to serve the Party's needs; resources were diverted into nationalised heavy industry; farms were collectivised into communes; and from 1953 the economy operated under Five-Year Plans in a centralised Soviet-like command economy.⁹⁷ In the mid-1950s, China moved away from Russian Marxist-Leninist communism and towards Mao's new interpretation of communism (known as Maoism). Its emphasis on 'strong Party' in the heart of China's future has survived until this day.

With a vision to (re-)build a 'great China,' Mao initiated a set of far-reaching reforms known as the 'Great Leap Forward' in 1958-60 to transform the country into an industrial and military superpower. His reforms, however, ended in a disaster. Most importantly, it led

⁹⁷ Lin (2004) at 8-10: the plans dictated when, what, and for how much SOEs produce their goods. The wages were determined not by performance, but by with reference to one's status (age, education, position, etc.). The state owned, controlled and financed all projects, covering both losses and profits of its companies: see Kipnis, Tomba, and Unger (2009)

to the ‘Great Famine’ that caused between 14 and 43 million excess deaths.⁹⁸ This historical experience has informed all post-Mao reforms and experiments.

To salvage the situation, the then-prime minister Zhou Enlai instituted several reforms which culminated in the ‘Four Modernizations’ programme (in agriculture, industry, science and technology, and defence) in 1964-5. However, their implementation was prevented by the ‘Cultural Revolution’ in 1966-1976. During this ten-year civil war, Mao sought to ideologically purify the Party – overthrowing his enemies and some ex-colleagues – and politically reinvigorate China’s youth. Millions of people were killed or persecuted over their ‘wrong’ (i.e. non-communist or insufficiently zealous) political attitudes. Many cadres were publicly humiliated by the Red Guards (self-appointed police of approximately 100 million zealots), leading to many atrocities.⁹⁹ The ensuing chaos interrupted production and transportation of food, proper functioning of trade and exports, and normal life in the society, and caused another wave of famine.¹⁰⁰ Towards the end, Mao’s deteriorating health and ultimate senility left China in the hands of his ambitious wife Jiang Qing and her ‘Gang of Four.’ When Mao died in 1976, China was impoverished and isolated.

Zhou Enlai’s reforms resurfaced after Mao’s death, under the informal leadership of Deng Xiaoping who took charge in 1978. Although never in a top political post, Deng became China’s paramount leader and reformer, who transformed the poverty-stricken China into an economic miracle between 1978 and his retirement in 1989. Unlike Mao and his followers, Deng recognised the weaknesses of the planned economy and sought to learn

⁹⁸ The estimates vary. See e.g. MacFarquhar (1983); Bernstein (1984)

⁹⁹ See e.g. Andreas (2002); Teiwes and Sun (2009); Pollard (2011)

¹⁰⁰ *Ibid.*

from China's fast-developing market-oriented neighbours – in particular Hong Kong, Taiwan, South Korea and Singapore – albeit adjusted to China's needs.

The problems that China faced in the later 1970s were deep-rooted and ubiquitous: state-owned enterprises ('SOEs') were inefficient, productivity was low, the financial sector was underdeveloped, and there was a lack of expertise and money due to China's isolation under Mao's reign. Deng believed in the merits of introducing a more market-based economy and started gradual reforms that transformed China into a blend of socialism and capitalism – often referred to as a 'socialist market economy' with 'Chinese characteristics'.¹⁰¹ Deng was a pragmatist who focused more on the effectiveness of his policies than ideology. He adopted a dual-track approach to transition: a part of the economy (non-priority sectors like commodity production, light industry, services, etc.) was liberalised and put under slowly-emerging market conditions, while the rest remained under state control (heavy manufacturing, energy, oil, etc.).¹⁰² His reforms – each first tested in newly-created Special Economic Zones ('SEZ') before their nation-wide implementation – started opening the economy to foreign influence and expertise, international trade and cooperation, they led to more market-based production, and helped create a simple capital market.¹⁰³

The reforms focused on several key issues. Within China, Deng focused on reforming corporate ownership through reorganisation and privatisation of SOEs and communes, and

¹⁰¹ For discussion of ideological and economic transformation see Wedeman (2003). See also Chan, Madsen and Unger (1992) Chapters 11-12; Meisner (1996); Lin (2006)

¹⁰² Lin (2004) at 12; Yueh (2009) at 754

¹⁰³ Further see Pollard (2011) at 157-8

expansion of private ownership.¹⁰⁴ These changes, however, disrupted the state's traditional role in social welfare provision – institutionalised through its policy of *iron rice bowl* where everyone was employed and otherwise provided for from birth to death by the state through an SOE.¹⁰⁵ Consequently, secondly, the reforms included re-conceptualisation of employers' duties and de-powering of state-controlled Labour Unions which previously regulated professional and social lives of their members.¹⁰⁶ As a result, people gained freedom to move and live without state's intervention, but they also lost the former certainty of a life-long social welfare provision.¹⁰⁷ Naturally, many people fear the growing insecurity and so popular protests have been on the rise.¹⁰⁸ With an estimate of 200,000 public protests in 2010 alone,¹⁰⁹ local governments are careful to closely police and minimise disputes and controversies which could give rise to mass uprisings.¹¹⁰

Many of Deng's reforms also sought to attract foreign investors, their know-how, skills and new products. First four SEZs were opened in 1980 for that purpose – offering tax concessions and access to an untapped market in exchange for capital and technical

¹⁰⁴ For more see Chapter 3.4

¹⁰⁵ Post-reform provision of healthcare outside the SOE structure has been difficult, especially in the countryside: Chow (2010). See also Leung (1994); Cook (2000)

¹⁰⁶ Under the *hukou* 户口 principle and the *danwei* 单位 principle

¹⁰⁷ China still does not have a functioning social welfare system: for more, see Chapter 5.2.2.1

¹⁰⁸ For the numbers and examples of incidents see Chen (2009) at 10; Lum (2006)

¹⁰⁹ Goebel and Ong (2012)

¹¹⁰ As a result, China's national budget for 'stability maintenance' (*weihuwending* 维护稳定, or *weiben* 维稳) is significant. In 2012 China spent 105 billion USD on defence, but 110 billion USD on stability maintenance: Li in Joseph (2014) at 220

knowledge¹¹¹ – and helped increase the contribution of foreign trade to China's GDP increased from 7 to 37 percent of GDP between 1978 and 1998.¹¹² This also gave access to Chinese companies to new export markets.

During Deng's reforms, China's GDP increased by 465 percent (from RMB 367 billion to RMB 1.7 trillion), its GDP per capita grew by almost 400 percent (from RMB 385 to RMB 1,536), and ten million people were lifted out of poverty.¹¹³ However, the infamous massacre of the protesters at Tiananmen Square in Beijing in June 1989 and the crumbling of the Soviet Union in 1989 led to reversal of many pro-market reforms¹¹⁴ and economic stagnation which was only reversed in early 1992¹¹⁵ after Deng embarked on his famous Southern Tour where he encouraged people to 'be a little bolder, go a little faster.'¹¹⁶ The 14th Party Congress in September 1992 – for the first time – formally endorsed Deng's idea of 'socialist market economy' in China as its reform goal, and the results were astonishing. The FDI increased, many new joint Sino-foreign companies were established, and several SOEs listed on overseas stock markets. Many poorly managed SOEs were restructured into corporations, internally reorganised, refinanced through FDI and many even made it to Fortune Global 500 list by 2009. FDI also accelerated development of

¹¹¹ See e.g. Chen in Tay and Leung (1995) at 156-182

¹¹² Chow (2004) at 131

¹¹³ See Tables 3-1 to 3-4 for details

¹¹⁴ Yang (1996) at 217; Breslin in Zheng, Lu, and White (2010), Vol.2 at 206

¹¹⁵ Shortly after the final fall of the Soviet Union in late 1991

¹¹⁶ Kynge (2006) at 25

China's non-state sector which became the real engine of China's miraculous double-digit growth for several decades.¹¹⁷

The beginning of 21st century marked China's formal entry into the global market, primarily through its accession to the World Trade Organisation ('WTO') in December 2001 after 15 years of negotiations. China agreed to introduce many substantial legal reforms to ensure China's smooth integration into the international trading system and to appease the existing WTO members and create market-style protections for foreign companies that operate in or with China.¹¹⁸ In December 2006, five years after its accession to the WTO, the Chinese government decided to slow down the pro-market reforms, it reinstated its control over the banks and revived some old-time protectionist measures in favour of the state sector.¹¹⁹ The leadership's reluctance to follow the Western capitalist models was further deepened following the global financial crisis in 2008-2010.

China remains a hybrid socialist-capitalist system where certain elements of the old regime (planning and central control in the state sector) mix with new mechanisms (market allocation, responsive pricing system in the private sector), creating inefficiencies and blockages in the system as a whole.¹²⁰ In recent years, local governments have been under extra pressure to deal with massive migration from rural areas to the cities (see Diagram 3-6

¹¹⁷ See Chapter 3.4 for more

¹¹⁸ Esplugues (2009) at 1-7: China agreed to make its legal system more transparent, to ensure uniform, impartial and reasonable application of the law, and to provide for efficient judicial review. Although improvements have been made, there is still only limited transparency, laws are often not fully implemented, and effective judicial decision-making has been hindered by corruption, local protectionism, nepotism, red tape, lack of judges' expertise and independence, internal political struggles, etc.

¹¹⁹ Walter and Howie (2011) at 4-5 and 20-22

¹²⁰ Steinfeld (2002) at 385

and compare with Diagram 3-7), with the most population now living in coastal regions (see Diagram 3-7). Nevertheless, the most populous provinces (darkest blue in Diagram 3-7) are not necessarily the ones with the highest gross regional product (in absolute terms, Diagram 3-8, and per capita, Diagram 3-9). This creates new challenges for the government and puts extra strain on local infrastructure and planning.¹²¹

¹²¹ See e.g. Cao, Lu, Zheng and Wang (2014)

Diagram 3-6: Geographical map by birth rate in 2015



Source: NBS

Diagram 3-7: Geographical map of population in 2015



Source: NBS

Diagram 3-8: Geographical map by gross regional product in 2015



Source: NBS

Diagram 3-9: Geographical map by per capita gross regional product in 2015



Source: NBS

3.2 Power and the Party-state

Outsiders' understanding of China's power structures is riddled with myths and generalisations. In the words of Professor Dickson:

In the popular imagination, China's political system is a brutal authoritarian regime that represses its critics, is riddled with corrupt and venal officials, and in danger of collapse if it does not sustain rapid economic growth. That image contains much that is true, but it overlooks the image that is most prominent for most people in China: a regime whose policies generate resentment and protest, but nevertheless enjoys a surprisingly high level of popular support; a regime that consults with a wide range of specialists, stakeholders, and the general public in a selective but yet extensive manner; a regime that tolerates and even encourages a growing civil society, even while restricting which interests can organise and which groups can operate; and a regime that is seen as increasingly democratic by the majority of its people, even though it does not allow political competition and its leaders are not accountable to the electorate.¹²²

To shed light on who holds the reins of power and how decisions are made in China, this section first provides a brief outline of the structures through which power is exercised (3.2.1). It then looks at the role of the government (3.2.2) and of the Party (3.2.3). It concludes with a short analysis of the relationship between the two (3.2.4).

¹²² Dickson (2016) at 1-2

3.2.1 The Structure of power in China

As shown in Diagram 3-10, power in China is shared by six bodies: the Party holds political power (i.e. sets policies); the People's Congresses and their committees hold legislative power (i.e. make laws); the State Council, its ministries and commissions hold executive power (i.e. make and carry out policies); the Supreme People's Court holds judicial power (i.e. adjudicate cases); the Supreme People's Procuratorate holds procuratorial power (i.e. investigate and prosecute violations of the law); and the Central Military Commission holds military power (i.e. ensure internal and external security). Each has its role and responsibilities, but there is no clear separation of powers.¹²³



¹²³ See e.g. Li (n.110)

The six bodies are not equally powerful. Instead, so-called Four Big Organisations (*Sidabanzi* 四大班子) govern the country, namely the Party, the National People's Congress ('NPC'), the State Council and they are all advised by the Chinese People's Political Consultative Conferences ('CPPCC'). In reality, however, the Party oversees and controls the others, which makes it the real decision-maker and ruler of China.¹²⁴

3.2.2 The Chinese state: government and legislature

China's Constitution states that the highest organ of state power is the NPC.¹²⁵ The NPC elects executive power-holders – the President (and Vice-President),¹²⁶ members of the central government called the State Council,¹²⁷ and the government's chair called the Premier (and Vice-Premier) – as well as the Chair of the State Central Military Commission, the Chief Justice of the Supreme People's Court, and the Chief Procurator of the Supreme People's Procuratorate. Delegates in the NPC are elected every five years¹²⁸ and meet annually for about two weeks to discuss and vote on major political issues. When not in session, the NPC's power is exercised by its Standing Committee in their meetings (every two months).

¹²⁴ For more see Chapters 3.2.3-4

¹²⁵ Art 2 of the Constitution of the PRC 1984, as amended 2004

¹²⁶ Sometimes the word 'Chairman' is used instead. Both have the same Chinese translation *zhuxi* 主席. The Chinese word for a president, *zongtong* 总统, is not used in China.

¹²⁷ i.e. the Premier, several Vice Premiers, several State Councillors, and 29 ministers and heads of State Council Commissions

¹²⁸ E.g. the Twelfth Congress was elected in 2013 and will hold the power until the next election in 2018

There are six levels of government: national (or central), provincial, municipal, county, township and village (or grassroots).¹²⁹ The delegates to village-level people's congresses are elected directly by the people, albeit from candidates that were pre-selected and approved by the Party. At the township level and above, the delegates are elected indirectly by the congress one level below them from a pool of candidates that is capped at 110-150 percent of the number of the available seats (depending on the level of the election).¹³⁰

The central government appoints governors in provinces and autonomous regions. However, it does not exercise direct control over the entire system. Instead, the governance system has been decentralised.¹³¹ Local governments are in charge of administration and management of social, political and economic affairs of their area. The structure of the government is replicated at each lower level, and the higher-level bodies control those immediately below them.¹³² One of the main tools for control is the cadre responsibility system (*ganbukaohezhidu* 干部考核制度, or *gangweizerenzhi* 岗位责任制)¹³³ and the political performance contracts, which the leading cadres at each level sign with their immediate superior authorities.¹³⁴ These performance contracts always include a duty to promote local economic development, maintain economic and social stability, and collect

¹²⁹ NB: Township and village level are sometimes put together as 'local' level

¹³⁰ See http://www.npc.gov.cn/englishnpc/about/2007-11/20/content_1373251.htm (accessed on 12.2.2017)

¹³¹ For an excellent, even if slightly out-of-date analysis see Tanner (1995). For the details of local-level governance, see Xia (2008)

¹³² NB: the autonomous regions and the municipalities answer to the national level directly

¹³³ See an excellent empirical paper by Wang (2013)

¹³⁴ See Edin (2000); Whiting (2006) at 124

state and local taxes, and all are measured against set targets.¹³⁵ Satisfaction of the targets is rewarded with better career opportunities¹³⁶ and monetary rewards while failing to fulfil one's targets leads to reprimands and loss of career progression opportunities,¹³⁷ and in some instances also a loss of deposit paid when certain tasks are assigned.¹³⁸

This multi-layered governance system creates benefits – such as a more easily controlled chain of responsibility – but also disadvantages – such as complex conflicting interests.¹³⁹ On the positive side, decentralisation has helped with people's traditional mistrust to outsiders, local officials benefit from the knowledge of local customs and history, and so they get things done more quickly and efficiently.¹⁴⁰ Weaker supervision has also led to some innovative political solutions which were later successfully implemented nationwide. In line with the ancient saying 'The mountains are very high, and the emperor is far away',¹⁴¹ local governments have become the new centres of power and influence which determine the growth of China's economy.

On the other hand, however, leaving so much discretion in the hands of local leaders has also led to harmful local protectionism, rent-seeking, and conflicting interests between

¹³⁵ Zhong (2003) at 139-140

¹³⁶ Also, it makes the leader more politically visible: Yan (2004) at 31
Albeit, this is most pronounced at provincial level, less so at lower levels of local Party-state: Nevitt (1996) at 39-40

¹³⁷ *Ibid.*

¹³⁸ Edin (2000) at 277

¹³⁹ For a great analysis see Li (n.110)

¹⁴⁰ Shue (1980) at 6-8 and 323-4

¹⁴¹ *shangaohuangdiyuan* 山高皇帝远

local and national level of government. As a result, although local officials are still appointed and dismissed by the central government, the latter's ability to control and monitor local activities has been greatly diminished while local officials' position has been strengthened by their access to local information and resources.¹⁴²

The current, fifth generation leadership under President Xi Jinping has introduced several campaigns aimed at reasserting that the ultimate power lies with the central government. Among the most pronounced has been the anti-corruption campaign which has already caused a downfall of several high-ranking local politicians. Furthermore, the current leadership has also withdrawn the absolute protection previously provided to the local government elite, as shown e.g. by the trial of Bo Xilai, once a powerful Minister of Commerce (2007-2012), a member of the Central Politburo (2007-2012), a secretary of the Party's Chongqing branch (2007-2012) and one of the most powerful men in China until his downfall in 2013 when he was arrested, tried and convicted for corruption and abuse of power, losing all his assets and bound to spend the rest of his life in prison.¹⁴³

Nevertheless, the relationship between central and local governments is not as clearly hierarchical as it once was and the central-local power divide continues to impact on the way laws are made and enforced.

¹⁴² Zheng, Lu and White (2010) at 21

¹⁴³ Zhai (January 2012)

3.2.3 The Communist Party of China

No analysis of power and policy-making in China would be complete without considering the role of the Party. Leading China since its foundation in 1949, the Party is reported to have 85 million members,¹⁴⁴ which is about 6 percent of the total population. To become a member, one must be invited or sponsored by an existing member when applying,¹⁴⁵ and many members were first a part of the Communist Youth League.¹⁴⁶ Each new member must take an admission oath, promising:

*to uphold the Party's program, observe the provisions of the Party constitution, fulfil a Party member's duties, carry out the Party's decisions, strictly observe Party discipline, guard Party secrets, be loyal to the Party, work hard, fight for communism throughout my life, be ready at all times to sacrifice my all for the Party and the people, and never betray the Party.*¹⁴⁷

Unlike in the past when the main emphasis was on one's ideological zeal, candidates' professional expertise and abilities are now the primary focus. Private entrepreneurs – once flogged and killed by the Red Guards during the Cultural Revolution – have been able to join since the emergence of a strong private sector and the subsequent amendment of the Constitution in 2004.

¹⁴⁴ Roberts (12.6.2014)

¹⁴⁵ Callick (2013) at 16-18

¹⁴⁶ The Communist Youth League is a branch of the Party for the ideologically active youth aged 14-28. It had 89 million members in 2013 (http://news.xinhuanet.com/english/china/2013-06/17/c_132461856.htm)

¹⁴⁷ The Communist Party's admission oath (emphasis added)

The Party membership, like any exclusive club membership, carries significant benefits but also duties. It provides valuable networking opportunities for businesses and gives its members access to information and resources (most owners of large private enterprises are Party members). For many students, the membership also provides an entrance ticket into the much-desired civil service.¹⁴⁸ But there are also duties. All members must participate in regular education and indoctrination courses.¹⁴⁹ They must also provide insider information through Party branches in businesses and law firms in China (often unknowingly to the owners), with the general manager usually acting as a secretary of the department's Party branch.¹⁵⁰

In recent years, the membership base has become more varied and less ideology-driven. Nevertheless, the real power is still concentrated in the hands of about 2,500 high-level cadres (*gaojiganbu* 高级干部).¹⁵¹ And despite Deng Xiaoping's attempts to introduce 'new blood' into the Party leadership, the most influential posts are still occupied by members of the old elite whose roots go back to the 'Eight Immortals' who were the founding fathers of the Party in the 1920s.¹⁵²

The power-structure of the Party mirrors that of the government (see Table 3-11). The highest organ in the Party's organisational structure is the National Party Congress when in session (once every five years), otherwise its inner circle – the Central Committee.

¹⁴⁸ According to an extensive survey, entering civil service is the most desired career path for university students: Gore (2011) at 72

¹⁴⁹ There is a strong emphasis on this for high-level cadres: see Pieke (2015)

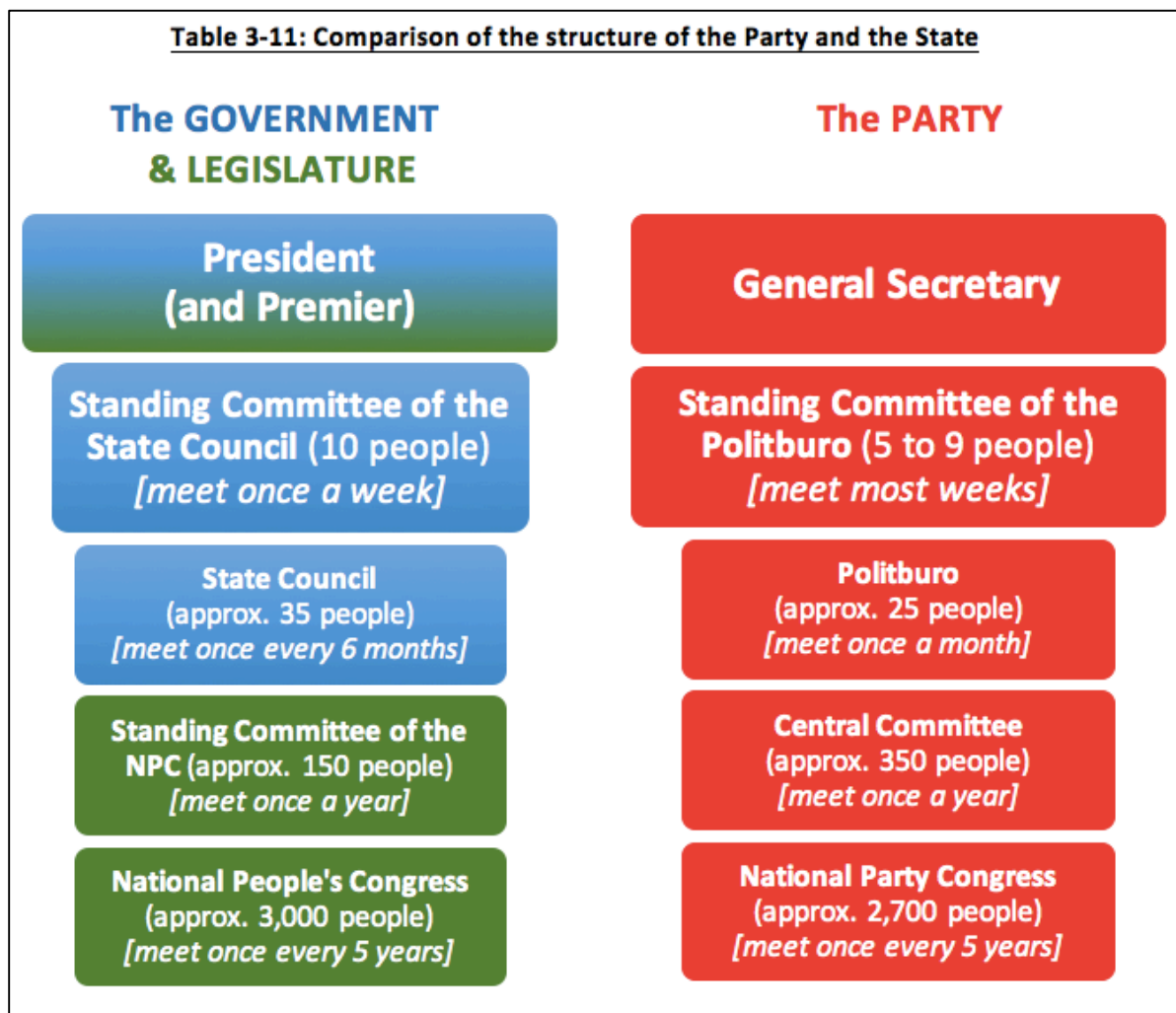
¹⁵⁰ Callick (2013) at 16

¹⁵¹ Brown (2014) at 20

¹⁵² *Ibid.* at 3-8

In theory, the National Party Congress or the Central Committee then elect the most powerful organs of the Party, namely the 25-man-strong leadership group known as the Politburo, its 7-man-strong Standing Committee, and the Party's leader, the General Secretary. In practice, the members of the outgoing Standing Committee of the Politburo influence the election choices to the highest positions in the Party.¹⁵³ Moreover, because the Central Committee only meets once a year, its power is usually exercised by the Politburo and its Standing Committee. Above all these bodies, however, is the Party's leader who is the General Secretary of the Central Committee (civilian affairs), the Chairman of the

Table 3-11: Comparison of the structure of the Party and the State



¹⁵³ For more see Joseph (2014) at 196

Central Military Commission (military affairs), and the President of the PRC (representative role). Since 2012, Xi Jinping has held all three roles.

There are also provincial-, municipal- and county-level Party Committees that are elected by the same-level Party Congress once every five years. As in the government, lower-level Party Committees are accountable to those immediately above them.¹⁵⁴

3.2.4 The Party-state

The government and the Party extensively interact with one another. As explained above, the State Council sets policies and the NPC makes laws in China. But in practice, the Party holds the ultimate control over both central and local government institutions. As a result, the form, substance, implementation and enforcement of policies and laws in China are, to a large extent, determined by a Party-state hybrid.¹⁵⁵

The Party's control over the executive and legislative branches takes on several forms. Firstly, although in theory subordinated to the Central Committee and the Politburo, the Standing Committee of the Politburo is the most powerful decision-making organ in China, and its members hold the key roles within the country's governance structure. Members of the current Politburo Standing Committee (in 2017) also hold important government positions, for example, Xi Jinping is also the President of China and the Chairman of the Central Military Commission; Li Keqiang also chairs the State Council as the Premier; and Zhang Dejiang is also the Chairman of the NPC.

¹⁵⁴ For more see Gore (2011) at 35

¹⁵⁵ See e.g. Lampton (2014)

Secondly, the Party leadership controls the appointments to the most powerful positions in people's congresses. All voting delegates in the NPC are Party members. A member of the Politburo Standing Committee chairs the NPC Standing Committee meetings, and the Party *de facto* appoints all members of the NPC Standing Committee.¹⁵⁶

Thirdly, although the law can only be proposed by one of the authorised bodies with no mention of such power belonging to the Party, the latter has significant influence both at the preparatory stage and during the consultations in the NPC Standing Committee and in the NPC itself. The voting in the NPC is then mostly a formality. The once-absolute power of the Party has been eroded by the market forces and by the diversification of the Party membership base, and its decisions are often informed by consultations with experts and stakeholders and, where possible, local experimentation and experience.¹⁵⁷ Nevertheless, the Party has retained the dominant role and influence over the state governance.¹⁵⁸

The Party – through various governmental arms – enforces its ideology¹⁵⁹ and goals.¹⁶⁰ However, the hierarchy of power is more complex than the Party deciding everything and the state organs simply executing such decisions.¹⁶¹ Nevertheless, the Party undeniably influences the state through an astoundingly complex overlay of the Party

¹⁵⁶ See e.g. Li (n.110)

¹⁵⁷ For more see Chapter 3.3

¹⁵⁸ Gore (2011) at 26; Callick (2013) at 55

¹⁵⁹ Broadly based on Marxism-Leninism, but significantly updated by the five generations of Chinese leaders: see Chapter 3.3.3

¹⁶⁰ These are often intertwined with the goals of local governments. They are treated together in the remainder of this work

¹⁶¹ My interviews and research support the work by Lampton (2014) Chapter 3. But Cf Tanner (1999). For a more up-to-date discussion see Gore (2011) at 25

organs and the state organs: the Central Committee shadows the State Council; the Standing Committee of the Politburo controls the NPC Standing Committee; provincial-, municipal- and county-level governments are followed by same-level Party committees. The Party has representatives at universities, in law firms, in courts, in enterprises (private and state-owned, Chinese and foreign), and even in non-profit and non-governmental organisations.¹⁶² The result is a powerful Party-state that jointly controls and governs most aspects of social, political and economic life in China.

3.3 Laws and rules in China

Private and business affairs in China are governed by a mixture of social norms and legal rules that have evolved over time. This section, therefore, first looks at how these different rules co-exist and interact (3.3.1). It then examines the role of law and law-making in China (3.3.2). It concludes by looking at the limitations in law enforcement, and the reasons that lie behind them (3.3.3).

3.3.1 Social norms, laws and rule-layering in China

Laws are now more central to people's activities in China than before, but many interactions are still governed and resolved using non-legal principles and norms. Despite political changes and wars in China's imperial past, formal laws provided a stable system of basic rules that remained largely unchanged for centuries.¹⁶³ Nevertheless, written law (*fa* 法)

¹⁶² For details see Gore (2011) at 35 onwards

¹⁶³ Ladany (1992) at 2

was always less important¹⁶⁴ than the unwritten social norms that codified acceptable behaviour and moral values (*li* 礼).¹⁶⁵ Many of these norms were reflected in Confucius' teachings¹⁶⁶ which stressed the importance of the cultivation of virtues, hierarchical organisation of society, and a focus on maintaining a persons' relational networks (*guanxi* 关系) rather than focusing on personal needs.¹⁶⁷ It also encouraged resolving disputes through non-adversarial negotiations and mutual compromise where possible,¹⁶⁸ intermediated by respected laymen from the claimant's community rather than trained outsider judges.¹⁶⁹ This emphasis on informality coupled with the need for expertise may help explain why so many disputes in modern China are resolved in arbitration or mediation¹⁷⁰ rather than in inherently adversarial and conflict-oriented court.¹⁷¹

Co-existence of laws and social norms is not unique to China. Literature suggests that many societies are governed by a web of formal and informal rules. We saw that neo-institutionalists see all rules ('institutions') as constraints on human behaviour that motivate

¹⁶⁴ Because codified law was seen as being easily manipulated by the ruler to his benefit: He (2012) at 135-6

¹⁶⁵ DeLisle in Joseph (2014) Chapter 7

¹⁶⁶ Confucius lived 551-479 BC. Confucianism was accepted as a state ideology during the Han dynasty (206 BC – 221 AD) and still influence people's values in modern China: Tomasic et al (1996)

¹⁶⁷ Fan (2014) Chapter 8.2

¹⁶⁸ See e.g. Ladany (1992); Sim (2003) at 254.
On the rule of law in China see Peerenboom (2002)

¹⁶⁹ He (2012) at 133-134

¹⁷⁰ See e.g. People's Court Daily (18.2.2009). See also Fan (2014) and Chapter 4.2.4

¹⁷¹ Derived from Confucian ideal of harmony (*zhongyong* 中庸): see Katz (2008) at 7-8; Guo (2013) at 48

people to behave in a certain way.¹⁷² The constraints can be informal (social norms¹⁷³) or formal (law). Informal constraints are usually created over time in a particular environment,¹⁷⁴ are based on social equilibria,¹⁷⁵ and are mostly unwritten but shared by a large part of society.¹⁷⁶ Formal law, on the other hand, is always written down and is mostly formulated and imposed from above (by a legislative body or a ruler). Unsurprisingly, many *formal laws* develop from stable widely-accepted *social norms*.¹⁷⁷ It appears that the respective role and importance of social norms and laws depend on the nature of the parties' interaction.

Informal and simple constraints are effective in closely-knit groups where the parties know each other, and in dealings that are straightforward, geographically close, short-term and likely to be repeated. For example, when financing a new project through relational lending (i.e. from family and friends), it is usually enough to rely on informal *social norms* since there is often no contract and no wish to involve any outsiders in potential enforcement of repayment. Similarly, when a borrower considers whether or not to repay a loan from a *hui*, they need not only consider their legal position (i.e. their formal rights and

¹⁷² See Chapter 2.1

¹⁷³ See e.g. Posner (1997); Ellickson (1991); Glenn (2007)

¹⁷⁴ Deakin (2011)

¹⁷⁵ Greif (1989); Bernstein (1992)

¹⁷⁶ NB: Some authors suggest that these underlying shared beliefs may not be derived from rational behaviour, but rather from 'culture', 'history' or 'precedent': Gintis (2009) at 223; Aoki (2010) at 131

¹⁷⁷ Deakin (2011) at 2; Glenn (2007) at 348-9. For further discussion of evolution of social norms into formal law see Cooter (1997)

obligations), but also the societal rules and consequences that would flow from failing to repay their neighbours (i.e. reputational loss, social exclusion).¹⁷⁸

If, on the other hand, an agreement is made at arms' length through commercial lending (i.e. debt finance from bank-like institutions, equity finance from stock market) or other form of public finance (i.e. finance with generalised, impersonal conditions known and accessible to a wide range of people), the parties are more likely to rely on *formal law* when enforcing repayment, especially where this is more efficient (i.e. faster, cheaper, more precise) than private ordering (e.g. private workout).

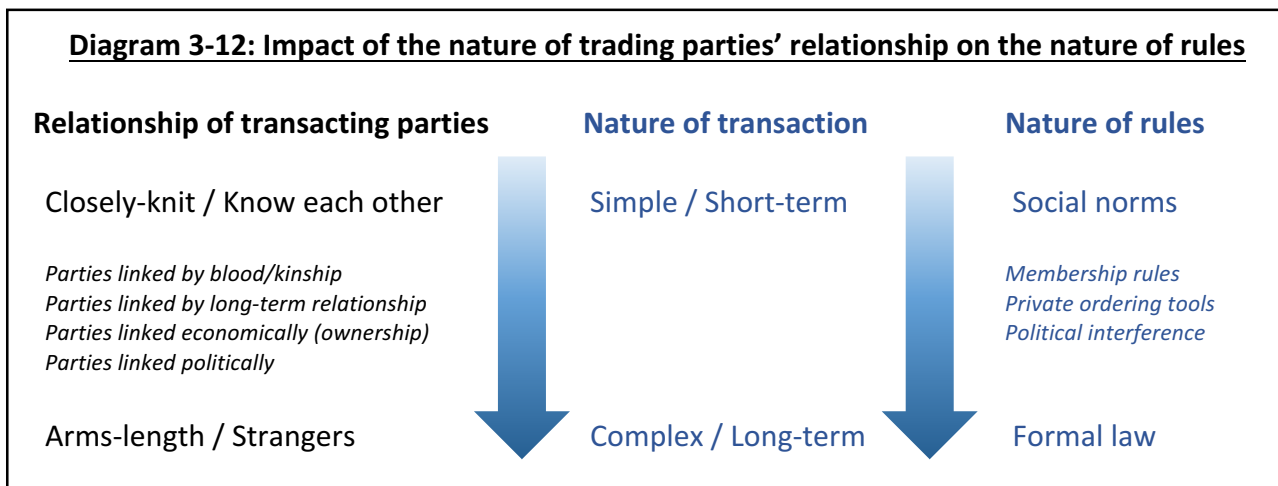
In between these two extremes – relational dealings and arms' length dealings – is a whole spectrum of hybrid relational-market arrangements where the lender and the borrower are not complete strangers and the lending conditions tend to be more defined and explicit than in relational lending and more project-specific than in arms' length lending.¹⁷⁹ Such hybridisation of the nature of transacting parties and their dealings often takes place during economic transition from plan to market – as we can observe in China since the reforms started in 1978. As trading partners become more heterogeneous and less well-known to each other, and as the transactions become increasingly more complex, span longer periods of time, and become less frequent (or even not repeated),¹⁸⁰ the parties' needs change – and their preferred solutions often shift from pure reliance on social norms to a mixture of social norms and laws to enforce their agreements and secure their deals.

¹⁷⁸ For more, see Chapter 4.2.2.2

¹⁷⁹ For an interesting discussion of this categorisation, see Coote and Schäfer (2011) at 113-115

¹⁸⁰ For an excellent overview of legal anthropology see Glenn (2007), in particular chapters 1, 2 and 10.

The reason for this shift is that all dealings rely on individuals' ability to make credible commitments to one another. In simple relational dealings parties can rely on trust and reputation. In more complex arms-length dealings, on the other hand, they tend to use written contracts, fiduciary duties and other law-derived mechanisms.¹⁸¹ During transition, when *formal law* is still imperfect or outright non-existent, club enforcement mechanisms, private ordering tools, and state interference are often used to ensure enforceability of parties' promises (which, in turn, enables trade beyond one's immediate relational network).¹⁸² This dynamic is illustrated in Table 3-12.



Literature suggests that as the nature of transacting changes, new, more formal rules are introduced and they enrich – rather than replace – informal rules.¹⁸³ As a result,

¹⁸¹ The existence of public ordering mechanism strengthens the credibility/reliability of private ordering: Morrison and Wilhelm (2015)

¹⁸² See Cooter and Schäfer (2011) at 18: 'Under communism, state planning displaced markets, nationalized industries dwarfed private ownership, and public law crowded out private law. Even so, stable bureaucracies gave officials economic power somewhat like property rights, and political bargains created obligations resembling contracts.'

¹⁸³ Different rules coexist: Cooter (2000); Cooter and Schäfer (2011) at 35; Milhaupt and Pistor (2008) at 193. Moreover, formal rules often rely for their content and/or legitimacy on informal rules: North (1994); Peng (2004), Ellickson (1998), Posner (1997), Huang and Wu (1994).

new layers of enforcement tools are added to suit the increasing complexity of parties' interaction, which in turn enables greater amount of more diverse cooperation to take place because previously unenforceable promises can be comparatively efficiently enforced.¹⁸⁴ The whole spectrum of formal and informal rules plays an important role in debt enforcement in China.¹⁸⁵

3.3.2 Role of law in China

China had several legal codes before the fall of the empire in 1911,¹⁸⁶ but its current legal system only dates back to the 1980s economic reforms. In the aftermath of the 1949 Revolution, all laws were abolished and replaced by very basic, non-specialist written regulations that could be easily changed. Mao abhorred the law because he believed it suffocated the free flow of revolution and served as a capitalist tool of oppression. As a result, the Party enjoyed absolute power with no constraints on its exercise. The legal vacuum that existed in China between 1949 and 1975 was only disturbed by the Marriage Law and the 1954 Constitution.¹⁸⁷ The effect of the resulting legal uncertainty together with the Party's propaganda against the rule of law¹⁸⁸ was that it became natural to distrust the law. The last ten years of Mao's rule – the 1966-76 Cultural Revolution – was a time of

¹⁸⁴ For a full discussion of the idea see e.g. Thelen (2004); van der Heijden (2011)

¹⁸⁵ For discussion of formal and informal mechanisms used, see Chapters 4.2 and 5.4. For a general discussion of the interaction between law and trust-based transacting see Chen, Deakin, Siems and Wang (2017)

¹⁸⁶ Despite erroneous assumptions to the contrary in many Western texts. See e.g. DeLisle (n.165)

¹⁸⁷ The Party's position was that 'Laws are odious: they tie hands of the leaders': Ladany (1988) at 55. See also Li (n.110) at xxxvii-xxxviii

¹⁸⁸ See e.g. Ladany (1992) at 69

anarchy. Mao was made a permanent head of state in 1970 to confirm his absolute, emperor-like power over China. At the same time, the Red Guards humiliated and killed millions of intellectuals and people who opposed the regime, with no trials and no laws to protect them. As Ladany, a long-term resident and observer of China at the time, put it: ‘This was lawlessness organised from above. [...] Law, in any intelligible sense, was at an end.’¹⁸⁹

Only when Mao’s power declined due to his deteriorating health could the law come back. The NPC met after a decade of passivity in 1975. And when Deng rose to power in 1976 and started his reforms in 1978,¹⁹⁰ laws were slowly reintroduced. Deng recognised that laws could be used to formalise and consolidate the achievements of economic reforms, to bring stability, and to enable future changes. The Ministry of Justice was re-established in 1979 (it had closed in 1959), and the 1980s saw a shift towards perceiving the legal system as a pre-requisite for much-desired social and economic development.¹⁹¹ The 1982 Constitution, although minimalistic, laid foundations for a greater role for the rule of law in China. It was amended several times, *inter alia* in 1988 to legitimise the existence of the fast-developing private sector, in 1993 to formalise the ‘socialist market economy’ direction, and in 2004 to recognise private ownership.¹⁹²

¹⁸⁹ Ladany (1988) at 73

¹⁹⁰ See Chapter 3.1 for more

¹⁹¹ See Zhang (1981); Tay and Leung (1995); Ladany (1992)

¹⁹² For commentary see Chen (1994) at 5; Legal Daily (2.1.1994)

3.3.2.1 *Limited rule of law in China*

Many new laws have been introduced and subsequently updated since the reforms started in 1978. However, despite statements to the contrary by the Party-state and some Chinese scholars,¹⁹³ China does not have a robust rule of law.¹⁹⁴ There is no separation of powers,¹⁹⁵ and control is concentrated in the hands of the Party-state, without any meaningful checks and balances on its exercise.¹⁹⁶ Law remains subjected to the Party-state's will. This is the case at the law-making level – through influencing the NPC's law-making activities – and at law-enforcement level – through influencing legal professionals¹⁹⁷ and courts.¹⁹⁸ Moreover, there is no supremacy of law.¹⁹⁹ Instead, some say that Deng's reforms and subsequent laws simply 'replaced state-led growth with state-protected growth.'²⁰⁰ As a result, laws' creation and enforcement are fully controlled by the Party-state. Similarly, the Constitution is not treated as superior to other rules and organisations, and instead the society is governed by ideology and the will of the Party-state. In addition, laws are not made and enforced in a transparent and objective manner. Instead, major decisions are still made behind closed doors, and a review of the Party-state's decisions is unavailable. Moreover, protectionism is

¹⁹³ See Duan (2008)

¹⁹⁴ Not even a thin version of it: for a discussion see Blasek (2015) at 10, 13-16

¹⁹⁵ von Hayek (1993) at 210. Instead, China has a division of duties: Blasek (2015) at 19-32

¹⁹⁶ Blasek (2015) Chapter 4.1

¹⁹⁷ See e.g. The Economist (15.6.2017)

¹⁹⁸ See Chapters 3.3.3.2-3, below

¹⁹⁹ Blasek (2015) Chapter 4.2

²⁰⁰ Coote and Schäfer (2011) at 22

rampant, especially at local level, which prevents fair and impartial enforcement of the law.²⁰¹

And so, although formal law has gained more weight in recent years – exemplified also in the 1999 addition of Article 5(1) to the Constitution which stipulates that the country is to be ruled ‘in accordance with the law’ and the emphasis on the rule *by* law since 2008²⁰² – the Party remains above law,²⁰³ it determines access to business opportunities and most bank-finance,²⁰⁴ and local protectionism is ubiquitous. It is, therefore, hardly surprising that relational *guanxi* networks remain significant²⁰⁵ – especially to private entrepreneurs who face severe credit constraints,²⁰⁶ red tape, and often also closed doors at courts.²⁰⁷

However, saying that nothing has changed since Mao’s era would be inaccurate. Many important laws have been introduced, and steps are being taken for them to be enforced. Certain elements of state power are restricted.²⁰⁸ The Party-state’s ideology has also changed significantly to provide for a greater role of law – including improvements in governance, a new access to courts’ decisions online, a creation of new procedures for

²⁰¹ For a discussion see Blasek (2015) at 10

²⁰² This sounds the same as rule of law in Chinese (...). For more, see Blasek (2015) at 43; “Rule by Law: A Series” at http://www.nytimes.com/ref/world/asia/rule_index.html

²⁰³ Chow (2004) at 144

²⁰⁴ Zheng and Zhou (2013) show that loans are granted to companies based on their political connections rather than their profitability or promise.

²⁰⁵ As He (2012, at 73) has put it: ‘Like most countries, China has a well-written constitution. China’s constitution, however, does not tell how the state actually operates.’ See also Tay and Leung (1995) at 1-10, 182

²⁰⁶ Yueh (2009)

²⁰⁷ Kahn (2005, at 365) reports that ‘Courts legally must issue written rejection notices if they choose not take the case. But to avoid appeals, court clerks often decline to take possession of legal papers. No rejection notice is needed if the case does not, in China’s political-legal cosmos, formally exist.’

²⁰⁸ For example, the revocation of land-usage rights: see 4.1.3.5 and 5.2.1.5

communication of grievances and complaints, and more transparency and involvement of stakeholders in the law-making process. Moreover, law plays an important role in arms-length dealings among private sector companies. And more people are now turning to the law to resolve their disputes and seek redress for wrongdoing – even in purely personal disputes.²⁰⁹

3.3.2.2 Law-making process in China

These limitations on the rule of law are reflected in how laws are made – discussed here – and in how the laws are enforced – discussed in the next section. According to the Constitution and other laws, law-making power is held by the NPC and the NPC Standing Committee²¹⁰ who are supposedly representing the people's interests and wishes. The NPC adopts and amends the Constitution (*xianfa* 宪法), basic laws (*jibenfalv* 基本法律), and decisions (*jueding* 决定). When the NPC is not in session (i.e. most of its five-year term), the NPC's legislative powers are delegated to the NPC Standing Committee. Further legislative powers are held by the State Council which can make secondary laws, namely administrative measures (*banfa* 办法) and administrative regulations (*xingzhengfagui* 行政法规), and it can issue decisions (*jueding* 决定) and orders (*mingling* 命令) to implement these basic laws so long as it acts within the limits of the power delegated from the NPC and the NPC Standing Committee. This hierarchy is then duplicated at local levels (provincial, municipal, and county) and in SEZs and other approved areas within China, creating subordinate layers of local regulations (*difangxingfagui* 地方性法规) which are binding on

²⁰⁹ SZICA (18.2.2013)

²¹⁰ Art 7 of the Legislation Law 2000

the local community so long as they do not contradict any of the higher-level rules and are approved by the relevant provincial-level people's congress. These rules are further supplemented by the SPC which regularly publishes guidelines for lower courts, including interpretations (*jieshi* 解释), opinions (*yijian* 意见) and non-binding but nevertheless persuasive guiding-style cases (*zhidaoxinganli* 指导性案例).²¹¹

The Legislation Law 2000 sets out the procedure of law-making in the NPC and the NPC Standing Committee²¹² – as outlined in Diagram 3-13. In most cases, a proposed bill is first submitted to the NPC Standing Committee which then decides whether to recommend it for consideration at a full session of the NPC.²¹³ Once on the agenda, the bill is introduced, and its key aspects are explained by its sponsor. The bill is then reviewed and considered by individual delegates, by relevant special committees, and by the Law Committee who then submit their opinions to the Presidium.²¹⁴ Non-state actors and stakeholders can influence the process during Preparation and Review stages.²¹⁵ A bill is often re-drafted multiple times by the Law Committee to reflect the opinions of the delegates, the committees, technical experts and the interested delegations. During the review period, the draft rules are often also trialled in several selected regions to determine their impact and any problems that they may face in practice.²¹⁶ Sometimes, local governments unilaterally trial new initiatives,

²¹¹ For more see SPCM (10.7.2015)

²¹² Chapter II of the Legislation Law 2000

²¹³ Art 14 of the Legislation Law 2000

²¹⁴ Arts 16-18 of the Legislation Law 2000. The Law Committee's opinion must highlight any major controversies, assess the feasibility of the proposed law, and explain any proposed amendments are relevant.

²¹⁵ Art 19 of the Legislation Law 2000

²¹⁶ See e.g. Karindi (2008)

which – if successful – are adopted nation-wide.²¹⁷ Changes are usually gradual, following Deng's reform motto: 'crossing the river by feeling the stones.'²¹⁸ Only then, when the Presidium is satisfied that the draft law reflects all the comments it deems necessary, can the bill progress to the fourth, voting stage. The law passes by a simple majority vote²¹⁹ but, in reality, most bills either never make it to this stage or are (almost) unilaterally accepted. The law is then signed by the President and published.



²¹⁷ That was the case with insolvency law as well: Zhang and Booth (2001) at 22-24

²¹⁸ *mozheshitouguohe* 摸着石头过河

²¹⁹ Art 22 of the Legislation Law 2000

3.3.3 Limited law enforcement in China

Most Chinese laws are written at a ‘high level’ – i.e. without many details – and so they need proficient, effective and independent enforcers to apply them in practice.²²⁰

Unfortunately, law enforcement is problematic in China. This section, therefore, looks at the root of the problem – namely lack of judicial independence (3.3.3.1) – and its causes – the interference from the Party-state (3.3.3.2) and the courts’ subordination to it (3.3.3.3).

These issues are further explored in the context of the EBL in Chapter 5.3.

3.3.3.1 Lack of judicial independence in China

A number of studies suggests that strong independent judiciary is beneficial for economic development.²²¹ There is evidence to suggest that the degree of judicial independence is correlated with economic growth.²²² Similarly, more independent and stronger judiciary may help create better business environment and appears to be correlated with faster growth of companies.²²³ Studies across different regions of select countries further suggest that regions with stronger, more effective courts also enjoy better access to credit, while regions with weak, ineffective courts often suffer from limited investment and economic

²²⁰ Dam (2006, Chapter 5); Feld and Voigt (2003)

²²¹ Measured by e.g. length and cost of procedures, responsiveness to filed claims, ability and capability to cope with the caseload, etc.: Trebilcock and Prado (2011) at 114-115; Dam (March 2006). But Cf Gilson and Milhaupt (2010) who argue that there are other alternatives

²²² Feld and Voigt (2003); Klberman (2007)

²²³ Islam (2003) at 7-9

inefficiencies due to companies' reluctance to switch to new (even if cheaper) suppliers for the fear of not being able to enforce their agreements and get remedies in courts.²²⁴

Judicial independence in China is a much-debated topic, but it is generally accepted that courts are heavily influenced by the Party-state.²²⁵ On paper, written laws make Chinese judges fully-independent final arbiters and balance-keepers who ensure fair application of legal rules and principles.²²⁶ Chinese judges – like other civil law judges, e.g. in Germany – are heavily involved in the hearing and management of cases, and they do not provide detailed explanation of their decision.²²⁷ However, much of the substantive law is derived from common law countries (e.g. UK, US) where independent judiciary help co-create and develop the law. This creates tensions and gaps, and gives rise to even greater need for judicial independence.

In practice, courts follow Party-state's guidance about which cases to hear and how²²⁸ in order to protect Party-determined interests and goals.²²⁹ And despite identifying 'judicial independence' as one of the key reform goals, the Party-state has made it clear that they may embrace enhanced courts' autonomy, but not a complete separation of power with the Party-state retaining its ability to interfere in complex and important cases.²³⁰

²²⁴ The same result was found in e.g. Argentina, Brazil, Mexico, Russia, Vietnam, etc.: World Bank (2004) at 86

²²⁵ See e.g. Delisle (n.165)

²²⁶ The EBL is not exception: Chapters 5.1.1 and 5.3.1

²²⁷ Clark (2002) at 75

²²⁸ Interviews J1-c to J9-c, L2-s to L15-c, P1-r, P3-r, R3-r, R6-c to R10-c, R14-s

²²⁹ SPCM (19.3.2017)

²³⁰ Congressional-Executive Commission on China, "Judicial Independence in the PRC" at www.cecc.gov/judicial-independence-in-the-prc See also views expressed in CPD (10.10.2015)

3.3.3.2 Why does the Party-state interfere

The Party-state interferes in judicial decision-making for a number of reasons, albeit the exact *modus operandi* depends on local needs and development trajectories.²³¹ I first look at institutional-level reasons and how they are affected by the differences in preferences and interests at national and local levels of the government. I then look at personal-level reasons that affect individual officials' behaviour vis-à-vis courts in particular cases. The two sets of incentives are summarised in Table 3-14.

Table 3-14: The Party-state's incentives to interfere in law enforcement

Incentives to interfere in law enforcement	
Institutional-level reasons	NATIONAL GOVERNMENT makes laws → its focus: long-term prosperity - national economy - efficiency-maximising - pro-foreign cooperation → influenced by international pressure (WTO, IMF, the World Bank, Chambers of Commerce, foreign governments)
	LOCAL GOVERNMENTS implement laws → their focus: short-term prosperity (their term in office) - local economy - raise local taxes, make local profits - local protectionism → influenced by local stakeholders (employees, companies)
Personal-level Reasons	Local governments' officials' CAREER PROSPECTS → targets that measure ability to promote economic development, to maintain social and economic stability ➔➔ leads to falsification of data, local protectionism, interference in law enforcement
	ACTUAL / POTENTIAL PRESSURE from STAKEHOLDERS on local governments' officials → letters and visits → media pressure → (threat of) a mass protest → personal pressure through special relationships ➔➔ leads to local protectionism, interference in law enforcement

²³¹ All my interviewees stressed that the importance and impact of the discussed issues vary across provinces and regions in China and across national and local layers of the Party-state.

At the *institutional level*, the key issue arises from the divergence in the focus and interests of those who make the law – i.e. the national government²³² – and those who implement and enforce it – i.e. local governments. The national government is primarily concerned with long-term interests of the country and the economy as a whole. As a result, national law reforms tend to focus on macroeconomic efficiency, on gaining access to the international market, and so on ensuring continued growth of China's economy.

On the other hand, local governments focus more on shorter-term,²³³ individual needs of their respective provinces because they are ultimately accountable for their performance in their region.²³⁴ While the national government faces pressure from the international community, local governments respond to the needs and pressure from (local) individual companies and particular problems which are often unique to their region.²³⁵ Moreover, the national government is concerned with overarching principles, ideology, the overall performance of the economy, overall levels of employment, and their appearance vis-à-vis the outside world (markets, investors, governments) and Chinese people as a whole. In contrast, local governments are often concerned with local-version of such problems, they face the immediate effects of their policies and actions (such as labour strikes, lower taxes, lower FDI, etc.), and therefore have to be more pragmatic in their

²³² And more importantly the small power-centre called Politburo Standing Committee of the Communist Party. For the purposes of this chapter I treat them as one. See also Chapter 3.4

²³³ For details see the discussion of personal-level incentives, below

²³⁴ The accountability of local government translates into individual officials' duties and incentives, below

²³⁵ Interviews C1-c, C4-c, C5-r, C7-s, C11-c, J1-c, J4-c, J5-s, J8-c, J9-c, L2-s, L4-r to L6-s, P1-r, P3-r to P5-c, R1-r to R3-r, R6-c to R11-c, R21-c, R15-s

promises and approach to rules passed down to them from the national level.²³⁶ This divide was further reinforced by the fiscal decentralisation²³⁷ which has given local governments greater powers with regards to the property and resources under their control – strengthening their incentives to maximise economic development and profits.²³⁸ At the same time, however, local governments became responsible for raising most revenue for the local budget.²³⁹ It has led to a boost in efforts to maximise profitability of local enterprises, but the resulting financial pressure also led to local preference for short-term revenue over potentially profitable but long-maturity projects.²⁴⁰ Moreover, it also strengthened local governments' tendency to protect local companies regardless of their efficiency and competitiveness.²⁴¹

In addition to institutional-level incentives, individual officials' *personal-level* incentives also trigger Party-state's interference – mostly at local level. The discussion will focus on two examples, namely incentives relating to officials' career prospects, and those arising from actual and potential pressure from affected stakeholders in particular cases.

The first type of personal-level incentives is tied to career progression of local government officials. Each official's political career depends, to a large extent,²⁴² on their

²³⁶ *Ibid.*

²³⁷ See Xu (2011) at 1084-1087

²³⁸ Oi (1992) at 100

²³⁹ Yand (2004) at 27

²⁴⁰ Saich in Tomba (2002) at 79

²⁴¹ Local governments' short-termism is further reinforced by the fact that top cadres in local governments usually only stays in power for five years and their performance is judged over one-year and the total five-year period.

²⁴² Person's connections and ancestry are also important. Many of the most powerful posts are held by the princelings: Brown (2014)

proven abilities to promote economic development and to maintain social and economic stability.²⁴³ Individual officials who wish to advance their respective careers can demonstrate such abilities through a position in a local provincial government²⁴⁴ – often in one of the more problematic or underperforming provinces.²⁴⁵ The satisfaction of this requirement is assessed primarily against easily measurable economic targets,²⁴⁶ with the aim to incentivise the officials to maximise their region’s economic development and economic output. However, there are many problems associated with such quantitative assessment system. Most importantly, the targets are usually measured over a one-year period,²⁴⁷ and so their use creates a bias towards short-termism. Moreover, research suggests that simple targets may not be able to incentivise sustained effort and performance.²⁴⁸ As a result, officials’ incentives are skewed towards protectionism and inefficiency.

The situation is illustrated in Diagram 3-15, below. From officials’ point of view, if they know that their output is not sufficient to meet their targets, they have two options: either to falsify the data or to report the truth. If they admit to failing to meet their targets – i.e. if they report the truth – they will not be promoted and may face a fine or other punishment under the cadre responsibility system and the professional performance

²⁴³ Interviews C5-r, C7-s, P1-r, P3-r to P5-c, R1-r, R3-r to R9-c, R12-c, R15-s. As we saw, this is formalised and further reinforced through cadre responsibility system and political performance contracts: Chapter 3.2.2

²⁴⁴ *Ibid.*

²⁴⁵ *Ibid.* A large majority of the past and current Chinese leaders made their way up through successful career in the provinces: Xu (2011) at 1098. See also Li (n.110)

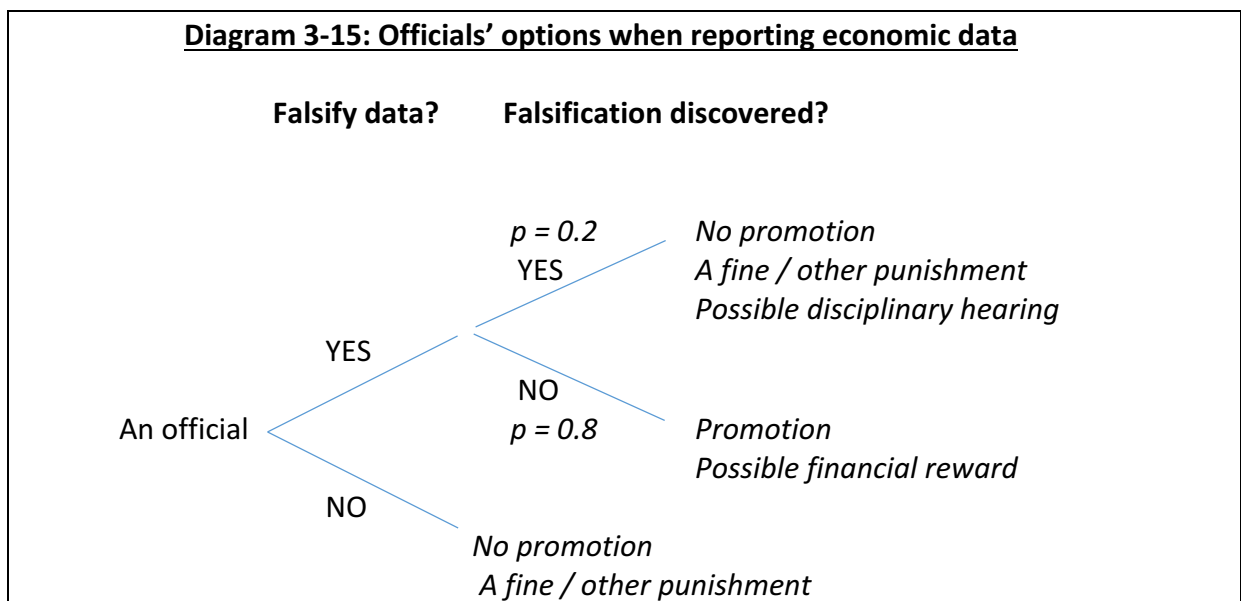
²⁴⁶ GDP, FDI, growth rates, import and export, trade volume, etc.: Xu (2011) at 1098

²⁴⁷ i.e. 1-year period for cadre performance system and 5-year period for local (provincial) governments’ election period: “People’s Republic of China” in *Concise Encyclopaedia of Democracy* (2013) at 94-98

²⁴⁸ Baker, Jensen and Murphy (1988); Kohn (1993) – confirmed in Interviews C5-r, C7-s, P1-r, P3-r to P5-c, R1-r, R3-r to R9-c, R12-c, R15-s

contract.²⁴⁹ If on the other hand, they falsify the data they may be rewarded with a promotion and possibly also financial reward if the falsification is not discovered; or if the falsification is discovered, they would not be promoted and face a fine, other punishment and possibly also disciplinary hearing.²⁵⁰ Thus reporting the truth, and falsifying the data and being found out carry similar levels of punishment. Given that the probability of falsification of data being discovered²⁵¹ is low – let's say 20 percent²⁵² – it is rational for officials to falsify the data to their advantage.

Diagram 3-15: Officials' options when reporting economic data



²⁴⁹ Chapter 3.2.2

²⁵⁰ Under the Statistics Law 1984, as amended on 2009, government officials may be liable if they refuse to answer or answer untruthfully statistical investigation inquiries or if they refuse to participate in or otherwise hinder statistical surveys and investigations: Art 40. Moreover, companies and institutions violating the law may be fined up to RMB 200,000: Art 41. However, enforcement has been rare: Reuters (12.2.2014)

²⁵¹ i.e. their superiors will be able and willing to check whether the data that they submitted is correct

²⁵² My interviews (B1-c, B3-c, C1-c, C4-s to C7-s, C11-c, E1-c to E5-c, J1-c, J4-c to J9-c, L1-r to L17-c, P1-r, R2-r, R3-r, R6-c, R7-c, R9-c, R10-c) suggest that falsification of data is rampant and that, in their experience, it was very unlikely for the data to be checked in practice. Indeed, in practice there are very few examples of revealed falsifications of the economic data (see e.g. China Daily (Europe) (6.9.2013)). Therefore, I assume the probability of discovery to be 20 percent, although it may be much less.

Similarly, officials have to show their ability to maintain social stability. This usually involves them preventing or mediating large-scale disputes and disturbances, including labour unrest which is now commonplace in China. There were about 2,770 large-scale labour strikes and protests in 2015.²⁵³ They are often triggered by calls for higher wages, pay cuts, late or non-payment of wages, or factory closures (due to insolvency, reallocation, etc.).²⁵⁴ Local governments try to suppress them by declaring them illegal and threatening imprisonment and fines, often with the assistance of police who disperse the protesters.²⁵⁵ Any such suppression or use of force, however, has to be carefully managed because underestimating the problem or overreacting to it may cost an official his career.

Another type of personal-level incentives that discourage local government officials from allowing objective law enforcement is *stakeholders' pressure*. Although China is not a democracy, local governments do pay close attention to individuals' grievances, particularly where they could lead to disturbances of social stability.²⁵⁶ This is due to the pressure from above and from below. From above, higher levels of government evaluate lower levels with regards to their ability to maintain a 'harmonious society' as a part of their career-progression evaluation process. From below, stakeholders whose interests would be affected by objective law enforcement often exert pressure on local governments, and thereby also indirectly on the courts. There are four key methods that they use, namely

²⁵³ China Labor Bulletin (2016)

²⁵⁴ Hernandez (14.3.2016)

²⁵⁵ *Ibid.*

²⁵⁶ Interviews C4-s, C5-r, C7-s, C11-c, J1-c, J4-c to J9-c, L2-s to L7-c, L9-c to L15-c, P1-r, P3-r, P5-c, R2-r, R3-r, R6-c, R7-c, R9-c, R10-c

‘letters and visits;’ pressure through the media; protests; and exploitation of the interconnectedness of the Party-state and state sector companies.

Firstly, the practice known as ‘letters and visits’ (*xinfang* 信访) enables aggrieved individuals to lobby their local government through both written (letters) and personal (visits) pressure.²⁵⁷ The tendency to avoid personal clashes and disagreements coupled with the fear of social unrest often encourage local governments to respond to such popular pressure and intervene.²⁵⁸ Interestingly, the petitioning process handles significantly more cases per annum than courts.²⁵⁹ However, responding to popular pressure may detract from objective delivery of justice, and so endangers the creation and application of uniform rules,²⁶⁰ which weakens the rule of law and empowers the rule of man instead.²⁶¹

Media pressure is another method of influencing local governments and courts.²⁶² Existing research suggests that media can play an important role in exposing injustice and enforcing fairer judicial decisions.²⁶³ Interviews with Chinese lawyers suggested that support from media is often ‘the most important factor leading to a successful lawsuit.’²⁶⁴ Media

²⁵⁷ Mozner (2006, at 107 and 174-5) argues that it enables citizens’ political participation, and is a replacement for the inefficient judicial appeal process

²⁵⁸ Interviews B3-c, C1-c, C4-c, C5-r, C7-s, C11-c, J1-c, J5-s, J7-c to J9-c, L2-s to L7-c, L9-s to L12-c, L15-c, P1-r to P5-c, R7-c to R10-c. See also Liebman (2008) at 22-25

²⁵⁹ E.g. in 2002, the national Xinfang bureau received 11.5 million cases, while courts handled 7.8 million cases (both numbers are from county level and higher): Interview with Zhou Zhanshun, Director of the State Bureau of Letters and Calls, Banyue Tan, 20.11.2003

²⁶⁰ Mozner (2006) at 103; Liebman (2008)

²⁶¹ Mozner (2006) at 172

²⁶² For an overview, see Joseph (2014) at 241

²⁶³ Liebman (2008) at 22

²⁶⁴ *Ibid.* A similar sentiment expressed in my interviews (B3-c, C1-c, C4-c, C5-r, C7-s, C11-c, J1-c, L2-s to L7-c, L9-s to L12-c, L15-c, P1-r, R7-c to R10-c)

coverage of a particular story or case usually forces local officials and Party members to intervene and do what the pressure groups perceive as ‘just.’²⁶⁵

A third way of putting pressure on local governments to intervene in one’s favour is through threatening or actually staging a mass protest, which causes unwelcome publicity and draws attention to a local government’s failure to fulfil one of their target duties – maintenance of social stability. Officials’ incentive to help aggrieved parties is further strengthened by the real possibility that the affected stakeholders’ anger may turn into violence against local government officials.²⁶⁶ Protesters sometimes storm government offices hoping to enforce officials’ cooperation and protection because – the protesters believe – officials have the power and duty to help them.²⁶⁷ To maximise their career prospects and safeguard their personal safety, local government officials often try to avoid controversial clashes and instead appease and prevent potential unrest.²⁶⁸

Finally, companies may also be able to exert influence over local governments where their management is *interconnected with local Party-state* institutions. My interviewees said that such connections could be established through a close, long-term cooperation, through part-ownership of a company by a local government, through Party-state members serving in a company’s management, or through family ties between Party-state members and

²⁶⁵ *Ibid.*

²⁶⁶ Interviews B1-c, C1-c, C3-c to C5-r, C7-s, E1-c, E2-s, J1-c, J5-s to J9-c, L2-s, L4-r to L7-c, P1-r, P3-r to P5-c, R1-r, R3-r, R6-c to R10-c

²⁶⁷ *Ibid.* As we saw, social unrest can have significant impact on overall stability of the country, and so its prevention has been deemed the best safeguard for long-term development and success of China: Chapter 3.1.

²⁶⁸ Cai (2008)

company owners.²⁶⁹ The influence then goes both ways. On the one hand, the special relationship enables local Party-state to influence the company's actions – including its decision whether to invoke the law. But it also enables the company to lobby for special protection and help from the Party-state.²⁷⁰

As a result, local governments are incentivised – on an institutional level as well as individual officials' personal level – to influence whether and how laws are enforced and, often, impose their preferred solution instead.

3.3.3.3 Why do courts allow interference by the Party-state?

We saw that courts tend to follow Party-state's guidance on whether and how to apply the law. Courts appear to allow such interference for three reasons. First, there are internal control mechanisms that ensure judges' cooperation. Second, some judges feel that they *should not* act without Party-state's blessing. And third, some judges feel that they *cannot* act without Party-state's blessing and support.

Firstly, my interviewees suggested that courts' cooperation with the Party-state is ensured through internal control mechanisms that align courts' interests with those of the Party-state. On the Party-side, the mechanisms used include actual oversight of judicial decision-making through in-court Party branches²⁷¹ and requiring all judges to make an oath of loyalty to the Party where they promise 'to faithfully perform the sacred duties of a socialist-with-Chinese-characteristics legal worker; to be faithful to the motherland and the

²⁶⁹ And so they fall within the state sector – see Chapter 3.4

²⁷⁰ Kennedy (2005) at 49.

²⁷¹ Chapter 3.4

people; [and] to uphold the leadership of the Chinese Communist Party and the socialist system.’²⁷² In addition, local governments control judges’ remuneration and career progression.²⁷³ My interviewees suggested that judges are acutely aware of these restrictions, and see them as a strong incentive to cooperate and follow Party-state’s wishes.²⁷⁴

Secondly, my interviewees proposed that some judges feel that they *should not* independently accept and decide certain types cases due to what they perceive as their proper role as a judge in China.²⁷⁵ As explained earlier, Chinese judiciary is not structurally independent from the Party-state and that Chinese courts are more like an administrative extension of the Party-state whose instructions they follow.²⁷⁶ Because the Party-state holds itself out as representing the people,²⁷⁷ many judges do not see themselves as independent, objective arbiters, but rather as state employees who should simply assist the Party-state.²⁷⁸ Some commentators suggest that such unquestioning obedience stems from an implied duty to take into account state-preferred socio-economic interests under the policy of ‘participation in social management’ (*canyuchenhuiguanli* 参与社会管理),²⁷⁹ which forces judges to look beyond particular facts of each case and consider a number of socio-

²⁷² Legal Daily (21.3.2012)

²⁷³ *Ibid.*

²⁷⁴ Interviews C1-c, C5-r, C7-s, J1-c, J3-c to J9-c, R4-c, R6-c to R10-c

²⁷⁵ Interviews C7-s, J1-c, J3-c to J9-c, R9-c, R10-c

²⁷⁶ See Chapter 3.2

²⁷⁷ See Chapters 3.2 and 3.3.1

²⁷⁸ Interviews C7-s, J1-c to J9-c, L2-s, L4-r to L7-c, L10-s to L15-c, P1-r, P3-r, P5-c, R7-c to R10-c

²⁷⁹ See Qin (2011) at 241-242

economic issues²⁸⁰ and the effect that their ruling could have on other stakeholders. Judges are, therefore, expected to assist local governments in the organisation and management of the public by promoting ‘harmonious society’²⁸¹ and social stability, helping safeguard the interests of local and national economy, cooperating with the local government to ensure maximum employment and social welfare, encourage and assist in informal resolution of disputes, etc.²⁸²

Finally, there is evidence to suggest that some judges also refuse to act independently because they believe they *cannot* successfully resolve them without Party-state’s support.²⁸³ Some believe that due to the complexity of many cases, a powerful mediator – the Party-state – is needed to persuade the parties to negotiate and cooperate. Similarly, some judges also fear that even if they did make an independent ruling, they would not be able to effectively enforce it without Party-state’s assistance and support.²⁸⁴

3.4 Corporate ownership and control in China

Many powerful companies in China are owned and controlled by the state. It is, therefore, important to understand the structure and conduits of power that influence companies and their decision-making. This section, therefore, first looks at the meaning of state capitalism

²⁸⁰ In the context of the EBL, this is briefly discussed in Chapter 5.1.1, but their pro-state, pro-employee biases go well beyond what the substantive EBL allows.

²⁸¹ See Chapter 3.3.1 for a discussion of Confucianism and the law in China

²⁸² Wang (2011). For a detailed discussion see also She (2014)

NB: many of my interviewees – particularly from the more developed and pro-market regions – rejected such limitations on a judge’s role: Interviews J3-c to J6-s, J8-c, J9-c, L2-s, L4-r to L7-c, L10-s to L15-c

²⁸³ Interviews J1-c, J6-s to J9-c, L4-r to L7-c. The Chinese Lawyers’ Association seems to support this view (n.245)

²⁸⁴ *Ibid.*

in China (3.4.1). It then examines corporate ownership and control in China (3.4.2), and proposes an updated division of the economy into a state sector and a private sector (3.4.3). The discussion concludes by looking at the impact of corporate ownership and control on law enforcement in China (3.4.4).

3.4.1 State capitalism in China

Chinese ‘state capitalism’²⁸⁵ involves ‘(1) a comparatively high degree of direct state participation in the economy...; and (2) the use of capitalist forms of economic organisation – markets, corporations, and other investment vehicles – in combination with nondemocratic forms of public governance.’²⁸⁶ As a result, companies are an integral component of Party-state’s governance structure. The Party-state acts as a regulator, but also a direct corporate participant and a decision-maker.

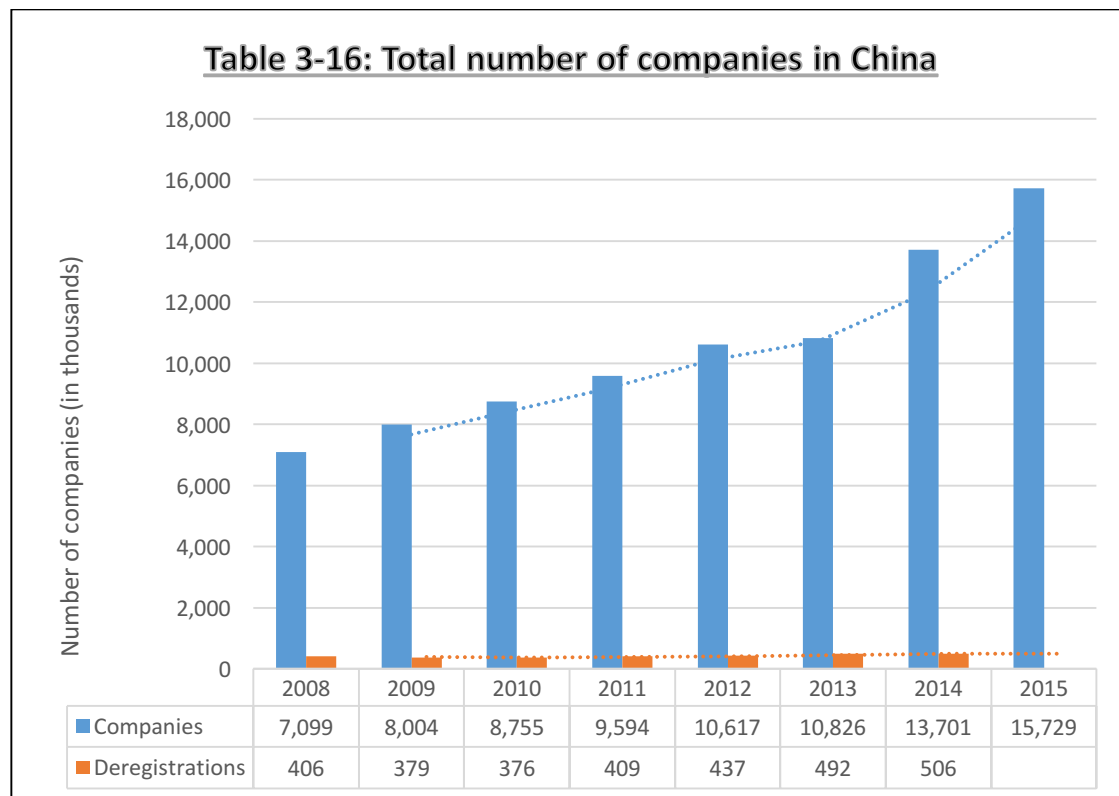
The number of companies in China increased from just over 6 million in 2006 to 17.5 million in 2016, a growth rate of about ten percent per year (Table 3-16). The Company Law amendments in 2013 simplified company formation. But data suggests that less than 70 percent of companies remain active after five years, and less than 50 percent survive the first nine years.²⁸⁷ Some companies deregister – see the orange columns in Table 3-16 – but many live on as zombie companies without liquidating or resolving their liabilities.²⁸⁸

²⁸⁵ For an in-depth discussion, see Milhaupt and Liebman (2016)

²⁸⁶ *Ibid.* at xiv

²⁸⁷ Judge Du Wanhua of the SPC, cited in Zhang (2016)

²⁸⁸ *Ibid.*



Source: NBS, SPC

Business activity – and so most companies – is largely concentrated in coastal areas, and in particular in coastal SEZs (Diagram 3-17).

**Diagram 3-17: Geographical map showing a number of legal entities
by region in 2015**



Source: NBS

Private companies are almost exclusively in coastal regions of Eastern China (Diagram 3-18), while SOEs are more widely-spread across China (Diagram 3-19).

Diagram 3-18: Geographical map showing a number of STATE-OWNED legal entities by region in 2015

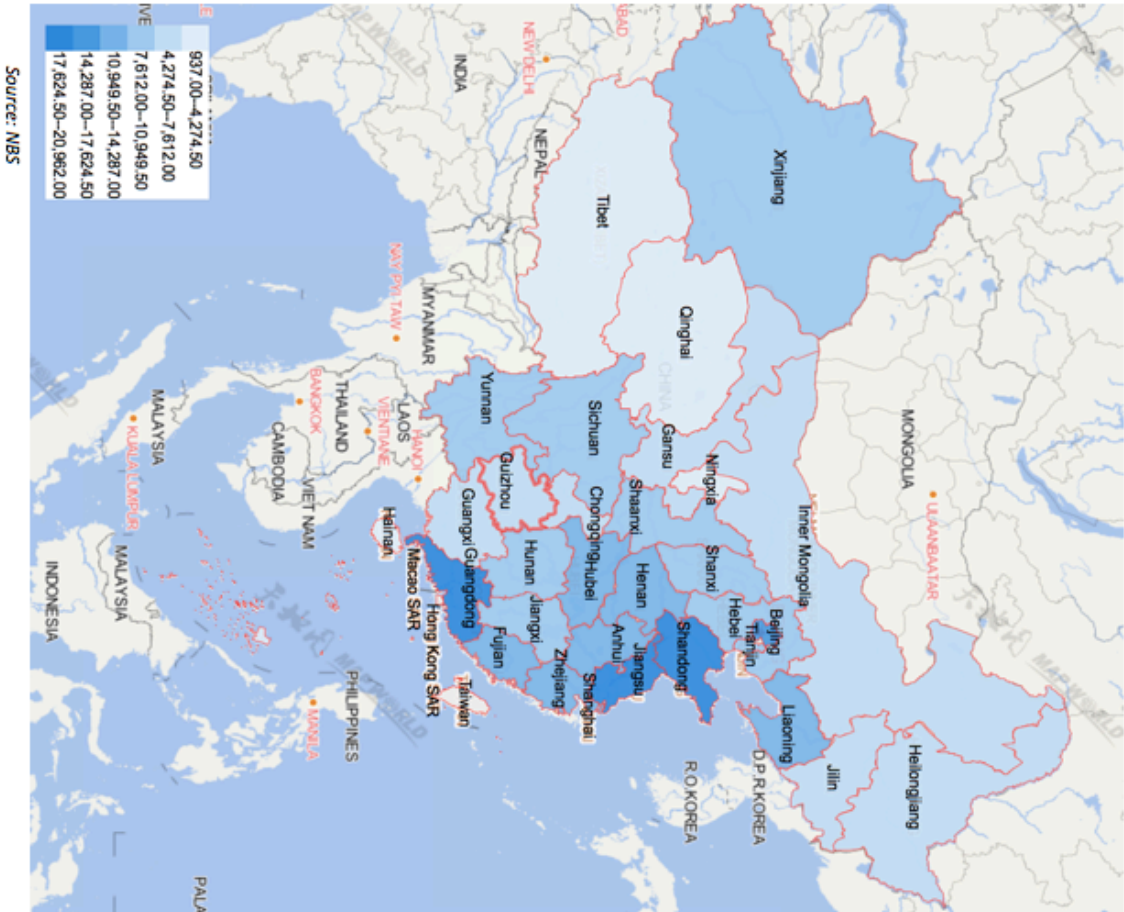
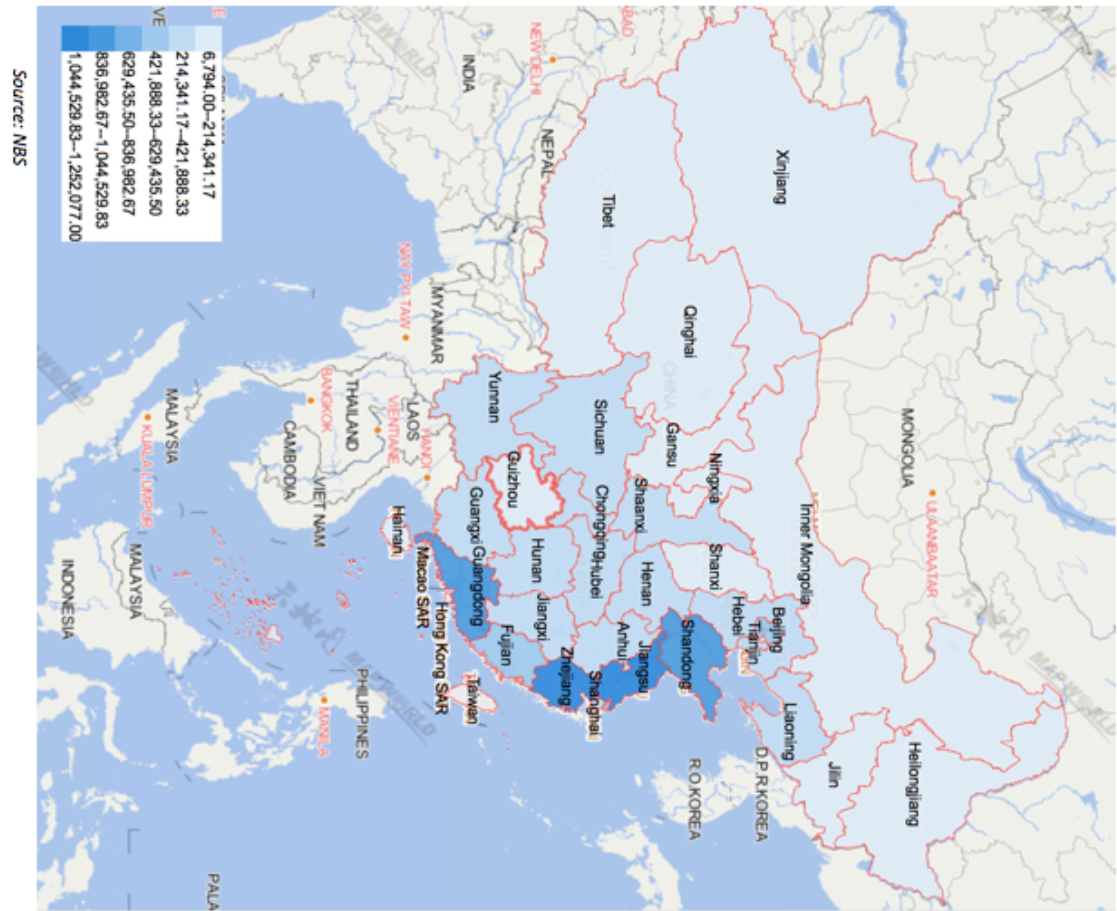


Diagram 3-19: Geographical map showing a number of PRIVATE legal entities by region in 2015



3.4.2 Corporate ownership and control in China

One of the primary building blocks of Chinese state capitalism is the SOEs – that is companies or corporations that are wholly or largely owned by a state department, organ or agency. When Deng started his reforms in 1978, all companies were state-owned, and about 80 percent of the population lived in the countryside and worked in collectively-owned and state-owned communes.²⁸⁹ Deng realised that central planning caused inefficient use of resources, overproduction of unwanted goods, and insufficient flexibility in responding to demand. In addition, talent was often wasted, and workers lacked incentives to do more than the bare minimum. To address these concerns, large communes were dismantled and replaced by *a responsibility system* in 1979 whereby each farm or farmer had to produce a certain amount of goods – and could keep or sell the rest. The process started illegally at first when several local political leaders – without an approval from the central government – allowed partial privatisation within their most poverty-stricken areas. The programme was so successful that communes were soon dismantled all over China²⁹⁰ and reforms were introduced to enable greater efficiency and responsiveness to consumers' needs within the state-owned economy.²⁹¹

In time, most SOEs were sold off to reduce the managerial burden on the state and to incentivise their greater efficiency and productivity. Privatisation of the SOEs was

²⁸⁹ Hutcheon in Tay and Leung (1995) at 40-47

²⁹⁰ For an excellent discussion of the grassroots initiatives see Xia (2008)

NB: As a result, grassroots initiatives have been supported ever since. Even the reformed EBL 2006 was partly based on Shenzhen local insolvency law – see Chapter 4.3

²⁹¹ e.g. by allowing farmers to decide which crops to grow, to sell any surplus for profit, etc. As a result, agricultural productivity grew by about 30 percent (from 305 million tonnes in 1978 to 407 million tonnes in 1984): Kynge (2006) at 14

gradual.²⁹² It played an important role in dismantling rigid control and planning of the economy, and so lay the foundations for liberalisation of trade. Privatised SOEs attracted new investment and management. Some failed, others succeeded, but mostly they introduced a new stage of China's transition away from state-directed development to less predictable but potentially more rewarding market-based development.

The state retained ownership and control of profitable SOEs in key industries (manufacturing, natural resources, infrastructure), but gave them partial autonomy in marketing, investment and production decisions in order to encourage greater productivity and efficiency. In time, SOEs started operating under government's guidance rather than mandatory planning system, and from 1984 each SOE only had to give the government a fixed sum or goods and could keep or sell any surplus on an emerging internal market.²⁹³ Several large SOEs were listed in the 1990s to attract new investment, albeit the state usually kept the majority stake in them. To monitor and supervise SOEs controlled by the central government, the State Assets Supervision and Administration Commission ('SASAC') was created in 2003. Itself under a direct state supervision, SASAC has been in charge of China's biggest SOEs – the national champions²⁹⁴ – to supervise and ensure compliance with state guidance.²⁹⁵ In recent years, the number of companies under SASAC's control fell from

²⁹² Privatisation was gradual in China, unlike the Soviet Union where it took only 500 days and led to dangerous instability and, unrest, and abuse by the insiders: see Chow (2004)

²⁹³ Pollard (2011) Chapter 6; Zhou (1996); Sim (2003) at 31-50; Barbara-Francis (2001); Lin (2004) at 13-14

²⁹⁴ For an insightful analysis of their formation, interconnectedness and state influence, see Milhaupt and Lin (2013)

²⁹⁵ See <http://en.sasac.gov.cn/n1408028/n1408521/index.html>

For an overview of the developments, see Deng Feng in Milhaupt and Liebman (2016) Chapter 2; see also Tenev and Zhang (2000) at 20–28

189 to 102 – largely due to mergers which are hoped to increase the companies' competitiveness and global impact²⁹⁶ – but its importance continues in ensuring political loyalty of China's national champions.²⁹⁷ Additional indirect control mechanisms were also retained, such as the Party-appointed managers,²⁹⁸ the Party cells operating within SOEs, and state-controlled access to bank finance.²⁹⁹

Although state ownership has its advantages – including easier provision of social welfare and implementation of state policies – there is a growing body of literature that identifies and analyses its disadvantages. Among other problems, SOEs' profits 'come from their monopolistic positions, at the cost of private-sector business and their inefficient provision of public goods and services;'³⁰⁰ state-ownership can lead to inefficient allocation of resources and capital; it can also lead to conflicts of interests due to the state's role as both a shareholder and a regulator;³⁰¹ and, in China, it has also led to the creation of inefficient zombie companies.³⁰² Central and local governments have tried to deal with these problems, but refuse to cede control over SOEs.³⁰³

²⁹⁶ Wildau (29.2.2016); Mitchell (31.12.2014)

²⁹⁷ Wu (17.6.2017)

²⁹⁸ Tenev and Zhang (2000) at 20–28

²⁹⁹ Aziz and Duenwald (2003) discover that most bank loans go to provinces with heavy concentrations of SOEs

³⁰⁰ Milhaupt and Liebman (2016) at 4

³⁰¹ Pargendler (2012)

³⁰² For more see Chapters 5.4.2 and 6.1

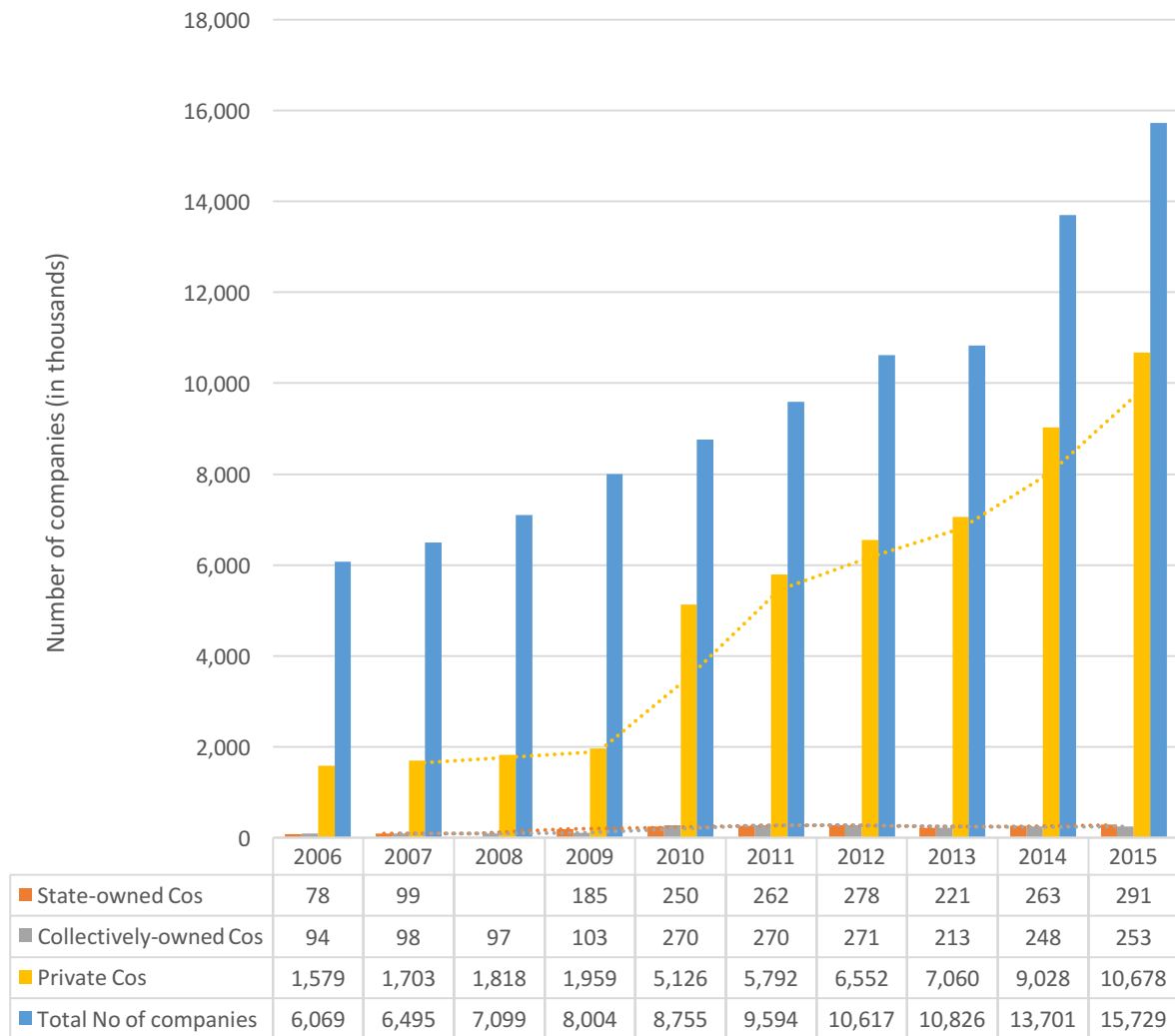
³⁰³ Milhaupt and Liebman (2016) at 49, 133; Wildau (14.9.2015); Hornby (14.7.2016); Wildau (9.1.2017)

Besides the SOEs, however, much of China's growth in the last three decades originated from private enterprises. As discussed earlier, privatisation started in the countryside as a response to the inefficiencies and inflexibility of the management of agricultural production. Besides privatisation of SOEs, local governments in Beijing and other large cities also permitted a creation of private companies in the early 1980s when crowds of able, educated people flooded the cities – which had no jobs for them – after they were released from 're-education camps'.³⁰⁴ Allowing the migrants to start their own small businesses and provide for themselves proved to be an efficient solution.

Private companies grew in number and importance. Their status was formally recognised in 1988 and fully legalised in 2004 when the Constitution was amended to confirm that private property³⁰⁵ enjoys the same protection as state property (and private entrepreneurs have the same rights as SOEs). Since then, the number of privately-owned companies grew and soon overtook the total number of collectively-owned and state-owned companies (Table 3-20).

³⁰⁴ Similar to Soviet gulags: *Ibid.*

³⁰⁵ Art 11 of China's Constitution

Table 3-20: Total number of companies (in thousands) in China

Source: NBS, data.stats.gov.cn

This expansion heralded a new chapter in China's development.³⁰⁶ As the private sector grew,³⁰⁷ in time it became an important source of China's miraculous economic growth. By 2010, private enterprises provided more employment than SOEs, produced twice more

³⁰⁶ Tsai (2007); Li (2012)

³⁰⁷ At first, state retained at least partial ownership and control of new companies, but in time completely private and later also foreign enterprises were allowed to operate. In 1997, it was decided that the state would relinquish control of small and medium enterprises ('SMEs') and their newly issued shares were offered to their managers and staff. The privatisation was substantial but relatively quiet, and state ownership fell by 40% in the first five years alone: Guo and Yao (2005). See also Naughton (1996); Kynge (2006)

exports than SOEs, introduced more technology and innovation, accounted for 80 percent of all new urban jobs, re-employed 19 million workers laid-off by SOEs, and generated 800 billion RMB.³⁰⁸ By 2015, private companies employed twice as many people as SOEs in urban areas.³⁰⁹ There were about ten times more private industrial enterprises by number,³¹⁰ but SOEs held almost twice as many assets by value³¹¹ and each industrial SOE on average owned thirteen times more assets than each private industrial enterprise.³¹²

3.4.3 Two economic sectors

Contrary to most literature which divides China's economy into state-owned and privately-owned sectors, this thesis divides the economy into a 'state sector' and a 'private sector' along not only ownership but also economic significance. The division is based on insights of all my interviewees who spoke of ownership as merely one of several factors that determine whether and how the Party-state exercises control over individual companies' decision-making, their access to finance and their access to courts. The division also builds on two recent projects. Firstly, in determining whether a particular company falls within a state or private sector, it considers issues identified by Kennedy in the context of lobbying,³¹³

³⁰⁸ Li (n.110) estimates that the private sector contributes more than 60% of China's GDP; Nee and Oppen (2011) estimate it is 70% of China's GDP. See also: Allen, Qian, and Qian (2005) *Journal of Financial Economics* 57; Huang (2008)

³⁰⁹ NBS 2016, section 4-1

³¹⁰ 19,273 industrial SOEs v. 216,506 private industrial enterprises: NBS 2016, section 13-4, 13-6

³¹¹ Total assets amounted to 39.74 trillion RMB in industrial SOEs v. 22.9 trillion RMB in private industrial enterprises: NBS 2016

³¹² Assets per enterprise: 2.02 billion RMB per each industrial SOE v. 0.16 billion RMB per each private industrial enterprise: NBS 2016

³¹³ The same issues were repeatedly mentioned in my interviews with stakeholders and practitioners

namely ownership, (absolute and relative) size, profitability, industry affiliation, and location.³¹⁴ And secondly, the proposed division draws on a recent re-examination of the role of ownership by Milhaupt and Zheng in the context corporate reforms in China.³¹⁵ The authors argue – and my interviewees agreed – that reforms of the state sector in China cannot focus purely on state-owned companies. Instead, they say, reforms need to focus on all companies that are under state control – including privately-owned companies under state capture – in order to address the problems raised by state capitalism and make the corporate reform programme more effective.

The particular attributes of the state sector (3.4.3.1) and the private sector (3.4.3.2) are discussed below. The two sectors differ in many aspects, most importantly in terms of the presence/absence of both formal and informal state control and direction; the degree of protectionism and involvement from national and local governments in the resolution of their financial distress; debtors' and creditors' ability to file for a court-based insolvency resolution mechanism; courts' ability to accept such insolvency petition; and their individual economic significance. The resulting access to different sources of debt finance – from the state, shadow market or private sources³¹⁶ – is an additional factor which influences debtors' and creditors' choice of debt-resolution mechanism.³¹⁷

³¹⁴ Kennedy (2005) argues that, contrary to the popular belief about doing business in China, companies' influence in the law-making process depends less on one's *guanxi* and more on one's economic importance. His work also highlights that much of existing research overlooks important dimensions – such as size and industry affiliation – which seems to explain the divergence in one's access and influence far better than ownership or political connections alone.

³¹⁵ Milhaupt and Zheng in Milhaupt and Liebman (2016) Chapter 9

³¹⁶ Chapter 4.1

³¹⁷ Chapter 5.4 returns to this issue when discussing whether a company uses private or politically-driven debt enforcement alternatives

3.4.3.1 State sector (*zhengfuyingjingji*)

My interviewees suggested that there are two key characteristics which determine whether a given company falls within the *zhengfuying jingji* (政府营经济) – which means, literally, government-managed economy. The two characteristics are, namely, a company's (i) state ownership, and (ii) economic significance.

Much has been written about the protectionism of SOEs³¹⁸ in China to the point that it is often assumed only SOEs comprise the entirety of the state sector. However, that is not accurate. Firstly, state ownership is now more complex than it was at the inception of the economic reforms in 1978. As was discussed earlier, state ownership is no longer only direct but, increasingly, also indirect through SASAC and other vehicles and structures.³¹⁹ Furthermore, as the relative contribution of SOEs to local economies began to shrink³²⁰ and several previously state-only sectors opened up to private competition, a number of new non-state players entered the market, and some became important economic players in their own right. Local governments – incentivised by their new responsibility to raise funds for their respective local budgets – responded to these developments by extending their (in)visible hand to economically significant privately-owned companies.³²¹ As a result, a

³¹⁸ See Chapters 3.4.2 and 3.4.4. For the Party-state's reasons for interfering, see Chapters 3.3.3 (general) and 5.3.3 (EBL-specific). For the ways of Party-state's interference, see Chapter 5.4.2 (debt enforcement)

³¹⁹ See Milhaupt and Zheng (n.315)

³²⁰ E.g. lower industrial output, profitability, employment, contribution to GDP and taxes. See Chapter 3.1.

³²¹ Milhaupt and Zheng (n.315) analyse this in terms of the mechanism use – namely state capture. The focus here is on the reason for state's control

company's economic significance became more important for determining state control and protectionism than mere state ownership.³²²

While there is no single commonly-accepted definition, a number of characteristics appear relevant to whether or not an enterprise is considered 'economically significant.' Economically significant companies which fall under state control and protection – and so within the state sector in this thesis – tend to control a large amount of assets, have many employees, or produce a large tax output and contributions to the local or national GDP.³²³ They are often important in terms of economic growth, innovation and research.³²⁴ They are often connected with other important companies through ownership, debt guarantees, trade agreements, etc.³²⁵ In addition, they often also operate in key industries³²⁶ and locations.³²⁷ They are often listed on one of China's stock exchanges, and possibly also abroad.³²⁸ And they tend to have access to credit from the state-owned banks.

³²² Interviews B1-c to B3-c, C5-r, C7-s, E2-s, J1-s to J9-c, L2-s to L7-c, R10-c. This conclusion is supported by research carried out by Zhang (1995) in Wenzhou, Zhenjiang and other places

³²³ Local government officials' incentives are built so that they protect these companies: see Chapters 3.3.3.2 5.3.3.1

³²⁴ *Supra* n.322

³²⁵ Interviews C5-r, C7-s, J1-s to J9-c, L2-s to L7-c, L14-c, R2-r, R9-c, R10-c

³²⁶ Several industries are dominated by SOEs (e.g. the armaments, power generation and distribution, oil, petrochemicals, telecommunications, coal, aviation and shipping industries: Zhao (19.12.2006)). However, others significantly significant industries (manufacturing, technology, IT, etc.) are accessible to private companies

³²⁷ Examples include SEZs, large cities, and areas designated for particular products (a remnant of planned economy): *Ibid.*

³²⁸ Listing status is very hard to get in China. For this reason, listing carries with it a degree of protectionism which is, in and of itself, a valuable asset. My interviewees suggested that this alone can be one of the reasons why the courts are more willing to allow Reorganisation petitions of listed companies: Interviews J1-c, J3-c to J9-c, L2-s, L4-r to L7-c, P1-r, P3-r, R10-c

3.4.3.2 Private sector (*minyingjingji*)

Private ownership was first permitted and grew as a response to SOEs' inefficiencies.³²⁹

There are now many important private companies which are de facto controlled by (local) governments and so, for the purpose of this research, fall into the above-defined state sector and outside the scope of the private sector.³³⁰

Minying jingji (民营经济 which means, literally, 'people-run economy') is, nevertheless, crucial for China's economic development because it has been a breeding ground for many of China's subsequent economic success stories. Such private companies are usually comparatively small (v. state sector),³³¹ with fewer assets,³³² and with fewer employees. Consequently, they are of lesser importance for local taxes and GDP growth – and so the Party-state does not interfere in their day-to-day management or in the resolution of their financial distress.

Nevertheless, in the aggregate, the private sector of the economy accounted for about half of China's GDP and three quarters of new urban employment across China in 2010.³³³ One of the major hubs of the private sector is the city of Wenzhou, in Zhejiang

³²⁹ Chapters 3.1 and 3.4.2

³³⁰ This does not mean that they are no privately-owned. Instead, it is submitted that the nature of ownership is secondary in determining whether the Party-state interferes in a resolution of the given company's financial distress

³³¹ For our purposes, small private sector companies are sole traders and family businesses. Medium private companies are those who employ others outside the owner and their family and who are not so economically significant so as to fall within the state sector – and so under the state protection.

³³² Many smaller companies hire the machinery they need because they do not have the capital to buy their own

³³³ Tse and Shira (2012). Unfortunately, it is unknown what proportion of these are economically significant private companies controlled by the state, and how many would fall within the private sector

Province, with approximately 400,000 companies³³⁴ and deep-rooted acceptance and support for private entrepreneurs.³³⁵

Sometimes, a company falls within the state sector generally, but with some of its operations (a department, a subsidiary, or an internally separated part of its activities) taking place within the private sector. Such companies are treated as falling into the sector which is most appropriate for the activities in question; for example, a state bank is treated as falling into the state sector when it lends to state sector companies, but it is treated as belonging to the private sector when investing in the shadow market. The result of such a split is that such companies face mixed incentives, especially with regards to whether the state would be involved in resolving their financial distress;³³⁶ whether they would themselves opt for a private or politically-driven debt enforcement mechanism;³³⁷ and whether creditors' claims and debtors' obligations would be recognised in a court hearing.³³⁸

3.4.4 Impact of corporate ownership and control on law enforcement

Literature predicts that state ownership affects implementation of laws.³³⁹ State-owned companies are often protected from strict application of the law and are instead protected

³³⁴ i.e. one company per 25 inhabitants

³³⁵ Interviews C1-c, C5-r, C7-s, C11-c, J1-c, J3-c to J9-c, L2-s to L15-c, P1-r, R2-r, R3-r, R6-c to R10-c

³³⁶ See Chapter 5.3.3, below

³³⁷ See Chapter 5.4

³³⁸ See Chapter 5.3

³³⁹ See e.g. Shleifer (1998); The World Bank (1995); van Zwieten (2015)

by the state.³⁴⁰ In the context of corporate insolvency, state-owned companies often do not have to face the consequences of their bad financial decisions when their budgetary constraints are breached.³⁴¹ Instead, the state influences whether and how creditors and courts enforce debt-related legal rights.

China-specific research confirms these claims.³⁴² There is evidence that privately-owned companies without political connections – i.e. private-sector companies – cannot access bank finance and commercial opportunities (v. SOEs), face heavy regulation, extra layers of bureaucracy (so-called ‘red tape’), and local governments’ rent-seeking.³⁴³ Empirical studies also show that Chinese SOEs do not face hard-budget constraints and receive financial support from the government.³⁴⁴ Another study finds that SOEs’ managers make little effort, compared to their private-company counterparts, to ameliorate their company’s financial distress because they expect the state to provide fresh finance or another solution.³⁴⁵ My interviewees provide further evidence to support these findings. For a detailed discussion, see particularly Chapters 5.1.1 (the impact of the EBL wording on how courts weigh up various stakeholders’ interests in insolvency cases), 5.3.3 (the impact of the Party-state’s influence on courts’ ability and willingness to hear insolvency cases) and 5.4 (politically-driven debt-enforcement mechanisms that are used instead of the EBL).

³⁴⁰ See e.g. Szamosszegi and Kyle (2011)

³⁴¹ i.e. they face soft-budget constraints: see e.g. Kornai (1979); Kornai (1980)

³⁴² Szamosszegi and Kyle (2011)

³⁴³ Du and Girman (2010)

³⁴⁴ Megginson, Ullah and Wei (2014); Cull and Xu (2003)

³⁴⁵ See empirical research by Fan, Huang and Zhu (2013)

Chapter 4. DEBT FINANCE AND DEBT ENFORCEMENT IN CHINA

Debt finance plays a crucial role in enabling development and expansion of economic activities. This chapter, therefore, focuses on the provision of debt and enforcement of debt agreements in China. It first looks at types of debt financing; what determines companies' access to a particular type of finance; and general challenges to debt enforcement (4.1). It then briefly examines informal and formal, individual and collective debt enforcement mechanisms other than insolvency law (4.2). And it concludes with a detailed overview of insolvency law in China – its history, rules and principles contained in the EBL (as written), and the statistical data on the use of the EBL (4.3). The information below comes from primary and secondary literature (in Chinese, English, French and German), practitioners' commentaries, and my original research.

4.1 Debt finance in China

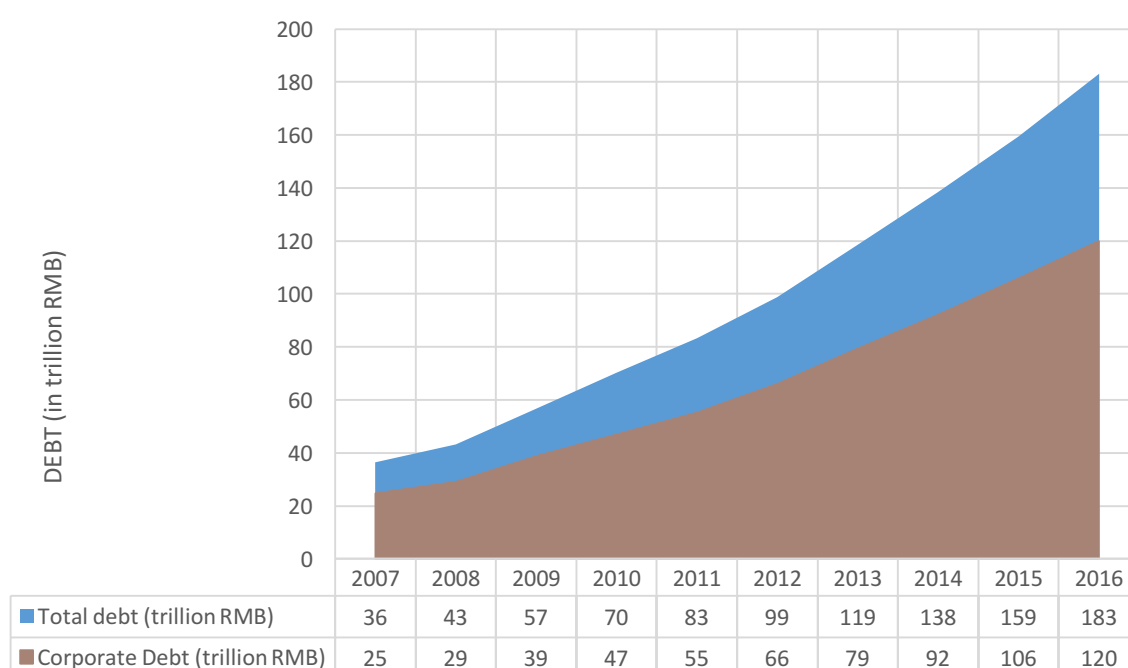
Insolvency proceedings are triggered by non-payment of debts or by debts exceeding assets. This section, therefore, focuses on the availability and problems associated with debt finance in China. It first examines the available statistics that shed light on the total volume of debt, its ratio to the GDP, and the significance of non-performing loans (4.1.1). It then looks at types of credit and access to it by private and state companies (4.1.2). It concludes by discussing general challenges to debt enforcement in China (4.1.3).

4.1.1 Debt in China's economy

China's economy has undergone a significant expansion, but it has also started accumulating an ever-growing pile of debt. China's total debt has grown more than five-fold over the past

ten years – from 36 trillion RMB in 2007 to 183 trillion RMB in 2016³⁴⁶ (Table 4-1). About two thirds is corporate debt.³⁴⁷ And about 5 trillion RMB, or 7 percent of the GDP, is estimated to be bad debt.³⁴⁸ The real number is likely to be even higher as most bad debt in state-owned banks is concealed as bridging loans so as not to appear on the banks' books as non-performing assets.

Table 4-1: Total amount of debt in China



Source: BIS

The growth of total debt is significant even when adjusted for China's spectacular GDP growth. Table 4-2 shows that debt-to-GDP ratio almost doubled between 2007 and 2016, from 146 percent to 254 percent of the GDP. Corporate-debt-to-GDP ratio grew at a

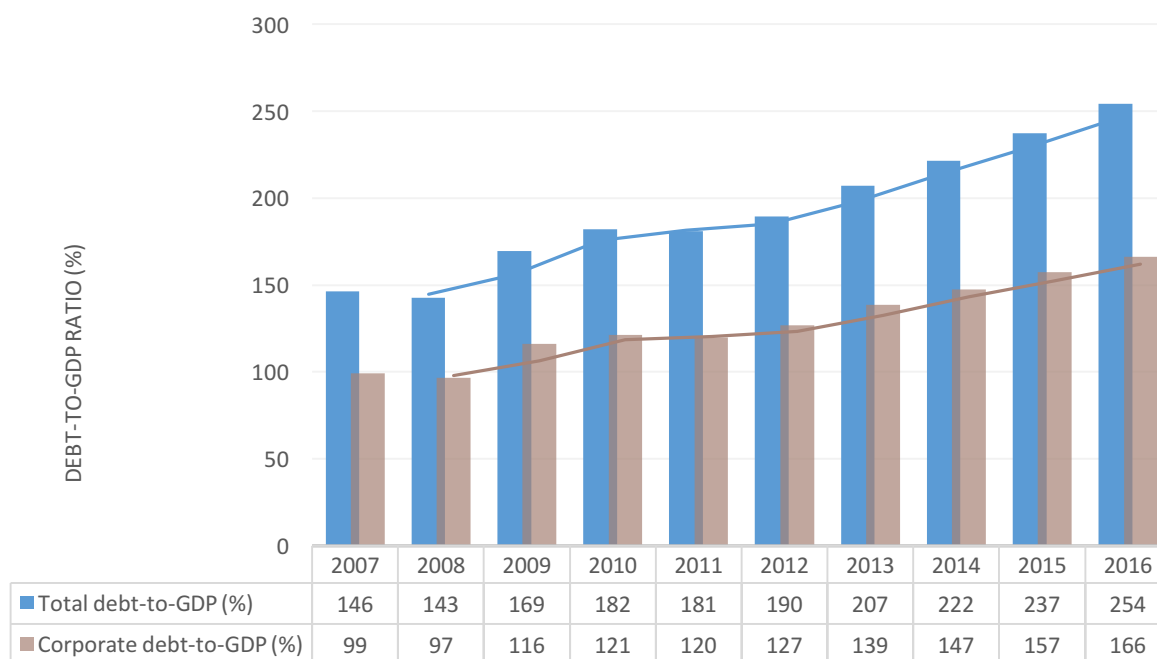
³⁴⁶ Cf the IMF report suggests that China's debt is worth 225 percent of GDP: Maliszewski et al (2016)

³⁴⁷ Reuters (10.10.2016)

³⁴⁸ Maliszewski et al (2016)

similar pace, increasing from 99 percent in 2007 to 166 percent in 2016.

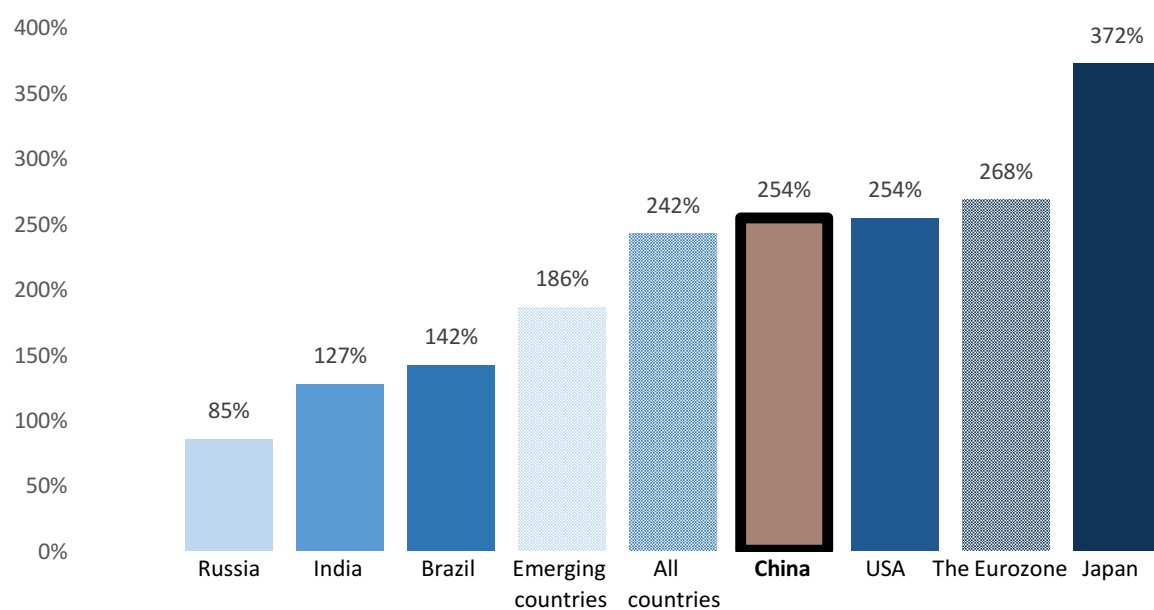
Table 4-2: Debt-to-GDP ratio in China



Source: BIS

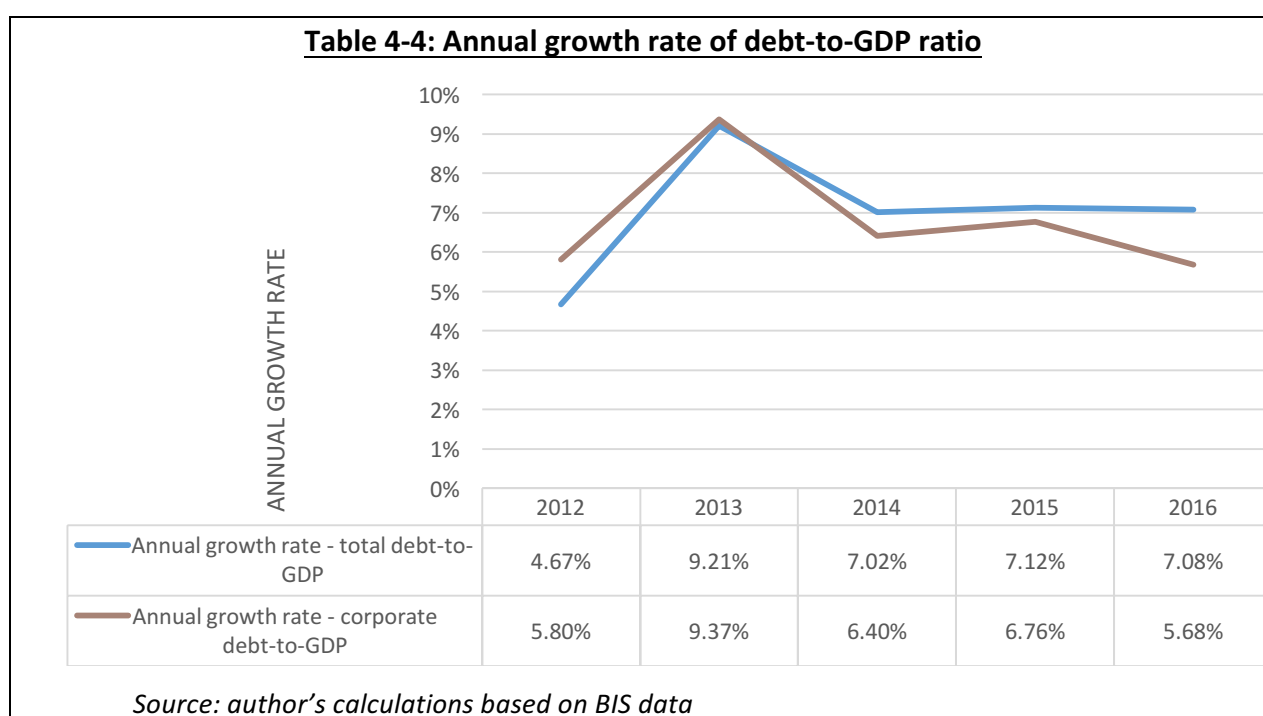
Table 4-3 puts China's 2016 data into global perspective.

Table 4-3: Debt-to-GDP ratio in China and elsewhere (2016)



Source: BIS

Observers and Chinese regulators are worried about the speed and uncontrollability of debt expansion in China.³⁴⁹ When compared year-on-year, the annual growth rate of the debt-to-GDP ratio has increased from about 5 percent in 2012 to about 7 percent in 2016 (Table 4-4). The trend is broadly consistent in total debt and corporate debt categories.

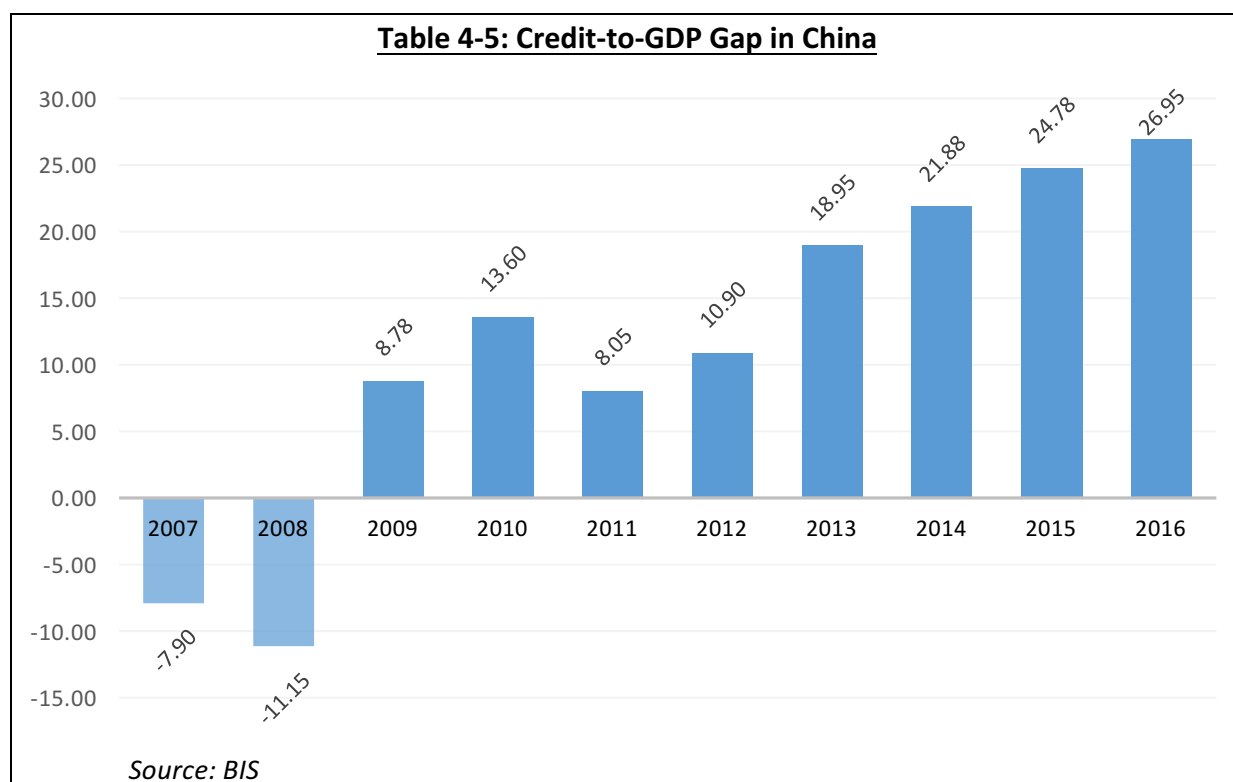


The Bank of International Settlements ('BIS') recently issued a warning that China may be facing serious credit problems. The credit-to-GDP gap³⁵⁰ is an indicator that reflects credit health of a country. Healthy economies maintain the credit-to-GDP gap between 2 and 10, but anything higher signals credit excess, with large gaps usually serving as early

³⁴⁹ Ruwitch and Chen (23.5.2017); Wildau (12.10.2016); Tang (9.3.2017)

³⁵⁰ Defined by BIS as the difference between the credit-to-GDP ratio (c_t/y_t) and its long-run trend t_t (http://www.bis.org/publ/qtrpdf/r_qt1609.pdf)

warning indicators of banking crises and systemic financial distress.³⁵¹ China's has been at the upper end and beyond the 10-mark since 2009, reaching almost 25 in 2015 and almost 27 in 2016 (Table 4-5).³⁵²



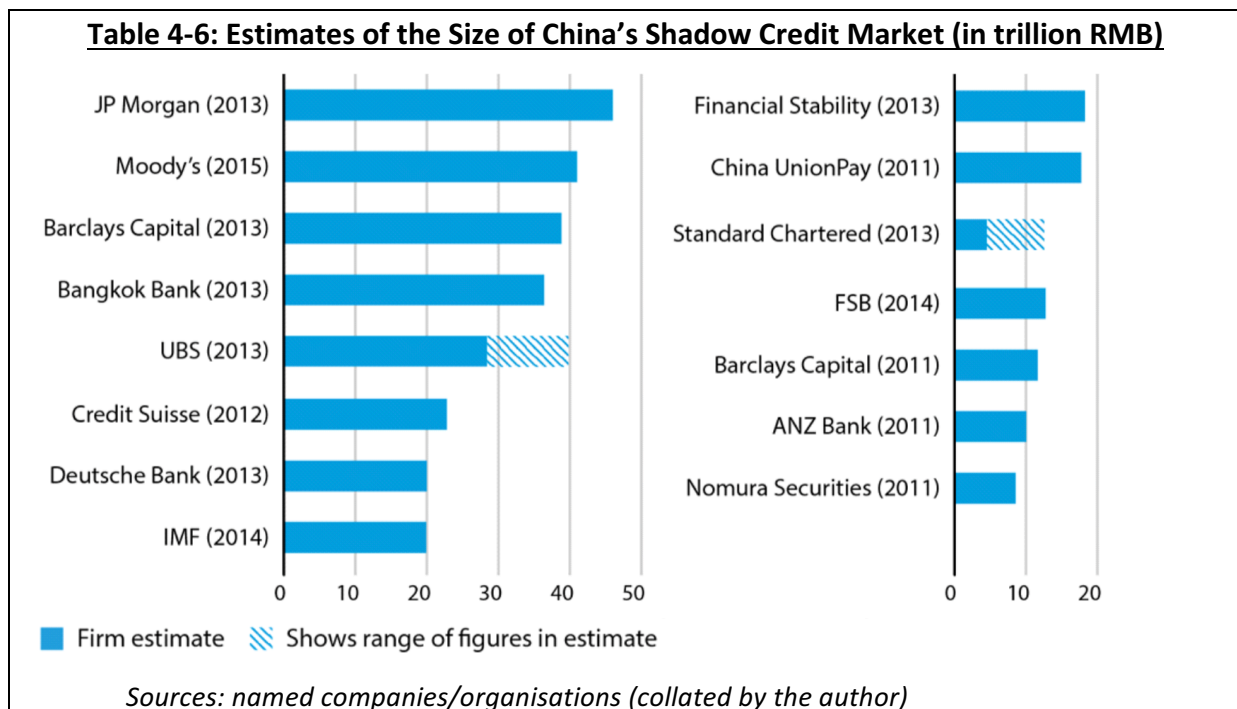
Many observers are also worried that the official data is incomplete – and that China's debt-related problems are much more severe. They point to four major gaps. Firstly, Chinese statistics are notoriously unreliable, and many commentators believe that official statistics underestimate the size of the problem.³⁵³ Secondly, the dependence of some banks and non-bank financial institutions on wholesale borrowing may indicate that they

³⁵¹ Drehmann and Tsatsaronis (2014)

³⁵² "BIS Quarterly Review March 2016" at http://www.bis.org/pub/qtrpdf/r_qt1609.pdf

³⁵³ Wildau (8.12.2016)

are postponing debt-related problems.³⁵⁴ Thirdly, the data does not reflect the debts that get repaid by the state – e.g. state bailouts and subsidies to financially distressed state-sector companies – and by state-owned banks – through forgiving debt, and guaranteeing and if necessary honouring SOEs' corporate bond repayments. This strategy was severely criticised in recent months³⁵⁵ because state-provided solutions often postpone financial distress but do not resolve the root of the problem. And lastly, China's official figures fail to account for the enormous and largely unregulated shadow debt market which now drives China's private sector.³⁵⁶ Although no official statistics exist, experts estimate that there is between 5 and 46 trillion RMB in shadow debt finance, depending on what is included (Table 4-6).³⁵⁷



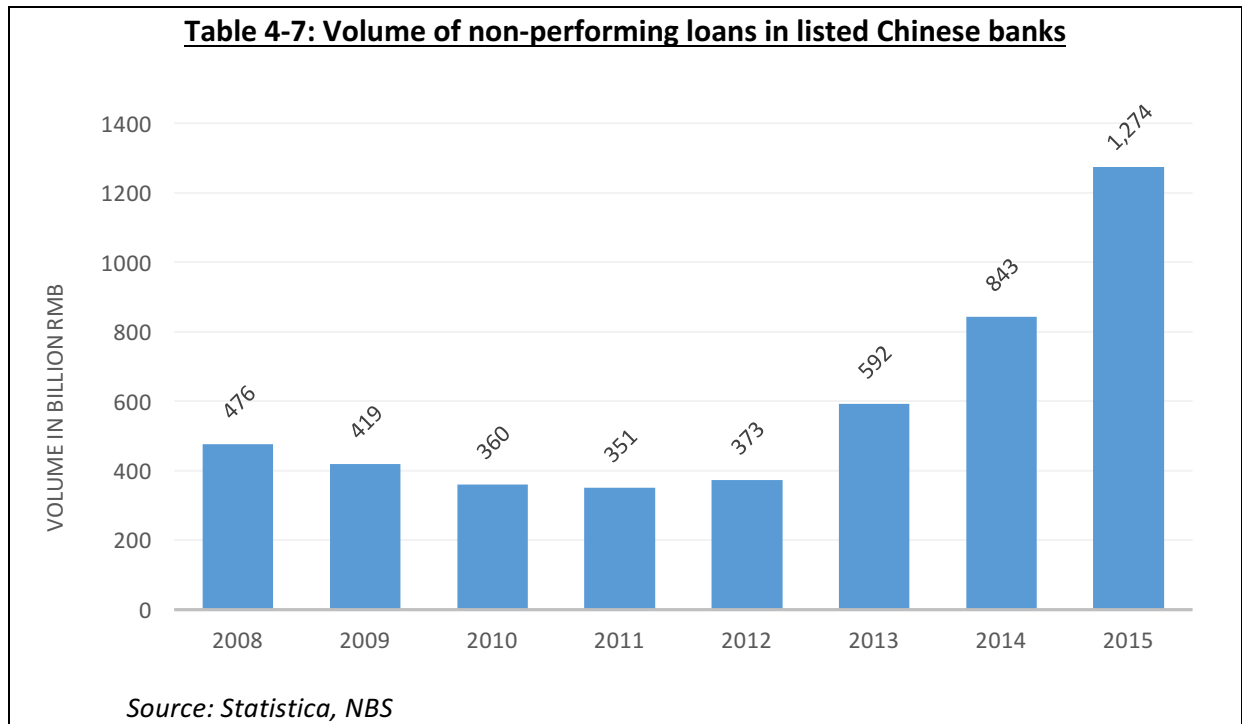
³⁵⁴ See e.g. Kaminska (16.3.2017)

³⁵⁵ E.g. Dongbei Special Steel Group which defaulted nine times in 2016

³⁵⁶ See Chapter 4.1.2

³⁵⁷ Wealth-management products and trust products are often not included

An additional problem that China faces are non-performing loans ('NPLs'). Table 4-7 provides an overview of the volume of NPLs (official statistics) in China's listed banks.



Chinese banks report that NPLs represent only 1.47 percent (Bank of China) to 2.4 percent (Agricultural Bank of China) of their loans.³⁵⁸ However, most commentators agree that this is a gross underestimate.³⁵⁹ Instead of classifying bad debts as NPLs, banks often roll over or extend the term of unpaid loans, they write off bad debt or move it off their balance sheets into local-government-funded asset management companies, they negotiate debt-for-equity swaps, or they classify NPLs as an investment.³⁶⁰ There is also an unknown but significant amount of NPLs in the shadow debt market.

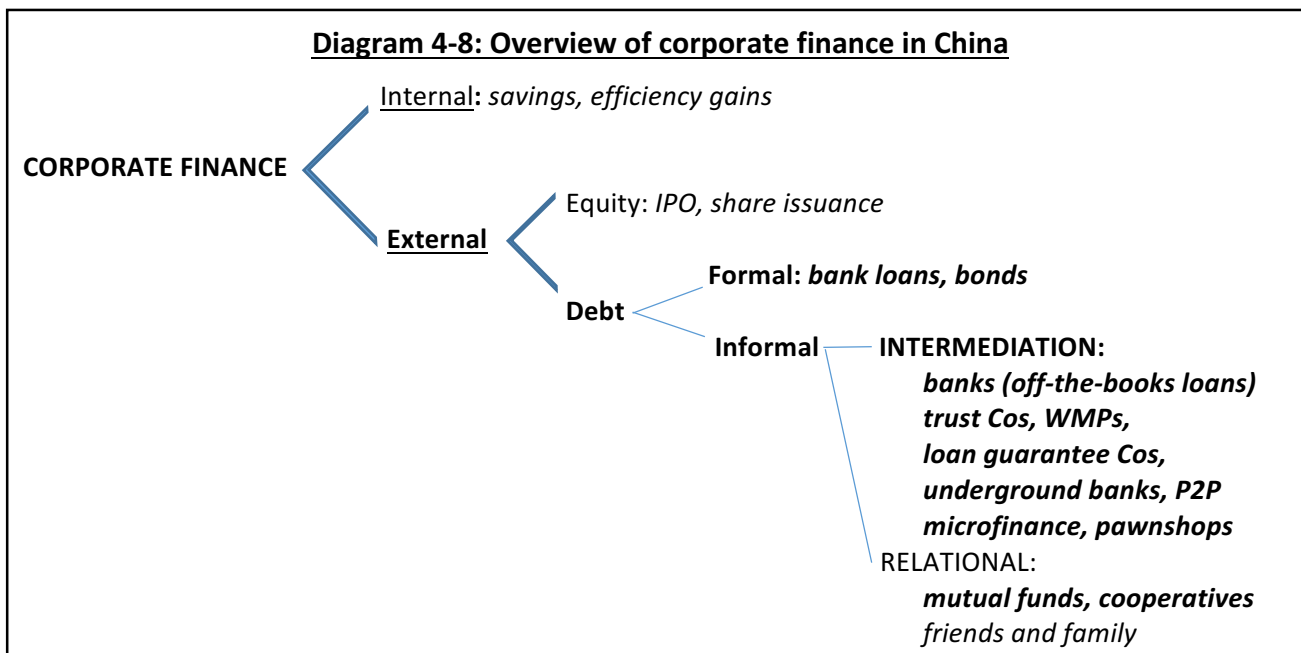
³⁵⁸ Data for Q2 2015: Bank statements. Cf the world average is about 4 percent (2009-2016, The World Bank)

³⁵⁹ Wildau (30.10.2014)

³⁶⁰ Balding (28.10.2015) – for more see Chapters 4.2 and 5.4.2

4.1.2 Companies' Access to Different Types of Credit

Companies can fund their activities through internal or external finance, as summarised in Diagram 4-8. This section will first explore the main sources of external debt finance in China. It will then turn to the question of what determines access to these different types of credit in China, and how this influences the parties' debt enforcement options.



Bank loans are usually secured over company's assets. Common forms of security include a mortgage or a pledge, and they are granted over real estate (land, buildings, land use rights, fixtures), tangible property (machinery, raw materials, finished goods, etc.), financial instruments (shares, negotiable instruments), or claims and receivables. Security cannot be granted over future assets, certain public facilities, illegal constructions, and – in practice – security is not granted over fungible assets.³⁶¹ The 'Big Four' commercial banks

³⁶¹ This is because "the relevant registration authority will require a clear description of the mortgaged or pledged property": Zhang (2014)

are all owned and controlled by the central government. There are also three policy banks through which the state finances its economic and trade development projects.³⁶² At sub-national level, there are 132 city commercial banks³⁶³ which are owned or controlled by local governments and whose role is to provide credit to local companies and projects.

Private banks entered the market in 2014.³⁶⁴ However, their ability to compete has been curtailed by the strong and established position of the Big Four state banks and constraints imposed on the new entrants by the regulator.³⁶⁵ Similarly, foreign banks have been allowed to operate in China for about a decade, but their operations are small – their total assets accounted for just 1.38 percent of total banking assets at the end of 2015.³⁶⁶

Lending policies and regulations are determined by the central bank – the People’s Bank of China (‘PBoC’). Some of its functions have been taken over by the China Banking Regulatory Commission (‘CBRC’) in 2003. Bank finance is now heavily regulated, and permissible proportion of NPLs has been limited. To comply with this limitation, banks have been providing bridging loans to replace NPLs; and bank credit officers have been made personally responsible for loans that turn sour, which has led to a degree of reluctance by banks to extend credit.³⁶⁷ This has been causing further credit squeeze for private borrowers.

³⁶² This role was previously fulfilled by the Big Four banks

³⁶³ PR News (11.7.2016)

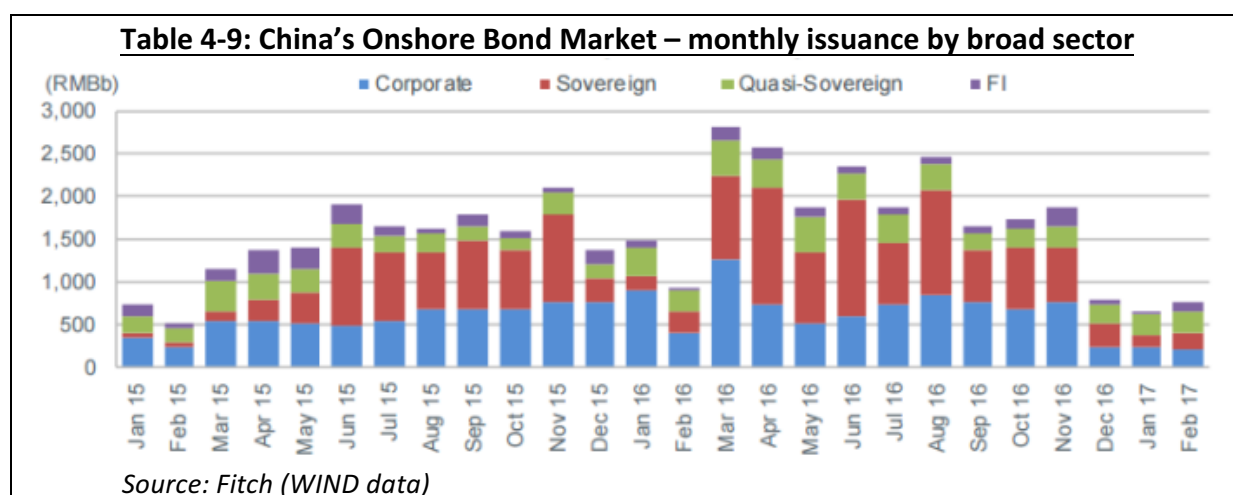
³⁶⁴ Morrow (6.6.2014); Xinhua (27.12.2016)

³⁶⁵ Wildau (12.12.2016)

³⁶⁶ Chandrasekhar and Ghosh (10.4.2017)

³⁶⁷ Smyth et al (2015) at 63

China's corporate bond market is an important alternative source of funding, primarily for those who do not have access to bank finance. As shown in Table 4-9, bond issuance helped raise between 0.5 and 2.8 trillion RMB per month in 2015-16. However, many of the bonds are issued by local governments in an attempt to circumvent financing restrictions.³⁶⁸



Moreover, credit to otherwise excluded borrowers is intermediated through China's enormous 'shadow' market.³⁶⁹ Strong demand for shadow finances – from e.g. small private companies and companies with cash-flow problems³⁷⁰ – is reinforced by considerable supply from banks, companies and general depositors with significant household savings³⁷¹ who

³⁶⁸ See Milhaupt and Lin in Milhaupt and Liebman (2016)

³⁶⁹ Cai (6.1.2014)

³⁷⁰ Durden (10.12.2015)

³⁷¹ Household savings share of total savings in China was 71 percent in 1991 (Cull and Xu (2003) at 535) and about 60 percent throughout 2000-2003 (Farrell et al (2006) at 69)

look for profitable investment opportunities outside of state banks.³⁷² Moreover, there are very few onshore investment opportunities, and offshore investment is severely restricted.³⁷³ It is, therefore, not surprising that the informal debt market is thriving, despite the dangers associated with engaging in activities that may not be legal.³⁷⁴

Shadow lending encompasses an enormous range of activities. State banks engage in the shadow market to increase profits and to counter their losses from state-directed lending and NPLs. They provide services such as letters of credit, loan commitments, wealth-management products ('WMPs') with risky underlying assets (often real estate), loan guarantees, and entrusted loans. These are usually realised through trust companies and wealth-management vehicles to counter regulatory rules such as mandatory capital requirement and restrictions on lending to certain sectors (imposed by the CBRC to reduce systemic risk). Trust companies take banks' illegal loans, repackage them as WMPs and sell them to investors, including the banks, as bonds.³⁷⁵ By 'selling off' these loans or classifying them as 'investment' WMPs, banks comply with the regulations without giving up profitable – albeit risky – shadow activities.³⁷⁶ This is problematic because it exposes banks to

³⁷² State banks often offer depositors interest rates that are lower than inflation rates. For example, PBoC's interest rates range from 0.3 percent for current account and 1.75 percent for a twelve-month term deposit, but inflation rates have been about 2 percent (5.4 percent in 2011): PBoC historic data. See also Zhao and Qing (29.9.2011)

³⁷³ E.g. Wei (26.11.2016)

³⁷⁴ See Chapter 5.1.2.2

³⁷⁵ This is illegal, but evidence shows that it is still happening. See e.g. Wildau (23.11.2016)

³⁷⁶ See e.g. Wildau (29.7.2016)

unknown risks and most likely further worsens systemic risk by spreading the bad loans through WMPs.

Loan guarantees are provided by specialised companies or by enterprises with surplus capital which – in exchange for a percentage of the principal – guarantee loan repayment for others.³⁷⁷ This service is particularly important for smaller borrowers who would otherwise not be able to access bank finance. The problem is four-fold. Firstly, it is often SOEs – who have access to credit from state-banks – who engage in this activity and so expose themselves to external risk. Secondly, loan guarantee companies have started lending directly. However, because they make no or limited background checks, their lending is more risky which, in turn, adversely affects their stability. Thirdly, loan guarantee companies take relatively risky positions but without putting sufficient amount of capital aside in case they have to repay the principal. And fourthly, loan guarantee companies are regulated at a local level, and so are more susceptible to political influence.³⁷⁸

Underground banks also provide shadow credit. They operate without a licence,³⁷⁹ and so avoid CBRC's regulation and oversight. They attract deposits by promising exceptionally high interest rates – usually about 20-30 percent – and provide loans to private borrowers. As a result, they tend to operate in provinces with a strong private sector, such as Zhejiang. Their vulnerability stems from the lack of regulation and – as many believe – less sophisticated risk assessment.³⁸⁰

³⁷⁷ SOEs often guarantee loans for each other, and so create guarantee chains.

³⁷⁸ Borst (2011)

³⁷⁹ Local officials tend to turn a blind eye because they provide finance to companies with no access to formal credit. Growth of these companies then enables regional development. *Ibid.*

³⁸⁰ See e.g. Wei (2016)

Another type of shadow lending is peer-to-peer (P2P) online lending. P2P platforms connect depositors and borrowers for a small commission. Interest rates are usually much higher than in bank loans, but credit is available to borrowers who do not have access to bank finance. The lending platforms perform minimal risk assessment and make a recommendation to the lender who then decides whether to lend or not. P2P lending started in 2007 and, by the end of 2015, it is estimated to have provided 982 billion RMB in loans.³⁸¹ The PBoC started actively monitoring and regulating P2P lenders in early 2017³⁸² in response to an increasing number of failures and fraud³⁸³ in the industry.

Smaller borrowers also rely on microfinance lenders and pawnshops. Microfinance lenders provide small unsecured loans for high interest rates and additional fees.³⁸⁴ Pawnshops provide short-term credit to small borrowers at very high interest rates – usually as temporary working capital or as a bridge loan. The lending is less risky due to high collateral requirements.

Finally, companies can also rely on relational lending. Besides financing from family and friends, small companies often rely on local credit associations, local mutual assistance associations and assistance funds, local finance cooperatives, and other forms of profit-oriented community-based arrangements.³⁸⁵ Because the members know each other, they

³⁸¹ Data from www.wangdaizhijia.com

³⁸² Lockett (3.4.2017)

³⁸³ E.g. the case of Ezubao where 900,000 depositors lost their money, approximately 7.6 billion USD, due to fraud in 2015: Gough (1.2.2016)

³⁸⁴ Borst (2011)

³⁸⁵ See e.g. Newsweek (17.11.2007)

can perform risk assessment, monitoring and enforcement without additional costs, and so defaults are practically unheard-of.³⁸⁶

The main difficulty with shadow lending is that it increases systemic risk in China's economy.³⁸⁷ This is mainly due to a lack of transparency; inherent difficulties in regulating, monitoring and managing the risks;³⁸⁸ and lending concentration, liquidity mismatches, and the resulting risk of liquidity shortages.³⁸⁹ As summarised in Table 4-10, national and local rules and policies treat many shadow lending activities as quasi-legal or illegal.

Table 4-10: Legal status of shadow finance in China

Legal finance	Practices penalised by the People's Bank of China	
	Quasi-legal finance	Illegal finance
	Mostly tolerated, but not strictly legal practices	
Interpersonal lending	Cooperatives	Underground banks
Rotating credit associations In some areas	Corporate professional lending ('red hats')	Rotating credit associations In some areas
Pawn shops In some areas	Pawn shops In some areas	Professional brokers and money lenders charging high interest rates (loan sharks)
Trade credit		Ponzi schemes
P2P lending Since 2015	P2P lending Since 2015	

Source: Tsai, Back-Alley Banking, 2002 pp.35-36

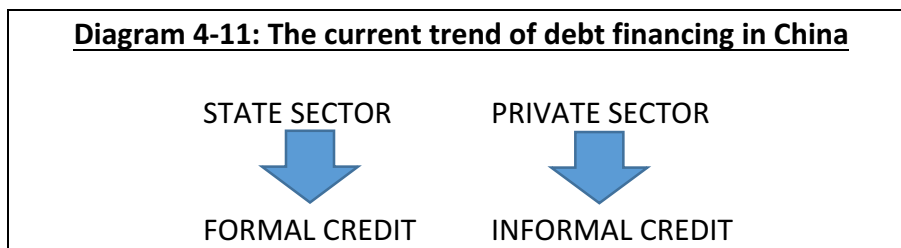
³⁸⁶ *Ibid.*

³⁸⁷ Mitchell and Wildau (6.5.2017)

³⁸⁸ As illustrated by a chain-failure of several underground banks in Wenzhou in 2011, the Ezubao Ponzi-scheme in 2015, the growing real estate bubble, and others.

³⁸⁹ Herrero, Schwartz, Xia and Xu (2011)

Existing literature and many of my interviewees³⁹⁰ suggested that access to formal bank finance depends on whether or not a borrower falls within the state sector.³⁹¹ In general, state sector companies have direct access to bank finance, while most companies in the private sector tend to rely on private funding³⁹² and shadow credit.³⁹³ In this thesis, therefore, the state sector is equated with ‘formal’ bank credit and the private sector with ‘informal’ shadow credit (Diagram 4-11).



As previously discussed, a company affiliated with one sector can have activities or even whole departments affiliated with the other economic sector. The source of credit often determines the enforcement options and their payoffs in insolvency.³⁹⁴

³⁹⁰ Interviews B1-c to B3-c, C1-c to C5-r, E1-c to E5-c, IF1-s, IF2-c, L1-r to L7-c, L10-s to L14-c, R1-r to R3-r, R6-c, R7-c, R9-c, R10-c. A survey in 2000 (Gregory, Tenev and Wagle (2000)) suggested that lack of relationship with banks was a major constraint in accessing bank finance. Findings confirmed in Hale and Long (2010)

³⁹¹ See Chapter 3.4

³⁹² Savings and money from friends and family are the main source of finance for start-ups in China: Gregory et al (2000)

³⁹³ *Supra* n.397

³⁹⁴ For more details, see Chapters 4.2 and 5 (in particular 5.2.3)

4.1.3 General challenges to debt enforcement in China

Debt enforcement in China faces numerous challenges, which arise from an incomplete ‘infrastructure for bankruptcy.’³⁹⁵ This section examines five of them in detail. First, the amount of reliable, publicly available financial information – necessary for enabling courts to determine the true health of a company and to confirm entitlements of various stakeholders under the EBL – is insufficient (4.1.3.1). Second, it is often difficult to verify ownership of property rights (4.1.3.2). Third, the surrounding laws needed to protect property rights – crucial to ensuring maximum recovery and equal treatment of similar stakeholders – are incomplete and inadequately enforced (4.1.3.3). Fourth, the rules to prevent asset stripping are not properly enforced, which enables insiders to tunnel out and abandon indebted companies without facing the consequences (4.1.3.4). And fifth, Chinese land laws do not sufficiently ensure that immovable property on government-allocated land remains usable, and so retains its value (4.1.3.5).

These constraints affect all types of debt enforcement. Their comparative effect on the EBL (v. non-EBL enforcement mechanisms) is discussed in detail in Chapter 5.2.1.

4.1.3.1 Insufficient amount of reliable financial information

All my interviewees agreed that effective debt recovery in China is seriously hindered by the insufficient amount and low quality of information available to evaluate debtors’ true financial situation or to enforce one’s rights. These shortcomings mostly stem from the use

³⁹⁵ Wihlborg, Gangopadhyay and Hussain (2001)

of forged and falsified documents, and problems with locating and identifying the real debtor. Despite many attempts to improve the situation,³⁹⁶ much still remains to be done.

Falsified information is used by companies,³⁹⁷ provincial governments³⁹⁸ and the NBS.³⁹⁹ Companies use fake receipts, contracts and invoices, which distort the information about companies' financial health, their assets and their liabilities. The use of such documents is illegal in China,⁴⁰⁰ but they remain widely available and easily accessible.⁴⁰¹ The determination of asset ownership, allocation of responsibility for corporate (mis)management, and accurate risk assessment are further inhibited by so-called dual-accounting – a practice of having one 'official' set of accounts for outsiders and one true set of accounts for internal purposes⁴⁰² – which makes it difficult to identify asset owners, to allocate responsibility for corporate (mis)management, and to enable outside lenders to accurately assess lending risk.

Many of my interviewees suggested additional information-related problems arise in identifying and locating the real debtor. The ownership of assets and property interests apparently belonging to the debtor company is often unclear and can be manipulated to the debtor's advantage as necessary – particularly in corporate groups which co-use land rights

³⁹⁶ E.g. Property Law 2007 created institutional framework for acquiring, exercising and disposing of property rights. Similarly, Criminal Law 2015 makes it a crime to make or deal with forged documents

³⁹⁷ Durden (25.9.2014)

³⁹⁸ Hancock (18.1.2017)

³⁹⁹ Wildau (8.12.2016)

⁴⁰⁰ See Chapter 5.1.2

⁴⁰¹ Forgeries are available from many sources: Barboza (8.8.2013)

⁴⁰² This is a well-known fact in China. Confirmed in Interviews B1-c to B3-c, C1-c to C5-r, E1-c to E5-c, J1-c, L2-r to L7-c, L10-s, L13-c, P3-r, R2-r, R9-c, R10-c. See also Tang and Ward (2003) at 51-52

and assets without clearly defining individual company's ownership rights.⁴⁰³ In SOEs, the confusion arises from the undefined division of rights between the state and the company.⁴⁰⁴ This makes debt recovery particularly unpredictable and complicated.

4.1.3.2 *Difficult verification of property rights*

Research suggests that the ability to verify ownership of assets is vital for the economy. Borrowers can use their assets as collateral – and so borrow against these assets – and lenders can perform risk assessment *ex ante* and have a greater chance of recovery *ex post* – and so are more willing to lend and do so with favourable conditions.⁴⁰⁵ However, despite announcing and legislating for a national land registry in 2013-14,⁴⁰⁶ releasing national guidelines on the protection of property rights in 2016,⁴⁰⁷ and adopting the new Property Law in 2007, China still lacks a reliable and comprehensive national property registry.⁴⁰⁸ As a result, verifying assets' ownership remains difficult.⁴⁰⁹ This is problematic because companies often cannot use their property to assist with raising capital, which limits their

⁴⁰³ *Ibid.*

⁴⁰⁴ *Ibid.* These are often explained as remnants of the planned economy where ownership, possession and use rights were owned by the state, and so there was no need to define anything.

⁴⁰⁵ De Soto (2000); Woodruff (2001). See also Chapter 2.3.1

⁴⁰⁶ In a report to the annual plenary session of the NPC in 2013 the then-Premier Wen Jiabao announced that the government will release a statute on property registration by the end of June 2014

⁴⁰⁷ See e.g. Xinhua (27.11.2016)

⁴⁰⁸ This is largely due to the resistance from local governments. See e.g. Reuters (11.1.2016)

⁴⁰⁹ The International Bank of Reconstruction and Development and the World Bank (2008)

ability to access safer bank loans and often forces them to turn to riskier and more expensive shadow finance.⁴¹⁰

4.1.3.3 *Limited protection of property rights*

All my interviewees suggested that companies also face difficulties in protecting their property rights in China. Land-related property rights⁴¹¹ are sometimes disturbed by asset grabbing by claimholders who try to satisfy their claims independently, without debtors' or courts' authorisation, and without opposition from the police or punishment by courts.⁴¹² This negatively affects *ex post* recoverability of debts which impacts borrowing ability *ex ante*.⁴¹³ Similarly, courts also fail to protect intellectual property rights – as well as land rights – which negatively affects raising of finance,⁴¹⁴ debt enforcement,⁴¹⁵ foreign direct investment⁴¹⁶ and corporate spending on research and development.⁴¹⁷ The State Council

⁴¹⁰ This is particularly problematic for private sector companies who cannot rely on state guarantee, and so are often excluded from formal finance: Interviews B1-c to B3-c, C1-c, C2-c, C4-c, C5-r, C7-s, E1-c to E5-c, IF1-s, IF2-c, J1-c, J5-s, L2-s to L7-c, R3-r, R2-r, R7-c, R9-c, R10-c. See also 5.2.1.2 for a discussion in the EBL context

⁴¹¹ Ownership and usage rights related to the company's land, as well as its moveable and immoveable assets

⁴¹² Interviews B1-c, B3-c, C1-c to C7-s, C9-c, C11-c, E1-c to E5-c, J3-c, L1-r, L2-s, L4-r to L7-c, L9-s to L14-c, R2-r, R3-r, R7-c, R9-c, R10-c. As a result, the use of land-related assets as collateral for formal finance is severely limited: Bai, Lu and Tao (2006)

⁴¹³ Chapter 2.3.1

⁴¹⁴ Where IP rights are used as collateral

⁴¹⁵ Where secured against IP rights

⁴¹⁶ Awokuse and Yin (2010)

⁴¹⁷ Lin, Lin and Song (2010)

and the Party released joint guidelines on protecting all property rights in November 2016,⁴¹⁸ but it remains to be seen whether they will be successful in practice.

Furthermore, property rights in China are also affected by the Party-state. Many interviewees witnessed violations of private property in the form of arbitrary sealing up, freezing and taking of private enterprises' assets.⁴¹⁹ Since local courts and police are controlled by the local Party-state, there is often no protection against such abuses.⁴²⁰

4.1.3.4 Unpunished tunnelling, asset stripping and the use of ghost companies

Companies are also vulnerable to asset depletion by directors and managers⁴²¹ who take or transfer their company's assets either for themselves – stripping company's assets – or for a new company – leaving behind an empty shell called a 'ghost company' (*kongqiao gongsi* 空壳公司).⁴²²

Directors and managers sometimes deplete their company's assets which could otherwise be used to repay debts. These activities include tunnelling; asset stripping; disadvantageous de-capitalisation (e.g. increasing top management's wages); unsound

⁴¹⁸ The Opinions of the Central Committee of the Communist Party of China (CPC) and the State Council on improving the property rights protection (PRP) system and lawfully protecting property rights

⁴¹⁹ Particularly in less developed regions: Interviews B3-c, C1-c, C2-c, C5-r, C7-s, E1-c to E3-s, L2-s to L6-s, L14-c, L15-c, R3-r, R9-c, R10-c. See also Hsu (30.11.2016)

⁴²⁰ *Ibid.*

⁴²¹ This is not unique to China. It stems from the agency conflicts which arise between companies' owners and management: Kraakman et al (2017) Chapter 2

⁴²² Can be also translated as 'shell companies'

investments motivated by corruption; and other examples of insider control abuse.⁴²³

Criminal Law includes provisions that are aimed at punishing – and preventing – such unauthorised asset depletion by insiders.⁴²⁴ Similarly, China’s Company Law and Corporate Governance Code⁴²⁵ also create incentives and punishment for self-dealing directors. However, many of my interviewees argued that these rules are poorly enforced, and so asset depletion remains relatively common in China.⁴²⁶

Similarly, directors and managers sometimes create so-called ghost companies to avoid old liabilities. The scheme is quite simple: existing management transfers company’s valuable assets, its employees and selected contracts into a new company, leaving its liabilities⁴²⁷ behind in the shell of what is now a ghost company.⁴²⁸ Such practice is illegal, but the rules are not enforced.⁴²⁹ As a result, ghost companies are widely used – particularly in China’s less-developed regions – as a debt-avoidance scheme.⁴³⁰

⁴²³ Cheung et al (2009) at 372. For a discussion of similar problems in Russia and elsewhere: Kossov and Lovyrev (2014)

⁴²⁴ See 5.1.2. See also Chen (2016) at 110

⁴²⁵ NB Poor corporate governance is believed to permit abuse of power and unreliable financial reporting (Plazzi and Torous (2016)). Moreover, it is also believed to help reduce agency conflicts (Dey (2008)).

⁴²⁶ Interviews C1-c, C5-r to C7-s, L1-r to L15-c, R2-r, R3-r, R6-c, R9-c, R10-c

⁴²⁷ These are the debts owed to the old creditors with whom the new company will not cooperate and statutory payments: Interviews C1-c, C4-c, C7-s, E2-s, L2-s to L7-c, L11-c to L14-c, R2-r, R10-c

⁴²⁸ Described in all my interviews. See e.g. News.163 (24.11.2014); Law Time (17.2.2016); Sina (1.12.2015) Note that this is different from UK-style phoenix companies where the old company is closed (and de-listed) and a new company, with the same name, is established.

⁴²⁹ Interviews B3-c, C1-c, C4-c, C5-c, C7-s, L1-r to L15-c, R2-r, R3-r, R6-c, R9-c, R10-c

⁴³⁰ *Ibid.* Confirmed by an SPC judge: Cao (7.1.2016)

4.1.3.5 *Issues arising from the nature of land ownership and land usage rights*

Finally, debt enforcement is also adversely affected by the nature of land ownership in China. All land in China is under state or collective ownership, and under the Party's control.⁴³¹ Only holders of so-called land usage rights can use and develop land. Land usage rights last for 40 to 70 years – depending on the nature of the use⁴³² – and the state can claim the land after that period expires.⁴³³ Renewal of the rights can be sought a year in advance, but the government has a complete discretion whether or not to grant it.⁴³⁴

Moreover, the government can, in narrowly defined circumstances, cancel a land usage right, but must provide adequate compensation.⁴³⁵ My interviewees suggested that the state does sometimes revoke the rights in practice,⁴³⁶ which impacts the value of these rights and any property on the land – making potentially valuable assets relatively valueless. This affects debt repayment because it reduces the overall value of companies' assets.

⁴³¹ Land Administration Law 1986, last amended in 2004

⁴³² Order No.55 (State Council 1990). My interviewees (C1-c, C4-c, E2-s to E4-c, L4-r to L6-s, R2-r, R7-c, R9-c) suggested that private-sector companies must purchase land usage rights, but SOEs can get them for free. See China Briefing (19.2.2014)

⁴³³ Media discussion of land-use rights: Xinhua (4.11.2013)

⁴³⁴ *Ibid.* – the regulations are decided locally, and so differ in form and substance. However, Art 22 of the Law on Urban Real Estate Administration 1994 (amended in 2007) states that the extension should be granted, unless the land is required for a public interest project (widely-defined).

⁴³⁵ Art 58 Land Administration Law 1986 (amended in 2004)

⁴³⁶ Interviews B1-c, B3-c, C1-c, C4-c, C5-r, C7-s, E2-s, E3-s, IF1-s, IF2-c, J1-c, J6-s, L2-r to L7-c, L9-s to L14-c, P3-r, R2-r, R3-r, R7-c, R9-c, R10-c

4.2 Non-EBL debt enforcement mechanisms in China

Debt collection agencies are prohibited in China.⁴³⁷ Instead, claimholders try to recover their debts by dealing directly with the debtor – in an ‘informal’ solution – or with an assistance of an authorised third-party decision-maker such as a court or an arbitrator – in a ‘formal’ solution. A claimholder can deal solely with their own claim – under an ‘individual’ approach – or they can join others – under a ‘collective’ approach.

This subchapter first looks at informal individual enforcement (4.2.1) and informal collective enforcement (4.2.2). It then examines formal individual enforcement (4.2.3) and formal collective enforcement (4.2.4). Claimholders’ options are summarised in Table 4-12.⁴³⁸

Table 4-12: Overview of debt enforcement in China

	<u>Individual</u>	<u>Collective</u>
<u>Informal</u>	contractual solutions	
	threats / violence	reputational mechanism
<u>Formal</u>	payment order	EBL Composition
	security enforcement	EBL Reorganisation
		EBL Liquidation
	diversified dispute resolution	

This subchapter provides a factual overview of these mechanisms as described in existing literature and my interviews. The options and rules for enforcing debt repayment under the EBL are discussed in the next section (4.3). Further analysis and explanation of how these non-EBL alternatives affect the parties’ perception of the EBL – and how they contribute to the low use of the EBL – are then found in Chapter 5.4.

⁴³⁷ Notice on Prohibition of Establishing Debt Collections Companies 1995; Notice on Revocation of Various Kinds of Debt Collection Companies and Attack on Illegal Debt Collections Activities 2000
Cf individuals sometimes assist others in collecting their debts for a fee: Leggett (21.9.2000)

⁴³⁸ This list is merely illustrative, and include some of the most usual options that the parties use

4.2.1 Informal individual enforcement

In China, as elsewhere, unpaid lenders often first try to achieve repayment informally, by dealing directly with the borrower. Two types of such direct approach are discussed below, namely private negotiations (4.2.1.1) and the use of threats and violence (4.2.1.2).

4.2.1.1 Bilateral negotiations and contractual solutions

All of my interviewees agreed that parties often first try to encourage debt repayment through an amicable private negotiation before turning to a more formal – and, therefore, also more costly – mechanisms.⁴³⁹ Although not alone in using informal negotiations to resolve disputes,⁴⁴⁰ Chinese culture has traditionally placed a particularly strong emphasis on informal, amicable conflict-resolution due to the underlying Confucian focus on harmony and maintenance of relationships.⁴⁴¹ This cultural preference still influences parties' negotiations in modern China.⁴⁴²

Private negotiations often result in a contractual deal that rewrites the original agreement. Such renegotiated deals are enforceable in law.⁴⁴³ When a debtor company is still active and solvent, lenders try to persuade it to come up with a repayment plan. Indeed, many corporate agreements include a provision that parties will first negotiate before

⁴³⁹ A recent survey of 3,900 private firms in China suggested that private companies are reluctant to use formal court enforcement and prefer using informal alternatives: Ang and Jia (2014)

⁴⁴⁰ See e.g. Shenkar and Ronen (1987)

⁴⁴¹ See Chapter 3.3.1

⁴⁴² Interviews C1-c, C4-c, C7-s, E1-c to E3-s, E5-c, L2-s, L4-r to L7-c, L9-s, L10-s, L12-c, L15-c to L17-cR3-r, R7-c, R9-c, R10-c.

⁴⁴³ Arts 77 and 91(v) Contract Law 1999

seeking third-party assistance in resolving their disputes.⁴⁴⁴ This may involve forgiveness of a part of the debt or substitution of other assets or services for some of the money due.⁴⁴⁵ Alternatively, lenders sometimes extend the maturity of the existing loan or offer a bridging loan with a longer maturity or lower interest rates.⁴⁴⁶

Debt-for-equity swaps have also been used in more sophisticated deals.⁴⁴⁷ They enable further cooperation even where the debtor is cash-poor. Often lenders agree to it and hope that they will recoup some of the losses from the present dealings in the future.⁴⁴⁸ Some of my interviewees also suggested that where attempts to renegotiate fail, parties sometimes agree on a merger or acquisition.⁴⁴⁹

4.2.1.2 Violence, kidnapping and threats

Where negotiations fail, creditors sometimes use threats or violence to achieve repayment of their debt.⁴⁵⁰ Creditors' threats come in many forms. My interviewees said that they include general threats to 'make life difficult'⁴⁵¹ but also more specific threats to use violence against debtor company's management or their families or to damage debtor's and

⁴⁴⁴ Interviews C1-c to C5-r, L2-s to L6-s, R1-r to R3-r. Moser (2007) at 8

⁴⁴⁵ Interviews B1-c, B2-c, C1-c, C4-c, C5-r, C7-s, E1-c to E5-c, IF1-s, L1-r to L13-c, R3-r, R9-c, R10-c.

⁴⁴⁶ *Ibid.*

⁴⁴⁷ Interviews B1-c, C1-c, C7-s, L2-s, L4-r, L6-s, R7-c, R9-c.

⁴⁴⁸ Interviews B1-c, E1-c, C1-c, C7-s, E2-s, L2-s to L6-s, L9-s to L13-c, R7-c, R9-c, R10-c

⁴⁴⁹ Interviews C1-c, L2-s, L4-r to L6-s, R3-r, R9-c

⁴⁵⁰ This is not unique to China, and can be achieved directly or indirectly (by debt enforcers): Fijnaut and Paoli (2004)

⁴⁵¹ Interviews L4-r, L6-s

others' property.⁴⁵² Threats of – or actual – public shaming is another widely-used method.⁴⁵³ In some cases, creditors also threaten the debtor company with feared tax or criminal investigation.⁴⁵⁴

The credibility of such threats is bolstered by numerous reported cases of kidnapping and detention of debtor companies' personnel and their family members in a hotel room until the debtor company repays.⁴⁵⁵ Some interviewees also mentioned 'uninvited visits from the unpaid creditors and workers' who come as a group of five to ten people and stay in debtor company's personnel's house to put pressure on them to repay.⁴⁵⁶ Cases of actual violence against a person or property are rare but not unheard of⁴⁵⁷ – see Photos 1 and 2 – despite the fact that violent collection of debts is illegal.⁴⁵⁸

⁴⁵² Interviews C1-c, C4-c, L4-r, L6-s, L10-s, L11-c, L12-c, R9-c, R10-c

⁴⁵³ Global Times (20.6.2016)

⁴⁵⁴ *Ibid.*

⁴⁵⁵ Shanghai Scrap Blog (25.10.2008); Harris (16.5.2016); Kahn (1.11.2005)

⁴⁵⁶ Interviews C1-c, C4-c, C7-s, E2-s, E4-c, IF1-s, L2-s, L4-r, L6-s, L9-s, L11-c to L13-c, R7-c

⁴⁵⁷ See e.g. Want China Times (29.9.2011)

⁴⁵⁸ *Ibid.*



Photo 1: Police seized knives from debt collectors' car [Global Times]



Photo 2: Violent debt enforcement in Wenzhou [wantchinatimes.com]

4.2.2 Informal collective enforcement

Parties can also enforce their claims in a multilateral setting. This can involve multilateral negotiations where several claimholders come together and find a collective contractual solution with the debtor (4.2.2.1). Alternatively, a creditor can rely on collective reputation mechanism to enforce debt repayment (4.2.2.2).

4.2.2.1 Multilateral negotiations and contractual solutions

Involvement of more than two parties in contractual (re-)negotiations has the benefit of finding a single solution to connected problems, but it also faces significant difficulties – primarily to do with coordination and conflicts of interests. Nevertheless, several interviewees suggested that multilateral negotiations are commonly used in two types of cases as an initial attempt to reach an agreement without court involvement.⁴⁵⁹ The first type of cases is similar to the so-called London Approach:⁴⁶⁰ the main lender presides over re-negotiations with the debtor and its major claimholders – but without involving or informing smaller stakeholders whose claims continue to be honoured as if the debtor had no financial difficulties. The second type of cases involves large businesses which are interconnected by debt repayment guarantees or by triangular debt structures.⁴⁶¹ The negotiations take place behind closed doors, with no publicity, and very little is known about them.⁴⁶²

⁴⁵⁹ Interviews B1-c to B3-c, C1-c, C4-c, L2-s, L4-r to L7-c, L9-s, L10-s, L12-c, R9-c

⁴⁶⁰ Armour and Deakin (2001)

⁴⁶¹ i.e. non-mutual debts that create a chain of liabilities among these companies: Zhao and Qing (29.9.2011)

⁴⁶² My interviewees (n.466) heard of them, some hinted that they may have been involved in them, but they did not provide any details.

4.2.2.2 Reputation mechanism in debt enforcement

Reputation mechanism involves no or limited direct contact between a debtor and its creditors. Instead, debt enforcement is ensured through the threat of the debtor losing its reputation, which would lead to its exclusion from future cooperation, and so also from future opportunities and profits. It operates at a collective level because its efficiency relies on collective enforcement.

Much has been written about how reputation mechanism works. Game theory suggests that in a simple one-period exchange (one-off lending) with no enforcement, it is unlikely that a rational⁴⁶³ lender would lend. Although the lender wishes to lend and be repaid with interest, the borrower ideally wishes to take the money and keep it together with any return made thereon.⁴⁶⁴ Knowing this, a rational lender will not lend at all.⁴⁶⁵

Parties' incentives are altered with the introduction of a (potentially) multi-period interaction and borrower's reputation. Firstly, borrower's reputation provides the lender with information about borrower's past ability and willingness to repay, which, in turn, can help ascertain borrower's likely future behaviour. And secondly, the borrower can pledge his reputation as a costly *hostage* – which would be lost if he defaults – which enables him to credibly commit *ex ante* that he will repay *ex post*. Keeping or losing one's reputation in a

⁴⁶³ See Chapter 2.1

⁴⁶⁴ *Ibid.* (The model is based on the assumption that the players are self-interested)

⁴⁶⁵ In economic terms, 'not lend' is a strategy that is best for both players when taking into account the other player's strategy (the Nash equilibrium): *supra* n.40
Cf Bedford and Hwang (2003): payoffs in rural societies may extend beyond purely financial interests

multi-period interaction determines borrower's future access to loans (future financial gains) and often also his position in society (future social gains), and so losing it is costly.⁴⁶⁶

For the reputation mechanism to work as described above, parties must interact repeatedly. It must also be clear to the parties what constitutes 'good' (repaying) and 'bad' (defaulting) behaviour and what are the consequences of cheating (losing future financial and social gains).⁴⁶⁷ There also needs to be fast and effective *detection* of wrongdoing and information about borrower's 'bad' behaviour must be *communicated*⁴⁶⁸ quickly, cheaply and in a credible manner to the other members. Moreover, it must be highly likely that default will be *punished* and cooperation *rewarded* by a sufficient number⁴⁶⁹ of other club members (other lenders) because, otherwise, the defaulting borrower could simply go to the non-enforcing parties and his wrongdoing would go unpunished. That would weaken the reputation mechanism and could lead to a collapse of the lending system due to the lack of effective enforcement.⁴⁷⁰

⁴⁶⁶ *Ibid.* This is because the one-period gain a (the return minus the interest repayment) would be multiplied by the number of remaining rounds of future trade (i.e. total number of rounds, k , less the present round, n) – and so $a \cdot (k-n)$. The longer the expected period of future cooperation (i.e. higher $k-n$), the stronger the borrower's incentive to repay in the present round. The parties typically have open-ended trading relationships, and so I assume the variable k to be indeterminate. If the period k is finite, then there may be a problem because parties may realise that their payoff when lender lends and borrower repays is lower than their payoff at lender lending and borrower not repaying, at which point they might behave opportunistically

⁴⁶⁷ Desirable behaviour (in our context, repaying a loan) is often codified in social norms

⁴⁶⁸ This is easiest in smaller, closely-knit homogeneous groups with long-term relationships and repeated interactions: Ellickson (1991); Landa (1981); Greif (1989)
Monitoring and communicating in larger and more diversified groups (ethnically, culturally, geographically) is possible with assistance from modern technology: Bernstein (1992) at 116

⁴⁶⁹ The size of the group subscribing to the reputation mechanism, the more powerful incentive to repay it creates due to (i) the increased monitoring and detection capabilities, and (ii) the increased potential losses from future trade (cheated lender and all other members)

⁴⁷⁰ This relates to the idea of 'critical mass': Shelling (1978). Consequently, most membership groups have a rule that sanctions must be carried out by all members, and refusal to do so is punished: Greif (1989); Bernstein (1992)

Third-party enforcement may be personally costly for the third-party enforcers (other lenders),⁴⁷¹ and it carries no immediate reward. The resulting reluctance to punish a wrongdoer may be overcome with a rule that trading with a wrongdoer leads to exclusion from the club.⁴⁷² Moreover, members know that third-party enforcement benefits them in the long-run because it minimises the incentive to defect and increases cooperation, which in turn enables each member to benefit from future trade gains and limited expenditure on individual monitoring. In addition, tolerating a member's default against a non-member harms the reputation of all members,⁴⁷³ which incentivises intense internal monitoring and enforcement. Therefore, even self-interested members who suffered no harm punish defectors to discourage future bad behaviour in the group.⁴⁷⁴

Reputation mechanism may be extended beyond club members. Newcomers without established reputation may be prevented from cooperating with club members (the lending community) – due to their inability to signal their good behaviour – unless an existing member vouches for them (so-called *reputation pooling*).

4.2.3 Formal individual enforcement

Unpaid creditors who rely on third-party assistance in debt enforcement can seek a payment order in a simplified pre-court procedure (4.2.3.1). Alternatively, where they hold a security for their debt, they can enforce their security rights directly, or seek assistance

⁴⁷¹ The loss of trade opportunities and relationship network of the wrongdoer

⁴⁷² So-called 'club mechanism': Bernstein (1992)

⁴⁷³ Due to an implied underwriting of each member's good behaviour: Greif (1989)

⁴⁷⁴ *Ibid.*

from a court or an arbitral body (4.2.3.2). Where the debt and creditors' rights are undisputed, both mechanisms are simple and quick. Otherwise, creditors may need to start a costly and time-consuming civil litigation.

Irrespective of the above, additional enforcement assistance may be necessary to locate, appraise or freeze debtor's savings, income, or assets, or to supervise the delivery of assets or documents by the debtor.⁴⁷⁵

4.2.3.1 Payment order

A creditor can try to recover their debt in a pre-court procedure by petitioning a court for a 'payment order.' Where the debt is undisputed, this is relatively straight-forward. Once a court examines the validity of the claim, it issues an order against the debtor to repay which is enforceable fifteen days after being delivered to the debtor.⁴⁷⁶ A court can freeze debtors' assets or accounts to ensure enforceability of the award.⁴⁷⁷

If a court refuses to enforce the debt, if the debtor disputes the debt, or if the debtor fails to repay its debt, the affected creditor can petition the court to start full civil litigation to determine the validity and enforceability of the claim.

⁴⁷⁵ Wenfei Law (April 2014)

⁴⁷⁶ Art 189 Civil Procedure Law 1991

⁴⁷⁷ *Ibid.*

4.2.3.2 Security enforcement

Security in China usually takes the form of a mortgage or a pledge.⁴⁷⁸ Security is usually enforced directly, without a third-party enforcer. However, where the provider of security challenges its existence or scope, a court or arbitral body have to get involved. Mortgagor and mortgagee can agree on a sale or foreclosure of the mortgaged property without court's assistance.⁴⁷⁹ Failing that, a mortgagee can petition a court to sell or auction the mortgaged property. If the mortgage or the right to enforce mortgagee's security is challenged, the mortgagee must first obtain a judicial or arbitral award confirming their rights.⁴⁸⁰

Enforcing a pledge is now significantly streamlined thanks to the Property Law 2007 and the PBoC's Credit Reference Centre's online registration system for pledges over receivables. A pledgee can unilaterally sell or auction the pledged property in case of non-payment. A court or arbitral body usually get involved where the pledge agreement is disputed, and where the pledgee seeks its help in locating or enforcing the pledged assets.

4.2.4 Diversified⁴⁸¹ dispute resolution

Diversified (elsewhere 'alternative') dispute resolution ('DDR') mechanisms offer less formal, more confidential options for resolving disputes and enforcing agreements. DDR is

⁴⁷⁸ Chapter 4.1.2

⁴⁷⁹ Arts 196-7 Civil Procedure Law 1991

⁴⁸⁰ Property Law 2007

⁴⁸¹ *duoyuanhuaajiufenjiejuejizhi* 多元化纠纷解决机制

very popular in China⁴⁸² and has strong support from courts.⁴⁸³ In many disputes, courts first insist that parties use DDR to find a solution before they can commence court-based litigation.⁴⁸⁴ Three DDR mechanisms are explored below, namely mediation (4.2.4.1), arbitration (4.2.4.2), and a combination of the two (4.2.4.3).

4.2.4.1 Mediation

Mediation is an informal negotiation that is overseen by a professional mediator.⁴⁸⁵ It may be triggered by an *ex ante* provision or an *ex post* agreement to mediate. There are four types of mediation: *civil mediation* run by People's Mediation Committees⁴⁸⁶ in civil and economic disputes and minor criminal cases; *administrative mediation* run by local governments or government departments in civil, economic or labour disputes; *judicial mediation* run by a court in civil disputes; and *arbitration mediation* (discussed below).⁴⁸⁷ There are very few rules relating to the procedures – mostly contained in the Civil Procedure Law 1991, the Constitution, and a set of SPC regulations.⁴⁸⁸ A mediation agreement is only

⁴⁸² See Fan (2013) at 3, Chapters 1.3 and 8

⁴⁸³ In June 2016, the SPC issued a policy document to guide lower courts to use DDR more and in a more streamlined way: Opinion on the People's Courts more deeply reforming the diversified resolution mechanism

⁴⁸⁴ Interviews C1-c to C7-s, J1-c, J3-c to J9-c, L1-r to L15-c, R1-r, to R4-c, R6-c, R7-c, R9-c, R10-c, R14-s

⁴⁸⁵ The role of the mediator depends on the particular circumstances, and can vary from a passive forum-provider to a pro-active intermediary and negotiator: Eidenmüller and Griffiths (2009)

⁴⁸⁶ Art 111 of the Constitution

⁴⁸⁷ Arts 35 and 86-91 of the Civil Procedure Law 1991. For a summary, see http://www.lawinfochina.com/legal/Display_7.shtm (accessed on 12.1.2017)

⁴⁸⁸ SPC Regulation about courts' invitation to mediate [2016] No.14

enforceable where all affected parties consent to it.⁴⁸⁹ A written agreement resulting from mediation is legally binding and enforceable by court.⁴⁹⁰

4.2.4.2 Arbitration

Arbitration is a structured formal dispute resolution mechanism that is run by a professional arbitrator. China's arbitration system recognises three types of arbitration: foreign arbitration, foreign-related arbitration, and domestic arbitration. Chinese arbitrators only hear the last two. Foreign-related arbitration involves cases with a 'foreign element' – for example, one of the parties is a foreign national or a company domiciled abroad; relevant legal facts take place outside China; or the subject-matter of the dispute is situated outside China.⁴⁹¹ Foreign-related arbitrations are governed by the CIETAC Rules 2012, and enjoy a fair bit of flexibility.⁴⁹²

The focus in this thesis is on domestic arbitration, which is governed by the Arbitration Law 1995. Domestic arbitration can be used instead of court-based litigation, but only if there is a valid arbitration agreement⁴⁹³ – that is an agreement showing a clear intention by each party⁴⁹⁴ to resolve disputed matters through arbitration⁴⁹⁵ at a designated arbitration

⁴⁸⁹ Art 88 of the Civil Procedure Law 1991

⁴⁹⁰ Art 51 of the Arbitration Law 1995

⁴⁹¹ Art 304 of the SPC Opinion 22/1992 (*Fashi* [1992] No. 22)

⁴⁹² Fan (2013) Chapter 1.4.2-1.4.3

⁴⁹³ Art 5 Arbitration Law 1995

⁴⁹⁴ Unlike courts which derive their jurisdiction from statutory provisions or jurisdiction agreement, arbitral bodies derive their powers solely from a contractual agreement between the parties.

⁴⁹⁵ Art 4 Arbitration Law 1995

institution.⁴⁹⁶ A failure to designate an arbitration institution, or any uncertainty, invalidates the arbitration agreement.⁴⁹⁷ *Ad hoc* arbitration is not possible.⁴⁹⁸ Arbitrators are independent from administrative organs,⁴⁹⁹ and the parties can choose their own arbitrators⁵⁰⁰ in about 200 arbitration institutions around China.⁵⁰¹ Once rendered, arbitral award is final and enforceable by courts.⁵⁰² Courts can review the arbitral award where there is strong evidence to suggest that there was insufficient evidence for the award, it was tainted by an error,⁵⁰³ or that the law was wrongly applied.⁵⁰⁴ My interviewees suggested that judicial review of arbitral awards is rare.⁵⁰⁵

4.2.4.3 Mediation-Arbitration

Combining mediation and arbitration into a single procedure ('Med-Arb') is very popular in China. Initially, a third-party professional acts as a passive mediator – giving the parties more freedom to agree. But where it becomes clear that the parties are unlikely to reach a

⁴⁹⁶ Arts 6, 16 and 18 Arbitration Law 1995. Fan (2013) at 35

⁴⁹⁷ Art 18 Arbitration law 1995

⁴⁹⁸ Fan (2013) at 38-42

⁴⁹⁹ Art 14 Arbitration Law 1995

⁵⁰⁰ Art 31 Arbitration law 1995. Note that Art 13 of the Arbitration Law 1995 prescribes certain minimum requirements (quality and length of practical experience) with regard to professionals' eligibility to act as arbitrators.

⁵⁰¹ Fung and Wang (2003) at 159

⁵⁰² Art 9 Arbitration Law 1995. See also Fan (2013) Chapter 4

⁵⁰³ Art 63 Arbitration Law and Art 237(2) Civil Procedure Law 1991 (as amended in 2012)

⁵⁰⁴ Fan (2013) at 87-88

⁵⁰⁵ Interviews L2-s to L17-c, R9-c

solution, a mediator turns into an arbitrator who more forcefully navigates the parties towards a solution or, if that fails, imposes a solution on them.⁵⁰⁶

To be able to use this mechanism, the parties must have a valid arbitration agreement.⁵⁰⁷ An enforcement of the final award follows the same rules as an enforcement of an arbitral award.⁵⁰⁸

4.3 Insolvency law in China

Insolvency law is a comparatively new addition to China's legal system. This section will first discuss the history of insolvency law in China – and in particular the reasons for its introduction and subsequent reform (4.3.1). It will then provide a brief overview of the main features of the current law, the Enterprise Bankruptcy Law ('EBL') (4.3.2). It concludes by looking at the statistical data on the limited use of the EBL and set them in domestic and international context (4.3.3).

4.3.1 History of insolvency law in China

The EBL was a product of a laborious reform process aimed at ameliorating its predecessor, the Corporate Insolvency Law (Trial Implementation) 1986 ('the old law' or 'the 1986 law'). Although the process took long twelve years, many issues remained unresolved. To fully understand the initial driver behind introducing insolvency law in China and its amendments and roles over the years, this section first discusses insolvency-related rules that were in

⁵⁰⁶ Arts 49-52 Arbitration Law 1995

⁵⁰⁷ Discussed in Chapter 4.2.4.2

⁵⁰⁸ *Ibid.*

place before the EBL (4.3.1.1). Building on this important cultural and institutional background, the discussion then refocuses on the reasons why the law was reformed and why it took so long before the EBL was finally passed in 2006 (4.3.1.2).

4.3.1.1 Insolvency law in China before the EBL

China had no insolvency rules until the early 20th century. Debt-related disputes were resolved informally, and debts were inherited following a Confucian convention that ‘The son pays for the debts of his father.’⁵⁰⁹ China had the first basic insolvency law in 1906, but it was repealed in 1908 by Emperor Guang Xu ‘due to difficulties in implementation.’⁵¹⁰ After the fall of the empire in 1911 and before the Communist Revolution in 1949 there were two more insolvency laws: in 1915 (locally) and 1935 (implemented nationwide).⁵¹¹ The latter was based on German and Japanese legal codes⁵¹² and is still in force in Taiwan today. When Mao seized power in 1949, all laws were abolished, and for thirty years there was no legal mechanism for dealing with SOEs’ financial distress (there was no private ownership at that point).⁵¹³ Instead, individuals continued using the traditional informal mechanisms, and the government resolved problems behind closed doors.⁵¹⁴

⁵⁰⁹ Li (2001); Tomasic and Little (1997) at 51

⁵¹⁰ Tomasic and Wang in Tomasic (2006); Li (2001)

⁵¹¹ *Ibid.*

⁵¹² Neelen (2007) at 6

⁵¹³ See Chapters 3.1 and 3.3

⁵¹⁴ Tomasic and Wang (n.517) at 94; Li (2001)

Before the 1978 economic reforms, it was argued that there was no need for insolvency law since there were no cases of insolvency in a communist state. The absence of insolvency law was regarded as ‘an attribute that made a socialist economy superior to its capitalist counterparts’⁵¹⁵ and so something to be proud of because there were no ‘failures’ in China. Nevertheless, in the 1980s – as the economy continued expanding and commercial dealings became more complex – the desirability of insolvency law was recognised.⁵¹⁶

Naturally, there was a strong opposition against such a capitalist concept. However, with financial and economic development came greater awareness of the problems within the financial sector – in particular the cost of continued inefficiency of the SOEs⁵¹⁷ – and increasingly more people spoke in favour of introducing insolvency law. Among them was Cao Siyuan, an economist and legal reformist who played a crucial role in the drafting process. Cao argued that it was necessary to introduce hard budget constraint into firms’ operation and to create a clear connection between one’s effort and income to bolster productivity, encourage healthy competition, and so enable economic growth. Experiments in Wuhan and Shenyang suggested that insolvency law had potential to promote efficiency to revive China’s economy.⁵¹⁸

⁵¹⁵ Tomasic and Wang (n.517) at 94

⁵¹⁶ Cho (1996)

⁵¹⁷ The Legislative Work Committee (Cao (1986, Appendix B)) recommended that ‘it is most necessary to draw up an enterprise bankruptcy law since this would have a stimulating effect on state-owned enterprises that are poorly managed and whose economic returns are extremely poor.’

⁵¹⁸ Cao’s report (1986, Appendix A) to the Premier concluded that ‘the enterprise bankruptcy law is both necessary and feasible and ... we should firmly and unswervingly bring it out as soon as possible.’

And so, after what has been described as the ‘most furious debate in Chinese legislative history’⁵¹⁹ a new insolvency law was passed on 2 December 1986. It was implemented in November 1988. The law was a compromise between the accepted need for insolvency law and the ideological opposition to the idea of insolvency. As a result, the law only applied to SOEs; and the government had a very wide discretion in deciding whether an SOE could declare bankruptcy, who would be in charge and often also what should be the outcome. Creditors were marginalised in the process and were given a low priority in the distribution of debtors’ property.

The 1986 law introduced many important concepts and mechanisms, but it was only rarely used. There were, on average, only 277 cases annually between 1989 and 1993, and even when the number of cases reached almost 9,000 in 2000, commentators in China and abroad claimed it was still too low given the amount of bad debt, SOEs’ inefficiencies, and overall dysfunctionality of the Chinese economy.⁵²⁰ Nevertheless, because SOEs still provided most urban employment, local governments were under a lot of pressure from Labour Unions to prevent large-scale redundancies that could result from objective implementation of the law. Local governments responded by keeping the number of corporate insolvencies artificially low through bailouts, mergers and state-led negotiations.⁵²¹

It soon became clear that the 1986 law was inadequate and critical voices started calling for a more profound change. There were multiple complaints about the 1986 law.

⁵¹⁹ Wu (2004) at 241

⁵²⁰ Li (2001); Wu (2004) at 241; Booth (2008) at 279

⁵²¹ Li (2001) at 3-5

First, to assist the implementation of the 1986 law, a myriad of laws, SPC Opinions and policy documents were subsequently introduced. Unfortunately, they created a mixture of frequently irreconcilable rules which were too complex and difficult to follow.

The second complaint was that the law failed to address the complex economic reality of the 1980s China. Professor Li Shuguang, one of the drafters, criticised the final version of the 1986 law for being vague and deficient in ignoring financial distress of private enterprises, partnerships and natural persons. The private sector had grown in size and importance since its inception in the early 1980s, but the vast bulk of non-state companies existed and died in a legal void which was inefficient and potentially value-destructive. Li also complained that the increasingly diversified creditors received insufficient protection, that there was no reorganisation procedure, and that there were serious inconsistencies between the 1986 law and existing government policies.⁵²² The problems further grew after China's accession to the WTO in 2001.

Third, the 1986 law was criticised that it simply codified state control over the fate of failing SOEs and failed to give courts enough real power to provide more efficient solutions. Government's involvement was described as short-sighted and harmfully inefficient (*v.* developed market economies), and observers started calling for more transparency and independence.⁵²³

The final complaint was that, despite the early warnings from the pilot cities,⁵²⁴ courts, lawyers, local governments and business community were uninformed and

⁵²² *Ibid.* and Qi (2008) at 14

⁵²³ See e.g. Qi (2008) at 14

⁵²⁴ As we saw earlier, the law was first tested in Shenyang, Wuhan and Chongqing, and their experience and advice was submitted to the Premier and the National Congress in May 1986 (see Cao Siyuan, nn.524-25)

unprepared for the legal environment created by the 1986 law. The lack of understanding and legal training together with corruption and local governments' protectionism prevented any meaningful implementation of the 1986 law.

In 1993, in response to the low use and extensive criticism, the government decided to set up a reform committee that would look into the possibility of reforming the 1986 law.

4.3.1.2 Making of the EBL

In March 1994, six years after the 1986 law was fully implemented, the government asked the NPC's Finance and Economy Committee to draft a new law that would provide for corporate rescue, prevent unnecessary unemployment, reduce direct state intervention, ameliorate the position and equal treatment of all creditors, comply with international standards, and enable further FDI. The process took twelve years due to numerous tensions and conflicts of interests. The drafting started in 1994 and involved many Chinese and foreign experts, professionals, stakeholders, and even local governments. Many drafts were rejected after heated debates in the NPC and by various groups within the Party-state. A four-year deadlock was only broken in 2000 to enable China's accession to the WTO. In the meantime, the economic importance of SOEs diminished and further economic growth started relying on private companies and foreign trade.⁵²⁵ The reform of the outdated 1986 law could no longer wait.

Despite the widely accepted need to introduce a new insolvency law as quickly as possible, the drafting process was slowed down by numerous tensions between interests of

⁵²⁵ See Chapter 3.4.3

different stakeholders. Some of these tensions still affect whether and how the EBL is applied today.

One of the key conundrums in China's socialist system – and the reason why the reform process took twelve years – was the question whether to *prioritise claims from 'the people'* – i.e. debtors' employees – *or the money-providers* – i.e. debtors' (secured) creditors.⁵²⁶ On the one hand, employee protection is crucial given that China still does not have a functioning social welfare system,⁵²⁷ and so employees who are dismissed following corporate restructuring or liquidation face a loss of livelihood and existential uncertainty. As a result, there is a real danger of social instability.⁵²⁸ This is particularly problematic in large-scale corporate insolvencies where fast re-employment is particularly difficult.⁵²⁹ On the other hand, giving secured creditors priority to recover their claims in insolvency may benefit the whole economy. As was discussed in Chapter 2.3.1, lenders' expected *ex post* recovery in insolvency plays an important part in their *ex ante* risk-assessment, which in turn informs their decision whether to lend and with what conditions (term, costs). Without credit and stability, companies would suffer which would, in the long run, affect employment. Moreover, employees can be given protection through other means, but creditors cannot.⁵³⁰ As a result, the tension was eventually resolved by affording secured creditors priority over employees' interests.⁵³¹

⁵²⁶ See Chapters 4.3.2.5 and 4.3.2.7 for unsecured creditors

⁵²⁷ See Chapter 5.2.2.1

⁵²⁸ See Chapters 3.3.3.2 and 5.3.3.1

⁵²⁹ Cao (1986) point 3

⁵³⁰ See Chapters 5.1.1 and 7.1.2

⁵³¹ See Chapter 4.3.2.7

Equally difficult was the question of *what role should the Party-state have in insolvency law*. In other words, it was necessary to determine how to balance, on the one hand, insolvency law's need for objective (and independent) enforcement, and, on the other hand, the ideological setting where the Party-state – as a representative of the people – needs to have a say in the process to protect its (non-financial) interests. In the end, the central government took the view that, in the long term, not allowing inefficient companies to reorganise or liquidate may lead to serious economic problems which would undermine its image as a strong, capable leader. Consequently, the EBL as written puts courts in charge of EBL procedures and removes the Party-state's influence.⁵³²

And finally, China was under a lot of *pressure to comply with international demands*. In exchange for its ability to access international markets⁵³³ and to attract FDI, China agreed to update its laws – including insolvency law – to comply with international standards. To support China's effort, foreign governments and international bodies offered expertise and funding but also sought to ensure that the new regime would provide equal playing field, prevent local protectionism, protect efficiency-driven competition, and ensure more transparency and objectivity in law enforcement. As a result, the EBL applies to all companies – Chinese or foreign – and it contains provisions on cross-border insolvencies. In addition, numerous foreign concepts – such as moratorium, cram-down, *pari passu*, post-petition financing, etc. – have been included in the final draft of the EBL.

⁵³² See Chapters 4.3.2.3 and 4.3.2.6.
But Cf Chapter 3.3.3 and 5.3.3

⁵³³ Most importantly since its accession to the WTO in 2001

In the end, with the benefit many local experiments,⁵³⁴ the EBL was finally enacted on 27 August 2006 and it came into effect on 1 June 2007. It received praise for its progressive drafting,⁵³⁵ but also criticism for the remaining difficulties and warnings about the amount of work that still remained.⁵³⁶

4.3.2 Black-letter overview of the EBL 2006

The EBL has introduced a comprehensive set of rules and principles to govern cases of corporate insolvency regardless of debtors' ownership or financing structures. The new law contains 136 articles in 12 chapters (v. 43 articles in 6 chapters in the old law) and is supplemented by two SPC Interpretations that provide mandatory instructions about filing and opening of EBL cases, administrators, and avoidance of repayment issues for all Chinese courts.⁵³⁷

The EBL represents an amalgamation of China's economic⁵³⁸ and non-economic⁵³⁹ interests, and international best practice derived from American, English, and German insolvency laws, and the recommendations of the WTO, the IMF and the UNCITRAL Legislative Guide on Insolvency Law ('UNCITRAL Guide').⁵⁴⁰ As will be examined in Chapters

⁵³⁴ Especially the successful local insolvency regulation from Shenzhen (implemented locally in November 1993): Zhang and Booth (2001)

⁵³⁵ See e.g. Tomasic and Wang (n.517)

⁵³⁶ Neelen (2007) at 2; Halliday (2007)

⁵³⁷ SPC's Provisions (I) concerning the Application of the EBL 2011 ('Judicial Interpretation No. 1'); SPC's Provisions (II) concerning the Application of the EBL 2013 ('Judicial Interpretation No. 2')

⁵³⁸ E.g. sustainable economic growth and competitiveness of Chinese companies

⁵³⁹ E.g. the Party's desire to maintain legitimacy and social stability, and to retain control over state assets

⁵⁴⁰ United Nations, New York 2005 (http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf)

5 and 7, this pick-and-choose method has created many problems in practice. Nevertheless, the EBL, as written, is revolutionary in China's transforming system: it broadens the scope of insolvency application to cover all legal persons, it establishes an administrator system, introduces strict time limits for insolvency proceedings, provides better protection for creditors' interests, makes creditors active players in insolvency procedures, punishes fraud and wrongdoing, enables court-driven restructuring, enhances courts' role, diminishes government's influence, and provides for extraterritorial insolvencies.

The remainder of this section examines key EBL provisions and – where relevant – provides comparison with insolvency laws in the UK, US and Germany.

4.3.2.1 Scope and objectives of the law

Unlike the old law that only applied to SOEs, the EBL applies to all legal persons.⁵⁴¹ Given the fast expansion of the private sector, extending insolvency law to all companies regardless of their ownership status was crucial and, as a result, did not face too much opposition. There was some debate whether SOE insolvencies should have a special regime.⁵⁴² The 1995 draft included a special state-driven procedure for resolving SOEs' financial distress which enabled special consideration for employees and the fact that one of the state-owned banks is usually the main creditor.⁵⁴³ No such provision was included in the final version of the EBL which treats all companies equally. Nevertheless, state's interference was permitted on a

⁵⁴¹ Art 2 EBL, in line with UNCITRAL Guide paras 8-10

⁵⁴² This is not unique to China. Similar issues arose in Russia, Eastern Europe, South America, and others.

⁵⁴³ Wang (2006) at 16-17

temporary basis in resolving 2,116 hand-picked SOEs⁵⁴⁴ – which were deemed to be at a particular financial risk or were operating in a sensitive industry (e.g. military and mining) – but only until 2008 when the special status expired.⁵⁴⁵

There were also calls that the EBL should extend to natural persons – or at least to partnerships and sole traders.⁵⁴⁶ Nevertheless, limiting the scope of the law to legal persons has been strongly favoured since the 1995 draft,⁵⁴⁷ and was maintained in the final version of the EBL. This significant exclusion in the scope of the new law sets it apart from the UK, US and Germany, where natural persons can go bankrupt – whether under the same regime as legal persons (Germany and the US Chapters 7 and 11) or under a parallel regime specifically designed for natural persons (the UK and US Chapter 13). See Table 4-13 for comparison.

Table 4-13: The Scope of insolvency laws in China, UK, US and Germany

	CHINA (post-2007)	UK	US	GERMANY
All legal persons	YES	YES	YES	YES
Natural persons	NO	YES <i>(separate regime)</i>	YES <i>(separate regime)</i>	YES <i>(single regime)</i>
Special regime for SOEs	NO	NO	NO	NO
Cross-border proceedings	YES	YES	YES	YES

⁵⁴⁴ Out of about 100,000 SOEs: Li (22.6.2004)

⁵⁴⁵ Art 133 EBL

⁵⁴⁶ In order to, inter alia, bring the law in compliance with UNCITRAL Guide para 1

⁵⁴⁷ See Wang (2000) for a discussion of the drafters' reasons

Similar to other modern insolvency laws, the EBL is intended to enable corporate restructuring before attempting liquidation.⁵⁴⁸ To support this aim, two new restructuring procedures were introduced, and courts are encouraged to allow corporate restructuring, where possible. However, unlike the US Chapter 11, which places predominant focus on saving ailing companies and providing ‘breathing space’ under the protection of the law, the EBL appears to be closer to the German insolvency law which is more concerned with a fair (re-)distribution of assets and rights.⁵⁴⁹ Thus, the EBL opens with the objective of fair and legitimate redistribution – Article 1 states that the law’s role is to ‘fairly liquidate claims and debts, [and] to protect the legitimate rights and interests of creditors and debtors’ – but balances it against non-economic concerns such as the requirement on the judges to ‘maintain the order of the socialist market economy,’⁵⁵⁰ and to also ‘safeguard the legitimate rights and interests of the employees of the insolvent enterprise.’⁵⁵¹ Moreover, Article 8 further stipulates that debtor’s EBL petition must include, inter alia, ‘employee’s resettlement scheme to be adopted, payment of employees’ wages and social insurance premium.’⁵⁵² This is a stringent requirement, especially when interpreted as a pre-condition for acceptance of EBL applications. Usually, resettlement of employees is a matter for the government, but the EBL may push this responsibility onto the company.⁵⁵³

⁵⁴⁸ Li (2001)

⁵⁴⁹ Section 1 German Insolvency Law 1994

⁵⁵⁰ Art 1 EBL

⁵⁵¹ Art 6 EBL

⁵⁵² Art 8 EBL

⁵⁵³ For more, see Chapter 5.1.1

4.3.2.2 Entry requirements

Under the 1986 law, government's permission was needed to declare insolvency. This was logical at the time when all companies were owned and controlled by the state. The requirement was removed in the EBL, and so any creditors and debtors can file an insolvency petition⁵⁵⁴ directly to the local court provided they satisfy the insolvency test.⁵⁵⁵

The EBL also replaced the broader entry requirements of 'serious losses' and 'result of ... poor operations and management' that were vulnerable to subjective, politically-susceptible interpretation⁵⁵⁶ by a more objective insolvency test.⁵⁵⁷ The drafters were influenced by Sections 17 and 19 of the German Insolvency Law 1994, which requires that a debtor must be suffering from 'illiquidity' or 'over-indebtedness' in order to be allowed to use insolvency law.⁵⁵⁸ The EBL insolvency test depends on who submits the petition. A creditor petitioning for EBL Reorganisation or Liquidation must satisfy a one-limb *cash-flow test* by showing that the debtor is unable to pay off debts as they fall due.⁵⁵⁹ A petitioning debtor, on the other hand, must satisfy a two-limb test, namely the *cash-flow test* (as for creditors) and a *balance-sheet test* where he must show that the company's assets fail

⁵⁵⁴ Art 8 EBL stipulates that the petition must contain, inter alia, a contingency plan for employees' resettlement, and payment of employees' wages and social insurance premium

⁵⁵⁵ Art 7(1) EBL

⁵⁵⁶ Tomasic and Wang (n.517) at 9

⁵⁵⁷ The simplification – in line with UNCITRAL Guide para 21 – was introduced in the 1995 draft despite calls to retain the requirement for 'serious losses': Wang (2000)

⁵⁵⁸ Interviews P1-r, P3-r, R2-r, R3-r, R7-c to R10-c

⁵⁵⁹ Art 7(2) EBL

to meet its debts.⁵⁶⁰

In terms of pre-insolvency use of the law, China was also heavily influenced by the German law. Article 2(2) of the EBL states that a debtor can apply for Reorganisation (but not Liquidation or Composition) where it is 'obviously likely to become insolvent' – a requirement that closely reflects the German requirement of imminent illiquidity.⁵⁶¹ The drafters followed the broad guidance in the UNCITRAL Guide⁵⁶² but did not go as far as the US Chapter 11 which allows restructuring in a wide set of circumstances, regardless of debtor's ability to pay its debts. For a comparison, Table 4-14.

Table 4-14: Entry requirements into insolvency proceedings in China, UK, US, and Germany

	CHINA (post-2007)	UK	US	GERMANY
Who can apply?	Debtor Creditors Some investors ⁵⁶³	Debtor Creditors Co's directors	Debtor ⁵⁶⁴ Some creditors ⁵⁶⁵	Debtor Creditors Co's directors, officers
Insolvency test(s)	Debtor: cash-flow test <i>and</i> balance-sheet test Creditor: cash-flow test	Cash-flow test <i>or</i> Balance-sheet test	No requirement of insolvency Good faith, and with intention to restructure or to sell the company	Cash-flow test ("illiquidity") <i>or</i> Balance-sheet test ("over-indebtedness")
Pre-insolvency entry?	YES, but only Debtor's Reorganisation application: an obvious possibility that it will lose the capability to repay its debts	YES (likely to become unable to pay its debts as they fall due)	YES (same as above)	YES, but only Debtor's application: highly probable that at some date in the future it will be unable to pay its debts as they fall due

⁵⁶⁰ *Ibid.* The Standing Committee insisted on the two-limb test for voluntary petitions to prevent much-feared floodgates and debt-avoidance by the debtors. It broadly complies with UNCITRAL Guide para 21.

⁵⁶¹ Section 18 German Insolvency Law 1994

⁵⁶² UNCITRAL Guide paras 48-49

⁵⁶³ Those holding more than 10% of the debtor's registered capital: Art 70 EBL

⁵⁶⁴ Creditor can submit counter-petition to have the Chapter 11 proceedings closed down

⁵⁶⁵ Creditors holding unsecured non-contingent undisputed claims that amount to more than \$12,300 (in large company), or where the debtor company is "generally not paying debts as such debts become due"

Once filed, the petition is considered by a court. Under the 1986 law, courts had no procedural requirements or time limit for responding to the application. Moreover, creditors could only commence insolvency proceedings in very limited circumstances.⁵⁶⁶ In contrast, under the EBL, the government has no formal role in corporate insolvency proceedings, and the decision to accept or reject a petition lies solely with a court. Petitions can be filed by debtors or creditors, and their acceptance or rejection should be communicated by a court within 27 days.⁵⁶⁷ If the petition is rejected, the petitioning creditor can appeal to a higher court within 10 days to have the decision affirmed or reversed within 15 days.⁵⁶⁸ The court can in ‘special circumstances’ extend the hearing by 15 days.⁵⁶⁹ If the petition is accepted, the court must notify all known creditors within 15 days and make a public announcement of the ruling.⁵⁷⁰ The insolvency process then formally starts.

4.3.2.3 Procedures

There are three EBL procedures, namely Reorganisation, Composition, and Liquidation. Entered into through the same insolvency test, the three procedures offer a range of tools for different outcomes. Although Liquidation is by far the most widely used procedure,⁵⁷¹ the drafting process and EBL’s structure hint at a preference for restructuring. Below are

⁵⁶⁶ Art 3 of the 1986 law

⁵⁶⁷ Arts 10(1) and 11 EBL

⁵⁶⁸ Arts 12(1) and 10(2) EBL

⁵⁶⁹ Art 10(3) EBL

⁵⁷⁰ Art 14 EBL

⁵⁷¹ See Chapter 4.3.3, below

summaries of the three procedures, and a brief comparison with their UK, US and German counterparts.

4.3.2.3.1 Reorganisation⁵⁷²

The EBL established a widely-accessible, court-supervised and time-limited Reorganisation procedure with an optional expert supervision. To use it, a debtor or creditor files a general EBL petition⁵⁷³ but specify a preference for Reorganisation.⁵⁷⁴ It is then at court's discretion whether it considers the case to be appropriate for restructuring. Alternatively, a debtor or a capital contributor holding more than ten percent of debtor's registered capital may request that a creditor's petition for Liquidation be re-classified as Reorganisation once the general insolvency petition is accepted by a court.⁵⁷⁵

Once Reorganisation is authorised, an administrator or a debtor (with court's permission and under administrator's supervision) manages the business.⁵⁷⁶ As such, the Chinese regime is closest to the German Insolvency Law 1994 which gives courts a discretionary power to allow debtors to stay in possession. Chinese Reorganisation procedure is, therefore, quite different from the US Chapter 11 where the debtor remains in

⁵⁷² Chapter VIII EBL

⁵⁷³ See general entry requirements (Chapter 4.3.2.2).

Cf the 1995 draft also required that the debtor could show that rehabilitation was possible: Wang (2000) at 10

⁵⁷⁴ Art 70(1) EBL

⁵⁷⁵ Art 70(2) EBL

⁵⁷⁶ Arts 13, 73-4 and 89 EBL. The power-sharing, details of the debtor-in-possession (DIP) regime, and administrator supervision are unclear.

control during the proceedings and is only replaced if the management is incompetent.⁵⁷⁷ It is also different from the UK administration where the debtor is automatically replaced by an administrator.

A moratorium is imposed automatically once a court accepts the petition.⁵⁷⁸ An interim moratorium is imposed until administrator's appointment, and a main moratorium is imposed thereafter.⁵⁷⁹ Both types stay all judicial measures against debtor's property and all security enforcement by secured creditors (unless a court decides otherwise).⁵⁸⁰ An interim moratorium also temporarily stays pending civil and arbitral cases that involve the debtor.⁵⁸¹ This two-stage moratorium conception is another transplant from the German insolvency law, but the fully automatic nature of the moratorium is closer to the US and UK regimes. For a full comparison see Table 4-15.

⁵⁷⁷ Patel (2009)

⁵⁷⁸ In compliance with UNCITRAL Guide recommendations 39, 45-47, and 49-51

⁵⁷⁹ Arts 19-20 EBL

⁵⁸⁰ Arts 19 and 75 EBL

⁵⁸¹ Art 20 EBL

Table 4-15: Moratorium in restructuring proceedings in China, UK, US and Germany

	CHINA (post-2007)	UK	US	GERMANY
Procedure(s)	Reorganisation	Administration	Reorganisation (Chapter 11)	Insolvenzordnung
Timing	<i>Interim:</i> From acceptance of application to administrator's appointment <i>Main:</i> From administrator's appointment to the end of reorganisation	From acceptance of application until the end of administration	From filing of application until the end of reorganisation	<i>Interim:</i> from opening proceedings of the court to administrator's appointment <i>Main:</i> from opening of insolvency proceedings until the end of reorganisation
Discretionary?	Automatic (interim) Automatic (main)	Automatic	Automatic	Discretionary (interim) Automatic (main)
Scope - includes	(i) All judicial enforcement measures (including security enforcement) <i>Interim only:</i> (ii) All civil and arbitral cases	All judicial enforcement measures against unsecured creditors	All judicial enforcement measures	All judicial enforcement measures against unsecured creditors. Where secured creditors wish to enforce security rights over moveable assets, administrator has the right to sell and distribute proceeds to secured creditor
Scope - excludes	(i) Secured creditor can be permitted by court to enforce their security rights where the secured asset is at the risk of being destroyed or its value is at the risk of being reduced dramatically to the extent of impairing the rights of secured creditors	(i) Where judicial enforcement permitted by court or administrator (ii) Where creditors enforce security rights (iii) Where creditors wish to terminate contracts or exercise rights of set-off	(i) Where judicial enforcement permitted by court	<i>Interim moratorium</i> (i) claims against immoveable assets can only be deferred by court in charge of the relevant enforcement proceedings <i>Main moratorium</i> (ii) administrator may apply for a temporary stay on enforcement of security against immoveable assets

The debtor or administrator in charge has six to nine months to propose Reorganisation plan.⁵⁸² This is similar to the US Chapter 11 where the exclusivity period lasts 120 days to 18 months, and the UK administration where the administrator has eight weeks (or longer if the court allows) to present a proposal. There is no such requirement in the

⁵⁸² Arts 79(1)-(2) and 80 EBL

German law. In China – as in the UK, US and Germany – all debts must be covered by the plan.

The supervising court then convenes a creditors' meeting⁵⁸³ where creditors vote on the plan in four pre-determined groups (secured creditors; employees; tax claimants; and other general claimants).⁵⁸⁴ This class-voting system is similar to the US Chapter 11 and German restructuring but different from the UK where creditors vote en masse.

The voting rules are also slightly different. In China and the US, the plan is deemed adopted if in each group creditors representing more than a half in number and two-thirds in value accept the draft plan.⁵⁸⁵ In Germany, the proposed plan is accepted if voted for by a majority present and a majority in value. And in the UK, the proposed plan is accepted if agreed by a simple majority in value of all the creditors present and voting.

Similar to the German law, the EBL empowers a debtor or an administrator-in-charge to negotiate with the group that failed to approve the plan, but can – in limited circumstances – petition the court to cram-down the dissenting class.⁵⁸⁶ The US Chapter 11 also empowers courts to cram down a dissenting class(es), but the scope is broader. In China and Germany, the reorganisation plan must subsequently also be approved by the court. There is no such requirement in the UK or the US.

⁵⁸³ Art 84 EBL

⁵⁸⁴ Arts 81-82 EBL: Court can sanction creation of further groups
Cf in the US and UK procedures, parties determine and court reviews proposed classes in each case.

⁵⁸⁵ Arts 84 and 86 EBL. This is identical with the US Chapter 11, and very similar to all UK procedures (where the approval rate must be 75 percent, not two thirds, in value)

⁵⁸⁶ Art 87(2) EBL: cram-down is only possible if (1) secured creditors' rights are not infringed; (2) labour and tax creditors voted for Reorganisation plan or are fully paid; (3) general creditors are not worse off than they would be in Liquidation; (4) corporate investors voted for Reorganisation plan or Reorganisation plan is fair and impartial; (5) the draft Reorganisation plan treats creditors within the same class fairly and in accordance with the priority of repayment order in Art 113 EBL; and (6) debtor's proposed plan is feasible.

Once approved, EBL Reorganisation is terminated, and the plan becomes binding.⁵⁸⁷

The plan is then implemented by the debtor under administrator's supervision.⁵⁸⁸ The administrator submits a supervision report to the court at the end of the supervision period.⁵⁸⁹ Chinese system here lies half-way between the German regime where the debtor is in charge with optional administrator's supervision and the English regime where the administrator is fully in charge. It is furthest away from the US where the plan is implemented by the debtor alone.

4.3.2.3.2 Composition⁵⁹⁰

A simpler alternative to Reorganisation is the Composition procedure. A debtor (but not its creditors)⁵⁹¹ can apply for Composition directly, or it can ask a court to re-classify a pending Liquidation application as Composition.⁵⁹² Together with the application, the debtor must also submit a draft Composition agreement.⁵⁹³ Once a court is satisfied that the debtor is insolvent, it opens the proceedings, makes a public announcement thereof, and convenes a

⁵⁸⁷ Arts 86(2) and 92(1) EBL

⁵⁸⁸ Arts 89-90 EBL.

⁵⁸⁹ Art 91 EBL

⁵⁹⁰ Chapter IX EBL. Sometimes translated as Conciliation or Reconciliation

⁵⁹¹ Interestingly, in the old law and the early drafts of the EBL, the government was put in charge of the process. See e.g. Wang (2000) at 7.

⁵⁹² Art 95 EBL

⁵⁹³ *Ibid.*

creditors' meeting to discuss the draft Composition plan.⁵⁹⁴ The procedure is overseen by an administrator and a court, albeit in a much more limited manner than in Reorganisation.

Unlike Reorganisation, Composition usually involves only some of the debtor's creditors.⁵⁹⁵ In this sense, it is very similar to the English Schemes of Arrangement,⁵⁹⁶ which is also commonly used to agree with only certain classes of creditors. There are no voting classes and the debtor has only one chance to persuade the creditors to accept its Composition plan. The plan is deemed adopted if approved by a majority in number and two-thirds in value of the creditors present and entitled to vote, and if sanctioned by the court.⁵⁹⁷ Otherwise, the procedure is terminated and the debtor is declared bankrupt.⁵⁹⁸

Composition is not commonly used in China.⁵⁹⁹ An interview with a leading member of the drafting team of the EBL suggests that the procedure was always intended as an option for 'small companies and simple cases,' and it was assumed from the beginning that it would be rarely used.⁶⁰⁰ The drafting team of the EBL discussed the possibility of not including Composition in the EBL – following France and Germany – but it was concluded that it was better to 'cultivate a small garden with a hoe rather than a tractor,'⁶⁰¹ and so,

⁵⁹⁴ Art 96(1) EBL

⁵⁹⁵ Art 100 EBL

⁵⁹⁶ *Cf. Payne (2014)*

⁵⁹⁷ Arts 97-8 EBL

⁵⁹⁸ Art 99 EBL

⁵⁹⁹ Unfortunately, there are no available statistics

⁶⁰⁰ See Li (2001); interview with Professor Li in Legal Daily (12.2.2007)

⁶⁰¹ Wang (2000) at 8

inspired by the multi-procedure regime in the UK, Composition remained as an alternative to the other two costly and complex mechanisms.

4.3.2.3.3 Liquidation⁶⁰²

Liquidation is a fall-back option in the EBL. A petition for Liquidation can be submitted by a debtor or its creditors. When a court declares a debtor bankrupt, it must make a public announcement to that effect and notify the administrator and the creditors within five and ten days, respectively.⁶⁰³ Secured creditors can then enforce their claims over specific assets, and the remainder of the debtors' assets becomes known as general assets.⁶⁰⁴

An administrator then 'promptly' formulates a disposition plan – which must comply with the statutory priority of repayment⁶⁰⁵ – and submits it to creditors' meeting and a court for approval.⁶⁰⁶ Debtor's remaining assets are then usually sold in an auction and are distributed⁶⁰⁷ in accordance with the statutory priority rules. The distribution plan is implemented by an administrator.⁶⁰⁸

⁶⁰² Chapter X EBL

⁶⁰³ Art 107 EBL. Liquidation can be reversed if all due debts are paid off, or where a third party provides good security for the outstanding debts: Art 108 EBL

⁶⁰⁴ Arts 109-110 EBL

⁶⁰⁵ See Chapter 4.3.2.7

⁶⁰⁶ Arts 111 and 115 EBL. A court has the final say (Art 65 EBL), but its decision can be appealed (Art 66 EBL)

⁶⁰⁷ Arts 112 and 114 EBL

⁶⁰⁸ Art 116 EBL

If a debtor has no available property to distribute, an administrator must ask a court to terminate the procedure. Otherwise, Liquidation is terminated by a court upon receipt of administrator's distribution report.⁶⁰⁹

4.3.2.4 Powers and duties of debtors

There are three main users empowered by the EBL to get involved in EBL procedures: debtors can propose Composition, both debtors⁶¹⁰ and creditors can initiate insolvent Liquidation and Reorganisation, while courts – often assisted by an administrator – manage and oversee all three procedures and have the final word in cases of dispute. This section looks at the powers and duties of debtors. The following two sections then explore creditors' (4.3.2.5) and courts' and administrators' (4.3.2.6) powers and duties.

Where a debtor fulfils the insolvency test,⁶¹¹ the law states that it *may* choose to file a petition to apply for Reorganisation, Liquidation, or Composition. But it stops short of imposing a legal duty on the debtor to monitor its financial health and liquidate or restructure where it becomes insolvent. Nor does it – unlike the earlier EBL drafts – impose personal or criminal liability on the management of the debtor company where they 'were or should have been aware of the company's inability to pay off debts as they fall due, but still unreasonably spend money and property or squander the property.'⁶¹² In that sense,

⁶⁰⁹ Art 120(1)-(2) EBL

⁶¹⁰ And certain capital contributors: Art 70 EBL 2006

⁶¹¹ See Chapter 4.3.2.2

⁶¹² This was included in the 1995 EBL Draft and worked well in the test cities: Zhang and Booth (2001)

the law is similar to the US Bankruptcy Code which does not impose any duty related to insolvent trading. In contrast, both the UK and German systems do require the debtor to monitor its financial health and to submit to insolvency law if insolvent.

Debtors can object to creditors' EBL petition.⁶¹³ But once the EBL petition is accepted by court, the debtor personnel become subject to a number of duties, namely they must submit to a court all details of debtor's property, debts and claims, financial and accounting reports, and information about employee's wages and social insurance premium.⁶¹⁴

Debtor's senior personnel must cooperate with the court and administrator, they must attend creditors' meeting as non-voting delegates,⁶¹⁵ and they cannot act as senior officers in another company or leave their place of domicile without court's permission.⁶¹⁶ These rules are similar to the UK, US and Germany, and in compliance with the UNCITRAL Guide.⁶¹⁷

A debtor may remain in control in Reorganisation, but only with court's or administrator's permission and under administrator's supervision.⁶¹⁸ Where left in charge, the debtor is responsible for formulating and submitting Reorganisation plan, explaining it to and negotiating with creditors, and implementing it if accepted.⁶¹⁹ If the debtor refuses

⁶¹³ Within five days: Art 10(1) EBL

⁶¹⁴ Art 11 EBL

⁶¹⁵ Arts 15(1)-(3) and 68 EBL

⁶¹⁶ Art 15(4)-(5) EBL

⁶¹⁷ in particular Recommendations 108-116

⁶¹⁸ Chapter 4.3.2.3.1

⁶¹⁹ *Ibid.*

to cooperate or to implement the plan, the court can punish the responsible personnel⁶²⁰ and declares the debtor bankrupt.⁶²¹

The debtor has no rights or powers in Liquidation, but – similar to the UK and German regimes – may be subject to legal liabilities for their pre-EBL activities.⁶²²

4.3.2.5 Powers and duties of creditors

The EBL has greatly enhanced creditors' position and powers. Creditors can petition a court to reorganise or liquidate a debtor who is unable to pay off their debts as they fall due.⁶²³ If the petition is accepted and their claims are verified, creditors can attend creditors' meetings and vote on the Liquidation, Composition and Reorganisation plans; the management and distribution decisions relating to the debtor's property; and the remuneration and replacement of an administrator.⁶²⁴ A resolution is passed if approved by a simple majority of creditors present at the meeting, provided that they represent more than half of the creditors with voting rights and that their claims amount to more than half of all unsecured creditors' claims.⁶²⁵ Creditors can also establish a creditors' committee

⁶²⁰ Arts 125-129 and 131 EBL

⁶²¹ Art 93 EBL

⁶²² See Chapter 5.1.2

⁶²³ Chapter 4.3.2.2

⁶²⁴ Chapter VII EBL; Arts 59(1) and 61 EBL

⁶²⁵ Art 64(1)

(subject to court's approval) of up to nine members who have additional powers and represent the whole body of creditors.⁶²⁶

Creditors' role and powers are particularly pronounced in Reorganisation because the moratorium prevents enforcement of their claims,⁶²⁷ and the drafters believed – in line with international practice and recommendations – that creditors are entitled to have a degree of control over the process.⁶²⁸ Once the administrator or debtor makes a Reorganisation plan, secured and unsecured creditors vote as two of several classes. The plan is adopted if accepted by voting members who amount to more than half in number and two-thirds in value in each group.⁶²⁹ If creditors reject the plan, the administrator or debtor may negotiate with them, or can ask a court to cram-down the dissenting group.⁶³⁰ Similarly, creditors in Liquidation also discuss and vote on administrator's distribution plan.⁶³¹

4.3.2.6 Powers and duties of courts and administrators

Courts have extensive powers under the EBL. They have the final say in deciding whether to accept insolvency petitions,⁶³² whether to use Reorganisation instead of Liquidation,⁶³³ and

⁶²⁶ Art 68 EBL

⁶²⁷ Arts 19-20 (unsecured creditors) and 75 (secured creditors) EBL

⁶²⁸ This is similar to the UK and Germany and complies with UNCITRAL Guide recommendations 126-134. It is more extensive than in the US Chapter 11 where their rights are said to be protected by an administrator.

⁶²⁹ Chapter 4.3.2.3.1

⁶³⁰ *Ibid.*

⁶³¹ Chapter 4.3.2.3.3

⁶³² Art 10 EBL

⁶³³ Art 72 EBL

whether to enforce Reorganisation plan despite its rejection by a class of creditors.⁶³⁴ They also decide whether to terminate Reorganisation and Composition.⁶³⁵

In addition, courts are also charged with preventing and punishing malpractice, fraud and incompetence. To this end, courts must always investigate whether debtor's managers acted in breach of their legal duties.⁶³⁶ If they have – for example by submitting no or false statements, or by fabricating or destroying evidence⁶³⁷ – the court can fine them. In addition, courts can also fine administrators who fail to perform their duties loyally and diligently.⁶³⁸ And to enable proper investigation, courts can also detain managers to prevent their escape and fine them if they leave without prior consent.⁶³⁹

Such prominent role of courts sets the Chinese system apart from the UK, Germany and the US – where courts primarily only rule on the validity of insolvency petition and, in varying degrees, act as final arbiters and high-level supervisors. Instead, the role of Chinese judges brings the EBL closer to the French insolvency regime where courts have a more proactive role.⁶⁴⁰

⁶³⁴ Arts 86-87 EBL

⁶³⁵ Arts 78-79, 96 and 98 EBL

⁶³⁶ Art 6 EBL. Breaching the fiduciary duty results in a 3-year ban to manage any enterprise: Art 125(2) EBL

⁶³⁷ Art 127 EBL

⁶³⁸ Serious violations may give rise to criminal liability: Arts 130-1 EBL

⁶³⁹ Art 129 EBL

⁶⁴⁰ French Insolvency Code 1985 and 2005 (*Redressement judiciaire*) See also recent L'ordonnance pour des procédures préventives plus faciles (12 March 2014) which encourages collaboration and informal reorganisation

Courts' work is supported by administrators whom they appoint and supervise.⁶⁴¹ Administrators are professional,⁶⁴² impartial supervisors who replaced politically-controlled Liquidation committees which operated under the 1986 law. They supervise EBL procedures, recommend whether to close or sell or otherwise reorganise the debtor company prior to the first creditors' meeting, manage the debtor company and its property and information, investigate and in some cases formulate Reorganisation and Liquidation plans, make interim decisions (often subject to court approval), assist creditors, and in general act as intermediaries between the parties.⁶⁴³ They are subject to duties of due diligence and loyalty to the creditors and to the company as a whole,⁶⁴⁴ and once appointed, they are not allowed to resign without justifications that would be accepted by the supervising court.⁶⁴⁵

Furthermore, the EBL contains a number of provisions to prevent pre-insolvency asset dissipation and deprivation, and puts administrators in charge of their enforcement. Administrators must investigate and apply to court to reverse certain activities that affected debtor's property *within one year prior to the acceptance of the EBL application*.⁶⁴⁶ They include transactions at an undervalue; security given for past value; payments of undue

⁶⁴¹ Arts 22-23 EBL. Administrators are chosen at random from administrators' register, which is managed by local courts: Art 20 of the Interpretation on Appointment of Administrators (*Fashi* [2007] No.8)

⁶⁴² Art 24 EBL

⁶⁴³ Chapter III, Arts 23 and 25 EBL

⁶⁴⁴ Art 27 EBL

⁶⁴⁵ Art 29 EBL and Art 35 of the Interpretation on Appointment of Administrators (*Fashi* [2007] No.8)

⁶⁴⁶ Art 34 EBL

debts; and waivers of claims or other transactions that defrauded creditors.⁶⁴⁷ A similar duty exists in relation to any inappropriate income acquired and property misappropriated by any director, supervisor and other managerial officers of the debtor who took advantages of their positions.⁶⁴⁸ In addition, administrators must also claw back preferential payments made within six months before the EBL procedure commenced;⁶⁴⁹ seek and claim back property hidden or transferred to evade debts;⁶⁵⁰ and reveal and claw back money and property paid over in satisfaction of fabricated debts.⁶⁵¹ Administrators must also collect unpaid capital contributions from shareholders.⁶⁵² Administrators' broad-ranging powers and duties under the EBL reflect those found in insolvency codes around the world and comply with the general guidelines in the UNCITRAL Guide.⁶⁵³

Administrators also have a broad range of powers. Similar to the French system, an administrator can affirm or terminate a contract entered into prior to the EBL application.⁶⁵⁴ This power is much more extensive than that of administrators in the US and UK. In Germany, insolvency administrator may choose to affirm or terminate some types of contract.

⁶⁴⁷ Art 31 EBL

⁶⁴⁸ Art 36 EBL

⁶⁴⁹ Art 32 EBL

⁶⁵⁰ Art 33(1) EBL

⁶⁵¹ Art 33(2) EBL

⁶⁵² Art 35 EBL

⁶⁵³ In particular, UNCITRAL Guide recommendations 87-92

⁶⁵⁴ Similarly, a contract is automatically terminated if administrator fails to respond within one month to a formal notice served by the other contracting party: Art 18 EBL

Administrators' remuneration is determined by a court⁶⁵⁵ following SPC's seven-grade system (Table 4-16) according to the total value of debtor's liquidated assets and the likely workload on the administrator.⁶⁵⁶ Nevertheless, local courts can adjust the remuneration to reflect local circumstances so long as they make the new guidelines known through a well-known media and report the same to the SPC.⁶⁵⁷

Table 4-16: Guidelines for Determining Administrators' Remuneration

	Total value of liquidated assets	Maximum compensation
Grade 1	up to RMB 1 million	12% or less
Grade 2	more than RMB 1 million but less than RMB 5 million	not more than 10%
Grade 3	more than RMB 5 million but less than RMB 10 million	not more than 8%
Grade 4	more than RMB 10 million but less than RMB 50 million	not more than 6%
Grade 5	more than RMB 50 million but less than RMB 100 million	not more than 3%
Grade 6	more than RMB 100 million but less than RMB 500 million	not more than 1%
Grade 7	more than RMB 500 million	not more than 0,5%

4.3.2.7 Priority of distribution

Outside insolvency law, creditors get their money back on a first-come first-served basis. Such approach is seen as inefficient, resulting in a destruction of value and unequal or unfair distribution of debtor's assets.⁶⁵⁸ To prevent it, insolvency law steps in and provides a collective recovery framework that, inter alia, regulates the priority of repayments.

⁶⁵⁵ Art 28 EBL

⁶⁵⁶ Arts 2 and 4 of the Interpretation on Compensation for Administrators (*Fashi* [2007] No.9)

⁶⁵⁷ *Ibid.*

⁶⁵⁸ Goode (2011) Chapters 2-04 and 2-05; Kraakman et al (2017) Chapter 5

As was discussed in Chapter 4.3.1.2, the issue of priority was one of the reasons why the reform took twelve years.⁶⁵⁹ When the EBL was finally enacted in 2006, it contained an uneasy compromise in order to accommodate China's transition from socialist (pro-employee) to market (pro-creditor) system. To allow Chinese government time to expand its social welfare system to provide for the unemployed and to appease the powerful Labour Unions,⁶⁶⁰ Article 113 of the EBL states that, after expenses, employees rank ahead of all other claims. However, Article 132 of the EBL qualifies this by saying that this preferential treatment only extends to employee claims that were incurred before the new law came into effect, i.e. before 1 June 2007. As a result, employee claims now rank behind those of secured creditors, similar to insolvency laws elsewhere (see Table 4-17).⁶⁶¹

Table 4-17: Priority of distribution in China, UK, US and Germany

	CHINA (post-2007)	UK	US	GERMANY
1 st	Secured creditors	Secured creditors (fixed charges)	Secured creditors	Secured creditors *
2 nd	Insolvency expenses and Debts of common interest	Insolvency expenses	Insolvency expenses	Insolvency expenses
3 rd	Preferential creditors FIRST: Employees' claims SECOND: Social insurance contributions, taxes	Preferential unsecured creditors (wages, pension contributions)	Preferential unsecured creditors (wages, pension contributions, taxes)	Unsecured creditors
4 th	General unsecured creditors	Secured creditors (floating charge)	General unsecured creditors	Subordinated claims (shareholder loans)
5 th		General unsecured creditors (including taxes, shareholder loans)	Subordinated claims (discretionary)	

** In Germany, an administrator can take his fee from the proceeds of sale of movable secured assets before paying the secured creditor*

⁶⁵⁹ This dilemma is not unique to China: see e.g. Eidenmüller (2016) at 7-12

⁶⁶⁰ See Chapter 4.3.1.2

⁶⁶¹ See also UNCITRAL Guide paras 62-75 and recommendations 185-193

Post-June-2007 claims are, therefore, paid out in the following order:⁶⁶² (1) outstanding secured creditors' claims;⁶⁶³ (2) insolvency expenses⁶⁶⁴ and debts of common interest⁶⁶⁵; (3) employees' claims;⁶⁶⁶ (4) other social insurance premiums and taxes; and (5) (declared) general unsecured debts, treated *pari passu*.

4.3.3 Limited use of the EBL

The passage of the EBL received much attention and praise from abroad, being called 'landmark in the legislative history of China'⁶⁶⁷ and 'a watershed moment for Chinese capital markets.'⁶⁶⁸ The new law addressed many problems of the 1986 law and caught up with China's economic reality. However, it has not fulfilled the high hopes about it revolutionising the resolution of corporate financial distress in China.

The EBL's predecessor, the 1986 law, was initially used in several hundred and later several thousand cases per year, which was criticised for not being enough.⁶⁶⁹ However, as

⁶⁶² Arts 43, 113 and 132 EBL

⁶⁶³ Secured creditors are not stayed from enforcing their security in Liquidation (unlike in Reorganisation: Art 75 EBL), but if they fail to enforce their security, then their claims are satisfied first: Art 109 EBL

⁶⁶⁴ i.e. litigation costs; cost of administration, appraisal and distribution of debtor's property; and administrator's remuneration: Art 41 EBL

⁶⁶⁵ i.e. debts incurred by enforcing performance of unfinished contracts; debts incurred from voluntary service to the debtor's property by a third party; and the wages and social insurance premiums for continued operations: Art 42 EBL

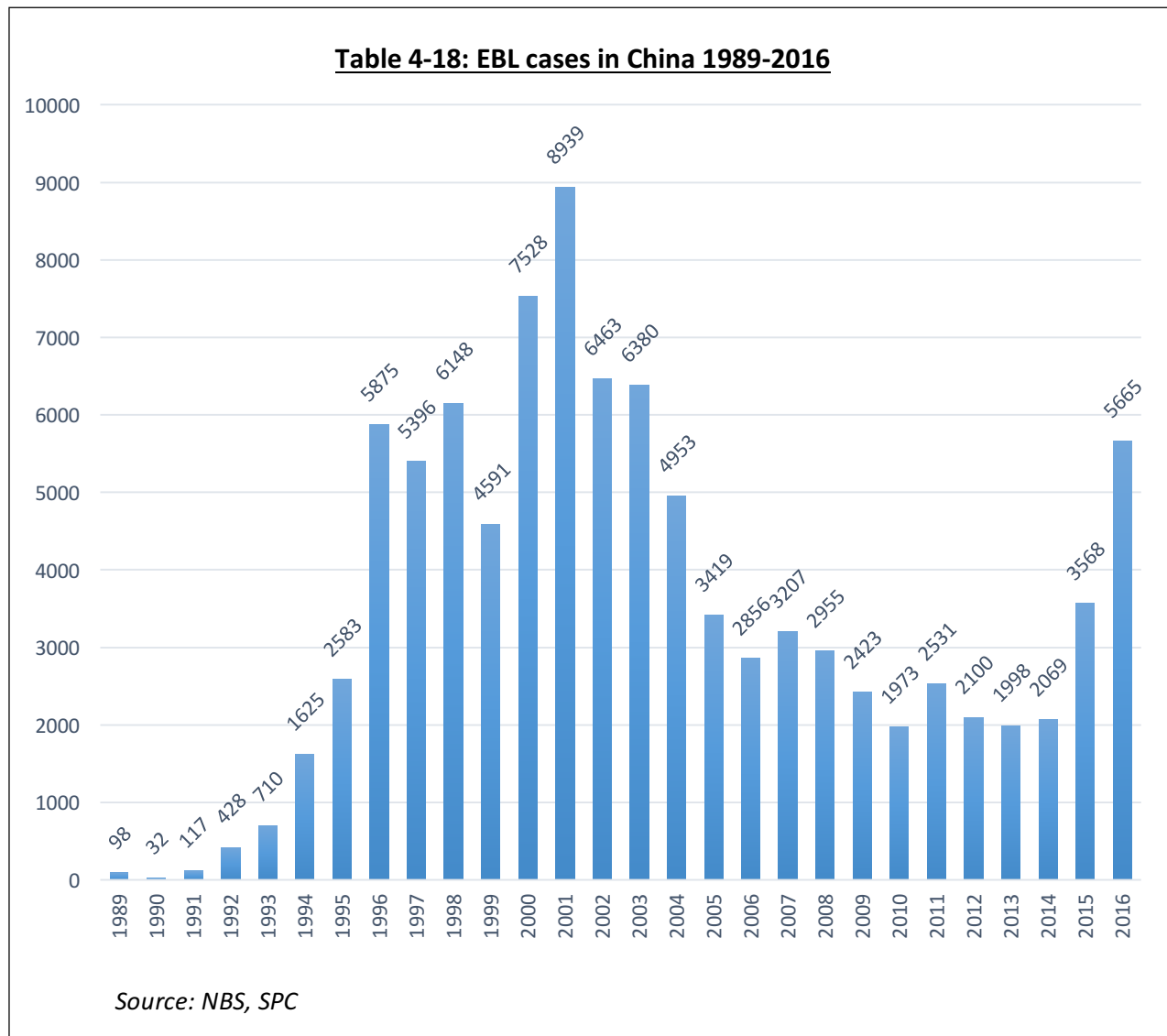
⁶⁶⁶ i.e. medical/disability fees and compensations, and support payments owed to employees and their families; employees' basic pension and medical insurance premiums; and any other compensations payable to the employees: Art 113(1) EBL

⁶⁶⁷ Tomasic (2010)

⁶⁶⁸ Eaton, Norley, Huang and Asimacopoulos (October 2006)

⁶⁶⁹ Li (2001)

we can see in Table 4-18, the number of cases actually *fell* after the EBL was promulgated and came into force in 2007.⁶⁷⁰



Several thousand cases per annum is not negligible, but – as will be discussed in Chapter 6.1 – it is unlikely to represent the real need and demand for insolvency law in China.⁶⁷¹ There were, on average, about 2,000 EBL cases each year until 2014. In 2015, the number of cases

⁶⁷⁰ See e.g. Watson (30.9.2008)

⁶⁷¹ In terms of ratio of bankruptcies to the number of firms, the US has the ratio of 3.65 and the UK ratio of 1.85. There is insufficient data to calculate such ratio for China (but it is likely to be very low, probably similar to the ratio of 0.22 in Russia): Claessens and Klapper (2002) Table 1

doubled to 3,568 cases, and in 2016 it grew further to 5,665. Unfortunately, this increase may only be temporary as it is most likely caused by the government's recent efforts to remove zombie companies from the market.⁶⁷² As such, it appears to be politically-driven use similar to that in 2001 when the old law was used to cleanse the system as a part of China's accession to the WTO.

Furthermore, the distribution of EBL cases is very asymmetrical. For example, in 2015 the courts in Zhejiang Province heard 638 EBL cases (or 18% of the total number). Although Zhejiang has a very active corporate market, a quick look at the geographical map that illustrates the spread of total losses in loss-making enterprises in China (Diagram 4-19) clearly shows that Zhejiang is far better off than some of the other provinces – mainly in northern and central China – where the EBL is hardly used.

⁶⁷² These are companies that are technically insolvent and are surviving only with regular state financial injections. As such, they are an enormous drain on China's state finances. For more, see Chapters 5.4.2 and 6.1

**Diagram 4-19: Geographical map by total losses
in loss-making industrial enterprises in 2015**



Source: NBS

Moreover, although the legislators intended that the EBL be used as a restructuring tool in the first instance,⁶⁷³ the number of Reorganisation cases is very low. Since the new law came into effect, Reorganisation has hardly been used (Table 4-20).⁶⁷⁴

Table 4-20: Reorganisations in China 2007-2010

Year	Number of cases	Percentage of reorganisations out of all EBL cases
2007	12	0,37%
2008	23	0,78%
2009	47	1,94%
2010	16	0,81%

Source: privately-collected data

⁶⁷³ See Chapter 4.3.2.1

⁶⁷⁴ Unfortunately, data after 2010 is not publicly available

PART II: CONSTRAINTS ON THE OPERATION OF THE EBL

Chapter 5. FOUR CONSTRAINTS ON THE OPERATION OF THE EBL IN CHINA

Since 1978, China has undergone large-scale economic changes which have facilitated a rapid increase in the number of companies, the level of corporate indebtedness (and NPLs), and increasing complexity in commercial dealings – which should, one might expect, lead to a greater number of instances of corporate insolvency in the aggregate.⁶⁷⁵ Chapter 4.3.1 explained that reformed corporate insolvency law was introduced in 2006 to keep up with these changes. Nevertheless, the number of court-run insolvency cases has, in fact, *decreased* after the EBL was introduced. Despite this, there is surprisingly little research into why the law is so rarely used. This chapter, therefore, presents insights offered by my interviews and research to explain why eligible debtors and creditors (hereafter ‘the parties’) may be unwilling or unable to use the EBL.

My research highlighted a number of issues that are presented in four broad categories of *constraints* on a more effective and efficient operation of the EBL, which – it is proposed – may explain why the law is only rarely used.⁶⁷⁶ The first such constraint is that certain EBL provisions are perceived by the parties as insufficiently protecting their interests (5.1). The second constraint concerns the surrounding rules and practices that reduce or prevent recoveries under the EBL – that is, reasons beyond the EBL itself. A discussion of this constraint will include an examination of how these general and EBL-specific flaws in

⁶⁷⁵ For a detailed discussion of why the number of EBL cases is too low, see Chapter 6.1

⁶⁷⁶ This thesis uses rational choice theory to understand creditors’ and debtors’ respective incentives regarding use of the EBL: see Chapters 1.2 and 2.1

debt enforcement hinder recoveries under the EBL, and how certain debt contracts *de facto* fall outside the scope of the EBL (5.2). The third constraint arises from the limitations and biases of EBL enforcers – lawyers, administrators, courts and local governments – which prevent effective operation of the EBL, and so further reduce recoveries under the law (5.3). The fourth and final constraint on the use of the EBL that reinforces debtors’ and creditors’ unwillingness to use the EBL is that the parties (often inaccurately) perceive non-EBL debt enforcement alternatives as comparatively more effective or attractive (v. the EBL), and so use them instead of the EBL (5.4).

The discussion in this chapter is largely positive, as it presents new insights into why the parties avoid using the EBL. Normative analysis and a discussion of possible ways forward are then contained in Chapters 6 and 7.

5.1 The First constraint: Certain EBL provisions are perceived by the parties as insufficiently protecting their interests

My interviewees identified several issues in the EBL – as written and applied in practice – which may discourage creditors and debtors from triggering the law in the first place. Three of them – which were highlighted as particularly important – are discussed here. Firstly, it will be proposed that the courts’ duties to protect employees affect creditors’ willingness to use the EBL (5.1.1). Secondly, several EBL provisions that increase the likelihood of scrutiny and imposition of liability on a debtor and its management upon initiation of an EBL procedure will be examined.⁶⁷⁷ This, naturally, discourages them from using the EBL in the first place (5.1.2). And thirdly, it will be argued that the requirement of insolvency as a pre-

⁶⁷⁷ Or once the news of their financial distress becomes publicly known through their initiation of bankruptcy procedure

condition to using the EBL disincentivises the parties from using Reorganisation (5.1.3).

Table 5-1, below, summarises the impact of each of these issues on the relevant stakeholders.

Table 5-1: Who is affected by the problematic EBL provisions

	Secured creditors	Unsecured creditors	Debtors	Employees
Courts' duties to protect employees (5.1.1)	–	–	–	+
Heightened threat of scrutiny and liability (5.1.2)			–	
Insolvency as entry requirement in reorganization (5.1.3)	–	–	–	–

– denotes harmful effect, + denotes beneficial effect

5.1.1 Implications of courts' duties to protect employees

As was discussed in Chapter 4.3.1, the question of how to deal with employees in corporate insolvencies had caused a lot of difficulties and disagreements in the drafting period. When the policy ensuring absolute protection of SOEs was formally removed in 2000, there was a protracted discussion whether employees should be afforded any special protections under the EBL, and what should be the status of their claims vis-à-vis other stakeholders. In the end, the EBL was passed containing several provisions that are aimed at – directly and indirectly – protecting employees. Three of them are discussed here. Firstly, the requirement that debtors' EBL applications must contain a plan for employee resettlement will be examined, and it will be proposed that it disincentivises debtors from using the law (5.1.1.1). Secondly, the conflicting guidelines in the EBL as to whether courts should prioritise *secured creditors'* or employees' interests will be explored, and it will be argued

that the clear preference for the latter in practice disincentivises secured creditors from using the EBL to seek recovery of their money (5.1.1.2). And thirdly, it will be proposed that the position of *unsecured creditors* and their near-certainty of nil net recovery pursuant to EBL rules – the hierarchy of repayment, as written and applied in practice – also reduces the parties’ incentive to use the EBL. (5.1.1.3).

5.1.1.1 Plan for employee resettlement

According to Article 8 of the EBL, debtor’s EBL petition must contain an employee resettlement plan. This is the case regardless of which procedure a debtor wishes to pursue. The EBL provides no further details, and there is no further guidance from the SPC. The Chinese judges and practitioners that I interviewed suggested that, in practice, courts tend to interpret the requirement strictly, as a pre-condition to accepting EBL cases. They all agreed that it was a burdensome requirement, and several of the lawyers said that they knew of insolvent companies for which this was an important reason why they did not use the EBL.⁶⁷⁸ Half of the interviewed judges and several consultants agreed that requiring the resettlement plan hinders the use of the EBL.⁶⁷⁹

Reasons for such strict interpretation are unclear. Some interviewees sought to defend it as a necessary ‘balancing tool’ to ensure that corporate insolvencies have minimal impact on social welfare of the people,⁶⁸⁰ and many interviewees also said that the key problem is that China still does not have a functioning social security system – and so the

⁶⁷⁸ Interviews L1-r, L2-s, L7-c, L8-c, L10-s, L11-c, L14-c, L15-c

⁶⁷⁹ Interviews J1-c, J2-c, J8-c, J9-c, C5-r, C6-c, C7-s

⁶⁸⁰ Interviews J3-c, J9-c, L14-c

implementation of the EBL has to partly fill this gap.⁶⁸¹ In doing so, courts not only adjudicate the case in front of them but also implement wider socio-economic policies of their immediate superior – a local government.⁶⁸² Local governments are particularly concerned about maintaining social stability, and large-scale redundancies have, in the past, caused significant problems in this regard.⁶⁸³ Unsurprisingly, therefore, local governments' influence was identified in all my interviews as an important factor in the strict interpretation of the requirement to submit an employee resettlement plan.

Regardless of the reasons why courts impose this strict requirement, all the interviewed enterprise representatives, consultants and lawyers agreed that financially distressed debtor companies are likely to be disincentivised by this requirement because its fulfilment costs them resources and slows them down at the time when 'time is of essence if we want to restructure or effectively liquidate a struggling business.'⁶⁸⁴

5.1.1.2 Courts' conflicting duties: secured creditors and public policy

As was discussed earlier, secured creditors have two main options for recovering their debts – individual security enforcement and collective debt enforcement under the EBL – and they usually prefer using individual, small-scale security enforcement pursuant to which they can recover their money directly and relatively cheaply and quickly.⁶⁸⁵ However, where they fail

⁶⁸¹ Interviews C2-c, C3-c, C5-r, C7-s, C8-s, J1-c, J3-c, J5-s, J6-s, J8-c, L1-r, L3-r, L4-r, L7-c, L9-s, L11-c, L13-c, L14-c, L15-c, P1-r, P3-r, R1-r, R3-r, R4-c, R10-c

⁶⁸² See Chapters 3.3.3 and 5.3.3 for details about this relationship

⁶⁸³ *Ibid.*

⁶⁸⁴ L6-s. The sentiment was echoed in most interviews.

⁶⁸⁵ See Chapters 4.2.2 and 4.3.2.5 for details

to *complete* the enforcement of their security before an EBL petition is accepted by a court, their enforcement is stayed under an interim moratorium until court appoints an administrator. In Reorganisation, secured creditors are then further stayed from realising their claims under a main moratorium.⁶⁸⁶ And although the EBL states that in Liquidation the moratorium should be lifted, my interviewees suggest that secured creditors are, nevertheless, often prevented from enforcing their claims freely in Liquidation.⁶⁸⁷ The discussion below, therefore, examines general provisions that guide courts' dealings with secured creditors in all procedures. It then looks at particular provisions that only apply in Reorganisation. Together, they create uncertainty and decrease the likelihood of recovery, and so contribute to secured creditors' preference for avoiding the EBL – and why they are cautious in extending credit in the first place.⁶⁸⁸

My interviewees who had dealt with secured debt in insolvency suggested that where secured creditors are forced to recover their debts under a collective EBL procedure, their rights are more often than not compromised in favour of employees' claims.⁶⁸⁹ The reason lies not only in the capture of the judiciary by the Party-state's political interests⁶⁹⁰ but also in the conflicting guidance in the EBL which enables courts to read in and prioritise employees' interests – despite the EBL also affording protections to secured creditors.

⁶⁸⁶ See Table 4-15 in Chapter 4.3.2.3.1.

Court may grant a special exemption in limited circumstances: Art 75 EBL

⁶⁸⁷ Interviews B1-c, B2-c, B3-c, C2-c, C5-r, C7-s, E1-c, E5-s, J1-c, J5-s, L1-r, L2-s, L5-c, L13-c, R2-r, R3-r, R9-c

⁶⁸⁸ This decreases the volume and increases the cost of credit in China: see Chapters 2.3.1 and 6.1.2.4

⁶⁸⁹ Interviews B1-c, B2-c, B3-c, C4-c, C5-r, C6-c, IF1-c, IF2-c, J1-c, J3-c, J5-s, J6-s, J8-c, L1-r, L2-s, L4-r, L6-s, L7-c, L9-c, L10-s, L11-c, L14-c, L15-c, P1-r

⁶⁹⁰ Discussed in Chapter 3.3.3

On the face of it, the EBL protects secured creditors.⁶⁹¹ Article 109 of the EBL states that ‘secured creditors are entitled to obtain payment in priority over debtor’s specific asset,’ that is regardless and ahead of claims from any other party. However, the reality is different. Ancillary provisions which enable consideration of other non-market interests are scattered throughout the EBL. These provisions do not explicitly direct courts to prefer socio-economic interests, but they have, nevertheless, given courts a scope to circumvent otherwise clear priority of secured creditors.⁶⁹² The reasons why courts exploit these conflicts in the EBL provisions to the advantage of employees and socio-economic interests are explored later.⁶⁹³ First, however, it is important to look at the provisions themselves to understand the basis of the courts’ reasoning.

Framing the whole law, Article 1 of the EBL states that besides protecting ‘the legitimate rights and interests of creditors and debtors,’ the law is intended to ‘maintain the order of the socialist market economy.’ This is further reinforced in Article 6 of the EBL which orders courts to ‘safeguard the legitimate rights and interests of the employees of the insolvent enterprise.’⁶⁹⁴ Note that these general provisions expressly enable only protection, not prioritisation. Nevertheless, many of my interviewees suggested that they have been interpreted as enabling courts to provide preferential treatment to employees in all EBL procedures.⁶⁹⁵

⁶⁹¹ Indeed, the EBL entitles secured creditors to recover ahead of everyone else. See Chapter 4.3.2.7

⁶⁹² Interviews B1-c to B3-c, C7-s, IF1-c, IF2-c, J1-c, J3-c to J6-s, J8-c, L1-r, L2-s, L4-r, L6-s, L7-c, L9-c, L10-s, L11-c, L14-c, L15-c, P1-r

⁶⁹³ See Chapter 5.3.3.1

⁶⁹⁴ Note that Article 6 does not impose an equivalent direct duty to consider creditors’ rights

⁶⁹⁵ Interviews C2-c, C5-r, C7-s, C9-c, J1-c, J3-c, J7-c, J8-c, J9-c, L1-r, L2-s, L4-r, L5-c, L8-c, L9-c, L12-c, L13-c

These protections are further reinforced by additional powers given to employees in the EBL. One example is a debtor's duty to submit an employee resettlement plan, discussed above. Another example is the supervisory power given to employees' and labour union's representative who can attend creditors' meetings and voice any concerns with the proposed Liquidation or Reorganisation plan.⁶⁹⁶ Moreover, if a creditors' committee is established, the representative must be one of its nine constituent members.⁶⁹⁷

The practical application of these EBL provisions resembles the approach taken under the 1986 law. On paper, secured creditors were to enjoy absolute priority,⁶⁹⁸ but in practice, these were overridden by policy decrees which prioritised employees' interests and resettlement protection.⁶⁹⁹ This was seen as problematic, and the reform committee empathically stressed in many drafts and reports that reliable protection of secured creditors' rights is a crucial element of modern insolvency law.⁷⁰⁰ Nevertheless, my research suggests that courts have continued to treat secured creditors in line with political interests rather than the clearly set-out priority in the EBL.

Probably most controversial, however, are the provisions regulating EBL Reorganisation. As was discussed earlier, secured creditors cannot enforce their claims under a separate enforcement procedure once a court accepts its Reorganisation petition

⁶⁹⁶ Art 59 EBL

⁶⁹⁷ Art 67 EBL

⁶⁹⁸ Arts 32 and 37 of the 1986 law

⁶⁹⁹ Booth (2008) at 307-8

⁷⁰⁰ *Ibid.* See also Chapter 4.3.1

and a main moratorium is automatically triggered which stays individual enforcement.⁷⁰¹

Secured creditors and labour claim holders⁷⁰² each then form one of several classes for the purpose of voting on Reorganisation plan.⁷⁰³ If a voting class fails to approve the plan, it can be crammed down by the court. Article 87(1) of the EBL provides that secured creditors' rejection is fatal to the plan, as secured claims must be repaid in full. Nevertheless, some of my interviewees suggested that this is not always respected.⁷⁰⁴ As a result, despite the absolute priority of secured creditors in Article 109 of the EBL, secured claims are often subordinated to employees' claims based on EBL's broad ancillary provisions.

The result of interpreting the conflicting duties in the EBL in favour of employees and against secured creditors is that the latter often lose the very priority which customarily defines their position and are instead treated as *de facto* unsecured creditors. This is particularly important for institutional finance providers – in particular banks – who then refuse to lend without additional guarantees, and as a result, often end up lending only to state-sector companies which receive an implied guarantee from the state.

5.1.1.3 Priority of repayment: unsecured creditors versus employees

Ostensibly, the pool of assets for satisfying unsecured creditors' claims appears to be relatively larger in China than elsewhere due to the aforementioned general tendency to

⁷⁰¹ Note that imposing main moratorium is discretionary, not automatic: see Chapter 4.3.2.3.1

⁷⁰² This is defined broadly – see Chapter 4.3.2.7

⁷⁰³ *Ibid.*

⁷⁰⁴ Interviews B1-c, B2-c, C1-c, C4-c, C6-c, IF1-s, IF2-c, J1-c, J6-s, L2-s, L6-s, L14-c, L15-c

ignore security rights⁷⁰⁵ and because most (private) companies rely exclusively on unsecured credit.⁷⁰⁶ However, the finance providers and consultants that I interviewed suggest that in reality, unsecured creditors are unlikely to recover anything at all under the EBL.⁷⁰⁷

The EBL puts unsecured creditors' claims at the bottom of the repayment order.⁷⁰⁸ Such treatment of unsecured creditors is not unique to China – in fact, many jurisdictions treat unsecured creditors this way.⁷⁰⁹ However, what is different compared to other jurisdictions is that, firstly, employees are entitled to recover all their claims first,⁷¹⁰ and secondly, employees' claims are particularly large with no cap on how much they can recover.

Employees' claims under the EBL include past and a portion of future wages. Dismissed employees are entitled to severance pay in the form of a month's wage for each year worked for the employer.⁷¹¹ Moreover, employees' claims are defined broadly. Apart from employees' wages they also include, importantly, basic pension entitlements and medical insurance premium defaulted by the debtor, and other compensations payable by

⁷⁰⁵ See Chapter 5.1.1.2

⁷⁰⁶ Access to secured (mostly state-bank) credit is limited to SOEs and few economically important private companies – see Chapter 4.1

⁷⁰⁷ Interviews B1-c to B3-c, C1-c to C11-c, IF1-s and IF2-c

⁷⁰⁸ See Chapter 4.3.2.7

⁷⁰⁹ *Ibid* – Table 4-17

⁷¹⁰ this is similar to the French system

⁷¹¹ Labour Contract Law 2008. In SOEs where many people worked most of their lives, the sum of such compensation packages can be significant.

the debtor to the employees in accordance with other applicable laws and rules.⁷¹² Social insurance payments are also included and recoverable ahead of unsecured debts.⁷¹³ As a result, unsecured creditors usually recover nothing in EBL Liquidation and nothing or ‘practically nothing’ in EBL Reorganisation.⁷¹⁴

Such generous pro-employee policy operates as a substitute for China’s incomplete social security system. It also assists local governments in keeping employees content in order to maintain public order. Nevertheless, many of my interviewees expressed a view that, in the long-term, unlimited employee protectionism is very harmful to the economy as creditors are unlikely to use the EBL in a timely manner – which may lead to inefficient resolution and value-destruction.⁷¹⁵ Moreover, unsecured creditors are incentivised not to submit to a collective debt recovery under the EBL and instead try to recover their money through private enforcement alternatives,⁷¹⁶ which they perceive – often erroneously – as offering a greater chance of at least part-satisfaction of their debt and, therefore, better payoffs than the EBL.⁷¹⁷

⁷¹² ‘Other compensations’ include employer’s compulsory contributions to the insurance, to a pension fund and to a housing fund – up to 50 percent of each employee’s salary (with some regional variations): Art 1-56 of the Social Insurance Law 2011. See also Livermore (21.2.2012)

⁷¹³ See Chapter 4.3.2.7

⁷¹⁴ Interview IF1-s, also interviews B1-c, C2-c, C3-c, C5-r, E3-s, IF1-s, IF2-c, L2-s, L7-c, L11-c, L17-c, R9-c

⁷¹⁵ Interviews E1-c to E5-c, IF1-s, IF2-c, C2-c, C4-c, C7-s, L2-s, L4-r, L5-c, L6-s, L11-c, L15-c
For the importance of timely resolution, see Chapter 7.1.4.1

⁷¹⁶ Discussed in Chapter 5.4.1

⁷¹⁷ Interviews B1-c, B2-c, C1-c, C3-c, C5-r, C7-s, E2-s, E3-s, IF1-s, IF2-c, L2-s, L9-s, R9-c, R10-c.
See Chapter 6.1.2.1 why this is limiting and inefficient.

5.1.2 Heightened threat of scrutiny and liability

A second major objection to the EBL raised in my interviews is that debtor companies' personnel⁷¹⁸ often feel that using the EBL increases the likelihood of them being investigated and facing liability arising from the company's insolvency. Such liability arises directly from the EBL provisions (5.1.2.1) as well as indirectly from non-insolvency laws and practices, which are triggered, *inter alia*, when a company uses the EBL (5.1.2.2). Due to the scarcity of prior literature that deals with liability under both the EBL and such other laws, on paper as well as in practice, this section first provides a short high-level description of the rules governing each type of liability before delving into the discussion of how they affect a debtor's decision (not) to use the EBL.

Many liability provisions in China are vaguely defined, which – as many of my interviewees highlighted – creates much *ex ante* uncertainty in practice.⁷¹⁹ This is further exacerbated by how courts apply them in practice. The practitioners that I interviewed argued that the vague EBL provisions are often interpreted by courts and governmental bodies in a manner which imposes liability regardless of any actual wrongdoing or proven fault⁷²⁰ of those being punished.⁷²¹ Given that such extensive and, in many ways, unpredictable liability is triggered by debtor company's EBL petition – particularly where,

⁷¹⁸ I speak mostly of directors and supervisors, but 'relevant personnel' is defined broadly in Art 15(6) EBL as including – if court so decides – 'financial and accounting personnel as well as other managerial personnel'

⁷¹⁹ Interviews with all consultants (C1-c to C10-s), all entrepreneurs (E1-c to E5-c), IF1-s, IF2-c, L1-r, L2-s, L5-c, L6-s, R3-r, R6-c, R7-c, R9-c

⁷²⁰ As is widely accepted, financial distress arises as a result of many different types of circumstances, *inter alia*, bad management, changes in trends and consumer demand, new technology, etc.: Coote and Schäfer (2011) Chapter 10

⁷²¹ Interviews C1-c, C2-c, C5-r, C7-s, C10-s, all lawyers, R1-r, R2-r, R3-r, R9-c

without such trigger, the provisions would probably never be invoked even in instances in which the company or its personnel were in fact guilty of wrongdoing – it is only rational that debtor companies' personnel are reluctant to use the EBL.⁷²²

5.1.2.1 *Liability arising directly from the EBL*

One of the novel elements in the EBL is that Article 6(2) creates a general duty for courts to investigate insolvent company's personnel for their '*legal liabilities*.' Articles 125 to 131 of the EBL then explain the circumstances under which courts can impose criminal, personal or professional liability, and when they can impose career-affecting sanctions. Several examples are discussed below.⁷²³

Criminal liability

Firstly, Article 131 of the EBL states that where a violation of any provision contained in the EBL constitutes a criminal offence, courts must investigate potential *criminal liability* of the debtor company's personnel.⁷²⁴ Detailed provisions are found in the Criminal Law.⁷²⁵ Many of the relevant provisions can be invoked outside the EBL. However, all my interviewees

⁷²² *Ibid.*

⁷²³ NB: Two interviewees (L4-r, L6-s) argued that courts in different provinces and regions impose the sanctions with varying degrees of severity

⁷²⁴ There are slight variations, but this most often includes directors, supervisors and managers

⁷²⁵ China's Criminal Law was introduced in 1979 and has been amended nine times. For our purposes the key changes took place in 2010 (limitations on the use of the death penalty, stricter rules on imprisonment, criminalisation of refusal to pay employee remuneration), in 2009 (tax-related crimes added, Ponzi schemes and some shadow lending market activities criminalised), and in 2006 (provision of false information criminalised, concealment of property and fabrication of debts to avoid having to repay criminalised, detailed account of directors' duties and criminalisation of their breach, deception in obtaining loans criminalised)

agreed that, in practice, the likelihood of criminal investigation is significantly increased if a company uses the EBL.

There is a wide range of circumstances where courts impose criminal liability – mostly leading to fines and imprisonment.⁷²⁶ This section explores three examples, which my interviewees identified as particularly significant. Firstly, personnel of insolvent companies can be liable for white-collar crimes, which range from interference with company accounts⁷²⁷ to ‘seriously injuring’ the company’s creditors and stakeholders.⁷²⁸ ‘Injury’ is then defined as including taking property of ‘comparatively large value’ which properly belongs to the company, and keeping it for one’s benefit.⁷²⁹ But there is no definition of what ‘serious’ injury means, which affords broad discretion to courts.⁷³⁰ If the property thus taken is ‘public property,’ and is taken by a State official or a person authorised by state organs or SOEs, the maximum punishment is a death sentence and confiscation of the wrongdoer’s property.⁷³¹

⁷²⁶ These are discretionary, and go up to 10 years in prison and 500,000 RMB. The sanctions occasionally exceed this level – see particular examples below.

⁷²⁷ The common business practice of dual-accounting and a provision of false, adjusted accounts to a court under the EBL may also lead to liability for ‘obstruction of justice’ – in particular under Arts 305 and 306 of the Criminal Law, which deal with destroying or fabricating evidence and making false statements under oath. For more, see Chapters 4.1.3.1 and 5.2.1.1

⁷²⁸ Art 162 EBL

⁷²⁹ Art 271 Criminal Law 2015

⁷³⁰ Falsely declaring bankruptcy to avoid having to repay one’s debts where the company has enough assets to do so, also counts as ‘serious’ injury: Art 162(2) EBL. Several interviewees (J1-c to J9-c, L2-s, L4-r, L6-s, L14-c, L16-c) suggested that courts are particularly proactive in protecting employees’ interests, and will only step in to protect creditors’ rights in extreme cases.

⁷³¹ The particulars depend on the value of the misappropriated assets: Art 383(1)-(4) Criminal Law 2015

Secondly, endangering collection of taxes is also considered a crime in China.⁷³²

Several interviewees suggested that this is particularly relevant in the EBL context where debtors and outside providers are guilty of a common business practice of making⁷³³ or forging and selling⁷³⁴ invoices with the purpose of gaining a tax advantage.⁷³⁵ If these invoices cause ‘seriously heavy losses to the state interests,’ the guilty parties face life imprisonment or a death penalty and confiscation of property.⁷³⁶ My interviewees all agreed that, regardless of whether tax evasion is an express aim or an unintended consequence, opening company’s books to an outsider (courts, administrators, creditors) by filing an EBL petition exposes the company to a much greater likelihood of liability.⁷³⁷ It is, therefore, contrary to the interests of debtor companies’ personnel to voluntarily use the EBL since it may expose a number of existing, but previously undiscovered criminal transgressions and expose them to potentially significant liability.

And thirdly, SOEs’ personnel may also face criminal liability for ‘causing [an SOE’s] insolvency or serious financial distress’⁷³⁸ and for ‘causing great financial loss to [an SOE].’⁷³⁹ The provided illustrative list of relevant examples contains several situations that give courts

⁷³² Failing to repay or underpaying and hiding property to avoid paying taxes: Arts 201 and 203 Criminal Law 2015

⁷³³ Art 205 Criminal Law 2015

⁷³⁴ Art 206 Criminal Law 2015

⁷³⁵ Interviews L1-r, L2-s, L4-r, L6-s, L9-s, L10-s, L11-c, L12-c, L160c, J6-s, C2-c, C5-r

⁷³⁶ Art 205(2) Criminal Law 2015

⁷³⁷ Interviews E1-c to E5-c, C1-c, C2-c, C5-r, C7-s

⁷³⁸ Art 168 Criminal Law

⁷³⁹ Art 169 Criminal Law

further discretion and create uncertainty.⁷⁴⁰ For example, imposing criminal sanctions where SOE's personnel loan their company's assets to persons or companies who are 'clearly unable to repay'⁷⁴¹ is problematic due to the state of company accounts in China and the low quality and amount of information about companies.⁷⁴² Similarly, providing a repayment guarantee for a person or a company where SOE's personnel have 'no reasonable grounds for giving the guarantee' is also a crime.⁷⁴³ However, many interviewees stressed that providing repayment guarantees for other SOEs or connected private companies is fairly common in China, and it often takes place at the request of a local government.⁷⁴⁴ Lack of a definition and guidance about the meaning of 'reasonable grounds' for giving a guarantee creates further uncertainty and gives courts scope to punish those SOEs whose personnel acted without local government's support since governmental approval is regarded as fulfilling the reasonableness requirement.⁷⁴⁵ As a result, debtor SOEs are unlikely to use the EBL procedures unless they receive express permission from a local government because they fear that 'the web of rules and liabilities which would trip them up if [the SOE personnel] act independently.'⁷⁴⁶

⁷⁴⁰ Interviews C5-r, C7-s, L1-r, L2-s, L4-r, L5-c, L6-s, L9-s, L11-c, L13-c, L14-c

⁷⁴¹ Art 169(3) Criminal Law 2015

⁷⁴² See Chapters 4.1.3.1 and 5.2.1.1

⁷⁴³ Art 169(4) Criminal Law 2015

⁷⁴⁴ Interviews E1-c to E5-c, L1-c to L6-s, L12-c, L14-c, P1-r, R1-r, R3-r, R6-c

⁷⁴⁵ *Ibid.*

⁷⁴⁶ Interview L4-r, similar views in C2-c, C3-c, C7-s, E2-s, J1-c, J5-s, J9-c, L1-r, L2-s, L4-r, L5-c, L6-s, L8-c, L12-c,

Such vague language enables courts to impose criminal liability even for activities that are common-place and relatively unobjectionable⁷⁴⁷ so long as they coincide with a company's financial distress. Strict causation is not always required by courts.⁷⁴⁸ Instead, several of my interviewees proposed that courts often presume director's and supervisor's guilt⁷⁴⁹ because – unlike in the West – directors in China are actively involved in their company's daily activities and so are deemed to have participated or at least supervised (and so explicitly or implicitly sanctioned) their company's criminal activities.⁷⁵⁰ The resulting threat of multifaceted, unpredictable criminal liability is, therefore, sufficiently serious that – even if a financially distressed company could be saved under EBL Reorganisation – many debtors in China find the prospect of using the EBL highly undesirable.⁷⁵¹

Personal or civil liability

Besides criminal liability, directors of insolvent companies can also face personal or *civil liability* under the EBL. Under Article 125(1) of the EBL, debtor companies' directors⁷⁵² can be found personally liable if their breach of fiduciary duties of loyalty and diligence results in

⁷⁴⁷ e.g. providing guarantees, inter-company loans, etc.: Interviews C2-c, C5-r, C8-s, L1-r, L2-s, L4-r, L6-s, L8-c, L9-s, L14-c, L15-c, R1-r, R4-c, R6-c, R9-c

⁷⁴⁸ Interviews J1-c, J4-c, L2-s, L4-r, L6-s, L7-c, L8-c, L14-c, L15-c, R1-r, R4-c, R6-c, R9-c. For details see 5.2.3

⁷⁴⁹ Interviews C2-c, C5-r, C10-s, E2-s, E3-s, J1-c, J4-c, L2-s, L4-r, L6-s, L7-c, L8-c, L14-c, L15-c, R1-r to R4-c, R6-c, R7-c, R9-c

⁷⁵⁰ *Ibid.*

⁷⁵¹ This provides some support to White's proposal that the *ex ante* costs of *ex post* manager/director liability are potentially the most significant of all: White in Bhandari and Weiss (1996) Chapter 30

⁷⁵² And under Art 147(1) Company Law also company supervisors and senior officials

their company's insolvency. A breach of these duties gives rise to a fine and a duty to compensate affected stakeholders.⁷⁵³ Further details are provided in the Company Law,⁷⁵⁴ but the duty of loyalty is only broadly defined,⁷⁵⁵ and the duty of diligence is not defined at all. Instead, the law offers an illustrative list of activities which would breach directors' duties.⁷⁵⁶ Importantly, in the context of shadow lending activities of many companies, punishable activities include illegally (i.e. shadow-market) lending their company's funds and accepting as their own the commissions of a transaction between another person and the company.⁷⁵⁷ The list also includes a catch-all category of 'other acts' that violate directors' fiduciary obligation to the company.⁷⁵⁸ Several interviewees suggested that this open-endedness of the list makes debtor companies' directors particularly worried due to courts' manifested readiness to punish activities which are generally accepted by the business community, but which contravene informal state policies and so are seen by courts as giving rise to liability under the last heading on the list – often at the request of local officials.⁷⁵⁹ Although the EBL expressly requires a breach of the above to *cause* the company's insolvency to give rise to liability, some of my interviewees argued that, in practice, courts often do not require a proof of causality and impose liability where a breach

⁷⁵³ Art 149 Company Law. The 2013 amendment to the Company Law added new guidelines on compensation

⁷⁵⁴ First introduced in 2005, amended in 2013. Hereafter 'Company Law.'

⁷⁵⁵ As 'a ban on taking advantage of one's position and powers in the company to collect or accept bribes or other illegal income and to encroach upon the company's property' Art 147(2) Company Law

⁷⁵⁶ Art 148 Company Law

⁷⁵⁷ *Ibid.*

⁷⁵⁸ *Ibid.*

⁷⁵⁹ Interviews C2-c, C5-r, E1-c to E5-c, L1-r to L6-s, L11-c, L15-c, L9-c.

and company's insolvency simply exist at the same time.⁷⁶⁰ Courts, therefore, have a very wide and far-reaching discretion and the resulting increase in a threat of civil liability acts as an additional reason for avoiding the EBL when dealing with one's financial distress.

Career-related consequences

And finally, debtor company's personnel also fear *career-related consequences* of using the EBL, such as losing their respective jobs – a natural consequence of corporate insolvency – and facing an automatic three-year disqualification from acting as directors, supervisors and senior managers in any company in China.⁷⁶¹ What's more, unlike the other employees whose interests are vigorously protected by courts and local governments, senior managers and directors are not treated as employees in insolvency. Their unpaid wages are generally not recoverable.⁷⁶² Moreover, courts and administrators can adjust managements' contractual provisions regarding their compensation for termination of employment if they deem it appropriate.⁷⁶³ These consequences, therefore, further discourage debtor's senior personnel from using the EBL and encourage the use of alternative enforcement mechanisms instead.⁷⁶⁴

⁷⁶⁰ In other words, correlation is often treated as causation for the purposes of the EBL – interviews C2-c, C5-r, C10-s, E2-s, E3-s, J1-c, J4-c, L2-s, L4-r, L6-s, L7-c, L8-c, R1-r to R4-c, R6-c, R7-c, R9-c

⁷⁶¹ Art 125(2) EBL. They are also under a duty not to take up or hold any other managerial post in another company: Art 15(5) EBL.

⁷⁶² Interviews C2-c to C8-s, E1-s, E3-s, E4-c, L2-s to L8-c. See also Legal Advice 110 (24.9.2013)

⁷⁶³ *Ibid.* See also Legal Advice 110 (15.11.2012)

⁷⁶⁴ Discussed in Chapter 5.4

5.1.2.2 Increased scrutiny and liability under non-insolvency laws and practices that are triggered by the use of the EBL

Previous section detailed liabilities that arise directly from the EBL where a company is insolvent.⁷⁶⁵ This section, on the other hand, discusses the liabilities that arise regardless of a company's financial health where the involvement of the EBL merely acts as a *trigger* or a *catalyst for scrutiny*, but where the EBL itself does not directly give rise to the liability. The discussion considers criminal liability arising due to one's involvement in shadow lending activities; personal liability to repay company's debts where repayment guarantee was provided; and detention and other consequences facing debtor company's representatives in cases of non-payment.

Criminal liability for involvement in shadow market activities

Firstly, debtor companies' representatives can face imprisonment and large fines for their involvement in shadow lending activities. Many of my interviewees spoke of managers' liability if they borrowed from 'too many people.'⁷⁶⁶ Article 176 of the Criminal Law defines the crime as 'illegally taking deposits from the general public or through an equivalent activity whereby disrupting the financial order.' Borrowing even small sums from many individuals – other than one's family and friends – and from lenders who found out about the opportunity through social channels (e.g. social media, promotion meetings, leaflets, wide-range advertising, etc.) falls within this definition.⁷⁶⁷ Many – particularly private –

⁷⁶⁵ Or financially distressed, which is sufficient for using EBL Reorganisation: Chapter 4.3.2.2

⁷⁶⁶ Interviews E1-c to E5-c, C2-c to c7-s, C10-s, L6-s to L10-s, R2-r, R3-r, R9-c, R10-c

⁷⁶⁷ Clarified in 2010 in the SPC Judicial Interpretation on Several Issues Concerning Implementation of Laws in Criminal Law Cases of Illegal fundraising (*Fashi* [2010] No.18). Interviewees L2-s, L4-r said that this is usually 'more than 200 people,' but neither could point to a particular

companies are financed in this way, and their entry into an EBL procedure significantly increases the likelihood that their ‘illegal’ borrowing activities get discovered and punished.⁷⁶⁸

Similarly, several interviewed practitioners reported that their clients (debtors and creditors) often do not want to use the EBL because they have taken out bank loans and re-invested the money in the shadow market.⁷⁶⁹ Legally speaking, it is a crime for a company to obtain a bank loan in order to re-lend the money at high interest rates.⁷⁷⁰ My interviewees suggested that this is particularly problematic for state sector companies,⁷⁷¹ who are often coerced by the government to carry out money-losing projects but are – at the same time – made responsible for the overall financial health of the company.⁷⁷² Therefore, they often try to make additional gains by ‘gambling in the shadow market’ using bank finance which is available to them, because shadow market is perceived by many as an opportunity to ‘make [them] rich, quickly.’⁷⁷³ Using the EBL triggers scrutiny and where it becomes apparent that these activities gave rise to ‘relatively large’ illegal gains, then those responsible face

provision which defines a precise number. Rather, they suggested, the law sets the standard broadly, and courts tend to determine what ‘many people’ means - in coastal cities, SEZs and similar, it was suggested that courts were likely to find that 200 satisfies the requirement.

⁷⁶⁸ Interviews C2-c to C7-s, C10-s, C11-c, IF1-s, IF2-c, J6-s, L1-r to L6-s, L8-c to L17-c, R1-r to R3-r, R6-c, R9-c, R10-c

⁷⁶⁹ Interviews L1-r to L6-s, L9-s, L11-c to L15-c, C5-r

⁷⁷⁰ Art 175 Criminal Law. For further discussion, see Chapter 5.2.3

⁷⁷¹ See Chapter 3.4 for the definition

⁷⁷² Interviews C2-c, C5-r, C7-s, L2-s, L4-r, L6-s, P1-r to P3-r

⁷⁷³ *Ibid.*, quote from interview L2-s

imprisonment and a discretionary fine.⁷⁷⁴ As a result, those in charge of state sector companies are further incentivised to avoid the EBL.

Moreover, both private and state sector companies are further incentivised not to use the EBL if they are involved in the shadow market in any other way because courts⁷⁷⁵ have an additional power to criminalise any other activities they deem to be a ‘disruption of market order.’⁷⁷⁶ Many interviewees felt that this is an extreme and rarely used measure, but it is nevertheless considered a threat, particularly by large players in the market who are often heavily involved in shadow market activities as lenders, borrowers and intermediaries.⁷⁷⁷

Personal liability under a personal guarantee

Secondly, directors can also find themselves liable to repay their company’s debts where they provided a personal guarantee that the company would repay and it does not. Such guarantees are particularly common in smaller and less well-connected companies which would otherwise not be able to access arms-length finance.⁷⁷⁸ Several interviewees argued that while an ordinary Chinese creditor may try to renegotiate the repayment conditions or find another solution,⁷⁷⁹ creditors with a personal guarantee can go beyond debtor

⁷⁷⁴ Art 175 Criminal Law 2015

⁷⁷⁵ Or, in practice, the local government

⁷⁷⁶ Art 225(3) Criminal Law

⁷⁷⁷ Interviews L1-r to L9-s, L11-c to L15-c, C1-c, C5-r

⁷⁷⁸ *Ibid.*

⁷⁷⁹ All my interviews agreed that in China the first step is always to try to renegotiate the loan before enforcing them – see Chapter 5.4.1

company's assets and into its directors' personal funds and property.⁷⁸⁰ This raises further difficulties, not only because it incentivises directors who provided personal guarantees to avoid entering the EBL even where a formal restructuring or liquidation would be beneficial to the company and its stakeholders,⁷⁸¹ but also because China does not have personal bankruptcy rules.⁷⁸² As a result – some interviewees proposed – there are many stories of run-away directors, particularly in regions with a strong private sector and an economy reliant on smaller businesses whose financing comes from non-banks and is often secured by personal guarantees from the directors.⁷⁸³

Detention

And finally, if the fact of insolvency becomes publicly known,⁷⁸⁴ debtor company's representatives can also find themselves forcibly detained to ensure repayment of debts. As was discussed earlier, the EBL orders debtor company's personnel not to leave their place of domicile without court's approval, and if they try to leave, a court can issue a warrant to detain them.⁷⁸⁵ However, several interviewees suggested that courts often act too slowly⁷⁸⁶

⁷⁸⁰ Interviews B1-c to B3-c, C2-c to C7-s, E2-s, E3-s, IF1-s, IF2-c, L2-s, L10-s to L16c, R9-c

⁷⁸¹ Such circumstances are discussed in Chapter 6.1

⁷⁸² Interviews C1-c, C5-r, J1-c, J6-s, L4-r to L8-c, L14-c to L16-c. These have been attempted locally, e.g. in Shenzhen and Wenzhou, but with mixed success: J6-s

⁷⁸³ *Ibid.* See also Chapter 6.1.2.2

⁷⁸⁴ In the Lipu County, in Guilin, there were no EBL cases because people would do 'anything to avoid the public large-scale monster process:' People's Daily (10.10.2015)

⁷⁸⁵ Art 15 EBL

⁷⁸⁶ As was the case in Zhejiang in 2011 where more than 200 business owners went into hiding to avoid repayment of debts. See e.g. SCMP (12.10.2011)

and so – to prevent debtor’s representatives from fleeing (and so enable subsequent court enforcement) – creditors sometimes detain debtor’s representatives without court’s assistance.⁷⁸⁷

The combination of personal and professional liability that arises directly from the EBL and indirectly from non-insolvency laws but which is triggered when the EBL is used, therefore, incentivises debtor company representatives not to use the EBL and, where possible, cover up their financial distress or at least resolve their problems through alternative mechanisms.⁷⁸⁸ As such, it is another plausible explanation of the low use of the EBL.

5.1.3 Insolvency as entry requirement for Reorganisation

A third and final major constraint on the use of the EBL that arises from the wording of the law itself – according to my interviewees – is the *requirement of insolvency as a pre-condition* to using the EBL.⁷⁸⁹ This is particularly problematic in the context of Reorganisation because the parties perceive insolvent restructuring as unable to save the company, a part of the business, or even to offer the parties comparatively higher payoffs than those that they would receive outside the EBL regime because the restructuring takes

⁷⁸⁷ Interviews L1-r to L7-c, L11-c to L15-c, C2-c to C5-r, C7-s, E2-s, R2-r to R4-c, R7-c, R9-c to R11-c
Unpaid creditors sometimes resort to extreme methods so as to enforce repayment of their money, such as a case of a Guangdong businessman who was put in a cage for three months for defaulting on a loan of 1 million RMB owed to the local government: SCMP (4.12.1999). See also Harris (11.1.2016)

⁷⁸⁸ For details, see Chapters 5.4.1 and 6.1.2.2

⁷⁸⁹ For details, see Chapter 4.3.2.2

place too late.⁷⁹⁰ The consequences are felt by creditors who are less likely to recover their claims, by debtors who lose a chance to restructure, by employees who lose their jobs, and by society at large due to, *inter alia*, the resulting fall in tax income, provision of fewer goods or services, and – depending on the circumstances – possible industry- or economy-wide impact.⁷⁹¹

5.2 The Second constraint: Surrounding rules and practices reduce or prevent recoveries under the EBL

The first constraint on the use of the EBL was concerned with certain flaws in the EBL and the ways in which they reduce the parties' expected payoffs – and, therefore, also their incentive to use the law. This second, complementary, constraint is concerned with how the parties' expected payoffs and ability to use the EBL are affected by the identified shortcomings in the *institutional environment in which the EBL is enforced*. Based on my interviewees' experience and insights, this section will propose that the flaws in surrounding rules and practices reduce or outright prevent recoveries under the EBL, and so disincentivise creditors from using the law.⁷⁹²

The discussion will focus on three broad issues. Creditors' expected payoffs under the EBL are reduced due to missing or incomplete supporting mechanisms and rules. This includes, firstly, *general flaws* in debt enforcement that affect EBL recoveries (5.2.1) and,

⁷⁹⁰ All interviewees expressed their misgivings about this test. Some were particularly sceptical, stating that successful restructuring was practically impossible: interviews C3-c, C5-r, E2-s, E4-c, L2-s, L4-r, L6-s, P1-r, R10-c

⁷⁹¹ For a comparative discussion and a discussion of why pre-insolvency use of Reorganisation is important, see Chapter 7.1.4.1

⁷⁹² It also provides further weight to claims that insolvency law cannot function well unless surrounded by effective institutions and norms that help define, support and enforce it: Wihlborg, Gangopadhyay and Hussain (2001).

secondly, shortcomings in surrounding rules and practices that *specifically* affect EBL enforcement and which affect creditors' decision whether to use the EBL (5.2.2). Finally, recoveries under the EBL are further limited due to existing rules that regulate lending and other debt-related activities, which also disincentivise or outright bar certain creditors from recovering under the EBL (5.2.3). In the aggregate, these surrounding rules and practices reduce creditors' expected and actual recoveries, and so – my interviewees suggested – contribute to the low use of the EBL.

Table 5-2: Impact of the problematic surrounding rules and practices

	Cause of reduced recoveries	Scope of impact – type of enforcement
General flaws (5.2.1)	Incomplete or missing rules	All debt enforcement
EBL-specific flaws (5.2.2)	Incomplete or missing rules	EBL only
Restrictions on lending (5.2.3)	Rules restricting lending activities	Certain credit contracts All debt formal enforcement

5.2.1 General flaws in debt enforcement that negatively affect recoveries under the EBL

Chapter 4.1.3 outlined several problems that face debt enforcement in China. These problems are further explored here, in the context of EBL enforcement. The discussion is structured in the same order, namely problems arising from unreliable financial information (5.2.1.1); difficulties with verification of property rights (5.2.1.2); problems arising from the limited protection of property rights (5.2.1.3); tunnelling, asset stripping practices and the use of ghost companies (5.2.1.4); and revocability of land usage rights (5.2.1.5). Many interviewees argued that, in the aggregate, these flaws further disincentivise creditors from using the EBL because they make recovery of their financial claims *ex ante* uncertain,

and *ex post* limited or non-existent.⁷⁹³ The impact on different types of stakeholders is summarised in Table 5-3.

Table 5-3: Who is affected in the EBL regime by general flaws in surrounding rules

	Secured creditors	Unsecured creditors	Debtors	Employees	Courts
Lack of reliable financial information (5.2.1.1)	–	–	+	+	–
Difficult verification of property rights (5.2.1.2)	–	–			
Limited protection of property rights (5.2.1.3)	–	–		+	–
Unpunished asset stripping & the use of ghost companies (5.2.1.4)	–	–	+	–	
Revocability of land usage rights (5.2.1.5)		–	–		

– denotes harmful effect, + denotes beneficial effect

5.2.1.1 Recoveries under the EBL are affected by lack of reliable financial information

Chapter 4.1.3.1 suggested that the lack of reliable and publicly *available information* – due to the use of forged and falsified documents and dual-accounting – hinders debt enforcement in China by complicating verification of creditors' claims and determination of asset ownership. Several interviewees argued that, in EBL enforcement, the information issues also complicate or outright prevent accurate assessment of debtor company's financial health, and so make it very difficult to determine whether a debtor satisfies the EBL insolvency test – a precondition to using the law.⁷⁹⁴ For example, where debtors use

⁷⁹³ Interviews B1-c, B2-c, C2-c, C3-c, C5-r, C7-s, J1-c to J9-c, L1-r to L15c, P1-r, R1-r to R4-c, R9-c, R10-c

⁷⁹⁴ Interviews B1-c to B3-c, C2-c, C3-c, C5-r, C10-s, J1-c, J3-c, J5-s, L2-s to L6-s, R1-r to R3-r, R9-c, R10-c

forged invoices, their assets – which would otherwise be available to creditors – are artificially reduced or augmented. Similarly, the use of dual-accounting hinders any meaningful determination of debtor’s financial health.⁷⁹⁵

Furthermore, some interviewees expressed concerns that the lack of reliable financial information makes it very difficult for courts and administrators to carry out their respective duties under the EBL.⁷⁹⁶ These include duties to claw back wrongly-transferred assets, to cancel vulnerable pre-EBL transactions,⁷⁹⁷ and to fulfil their general duty under Article 1 of the EBL to ‘fairly liquidate debts [and] to protect legitimate rights and interests of creditors and debtors.’ The interviewees doubted whether ‘fair’ allocation and protection of parties’ interests are possible under the EBL in its current institutional environment where the size of the pool of assets and the identity of all stakeholders are difficult to ascertain.⁷⁹⁸ Similarly, it puts debtors in breach of their duty to disclose and hand over all its assets, including all true documents.⁷⁹⁹ Consequently, this leads to imperfect enforcement, great uncertainty and lower payoffs to creditors.

An additional problem – albeit not unique to China – is that the inherent information asymmetry between the insiders (asset owners) and outsiders (potential buyers) makes it difficult to liquidate debtor’s assets effectively. Without reliable information about the quality and actual value of the assets, there are only two types of willing buyers of the distressed assets: insiders who know the real value of the assets, or opportunistic

⁷⁹⁵ *Ibid.*

⁷⁹⁶ Interviews B1-c to B3-c, C2-c to C5-r, C10-s, J1-c, J5-s, L2-s to L7-c, R1-r, R9-c, R10-c

⁷⁹⁷ For details see Chapter 4.3.2.6

⁷⁹⁸ Interviews – *supra* n.796

⁷⁹⁹ Arts 11(2) and 15 EBL

speculators. Both know that insolvency sends a negative signal about the assets' quality and that due to the information asymmetry very few people are willing to buy, and so they can successfully offer very low prices for distressed assets. This further reduces the recovery rates under the EBL and disincentivises creditors from resolving their claims under the EBL. This adverse selection problem is – several interviewees suggested – more pronounced in less-developed regions of China where the stigma of failure makes people particularly suspicious of anything and anyone connected with insolvency.⁸⁰⁰

Although private enforcement mechanisms⁸⁰¹ should, in principle, face similar information issues, several interviewees suggested that, in practice, it is often comparatively easier to recover debts using alternative enforcement mechanisms.⁸⁰² They argued that, firstly, imperfect financial information is less of a problem in informal enforcement since a creditor usually doesn't have to prove their claim to any third party. Instead, they observe and enforce their claim directly, without assistance from any third party.⁸⁰³ Secondly, creditors using informal enforcement often don't respect the legal limitation of only recovering from company-owned assets, and they are willing to threaten debtor's representatives or even their next-of-kin with violence and use other means to enforce

⁸⁰⁰ The stigma issue has been largely overcome in large, developed cities and market zones, but remains problematic in interior and northern provinces: Interviews C1-c, C2-c, C5-r, C10-s, E1-c to E4-c, L1-c to L6-s, L9s, L10s, L13-c, R1-r, R10-c

⁸⁰¹ For an overview of these see 5.4.1

⁸⁰² Interviews C2-c to C5-r, C7-s, E2-s, IF1-s, IF2-c, L1-c, L2-s, L4-r to L6-s, L9s, L10s, L13-c, R1-r, R10-c

⁸⁰³ Cf the idea of 'incomplete contracting' which is motivated by a concern that verification to a third party is often more costly than observation by a contracting party: see e.g. Hart and Moore (1988)

repayment.⁸⁰⁴ And thirdly, creditors using non-EBL mechanisms do not need to prove that the debtor company satisfies the EBL insolvency test. It is, therefore, not surprising that many creditors perceive non-EBL debt enforcement alternatives as more efficient, and so better than the EBL.

5.2.1.2 Recoveries under the EBL are affected by difficult verification of property rights

Further two challenges to debt enforcement in China relate to property rights, namely parties' *inability to prove entitlements and interests in property* (discussed here); and insufficient protection of property rights (discussed in the next section).⁸⁰⁵

One of the crucial roles that the EBL performs is collection and subsequent redistribution of debtor's assets according to a pre-determined order. However, this function is severely impaired due to the parties' inability to check and prove ownership of property and property-related interests and rights due to the lack of a fully functioning property rights registration system. Several interviewees suggested that this has a significant impact on the size of the pool of assets due to administrators' inability to collect *all* relevant assets; which, in turn, reduces creditors' *expected* payoffs in the EBL because they have to share smaller amount of assets, and consequently also their willingness to use the law to recover their debts from insolvent debtors.⁸⁰⁶ This is particularly problematic in the EBL – as a collective mechanism – because most other enforcement mechanisms involve

⁸⁰⁴ See Chapter 5.4.1

⁸⁰⁵ See Chapter 4.1.3.2-3

⁸⁰⁶ *Supra* n.802

individual enforcement and so do not necessarily rely on the aggregation of debtor's assets prior to debt enforcement.

Moreover, several interviewees also pointed out that the difficulties in verification of creditors' property rights in debtor's assets hinder creditors' ability to prove their claims – as required under Article 49 of the EBL – and so make it difficult for them to recover, *pro rata*, for the entirety of their claims.⁸⁰⁷ On the other hand, unlike the EBL, creditors using informal enforcement do not have to prove their claim to any third party – and so can function without a property rights register – as they enforce directly against the debtor.⁸⁰⁸

5.2.1.3 Recoveries under the EBL are affected by limited protection of property rights

In addition to problems with verification of financial information and property ownership, debt enforcement in China is also affected by severe limitations in *protection* of property rights. As was discussed in Chapter 4.1.3.3, the disregard for and failure to protect property rights is not unique to China, nor does it only affect enforcement under the EBL. However, my interviewees suggested that protection-related issues are particularly severe under EBL enforcement.

One example of this issue has already been discussed in the context of subordinating secured creditors' rights.⁸⁰⁹ This section will, therefore, focus on another example, namely

⁸⁰⁷ *Ibid.* This is particularly difficult for secured creditors.

⁸⁰⁸ *Ibid.* Note that without a registration system – even if such enforcement usurps another's right – there is no way of proving that the informal enforcement was unfair: Interviews C5-r, L2-s, L6-s, R1-r, R10-c

⁸⁰⁹ Chapter 5.1.1.2 showed that security rights are often subordinated to employees' claims by courts. As a result – several interviewees concluded – any meaningful pre-lending analysis and costing of the provided

asset grabbing and looting of debtor's property by claimholders – employees and creditors – who often react to the news of debtor's petitioning to use an EBL procedure by racing to recover their claim instead of waiting for an uncertain recovery in the future.⁸¹⁰

Arguably the best protection of debtor's property rights would involve *ex ante* prevention of asset grabbing and looting by affected claim-holders. Unfortunately, many of my interviewees agreed that, in practice, local governments and police are often unable or unwilling to step in to prevent debtors' angry employees and creditors from satisfying their claims informally and directly, without going to court or waiting for a collective resolution under the EBL.⁸¹¹ A second-best solution would be *ex post* protection through e.g. clawing-back and recovering debtor's misappropriated assets. Asset grabbing is reversible under the EBL: once located, the stolen objects can be returned to the debtor company. However, several interviewees said that, in practice, this is not done due to the perceived costs and practical and evidential difficulties.⁸¹²

Moreover, the damage caused by looting is in many ways irreversible. Although illegal and punishable by a prison sentence under Criminal Law,⁸¹³ looting of a debtor company and accompanying public disorder almost invariably destroy or devalue debtor's property. This, in turn, reduces the amount and value of debtor's assets and so diminishes

credit become meaningless, and so disincentivise creditors from using the EBL in the first place: Interviews B1-c to B3-c, C2-c, C5-r, L2-s, R3-r, R9-c

⁸¹⁰ For a general discussion of race to collect see e.g. Armour in Austin and Aoun (2012)

⁸¹¹ Interviews B1-c to B3-c, C2-c to C5-r, C7-s, E2-s, IF1-s, L2-s to L7-c, L10-c, L14-c to L16-c, R1-r to R4-c, R8-s to R10-c

⁸¹² *Ibid.*

⁸¹³ Arts 268 and 270 (gathering with the aim to seize and seizure of another's property), and 275 (looting, intentional damage to another's property) of Criminal Law 2015

creditors' payoffs in the aggregate. Some value may be recovered by imposing fines on the looters,⁸¹⁴ but the interviewees suggested that courts tend not to impose criminal sanctions for such behaviour in practice, which means that no money is recovered and looting is not sufficiently deterred.⁸¹⁵

Many of my interviewees⁸¹⁶ and numerous news stories⁸¹⁷ suggest that asset grabbing and looting are often triggered by the news of debtor's financial problems, which is often brought about by the company petitioning for or entering into an EBL procedure. It is, therefore, often not in creditors' best interest to commence EBL procedures either because they prefer to enforce directly, or because they may fear that petitioning to use the EBL may trigger a race to collect and looting which may, in turn, lead to value destruction and so limit their recovery under the EBL.

5.2.1.4 Recoveries under the EBL are affected by unpunished tunnelling, asset stripping and creation of ghost companies

Besides asset grabbing by claimholders, debtor companies are also vulnerable to *tunnelling* and *asset stripping* by directors and managers. In addition, directors sometimes also transfer valuable assets into a new company, and leave the liabilities and valueless assets behind in a shell known as a '*ghost company*.' Chapter 4.1.3.4 suggested that these

⁸¹⁴ Or clawing back the stolen assets, where possible: *Ibid*.

⁸¹⁵ *Supra* n.803 – some limited exceptions do exist.

⁸¹⁶ *Ibid*. This is not very different from the pre-EBL era when, as one banker put it, one could only recover one's unsecured loan if they 'react immediately to early distress signals and obtain immediate payment or additional collateral by using all kinds of threats against the firm and its managers and owners as long as they are legal.': Tenev, Zhang and Brefort (2002)

⁸¹⁷ See e.g. Durden (10.12.2015); Kaiman (9.1.2016)

practices affect all types of debt enforcement by reducing assets available in debtor companies for repayment of their debts. Nevertheless, several of my interviewees – who had a first-hand experience with these practices – suggested that although asset stripping and the use of ghost companies can and do happen in a normal course of business, their use is particularly pronounced at a brink of insolvency.⁸¹⁸ They argued that, often, once it becomes clear that a debtor will not recover, and especially where a creditor petitions or threatens to petition a court to start an EBL procedure, directors and managers take their company's assets and run away,⁸¹⁹ or they transfer valuable assets to a new company in a way that makes them hard to trace or claw back.⁸²⁰ Then they start afresh with the stolen assets in a new company – leaving behind the shell of a ghost companies.

The creation of ghost companies and asset stripping practices are reversible by courts and administrators under the Company Law and the EBL.⁸²¹ Nevertheless, several interviewees argued that these reversal mechanisms are only rarely used in practice – and in particular in the context of corporate insolvency cases which are seen by many judges as 'already difficult enough without the added difficulty of reversing hard-to-trace transfers.'⁸²² As a result, my interviewees argued, creditors fear that their payoffs under the EBL would

⁸¹⁸ Interviews C2-c, C3-c, C5-r, E2-s, L2-s, L4-r, L6-s, R3-r, R10-c. See also Zheng et al (2010) at 315-342

⁸¹⁹ The problem of run-away bosses was discussed in Chapters 5.1.2.2 and 6.1.2.2

⁸²⁰ E.g. through a seemingly *bona fide* third party purchaser so that the law would not allow these to be clawed back. *Supra* n.825

⁸²¹ For the details of the administrators' duties and its enforcement in practice see 4.3.2.6 and 5.3.2, respectively

⁸²² Interview J1-c. Similar views that courts are often unwilling to engage in a search for misappropriated assets were expressed by several other judges (J4-c, J7-c), lawyers (L2-s to L4-r, L6-s, L11-c to L13-c) and consultants (C2-c to C5-r, C8-s, C9-c).

be severely diminished compared to their expected recovery in informal enforcement mechanisms, and so creditors are disincentivised from using the law.⁸²³

5.2.1.5 Recoveries under the EBL are affected by revocability of land usage rights

And finally, an additional but independent issue which further diminishes expected and actual payoffs to creditors under the EBL stems from the *nature of land ownership* in China. As was discussed in Chapter 4.1.3.5, all urban land in China is state-owned and all rural land is under state or collective ownership. Therefore, most companies can only acquire land usage rights from the state (or a state-controlled collective) and only for a fixed period. However, in contrast with the general protections of these rights when the right-holder is solvent, if the right-holding company becomes insolvent,⁸²⁴ their land usage rights can be cancelled immediately and without any compensation.⁸²⁵

Many of my interviewees reported that the state does, in fact, use this power in practice, and thereby makes it practically impossible to sell the land usage right or the buildings and other immovable property on such land once the holding company becomes insolvent.⁸²⁶ This significantly reduces the total assets out of which creditors and other stakeholders can be repaid.⁸²⁷ And so, unsurprisingly, my interviewees argued that debtors

⁸²³ Interviews C2-c to C5-r, C8-s, C9-c, L2-s, L4-r, L6-s, L9-s to L13-c, R3-r, R10-c

⁸²⁴ Insolvency is not defined, but my interviewees suggested that acceptance of EBL petition is needed in practice: Interviews C2-c, C5-r, C7-s, E1-c, E2-s, J1-c, J3-c to J9-c, L2-s to L9-s, R1-c to R3-r, R9-c, R10-c

⁸²⁵ This is confirmed in Art 38 EBL

⁸²⁶ or, in practice, once it becomes official that the company is insolvent because court accepted their EBL petition: Interviews C2-c, C5-r, C7-s, E1-c, E2-s, J1-c, J3-c to J9-c, L2-s to L9-s, R1-c to R3-r, R9-c, R10-c

⁸²⁷ *Ibid.* This is further supported by Ma (2015)

who use state-owned land and their creditors often avoid using the EBL. This is mainly because they believe that by avoiding a formal declaration of insolvency under the EBL, they ensure that the government does not revoke debtor's land usage rights, or that if it is revoked under one of the pre-defined circumstances,⁸²⁸ the debtor would be compensated according to the law.⁸²⁹ Consequently, creditors' payoffs under the EBL are lower than under other debt enforcement mechanisms, which disincentivises creditors from using the EBL in the first place.

5.2.2 Shortcomings that specifically affect EBL enforcement

In addition to the general shortcomings that affect all debt enforcement, my interviewees also identified further two problems in surrounding rules and practices that *specifically* affect debt enforcement under the EBL. These are, firstly, incomplete social security system (5.2.2.1), and secondly, issues arising out of the interconnectedness of large companies in China (5.2.2.2). While the general flaws operate at creditors' and debtors' level by affecting their willingness to use the EBL, the specific issues discussed in this section affect the willingness of courts and local governments to allow the parties to use the EBL. In other words, the two shortcomings discussed below provide further details to why local governments influence courts – as discussed in Chapters 3.3.3 (general) and 5.3.3 EBL-specific) – and forbid certain cases of corporate insolvency to be resolved under the EBL in

⁸²⁸ See 4.1.3.5 for details

⁸²⁹ Interviews C2-c, C5-r, C7-s, E1-c, E2-s, J1-c, J3-c to J9-c, L2-s to L9-s, R1-c to R3-r, R9-c, R10-c

order to protect employees and other state interests.⁸³⁰ The impact of these shortcomings is summarised in Table 5-4.

Table 5-4: Summary of EBL-specific flaws and their impact on willingness of local governments, courts, creditors and debtors to use the EBL

	Local governments (LG) and Courts	Creditors	Debtors
Incomplete social security system (5.2.2.1)	(i) LG fear social unrest due to lack of social welfare provision for newly unemployed (ii) Therefore, courts not accept petitions without LG's authorisation	Creditors fear that their interests subordinated to employees (5.1.2), and their payoffs reduced	Debtors fear loss of ability to use reorganization (fresh start), subordination of their interests to state interests, reduced payoffs
Interconnectedness of large companies (5.2.2.2)	(i) LG fear domino effect (ii) Therefore, courts not accept petitions without LG's authorisation	Creditors fear that their interests subordinated to state interests, payoffs reduced	Debtors fear loss of ability to use reorganization, subordination of their interests, reduced payoffs

5.2.2.1 Incomplete social security system

Economic reforms and the legalisation of private companies eventually led to the dissolution of the iron rice bowl regime under which SOEs provided employment and social security for every Chinese citizen from birth to death.⁸³¹ The introduction of the 1986 insolvency law (and its reform in 2006) then enabled corporate closures and large-scale redundancies which, in the aggregate, contributed to the increasing uncertainty for people who were used to life-long social provision from the state. Although in the late 1980s and

⁸³⁰ The threat of such interference then disincentivises creditors and debtors from wanting to use the EBL. Alternative mechanisms that are then used instead are discussed in 5.4.1 (private alternatives) and 5.4.2 (state-driven alternatives).

⁸³¹ See Chapter 3.1 for more details

the early 1990s the government introduced a new set of rules for social security provision which, it was hoped, would counter people's uncertainty, the system was simplistic and incoherent, the rules scattered across multiple regulations and provisions.⁸³² A new, unified regime was then introduced and codified in Social Insurance Law in 2011. Nevertheless, problems remain.

Although the 2011 law, as written, introduced comprehensive coverage, procedural rules, and clear entitlements to workers, retired persons and the unemployed,⁸³³ most interviewees argued that its implementation has been very problematic.⁸³⁴ The new Chinese regime for unemployment benefits relies on employees' and employers' contributions to the unemployment insurance fund. However, by the end of 2015, only 22.3 percent of all workers – that is 173 million workers out of the total of 775 million workers⁸³⁵ – were participating. Moreover, the law states that unemployment benefits must be lower than local minimum wage – which is generally very low and considered to be less than a living wage⁸³⁶ – and are determined by the length of employment⁸³⁷ and the contributions to the unemployment fund, with a maximum of 24 months of payments. In addition, my

⁸³² In particular, Labour Law 1994, the State Council's Regulations on Unemployment Insurance 1999, and Labour Contract Law 2008

⁸³³ For an excellent overview, see <http://www.clb.org.hk/content/china's-social-security-system>

⁸³⁴ Interviews C1-c, C4-c, C5-r, C7-s to C11-c, J1-c, J4-c to J9-c, L2-s, L4-r to L6-s, L14-c to L16-c, P1-r, R1-r to R4-c, R6-c to R10-c

⁸³⁵ NBS Yearbook 2016

⁸³⁶ In 2016, minimum wage in small cities was about 1,000 RMB (149 USD) and in most major cities around 1,600 RMB (239 USD) per month. National average income was about 3,300 RMB (492 USD) per month, and in most major cities around 4,000 RMB (597 USD): NBS Yearbook 2016 and "Wages and Employment" China Labour at <http://www.clb.org.hk/content/wages-and-employment>

⁸³⁷ Full benefits are only available after 10 years of previous employment – *Ibid.*

interviewees also suggested that, in many places where the unemployment insurance contributions have been collected the system, nevertheless, failed due to a lack of an effective mechanism for distribution of unemployment benefits to their rightful recipients.⁸³⁸

All my interviewees suggested that the failure to implement an effective and holistic social security system has had a major impact on the use of the EBL. Until 2011, there was no system in place. As a result, local governments have been actively avoiding and preventing the use of the EBL in order to respond to significant popular pressure to deal with large-scale redundancies;⁸³⁹ to appease the unemployed;⁸⁴⁰ and to fulfil their duty to ensure social stability in their region by preventing further protests.⁸⁴¹ And although the new system that was introduced in the 2011 law has the potential to improve the situation, it has failed to ameliorate the situation in any meaningful way in practice.

The lack of social security system appears to be one of the motivating factors why local governments force courts to ignore EBL petitions – particularly from (large) companies with a significant number of employees – that have not been authorised by local governments.⁸⁴² My interviewees suggested that this may, *inter alia*, partly explain courts' tendency to interpret conflicting guidelines in the EBL as affording priority to employees

⁸³⁸ Interviews C1-c, C4-c, C5-r, J1-c, J4-c to J8-c, L2-s, L4-r to L6-s, P1-r, R1-r to R4-c, R6-c to R10-c

⁸³⁹ *Ibid.*

⁸⁴⁰ Local governments fear that a large-scale use of EBL Liquidation (some suggested that even if they allowed Reorganisation under the EBL, as the signalling effect of entering the EBL would suffice) may trigger strikes by the affected employees: : Interviews C5-r, E3-s, J1-c, L4-r, L6-s, R1-r, R7-c, R10-c

⁸⁴¹ Local governments fear that using the EBL would cause social unrest, 'publicise the local government's failure to deal with the situation,' and otherwise 'cause trouble.' See Chapter 3.3.3.2, this is also confirmed in many of my Interviews C2-c to C5-r, C7-s, C10-s, E2-s, E3-s, J1-c, J6-s to J9-c, L2-s to L6-s, P1-r, P3-r to P5-c, R1-r to R3-r, R7-c to R10-c

⁸⁴² *Ibid.*

over (secured) creditors – as was explained in Chapter 5.1.1. That chapter focused on how the EBL enables courts to do this. Here, the focus shifts to one of the reasons why courts – and local governments – are so concerned with the position of employees in insolvency. The two constraints reinforce each other.

The lack of social security system, therefore, affects the incentives of courts and local governments with regards to the use of the EBL. But it does more than that. In practice, this shortcoming in the institutional environment in which the EBL is enforced also diminishes expected (and often also actual) recoveries by creditors under the EBL. Moreover, the issue also affects debtors who, even if they wish to, cannot use the EBL to reorganise their company and start afresh where local governments and courts do not let them. As a result, the lack of unemployment safety net may be a further reason for the low use of the EBL.

5.2.2.2 Interconnectedness of large companies

Many of my interviewees also suggested that local governments are reluctant to permit the use of the EBL where there is a danger that insolvency of one company may lead to other insolvencies or have a significant adverse effect on the financial health of other companies, a particular industry or the economy at large.⁸⁴³ The interviewees identified two main sources of this dangerous interconnectedness, namely mutual debt guarantee chains⁸⁴⁴ and

⁸⁴³ Interviews B1-c, B3-c, C1-c, C4-c, C5-r, C7-s, E5-c, all judges (J1-c to J9-c), L4-r to L7-c, L10-s to L12-c, L16-c, P1-r, P3-r, R1-r to R4-c, R10-c, R13-c

⁸⁴⁴ These guarantee chains survive EBL procedures: Art 124 EBL. See e.g. McMahon (23.11.2014); Wildau (28.4.2014)

triangular debts.⁸⁴⁵ The problem seems to be particularly pronounced in state-sector companies in traditional, protected industries (e.g. manufacturing, mining) where these techniques are common.⁸⁴⁶ As a result, my interviewees argued, many large companies are not allowed to use the EBL – either at all or independently without state assistance.⁸⁴⁷

Firstly, many SOEs provide *debt repayment guarantees for other SOEs* who, in turn, provide debt repayment guarantees for them. As a result, these companies are interlocked in a web of mutual obligations to pay to third-party lenders in case of the other's inability to do so (including its insolvency). Many of my interviewees suggested that large companies in China are often involved in entire chains of such guarantees, and for significant sums.⁸⁴⁸ This makes them vulnerable, because one corporate insolvency may trigger a chain of other insolvencies where the other companies guaranteed the debt but are unable to service it and so are pushed into insolvency themselves.⁸⁴⁹ In an extreme case, this may have a serious destabilising effect on the local economy as a whole.⁸⁵⁰

In addition, large companies are also often involved in significant *non-mutual debts* among themselves – often referred to as 'triangular SOEs debt structures' – which have a similar effect to debt guarantees. If one of the lending companies in this structure declares

⁸⁴⁵ See Chapter 4.2.2.2 for non-EBL solution used

⁸⁴⁶ *Ibid.*

⁸⁴⁷ *Ibid.*

⁸⁴⁸ Interviews B1-c to B3-c, C1-c to C7-s, C10-s, C11-c, E1-c to E3-s, IF1-s, J1-c, L2-s to L6-s, L8-c, L11-c to L15-c, P1-r, P4-c, P5-c, R1-r to R3-r, R6-c, R9-c, R10-c

⁸⁴⁹ *Ibid.*

⁸⁵⁰ *Ibid.* Note that, in 2015, a member of the special Committee for Bankruptcy and Reorganisation within Chinese Lawyers' Association warned of a systemic risk this may pose: *supra* n.230

insolvency under the EBL, its debts are repayable immediately⁸⁵¹ which may trigger insolvency in other companies in the debt structure. Alternatively, if one of the borrowing companies in this structure declares insolvency under the EBL, its debts may not be repaid in full – regardless of whether the lender is secured or not, as explored in Chapter 5.1.1 – which may also trigger a chain of financial distress or insolvencies in other companies in the debt structure. As a result, my interviewees suggested that local governments often prefer individual, politically-driven alternatives to the publicity and limitations in the EBL procedures, focusing in particular on the need to manage systemic risk that the interconnectedness of the companies poses.⁸⁵² As above, this then reduces the value of creditors’ expected recoveries under the EBL, and it prevents debtors from using the EBL as they wish. This constrains the utility of the EBL, and so may partly explain the limited use of the EBL in practice.

5.2.3 The EBL may not be a viable option due to nature of certain debt contracts

Finally, in certain types of debt contracts, the EBL is not available for creditors⁸⁵³ due to the circumstances in which their loans were made. This chapter considers three types of situations when the EBL is not a viable option. It first examines how the use of the EBL is prevented if the loans originated in China’s shadow market.⁸⁵⁴ There are two impediments

⁸⁵¹ Art 46 EBL states that all immature claims at the time of the case being accepted shall be deemed mature

⁸⁵² *Ibid.*

⁸⁵³ This section focuses on the position and incentives of creditors. The corresponding impact on debtors is triggered under the EBL investigation provisions, and are discussed in Chapter 5.1.2, above.

⁸⁵⁴ For details on sources of corporate funding see 4.1

that may arise in this context. Firstly, loans may not be recoverable under the EBL because they were not made by state-authorised lenders and, as a result, are not enforceable in court (5.2.3.1). And secondly, if the lenders charge interest that is higher than the permitted maximum, any excess is not recoverable (5.2.3.2). Using the EBL in either case would also draw undesirable attention to such lenders' activities, which may be an additional reason why shadow lenders in either case prefer to avoid using the EBL. The third type of situation is where creditors – often state-related – are technically allowed to use the EBL but tend not to do so because doing so may expose their lending activities which contravened policy restrictions on lending into certain sectors. The consequences of being discovered range from the Party-state's displeasure to criminal and other sanctions (5.2.3.3). These situations are summarised in Table 5-5, and each issue is then dealt with in detail below.

Table 5-5: Summary of the reasons why the EBL may not be used in certain credit contracts

	EBL available?	Why EBL not used
Contracts made by unauthorised lenders (5.2.3.1)	No	(i) Contracts not legally recognized, not enforced by courts (ii) Creditors prefer not to draw attention to their activities
Contracts charge usurious interest rate (5.2.3.2)	No (usurious interest) Yes (up to the permitted interest)	(i) Creditors believe they can get higher payoffs outside the EBL (ii) Creditors prefer not to draw attention to their activities
Contracts contravene policy restrictions (5.2.3.3)	Yes	(ii) Creditors prefer not to draw attention to their activities, because they fear career-related and criminal/other sanctions

5.2.3.1 The Origin of the debt finance

As was discussed in Chapter 4.1, China's shadow finance market is vast and increasingly important for the economy. Until recently, its unauthorised, private lending activities would

not be recognised by courts, and they are still mostly forbidden by the state. And although in recent years shadow lenders in a few provinces have been able to enforce their credit contracts in court,⁸⁵⁵ many of my interviewees suggested that – even in those provinces – shadow lenders remain unable or at least reluctant to use the EBL.⁸⁵⁶ My interviewees pointed to two main reasons: firstly, shadow lenders’ activities are often illegal, and so there is a risk that their claims will not be recognised.⁸⁵⁷ But, what’s more, they face a particularly high risk of scrutiny and significant criminal liability pursuant to an EBL case, which – the interviewees suggested – shadow lenders believe can be avoided if they use non-EBL enforcement mechanisms.⁸⁵⁸ This belief draws support from the fact that EBL procedures typically affect many stakeholders, and so attract unwanted attention.⁸⁵⁹ To avoid it, lenders use non-EBL enforcement mechanisms instead.⁸⁶⁰

My interviewees pointed to the fact that the fear of an increased scrutiny of shadow lenders’ activities under the EBL is particularly pronounced among creditors in regions with a small private sector and little support for pro-market measures.⁸⁶¹ Until recently, shadow

⁸⁵⁵ Available data show that shadow lenders are slowly getting comfortable using formal individual debt enforcement mechanisms in select provinces such as Zhejiang, Wenzhou. For an excellent summary, see Finder (5.6.2015)

⁸⁵⁶ Interviews C2-c to C7-s, IF1-s, IF2-c, J1-c, J4-c, J7-c, J8-c, L1-c to L17-c, R1-r to R3-r, R6-c, R10-c

⁸⁵⁷ *Ibid.*

⁸⁵⁸ *Ibid.* For an overview of criminal provisions concerning shadow lending see Chapter 5.1.2. For a discussion of non-EBL alternatives, see Chapter 5.4

⁸⁵⁹ *Ibid.* – Interviewees L2-s, L4-r and L6-s spoke of several examples where their clients were subjected to such unwanted attention, and compared it to other, similar cases where private enforcement through negotiations or bilateral arbitration led to ‘more desirable, less heated, and more efficient results’ (Interview L4-r)

⁸⁶⁰ *Ibid.*

⁸⁶¹ *Ibid.* However, two of my interviews (L4-r and L6-s) argued in the regions with particularly strong private sector and pro-market courts – most importantly Zhejiang Province and Wenzhou City – the shadow lenders are treated like normal lenders, and their claims are often satisfied even under the EBL because the local government and the courts fear that ruling any other way would cause a serious social unrest, which they wish

lenders could be sentenced to death for their illegal activities.⁸⁶² And even though this is no longer the case, creditors⁸⁶³ involved in unauthorised borrowing from the general public, re-lending bank loans in the shadow market, carrying out any other ‘unauthorised activities’ which ‘disrupt’ the market, or collecting deposits and setting up financial institutions without the permission of the regulator⁸⁶⁴ nevertheless face severe fines and long-term imprisonment. As a result – many interviewees claimed – shadow creditors are disinclined to use the EBL procedures.⁸⁶⁵

5.2.3.2 Usury laws

Apart from the difficulties that shadow lenders face in general, the lenders who charge ‘high’ or ‘usurious’ interest rates also face an increased probability that courts will not protect their claims even in provinces where shadow lenders enjoy some judicial recognition, and that their activities – once exposed – will lead to the imposition of criminal liability. It was discussed earlier that private lending with high interest rates is a criminal

to avoid. Moreover, R10-c also suggested that – according to their extensive research in China – courts may in some cases be so worried about violent enforcement against private persons by shark lenders that they give them full protection and priority to their claims, including full interest rate repayment.

⁸⁶² E.g. the notorious case of Wu Ying, a 31-year-old tycoon who raised and lent about USD 122 million through the private capital market, who was given a death sentence for fraud (reduced to life imprisonment after public protests): Li, He and Xu (14.2.2014). The death penalty has now been abolished (through a state policy, not in Criminal Law): Cao (26.11.2014)

⁸⁶³ And debtors, as we saw in Chapter 5.1.2

⁸⁶⁴ Arts 176, 175, 225(3) and 174 Criminal Law (amended 2015), respectively. For full details see Chapter 5.1.2

⁸⁶⁵ *Supra* n.856

offence punishable by imprisonment and fines,⁸⁶⁶ and until 2014 – in particularly serious cases – by a life imprisonment or even a death penalty.⁸⁶⁷

Although there is no definition of what constitutes ‘high interest rate,’ many of my interviewees suggested that, until recently, it was a flexible concept allowing for a degree of judicial (and political) discretion, but usually meaning more than the official lending rates.⁸⁶⁸ The SPC has now confirmed that a ‘high interest rate’ is more than 24 or 36 percent.⁸⁶⁹ However, this ruling will only have an impact on cases in late 2015 and beyond – and has, therefore, very little explanatory power for cases decided earlier. The threat of a severe punishment for the vaguely-defined crime of lending with high interest rates was, therefore, present in creditors’ minds when deciding whether to use the EBL for most of the studied period between 2007-15.⁸⁷⁰ Moreover, even post-2015, it is proposed that the restriction of permissible level of interest rates is likely to affect the preferences of many shadow lenders – who often charge tens to hundreds of percent in annual interest rates and are often able to recover them using non-EBL enforcement alternatives.⁸⁷¹

Besides the issue of recoverability, many interviewees also suggested that shadow creditors fear that using the EBL would increase the likelihood that their activities would be

⁸⁶⁶ See Chapter 5.1.2

⁸⁶⁷ *Supra* n.862

⁸⁶⁸ Interview C1-c to C7-s, C10-s, E1-c to E3-s, IF1-s, IF2-c, J5-s, J6-s, J8-c, L2-s to L6-s, L12-c, L13-c, L16-c, R1-r to R3-r, R6-c, R9-c, R10-c. See also Zhang (2014)

⁸⁶⁹ The SPC suggested that courts will not enforce any claim for the interest repayments beyond 24 (and in some cases) percent: SPC Provisions on Several Issues concerning the Application of Law in the Trial of Private Lending Cases, which has become effective on September 1, 2015. For an overview see Li (3.11.2015)

⁸⁷⁰ *Supra* n.875

⁸⁷¹ See Chapters 4.1 and 5.4. See also Zhao and Qing (2012)

scrutinised under Criminal Law provisions.⁸⁷² If so, they could face criminal liability for their unauthorised lending activities⁸⁷³ as well as fines and imprisonment for their usurious lending practices.⁸⁷⁴ Several interviewees suggested that courts are ‘ready and willing to punish shark lenders,’ particularly given the ‘keen attention that the Party and the government pay to resolve the problems associated with shadow banking, and in particular with exorbitant interest rates, which can weaken the financial health of otherwise strong companies and can affect the macroeconomic stability of the whole country.’⁸⁷⁵ As a result, shadow market creditors who charge high interest rates – however determined – have a strong incentive not to use the EBL, especially where they have alternative means for enforcing their claim.⁸⁷⁶

5.2.3.3 Policy restrictions on lending

While the main reasons for avoiding the EBL in the previous two sections were attributable to the affiliation of the creditor, in this section, it is the affiliation of the debtor that diminishes creditor’s ability to recover. My interviewees used the example of lending to real estate companies but suggested that this issue concerns any sector that is affected by policy

⁸⁷² Interviews C2-c to C7-s, C10-s, C11-c, IF1-s, IF2-c, J6-s, L1-r to L6-s, L8-c to L17-c, R1-r to R3-r, R6-c, R9-c, R10-c

⁸⁷³ See Chapters 5.1.3.2 and 3.3.3

⁸⁷⁴ *Supra* n.869. They propose that the regulator has a good reason to prevent such high-interest-rate lending. The problem is not only its immorality, but the fact that it pushes objectively healthy companies into factual insolvency, leading to destruction of companies and jobs and to very few people getting rich from it.

⁸⁷⁵ Interview R10-c, similar views were also expressed in Interviews C2-c to C5-r, C11-c, IF1-s, IF2-c, J1-c, J6-s, L1-r to L6-s, L8-c to L11-c, L14-c to L17-c, R1-r to R3-r, R6-c, R7-c, R9-c

⁸⁷⁶ These alternatives are explored in Chapter 5.4.1

restrictions on lending.⁸⁷⁷ Although Chinese real estate projects once enjoyed an almost unlimited supply of bank finance – being perceived as a low-risk, certain growth – the market regulator started imposing restrictions on the supply of finance in 2001 to cool growth of the property market and manage what was feared to be a growing property bubble.⁸⁷⁸ Instead of slowing down, however, property developers turned to shadow lenders who readily extended large loans to them. A Credit Suisse study estimated that at one point, about 60 percent of all shadow lending went into the real estate sector.⁸⁷⁹ As a result, there is an increasing number of empty houses and so-called ghost towns where new blocks of flats fail to attract purchasers and occupants.⁸⁸⁰ Despite that, however, real estate companies keep building, and property prices are still climbing, which further fuels the property bubble and could be extremely dangerous for China's fragile economy, and so needs to be managed by the regulator.⁸⁸¹

Many interviewees argued – and numerous newspaper stories seem to support – that many real estate companies have been financially distressed and even insolvent.⁸⁸² However, to date, they have tended not to use the EBL to resolve their financial problems.

⁸⁷⁷ Interviews B1-c, C1-c to C7-s, E3-s, IF1-s, IF2-c, L1-r to L6-s, L9-s to L15-c, R1-r to R3-r, R6-c, R7-c, R9-c, R10-c

⁸⁷⁸ See e.g. Powell (22.3.2010); AsiaNews (28.11.2011); Yang (19.12.2016); Rabinovitch (2.12.2012)

⁸⁷⁹ A large proportion of the 2008-2009 financial stimulus from the state – aimed at counteracting the effects of the global financial crisis – ended up in the real estate sector. This took place directly as new loans and indirectly as bridge loans to repay the outstanding bank loans: Lava et al (2011) at 1 and 3

⁸⁸⁰ BBVA (23.11.2011) at 1 and 7

⁸⁸¹ *Supra* n.877

⁸⁸² Interviews B1-c, B2-c, C2-c to C5-r, C7-s, IF1-s, IF2-c, L2-s to L6-s, L9-s to L17-c, P1-r, R1-r to R3-r, R6-c, R7-c, R9-c, R10-c, R13-c.
Recent large-scale defaults or near-defaults included 1.6 billion USD in debt by Tianyu Construction company in 2012 and 564 million USD in debt by Zhejiang Xingrun Real Estate in April 2014. See e.g. Sweeney (3.4.2014). The problems – and corresponding restrictions – are likely to continue: Hsu (16.1.2015)

My interviewees suggested that one of the reasons is that creditors – and in particular state-related creditors – with claims against real estate companies prefer to recover their claims informally, where possible, because they wish to avoid drawing too much attention to their activities, which go against express policy restrictions on lending.⁸⁸³ Alternatively, the interviewees suggested, if a failure of a large, economically significant real estate company would lead to significant redundancies or a region-wide social and economic disturbance, the affected creditors can often rely on politically-driven alternatives which can provide them with superior payoffs than what they could recover under the EBL.⁸⁸⁴ Therefore, most creditors lending to real estate borrowers affected by policy restrictions on lending either do not want to or do not need to use the EBL.

5.3 The Third constraint: Enforcers' limitations and biases negatively affect enforcement of the EBL

Besides the EBL provisions and the surrounding rules and practices in which the EBL is enforced, my interviewees also suggested that the quality of enforcement – and in particular the quality of its enforcers – co-contribute to the low use of the EBL. This section, therefore, discusses what my interviewees revealed about the limitations and biases that affect EBL's direct⁸⁸⁵ and indirect⁸⁸⁶ enforcers. It first looks at courts' and lawyers' internal limitations that affect their perceived ability to deal with insolvency cases effectively, fairly and objectively (5.3.1). It then examines administrators' passivity in carrying out EBL pro-

⁸⁸³ Interviews B1-c, B2-c, C2-c to C5-r, C7-s, IF1-s, IF2-c, L2-s to L6-s, L17-c, R1-r to R3-r, R7-c, R9-c, R10-c

⁸⁸⁴ *Ibid.* See also Chapter 5.4.2

⁸⁸⁵ i.e. judges, lawyers and administrators

⁸⁸⁶ i.e. local governments and local Party representatives

creditor duties and powers and discuss how it reduces the parties' potential payoffs (5.3.2).

It concludes by looking at when and how the Party-state interferes with courts'

enforcement of the EBL and how that adversely affects the parties' incentives and ability to

use the EBL (5.3.3).

Table 5-6: Overview of enforcers' limitations and biases

	Cause of enforcers' limitations & biases	Impact on debtors' & creditors' expectations
Courts' & lawyers' limitations (5.3.1)	(i) lack of expertise & experience (ii) delays, length & cost (iii) courts' internal quotas (iv) judicial corruption	(i) Limits debtors' & creditors' trust that enforcement of the EBL is effective, fair and objective (ii) Reduces creditors' expected payoffs (iii) Possible inability to use the EBL
Administrators' passivity (5.3.2)	(i) general enforcement issues (ii) courts do not force administrators to use their powers (iii) pressure from the Party-state not to act	(i) Loss of a major advantage of using the EBL
Party-state's influence over courts (5.3.3)	(i) lack of judicial independence due to interference from local Party-state in EBL cases	(i) Limits debtors' & creditors' trust that enforcement of the EBL is effective, fair and objective (ii) Reduces creditors' expected payoffs (iii) Possible inability to use the EBL

5.3.1 Courts' and lawyers' internal limitations

As was discussed earlier, courts are at the front and centre of EBL procedures and can, in theory, ensure that the parties carry out their respective duties and powers according to the EBL.⁸⁸⁷ They have the final say in cases of conflict, they can sanction or prevent agreements

⁸⁸⁷ See Chapters 4.3.2.6 and 5.1.1

from going ahead, and they can impose their own ‘best solution’ on the parties.⁸⁸⁸ Many of my interviewees expressed sincere appreciation for the work of Chinese courts and judges who, as one interviewee put it, ‘do their best given the circumstances.’⁸⁸⁹ However, they also suggested that there are serious limitations regarding courts’ abilities, capacity and power to deal with EBL cases efficiently. Some of these internal limitations disincentivise creditors and debtors from using court-driven EBL procedures and instead use alternative enforcement mechanisms⁸⁹⁰ which they perceive as relatively cheaper, quicker, easier and more accessible.⁸⁹¹ My interviewees suggested that key limitations include the lack of courts’ and lawyers’ commercial and insolvency-related expertise and experience (5.3.1.1) and the relative length and cost of the EBL process (5.3.1.2). Other limitations on courts’ ability and willingness to accept EBL cases include courts’ internal quota system (5.3.1.3) and possibly also judicial corruption (5.3.1.4).⁸⁹²

Although most of the issues below relate to judges, some of my interviewees highlighted that the limitations and biases of lawyers – as corporate advisors and problem-solvers – also influence whether and how the EBL is used.⁸⁹³ Lawyers’ role and limitations are mostly ignored in prior literature, but the importance of lawyers and their ability to understand, offer and explain the EBL procedures to financially distressed companies and

⁸⁸⁸ *Ibid.*

⁸⁸⁹ Interview L6-s. Similar views were also expressed in Interviews C2-c, C5-r, C7-s, L1-r to L5-c, R1-r, R3-r, R10-c

⁸⁹⁰ See Chapter 5.4.1

⁸⁹¹ For a discussion why this may be problematic, see Chapter 6.1

⁸⁹² Further limitations on courts’ power and ability to act stem from biases arising from the Party-state’s interference which I explore in the final section (5.3.3)

⁸⁹³ Interviews C2-c, C7-s, J7-c, J8-c, L4-r to L6-s

unpaid creditors was repeatedly highlighted during my participation in several legal training programmes in China where I led practitioners' workshops about the EBL. The relevant insights are, therefore, included in the discussion below.

5.3.1.1 Expertise and experience

My interviewees suggested that many creditors and debtors perceive China's generalist courts⁸⁹⁴ as lacking sufficient understanding of commercial and technical matters, which disincentivises them from using the EBL.⁸⁹⁵ A number of my interviewees – mostly themselves potential creditors or advisors to creditors and debtors – said that companies are often reluctant to give up control over their claims to a generalist judge who has 'limited appreciation of the particular practices and norms of their trade,'⁸⁹⁶ and so is more likely to 'ignore [their] interests and protect the state and employees instead.'⁸⁹⁷ In this regard, their arguments are similar to one of the reasons why the diamond traders elected to contractually opt out of the legal system and instead operate under their own rules and judges.⁸⁹⁸

⁸⁹⁴ China does not have specialised courts. Although several provinces started experimenting with the idea in 2016, it is not yet a national standard. For more, see Chapter 7.3.1

⁸⁹⁵ Interviews B1-c, C1-c to C5-r, C7-s, C10-s, all entrepreneurs (E1-c to E5-c), IF1-s, IF2-c, L2-s to L6-s, L9-s to L15-c, R1-r to R3-r, R6-c, R7-c, R9-c, R10-c

⁸⁹⁶ Interview E4-c, similar views expressed in Interviews C1-c, C4-c, C5-r, C7-s, E2-s to E5-c, IF1-s, IF2-c, L1-r to L6-s, L10-s

⁸⁹⁷ Interview L4-r, similar views expressed in Interviews C1-c, C4-c to C7-s, E2-s to E4-c, IF1-s, IF2-c, L1-r to L6-s, L9-s, L10-s

⁸⁹⁸ As explained in Bernstein (1992). See also Chapter 3.3.1

There have been calls for developing greater judicial expertise and experience in insolvency cases in China under the 1986 law,⁸⁹⁹ and these have been reiterated repeatedly in recent years in the context of the EBL.⁹⁰⁰ Several interviewees suggested that the core problem lies in the fact that EBL cases are heard by general civil courts who have no particular expertise in finance and insolvency, and – due to the low number of EBL cases each year – are unlikely learn more in the natural course of their job.⁹⁰¹ Judges, therefore, remain mostly ill-prepared to deal with the increasing demand for and complexity of EBL hearings⁹⁰² which result from China's gradual transition to a more market-driven economy.⁹⁰³

However, at the same time, it is important to also acknowledge the problems arising from the lack of expertise and experience of the EBL among corporate lawyers in China. Unlike courts which only get involved after the parties decide to use the EBL, lawyers play a role even before a debtor becomes insolvent and long before the parties decide to go to court. It is, therefore, crucial that lawyers understand how the EBL operates, what it offers to debtors and creditors, and what are its major advantages and disadvantages. Unfortunately, my interviewees suggested that very few lawyers have such understanding, and most of them work in select few SEZs in coastal regions of China.⁹⁰⁴ It is, therefore,

⁸⁹⁹ Critique of the 1986 insolvency law: Wang (2001).

⁹⁰⁰ See e.g. interview with Professor Li (n.600)

⁹⁰¹ Interviews C1-c, C4-c to C7-s, E2-s, E4-c, IF1-s, IF2-c, L1-r to L6-s, L10-s, P1-r, R1-r to R3-r, R6-c, R7-c, R10-c

⁹⁰² As the Chinese economy started slowly, the courts have allowed more cases in 2015. The government also ordered the courts to liquidate so-called zombie companies in 2016, which is likely to lead to a further increase – for details see chapter 6

⁹⁰³ See analysis of policy-making in this regard in Kuhn (2011) Chapter 21

⁹⁰⁴ Interviews C5-r, C7-s, J4-c, J8-c, L2-s, L4-r to L7-c, P1-r, R3-r, R10-c

likely that some creditors and debtors that would otherwise consider using the EBL are simply not aware of the option,⁹⁰⁵ or do not perceive it as sufficiently viable option due to an incomplete understanding of what the law offers.⁹⁰⁶ Moreover, lawyers have no definitive source where to find this information, there are very few local practitioners' insolvency association, and the practice varies significantly across provinces depending on the preferences of local governments and abilities of local courts.⁹⁰⁷

Consequently, an increasing number of voices call for specialised insolvency courts⁹⁰⁸ in the hope that courts' newly acquired skills and knowledge and the competency improvements could – in time – lead to a quicker and cheaper resolution of financial distress,⁹⁰⁹ which may increase the parties' willingness to entrust their case to a court-driven EBL procedure. In addition, I have also worked with a number of lawyers from various provinces in China who expressed a wish to learn more about insolvency law and practice in other provinces and other countries to better serve their clients.⁹¹⁰

Until an improvement in lawyers' expertise and experience takes place, it is highly probable that creditors and debtors involved in other than the simplest cases – which can, instead, be

⁹⁰⁵ Interviews L6-s, R3-r, R10-c

⁹⁰⁶ Interviews C5-r, J8-c, L4-r, L6-s, R10-c

⁹⁰⁷ Interviews C5-r, C7-s, J4-c, J8-c, L2-s to L7-c, P1-r, R1-r, R3-r, R9-c, R10-c

⁹⁰⁸ Similar to a specialised division in the Shenzhen Intermediate Court, which was established in 1993 as an experiment, and is one of the busiest courts in terms of EBL cases in China. In 2015, Shenzhen accounted for about 8 percent of all EBL cases: Sina (28.1.2016)

⁹⁰⁹ Cf a study of insolvency law reform in Brazil: Araujo, Ferreira and Funchal (2012)

⁹¹⁰ Based on informal discussion with a number of corporate and insolvency lawyers who participated in my practitioners' workshop about the EBL in China in 2016

resolved through less formal, less costly alternative mechanism – will remain unwilling to use the EBL.

5.3.1.2 Delays, length and cost of the EBL process

My interviewees all agreed that, in their experience, the relative length and cost of EBL procedures (v. alternative mechanisms) are also directly relevant to whether creditors and debtors choose to use them.⁹¹¹ This section, therefore, looks at the length (and delays) of EBL procedures and the cost of using the EBL and assess their impact on the parties' willingness to use the law.

The EBL has introduced tight deadlines for all stages of the EBL process.⁹¹² However, my interviewees suggested that the law on paper is not reflected in reality. Many petitioners never hear back about whether their petition was accepted or not, and even if they do, my interviewees suggested that it is very rare to take place within the authorised maximum period of 37 days.⁹¹³ The interviewed practitioners felt unable to provide a representative estimate of the average length of an EBL procedure.⁹¹⁴ They said that the main reasons are that each case and each province is very different, and that courts' and Party-state's response usually depends on a number of issues – namely debtor's size,

⁹¹¹ This is not unique to China. Most commercial parties in China and abroad consider the costs and benefits of their options and decide accordingly what is the best strategy. However, due to the weak enforcement of the EBL and non-existent monitoring thereof, the parties in China are, in practice, often able to avoid using the law altogether and choose to resolve debtors' financial distress informally.

⁹¹² See Chapter 4.3.2.3 for details

⁹¹³ Interviews C5-r, C7-s, L2-s, L4-r to L7-c, L9-s to L15-c, R3-r, R10-c

⁹¹⁴ Cf Chinese Credit Research Companies estimate the length at roughly 2-4 years: Euler Hermes (December 2015)

relative economic importance, affiliation with private or state sector, interconnectedness in the economy and with other large companies, interests of local government, number of employees, difficulty with finding alternative employment for the redundant workers,⁹¹⁵ courts' and administrators' experience and willingness to hear EBL cases, the complexity of the given case, whether the debtor's assets are located in a single province or not, whether there are foreign elements present, whether the case is likely to receive attention from international observers and media, etc.⁹¹⁶ Moreover, given the low number of cases in any given court, they felt it was not possible to provide a representative estimate of an average length 'because the [EBL] cases are so widely different.'⁹¹⁷

Nevertheless, all my interviewees agreed that EBL procedures are perceived as being long in their own right and comparatively much longer than non-EBL alternatives, which deter creditors from using them.⁹¹⁸ The reason for such perception, they suggested, was the significant delays that arise, firstly, between the time when a petition is submitted and when it is actually accepted, and secondly, between a commencement and a resolution of an EBL case.⁹¹⁹ Such delays enable grabbing and stripping of debtor's assets, and it also

⁹¹⁵ This was identified as the single most important cause of delay in EBL procedures, since courts often refuse (following local government's guidance) to close an EBL case without sufficient number of the redundant employees being reemployed: Interviews C2-c, C5-r, C7-s, J1-c, J6-s, L1-r to L6-s, L9-s, L11-c, L13-c, P1-r, P3-r, R1-r, R3-r, R10-c

⁹¹⁶ Interviews C2-c to C5-r, C7-s, J1-c, J6-s to J8-c, L1-r to L7-c, L9-s, L11-c, L13-c, L14-c, P1-r, P3-r, R1-r, R3-r, R4-c, R10-c

⁹¹⁷ Interview L2-s – this view was shared by all the Chinese lawyers that I interviewed (L1-r to L15-c)

⁹¹⁸ All my interviews agreed with this statement, and those with international experience (Interviews C1-c to C3-c, C7-s, L2-s, L4-c to L6-s) also added that particularly the overall length (when taking into account the pre-EBL negotiations as well as the court time under the EBL) is relatively greater than elsewhere.

⁹¹⁹ Interviews B1-c, C2-c, C5-r, C7-s, E3-s, E4-c, L10r to L6-s, L8-c to L13-c, R10-c.

provides an opportunity for debtor’s representatives to run away⁹²⁰ – both of which were highlighted as important obstacles to the functioning of the EBL in a recent in-depth report by Ma Jian who examined data and law users’ experiences in EBL cases between 2003 and 2012.⁹²¹

The issue of relative cost also appears to be an important consideration when deciding whether to use the EBL (v. alternative mechanisms). Many of my interviewees argued that invoking the EBL is too expensive for many smaller companies.⁹²² Some also argued that even for larger players – whose financial distress is often more complex and who may, therefore, conceivably benefit from external coordination under the EBL – the cost is still perceived as too high due to problems (both general and particular to the EBL) with enforcing the EBL in practice.⁹²³ This is because EBL enforcement includes not only practitioners’ and courts’ fees – some of which may also be charged in alternative debt enforcement mechanisms – but also the cost of the relocation of laid-off workers,⁹²⁴ the costs imposed on crammed-down creditors in politically-driven EBL cases,⁹²⁵ the macro-economic costs imposed through implied state guarantees to repay state companies’ debts,⁹²⁶ and the costs and debt write-offs imposed by the state against creditors in state

⁹²⁰ Both were discussed above: see 4.2.1 and 5.2.1.3-4

⁹²¹ Ma (27.6.2014)

⁹²² Interviews C4-c to C7-s, E1-c, E2-s, IF2-c, J1-c, J6-s to J9-c, L2-sto L6-s, R10-c. NB: this is no unique to China.

⁹²³ *Ibid.* and Interviews P1-r, R3-r, R6-c, R7-c

⁹²⁴ *Ibid.* – see also Chapter 5.1.1

⁹²⁵ See Chapters 5.3.3.2 and 5.4.2

⁹²⁶ *Ibid.*

sector corporate insolvencies.⁹²⁷ As a result, despite the advantages of collective procedures,⁹²⁸ the EBL is often much more expensive than alternative mechanisms.⁹²⁹ When combined with the fact that most EBL Reorganisations fail to save the company or its business⁹³⁰ and that EBL Liquidation cases evidence a preference for repayment of state-preferred stakeholders,⁹³¹ the EBL not only fails to create value due to the inefficiencies in the way it is implemented,⁹³² but it also destroys value through the attendant costs. It is, therefore, hardly surprising that creditors and debtors are reluctant to use the EBL regime.

5.3.1.3 Courts' informal quota system

In addition to creditors' and debtors' reluctance to entrust their case to courts whom they perceive as lacking in expertise, experience and ability to deal with their case comparatively quickly and cheaply, judges themselves are often reluctant to allow technically insolvent companies to invoke the EBL. Several of my interviewees suggested that courts face internal quotas of how many cases they should hear and resolve in any given period to 'satisfy the internal performance requirements, [...] look good to [their] boss – the local government.'⁹³³

⁹²⁷ *Ibid.*

⁹²⁸ Such as preservation of asset value, higher sale price in Liquidation, higher chance of saving the business or the whole company in Reorganisation – see 2.1 and 6.1 for discussion

⁹²⁹ See e.g. an interview with Professor Li (n.600). The same view was expressed in Interviews C4-c to C7-s, E1-c, E2-s, IF2-c, J1-c, J6-s to J9-c, L2-sto L6-s, P1-r, R10-c

⁹³⁰ These conclusions are drawn from a summary of the EBL cases in Wenzhou from the period of 2012-2015 (privately acquired dataset with the author)

⁹³¹ See Chapters 5.1.1, 5.2.2 and 5.3.3

⁹³² As discussed in Chapters 5.1 and 5.2.1

⁹³³ Interview R10-c – similar views were also expressed in Interviews C2-c, C5-r, C7-s, C9-c, J1-c, J6-s to J8-c, P1-r, R1-r, R4-c, R7-c. See also interview with Professor Li (n.600)

The problem here is that many EBL cases, and particularly large-scale Reorganisations, are often complex and, therefore, take a long time to resolve.⁹³⁴ As a result, courts do ‘not want to clog [their] books with cases which either take too long or may be too expensive and too difficult to resolve.’⁹³⁵ This adds to courts’ tendency to prioritise the use of their limited resources to deal with ‘more urgent issues’⁹³⁶ rather than difficult, lengthy and controversial EBL cases. As a result, the interviewees suggested, courts sometimes ignore EBL petitions.⁹³⁷

5.3.1.4 Judicial corruption

Many academics and observers further blame courts’ unwillingness to hear certain cases on systemic judicial corruption in China.⁹³⁸ It is true that judicial corruption has been a real problem in China, and there have been several high-profile cases – including one involving SPC’s Vice-President – where judges were stripped of rank and sentenced for corruption.⁹³⁹ However, to what extent this problem affects EBL cases is unclear. My interviewees neither confirmed nor rejected this as a potential issue for the enforcement of the EBL⁹⁴⁰ and there

⁹³⁴ *Ibid.* See also People’s Daily (10.10.2015)

⁹³⁵ Interview J1-c. Similar views expressed in Interviews C2-c, C5-r, C7-s, C9-c, J7-c to J9-c, P1-r, R1-r, R4-c, R7-c, R10-c

⁹³⁶ Interview J1-c, same views also expressed in Interviews C5-r, C7-s, J3-c, J5-s to J9-c, L4-r to L6-s, P1-r, R1-r, R3-r, R10-c

⁹³⁷ *Ibid.* Several of them (C7-s, J10-c, J9-c, L4-r, L6-s, P1-r, R1-r, R10-c) suggested that the government does not wish to look bad when compared with other countries, and so there is a lot of pressure to be seen as resolving cases quickly and effectively. The quota system is one of the incentives that they use to achieve a quicker turnover of cases.

⁹³⁸ See e.g. Shih (12.7.2015); Li (2012)

⁹³⁹ SPCM (10.7.2016)

⁹⁴⁰ Some interviewees stated that creditors and debtors do not wish to use the EBL because the court decision-making process is perceived as ‘biased’ (Interviews C1-c, C5-r, C7-s, E1-c, L1-r to L7-c, L14-c, L16-c, R10-c).

is no evidence to suggest that judicial corruption is any more or less relevant in EBL cases than in other court-based enforcement mechanisms.⁹⁴¹ I have, therefore, not been able to confirm or disprove the role of judicial corruption in the parties' willingness to use the EBL.

5.3.2 Administrators' passivity

Chapter 4.3.2.6 explained that administrators are lawyers who assist courts in overseeing and managing debtors' day-to-day activities under the EBL. They also have a number of pro-creditor duties that are aimed at reversing certain vulnerable transactions and clawing back wrongfully transferred assets.⁹⁴² These extensive duties and corresponding powers could – in theory – be one of the greatest advantages and a potential selling point of EBL procedures to creditors, since they could help increase the value and amount of assets available for distribution⁹⁴³ and lead to greater, less risky recoveries than the use of costly and often illegal private enforcement. However, many of my interviewees reported that, despite the importance and in some cases the imperative mode of the provisions,⁹⁴⁴

However, this has been most strongly linked to the government's influence rather than judicial corruption *per se*.

⁹⁴¹ On the other hand, informal enforcement mechanisms (see Chapters 4.2 and 5.4) are not affected by judicial corruption, because the enforcement does not rely on judicial enforcement

⁹⁴² Including e.g. preferential payments, hidden or transferred property, payments of fabricated debts, and with court's approval also transactions at an undervalue, etc.

⁹⁴³ Including *ex ante* disincentive and *ex post* reversal of asset stripping and looting, which we discussed in Chapter 5.2.1.3-4

⁹⁴⁴ Note the use of 'have to' in Arts 32-33 EBL

administrators are often unable or unwilling to exercise such powers and duties fully.⁹⁴⁵

This, in turn, further disincentivises creditors from using the EBL.⁹⁴⁶

My interviewees proposed three major reasons for administrators' passivity. Firstly, administrators face the general enforcement obstacles explored earlier, such as a lack of reliable information, resources and time.⁹⁴⁷ Secondly, although courts can supervise and force administrators to perform their duties with loyalty and due diligence, my interviewees argued that courts rarely do either.⁹⁴⁸ And thirdly, administrators often face pressure from the local Party-state *not* to act, or at least not to act in line with their duties under the EBL, in circumstances where it would go against the state's wishes.⁹⁴⁹ The role of state interference in EBL cases, and its influence on courts' and administrators' passivity are further explored below, in section 5.3.3.

Regardless of the reasons, effective enforcement of the EBL relies on administrators to carry out their duties proactively, objectively and without outside interference. Otherwise, as is the case in China, potential payoffs are reduced which makes creditors less inclined to use the EBL.

⁹⁴⁵ Interviews B1-c, B3-c, C2-c, C4-c to C7-s, C9-c, L1-r to L15-c, P1-r, R1-r, R3-r, R4-c, R6-c, R7-c, R9-c, R10-c. However, two of the interviewees (L4-r, L6-s) – both practising in regions with strong markets – suggested that, in their regions, administrators carried out their duties diligently. All the other interviewees, however, spoke of inactive administrators who – mostly or wholly – fail to carry out their pro-creditor duties.

⁹⁴⁶ *Ibid.*

⁹⁴⁷ See Chapters 3.3.3, 4.1.3, 5.2.1 and 5.3.1

⁹⁴⁸ The reasons are explored in Chapters 3.3.3 and 5.3.3

⁹⁴⁹ Interviews B1-c, B3-c, C1-c, C2-c, C5-r to C7-s, J1-c, J3-c, J6-s to J9-c, L1-r to L6-s, L10-c to L15-c. The reasons for state interference are explored in Chapter 3.3.3.2

5.3.3 The Party-state's influence over court enforcement of the EBL

The previous two sections were largely concerned with the issues in EBL enforcement that reduce the parties' relative payoffs and so discourage them from using the EBL. This section, on the other hand, looks at the reasons and circumstances in which EBL enforcers prevent the parties from using the law even if they wish to do so. China is not unique in this. Existing literature suggests that courts in developing countries are often influenced by those in power and that state ownership creates biases in whether and how insolvency law is used.⁹⁵⁰ It was showed earlier that local governments interfere with courts' decision-making in order to protect their political and personal interests.⁹⁵¹ Moreover, courts have several personal and practical reasons for accepting Party-state's guidance.⁹⁵² However, what is not clear from prior literature is *when* and *how* the Party-state interferes in courts' enforcement of the EBL in China. This is the focus of this section.

My interviewees' observations and experiences provided new insights that enrich our understanding of how courts and the Party-state interact in the EBL context. This is particularly pronounced at the local level where local governments often put direct pressure on courts. Local government's interventions are, therefore, very visible, but – my interviewees suggested – the interests that local governments seek to protect are often informed by Party's ideology. This creates a chain of influence whereby the Party sets the macro-level agenda for local governments who then see to it that courts and other state

⁹⁵⁰ See Chapter 3.4

⁹⁵¹ See Chapter 3.3.3.2

⁹⁵² See Chapter 3.3.3.3

organs at their level and below adhere to the Party's state ideology as explained in the various policies, notices and orders.⁹⁵³

The rest of this section builds on the general discussion of why the Party-state interferes and why courts allow such interference in Chapter 3.3.3 and looks at their reasons in the context of the EBL (5.3.3.1). It focuses on what my interviewees revealed about the types of situations when the Party-state intervenes in EBL enforcement (5.3.3.2) and the methods that they use to achieve their goals (5.3.3.3).

5.3.3.1 Why does the Party-state interfere in EBL cases, and why do courts allow it?

Local governments play an important role in law enforcement, and the situation is no different in the context of EBL enforcement. As described by Ren Yimin, the head of the Bankruptcy and Restructuring department of the Zhejiang Lawyers Association, 'bankruptcy and restructuring of a large enterprise cannot occur without certain support from government.'⁹⁵⁴ The reasons for Party-state's interference in EBL cases and for courts' cooperation are similar to those discussed in Chapters 3.3.3.2 and 3.3.3.3, respectively, but their focus and weight are different. These differences are the focus of this section.

Party-state's institutional-level interests differ at national and local level, which has resulted in the different focus of the EBL as written (by the national-level Party-state) and as implemented (by the local-level Party-state), as summarised in Table 5-7.

⁹⁵³ As a result, it is rare to see local Party officials exercising direct influence over courts in bankruptcy-related matters, although they are able to do so through Party groups which operate within each court in order to enforce Party discipline: See Chapters 3.2 and 3.3.3

⁹⁵⁴ Hook and Davies (21.3.2013)

Table 5-7: Conflicts between the focus of national government (EBL-drafters) and local governments (EBL enforcers)

	National government	Local government
Role in the EBL	Write the EBL	Enforce the EBL
Focus (time period)	Long-term	Short-term
Focus (economic scope)	Macro-economic / Country-wide	Micro-economic / Provincial
Overall focus (EBL stakeholders)	Pro-creditor	Pro-employee
Desirability of objective EBL enforcement	Desirable in most cases	Not desirable

The EBL was written with long-term focus on macroeconomic benefits that insolvency laws can create.⁹⁵⁵ However, it has been implemented at local level with short-term focus on immediate needs of the provinces and the need to protect its primary contributors to the local budget – state-sector companies – following the fiscal decentralisation. The EBL was written as a part of a package of reforms with the intention to attract international trade and FDI. As a result, the EBL, as written, creates pro-creditor environment and puts a lot of emphasis on objective and professionally-driven enforcement. However, in practice, the EBL is strongly pro-employee in focus and it is only rarely enforced objectively, without state's interference. Similarly, professionals (courts and administrators) are usually guided by the local Party-state.

⁹⁵⁵ The national government was heavily influenced by pro-market experts, both home and abroad: see Chapter 4.1

Many of my interviewees suggested that the national government has been pushing for a greater use of the EBL in practice.⁹⁵⁶ It has also instructed the SPC to provide further guidance to encourage and educate lower courts about the EBL.⁹⁵⁷ However, with the exception of temporary increases in the number of EBL cases, their attempts have only had limited success. The interviewees argued that this is because local governments do not share national government's enthusiasm for the EBL, and instead prefer to use non-EBL alternatives which give them more scope to protect local interests.⁹⁵⁸ Given that local governments oversee the day-to-day decision-making of Chinese courts,⁹⁵⁹ their reserved attitude to the EBL appears to contribute significantly to the low use of the EBL in practice.

In addition, enforcing the EBL as written would mean closing down local companies, which may trigger temporary decreases in local economic activity and social unrest. Following from the earlier discussion of personal-level incentives of local Party-state representatives,⁹⁶⁰ this would negatively affect Party-state officials' career prospects. Although a greater use of the EBL would most likely lead to healthier local economies in the medium-to-long term, officials are judged through annual targets that need to be satisfied over their five-year term.⁹⁶¹ This is problematic because it may have incentivised production

⁹⁵⁶ Interviews C1-c to C5-r, C7-s, C9-c, C11-c, J1-c to J9-c, L2-s to L17-c, P1-r to P5-c, R2-r, R3-r, R6-c, R7-c, R9-c, R10-c

⁹⁵⁷ For details see Chapters 4.1-4.2 and 5.4.2.3

⁹⁵⁸ *Supra* n.956

⁹⁵⁹ See Chapter 5.2.3

⁹⁶⁰ See Chapter 3.3.3.2

⁹⁶¹ *Ibid.* Officials then usually move to another province.

of false information which is then relied on at higher levels of government.⁹⁶² What's more, several interviewees also suggested that it also incentivises local governments to cover up or bail-out large-scale insolvencies to avoid drawing attention of their superiors and triggering an investigation into the veracity of the economic data.⁹⁶³ These incentives are further reinforced by popular pressure and protests calling to keep troubled companies open as well as individual pressure from stakeholders through the media and visits in local government offices.⁹⁶⁴ As a result, instead of allowing or even encouraging the (efficient) use of the EBL, local governments prefer non-EBL alternatives⁹⁶⁵ and engage in local protectionism – both of which are likely to damage the economy and compromise economic development.

Local governments prevent the use of the EBL by putting pressure on the parties not to file EBL petitions; by forcing courts not to accept submitted petitions; or – when a petition is accepted – the Party-state dictates how the courts should apply the EBL in the given case. As was discussed in Chapter 3.3.3.3, courts have several reasons why they follow Party-state's guidance. The most important of them in EBL enforcement are judges' beliefs that they should not and technically cannot act without Party-state's support. Judges' internalised moral obligation to follow Party-state's will is illustrated in a recent article where Judge Ren (district-level court) opined that:⁹⁶⁶

⁹⁶² *Ibid.*

⁹⁶³ Interviews C1-c to C5-r, C7-s, J1-c, J4-c to J9-c, L2-s to L7-c, L9-s, L10-c, L14-c, L15-c, P1-r to P5-c, R2-r, R3-r, R6-c, R7-c, R9-c, R10-c

⁹⁶⁴ For details see Chapter 3.3.3.2

⁹⁶⁵ See Chapter 5.4

⁹⁶⁶ Ren (19.1.2016)

... bankruptcy cases involve vital interests of many people, and directly affect social harmony and stability. Thus, it is the social dimension of bankruptcy that determines that courts cannot act alone in bankruptcy cases. Some local governments do not want companies to go bankrupt for statistical, performance, maintenance of stability and other considerations.

Many of my interviewees supported this view, stating that the Party-state is best positioned to decide what is best for the people and for the economy.⁹⁶⁷

Similarly, courts often do not feel able to act independently because EBL cases tend to be complex, involve coordination of many parties and require the ability to enforce whatever arrangement is agreed in the end. Judge Ren said about this:⁹⁶⁸

Courts should actively seek support of the local government where the debtor is located in order to ensure reallocation of workers of the bankrupt company, payment of wages, and disposal of the bankrupt company's factory or other fixed assets. By communicating with relevant departments judges can ensure political support to help pay taxes, apply for transfer [of property], coordinate the interests of creditors, debtors, investors, employees and other stakeholders.

Although such attitude may be foreign to a non-Chinese audience, several of my interviewees stressed that Judge Ren's views are wide-spread in China, and so need

⁹⁶⁷ Interviews C7-s, J1-c, J3-c to J9-c, R9-c, R10-c

⁹⁶⁸ Ren (19.1.2016)

to be given due consideration when trying to understand courts' reluctance to accept EBL petitions.⁹⁶⁹

5.3.3.2 In what situations does the Party-state interfere?

The previous section explored why courts allow the Party-state to interfere in EBL enforcement. But this interference is not uniform across different types of companies and cases. This section, therefore, identifies four types of situations where the Party-state – especially local governments – is most like to interfere. The discussion builds on the findings of prior literature – that state ownership affects implementation of corporate insolvency law – and my research – that the Party-state's interference largely depends on the insolvent company's economic significance rather than its ownership – which were explored in detail in Chapter 3.4.

Firstly, the Party-state prevents enforcement of the EBL against a group of SOEs called 'special treatment companies,' which were exempted from falling under the EBL.⁹⁷⁰ Although these cases of corporate financial distress were supposed to be resolved once the EBL came into force in June 2007, several of my interviewees suggested that certain (mostly publicly-listed) SOEs still receive special protections and privileges well beyond those otherwise generally available to state sector companies.⁹⁷¹

⁹⁶⁹ Interviews C1-c, C3-c, C7-s, J1-c, J3-c to J9-c, L6-s, P1-r, R7-c, R9-c, R10-c.

As one interviewee (J1-c) put it: '[EBL procedures], and in particular Reorganisation, cannot succeed without local government's help, and so it is preferable for the local government to take charge of the process and only use courts when necessary.'

⁹⁷⁰ Art 133 EBL. See Chapter 4.2.1

⁹⁷¹ Interviews B1-c, B2-c, C1-c, C2-c, C5-r, C7-s, C11-c, J1-c, J6-s, J8-c, J9-c, L1-r to L6-s, L9-s to L13-c, P1-r, P3-r, R1-r, R3-r, R10-c. See also Legal Daily (1.3.2016)

Secondly, the Party-state – in particular local governments and local political-legal committees of the Party – is also heavily involved in ‘cases of significance.’⁹⁷² My interviewees proposed that significance is usually measured in terms of financial and economic impact of the given insolvency – and so is independent from the issue of corporate ownership.⁹⁷³ Financial problems in particularly large or otherwise important companies, therefore, attract a great deal of attention and command significant resources from local governments.⁹⁷⁴ They are usually not allowed to use the EBL, which local governments see as incapable of affording sufficient protection to employees and other state-preferred interests.⁹⁷⁵ And although EBL procedures are, at times, used in these cases, Party-state representatives tend to play an important role in the process or the EBL is only used to formally legitimise previously-agreed politically-acceptable solution.⁹⁷⁶

Thirdly, (local) Party-state representatives are also heavily involved in cases which are particularly politically or publicly sensitive, such as scandals and high-profile cases. Past examples include the Sanlu Group’s milk scandal which led to its insolvency in 2009. Formerly one of China’s largest agricultural companies, Sanlu collapsed after it transpired that they were adding a harmful chemical into baby milk powder to make it appear more

⁹⁷² Interview with the emigrated lawyer Chen in Callick (2013) at 63.
Also Interviews B1-c to B3-c, C1-c, C2-c, C5-r, C7-s, C10-s, C11-c, J1-c, J6-s, J9-c, L1-r to L7-c, L9-s to L15-c, P1-r, P3-r, R1-r, R3-r, R9-c, R10-c

⁹⁷³ *Ibid.* This is contrary to what most authors assume when writing about Chinese commerce: see Chapter 3.4

⁹⁷⁴ Interviews B1-c to B3-c, C1-c, C2-c, C5-r, C7-s, C10-s, C11-c, J1-c, J6-s, J9-c, L1-r to L7-c, L9-s to L15-c, P1-r, P3-r, R1-r, R3-r, R9-c, R10-c

⁹⁷⁵ *Ibid.* For discussion of these interests see Chapter 3.3.3.2

⁹⁷⁶ In other words, the solution is pre-packaged, and so the Party-state avoids having to deal with the interests that would have to be considered and protected under the EBL, most importantly creditors’ interests: *Ibid.* See also Chapter 5.4.2.3

nutritious. At least six babies died and about 300,000 fell ill following its consumption.⁹⁷⁷

Similarly, the government took charge of the high-profile insolvency of EastStar Airlines, a Hubei-based company, which was liquidated in 2009 after the court rejected its ‘unfeasible’ Reorganisation plan.⁹⁷⁸

And finally, listed companies also usually receive special attention. Although some have been allowed to use EBL Reorganisation, many of my interviewees suggested that this is mostly used as a backdoor way of selling its key asset – its listed status – which is very hard to get in China and so is very valuable.⁹⁷⁹ Such EBL Reorganisation is, therefore, not a typical restructuring process which aims to save the viable part of a business or the company as a going concern, but it is rather a way of gaining listed status by acquiring the listed shell. Although such process does often raise more money than if the company was liquidated and so more stakeholders are repaid, many of my interviewees saw it as controversial use of corporate insolvency law.⁹⁸⁰

Many interviewees suggested that if a distressed company does not fall into any of the above-mentioned categories – which is the case for most private sector companies – it tends to fall outside the Party-state’s scope of interest and so does not receive the Party-state’s express blessing to use the EBL.⁹⁸¹ Without it, the interviewees argued, a petitioning

⁹⁷⁷ See e.g. Branigan (2.12.2008); Xinhua (12.2.2009)

⁹⁷⁸ Xinhua (27.8.2009)

⁹⁷⁹ Interviews C2-c, C5-r, C7-s, J1-c, J5-s to J9-c, L1-r to L15-c, P1-r, R3-r, R10-c

⁹⁸⁰ Interviews C2-c, C5-r, C7-s, J6-s, J8-c, J9-c, L2-s to L6-s, L13-c to L15-c, P1-r, R3-r, R10-c

⁹⁸¹ Interviews B1-c to B3-c, C1-c, C2-c, C5-r, C7-s to C11-c, J1-c, J3-c, J5-s to J9-c, L1-r to L15-c, R1-r, R3-r, R9-c, R10-c

debtor or creditor may find it difficult to persuade a local court to accept their EBL petition.⁹⁸²

Despite the fears of many that foreign creditors would be discriminated against, the EBL, as written, puts foreign creditors and general Chinese creditors on the same footing. All my interviewees agreed that, in practice, foreign companies receive the same treatment as domestic ones – that is, their relative power depends on their size and relative economic importance, not ownership.⁹⁸³ This does not mean that the recovery rates are the same as they may expect in their home jurisdictions or even Hong Kong.⁹⁸⁴ But what it does mean is that foreign creditors can expect similar treatment to Chinese creditors.⁹⁸⁵ This was emphasised by all my interviewees – Chinese and foreign – suggesting that what really matters in this context is creditor's and debtor's relative position in the economy, not the origin of their funds.

5.3.3.3 *How does the Party-state interfere?*

My interviewees reported that representatives of the Party-state, usually local government officials, tend to interfere with EBL enforcement in three important ways. Firstly, they can

⁹⁸² *Ibid.* See also Li Shuguang (n.600)

A rare exception to this rule is the situation in Wenzhou province, where small private debtors and creditors do not need state permission to use the EBL. This is because the private sector is particularly strong and important there (see 3.4) and the courts are used to acting with less guidance from the local government than is customary in other parts of China: Interviews C1-c, C5-r, E3-s, J4-c to J8-c, R1-r, R10-c

⁹⁸³ The interviewees with experience from less developed, more protective regions in central China added that there may be a degree of preferential treatment towards big SOEs. But they all insisted that the clear trend and tendency is to treat the foreign and domestic creditors equally.

⁹⁸⁴ See e.g. Yiu (11.10.2015); Shim (12.4.2013)

⁹⁸⁵ See also Yau, You and Steele (2004) at 84

prevent the parties from filing EBL petitions. Secondly, they can force a court to reject EBL petitions. And thirdly, they can allow EBL petitions to be filed and accepted, but the government then establishes a committee⁹⁸⁶ which *de facto* runs the process instead of a judge. This section examines each situation in turn.⁹⁸⁷

Firstly, local governments can effectively prevent directors and managers of creditor and debtor companies from filing an EBL petition.⁹⁸⁸ Several interviewees reported that such interference is mostly seen in insolvencies of companies belonging to the state sector.⁹⁸⁹ In case of state-owned parties – such as SOEs and state banks – a local or national government can, as the main shareholder, refuse to give a company the necessary permissions to declare insolvency and use the EBL.⁹⁹⁰ My interviewees argued that non-state-owned creditors and debtors also usually need government's blessing because courts are unlikely to accept their EBL petition without it.⁹⁹¹

⁹⁸⁶ Similar to the pre-EBL regime: Chapter 4.3.2.6

⁹⁸⁷ This section focuses on the enforcement of the EBL and the Party-state's interference in the process. A related question of what alternative mechanisms the Party-state employs instead of the EBL is discussed in Chapter 5.4.2, below.

⁹⁸⁸ Interviews C2-c, C5-r to C7-s, J1-c, J6-s, J8-c, L2-s to L7-c, L13-c to L15-c, R1-r, R9-c, R10-c

⁹⁸⁹ For a definition see Chapter 3.4. Interviews C2-c, C5-r, C7-s, L2-s to L7-c, L13-c to L15-c, R1-r, R10-c

⁹⁹⁰ In practice, SOEs that wish to make any significant changes to their structure or market activities – including a market exit – need a variety of permissions from the state bodies, who, therefore, have an ability to delay, hinder or postpone these changes (Tang and Ward (2003) at 50-51). This derives, *inter alia*, from the Company Law rules because the state is a majority shareholder of the SOEs. Whether they ask national or local government depends on their ownership structure: Interviews C2-c, C5-r, C7-s, J1-c, J5-s to J9-c, L2-s to L7-c, L13-c to L15-c, R1-r, R10-c

⁹⁹¹ *Ibid.*

A prime example of such limitations is the position of state-owned banks, which are mostly prevented from exercising their creditor rights.⁹⁹² This is so despite the fact that they are now supposedly independent bodies which are fully responsible for their financial decisions and affairs.⁹⁹³ This responsibility system has, on the one hand, incentivised banks to avoid further bad debt by putting their debtors into Reorganisation or Liquidation or enforcing their security.⁹⁹⁴ However, in practice, banks cannot petition to use EBL procedures in state sector debtors without express permission of a local government. As a result, they must follow the instructions of their (direct or indirect) majority stakeholder, the government, and wait or lend more money to the distressed SOE instead of being able to use the EBL when financial problems arise.⁹⁹⁵

Secondly, apart from influencing creditors and debtors, local governments also discourage courts from accepting any EBL petitions that are not expressly sanctioned by them.⁹⁹⁶ As one judge put it, the ‘ties between judges and party officials are often close... It’s very difficult for judges to be impartial.’⁹⁹⁷ As was discussed earlier, many judges feel

⁹⁹² Interviews B1-c to B3-c, C5-r, P1-r, R10-c. See also Wildau and Hong (21.5.2012)

⁹⁹³ The bank responsibility system has been established through a series of central government’s policies: Interviews C1-c, C5-r, C7-s, L4-c to L6-s, R3-r, R9-c, R10-c. For details, see Smyth et al (2015)

⁹⁹⁴ Interviews B1-c to B3-c, C1-c, C5-r, C7-s, L2-s, L4-r, L6-s, L10-s to L13-c, R2-r, R3-r, R6-c, R9-c, R10-c

⁹⁹⁵ Interviews B1-c to B3-c, C1-c, C2-c, C5-r, L4-c to L6-s, R10-c. See also Anderlini (15.5.2015); Qian and Strahan (2007). The banks might also be unable or unwilling to recognise their poor lending decisions by declaring the debtor bankrupt, and instead lend again to roll the debt over. This is called zombie loans: see Ahearne and Shinada (2005); Caballero, Hoshi and Kashyap (2008)

⁹⁹⁶ Interviews C2-c, C5-r, C7-s, J1-c, J3-c to J9-c, L4-r, L6-s, P1-r, P3-r, R1-r, R6-c to R10-c. See also The Economist (9.10.2008); Zhang in Parry et al (2010)

⁹⁹⁷ Callick (2013) at 71

unable or unwilling to proceed without Party-state's support.⁹⁹⁸ Both the external and internal pressure to cooperate with the Party-state is, therefore, overwhelming and courts typically yield to it, some willingly and others by coercion.⁹⁹⁹

Although, at times, courts do accept EBL petitions without Party-state's permission, their decision is often then overridden by a local government whose desire to keep the local debtor companies alive (and so its workers employed) at any cost suppresses the interests of creditors and other stakeholders who may benefit from the use of the EBL.¹⁰⁰⁰

In the few cases where courts disregarded local government's wishes and accepted an EBL petition, a local government usually instigates a police criminal investigation of the debtor company and its directors which takes precedence over civil proceedings, including the EBL.¹⁰⁰¹ The financial distress is then resolved in line with the state-orchestrated solution,¹⁰⁰² or the company is allowed to fail and the management is made to face full liability in order to make an example of them to deter others from rebelling against the Party-state.¹⁰⁰³ Several interviewees suggested that judges are aware of this, and so it is rare that they would go against the local government's instructions.¹⁰⁰⁴

⁹⁹⁸ See Chapters 3.3.3.3 and 5.3.3.1

⁹⁹⁹ Interviews C2-c, C5-r, C7-s, J1-c, J3-c to J8-c, L2-s, L4-r to L7-c, P1-r, R2-r, R7-c, R9-c, R10-c

¹⁰⁰⁰ My interviews (B1-c, C2-c, C5-r, J1-c, J4-c, J6-s to J8-c, L4-r to L6-s, R10-c) confirm these propositions in Tomasic and Zhang (2012) at 322

¹⁰⁰¹ Interview C1-c, J1-c, L4-r, L6-s, R10-c. This happened in e.g. the Hubei EastStar Airline where criminal investigation into the CEO's activities was launched because the company and the creditors refused to 'cooperate with the government organs', i.e. refused to accept the local government's solution: Sina (16.3.2009)

¹⁰⁰² See Chapter 5.4.2

¹⁰⁰³ Interviewees C1-c, C5-r, L4-r, L6-s, L14-c, and L15-c spoke of personal experiences when this happened

¹⁰⁰⁴ Interviews C2-c, C5-r, C7-s, J1-c, J3-c to J9-c, L2-s, L4-r to L7-c, P1-r, R3-r, R7-c, R9-c, R10-c

And thirdly, although most cases of financial distress are not resolved under the EBL, in some cases local governments do allow a case to be heard by a court under the EBL.¹⁰⁰⁵ However, because local governments often do not trust creditors, debtors and courts to resolve financial problems in line with the Party-state's preferred interests¹⁰⁰⁶ without the latter's assistance,¹⁰⁰⁷ the more important EBL cases usually run with local government's supervision or involvement. This is achieved, in practice, by assembling 'bankruptcy committees' akin to those which existed under the old law to resolve SOEs' financial distress.¹⁰⁰⁸ Although such committees were officially removed and their functions given to courts and newly-created administrators under the EBL,¹⁰⁰⁹ many of my interviewees and other evidence suggest that they are still widely used.¹⁰¹⁰

My interviewees pointed to several mechanisms through which the Party-state ensures that courts and lawyers closely cooperate with these bankruptcy committees.¹⁰¹¹ As was discussed earlier, judges are monitored by a political-legal committee of the local Party branch and have to promise loyalty to the Party and its ideology in an oath.¹⁰¹² Similar

¹⁰⁰⁵ For particular examples see 5.4.2.5

¹⁰⁰⁶ These are discussed in 3.3.3.2

¹⁰⁰⁷ As one judge (J8-c) put it: 'Many judges would be perfectly capable of making independent decisions and help companies devise good solutions, only if they had the freedom to do so.' This is supported by several interviews with the practitioners and advisors who also believe that many judges do have sufficient experience and integrity to be able to decide without local governments' interference. Instead, they argued, local governments should focus on making the enforcement environment stronger and more reliable: Interviews C5-r, C7-s, L2-s to L7-c, L10-s to L17-c

¹⁰⁰⁸ See chapter 4.3.1

¹⁰⁰⁹ *Ibid.*

¹⁰¹⁰ Interviews C2-c, C5-r, C7-s, J1-c, J3-c to J9-c, L1-r to L7-c, P1-r, R2-r, R7-c, R9-c, R10-c. See also Li (2012)

¹⁰¹¹ Interviews C2-c, C5-r, J1-c, J3-c to J8-c, L2-s to L6-s, L9-s, L13-c to L15-c, R10-c

¹⁰¹² See Chapter 3.3.3.3

mechanisms are used to ensure lawyers' cooperation. All lawyers now have to take the same oath of loyalty to the Party in order to 'firmly establish ... faith in socialism with Chinese characteristics ... and effectively improve the quality of lawyers' political ideology.'¹⁰¹³ In addition, Party cells have been reinstituted in most law firms to monitor their activities.¹⁰¹⁴ This is a stark reminder of the status that courts and lawyers have in China in general, and under the EBL in particular.

As a result of the internal (sections 5.3.1 and 5.3.2) and external (section 5.3.3) limitations discussed in this chapter, enforcement of the EBL is ridden with protectionism and fails to maximise creditors' recoveries. When combined with the parties' perception that the EBL does not sufficiently protect their interests (discussed in Chapter 5.1) and that the problems in the surrounding rules further reduce recoveries under the EBL (discussed in Chapter 5.2), it is hardly surprising that creditors are often unwilling to use the EBL – and that debtors do not trust courts to help them resolve their financial distress effectively. My interviewees, however, identified one final element that motivates the parties not to use the EBL: the existence of alternative debt enforcement mechanisms which the parties perceive as offering them relatively higher payoffs than they would receive under the EBL. This is the focus of the next section.

¹⁰¹³ "New lawyers must make an oath of loyalty" China's Ministry of Justice (2012)

¹⁰¹⁴ *Ibid.*

5.4 The Fourth constraint: Parties often perceive alternative debt enforcement mechanisms as offering higher payoffs than the EBL

Finally, the parties often prefer or are limited to the use of non-EBL alternatives to resolve debtor's financial distress. Many of the non-EBL alternatives have been used since long before the (old) insolvency law was introduced in 1986.¹⁰¹⁵ Most of them developed incrementally, building on users' experiences and expectations over a long period of time. The resulting familiarity and simplicity of many of the alternative mechanisms together with stakeholders' ability to remain in control both in private and in the politically-driven alternative mechanisms – my interviewees suggested¹⁰¹⁶ – appear to make them a much more attractive option than the complex EBL which relies on incomplete supporting institutions, inefficient courts and administrators, and often unwelcome intrusions by courts or the local Party-state.¹⁰¹⁷ In other words, the perceived payoffs under the EBL are not sufficient to persuade the parties to use it instead of these familiar, immediately-available alternatives.

In general terms, the choice of alternative enforcement mechanism appears to depend on the seriousness of the financial distress – the simpler, more traditional private enforcement alternatives such as pressure and attempts to negotiate tend to be used

¹⁰¹⁵ See Chapter 4.2.

¹⁰¹⁶ Interviews B1-c to B3-c, C2-c to C7-s, C9-c, C11-c, E1-c to E5-c, IF1-s, IF2-c, J7-c, L2-s to L15-c, P1-r, P3-r, R1-r to R4-c, R6-c, R7-c, R9-c, R10-c, R12-c

¹⁰¹⁷ *Ibid.*

NB: Some of my interviews (C5-r, C9-c, J7-c, L11-c, R1-r) and some existing research speak of 'cultural preference for the non-legal dispute resolution.' However, the use of extralegal alternatives may be readily explicable as creditors' and debtors' preference for using the more effective, accessible and understood tools.

initially by all creditors to enforce, individually, repayment of their debt. When the simpler methods fail, parties move to stronger or more sophisticated mechanisms.

Besides complexity and seriousness of the financial distress, however, the chosen solution may also depend on whether debtor's activities fall within the state sector or the private sector.¹⁰¹⁸ If a debtor belongs to the private sector, the parties usually have to fend for themselves and are limited to the private alternatives or the EBL. If, on the other hand, a debtor belongs to the state sector, the stakeholders may have to yield control over their claim to the Party-state which may impose a politically-driven alternative or Party-state-led use of an EBL procedure in order to ensure that its socio-economic interests are protected.

The remainder of this section explores these non-EBL alternatives.¹⁰¹⁹ It first looks at private alternatives where parties resolve their debt-related disputes individually or with limited help of a third party (5.4.1). It then examines politically-driven alternatives where the Party-state controls and decides the outcome of the case (5.4.2). Table 5-8 summarises these options.

Table 5-8: Overview of non-EBL alternative debt enforcement mechanisms

	Private alternatives (5.4.1)	Politically-driven alternatives (5.4.2)
Informal (only affected parties)	(i) Private negotiations (ii) Violence, threats (iii) Reputation mechanism	(i) Politically-driven negotiations → State-enforced compromise → State-led M&A → State-led financial assistance → State-led private restructuring
Formal (third party involved)	(i) Enforcement of contract (ii) Enforcement of security (iii) Diversified dispute resolution (mediation, arbitration)	(i) State-led use of the EBL

¹⁰¹⁸ As was discussed in Chapter 3.4, the determinants of state influence include not only ownership, but also an array of other issues such as industry, relative economic importance, employment considerations, etc.

¹⁰¹⁹ Some of them were discussed in Chapter 4.2

5.4.1 Private alternatives and their perceived advantages

Private alternatives are mostly used by private sector companies. State sector players sometimes use them before the Party-state gets involved to try to find a solution without state's knowledge and interference. This section first looks at why the parties use these alternatives (5.4.1.1). It then looks at when and why the parties prefer private *informal* alternatives – most importantly private negotiations, violence, threats, and reputation mechanism – rather than the EBL (5.4.1.2). It concludes by looking at when and why the parties use private *formal* mechanisms – most importantly court-based enforcement of contract, court-based enforcement of security rights, and diversified dispute resolution mechanisms – rather than the EBL (5.4.1.3).

5.4.1.1 Why the parties use private alternatives

The discussion here builds on the earlier overview of the most prevalent options for debt enforcement without the use of the EBL and without Party-state's help.¹⁰²⁰ Unlike in the earlier discussion, however, the focus here is on the *reasons why stakeholders prefer* to use these alternatives. Besides the comparatively higher expected payoffs under the non-EBL alternatives (v. the EBL),¹⁰²¹ my interviewees identified three further reasons why the parties often prefer to using non-EBL debt enforcement alternatives.

Firstly, as was mentioned earlier, private alternatives are familiar to all stakeholders and they have been used for a long time. The EBL, on the other hand, is a relatively new and

¹⁰²⁰ See Chapters 4.2.1-2

¹⁰²¹ Chapters 5.1-5.3

little understood¹⁰²² mechanism. As a result, parties perceive the alternative mechanisms as a trusted fall-back option for dealing with corporate financial distress on individual as well as collective level.

Secondly, the parties often perceive non-EBL alternatives as comparatively cheaper and quicker (v. the EBL). Small private companies¹⁰²³ usually prefer non-EBL alternatives because their financial distress tends to be less complicated, more localised, their assets and net-worth are generally smaller, and so the impact of their potential failure is also less significant for the economy and social stability. As a result, the EBL would probably be disproportionately expensive and unnecessarily lengthy.¹⁰²⁴ Medium-sized private companies¹⁰²⁵ often face greater complexity and their size might justify the cost of an EBL procedure, but because they are not sufficiently economically significant (so as to warrant Party-state protection¹⁰²⁶) their EBL petitions are often ignored by the courts,¹⁰²⁷ and so they, too, have to rely on private alternatives.

And thirdly, the parties often prefer the privacy and informality of non-EBL alternatives. This is most pronounced in cases where creditors or debtors engaged in shadow market or lent to politically prohibited industries,¹⁰²⁸ and so they either cannot rely

¹⁰²² Chapter 7.3.1

¹⁰²³ See Chapter 3.3.3. For a definition of ‘small’ see note 329

¹⁰²⁴ See Chapter 5.2.2.1

¹⁰²⁵ See Chapter 3.3.3. For a definition of ‘medium’ see note 329

¹⁰²⁶ See Chapter 5.3.3

¹⁰²⁷ See Chapters 5.2.2 and 5.2.3 for courts’ reasons

¹⁰²⁸ See Chapter 5.2.3.3 and 5.2.3.4

on the Party-state's assistance, or they prefer not to draw attention to themselves and instead choose to resolve their disputes without the Party-state's help.¹⁰²⁹

5.4.1.2 Private informal mechanisms

Chapters 4.2.1 and 4.2.2 provided an overview of several informal mechanisms which the parties use to enforce debt repayment without having to resort to laws and court enforcement. The parties know how these mechanisms operate, they are relatively low-cost, and they enable the parties to enforce repayment directly – which create a perception that the alternatives are better than the EBL.

Private negotiations

Probably the most prevalent – and used initially by most parties – is private negotiations.¹⁰³⁰ Cheap and often effective, negotiations between a debtor and its creditor(s) is a universally preferred method which often achieves repayment or at least renegotiation of terms followed by a repayment.¹⁰³¹ Although, in theory, parties could use the threat of invoking the EBL as a way of motivating a debtor to negotiate in good faith so as to avoid losing control of their company – as literature suggests¹⁰³² – there is no evidence that would suggest that the EBL affects parties' negotiating. Although, in theory, the EBL

¹⁰²⁹ *Ibid.* and Chapter 3.3.3

¹⁰³⁰ For details see Chapters 4.2.1.1 and 4.2.2.1

¹⁰³¹ This is not unique to China. But my interviewees (J1-c to J9-c, L2-s to L15-c, P1-r, R1-r to R10-c, R12-c) suggested that courts in China will not accept a case without evidence that the parties tried to settle their dispute informally first.

¹⁰³² See e.g. Armour, Hsu and Walters (2008)

does provide an outside option in case of the parties' inability to reach a mutually satisfactory agreement, my interviewees provided no support for the threat of invoking an EBL procedure – i.e. bargaining in the shadow of the EBL – being used as a bargaining tool.¹⁰³³ If anything, two of my interviewees expressed their doubt whether the threat of using the EBL would be credible due to the known complexity and difficulty of using the law in China.¹⁰³⁴

Threats and violence

If a creditor is not willing to give their debtor another chance to repay, or if the initial negotiations fail, many interviewees suggested that creditors in China often use threats and, in some cases, violence.¹⁰³⁵ Although the use of violence to enforce payment is illegal and is punishable by fines and imprisonment, several of my interviewees suggested that it is often successfully used because it makes debtor's default position – non-payment – as inconvenient and 'miserable' as possible.¹⁰³⁶ In other words, knowing that court enforcement is slow and expensive (or, in some cases, unavailable), creditors try to credibly decrease debtor's payoffs for non-payment through harassment and credible threats of

¹⁰³³ Two interviewees (L4-r, L6-s) who operate in a developed city expressed some faith in the legal enforcement. But even they did not report that the parties would be bargaining in the shadow of the EBL.

¹⁰³⁴ Interviewee L6-s said: 'Few companies are concerned about the threats of civil litigation. Based on my experience and that of my colleagues, this is rational and perfectly reasonable given the local conditions.' Similar view was expressed by Interviewees L2-s, L4-r, L5-c and L10-s

¹⁰³⁵ See Chapter 4.2.1.2

¹⁰³⁶ Interview C1-c, C4-c, E2-s, E4-c, IF1-s, L2-s to L7-c, L9-s to L13-c, R7-c, R9-c

further trouble.¹⁰³⁷ This makes non-payment more difficult, costly and unpleasant than payment.¹⁰³⁸

In addition, creditors who choose to enforce repayment of their debts using threats or violence often operate in the shadow market. As a result, the debtor is incentivised to cooperate because they do not want their involvement in the shadow lending to become public, because – as was explored in Chapters 5.1.2 and 5.2.3.1 – borrowing from shadow lenders is a criminal offence.¹⁰³⁹

Reputation mechanism

In situations where a debtor and its creditors are a part of a club – including shadow lenders and small-scale lenders – they can also rely on the reputation mechanism to enforce debt repayment by a financially distressed debtor.¹⁰⁴⁰ Looking at the situation from a creditor's perspective, the reputation mechanism provides them with a valuable hostage against a debtor and those associated with it, which can help ensure recovery of the loan. In small companies that rely on relational finance, the hostage is their personal relationship with the lender and their standing in society. In larger companies or in arms-length lending, the hostage is the company's relationship with various stakeholders and the benefits arising

¹⁰³⁷ Interviewee L2-s said: 'In my experience, people in China and elsewhere do what they think they need to do – and no more – and obey rules which they think will be enforced.' – also stressed in Interviews L4-r to L7-c, L10-s to L14-c.

¹⁰³⁸ *Ibid.*

¹⁰³⁹ Although, arguably, the creditor is just as liable to be punished, some of my interviewees (C2-c, C4-c, C5-r, C7-c, E1-c, E3-s, IF1-s, IF2-c, L2-s, L4-r, L6-s, P1-r, R3-r, R9-c, R10-c) suggested that they are more accustomed to the risks associated with shadow lending and so are more willing to use criminal methods to enforce repayment.

¹⁰⁴⁰ For an overview, see Chapter 4.2.2.2

from it, potential liability of the company's directors and managers, and the career prospects of local government officials. Using the reputation mechanism – where it is available – instead of the EBL is considerably more efficient.¹⁰⁴¹

From a debtor's perspective, the news of its financial distress and its failure to honour its obligation to repay a debt adversely affect its reputation in two ways. Firstly, it affects the company itself and harms its relationships with other companies, potential investors and shareholders,¹⁰⁴² and possibly also its ability to attract good employees in the future.¹⁰⁴³ Moreover, where a debtor gained access to the lending market with assistance of a reputation intermediary – such as local government or Party officials, or an established company willing to act as an informal guarantor or agent – such an intermediary risks losing their own reputation, and so puts extra pressure on the debtor to repay.¹⁰⁴⁴

And secondly, the news of debtor's financial distress also affects the individuals associated with the company – most importantly its directors and managers,¹⁰⁴⁵ and in some cases also local government officials – because their career prospects and personal

¹⁰⁴¹ It is costless and almost immediate. Interviewees in Tomasic et al (1996) speak about the influence of the threat of reputational loss on their conduct in business. Allen, Qian and Qian (2005, at 94) also show that reputation loss in various sense is far more important a concern resulting from firm failure than economic loss or legal/safety consequences.

¹⁰⁴² This is either because they guaranteed repayment and so have to repay borrower's debt, or because they start perceiving the borrower as an unreliable counterparty: Interviews B1-c, C1-c, C4-c, C7-s, E1-c to E5-c, IF1-s, IF2-c, L1-r to L6-s, L11-c, L14-c, R3-r, R6-c, R7-c, R9-c, R10-c

¹⁰⁴³ See also Sina (28.9.2015)

¹⁰⁴⁴ *Supra* n.1037

¹⁰⁴⁵ This is further reinforced by the fact that managers and directors can be held personally liable if the borrower company fails to pay its debts (Interviews C1-c to C4-c, C7-s, C9-c to C11-c, E1-c, E3-s, J1-c, L2-s to L7-c, L11-c). If the situation further worsens, they can also be liable under the EBL and can be banned from managerial activities for three years: see Chapter 5.1.2

social standing may be affected by their company's failure.¹⁰⁴⁶ Several of my interviewees commented that debtor companies and their representatives, therefore, often do their best to repay their debts and avoid using the EBL because, for many Chinese, insolvency still means 'utter and complete failure [which] carries the stigma of not just economic failure, but a lifetime non-reversible declaration and admission of guilt and defeat in the person of the debtor.'¹⁰⁴⁷ Many practitioners stressed the importance of reputation for their corporate clients in China, and the fear they have of losing it.¹⁰⁴⁸ The implications of reputational loss then incentivise debtors to repay.¹⁰⁴⁹

5.4.1.3 Formal private mechanism

It was proposed in Chapter 4.2.3 that unpaid creditors can also seek (limited) third-party assistance to enforce their debts. These include court-based contract and security enforcement, and (mostly out-of-court) diversified dispute resolution mechanisms. My interviewees all argued that, to an average creditor, these mechanisms have the advantage of formal enforcement – similar to the EBL – but are less complex, and so cheaper and quicker than the EBL. However, what creditors often fail to fully acknowledge – the

¹⁰⁴⁶ This is further reinforced by the low mobility of personnel between provinces in China: *supra* n.1029

¹⁰⁴⁷ Tang (2005) at 8. Also Interviews C1-c to C4-c, C7-s, C9-c to C11-c, E1-c, E3-s, J1-c, L2-s to L7-c, L11-c. See e.g. an interesting interview in Leggett (21.9.2000) with a debt collector who claims that 'The Chinese don't like to lose face. But if they don't pay their bills, that's exactly what I do to them'

¹⁰⁴⁸ Interviews C1-c to C4-c, C7-s, C9-c to C11-c, J1-c, L2-s to L11-c

¹⁰⁴⁹ *Ibid.*

NB: debtors' fear of losing their reputation as a capable, healthy company may, however, make debtors avoid using court-driven EBL – in particular Reorganisation – since they fear that even if it succeeded in saving the business, the company would be finished because of the loss of reputation. A possible solution is proposed in Chapter 7.4

interviewees argued – is that these alternatives suffer from similar enforcer-related problems as the EBL¹⁰⁵⁰ and they may be ill-suited for resolving more complex cases of financial distress with multiple (types of) claimholders and conflicting interests.¹⁰⁵¹ Nevertheless, the parties often try to enforce repayment through one of the following alternatives.

Court-based enforcement of contract

A lender can seek recovery of their contractual debt in court.¹⁰⁵² However, similar to the reputation mechanism, for the threat of enforcement to be credible, it is important that it can be carried out where necessary. All my interviewees suggested that courts enforce bilateral lending contracts with significantly lower costs and fewer delays than when they deal with EBL claims. A court can issue a payment order – giving the debtor 15 days to repay.¹⁰⁵³ So long as a debtor does not dispute any of the claimed debts and so long as there is enough money to repay all claimants, this alternative provides a far more efficient method of recovery – even where there are multiple claiming creditors – and should be used instead of the EBL.

However, if a debtor makes a defence or brings a counterclaim the case must be dealt with in a full court hearing, which can slow things down.¹⁰⁵⁴ Similarly, this method is

¹⁰⁵⁰ See Chapters 5.2-3

¹⁰⁵¹ See Chapter 6.1.2.1

¹⁰⁵² See Chapter 4.2.3

¹⁰⁵³ See Chapter 4.2.3.1

¹⁰⁵⁴ Interviews C1-c, C4-c, C5-r, C7-s, J1-c, J4-c, J6-s to J9-c, L2-s to L7-c, L9-s to L15-c – most claims are disputed

inappropriate where the debtor cannot satisfy all its debts in full – i.e. is insolvent – and where enforcement of individual contracts would necessarily unfairly prejudice the other creditors.¹⁰⁵⁵ Once this happens, enforcement of individual debt contracts and issuing payment orders is inappropriate. Nevertheless, my interviewees suggested, individual creditors do not want to – and due to courts’ passivity often do not need to – consider other claimants’ position other than so far as it concerns their ability to recover.¹⁰⁵⁶ As a result, creditors do seek – and often get – payment orders from courts due to the information asymmetry – and courts’ resulting ignorance that they should be using the EBL – and courts’ reluctance to allow EBL petitions.¹⁰⁵⁷

Out-of-court and Court-based security enforcement

Similarly, secured creditors prefer to use non-EBL alternatives. In China, as elsewhere, secured creditors’ claims can be – and commonly are – enforced outside insolvency law proceedings because security rights attach to a particular asset which can be sold and the proceeds used to repay the secured debt. As was discussed in Chapter 4.2.3.2, security enforcement usually takes place out of court or through a simple court procedure whereby the secured asset is identified, sold, and the proceeds are used to repay the secured creditor. Where done successfully, the procedure is quicker and cheaper than

¹⁰⁵⁵ e.g. whose claims are not yet mature, or who have not yet realised that the debtor is in financial trouble

¹⁰⁵⁶ Interviews C1-c, C4-c, C5-r, C7-s, E1-c, E2-s, J1-c, J4-c, J6-s to J9-c, L2-s to L7-c, L9-s to L15-c, P1-r, R1-r, R3-r, R6-c, R7-c, R9-c, R10-c

¹⁰⁵⁷ *Ibid.*

recovery under the EBL – and without a risk to secured creditors that courts may postpone their rights to protect public policy interests instead.¹⁰⁵⁸

This process, however, faces similar difficulties as the EBL, namely information asymmetry, misleading accounting, limited willingness of courts to go beyond the assets known to and identified by the petitioning creditor as belonging to the debtor, etc.

To deal with the difficulties associated with contract and security enforcement, lenders sometimes use contractual guarantees and pawnshop-style lending to increase their ability to recover their money. A contractual guarantee makes repayment more likely because it nominates a third-party (guarantor) who would pay if a debtor becomes unable or unwilling to do so himself. My interviewees suggested that so long as the requisite formalities are satisfied, courts only have to confirm a guarantor's duty to repay.¹⁰⁵⁹ So long as a guarantor is able to make the payment, a lender can recover their money. Pawnshop-style lending is another mechanism used to increase the likelihood of debt recovery. It circumnavigates the problems associated with court enforcement altogether because a lender becomes a full legal owner of liquid asset(s) which a borrower provides as a quasi-security.¹⁰⁶⁰ If he fails to repay, a pawnshop owner can sell the asset and keep the money in satisfaction of the borrower's debt.

Diversified dispute resolution ('DDR')

Chapter 4.2.4 suggested that parties often take their disputes to a non-court third party – a

¹⁰⁵⁸ See Chapter 5.1.1.2

¹⁰⁵⁹ Unless instructed not to do so by the Party-state: see Chapter 5.3.3, above. Interviews C1-c, C4-c, C5-r, C7-s, E1-c, E2-s, J1-c, J4-c, J6-s, L2-s to L7-c, L9-s to L14-c, R1-r, R3-r, R6-c, R7-c, R9-c, R10-c

¹⁰⁶⁰ *Ibid.*

mediator, an arbitration panel, or a combination of the two. DDR is more formal than self-help debt enforcement mechanisms, but less public than court-assisted contract and security enforcement. As a result, it is very popular with private companies in China, particularly if informal attempts to resolve the dispute failed or if the issue is too complex for the simpler mechanisms.

My interviewees suggested several reasons why the parties tend to use mediation instead of the EBL. Mediation is often preferred where the parties hope to maintain a cooperative relationship but are themselves unable to reach an acceptable compromise.¹⁰⁶¹ It is also used where the parties wish to safeguard their reputation, which – they fear – could be tarnished by a public court hearing, but where they cannot rely on the reputation mechanism.¹⁰⁶² The perception of mediation's relatively higher speed and efficiency and lower cost were also highlighted in some of my interviewees.¹⁰⁶³ Mediation is also encouraged by the state which seeks to maintain public order and harmony, and by overburdened courts.¹⁰⁶⁴ Once made, a final mediation statement is enforceable in court.¹⁰⁶⁵

If the parties are unlikely to reach an amicable compromise, but do not want to hand their case over to a court, they can use arbitration – but only where they agreed and

¹⁰⁶¹ Interviews B2-c, C1-c to C5-r, C7-s, C8-s, C10-s, E1-c to E5-c, J1-c, L2-s to L7-c, L9-s to L12-c, L14-c, L16-c, P1-r, R3-r, R9-c, R10-c

¹⁰⁶² E.g. where the parties do not have a functioning club enforcement mechanism. Interviews C5-r, E1-c, E4-c, E5-c, L2-s to L7-c, L9-s to L12-c, L14-c, L16-c, R3-r, R6-c, R7-c, R9-c, R10-c

¹⁰⁶³ Interviews C1-c, C5-r, C7-s, E1-c to E5-c, L2-s to L7-c, L9-s to L12-c, L14-c, L16-c, P1-r, R3-r, R9-c, R10-c

¹⁰⁶⁴ Arbitration and mediation institutions are not in competition with courts in China; instead, they coexist and support one another. As we saw in Chapter 4.2.4, many DDR cases are managed by judges or are heard in centres which are associated with local courts. See e.g. SPCM (5.7.2016), which summarises the progress in preparing the SPC guidelines and further reform of DDR in China, suggesting that courts are encouraged to offer a 'one stop shopping' for dispute resolution.

¹⁰⁶⁵ Art 51 of the Arbitration Law 1995

incorporated a valid arbitration clause into the relevant contract *ex ante*, or if they make an arbitration agreement *ex post*.¹⁰⁶⁶ Where allowed, arbitration cases are heard in one of the numerous authorised domestic and international arbitration centres in China.¹⁰⁶⁷ Several interviewees proposed that the main advantages of arbitration over litigation include its speed,¹⁰⁶⁸ secrecy¹⁰⁶⁹ and independence¹⁰⁷⁰ of the process, and the adjudicators' expertise.¹⁰⁷¹ Moreover, an arbitral award is final¹⁰⁷² and internationally enforceable.¹⁰⁷³

China also makes use of Med-Arb, a combination of mediation and arbitration.¹⁰⁷⁴

Arbitrators – who initially act as mediators – can have private hearings with the parties to establish their respective bottom lines and assess whether their expectations and demands are likely to result in a mutually acceptable compromise. Some of my interviewees suggested that this is one of the key advantages of MedArb, because adjudicators are able to determine early on whether there is a realistic chance of a voluntary settlement, or

¹⁰⁶⁶ See Chapter 4.2.4.2

¹⁰⁶⁷ There were 176 domestic arbitration centres in 2006: Zheng (16.10.2015)

¹⁰⁶⁸ The parties do not face excessive delays leading up to a hearing and the arbitration hearing can only last for six months. Interviews C1-c, C5-r, C7-s, E1-c to E5-c, L2-s to L7-c, L9-s to L14-c, L16-c, P1-r, R3-r, R9-c, R10-c

¹⁰⁶⁹ Interviews C1-c, C5-r, C7-s, E1-c to E5-c, IF1-s, IF2-c, L2-s to L7-c, L9-s to L12-c, L14-c, L16-c, P1-r, R3-r, R9-c, R10-c and Art 40 of Arbitration Law 1995

¹⁰⁷⁰ Local governments are expressly excluded from the arbitration regime, and my interviews suggest that they play no significant role in practice: Interviews C1-c, C5-r, C7-s, E1-c to E5-c, IF1-s, IF2-c, L2-s to L7-c, L9-s to L12-c, L14-c, L16-c, P1-r, R3-r, R9-c, R10-c

¹⁰⁷¹ Art 13 of Arbitration Law 1995 states that members of the arbitration commission must have at least 8 years of work experience in arbitration or in law or in judiciary or in research and teaching at a senior level.

¹⁰⁷² Art 9 of Arbitration Law 1995. Wang and McKee (2015) suggest that, although in theory possible, court do not overturn the arbitral awards in practice

¹⁰⁷³ Because China is a signatory of the New York Convention. Judicial decisions, on the other hand, are problematic: Interviews C1-c to C7-s, C9-c, J5-s to J8-c, L2-s, L4-r, L6-s, R3-r, R10-c

¹⁰⁷⁴ See Chapter 4.2.4.3

whether a more adversarial, centrally managed procedure is necessary to impose a top-down solution.¹⁰⁷⁵ Another big advantage is that, without wasting the time necessary to start a new procedure and to give adjudicators time to familiarise themselves with the case, arbitrators can start off as quasi-mediators and immediately switch into arbitration when necessary.¹⁰⁷⁶ Moreover, regardless of the stage at which the award is made – in the early mediation or later arbitration stage – it is fully enforceable. Several of my interviewees suggested that this makes MedArb more like litigation, but with the added advantages of speed and privacy.¹⁰⁷⁷

Although mediation, arbitration and MedArb have many advantages, my interviewees doubted that, in their present form, they are optimal for all types of cases. Firstly, several interviewees highlighted that it may be problematic that arbitrators and mediators focus solely on the parties' financial interests instead of emulating courts' holistic approach of taking into account social interests and political preferences – especially in cases that involve state-sector companies.¹⁰⁷⁸ However, the problem with this criticism is that courts are slow and often distrusted partly because of such holistic approach. This may also be why China's arbitration decisions are often regarded with greater respect than court decisions, and enjoy greater enforceability internationally.¹⁰⁷⁹

¹⁰⁷⁵ Interviews C1-c, C4-c, C5-r, L2-s to L7-c, L9-s to L12-c, L14-c, L16-c, R3-r, R6-c, R7-c, R9-c, R10-c

¹⁰⁷⁶ As we saw, the shift can be initiated by the arbitrators or the dispute parties: Kaufmann-Kohler and Fan (2008)

¹⁰⁷⁷ Interviews C1-c, C5-r, C7-s, E1-c to E5-c, IF1-s, IF2-c, L2-s to L7-c, L9-s to L12-c, L14-c, L16-c, P1-r, R3-r, R9-c, R10-c

¹⁰⁷⁸ Interviews C5-r, C10-s, J1-c, J7-c, J9-c, L1-r, L14-c, L15-c, P2-s, R10-c. One of the interviewees suggested that the arbitrators 'cannot be trusted [because] they are not loyal to the nation'

¹⁰⁷⁹ Interviews C4-c, L2-s, L4-r, L6-s, L7-c, P1-r, R3-r, R9-c, R10-c

Secondly, some of my interviewees doubted the abilities of arbitrators in smaller cities and less developed regions.¹⁰⁸⁰ However, although the overall level of experience and expertise may be lower than in booming commercial centres, the knowledge and many of my interviewees thought that the understanding of local arbitrators tends to be significantly better than that of local courts.¹⁰⁸¹

Thirdly, some of my interviewees also complained that mediators and arbitrators do not have sufficient power to make their decision-making meaningful.¹⁰⁸² For example, they cannot order interim measures such as asset freezing, and instead have to rely on a relevant court to safeguard goods and evidence.¹⁰⁸³ Nevertheless, mediators and arbitrators can take steps to strengthen their power – e.g. by seeking a court order for interim measures. Similarly, at times, enforcing arbitral awards can be slow. However, the problems in enforcement are less frequent and less severe than those facing the enforcement of court decisions.¹⁰⁸⁴

5.4.2 Politically-driven alternatives and their perceived advantages

Section 5.4.1 discussed private alternatives, which are mostly used by private sector companies. This section examines the mechanisms which have been used to resolve financial distress of state sector companies ('state companies'). My interviewees argued

¹⁰⁸⁰ Interviews C1-c, C4-c, L4-r, L6-s

¹⁰⁸¹ Interviews C1-c, C4-c, C5-r, C7-s, E1-c, L2-s, L4-r to L6-s, R10-c

¹⁰⁸² Interviews C1-c, C5-r, C7-s, E2-s, L4-r, L7-c, L10-s, L16-c, R10-c

¹⁰⁸³ *Ibid.* See also Wang and McKee (2015)

¹⁰⁸⁴ *Ibid.*

that, given their social, political and economic significance, state companies are not free to resolve their financial distress as they wish. Instead, they are a part of the state-run economy, and so the resolution of their financial distress must satisfy Party-state's financial and non-financial interests – most importantly the need for maximum employment, social stability and (particularly short-term) economic prosperity.¹⁰⁸⁵ Instead of letting money-losing state companies fail,¹⁰⁸⁶ the Party-state uses a variety of mechanisms to resolve their financial distress.¹⁰⁸⁷ The mechanisms that they use include many of those used by private companies discussed above – albeit driven by political interests rather than solely financial interests – and many other top-down restructuring tools and solutions.

Building on the earlier discussion of why the Party-state interferes in the EBL regime,¹⁰⁸⁸ this section first looks at why the affected parties accept the Party-state's interference and preferred solutions (5.4.2.1). It then looks at when and why the Party-state prefers to use politically-driven *informal* mechanisms rather than the EBL (5.4.2.2). It concludes by examining the circumstances and reasons why the Party-state allows the use of the EBL and how it interferes in EBL procedures to protect its interests (5.4.2.3).

¹⁰⁸⁵ See Chapter 5.3.3.1

¹⁰⁸⁶ We saw earlier that where a state sector company becomes financially distressed, the Party-state – most importantly the local governments – often order the court not to accept the EBL petition or they control the way the EBL procedures are run through their own committees: See Chapter 5.3.3 for details

¹⁰⁸⁷ See e.g. Halliday (2007) 5. See also Pedone and Liu (2009)

¹⁰⁸⁸ See Chapter 5.3.3

5.4.2.1 *Why do the parties accept Party-state's solutions*

It was discussed earlier that the Party-state has many personal and institutional reasons which make it interfere in judicial decision-making in general,¹⁰⁸⁹ and debt resolution and insolvencies of state companies in particular.¹⁰⁹⁰ This section goes beyond these reasons, however, and focuses on why the affected parties – courts, state-company debtors and their claimholders – allow such interference from the Party-state, and why – in many cases – they welcome and even prefer such state-provided solutions to objectively-applied EBL.

Chinese courts are not independent and their operation is intertwined with that of the Party-state.¹⁰⁹¹ As a result, courts are guided in their interpretation and application of the EBL to protect politically preferred interests (e.g. employees' interests) over other interests (e.g. secured creditors' interests) under the EBL, even where this means going against EBL's provisions.¹⁰⁹² The reason why courts follow the Party-state's guidance is three-fold. Firstly, courts are internally monitored and incentivised by remuneration and career advantages to obey the Party-state.¹⁰⁹³ This is further reinforced by courts' experience with the difficulties of coordinating large groups of stakeholders and enforcing their judgments without Party-state's support.¹⁰⁹⁴ And finally, judges often see the Party-state as the ultimate representative of the people, and so willingly submit their decision-

¹⁰⁸⁹ See Chapter 3.3.3.2

¹⁰⁹⁰ See Chapter 5.3.3

¹⁰⁹¹ See Chapter 3.3.3

¹⁰⁹² See Chapter 5.1.1

¹⁰⁹³ See Chapter 3.3.3.3

¹⁰⁹⁴ *Ibid.*

making power to the Party-state which, many of them believe, is much better suited to resolve disputes in a holistic and meaningful manner.¹⁰⁹⁵ As a result, courts often do not resist Party-state's interference in their decision making.

At the same time, state-company debtors and their claimholders also tend to accept – and in many cases welcome – Party-state's interference.¹⁰⁹⁶ For state-company debtors, this usually means that their company will be saved instead of them having to face hard budget constraints and market-driven resolution of their distress. Party-state's interference also often gives them comparatively higher payoffs (v. the EBL) because where a debtor is bailed out or otherwise saved, claimholders are usually repaid in full, and there are minimal or no redundancies. On the other hand, however, where a state-company debtor and its claimholders do not agree with Party-state's interference or its preferred solutions, they have little say in the matter in practice and have no choice but to accept Party-state's interference.¹⁰⁹⁷

5.4.2.2 Informal state-led mechanisms

There are many mechanisms which the Party-state uses to resolve financial distress in state companies instead of independently-run EBL procedures. Companies can be quietly suspended or written off. The problem arises where there are unresolved claims and clashing interests that need to be addressed before a company can be closed. EBL

¹⁰⁹⁵ Interview J1-c, J4-c to J9-c

¹⁰⁹⁶ Interviews B1-c, C4-c, C5-r, C7-s, J1-c, P1-r, L7-c, L14-c, L15-c, R10-c

¹⁰⁹⁷ My interviewees suggested that many stakeholders are unhappy with Party-state's interference because their interests are subordinated contrary to the wording of the law (e.g. secured creditors' claims, banks that are forced debt-for-equity swaps, etc.). Although the Party-state may listen to their preferences and demands, it makes its final decision largely according to its own interests and preferences: Interviews C1-c, C5-r, C-s, L2-s to L6-s, L10-s to L15-c, R9-c, R10-c. See also Milhaupt and Liebman (2016); and Chapters 6.1 and 7.3

Liquidation and Reorganisation offer a regime for dealing with such issues. The Party-state, however, usually refuses to allow market-driven EBL to be used and instead impose its preferred solutions in financial distress of state companies.

The remainder of this section examines four informal techniques that the Party-state employs. Firstly, the Party-state uses its vast influence to force creditors not to insist on being repaid as originally agreed and to grant loan extensions or forgive the debt instead. Secondly, ailing companies can be ‘resolved’ by the Party-state forcing a merger with another, healthy state company in the hope of creating a stronger whole. Thirdly, the Party-state often provides financial assistance to struggling companies. It usually takes the form of bailouts, bad debt buyouts, and the creation of zombie companies. And finally, in some cases, Party-state representatives take charge and devise a restructuring plan behind closed doors with the key players. Each mechanism is discussed in turn.

Creditors to state sector companies forced to compromise

If a debtor knows that they may not be able to repay all debts in accordance with the original agreement(s), they often try to renegotiate the terms or reach a deal that would be satisfactory to both parties.¹⁰⁹⁸ However, many of my interviewees suggested that where such private negotiations concerning a *state-company* debtor fail then Party-state representatives often ‘forcefully encourage’¹⁰⁹⁹ creditors with claims against a state-

¹⁰⁹⁸ As discussed in Chapter 5.4.1.2

¹⁰⁹⁹ Interviews B1-c to B3-c, C1-c to C5-r, C7-s, J1-c, J8-c, J9-c, L2-s to L7-c, L10-s to L15-c, P1-r, P3-r to P5-c, R1-r, R2-r, R9-c, R10-c

company debtor to reach a compromise. This usually takes one of two forms: loan term adjustments or debt forgiveness.

Firstly, the Party-state – usually a local government – can order a bank¹¹⁰⁰ to extend the maturity of a company's loan, or to provide a bridging loan.¹¹⁰¹ Where a debtor company is in a temporary financial distress, creditors often willingly agree.¹¹⁰² However, my interviewees suggested that banks in China are increasingly reluctant to offer extra time or new loans to severely financially distressed SOEs and other large companies due to the responsibility system which makes bank representatives responsible for NPLs.¹¹⁰³ Nevertheless, local Party-state representatives can effectively force them to do so, because 'local banks and local branches of national banks rely on the goodwill of the local governments to gain access to the local market,'¹¹⁰⁴ and so a good working relationship with local officials is necessary for business. Banks, therefore, regularly extend the terms of bad loans and provide bridging loans if ordered to do so.¹¹⁰⁵

Secondly, Party-state officials can force banks and individual state-company creditors¹¹⁰⁶ to forgive a part or all of a debt owed to them. Several interviewees suggested

¹¹⁰⁰ State sector companies have access to state-controlled bank finance, as discussed in Chapter 4.1

¹¹⁰¹ Also called 'shifting loans' or 'zombie loans' where the debtor borrows money to repay old loans: Interviews B1-c to B3-c, C1-c, L2-s, L4-c, L6-s. See also Ahearne and Shinada (2005); Caballero, Hoshi and Kashyap (2008)

¹¹⁰² Chapter 5.4.1.2

¹¹⁰³ See Chapter 4.1 for the details of the responsibility system. Interviews B1-c to B3-c

¹¹⁰⁴ Interview B1-c. Similar sentiment was shared in interviews B2-c, B3-c, C1-c, C5-r, C8-s, L2-s, L4-c, L6-s, L9-s, L10-s, L13-c, P1-r, P3-r, R9-c, R10-c

¹¹⁰⁵ *Ibid.*

¹¹⁰⁶ My interviews (B1-c to B3-c, R10-c) suggest that this is mostly the case in SOEs

that creditors' main reason for cooperating is their need to maintain productive relationships with local officials who can ensure that business is channelled to them in the future.¹¹⁰⁷ This notion is supported in the existing literature, which highlights in particular the reliance of companies on the state for scarce resources and corporate opportunities.¹¹⁰⁸ Moreover, as was discussed earlier, state banks and state companies are often prevented from exercising their creditor rights, including security enforcement and debt recovery.¹¹⁰⁹ Therefore, refusing to cooperate provides no gains – unless the creditors can, on an individual basis, successfully rely on one of the private alternatives¹¹¹⁰ – and near certain long-term losses of business profits that would be otherwise ensured by Party-state's support.

State-led mergers

State-led mergers – where the Party-state orders a healthy state company to merge with an ailing one – have been used on several occasions in the last few decades. The first time the Party-state experimented with the use of mandated mergers as a substitute for formal insolvency proceedings was in the 1990s in response to the fears of the impact of large losses arising from the Asian economic crisis in 1997¹¹¹¹ and the considerable

¹¹⁰⁷ Interviews B1-c to B3-c, C3-c, C7-s, E1-c, L2-s to L10-s, L14-c, L15-c, P1-r, R3-r, R7-c, R9-c, R10-c

¹¹⁰⁸ See e.g. Zhou et al (2014); Peng and Luo (2000)

¹¹⁰⁹ See Chapters 5.1.1 and 5.3.3.3

¹¹¹⁰ Discussed in Chapter 5.4.1, but not court-assisted enforcement (see Chapter 3.3)

¹¹¹¹ In 1996, banks were owed RMB 26.1 billion, but they only managed to recover RMB 11.4RMB due to bankruptcies – see Li (2006)

unemployment problem.¹¹¹² The policy was initially tested in 18 cities in 1994 and later expanded to 111 cities in 1997. As a result, the number of insolvency cases dropped dramatically in those years.¹¹¹³ Ultimately, however, it was recognised that instead of resolving underlying issues, such mergers simply shifted them onto another enterprise. Also, the merged entity often failed to ameliorate the pre-existing issues of its distressed part, which in some instances led to a financial distress of the whole merged company. In time, it became apparent that this policy could, in the long term, reduce the number of profitable companies with which to merge and even lead to a total collapse of the state economy. What's more, after several unsuccessful mergers, there was growing opposition from healthy SOEs against the merger policy,¹¹¹⁴ and so politically-driven mergers were officially abandoned in 2000 when the government started promoting the use of insolvency law again.

However, regardless of the utter failure of the merger policy under the old 1986 insolvency law, my interviewees suggested that mergers have been used in more recent times under the EBL, to deal with important, large-scale insolvencies.¹¹¹⁵ Some of my interviewees proposed that one of the key reasons why local governments opt for a merger is because they believe it is the only viable alternative to liquidation – an option which they

¹¹¹² According to the official statistics, China had 5.76 million (i.e. 3.1%) unemployed people in urban areas in 1997. Additional at least 10 million people must be added to account for so-called *xiagang* (下岗) who were laid-off but paid a nominal wage by their previous working unit. Allowing more bankruptcies was feared to exacerbate this problem and could lead to much-feared social unrest: Li (2006)

¹¹¹³ See Chapter 4.3

¹¹¹⁴ See for example the case of Shanxi Textile Dyeing Plant case in Li (2006) at 2

¹¹¹⁵ Interviews C1-c, C4-v, C5-r, C7-s, C9-c, J1-c, L2-s, L4-r to L7-c, L9-s to L12-c, L14-c, L15-c, P1-r, P3-r to P5-c, R3-r, R6-c, R9-c, R10-c

see as unacceptable.¹¹¹⁶ Others suggested that mergers are sometimes driven by a desire to create national champions – big brand names with national and international significance – for the sake of local and national economic development and often also as ‘vanity projects’ (*mianzigongcheng* 面子工程).¹¹¹⁷

State-provided financial assistance

Forced loan extensions and debt forgiveness are, of course, problematic, because the Party-state effectively rescues its preferred company but the bill is picked up by creditors.

Similarly, forced mergers compel a healthy company to absorb debts and inefficiencies of an ailing one, but often without being permitted to then make its ailing part more efficient by – most importantly – laying off superfluous staff. Given that the majority of creditors who are forced to accept less than was originally agreed, and all companies involved in the mergers, are wholly or partly state-owned, the above can be viewed as examples of the Party-state providing *indirect* financial assistance to ailing state debtors at the expense of state and other (usually minority) creditors.

Unlike the above, this section will focus on state’s *direct* financial assistance, which – at least in the short term – benefits debtors and their creditors – and indirectly also other stakeholders such as employees, customers, investors and local governments. Three mechanisms are considered in detail, namely one-off assistance (bailouts), one-off bad debt buyouts, and continuous financial support to ‘zombie companies.’

¹¹¹⁶ Interviews C4-v, C5-r, C7-s, C9-c, J1-c, L4-r to L7-c, L10-s to L12-c, L14-c, L15-c, P1-r, P3-r to P5-c, R3-r, R6-c, R9-c, R10-c

¹¹¹⁷ Interviews C1-c, C5-r, C7-s, L2-s, L4-r to L6-s, L9-s to L10-s, L14-c, L15-c, P1-r, P5-c, R3-r, R6-c, R9-c, R10-c

My interviewees argued that, in many cases, Party-state representatives provide a one-off financial injection to overcome financial distress and return a state company to financial health – at least until the representative moves on to the next political office.¹¹¹⁸ Bailouts were regularly used under the 1986 insolvency law and continue to be used as a ‘quick-fix solution’ under the EBL, too.¹¹¹⁹ Several of my interviewees suggested that the decision to bail out a state company is often motivated by government officials’ personal incentives – most importantly the desire to have good economic results, to save jobs and ensure social stability¹¹²⁰ rather than by any genuine financial analysis realistically showing that the distress is, indeed, temporary, or that the one-off assistance can return the company back to health in the long term.¹¹²¹ Financial injections usually succeed in pulling the company out of financial distress, and – in the short term – the EBL is not needed.

Similar to a bailout, albeit less obvious and often less costly, is a bad debt buyout. The most significant – and most controversial – buyout took place in the early 2000s. NPLs started accumulating in China’s financial system because of directed lending based on administrative orders rather than commercial principles.¹¹²² When banking regulations later limited the permissible amount of bad debt, banks immediately replaced all NPLs with new loans and introduced the responsibility system.¹¹²³ To prevent the resulting credit squeeze,

¹¹¹⁸ Every five years: see Chapter 5.3.3.1.
Interviews C1-c, C5-r, C7-s, L2-s, L4-r to L6-s, L9-s to L10-s, L14-c, L15-c, P1-r, P5-c, R3-r, R6-c, R9-c, R10-c

¹¹¹⁹ *Ibid.* See also Wildau and Hong (2012)

¹¹²⁰ As discussed in Chapters 3.3.3.2 and 5.3.3.1

¹¹²¹ *Ibid.* See also Durden (11.7.2016)

¹¹²² See Chapter 4.1

¹¹²³ *Ibid.*

looming defaults and asset depreciation, it was decided to move SOEs' bad debt from banks' books to one of the newly-created state-owned asset management companies ('AMCs'). Formed by the government with the aim of assuming and then liquidating the NPLs, the AMCs were wholly state-owned, non-bank financial institutions with registered (state-provided) capital of 1.2 billion USD each and with direct funding from China's Ministry of Finance. The AMCs bought the NPLs at face value, i.e. without reference to the (much lower) market valuation, which was entirely unrealistic and caused large losses to the government.¹¹²⁴ At first, the AMCs seemed to be making a good progress in disposing of the NPLs through collecting and restructuring the debts, and selling and leasing associated real property. Much of the NPLs were repackaged and sold as securities with state-provided guarantees, which greatly enhanced its marketability. Some securities were bought by foreign investors, some by ordinary people through government-organised online auctions, and some by domestic companies and investors.¹¹²⁵ Unlike banks, the AMCs could sell the NPLs at a discount to face value which enabled them to re-negotiate and recover at least some of the debts.¹¹²⁶ Often, the discounted debt was collateralised with hard assets like buildings, machinery, and land rights, which made it easier to sell.¹¹²⁷ Individual reported recovery rates ranged from 8 to 60 percent, the median being about 25 percent (although

¹¹²⁴ Pierce and Yee (July 2001) at 2-5

¹¹²⁵ Sternberg (2011)

¹¹²⁶ Interviews B3-c, C1-c, C5-r, C7-s, L2-s, L4-r to L7-c, L10-s, L14-c, L15-c, P1-r, P2-s, P5-c, R3-r, R6-c, R7-c, R9-c, R10-c. See also Gesteland (22.4.2002)

¹¹²⁷ See Asiaweek (30.11.2001). Interviews C1-c, C4-c, C5-r, C7-s, C11-c, L2-s, L4-r to L15-c, R3-r, R6-c, R7-c, R9-c, R10-c

NB: The ability to use land rights, unlike the position under the EBL (5.2.1.3), greatly enhances this alternative.

some suggest it was 5 percent).¹¹²⁸ Certain assets were disposed of quickly while others had to be written off. However, although all the losses were ultimately absorbed – directly and indirectly – by the government, the AMCs have been perceived for the past 15 years as a successful alternative to the slow and uncertain insolvency law procedures.

Bad debt buyouts outside the AMCs have also been encouraged by the state and, in many cases, the state provided guarantees which made it easier for creditors to sell to interested investors and recover at least part of their money. Several interviewees suggested that securitisation programs, involving various tranches of debt, have been actively encouraged by the state to deal with banks' NPLs.¹¹²⁹ The securitised bad debt market functioned in China until 2009 and was then reopened in May 2016 to enable the banks to deal with the mounting NPL problem.¹¹³⁰

If a debtor company continually fails to ameliorate its financial distress, it can become reliant on regular financial injections from the state. Such companies are known as zombie companies (*jiangshiqiye* 僵尸企业). Many interviewees suggested that they are a significant drain on state's resources, but instead of letting them fail, local governments prop them up with regular financial injections, claiming that these companies are too big to be effectively restructured, and that the impact of their failure on the local economy, employment and social stability would be devastating.¹¹³¹ It is undeniable that zombie companies present a real challenge to the short-term and long-term prosperity and stability

¹¹²⁸ Enterprises' auction data in Allen, Qian & Qian (2005) at 77

¹¹²⁹ Interviews C1-c, C5-r, C7-s, C9-c, L2-s, L4-r to L7-c, L10-s to L14-c, P1-r, R1-r, R0-c, R10-c

¹¹³⁰ See e.g. Weinland (20.5.2016)

¹¹³¹ Interviews C1-c, C5-r, C7-s, L2-s, J1-c, J4-c to J7-c, L4-r to L6-s, L9-s to L10-s, L14-c, L15-c, P1-r, P5-c, R3-r, R6-c, R9-c, R10-c

of their home provinces, but they are also a direct result of local governments refusing to deal with their financial distress early on, which allows them to grow without taking any measures to ameliorate their situation. By the time a company becomes wholly reliant on state support, its operations, debts and employment impact are usually too big for any government to want to close it down. Nevertheless, EBL procedures are usually not used regardless of their potential long-term economic benefits.¹¹³²

State-driven private restructuring

State companies often benefit from short-term direct and indirect financial support from the state, with little or no role played by the EBL. However, in some cases, more is needed and the state has to get involved over an extended period of time. In such cases – several interviewees suggested – the state runs corporate restructuring by arranging new management, choosing new business partners, providing money and guarantees, negotiating or enforcing compromises in existing contracts, forcing parties to cooperate, and much more.¹¹³³ One such method has been developed to respond to the variations in companies' ownership structure and sources of credit and has been used repeatedly in the past instead of the EBL. Locally it became known as 'purchase-sale restructuring,' and nation-wide as 'Changchun-style restructuring.'¹¹³⁴

¹¹³² *Ibid.*

¹¹³³ Interviews B1-c to B3-c, C1-c to C5-r, C7-s, C10-s, L2-s to L6-s, L9-s to L15-c, P1-r, P3-r to P5-c, R3-r, R6-c, R9-c, R10-c

¹¹³⁴ It was named after an old industrial city in Northeast China with many SOEs dragged down by two decades of heavy debt, redundant workers, low-quality assets, inefficient management, and old technology and equipment. It is similar to the UK prepacks and the 19th century US equity receivership.

In essence, the government takes debtor's liquid profitable assets and leases land to a new company (NewCo) which then becomes a multi-shareholder entity.¹¹³⁵ The NewCo, the distressed company and the primary creditors (the bank which originally extended credit to the distressed company usually becomes the principal lender) enter into a common agreement. The bank lends an amount of money close to the valuation of the profitable assets to the NewCo which then acquires the said profitable assets from the debtor company. The process is similar to EBL Reorganisation, with the exception that most employees are transferred to the NewCo, and the government plays a major role both in the negotiations and in the disposition of the assets to protect the employees.¹¹³⁶ The bank ends up with security over NewCo's assets, and debtor company's creditors get paid from the consideration received from the NewCo. The difficult part here is differentiating between profitable and non-profitable assets. Also, since the valuation is performed by state-authorised specialists and sanctioned by the SASAC and the primary creditor (usually a state-owned bank), there is real danger that a pro-state (i.e. low) valuation will be favoured and that non-state creditors will be effectively abandoned with recourse only to the now-empty debtor company with no profitable assets from which to repay its debts.¹¹³⁷ In some cases, non-state creditors can also receive equity in the NewCo which may remedy any bias in valuation and reimburse some of their claims, but several interviewees suggested that

¹¹³⁵ Many companies are now partly owned by private shareholders, while the controlling stake remains with the government. See e.g. Szamosszegi and Kyle (2011)

¹¹³⁶ Wang (2002)

¹¹³⁷ Similar to a ghost company: see Chapters 4.1.3.4 and 5.2.1.4

this rarely takes place where the creditors are not affiliated with the state sector.¹¹³⁸ Unsold (i.e. unprofitable) assets in the distressed company are then usually resolved through Company Law liquidation or a quick EBL Liquidation, and the debtor company is officially dissolved.¹¹³⁹

5.4.2.3 Politically-driven formal mechanism: state-led use of the EBL

In some instances, the Party-state may decide to devise a restructuring plan with the assistance of key stakeholders – such as main creditors and employee representatives – behind closed doors, with only the parties present knowing about debtor's financial distress.¹¹⁴⁰ Once a plan is approved, the state then authorises the debtor company (or the principal creditor) to officially petition for EBL Reorganisation¹¹⁴¹ in order to legitimise the pre-agreed deal under the EBL. The process is similar to the UK pre-packaged administration¹¹⁴² in which a sale is negotiated, due diligence completed, price is agreed, and all transaction documents prepared and held in an escrow before an administrator is formally appointed. The data from China suggest that something similar is taking place there,¹¹⁴³ albeit the time period between the petition and ultimate sale is slightly longer. In

¹¹³⁸ Interviews C3-c, to C5-r, E1-c to E5-c, L2-s, L4-r to L7-c, L11-c, L14-c, L15-c, P1-r, P4-c, P5-c, R2-r, R7-c, R9-c, R10-c

¹¹³⁹ Where this happens, the cases show up in bankruptcy statistics, which makes the real number of bankruptcies even lower than thought.

¹¹⁴⁰ Interviews B1-c to B3-c, C5-r, C7-s, L2-s, L4-r to L14-c, P1-r, P4-c, P5-c, R2-r, R7-c, R9-c, R10-c

¹¹⁴¹ Liquidation is sometimes used in this scheme, but only rarely: *Ibid.*

¹¹⁴² See e.g. Frisby (2007); Armour in Austin and Aoun (2012)

¹¹⁴³ Tang (2005) at 1-3: Art 79 EBL gives the parties 6-9 months to negotiate the terms of Reorganisation proposal. Most companies in this empirical study needed less than 100 days, in five cases less than 2 months,

addition, in Chinese pre-packs (v. elsewhere), the state is heavily involved through a liquidation committee which *de facto* replaces an administrator and a court.¹¹⁴⁴ The problem with this approach is that the process is carried out without the safeguards and due processes set out in the EBL.

Alternatively – my interviewees suggested – the EBL is sometimes used as an *ex ante* deterrent or an *ex post* public punishment. State companies usually enjoy an informal state guarantee that if they get into difficulties, they will be rescued.¹¹⁴⁵ This is dangerous because it creates a potent moral hazard problem. Such state companies are likely to take more risks than they would otherwise because they will enjoy the upside (i.e. they will be rewarded for the success of the business) but they will not share in the downside (i.e. the losses are absorbed by the state). The state is aware of this and uses two tools to control it.¹¹⁴⁶ Firstly, there is a real threat that criminal and personal liability may be imposed against those in charge of an insolvent company.¹¹⁴⁷ And secondly, the state tries not to rescue each and every state company which needs its help. In some cases, the state steps in and forces a state company to reorganise or liquidate publicly under the EBL to warn and deter other state companies. A recent example is the forced Liquidations of several heavy-industry companies to deal with their overcapacity and over-indebtedness.¹¹⁴⁸ Similarly, the

and in one case it took only 33 days to finish the procedure. Such speed is inconsistent with my interviewees' experience.

¹¹⁴⁴ See Chapters 4.3.1 and 4.3.2.6

¹¹⁴⁵ Interviews B1-c to B3-c, C1-c to C7-s, C11-c, E4-c, J1-c, L2-s to L15-c, P1-r, P3-r to P5-c, R1-r to R3-r, R6-c, R9-c, R10-c, R13-c

¹¹⁴⁶ *Ibid.* See also an interview with Li Shuguang (n.600)

¹¹⁴⁷ See Chapter 5.1.2

¹¹⁴⁸ Wildau (29.2.2016)

central Party-state ordered local governments in 2015 to deal with – i.e. restructure or liquidate – zombie companies in their region,¹¹⁴⁹ and courts were instructed to help in the process.¹¹⁵⁰ Subsequently, the number of EBL cases rapidly increased in 2015 and 2016.

Besides managing moral hazard, the state occasionally forces a state company to use the EBL to signal state's determination to prevent certain types of activities. This was the case in the Sanlu Milk scandal, where the company knowingly sold contaminated powdered milk, which led to the death of several babies and made further 300,000 babies sick.¹¹⁵¹ The case raised serious questions about food safety and political corruption, and so directly endangered social stability and the interests of many powerful figures.¹¹⁵² Those involved in the scandal were criminally prosecuted, two were executed, one received a suspended death penalty, and three were imprisoned for life.¹¹⁵³ The company itself did not fare much better. The brand was tarnished, and so the company was broken up and parts of the business were sold under the EBL. Several interviewees suggested that there was a lot of political pressure to use the EBL to show to the people that the issue had been dealt with, to signal to the market that such transgressions will not be tolerated, and to avoid any further allegations of corruption and cover-ups.¹¹⁵⁴ Some further believe that the EBL was used to

¹¹⁴⁹ As explained in the introduction to 5.4.2.2, above, zombie companies are state companies who rely on state bailouts for survival

¹¹⁵⁰ A senior SPC Judge Du Wanhua said that courts shall assist local government and they 'shall become hospitals for sick companies' in SPCM (3.3.2016)

¹¹⁵¹ For details, see Chapter 5.3.3.2

¹¹⁵² Interviews C1-c, C5-r, C7-s, J1-c, J4-s to J7-c, L2-s, L6-s, P1-r, R10-c

¹¹⁵³ Zhu (23.1.2009)

¹¹⁵⁴ Interviews C1-c, C5-r, C7-s, C8-s, C11-c, J1-c, J4-s to J9-c, L2-s, L4-r to L6-s, P1-r, P3-r to P5-c, R2-r, R6-c, R9-c, R10-c

publicly shame the company and those involved in the scandal, and to show that the acquirers of the assets should not be tainted by the scandal, as they are ‘a new and different body from the disgraced Sanlu.’¹¹⁵⁵

Although these EBL cases are reflected in Chinese data, it is submitted that they are *not genuine EBL procedures* since stakeholders’ interests are not sufficiently protected and balanced according to EBL provisions. Moreover, in state-driven EBL cases, independent administrators are only rarely appointed, and courts often play no or minimal role – usually mere rubber-stamping and oversight over the implementation of the pre-negotiated deal as approved by a local government.¹¹⁵⁶ Therefore, the number of genuine EBL cases is likely to be even lower than the statistics show.¹¹⁵⁷

¹¹⁵⁵ Interview P3-r

¹¹⁵⁶ See Chapter 3.3.3

¹¹⁵⁷ For further discussion, see Chapters 4.3.3 and 6.1.1

PART III: DESIRABILITY AND OPTIONS OF REFORM

Chapter 6. DESIRABILITY OF REFORMING INSOLVENCY LAW IN CHINA

Before discussing what needs to be changed in order to achieve a greater, more efficient use of the (reformed¹¹⁵⁸) EBL in China, it is first important to consider whether reforming insolvency law in China is desirable. The first part of this chapter, therefore, puts forward a number of reasons why insolvency law does matter in China (6.1). Building on this debate, the second part of this chapter then considers what is the best way to carry out such reform. It examines three key issues that are likely to arise in the process – namely the proper focus of such reforms; likely obstacles to the reforms; and best format for carrying out the reforms (6.2). This chapter, therefore, bridges the positive analysis of the constraints on the use of the EBL – explored in Chapter 5 – and the substantive reform proposals (which encapsulate the key elements of the ‘reformed’ EBL mentioned throughout this chapter) in Chapter 7.

6.1 Does insolvency law matter in China?

The importance of insolvency law in China is linked to a more general debate about the role of law in China¹¹⁵⁹ and the role of insolvency law in economic development in general.¹¹⁶⁰ Against this background, this section first considers three reasons why a greater use of

¹¹⁵⁸ For detailed suggestions, see Chapter 7

¹¹⁵⁹ See Chapter 3.3.2: law plays a limited role due to the power and control exercised by the Party-state, but is of increasing importance in private sector and in arms-length dealings

¹¹⁶⁰ See Chapter 2.3

insolvency law is desirable in China (6.1.1). The discussion then shifts to examine the benefits that China's economy may reap from a greater use of the (reformed) EBL (6.1.2).

6.1.1 Is a greater use of insolvency law in China desirable?

There are three broad arguments that support the need for a greater use of insolvency law in China. Firstly, the Chinese government itself has admitted recently that the Chinese economy needs insolvency-law mechanisms to deal with corporate under-productivity, over-capacity, inefficiency, and bad debt (6.1.1.1). Secondly, the number of insolvency-law cases per year are significantly lower than elsewhere in the world. This is true both in absolute terms – when comparing the total number of cases in China and elsewhere – and in comparative terms – as a percentage of insolvency cases per total number of companies – across several reviewed economies (6.1.1.2). And thirdly, although China does not publish data on total number of technically insolvent companies, the available economic data and other sources suggest that there may be a large number of insolvent or nearly insolvent companies whose financial distress is either ignored or is dealt with using comparatively less efficient methods (v. insolvency law) (6.1.1.3). This section argues that, together, these are strong arguments to support the call for a greater use of insolvency law in China.

6.1.1.1 Government's call for reform

The Chinese government recognised the need to introduce insolvency law early on in Deng's economic reforms – which resulted in the introduction of China's first insolvency law in

1986.¹¹⁶¹ That law was soon deemed insufficient and was replaced with the EBL in 2006.¹¹⁶²

However, in 2015, the Chinese government acknowledged that the new law does not work in its current configuration, and put the EBL on its reform agenda.¹¹⁶³ In particular, they recognised that the law should be used more often and in a more efficient manner in order to deal with the general problem of growing levels of non-performing corporate debt in China and with SOEs' overcapacity and inefficiency.¹¹⁶⁴ Finding a solution to these problems is particularly pressing in the current climate as China's economy keeps slowing and SOEs' overcapacity and inefficiency are being openly discussed and criticised as excessively costly and problematic¹¹⁶⁵ in China and abroad.¹¹⁶⁶ As a result, national and local governments, courts, experts and academics have started discussing possible improvements to the EBL.¹¹⁶⁷

¹¹⁶¹ See Chapter 4.3.1.1

¹¹⁶² *Ibid.*

¹¹⁶³ The author has been working as a part of the team that made the initial reports to the government with regards to recommendations for reforming insolvency and other laws

¹¹⁶⁴ All these problems were discussed at length at the Economic Work Conference in December 2015 and again in the regional and national government meetings at the annual sessions of the NPC and Chinese People's Political Consultative Conference in Beijing in March 2016

¹¹⁶⁵ See e.g. Wildau (22.9.2015)

¹¹⁶⁶ The economic problems include stock market crash in early 2016 and the general macroeconomic slowing resulting in, inter alia, lower GDP growth rate, lower imports and exports, stacking non-performing loans (which cost the government some USD 900 million to clean up) and zombie loans (i.e. rolled over without hope of repayment or given through state direction as a de facto periodic bailout), etc. All these problems were discussed at length in the regional and national government meetings at the annual sessions of the NPC and Chinese People's Political Consultative Conference in Beijing in March 2016. For more, see Chapter 6.1.1.3

¹¹⁶⁷ Tackling corporate under-productivity and over-indebtedness was one of five 'national goals' for 2016 as identified by the Central Economic Work Conference in December 2015. This led to a renewed interest in insolvency law and its greater use to allow closures and reorganisations of insolvent companies in China. During 2016, many zombie companies – i.e. heavily indebted SOEs which cannot survive without state financial support – have been closed down, and others are being investigated. The SPC as well as Ministry of Finance and governmental agencies have been heavily involved in the process. For an excellent overview of recent developments, see SPCM (26.2.2017)

Beijing, Chongqing, Shanghai, Tianjin and several provincial capitals have been designated pilot regions to trial new approaches¹¹⁶⁸ that are aimed at improving the EBL. SPC Judge Du Wanhua was put in charge of the nation-wide efforts to reform the EBL.¹¹⁶⁹

6.1.1.2 Insolvency law usage in China comparatively much lower

Secondly, China should encourage greater and more efficient use of insolvency law because the number of insolvency-law cases is extremely low. This holds true both in terms of the total number of insolvency-law cases and in terms of the ratio of insolvency-law cases to total number of companies in China (v. several other jurisdictions).

In terms of the total number of insolvency-law cases, China has had, on average, about 2,000 cases per year since the EBL was implemented in 2007.¹¹⁷⁰ And although Chinese courts accepted a record 5,665 insolvency-law cases in 2016, this is still less than during 1996-2003 – under the much-criticised old law¹¹⁷¹ – when courts accepted on average 6,000 cases annually (and almost 9,000 cases in 2001 when China acceded to the WTO).¹¹⁷² Despite great hopes to the contrary, the new law is, therefore, used much less than the old one (which was, itself, criticised for a low use).¹¹⁷³

Moreover, as Table 6-1 illustrates, the number of insolvency-law cases in China is still far below other jurisdictions. For example, in 2015-16 (i.e. after the global financial crisis)

¹¹⁶⁸ SPCM (30.6.2016)

¹¹⁶⁹ For more, see Chapter 7.3.5

¹¹⁷⁰ See Chapter 4.3.3 (Table 4-18)

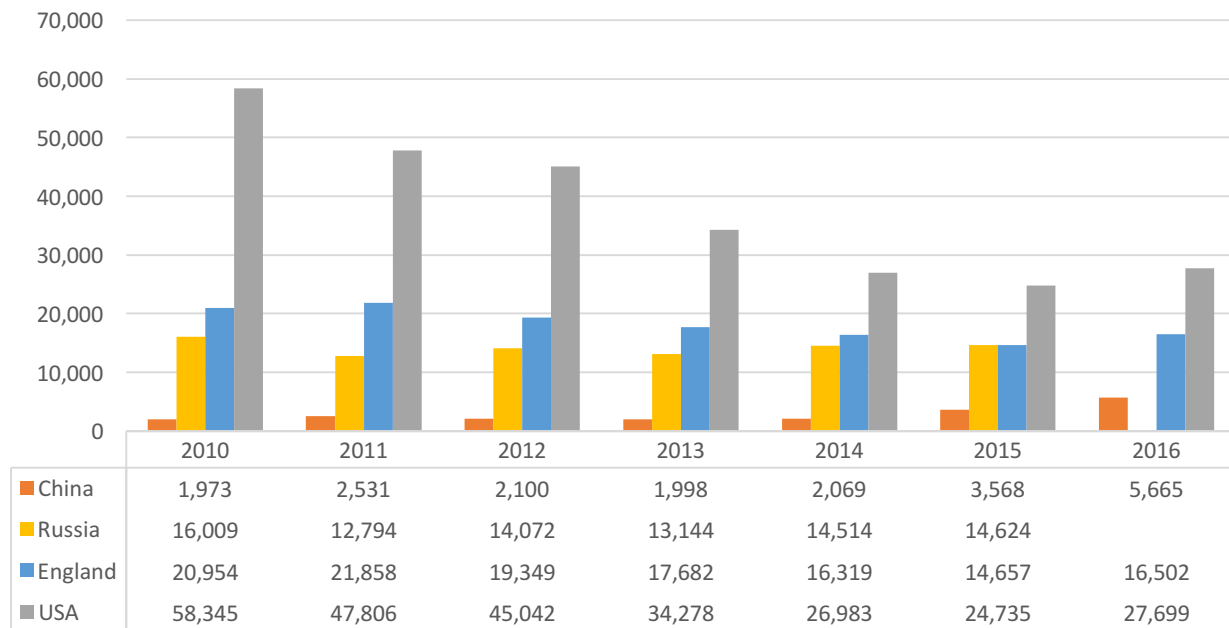
¹¹⁷¹ See Chapter 4.3.1

¹¹⁷² *Supra* n.1177

¹¹⁷³ See Chapter 4.3.1

there were on average 15,500 cases in England, 26,000 cases in the US, and 14,500 cases in Russia – but there were on average only 4,500 cases in China.

**Table 6-1: Total Number of Corporate Insolvencies
in China, Russia, England and the US in 2010-2016**



Sources: NBS, gks.ru, destatis.de, Company register UK, census.gov, abi.org

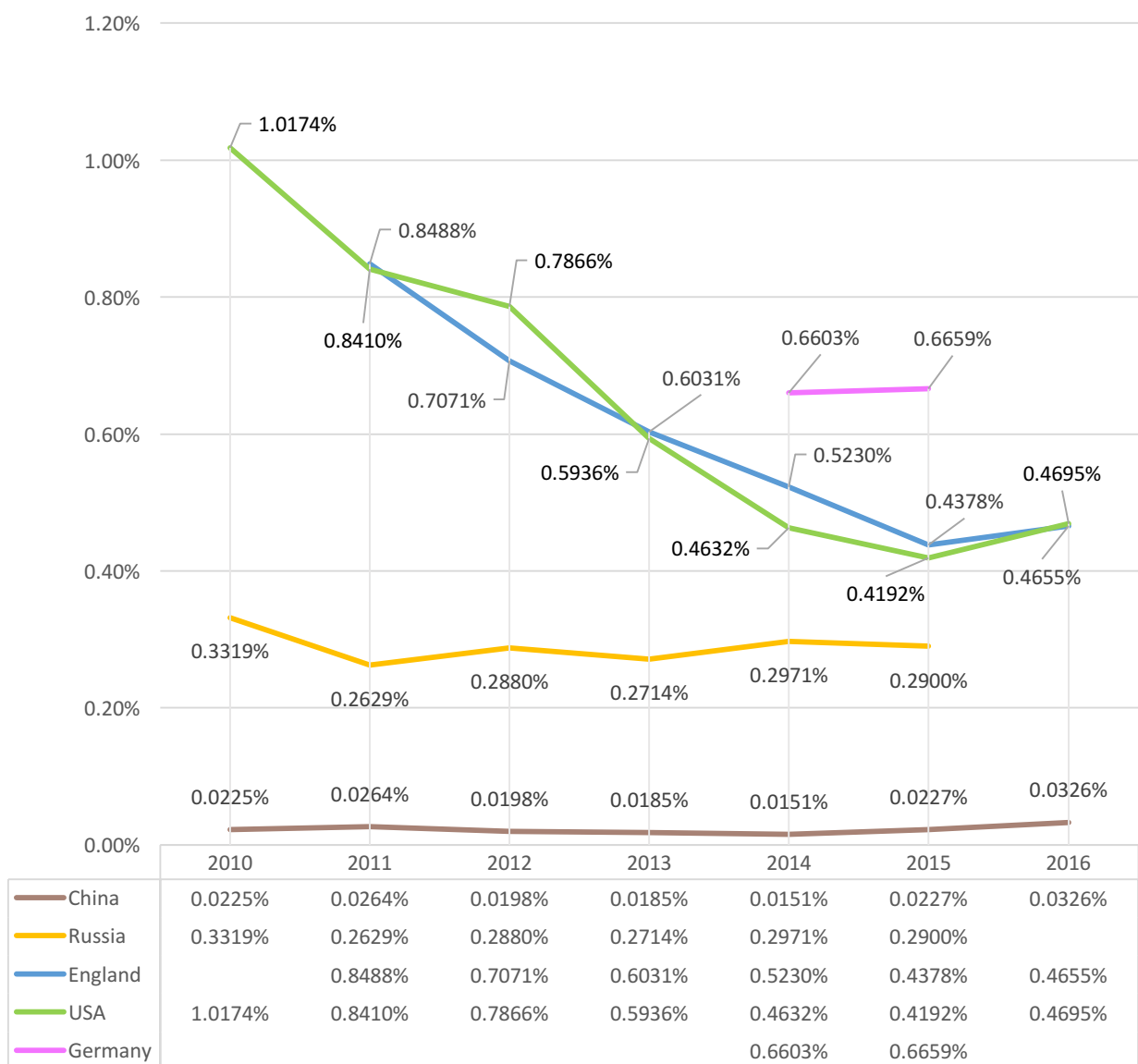
Admittedly, comparing the total numbers of cases is a crude metric. Each of these economies is different, and although the size of China's economy is similar to that of the US, China is still a developing country with many notable differences.

A more precise comparison may be drawn from looking at each country's ratio of the number of insolvency-law cases to the total number of registered companies. Interestingly, the numbers tell a similar story. As Table 6-2 shows, over 2015-16¹¹⁷⁴ – despite being China's highest level of use since the EBL was implemented – only about 0.03 percent of companies used insolvency law in China, while it was 0.29 percent in Russia (approximately

¹¹⁷⁴ This period was chosen in order to minimise the impact of the global financial crisis 2007-2010

ten times more than in China), about 0.45 percent in the US and England (approximately fifteen times more than in China), and about 0.66 percent in Germany (in 2015, which was approximately thirty times more than in China in 2015, and twenty times more than in China in 2016).

Table 6-2: Ratio of Corporate Insolvencies to Total Number of Companies in China, Russia, Germany, England and the US in 2010-2016



Sources: NBS, gks.ru, destatis.de, Company register UK, census.gov, abi.org; author's calculations

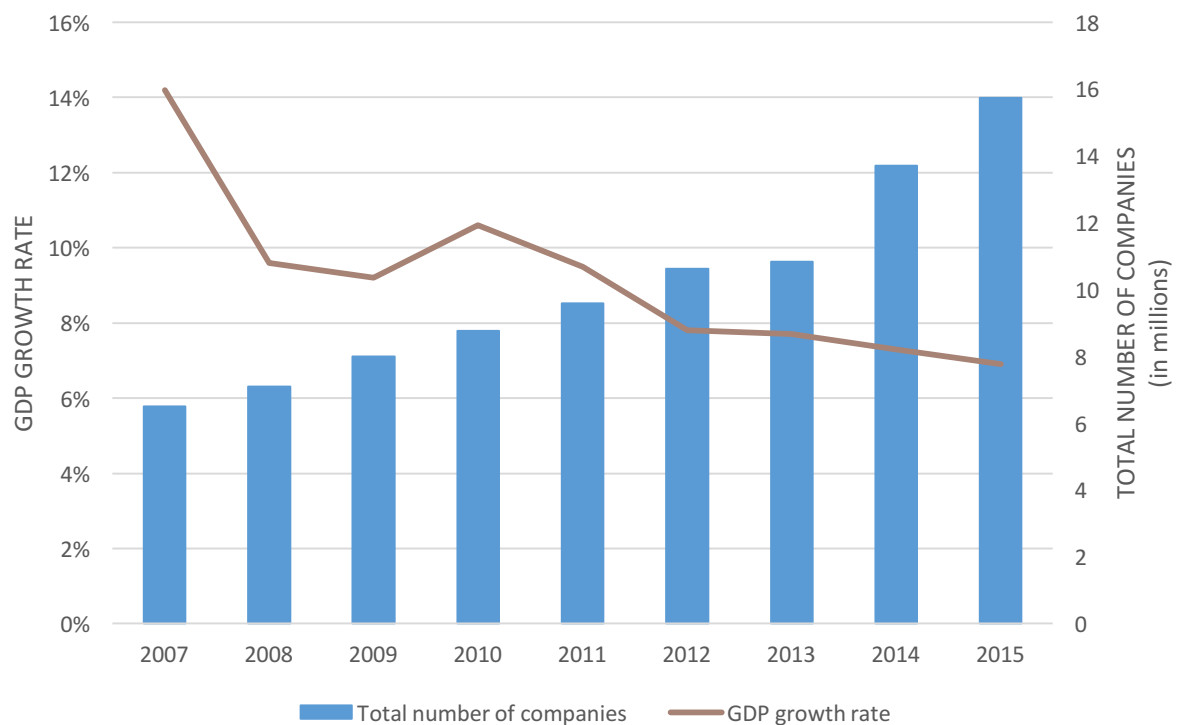
6.1.1.3 Economic need for a more efficient resolution of corporate insolvencies

A third argument for why a greater use of insolvency law is desirable relates to China's economic need for a more efficient resolution of corporate insolvencies, an introduction of discipline and fiscal responsibility into the state sector, and an empowerment of the private sector to use courts' assistance to deal with their financial distress. This section, therefore, looks at the state of China's economy as presented by its economic and financial data, newspaper stories and my interviews. It examines the economic slow-down, decreasing profitability of the state sector (which receives most bank loans), increasing volume of bad debt in the economy, indications that the EBL is not used where needed, indications that much of the EBL process is politically-driven (and so protectionist), and evidence that some companies that wish to use the EBL are barred from doing so. Together, they hint at a serious underlying problem in China's economy and strengthen the need for a more efficient solution of debt-related disputes than what is currently used in China.

China's stellar growth was long unaffected by the global slow-down. But in 2011 its annual GDP growth rate began falling¹¹⁷⁵ – as illustrated by the brown line in Table 6-3 – and reduced to around 7 percent in recent years.¹¹⁷⁶ This means that China is growing more slowly, despite the rapidly increasing number of registered companies – as illustrated by the blue columns in Table 6-3.

¹¹⁷⁵ See Table 3-1 in Chapter 3.1

¹¹⁷⁶ China Yearbooks 2008-2016

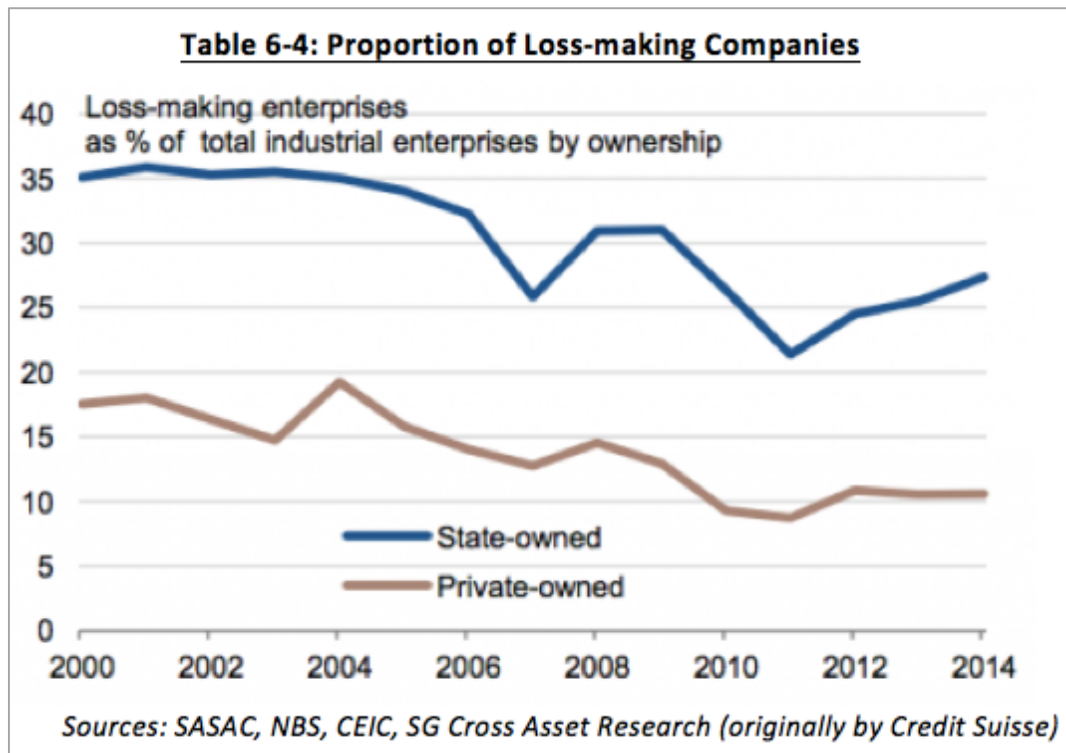
Table 6-3: China's GDP Growth Rate 2007-2015

Source: World Bank, NBS

On its own, slower rate of growth is not necessarily a bad thing. However, in China, it is further exacerbated by decreasing profitability and increasing levels of (bad) debt – discussed below – which make China's economy unstable. Together, it is reasonable to expect an increase in the number of financially distress companies.

Another economic problem that is likely to result in corporate financial distress is the decreasing profitability of many companies in China. As the next three tables illustrate, profitability of Chinese SOEs is comparatively low (v. private companies). Table 6-4 shows that the percentage of loss-making SOEs is approximately twice as high as the percentage of loss-making private companies, despite state's financial and other support to the former.¹¹⁷⁷

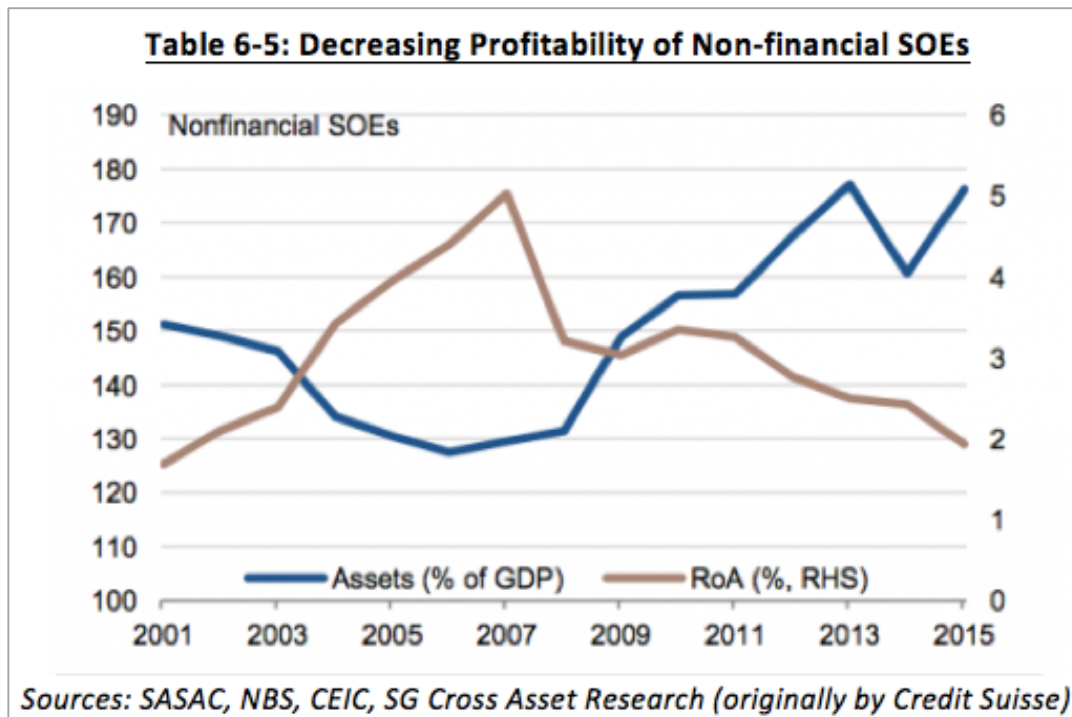
¹¹⁷⁷ See Chapter 3.4



What's more – as illustrated in Table 6-5 – profitability of SOEs is falling despite high level of state investment and consistently increasing amount (and value) of assets that they hold. The falling profitability is partly caused by the increased costs¹¹⁷⁸ – most importantly the cost of labour,¹¹⁷⁹ taxes, and materials – and partly by local governments' interventions which prevent restructuring efforts that would reduce SOEs' overcapacity – due to the fear of unrest resulting from large-scale redundancies.

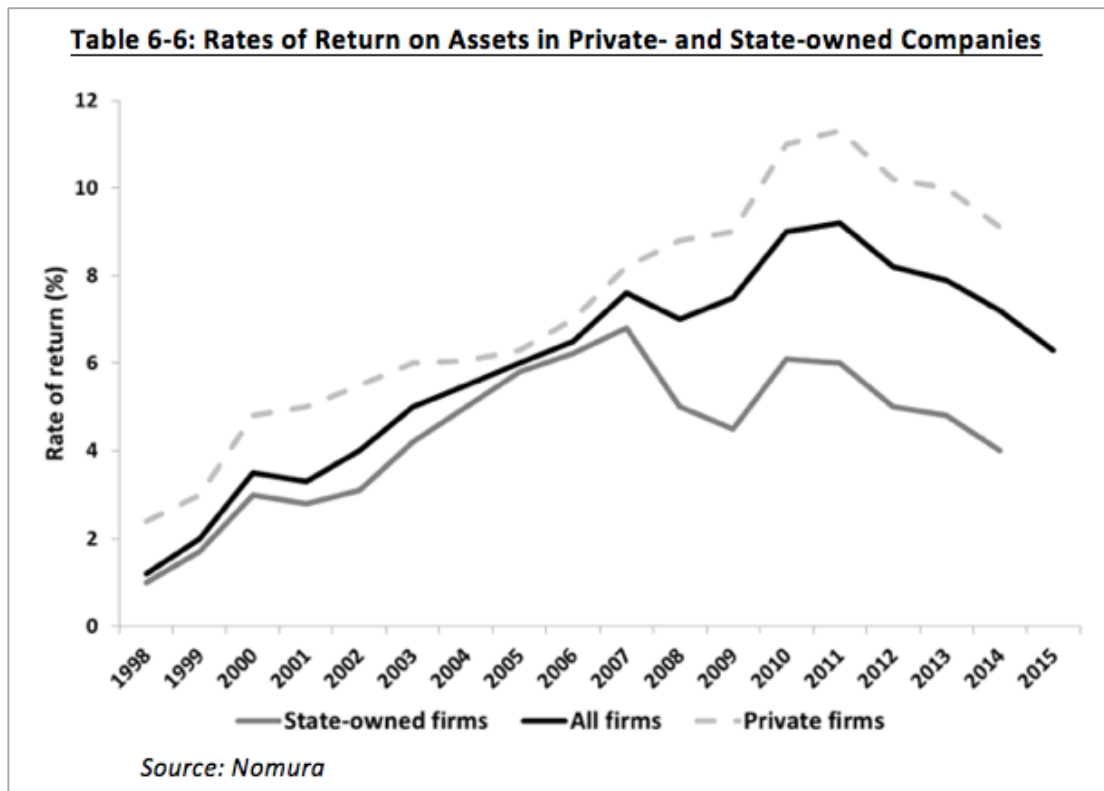
¹¹⁷⁸ But those affect private companies in the same way

¹¹⁷⁹ An annual average wage more than tripled in a decade, from 21,000 RMB in 2006 to 68,000 RMB in 2016. Similarly, minimum annual wage grew from 8,280 RMB in 2006 to 27,600 RMB in 2016. See www.tradingeconomics.com for further details.



However, as Table 6-6 shows, SOEs show much lower returns on assets than private companies, despite the fact that they receive most bank finance and other forms of state support.¹¹⁸⁰ Before 2007, the rates of return on assets in private- and state-owned companies were nearly the same. But the government's periodic stimulus efforts in the mid-2000s eventually led to excessive growth in production capacity and, without improved productivity, a significant decrease in profitability of SOEs.

¹¹⁸⁰ See Chapter 4.1.2



In the most extreme cases, these policies enabled the creation of zombie companies which rely on continuous state support to survive, and so are a drain on public finances.¹¹⁸¹

Because these zombie companies are concentrated in regions with significant economic problems – often due to their over-reliance on traditional industries such as coal mining, manufacturing, etc. – they could destabilise local economies, and therefore they attract significant political attention and protectionism. As a result, the cause of their financial difficulties is often not resolved at all, and the distress is patched up using short-term bailouts and measures that only postpone the core problem.¹¹⁸²

¹¹⁸¹ See Chapter 5.4.2.2

¹¹⁸² *Ibid.* For a discussion of local governments' short-termist incentives, see Chapter 3.3.3.2

In addition, the increasing volume of debt – and in particular bad debt – also suggests that China’s economy is harbouring many failed and financially distressed companies. As was shown in Chapter 4.1.1, the amount of total debt in China doubled between 2012 and 2016,¹¹⁸³ and the debt-to-GDP rate grew by 30 percent in the same period.¹¹⁸⁴ Similarly, the credit-to-GDP gap – which indicates credit health of a country – is three times higher than is deemed safe which may signify systemic financial distress.¹¹⁸⁵ In addition, the amount of bad debt in China’s largest banks has almost quadrupled between 2010 and 2015, reaching 1.27 trillion RMB in 2015.¹¹⁸⁶ Cleaning these up is estimated to have already cost the government over USD 900 million.¹¹⁸⁷ Moreover, many problems are concealed by rolled-over loans which the banks use to cover up the real extent of the problem.

The amount of bad debt in China’s economy is further increased due to the volume of NPLs in the shadow finance market.¹¹⁸⁸ However, unlike in bank lending, there is no official data about the size of shadow lending, there is no effective regulation of its activities, and there are many who fear that the size and riskiness of China’s shadow credit market is a ticking bomb waiting to set off a systemic financial distress which may destabilise the entire Chinese economy.¹¹⁸⁹

¹¹⁸³ See Table 4-1

¹¹⁸⁴ Table 4-2 in Chapter 4.1.1

¹¹⁸⁵ See Table 4-5 in Chapter 4.1.1

¹¹⁸⁶ See Table 4-7 in Chapter 4.1.1

¹¹⁸⁷ See Chapter 5.4.2.2

¹¹⁸⁸ See Chapter 4.1

¹¹⁸⁹ Huang (6.12.2016); La Roche (10.2.2016)

The extent of financial distress in Chinese companies can be further illustrated in the increased demand for short-term loans to finance operational costs such as bills and wages.¹¹⁹⁰ Companies' inability to pay debts as they fall due is one of two insolvency tests in the EBL which oblige a company to petition a court to use insolvency law to restructure or liquidate its business. However, the increase in demand for such short-term loans is not matched by a similar increase in the still-low number of EBL cases in Chinese courts.

Furthermore, the need for a greater use of insolvency law in China is also apparent from the number of recent high-profile cases of corporate distress and corporate failures which were not resolved through the EBL or where Party-state's heavy interference prevented courts from implementing the EBL objectively. These include high-value bond defaults – 29 in 2016 alone – including nine defaults by partly-state-owned Dongbei Special Steel Group worth 5.8 billion RMB and four defaults by Dalian Machine Tool Group worth 2.9 billion RMB;¹¹⁹¹ failures of many real estate companies in recent years;¹¹⁹² failures of 800 online P2P online lending platforms¹¹⁹³ in 2015; and numerous zombie companies which are factually insolvent but are still supported out by the (local) Party-state. Concurrently, there are many so-called ghost companies¹¹⁹⁴ – corporate corpses with unresolved liabilities, whose valuable assets were stripped and transferred to another company. In these cases, the use of insolvency law would empower an administrator to cancel the transfers, claw back the transferred assets, and distribute these assets to all

¹¹⁹⁰ Durden (10.12.2015). See also Chapter 4.1.2 and Table 4-9

¹¹⁹¹ Bloomberg (2.4.2017)

¹¹⁹² See e.g. Yan (19.3.2014)

¹¹⁹³ including Ezubao where 900,000 investors lost 50 billion RMB

¹¹⁹⁴ For more see Chapter 4.1.3.4

entitled claimholders. Instead, the EBL is not used in China, the wrongdoers can keep the spoils, the wrongdoing is not disincentivised, systemic uncertainty continues, and claimholders are left unsatisfied. This is inefficient and undesirable, especially given that the EBL could deal with this problem and improve the situation.

Furthermore, there are many other examples that suggest that objectively-enforced insolvency law could offer comparatively more efficient solution than the extralegal alternatives. Nevertheless, in China, many EBL cases are state-driven which leads to protectionism and comparatively inefficient solutions. A recent example is a state-driven restructuring of the Dongbei Special Steel Group – with 44.3 billion RMB in financial debt (including 5.8 billion RMB in unpaid bonds) and 11 billion RMB in operating liabilities – which was only commenced after pressure from creditors on all Chinese financial institutions to boycott the Liaoning Province, Dongbei's ultimate owner.¹¹⁹⁵ Nevertheless, the process has been heavily influenced by the local government and creditors do not expect to receive their strict EBL entitlements.¹¹⁹⁶

In addition, all my interviewees agreed that, in their experience, most demand for the EBL comes from creditors – which is similar to what happens in the UK, US, Russia and elsewhere. Nevertheless, a recent statistical analysis by Ma Jian for INSOL China¹¹⁹⁷ reveals that almost 70 percent of the *accepted* EBL petitions¹¹⁹⁸ are filed by a debtor. There are several possible explanations. Mr Ma suggests that creditors do not trigger the EBL because

¹¹⁹⁵ See e.g. Leng (13.10.2016)

¹¹⁹⁶ *Ibid.* Also Interviews B2-c, B3-c, C1-c, L4-r to L6-s, L14-c to L17-c, R10-c

¹¹⁹⁷ SPCM (14.11.2015)

¹¹⁹⁸ This is not the same as *filed* petitions – for more, see Chapters 5.1.1 and 5.3.3.3

they do not know the true state of financial health of its debtor; or they know but hope that the debtor recovers. Although these may be true in some cases, my research points to other explanations. My interviewees suggested that some market creditors submit their EBL petition but never hear back – either because their claim is not recognised by courts (e.g. shadow market participants),¹¹⁹⁹ or because the Party-state does not authorise the petition.¹²⁰⁰ Alternatively, some creditors wish to use insolvency law, but are not willing to initiate an EBL procedure because of the low expected payoffs.¹²⁰¹ Regardless of the reason, the high proportion of debtor-initiated EBL cases does not appear to be consistent with creditors' high demand for EBL procedures. This apparent lack of creditor-initiated EBL cases may be further evidence that there is a greater demand and need for EBL cases than is currently represented in the volume of use of the EBL in China.

Finally, many of my interviewees argued that there are many debtors and creditors who wish to use the EBL, but are not allowed to do so by courts and Party-state representatives. Courts sometimes ignore EBL petitions from the parties who do not have the Party-state's express approval.¹²⁰² Furthermore, as was discussed in Chapter 5.2.3, debt contracts concluded by shadow lenders and borrowers are not able to use the EBL because their debt contracts are not recognised by courts. In addition, by coming forward, they may face liability for being involved with shadow market or for lending into restricted sectors.

¹¹⁹⁹ See Chapter 5.2.3

¹²⁰⁰ See next paragraph

¹²⁰¹ Instead, they use non-EBL alternative mechanisms which they perceive as giving them higher payoffs: see Chapter 5.4

¹²⁰² See Chapters 5.1.1 and 5.3.3

And lastly, several interviewees also suggested that the parties are also sometimes pressurised into not using the EBL by an interested Party-state body.¹²⁰³

Together, these arguments provide significant support to the call for further reform of insolvency law in China in the hope that the parties will become empowered and incentivised to resolve their financial distress – through a timely and orderly use of EBL Reorganisation or Liquidation – using insolvency law and its protections.

6.1.2 How can the Chinese economy benefit from a greater use of the (reformed) EBL?

A greater use of the (reformed) EBL has the potential to deliver several economic benefits.

First, the (reformed) EBL may deliver comparatively more efficient solutions to financial distress than the currently-used non-EBL alternatives, particularly in more complex cases¹²⁰⁴

(6.1.2.1). Second, the (reformed) EBL may offer a better solution to creditors and other claimholders than the currently-used avoidance mechanisms which lead to non-payment

(6.1.2.2). Third, earlier interventions under the (reformed) EBL is likely to improve the control of bad debt (6.1.2.3). Fourth, it is likely that the cost and amount of credit in

China¹²⁰⁵ would ameliorate pursuant to improvements in the EBL (6.1.2.4). Fifth, it is also likely that China would experience better allocation of resources¹²⁰⁶ once the EBL and its

¹²⁰³ See Chapters 5.3.3 and 5.4.2.1

¹²⁰⁴ Some forms of sophisticated private workouts and state-led use of the EBL may, in some cases, also achieve this. However, the former may be hard to enforce and the latter are often politically-driven and protectionism.

¹²⁰⁵ Similar to the predictions in empirical literature: Chapter 2.4.1

¹²⁰⁶ Another prediction in prior literature: Chapter 2.4.2

surrounding rules and practices are improved (6.1.2.5). Sixth, using the (reformed) EBL regime may improve business environment and so lead to more investment and more entrepreneurship¹²⁰⁷ (6.1.2.6). And seventh, reforming the EBL may improve the rule of law in China (6.1.2.7).

6.1.2.1 Limitations of alternative debt enforcement mechanisms in post-2007 China

Non-EBL alternatives – discussed at length in Chapter 5.4 – are often used instead of the EBL because the parties believe that they will produce higher payoffs or because the parties are prevented from using the EBL. Allen, Qian and Qian argue that informal mechanisms will always dominate any formal mechanisms.¹²⁰⁸ However, although it may be true that – particularly in the earlier stages of development – informal mechanisms such as reputation mechanism, bailouts, and private workouts play an important role,¹²⁰⁹ it is not accurate at this stage of China’s economic development to suggest that informal mechanisms are superior or are alone sufficient to deal with financial distress.¹²¹⁰ This is mainly because as transactions grow increasingly complex, finding a resolution for the aggrieved parties becomes more and more difficult, or it may be outright impossible without an outside adjudicator.¹²¹¹

¹²⁰⁷ As predicted in empirical literature: Chapter 2.4.3

¹²⁰⁸ Allen, Qian and Qian (2005)

¹²⁰⁹ See also Clarke, Murrell and Whiting (2007); Allen, Qian and Zhang (2011); Minzner (2006)

¹²¹⁰ For a general discussion of the limitations of informal system see Yueh (2013); Chapter 2.3.4

¹²¹¹ See Yueh (2013) Chapter 2.5. For a longer discussion of this issue see Mrockova in Scaffardi (2015)

Moreover, the increasing complexity is often accompanied by an increase in the number of stakeholders involved – and so a much higher chance of encountering coordination problems and conflicts of interests. In addition, many transactions now take place at arms-length and so the parties often do not have sufficiently developed relationships to rely on informal relational solutions.¹²¹² Although there is no doubt that most parties first try to resolve their disagreements and force repayment informally, my interviewees agreed that this is often unsuccessful and so the parties have to rely on more formal enforcement – either through DDR or in courts. As a result, formal mechanisms become crucial for resolving more complex transactions where the parties cooperate at arms-length basis. Therefore, as Thalen and others argue, at certain stage, informal and formal mechanisms start coexisting and create a menu of solutions¹²¹³ to suit parties' individual needs and limitations. Arguably, China is at that stage.

What's more, some informal debt enforcement mechanisms in China involve criminal or otherwise undesirable behaviour, which should be disincentivised. For example, threats against debtors' personnel and their families often lead to violence and occasionally even death.¹²¹⁴ Similarly, the use of violence and looting against a debtor company¹²¹⁵ often lead to personal and property damage, which should be avoided. In the same way, the (legal) mechanism of detaining debtor's personnel to achieve repayment¹²¹⁶ is unsafe, it

¹²¹² In particular, the most informal mechanisms such as reputation mechanism, personal pressure, etc.

¹²¹³ For more see Chapter 3.3.1

¹²¹⁴ Hornby and Zhang (30.3.2017): debtor's mother was attacked and sexually insulted in front of the debtor who then killed one of the attackers

¹²¹⁵ See Chapters 4.2.1.2 and 5.4.1.2

¹²¹⁶ *Ibid.*

limits personal freedom, and damages China's image as a good investment destination. Moreover, Party-state-led non-EBL mechanisms¹²¹⁷ are often costly (e.g. bailouts), inefficient as they only protect certain parties and their interests (e.g. employees) at the expense of other worthy claimants (e.g. secured creditors), and they are limited as they may temporarily fix a particular problem but they often fail to address the root of the problem (e.g. mergers of healthy and distressed SOEs, or financial support of zombie companies).¹²¹⁸ Local governments' solutions may also be short-termist¹²¹⁹ and inefficient (e.g. shielding SOEs from competition from a more efficient private sector, or forcing banks to provide bridge loans to zombie companies).

Consequently, formal mechanisms may, in certain situations and for certain types of claimants, offer comparatively more efficient solution and disincentivise undesirable behaviour better than informal mechanisms.

6.1.2.2 Non-payment pursuant to avoidance mechanisms in China

The low use of the EBL is also problematic for the economy as the parties sometimes avoid repaying their debts altogether by using avoidance mechanisms. This section examines three such avoidance mechanisms that result in non-payment. Firstly, it looks at how debtors try to avoid having to repay. Secondly, it examines how state banks choose to forego debt enforcement where this would reflect poorly on their financial performance. And finally, it looks at how local governments prevent debt enforcement in order to make

¹²¹⁷ See Chapters 5.4.2.2 and 5.4.2.3

¹²¹⁸ For more details, see Chapter 7.3.4

¹²¹⁹ For more see Chapters 3.3.3.2 and 5.3.3.1

SOEs and state banks under their control look healthier¹²²⁰ – and so improve the perception of their leadership qualities and fulfilment of the career-progression criteria. These avoidance mechanisms are summarised in Table 6-7.

Table 6-7: Avoidance mechanisms that result in non-payment of debt in China

	Aim	Mechanisms used
Debtors' mechanisms	to avoid having to repay	(i) bosses run away (ii) ghost companies
Banks' mechanisms	to not enforce payment	(i) extend/roll over existing loan (ii) new (bridge) loans (iii) IPO (iv) <i>debt-for-equity swap agreements*</i>
Local governments' mechanisms	to find and enforce a preferred solution	(i) provide state guarantees (ii) force state banks to write off bad debt (iii) <i>force state banks to swap debt for equity*</i> (iv) <i>transfer bad debt from state banks to asset-management companies*</i>

** denotes that some payment may be received; nevertheless, the mechanism is not more efficient than the (reformed) EBL*

Debtors' avoidance mechanisms

Informal and shadow lending agreements are often initially enforced through threats and violence. Debtors' common response to such threats is paying up – even if they have to borrow from their family and friends or the shadow market to do so.¹²²¹ However, several of my interviewees suggested that in some limited cases where debtors do not have the money to repay or where avoidance is less costly than repayment,¹²²² and if they think they

¹²²⁰ NB: It not unusual that banks make soft loans and that state steps in to help state-owned companies resolve their financial distress: Fan, Huang and Zhu (2007) at 3

¹²²¹ Interviews C1-c to C5-r, C7-s, C11-c, E1-c to E3-s, IF1-s, IF2-c, L1-r to L6-s, L9-s to L14-c, L16-c, R2-r, R3-r, R6-c, R7-c, R9-c, R10-c

¹²²² In terms of a cost-benefit analysis: Chapter 2.1

can act quickly enough, debtors may go into hiding or run away to another province or abroad to avoid having to repay their debts.¹²²³ This is often the case where the debts are very large,¹²²⁴ or where debtors may face serious criminal liability for their involvement in the shadow lending market.¹²²⁵ Probably the most famous case of ‘the run-away bosses’ took place in Wenzhou in 2011 where several bosses of both large and small private companies ran away to avoid the consequences of what one observer described as ‘reputation and violence [replacing] laws and courts.’¹²²⁶ Although only a few entrepreneurs can afford to and dare to disappear like this,¹²²⁷ several interviewees suggested that if the EBL worked better, debtors would be incentivised to stay and resolve their debts¹²²⁸ which would be more efficient and more desirable for creditors and debtors alike.

Besides running away, debtor company’s management also sometimes transfer all valuable assets out of the ailing company and into a new company. What is left behind is known as a ‘ghost company.’ Such transfers are often left unreversed and unpunished¹²²⁹ – despite the fact the EBL orders an administrator to reverse all such transfers and claw back the assets for the benefit of debtor’s claimholders. If the EBL was used in such cases, avoiding debt repayment would become much more difficult.

¹²²³ *Supra* n.1212. See also Chapter 5.1.2.2; Zhao and Qing (29.9.2011)

¹²²⁴ *Ibid.*

¹²²⁵ For details see Chapters 5.1.2 and 5.2.3

¹²²⁶ EEO (8.10.2011); Yap and Orlik (15.2.2012)

¹²²⁷ Consequently, creditors’ threats remain, in general, a powerful debt enforcement tool

¹²²⁸ Interviews C5-r, C7-s, E1-c to E3-s, IF1-s, L2-s, L4-r, L6-s, L10-s, L14-c, R3-r, R6-c, R9-c, R10-c

¹²²⁹ See Chapter 4.1.3.4

State banks' avoidance mechanisms

Interestingly, creditors also sometimes prefer not to enforce repayment of their debts.

Although bank officials are now personally liable for failed loans,¹²³⁰ even more important is the overall image and financial performance of the bank as a whole. This is because, firstly, banks are now subject to macro-prudential regulation which defines maximum permissible level of bad assets,¹²³¹ and secondly, because bank managers' career progression into other managerial positions within the state-owned sector or bank regulator depends on their performance. As a result, non-performing debt is often restructured so as to be reclassified from a bad asset to a good asset (or as an investment). This can be done by providing bridging loans – i.e. repaying an old loan with a new one, with longer maturity – or by changing the terms of existing loans – e.g. by extending the maturity, or by agreeing to accept non-monetary or non-cash assets in satisfaction of the debt.¹²³²

Local governments' avoidance mechanisms

The Party-state influences political, social and economic happenings in China. As was discussed in Chapter 3.3.3.2, Party-state officials in local governments who wish to progress their careers have to meet certain socio-economic targets. At the same time, they control local SOEs and local branches of banks which rely on their protection for access and ease of business.¹²³³ As a result, the officials make and enforce the rules against their companies, and so they face a significant conflict of interests.

¹²³⁰ See Chapter 4.1

¹²³¹ *Ibid.*

¹²³² Chapter 5.4.2.2; McMahon (22.12.2014)

¹²³³ For more, see Chapters 3.3 and 4.1

The national-level Party-state tried to resolve this conflict by liberalising management and decision-making of both SOEs and state banks to make them more independent from the state. However, in reality, they are still perceived by (mostly local) governments as administrative extensions of the Party-state, and so they have to comply with (local) Party-state's ideology and directions. Several interviewees suggested that, as a result, state-sector debtors and creditors are often prevented from using the EBL at a local level.¹²³⁴ Instead, state-controlled creditors are often forced to write off their debts, or they have to accept debt-for-equity swaps in ailing companies in full satisfaction of their debts.¹²³⁵ These mechanisms often lead to unsatisfactory outcomes – either non-payment or an unwanted form of part-repayment – which is inefficient for the economy and undesirable for individual creditors.

Local governments also try to prevent corporate failures by providing state guarantees – and paying up when the debtor company fails to repay – and by creating asset-management companies that buy bad debt off banks and SOEs at full price and disposed of the bad debt as securities.¹²³⁶ Although these mechanisms, *prima facie*, result in full repayment of creditors' claims, the solution is inefficient because the bad debt is simply buried and paid off using public money which could and should be better spent elsewhere.

¹²³⁴ Interviews C1-c to C5-r, C7-s, C11-c, IF1-s, L1-r to L6-s, L9-s to L14-c, L16-c, R2-r, R3-r, R6-c, R7-c, R9-c, R10-c

¹²³⁵ *Ibid.* See also Chapter 5.4.2.1; Ren (10.3.2016); Sweeney (24.2.2017)

¹²³⁶ For more details, see Chapter 5.4.2

6.1.2.3 Control of bad debt under the (reformed) EBL

The size of corporate and state debt is enormous and growing in China – as was discussed in Chapter 4.1 – and much of it is non-performing. The (reformed) EBL can help control bad debt. Timely use of Liquidation – where a debtor company cannot be efficiently saved – and Reorganisation – where a part or whole business can be restructured and saved – could help manage the existing bad debt and prevent further piling up of bad debt in already distressed debtors. It could also provide comparatively better return to creditors (v. later) because timely closure and sale of assets would most likely attract a better sale price. For this to work – and to disincentivise and prevent still healthy companies from taking on excessive amounts of risky debt – the EBL would have to be allowed to impose hard-budget constraints and actually impose a duty¹²³⁷ to reorganise or liquidate financially distressed companies. This would introduce more market discipline and companies would only be able to borrow limited amount of money – which would constrain the maximum amount of bad debt that they can accumulate if (or by the time) they fail.

In addition, a greater use of the (reformed) EBL may also prevent deepening of financial distress of companies that are run in an inefficient manner by closing them down or reorganising them. The EBL could then redistribute (sell) their assets to more efficient users or enable restructuring to remove the impediment(s) that was responsible for the initial inefficiency. For this to work, however, it is necessary to change state-controlled parties' incentives. At the moment, state creditors (mostly banks) and state debtors (mostly SOEs) expect to be bailed out or otherwise assisted in case of financial distress. This creates

¹²³⁷ Such duty existed in the original Shenzhen insolvency law – see Chapters 4.3.1 and 7.1.4.1

moral hazard where state-controlled debtors have no incentive to try to improve their indebtedness¹²³⁸ because of their belief that they will be assisted by the state, and they also take great risks because they would benefit from the upside and would be bailed out if the risk materialises and they become financially distressed.¹²³⁹ Several interviewees explained this phenomenon by pointing to local governments' short-term incentives to maintain socio-economic stability – and so save failing companies – and their reliance on maintenance of employment and the tax revenue streams.¹²⁴⁰ This is particularly pronounced in cases of large, important companies which are interconnected with other important players in the economy, and which are, as a result, not usually allowed to fail because of the rippling effect that would have on the local economy.¹²⁴¹ Instead, they are resolved behind closed doors with a heavy involvement of local Party-state representatives.

These consequences of the non-use of the EBL create serious problems for the economy in general because soft-budget constraints and near-certainty of state solution incentivise healthy state companies to deliberately take too much risk. Changing these incentives, and not allowing distressed companies to continue without changing their financial strategy or direction would also help reduce governments' debt because they would not waste public resources in rescuing over-indebted enterprises. It is likely that, in the long term, this is the only way how China can manage its growing bad debt burden.

¹²³⁸ A degree of risk-taking is common in all firms – in China and abroad – but the near-certainty of state intervention worsens this tendency

¹²³⁹ See e.g. Tirole (2006) Chapter 1; Pauly (1968) at 535

¹²⁴⁰ Interviews C1-c to C5-r, C7-s, C11-c, IF1-s, L1-r to L6-s, L9-s to L14-c, L16-c, R2-r, R3-r, R6-c, R7-c, R9-c, R10-c. For details see Chapter 3.3.3.2

¹²⁴¹ Note a similarity with the too-big-to-fail phenomenon. See e.g. Sorkin (2009)

6.1.2.4 Improved availability and lower cost of credit pursuant to objective enforcement of the (reformed) EBL

Another potential improvement resulting from better enforcement of the (reformed) EBL relates to the availability and cost of credit. Empirical studies suggest that it is fairly common in emerging markets that credit is scarce and expensive as creditors only release little credit and require higher premiums to reflect the difficulties that they face when seizing assets and liquidating distressed companies to recover their debts.¹²⁴² Traditionally, debt-provision in China suffered from the same shortcomings.¹²⁴³ Many policies have been released to ameliorate the situation. However, much still remains to be done as private companies still struggle to access (enough) cheap credit in order to continue growing.

As was discussed in Chapter 2.3.1, one of the elements that may contribute to an increased availability and lower cost of credit is an efficient insolvency law regime. It is likely that the reformed EBL would enable such provision of credit. Even if state banks only continue lending to the state-sector companies, there is an increasing number of other sources of credit.¹²⁴⁴ However, at the moment, reasonably-priced¹²⁴⁵ arms-length lending is provided only where it is possible to predict whether a lender will be able to recover their debt, under what conditions, and what is the likely scope of recovery. In China today such risk-analysis is too difficult which makes arms-length finance scarce and expensive.¹²⁴⁶

¹²⁴² See e.g. Fan, Huang and Zhu (2007)

¹²⁴³ See Chapter 4.1 and 3.4

¹²⁴⁴ See Chapters 4.1.1 and 4.1.2

¹²⁴⁵ Excessively expensive shadow lending is available, but is very prohibitively costly and risky: see Chapter 4.1

¹²⁴⁶ *Ibid.*

Building on the predictions and observations in prior literature,¹²⁴⁷ the access to and the cost of arms-length finance is likely to improve if the debt-enforcement process becomes more predictable, if arms-length finance providers receive objective and equal treatment, and if state protectionism is limited or removed – all of which may be achieved under the (reformed) EBL. Similarly, arms-length lending would likely become much easier and cheaper if courts respected the priority of security rights – which can also be achieved under the (reformed) EBL. Given China's stage of development – where further growth and economic opportunities arise largely from arms-length, cross-provincial and cross-border relationships – a functioning insolvency law is crucial to enabling arms-length transactions to take place. Most of the expansion of China's economy in recent years relied on the private sector which, in turn, was forced to rely on expensive and highly volatile shadow finance where credit contracts are often hard to enforce or are enforced using undesirable methods.¹²⁴⁸ However, going forward, greater and more objective enforcement of the (reformed) EBL will likely be necessary to enable further expansion of the private sector without the risk and instability that have been associated with its growth so far.

6.1.2.5 More efficient allocation of resources and fewer value-destroying activities under the (reformed) EBL

Greater use of the (reformed) EBL is also likely to lead to a more efficient allocation of resources – as predicted in the literature¹²⁴⁹ – and fewer value-destroying activities by

¹²⁴⁷ See Chapter 2.3.1

¹²⁴⁸ See Chapters 4.1.2 and 6.1.2.1

¹²⁴⁹ See Chapter 2.3.2

financially distressed companies. Resources – labour, credit, input materials – are scarce, and so they need to be allocated to the most efficient user¹²⁵⁰ to ensure maximum returns. Unlike the initial period of growth when China could rely on a seemingly unlimited supply of cheap labour, China has now arguably reached a stage where further growth needs to be derived from increased efficiency rather than crude increases in the input.¹²⁵¹ Similarly, the limited supply of credit and raw materials also needs to be allocated based on efficiency – measured by, *inter alia*, return on assets, productivity, profitability, etc. – rather than based on political connections and protectionism. If companies faced hard-budget constraints and their survival was determined by efficiency-driven non-protectionist application of the (reformed) EBL, resources would either be retained in the same company but put to a better use following restructuring,¹²⁵² or they would be freed up after liquidation for more efficient users. This includes, firstly, money being allocated to efficient, profitable companies – many of which have no access to legal credit at the moment – rather than to prop up distressed SOEs; and secondly, materials and workforce from closed inefficient companies (SOEs and private) being used by others who can produce relatively greater returns on assets. The ability of insolvency law to do these things was recently recognised in the context of overcapacity and inefficiency of SOEs – and in particular zombie companies – when the government pushed the number of EBL cases to 5,665 cases in 2016 – almost double the number in 2015.

¹²⁵⁰ Or at least relatively more efficient than the previous user

¹²⁵¹ Yueh (2013)

¹²⁵² Where informal attempts failed

Moreover, timely use of EBL Reorganisation and Liquidation may also prevent further destruction of value. It is generally accepted that if Reorganisation is used too late, it may not be possible to save a business or even a whole company which could have been done earlier in the process by, for example, changing production methods, refocusing on different regions, upgrading technology, changing company policies, replacing management, or making other necessary changes. Similarly, if Liquidation is used too late, it is likely that more resources had been wasted in an attempt to save the company; the need for fast sale of assets is likely to push the sale prices even lower; the situation may worsen and become more complex in the meantime which may, in turn, make the process longer and more costly; and in China there is also the danger of looting by angry employees when the firm is closed. A timely, more predictable use of insolvency law has the potential to minimise a lot of these negative effects present in China at the moment, and so minimise destruction of value.

6.1.2.6 Better business environment, more investment, and more entrepreneurship pursuant to objective enforcement of (reformed) EBL

More objective enforcement of the (reformed) EBL may also have a positive impact on business environment in China. It is likely that resolving SOEs' financial distress objectively using insolvency law could lead to a short-term reduction in exports and sales of domestic products in certain industries. However, in the long-term, greater use of the (reformed) EBL is likely to lead to higher profitability;¹²⁵³ greater recoverability of debts;¹²⁵⁴ lower levels of

¹²⁵³ See Chapters 6.1.1.3 and 6.1.2.5

¹²⁵⁴ See Chapter 6.1.2.2

bad debt;¹²⁵⁵ reduced or no need to provide wasteful subsidies to inefficient SOEs;¹²⁵⁶ greater amount of cheaper credit that would be allocated using market mechanisms rather than protectionism and connections;¹²⁵⁷ better use of resources;¹²⁵⁸ stronger rule of law, more transparency and predictability;¹²⁵⁹ and more opportunities for private companies to grow and take their rightful place as national champions – as many have done already.¹²⁶⁰ Together, these improvements would also lead to a dramatic improvement in the business environment which – all my interviewees agreed – would encourage more domestic, intra-provincial and international investment and more entrepreneurship activity.¹²⁶¹

In terms of *increased investment and new trade cooperation*, many of my interviewees suggested that domestic and international investors are worried about the slow-down and problems in China's economy.¹²⁶² Although this is not reflected significantly in the data yet, my interviewees revealed some of their clients are considering alternatives and exit strategies if Chinese economic indicators continue to decline and if the local business environment does not improve.¹²⁶³ It is, therefore, very important to restore

¹²⁵⁵ See Chapter 6.1.2.3

¹²⁵⁶ See Chapters 6.1.2.3 and 6.1.2.5

¹²⁵⁷ See Chapters 6.1.2.4 and 6.1.2.5

¹²⁵⁸ See Chapter 6.1.2.5

¹²⁵⁹ See Chapter 6.1.2.7, below

¹²⁶⁰ See Chapter 3.4

¹²⁶¹ Commercial parties are increasingly enraged by the Party-state's interference because 'it is impossible to do business in an environment like this.' (Interview E2-s). See also Wildau (27.7.2016)

¹²⁶² Interviews B1-c to B3-c, C1-c to C7-s, C9-c, C11-c, E1-c, E2-s, E5-c, J6-s to J9-c, L2-s, L4-r to L7-c, L9-s to L17-c, P1-r, P2-s, P4-c, P5-c, R1-r to R4-c, R6-c, R7-c, R9-c, R10-c, R12-c, R13-c

¹²⁶³ Interviews B1-c to B3-c, C1-c to C7-s, C9-c, C11-c, E1-c, E2-s, E5-c, J6-s to J9-c, L2-s, L4-r to L7-c, L9-s to L17-c, P1-r, P2-s, P4-c, P5-c, R1-r to R4-c, R6-c, R7-c, R9-c, R10-c

investors' trust in order to keep receiving investment from within China and from abroad. For investors and finance providers that already operate in China, enhanced enforcement of insolvency law would lead to greater predictability of business outcomes as well as greater procedural and legal transparency, and so lower risk of doing business in China. This would enable these companies to invest more time and money in potentially profitable ventures and to engage in more complex transactions than is possible now thanks to the increased certainty that they can effectively (contractually or otherwise) protect their interests even if their counterpart fails. For the players who are considering potential cooperation with China, but have so far deemed it too risky or too unpredictable, greater and fairer enforcement of insolvency law would remove their fear and enable them to expand their operations and cooperation which, if planned well, is likely to profit both counterparts.

In addition, improved enforcement of the (reformed) EBL may also *encourage more entrepreneurship* – both in terms of greater creativity and (healthy) risk-taking by existing entrepreneurs, and entry of new entrepreneurs onto the Chinese market. More entrepreneurial activity leads to a healthier private sector and stronger economy. As was discussed in Chapter 3.4, China's private companies are crucial for its economy – they now provide most new jobs, they export more goods than SOEs, generate a large amount of tax, and significantly contribute to China's GDP growth. However, a precondition for entrepreneurial activity is that those with good ideas have access to sufficient funding and resources. Since both are scarce, it is important to ensure that it is possible to close down unsuccessful ventures and recycle the resources from failures to successes to feed further

economic growth.¹²⁶⁴ Insolvency law provides a collective mechanism through which such liquidations and recycling can be done.

Similarly, (potential) entrepreneurs also care about the existence of clear, fairly enforced rules that govern the consequences of potential failure, enable fresh start, and so also encourage creativity and enable risk-taking. Personal bankruptcy law and corporate insolvency law can ensure that entrepreneurs are only punished for actual wrongdoing, and that, instead of fearing failure or punishment, they are incentivised to be creative. Failure and new beginning are vital elements of a well-functioning market economy. Where the rules are enforced in a predictable, fairer way, private entrepreneurs are more likely to start new ventures and, in many cases, succeed thanks to the lessons learnt from their previous failure(s).

6.1.2.7 Improved rule of law in China pursuant to objective enforcement of the (reformed) EBL

Finally, improved enforcement of the (reformed) EBL would also strengthen the rule of law in China. The importance of the ‘rule of law’ for China was discussed at length at the Fourth Plenary Session of the 18th Congress of the Communist Party in October 2014. It was concluded that China’s stability and further economic development need to be underpinned by clear, accessible legal norms that apply equally to all, without unnecessary use of discretion or special treatment.¹²⁶⁵ Nevertheless, in most cases of corporate insolvency, courts either ignore the parties’ EBL petitions or cede control of the case to the affected

¹²⁶⁴ Coote and Schäfer (2011) at 157; Dam (2006) at 195

¹²⁶⁵ This definition is closer to the rule *by* law, since it does not elevate law above politics. See e.g. Hobbes (1647); Tamanaha (2004) at 3

local government which then determines the outcome without reference to stakeholders' rights and duties as defined in the EBL and in pursuance of its own interests and preferences. The officials in charge usually protect local important companies (state-sector companies) through subsidies, forced debt forgiveness, and other unfair commercial techniques rather than allowing insolvency law to determine which companies are fit to survive and which should be liquidated. This puts private and foreign companies at a disadvantage, and tends to affect their profitability as well as ability to survive in such a market. Objectively enforced EBL would put an end to most or all such interventions, and so create a level-playing field for all domestic and foreign companies. In the long term, this could be beneficial to everyone as all companies would be incentivised to focus on efficiency rather than special status or relationship with those in power.

The rule of law relies on transparency, predictability, and non-discrimination. Without these qualities, my interviewees suggested, Chinese market remains unattractive to many investors and companies that are mindful about the level of risk that they are willing and able to undertake. Improved enforcement of insolvency law would enhance the rule of law in China, create level-playing field, and – as a result – it would also encourage more risk averse companies and investors to come to China, and to enable (foreign) companies already in China to expand their activities to further projects (e.g. long-term cooperation, high-volume projects, intellectual property-related projects, etc.) without unacceptable risks.

6.1.3 Conclusion

China's government at all levels spends a lot of time and energy trying to resolve financial distress of state-sector companies. Against the background of decreasing profitability of many SOEs, increasing amount of corporate bad debt, and growing importance of private sector which nevertheless remains largely cut off from bank finance, it is surprising that the EBL is not used more in practice. This chapter, therefore, looked at the reasons why insolvency law matters in China and proposed that there are numerous economic benefits that are likely to result from better enforcement and greater use of the (reformed) EBL. These economic benefits provide powerful reasons for reform of the EBL, and go hand-in-hand with the key efficiency-enhancing goals that were proposed in Chapter 2 (Table 2-1) – as summarised in Table 6-8.

**Table 6-8: Likely Economic Benefits Arising from EBL Reform
Support Key Efficiency-enhancing Goals of Insolvency Law**

	(i) enable appropriate use of reorganisation or liquidation (ii) prevent abuse of insolvency law (iii) fair and value-maximising redistribution of assets (iv) increase pool of assets (v) more timely use of the law				
(1) more efficient solutions (v. alternatives), especially in complex cases	X		X	X	X
(2) better claim satisfaction than under avoidance mechanisms			X	X	
(3) likely improve control of bad debt, enable better and earlier resolution	X		X	X	X
(4) lower cost & increase amount of credit	X	X	X	X	X
(5) better allocation of resources	X		X		X

Against this justification for further reform of China's insolvency law, the remainder of this chapter discusses the focus and overall structure of the proposed reforms, as well as the

likely obstacles that may slow down or stall the reforms in practice. A detailed account of the proposed changes is then provided in Chapter 7.

6.2 Nature of further reform

With China's economy slowing down, particularly since late 2012, and with the dramatic increase in the amount of state and corporate bad debt, Chinese government and courts have slowly come to acknowledge that the current regime for resolving financial distress – which mostly consists of avoiding the use of the EBL and employing various private and state-led alternative enforcement mechanisms – is insufficient. As a result, some limited steps have been taken to permit a more market-driven debt resolution, to enable a more predictable enforcement of creditors' rights, and to allow inherently inefficient, insolvent companies to liquidate in order to recycle their resources and restart the economy. It was also acknowledged that, in the long term, it will be necessary to enhance the rule of law and provide more predictable and transparent protection to credit-providers who may then, as empirical studies suggest, release a greater amount of cheaper credit into the economy.

The reform proposals that are contained in the remainder of this thesis are set against this background. However, unlike previous attempts to reform insolvency law in China – which focused solely or largely on the written law – the recommendations that follow take a broader view and focus also on improving how the law is implemented and enforced in practice. The remainder of this chapter discusses the over-arching aims on which further reforms need to focus (6.2.1). It then looks at the likely obstacles to the process (6.2.2). It concludes by providing a high-level outline of the proposed dual-track reform (6.2.3) as a roadmap to the detailed proposals in Chapter 7.

6.2.1 *Necessary focus of further reforms*

Chinese government and its various agencies have made many attempts to improve the functioning of the EBL through SPC interpretations, local experimentation, and recently also top-down political pressure on local governments to use the EBL to deal with local zombie companies. Their aim has been to enable further, sustainable economic growth by removing systematic inefficiencies that lead to credit squeeze, misallocation of resources and scarcity of entrepreneurial activity.¹²⁶⁶

However, the primary focus of most of the reforms so far has been the law itself or only a very limited number of issues that prevent EBL's enforcement¹²⁶⁷ rather than the environment in which it is enforced and the general ability and willingness of the authorised enforcers to implement the law as written. Without a more holistic approach, it is unlikely that any reform will achieve a more efficient use of the EBL and deliver economic benefits that are often associated with efficient use of insolvency laws.¹²⁶⁸

This section provides an overview of what the proposed reforms need to focus on. It starts with a high-level discussion of *what* needs to be changed. It then looks at *how* the changes can be carried out in practice, and at *who* is in the best position to draft and enforce these changes in practice.

There are several over-arching issues which need to be addressed by the reform, as summarised in Table 6-9.

¹²⁶⁶ Interviews P1-r, R5-r, R10-c. For a discussion, see Chapters 2.2 and 2.3

¹²⁶⁷ SPC guidelines and limited judicial reforms

¹²⁶⁸ *Supra* n.1256

Table 6-9: Key issues & necessary focus of further reforms of the EBL

<u>Key issues</u>	<u>Necessary focus of reform</u>
IMPROVE PAYOFFS	Payoffs under the EBL are comparatively lower
	Perception that payoffs comparatively lower
CLARIFICATION	Clarify aim(s) and goals of the EBL (efficiency)
	Clarify preferred interests and priorities
	Clarify how to apply the surrounding rules under the EBL
ENABLE USE	Enable all parties to use the EBL
	Enable timely use
KNOWLEDGE	Insufficient understanding of the EBL by the parties
	Insufficient understanding of the EBL by enforcers
WILLINGNESS	Local governments to allow use of the EBL
	Courts to accept EBL petitions
OBJECTIVITY	Ensure objective use of the EBL

Firstly, the reforms must focus on parties' payoffs – both actual and as perceived. The new rules must create a regime which is capable of giving the parties *comparatively greater payoffs* than they would receive under non-EBL alternatives.¹²⁶⁹ It was proposed in Chapter 6.1.2.1 that in many cases the *reformed* EBL would likely provide a comparatively more efficient mechanism for dealing with debtor's financial distress than non-EBL alternatives. This can be achieved through a combination of changes to the EBL and the surrounding rules and practices, and by addressing the shortcomings and biases of the enforcers. Moreover, the data presented and analysed in Chapter 5.4 suggests that the parties often *perceive* non-EBL alternatives as giving them better payoffs than the EBL (regardless of whether this perception is accurate or not). The reforms, therefore, need to change the parties' *perceptions* of the expected payoffs under the EBL once the functioning of the EBL is improved so that the parties know that the EBL can offer them a better solution than the mechanisms that they are accustomed to using.

¹²⁶⁹ See Chapter 5.4 for details

Reformers' efforts to increase the parties' payoffs under the EBL are more likely to succeed if they also focus on five additional issues, namely further clarification of the rules, the ability of all parties to use the EBL, a better understanding of the EBL by the parties and enforcers, greater willingness of local governments and courts to allow the use of the EBL, and objective enforcement of the law. These five issues are outlined below.

Further *clarification* of the EBL and the surrounding rules and practices are necessary to enable – *ex post* – smoother application and better understanding of the EBL in insolvency cases and – *ex ante* – to enable lenders and other parties to carry out risk assessment of doing business in China. There are several areas where such clarification is needed. For example, the EBL needs to provide a fuller statement of EBL's aims and goals. Similarly, it is necessary to remove the contradictions in courts' duties under the EBL and clarify which interests take priority in order to enable smoother and more predictable resolution of conflicts of interests. Moreover, further clarification is needed in the context of how the surrounding rules – most importantly those that impose criminal liability – should apply under the EBL.

Dealing with the parties' *ability to invoke the EBL* where needed and desired must also be addressed by the reforms. This is particularly important for certain debt contracts – e.g. those originating in the shadow market and those involving activities that contravene policy restrictions¹²⁷⁰ – and for non-state debtors whose EBL petitions are often ignored by courts. Similarly, it involves enabling the parties to use the EBL in a timely manner – in particular where it is possible to save the debtor under EBL Reorganisation.

¹²⁷⁰ See Chapter 5.2.3

Improving the parties' and enforcers' *knowledge* of what the EBL can do, and deepening the understanding of how the EBL can assist financially distressed companies are also important issues that should be addressed in further reforms. The parties – and their legal advisors – need to know that the EBL provides a menu of options that can help them deal with their or their debtor's financial distress. Parties' ability to decide whether to use a less formal method or the EBL depends, *inter alia*, on the level of their understanding how the EBL operates and how it is different from the alternatives. At the same time, the authorised enforcers – courts and lawyers-administrators – also need to be aware of what the EBL does, how to use it, when to use it, and why it matters.

Local governments' and courts' *willingness* to permit the use of the EBL is also crucial. The Party-state plays an important role in law enforcement in China, and so local governments have to understand the role and functioning of the EBL. But understanding may not be enough. As was discussed in Chapters 3.3.3 and 5.3.3, the Party-state interferes with EBL enforcement – it is, therefore, important to incentivise Party-state officials to allow the EBL to be used. An increased willingness of local governments to allow the use of the EBL together with several other changes would then also incentivise courts to accept all EBL petitions that comply with the entry requirements.¹²⁷¹

And finally, the reforms need to enable (more) *objective enforcement* of the EBL. In other words, it is necessary to prevent Party-state's intervention in the enforcement of the EBL to ensure that the law is enforced in an objective and transparent manner.

¹²⁷¹ For details see Chapter 4.3.2.2

It is argued that the necessary changes would be best delivered in stages, similar to the reforms in Deng's era.¹²⁷² A variety of tools should be used. The key provisions should be anchored in national law. The changes which require local adaptation can be made through local laws and regulations. In addition, some changes can be implemented through SPC's opinions, interpretations, guidance notes, conferences with local courts, and cross-postings of EBL experts in less developed regions. At the Party-state level, changes can be introduced through officials' trainings, conferences, intra-provincial and national meetings, top-down agenda setting, bottom-up initiatives with corresponding rewards from superior level of the Party-state,¹²⁷³ and others.

As is usual in China,¹²⁷⁴ the changes should be first tested in selected regions – which should include a combination of rich and poor, coastal and internal, industrial and agricultural regions – in order to learn about different types of obstacles and allowing for regional variations. With the benefit of this understanding, the reformed EBL should then be implemented nationally. Where regional variations lead to significantly different results in terms of a boost in efficiency to the resolution of corporate financial distress, cost and availability of credit, allocation of resources, and entrepreneurial activity,¹²⁷⁵ it may be more

¹²⁷² See Chapter 3.1. See Myant and Drahokoupil (2011) for a discussion of benefits of gradual changes with local adaptations of the rules – also known as *Beijing Consensus* – over shock approach where new rules are introduced everywhere at once, without preparatory stages – known as *Washington Consensus*. Cf Lin and Milhaupt (2013) argue that implementation of some changes may be easier in authoritarian regimes. However, the problem in China is that a significant amount of decision-making power has been devolved to local levels of government, which means that China's central government is not able to unilaterally implement the changes that it wants without having to deal with local governments' opposition. For more, see Chapter 6.2.2.2.

¹²⁷³ For the structure, see Chapter 3.2

¹²⁷⁴ For details, see Chapters 3.3 and 4.3.1

¹²⁷⁵ All of these are the predicted benefits of reforming insolvency law – see Chapter 2.3

appropriate to make changes through local rules¹²⁷⁶ and SPC guidance in order to give the struggling regions more time to implement the changes in full. Nevertheless, extra time and flexibility should only be given subject to clearly defined responsibilities and timetables for local governments regarding when and how the EBL should be fully implemented in their province in order to achieve full national harmonisation. Moreover, the fulfilment of these aims should be included in local government officials' career-progression targets to ensure their full cooperation.

6.2.2 Likely obstacles to further reforms

My interviewees suggest that there is a strong support for further reform of the EBL (6.2.2.1). However, they also stressed that some of the changes are likely to face obstacles and opposition (6.2.2.2). These insights are discussed below.

6.2.2.1 Supporters of further reforms

All my interviewees suggested that there is a strong support for further reform from law-makers, law-users, and law-commentators. Central government (including the Legislative Affairs Committee of the NPC Standing Committee and the Ministry of Finance) and the SPC are already supporting improvements to insolvency law in China.¹²⁷⁷ They are likely to further support these efforts both in terms of monetary and other backing of the proposed

¹²⁷⁶ For example, Wenzhou has introduced additional local regulations which enable its court to function better in EBL cases, making the process quicker and cheaper. However, people in Wenzhou are more entrepreneurial and pro-market than most provinces, and so its additional regulations may not be well-suited for other regions: Interviews C5-r, C7-s, J4-c to J9-c, L4-r, L6-s, P1-r, R6-c, R7-c, R9-c, R10-c

¹²⁷⁷ See e.g. SPCM (5.7.2016)

projects. Their support will also be crucial in incentivising local governments to cooperate and in finding, financing and enforcing practical ways of improving the expertise, abilities and willingness of courts and local governments to implement the reformed EBL.

Moreover, some local governments – most importantly those in Zhejiang, Shanghai, Guangdong, and Shenzhen – have already started implementing centrally-suggested as well as locally-devised improvements to insolvency law. Other local governments – mainly from internal regions such as Yunnan, Inner Mongolia, Guilin, etc. – have been resisting the pressure to use insolvency law more. Nevertheless, several interviewees argued that there are a handful of officials and judges even in these regions who understand the importance of insolvency law.¹²⁷⁸ However, they need support from the outside with enhancing the understanding and appreciation of the potential benefits of insolvency law. Central government agencies, bankruptcy law centres, and enthusiastic experts will be crucial to changing the environment in which the EBL is enforced and in delivering information and training to potential users and enforcers of the EBL. Overall, my interviewees suggested that there is now a sufficient level of interest and a growing momentum across China, and so it is very likely that a change of attitude – which is crucial for a better implementation and enforcement of insolvency law in China – is possible.¹²⁷⁹

Furthermore, many potential law-users – businesses and business chambers in China and abroad – as well as expert consultants have been very supportive of a greater use of insolvency law because it helps create safer and more stable business environment, and so

¹²⁷⁸ Interviews C5-r to C9-c, J3-c to J9-c, P1-r, P3-r to P5-c, R7-c, R10-c, R13-c

¹²⁷⁹ *Ibid.*

enables greater business cooperation and economic growth.¹²⁸⁰ Similarly, many banks and finance providers in China also support further reforms to insolvency law – primarily to gain the ability to assess riskiness of individual loans and to recover more regardless of whether the borrower is a state company or not.¹²⁸¹ However, several interviewees also warned that state-controlled banks in China will not be able to go against the wishes of the same-level Party-state, and so winning the support of – in particular – local governments first will be crucial.¹²⁸²

Academics and other expert observers have also been calling for better implementation and enforcement of insolvency law for several years now. One of the key voices has been the Beijing-based Research Centre for Bankruptcy Law at Renmin University.

6.2.2.2 Obstacles to further reforms

However, not everyone supports the reforms – even within the generally supportive groups discussed above. The key obstacles to further reforms are likely to include, firstly, the opposition from those who fear that a more efficient use of the EBL would negatively affect their interests, and secondly, the slow pace at which these changes are likely to take place.

Many reform initiatives in China are stalled due to the *opposition* from local governments. In the context of the EBL, some local governments fear that more EBL cases would necessarily involve large-scale unemployment, social instability, and weaker

¹²⁸⁰ Interviews C1-c to C11-c, E1-cto E5-c, L2-s to L15-c, R10-c. See also Chapter 6.1.2.6

¹²⁸¹ Interviews B1-c to C3-c, C1-c, C4-c, C5-r, IF1-s, IF2-c, L2-s, L4-r, L6-s, R9-c, R10-c

¹²⁸² Interviews B1-c to C3-c, C5-r, L2-s, L4-r, L6-s, R9-c, R10-c

economic performance. Their opposition is translated into courts' reluctance to hear EBL cases.¹²⁸³ Although, in the long run, the drawbacks may be surpassed by economic benefits, locally and nation-wide, in the current environment – with short-term incentives and limited actual accountability¹²⁸⁴ – it is rational for local governments to oppose further reforms of the EBL and its greater use.

Local governments' opposition is further bolstered by the opposition of the entrenched parties – most importantly employees and SOEs – who benefit from the current regime. Under local governments' alternative solutions¹²⁸⁵ employees only face a limited chance of company closures and subsequent redundancies. Moreover, employees know from experience that local governments are likely to intervene in their employer's financial distress if enough of them put pressure on the government.¹²⁸⁶ If the EBL was used in all cases that fulfil the entry requirements, the likelihood of corporate closures, redundancies, and increased pressure to work harder to keep a job would ensue. In the short-term, employees are, therefore, incentivised to oppose reforms that would result in a more efficient use of the EBL.

Similarly, SOEs also benefit from local governments' support in the form of easy access to bank finance – without having to face hard budget constraints or competition from the private sector for credit – as well as limited competition from non-state companies due to local governments' protectionist policies, and financial support from government in

¹²⁸³ As explained in Chapter 5.3.3

¹²⁸⁴ *Ibid.*

¹²⁸⁵ See Chapter 5.4.2

¹²⁸⁶ See Chapters 3.3.3 and 5.3.3.1

case of financial distress. Reforms and a more efficient use of the EBL would most likely result in banks extending finance to private companies which would increase competition for money and market competition to SOEs. It could also impose hard budget constraints on SOEs and would force many of them to either restructure or liquidate due to their current low profitability and financial problems.¹²⁸⁷

And finally, many of the proposed changes in Chapter 7 will *require time*. In a way, changing the written law – although requiring some time to research, rewrite and pass through the NPC – may be the fast part of the reform. On the other hand, issues that are likely to take more time include changing people’s attitudes towards the concept of insolvency and debt forgiveness; disseminating information about the EBL, its procedures, and its benefits; training lawyers and courts; re-tuning local Party-state officials’ incentives to enable greater use of the EBL; persuading local governments that they stand to benefit from allowing objective enforcement of the EBL; and many others. In addition, the reforms will have to adapt differences among provinces – including different stages of economic development, different social norms and business environments, and different levels of experience, ability and willingness of local courts and governments to enforce the EBL. As was suggested in the previous section, these differences can be managed through a combination of hard national and local rules and soft guidance from the Party-state and courts. In the end, a coordinated effort and a lot of work will be needed to reform the EBL successfully.

¹²⁸⁷ See Chapters 3.4 and 6.1.1.3

6.2.3 What is likely to work in practice

Having concluded that China's economy stands to benefit from a greater and more efficient use of the (reformed) EBL – but also bearing in mind the nature of likely opposition to the changes – this section and Chapter 7 argue that it is best to adopt a dual-track¹²⁸⁸ approach to the reform.¹²⁸⁹ It involves a direct reform of the existing rules and environment (6.2.3.1), and an indirect reform which consists of introducing a new opt-in mechanism for certain types of companies which would enable out-of-court use of the EBL without having to wait for the necessary changes in attitude of individual courts and local governments (6.2.3.2). The opt-in mechanism is intended to help in particular those companies whose EBL petitions are currently ignored by courts – i.e. mostly private sector companies – by enabling them to make most of the EBL safeguards and protections in an alternative enforcement venue. Nevertheless, in the long run, it is important that all direct reform proposals are carried out.

6.2.3.1 Direct reform

The proposals for direct reform are contained in Chapters 7.1 to 7.3. The discussion is structured to follow Chapters 5.1 to 5.3 which discussed the constraints on the use of the EBL in China. Firstly, changes are proposed to the wording of the EBL. The proposals follow and add to the issues identified in Chapter 5.1 and are contained in Chapter 7.1. Secondly, changes are proposed to the rules and practices that form the environment in which the EBL is enforced. The proposals address the shortcomings identified in Chapter 5.2 and are

¹²⁸⁸ *shuangguizhi* 双轨制

¹²⁸⁹ This is similar to the way how all successful reforms since Deng's era have been carried out. During the 1980s reform, the intention was to maintain the planned economy while expanding the private sector, and gradually grow out of the plan: see Chapter 3.1

contained in Chapter 7.2. Thirdly, there are also several reforms aimed at improving the quality and capacity to enforce the EBL in China. This set of reforms follows the issues identified in Chapter 5.3 and is contained in Chapter 7.3. Together, the changes proposed in Chapters 7.1-7.3 also address the fourth constraint identified in Chapter 5.4 – the factual and perceived superiority of payoffs of non-EBL alternative mechanisms – by, firstly, improving the payoffs under the EBL, and secondly, by informing the (potential) parties of what the EBL has to offer. This relationship between the constraints and the direct reform proposals are represented in Table 6-10.

Table 6-10: Relationship between Constraints (Chapter 5) and Direct Reform Proposals (Chapter 7.1-7.3)

	Constraint 1: EBL provisions <i>[Chapter 5.1]</i>	Constraint 2: surrounding rules & practices <i>[Chapter 5.2]</i>	Constraint 3: enforcers <i>[Chapter 5.3]</i>	Constraint 4: alternatives perceived as better <i>[Chapter 5.4]</i>
Reform proposal 1: improve the EBL <i>[Chapter 7.1]</i>	X			X
Reform proposal 2: adjust other rules & practices <i>[Chapter 7.2]</i>		X		X
Reform proposal 3: improve enforcement capacity & quality <i>[Chapter 7.3]</i>			X	X

These direct reform proposals address the key issues identified earlier, in Chapter 6.2.1 (see Table 6-8), namely the need for improved payoffs, further clarification, greater access to the use of the EBL, greater knowledge and understanding of EBL procedures, greater willingness to allow the use the EBL, and greater objectivity and transparency in EBL enforcement.

Examples of proposed reforms that address these issues together with the particular

Chapter where they are discussed in detail are summarised in Table 6-11.

Table 6-11: Overview of how the direct reforms (Chapters 7.1-7.3) address the key issues

	<u>Necessary focus of reform</u>	<u>Reforms that address these issues</u>	<u>Dealt with in</u>		
			7.1	7.2	7.3
PAYOFFS	Payoffs under the EBL are comparatively lower	improve the EBL and surrounding rules	X	X	X
	Perception that payoffs comparatively lower	inform the parties about the improvements		X	X
CLARIFICATION	Clarify aim(s) and goals of the EBL (efficiency)	clearly defined aims & goals	X		
		make these known to the parties and the enforcers		X	X
	Clarify preferred interests and priorities	clarify priorities to enable predictable court enforcement	X	X	
	Clarify how to apply the surrounding rules under the EBL	clarify how to apply criminal liability under the EBL	X		
		clarify how to treat security rights under the EBL	X		
ENABLE USE	Enable all parties to use the EBL	excluded shadow finance/ non-state (origin)		X	X
		create special fast-track for small Cos (cost)	X		
	Enable timely use	reward timely use	X		
		allow pre-insolvency use of EBL reorganisation	X		
KNOWLEDGE	Insufficient understanding of the EBL by the parties	information / better training for advisors			X
	Insufficient understanding of the EBL by enforcers	enhance understanding by lawyers - training			X
		enhance understanding by judges - experience, reward			X
		enhance understanding by local governments			X
WILLINGNESS	Local governments to allow use of the EBL	deal with conflicts in institutional-level incentives		X	X
		change local governments' incentives			X
	Courts to accept EBL petitions	remove courts' internal quotas			X
OBJECTIVITY	Ensure objective use of the EBL	remove the Party-state from the process			X
		deal with local governments' protectionism			X

6.2.3.2 Indirect reform

The direct reform proposals are important, but they are likely to face obstacles – most importantly entrenched stakeholders’ opposition and the length of time that it will take to formulate and implement the reforms.¹²⁹⁰ As a result, to enable some of the companies that are currently unable or unwilling to use court-driven EBL procedures – and are likely to remain so for some time – this thesis also argues that the parties should be allowed to opt in to an out-of-court enforcement of the EBL. This mechanism would involve bypassing the formal institutions¹²⁹¹ – to mitigate the problems associated with tardy and often uninformed courts as well as the red tape from the Party-state – and using China’s Mediation-Arbitration mechanism as an EBL-enforcement venue following an *ex ante* or *ex post* agreement to resolve financially distressed debtors’ liabilities in this manner. This mechanism is discussed in detail in Chapter 7.4.

6.3 Conclusion

This chapter argued that insolvency law matters in China and that the Chinese economy stands to benefit from reforming the EBL and its enforcement infrastructure. It was suggested that the reforms have to focus on several key issues and that they are likely to face obstacles. In this context, it was argued that the reforms should include direct changes to the law and enforcement practices, as well as an indirect change through a novel use of an existing enforcement venue. The general framework introduced here is further

¹²⁹⁰ See Chapter 6.2.2

¹²⁹¹ For a discussion of two examples of institutional bypassing in Brazil, see Rosenn (1971); Hansmann, Gilson and Pargendler (2011)

expanded in Chapter 7 which discusses each reform proposal in detail and suggest possible measures for assessing the reforms' success over time.

Chapter 7. REFORM OPTIONS

Previous chapters discussed the EBL and other debt-enforcement mechanisms,¹²⁹² the environment in which they operate,¹²⁹³ the low use of the EBL,¹²⁹⁴ the constraints that appear to contribute to such low use,¹²⁹⁵ and the desirability of EBL's greater use.¹²⁹⁶ This final chapter turns to the proposed reforms which aim to alleviate the identified issues and thereby enable and incentivise greater and more efficient use of the EBL. This process requires very careful balancing and sensitivity to the existing socio-economic context in which the law operates. However, it also requires an appreciation of China's economic development and the changes that are necessary to enable further growth. Two important obstacles in this context may slow or prevent China's economic development: firstly, system-wide risk arising from unresolved corporate distress, and secondly, lack of cheap credit for private-sector companies. The reform, therefore, has to balance, on the one hand, the need for a predictable, fair and transparent allocation of risk among economic participants, and, on the other hand, the desirability to maximise the value of debtor companies for the benefit of its stakeholders. In the context of China, it also has to take into account the particular sensitivities such as employee protectionism and political interests identified and protected by the Party-state.¹²⁹⁷

¹²⁹² See Chapter 4

¹²⁹³ See Chapter 3

¹²⁹⁴ See Section 4.1.3

¹²⁹⁵ See Chapter 5

¹²⁹⁶ See Chapter 6

¹²⁹⁷ See Chapters 3.3.3 and 5.3.3

The rationale for the proposed structure of the reforms was briefly explained in Chapter 6.2.3. The first three of the four sections of this chapter focus on direct, substantive reforms of the existing framework, namely the possible improvements to the EBL as written (7.1), to the surrounding rules and practices that are necessary for the implementation of the EBL (7.2), and to the quality and objectivity of EBL enforcers (7.3). Each section explains the proposals in detail, explores the relationship between each constraint and each reform proposal, and assesses the likelihood of the given reform proposal being implemented in the current socio-political environment in China. Implementation of these three sets of reforms could, in the aggregate, help increase the parties' payoffs under the EBL. Unfortunately, in reality, some of the proposals are likely to take a while to be implemented or are unlikely to be carried out fully in today's China. Therefore, an additional – indirect – reform is proposed in section 7.4. It involves introducing a new way of using an existing enforcement venue – Mediation-Arbitration – as an institutional bypass mechanism for the parties that are excluded and for those where the use of the EBL would not be appropriate. The discussion concludes by drawing the proposals together and offering possible measures of reforms' success (7.5).¹²⁹⁸

The structure of this chapter closely follows that of Chapter 5, which identified and explored the key constraints to the operation of the EBL in China (Table 7-1). And just like in Chapter 5, the issues in this chapter are also inter-connected, and the impact of the reforms is cumulative.

¹²⁹⁸ In 2016 and 2017, I discussed several of the major reforms (Chapters 7.1-7.3) and the proposed measures (Chapter 8) with many China experts with experience in practice and academia, in China and abroad, when I was writing a report for the UK and Chinese governments about the possible reform projects that would help improve the enforcement of the EBL in China. I am grateful for all comments and insights of those who contributed their time and knowledge to this project. All mistakes are my own.

Table 7-1: Overlap between Constraints (Chapter 5) and Reform proposals (Chapter 7)

	Constraint 1: EBL provisions <i>[Chapter 5.1]</i>	Constraint 2: surrounding rules & practices <i>[Chapter 5.2]</i>	Constraint 3: enforcers <i>[Chapter 5.3]</i>	Constraint 4: alternatives perceived as better <i>[Chapter 5.4]</i>
Reform proposal 1: improve the EBL <i>[Chapter 7.1]</i>	X			X
Reform proposal 2: improve surrounding rules & practices <i>[Chapter 7.2]</i>		X		X
Reform proposal 3: improve enforcement capacity & quality <i>[Chapter 7.3]</i>			X	X
Reform proposal 4: introduce new opt-in mechanism <i>[Chapter 7.4]</i>	X	X	X	

7.1 Reforms aimed at improving EBL provisions

Most reform attempts so far have focused on improving the black-letter law. Overall, however, the EBL is written well. The EBL was introduced as a response to the complaints levelled against the old 1986 law. As a result, the EBL covers private and foreign stakeholders, it has a rescue mechanism, it enables imposition of a moratorium, it introduces hard-budget constraints, it provides detailed rules on the priority of repayment, and it also removes government's involvement in insolvency procedures by putting an independent insolvency practitioner in charge.¹²⁹⁹ Nevertheless, there are still several changes and additions that could improve the law on paper.

¹²⁹⁹ See Chapter 4.3

Five changes to the EBL are proposed in response to the issues identified in Chapter 5.1. The first four are based on existing provisions; the last one proposes to introduce two new provisions. The first and second proposals call for clarification of EBL’s aims and goals (5.1.1) and court’s role in employee protection in EBL procedures (5.1.2). The third proposal suggests that more guidelines need to be provided about when and how to apply criminal liability in EBL cases (5.1.3). The fourth set of proposals examines possible improvements to EBL Reorganisation such as reformulation of the entry requirements to enable its timely use and more guidance about how and when to use the cram-down power (7.1.4). The final set of proposals suggests that two further provisions should be inserted into the EBL, namely directors’ duty to monitor their company’s health and a fast-track EBL hearing for small companies (section 7.1.5). In conclusion, the proposals are drawn together to consider their likely cumulative impact in practice (7.1.6).

Table 7-2: Direct reforms of the EBL as written

	Content of reform	Timing of reform
Clarify existing rules	Clarify aims and goals of the EBL (7.1.1)	Any time
	Clarify courts’ role in employee protection in EBL procedures (7.1.2)	Implement after social security system becomes operational (7.2.2.1)
	More guidelines about imposition of criminal liability in EBL procedures (7.1.3)	Any time, but best together with judges’ training (7.3.1)
Change existing rules	Improvements to EBL reorganization (7.1.4)	Implement together with reforms aimed at enforcers (7.3)
Introduce new rules	Introduce additional provisions (7.1.5)	Any time, but effective only after reforms aimed at enforcers (7.3)

7.1.1 Clarify aims and goals of the EBL

The EBL provides only limited insight into law-makers' intended aims and goals of the EBL.

Article 1 states that the EBL's aim is 'to fairly liquidate claims and debts, to protect the legitimate rights and interests of creditors and debtors, and to maintain the order of the socialist market economy.' Article 6 then adds that courts, when applying the EBL, 'shall safeguard the legitimate rights and interests of the employees of the insolvent enterprise and hold officers of the insolvent enterprise accountable for their liabilities in accordance with law.' However, neither the EBL nor later regulations or public policy documents explain what are the parties' 'legitimate rights and interests,' or how to balance the conflicts between its aims of 'fairly' liquidating claims on the one hand and the protectionist measures that the Party-state often deems necessary to 'maintain ... socialist market economy.'

A clearer statement – in the EBL or otherwise – is, therefore, needed to ensure greater predictability of outcome for the parties, and to achieve greater harmonisation of the way how the rules are applied across China. In Germany, traditionally, the predominant aim of insolvency law has been to ensure effective allocation of the remaining resources,¹³⁰⁰ and requiring insolvency does not *per se* hinder that aim. On the other hand, the language used by Chinese officials and SPC judges when describing EBL's objectives brings it closer to

¹³⁰⁰ For an overview, see Remmert (2007). But note that the German regime has been refocusing on the need to enable restructuring in recent years: Clifford Chance (January 2012)

the US and UK insolvency laws¹³⁰¹ in that its primary aim is to enable value-creating or at least value-preserving restructuring of financially distressed debtor companies.¹³⁰²

If the aim of the EBL reform is to support further economic development,¹³⁰³ the law should facilitate *ex ante* lower cost and greater availability of credit by increasing the predictability and likelihood of greater recovery of debts *ex post*.¹³⁰⁴ Furthermore, insolvency law should enable efficient allocation of resources – away from inefficient projects and companies and to the most efficient users – by imposing hard budget constraints, reorganising distressed debtors who can be made more efficient, and liquidating all others.¹³⁰⁵ Similarly, insolvency law should aim to encourage more entrepreneurial activity by providing clear rules about the consequences of corporate failure – and so enable more risk-averse parties to engage in potentially value-creating projects.¹³⁰⁶ In addition, timely use of the correct procedure – Reorganisation or Liquidation, depending on which is most efficient in the circumstances – should also be encouraged.¹³⁰⁷

All these goals can be encapsulated – and should be reflected in EBL’s framing provisions – as an aim to *enhance the economic efficiency* of resolution of corporate financial distress. By moving to the yardstick of economic efficiency,¹³⁰⁸ the law could be

¹³⁰¹ And latest changes in Germany: *Ibid.*

¹³⁰² Interviews P1-r, R5-r, R10-c

¹³⁰³ See Chapters 2.3 and 6.2.1

¹³⁰⁴ See Chapter 2.3.1

¹³⁰⁵ See Chapter 2.3.2

¹³⁰⁶ See Chapter 2.3.3

¹³⁰⁷ Cf Table 2.1 and Table 6-8

¹³⁰⁸ As defined and discussed in Chapters 2.1 (especially footnote 42) and 2.2

applied in a more predictable and comparable fashion across provinces regardless of their social and economic differences. This change can be made at any time.

7.1.2 Clarify courts' role in employee protection in EBL procedures

Linked to the question of EBL's aims and goals is the issue of courts' role in employee protection. Chapter 5.1.1 pointed to several EBL provisions which have been interpreted as protecting employees at the expense of other stakeholders. This section argues that two elements of this regime need to be changed – remove the requirement for employee resettlement plan as a pre-condition to filing an EBL petition (7.1.2.1) and provide additional guidelines on how to resolve courts' conflicting duties (7.1.2.2) – which would put employees on par with other regular stakeholders.

The timing will be critical. Making these changes immediately would most likely face (potentially insurmountable) opposition from local governments. Therefore, the changes proposed below should be carried out after fully implementing the social security system¹³⁰⁹ which would reduce the pressure from employees on local governments.¹³¹⁰

7.1.2.1 Limit employee protectionism

The first change that is necessary in order to ensure more efficient – and fairer – treatment of all stakeholders is removal of the requirement to provide a resettlement plan for debtor company's employees as a pre-condition to filing an EBL petition. This duty is only imposed

¹³⁰⁹ See Chapters 5.2.2.1 and 7.2.2.1

¹³¹⁰ At the moment, dismissed employees face existential difficulties unless they have their own savings or support from their next of kin when they are between jobs: *Ibid.*

in debtors' EBL petitions. Although this provision conveniently shifts the responsibility for dismissed employees from local governments to a debtor, it is submitted that it provides wrong incentives for financially distressed debtor companies. Firstly, a financially distressed debtor is usually in no position to be able to reshuffle its employees to new jobs. This requirement may have made sense in the time when all companies were owned by the state because employees would be, *de facto*, moved from one branch of the state economy to another. But it makes no economic sense in the current economy where most companies operate as individual, independent entities. In addition, a financially distressed debtor should focus on finding a solution to its distress rather than having to redirect some of its efforts and concern itself with finding replacement jobs for its employees. Such requirement can, at best, slow down the finding of a solution because managers' attention is divided, and, at worst, it can jeopardise the resolution efforts by diverting too much attention away from the important – i.e. saving the company, or liquidating it to maximise value – to the less important – i.e. resettling employees *if* the company fails.

Moreover, debtor's inability to provide an employee resettlement plan prevents it from using EBL Reorganisation. This, in turn, bars them from using a mechanism which may be the only way of preventing its corporate failure in the first place. At the same time, it also ignores that a plan for employee resettlement may only be successfully put together in the course of EBL Reorganisation, but not at the time of filing to use it.

This requirement leads to four undesirable outcomes. Firstly, most users of the EBL are politically-connected players where local governments provide implicit guarantee of employee resettlement. Secondly, some parties may instead use pre-packaged

Reorganisation where they reach an agreement before filing EBL petition.¹³¹¹ Such use of the EBL negates one of the reasons for wishing to use the law in the first place, namely the desire to use a collective, structured mechanism where all stakeholders have pre-defined rights and duties. Thirdly, EBL petitions are sometimes accepted even without a clear employee resettlement plan, but this is only possible in market-driven regions – such as Wenzhou – where the provision is not applied literally and a resettlement plan can be supplied later, or only in vague terms.¹³¹² And finally, although the desire to protect employees is understandable, in the long run, it leads not to protection of employment and employees, but to survival of inefficient companies – which is costly due to direct and indirect financial support that they need¹³¹³ – and it traps limited resources in inefficient use instead of allowing them to be reallocated to the most efficient user with the help of insolvency law, thereby further harming the economy.

Efficient use of Liquidation and Reorganisation relies on speed, which is compromised where debtors have to make a resettlement plan for its employees. It is, therefore, suggested that this requirement should be removed altogether. Insolvency law cannot work efficiently if it has to act as a quasi-social security system.¹³¹⁴

¹³¹¹ See Chapter 5.4.2.3

¹³¹² Interviews J1-c, J4-c to J9-c

¹³¹³ See Chapter 6.1

¹³¹⁴ For more, see also Chapter 7.2.2.1

7.1.2.2 Provide clearer guidelines on how to resolve courts' conflicting duties

It was proposed in Chapters 5.1.1-2 that courts face conflicting duties with regards to their treatment of various stakeholders' rights. This is ultimately a political question. The EBL embodies a classical tension between the desirability of protecting lenders' interests – to incentivise greater and cheaper lending¹³¹⁵ – and the importance of keeping struggling companies alive in order to protect employment, to avoid potential social instability and political crisis.¹³¹⁶ The EBL does not clearly prefer one or the other. This creates harmful unpredictability and divergence in the way the law is enforced across China.

To ameliorate the situation, additional, clearer guidance should be provided about how to resolve the conflicts between employees' and (secured) creditors' interests. This guidance should clearly state that secured creditors' interests must be protected even where this would reduce employees' recovery. As argued above, insolvency law cannot and should not be used to replace social security system.

7.1.3 Provide more guidelines about imposition of criminal liability in EBL procedures

As was argued in Chapter 5.1.2, debtors face heightened risk of scrutiny and liability under the EBL (v. under the alternatives) because courts are under a general duty to investigate insolvent companies' personnel for their 'legal liabilities' and to examine whether a violation of any provision contained in the EBL constitutes a criminal offence. But while scrutiny and liability are not *per se* bad, more guidance is needed in order to ensure that managers and

¹³¹⁵ See Chapter 2.3

¹³¹⁶ See Chapters 3.2, 3.3 and 4.1

directors are only punished for their actual wrongdoing. What is particularly problematic is that, often, courts do not sufficiently investigate whether debtor's personnel actually caused the insolvency. Instead – several interviewees suggested – being in power at the time of insolvency (i.e. correlation) is often taken to satisfy the causation element.¹³¹⁷ This leads to excessive imposition of liability and deters debtors' personnel from using the EBL.

A way how to deal with this problem is to provide more guidance to courts – ideally from the SPC – to explain that causation, and not merely correlation, is needed to establish criminal liability under the EBL. Such guidance should also give an illustrative list of what evidence is permissible and clarify that there is no presumption of guilt.¹³¹⁸ If the EBL is excessively and unfairly punitive, it disincentivises the parties who are least affected by the information asymmetry – managers and directors of distressed companies – from using the EBL in a timely manner. This is particularly problematic for Reorganisation where timely use matters most.

Moreover, in debtor-invoked EBL Reorganisations – to encourage its greater use – courts should be encouraged to impose lesser punishment and reward timely use in cases of genuine financial distress. This could be included in the guidance to courts, and it should be accompanied by a training session or a conference where judges can meet and discuss their views and experiences.¹³¹⁹

¹³¹⁷ Interviews C2-c, C3-c, C7-s, E2-s, J1-c, J5-s, J9-c, L1-r, L2-s, L4-r, L5-c, L6-s, L8-c, L12-c,

¹³¹⁸ Several interviewees (C5-r, C7-s, J1-c, J2-c, J8-c, J9-c, E3-s t E5-c, L2-s to L7-c, L13-c to L15-c, P1-r, R6-c, R7-c, R9-c, R10-c) suggested that some judges view managers who cannot prevent their company's distress as inherently guilty.

¹³¹⁹ More about this in Chapter 7.3

7.1.4 Improvements to EBL Reorganisation

It was proposed in Chapter 4.3 that the EBL was made with a particular emphasis on Reorganisation and its promise to restructure (and, where possible, save) rather than close distressed companies.¹³²⁰ Nevertheless, my interviews and existing data suggest that Reorganisation is only rarely used, and that it is mostly used in large¹³²¹ listed companies – to buy the valuable listed status¹³²² – and in politically-driven restructuring to legitimise the pre-agreed deal.¹³²³ However, EBL Reorganisation needs to be used more widely in cases where restructuring is more efficient than Liquidation or one of the self-help alternatives. To enable its greater use will require multiple changes. In terms of how the procedure is set up on paper, there are two important changes that should be implemented. These are, firstly, allowing the use of Reorganisation before the company is insolvent or about to become insolvent (7.1.4.1); and secondly, providing more guidance to courts about how and when to use their power to cram down dissenting stakeholders in Reorganisation (7.1.4.2).

¹³²⁰ See also Wang (2000) at 9-10, which discussed a report about the 1995 draft of the EBL, saying: 'It can be therefore concluded that the objective of the draft reorganisation proceeding is to rescue enterprises in difficulties while fairly clearing their debts.' This shows that Reorganisation is not necessarily seen only as rescue where it is technically and economically feasible, but also for political reasons

¹³²¹ See senior judge Bi (2009)

¹³²² Interviews J1-c, L2-s, L4-r, L6-s. See also Kynge (2006) 176; Szamosszegi and Kyle (2011)

¹³²³ See Chapter 5.4.2.3

7.1.4.1 Expressly allow pre-insolvency use of Reorganisation

As was discussed earlier, the Chinese EBL – just like the German Insolvency Law – requires some form of insolvency as a pre-condition to using its procedures.¹³²⁴ As a general rule, the choice of entry requirement is linked to the core justification for allowing alteration of the parties' initial (substantive and procedural) entitlements. Insolvency is often seen as the only legitimate justification for such *ex post* interference in private actors' dealings.

In Germany, the primary aim of insolvency law is to ensure effective allocation of the remaining resources, and requiring insolvency does not *per se* hinder that aim.¹³²⁵ On the other hand, EBL's primary aim – similar to insolvency laws in the US and the UK – is to enable efficient restructuring of financially distressed debtor companies.¹³²⁶ In order to achieve that, however, it may be necessary also to follow the American and English entry requirements for a reorganisation procedure where debtor's insolvency is not required.

Allowing pre-insolvency use of Reorganisation has several benefits. Many interviewees pointed out that, in practice, creditors often petition a court to use the EBL after – and not as soon as – the debtor becomes technically insolvent (by either test) because – due to the information problems – they may not know when the debtor became insolvent.¹³²⁷ Similarly, debtors may not petition to use Reorganisation as soon as they become insolvent because they try to find an internal solution and return the company back

¹³²⁴ For detailed discussion see Chapter 4.3.2.2 - Debtor or one of its creditors can only start insolvency procedure because of over-indebtedness or (actual or threatened) illiquidity: sections 16 and 17-19 of German Insolvency Law 1994

¹³²⁵ Chapter 7.1.1

¹³²⁶ *Ibid.*, Interview P1-r, R10-c

¹³²⁷ See Chapter 7.2.1.1

to health without any third parties.¹³²⁸ However, more often than not, financial problems continue and often also get worse over time, and so by the time the debtor company petitions to use Reorganisation, there is nothing to save in the company, and so the court automatically pushes the debtor into Liquidation.¹³²⁹ Fire sale of assets further depresses the value of the debtor company, and any delays in negotiating with the creditors lead to further loss of value.¹³³⁰

If on the other hand, companies are allowed and encouraged to enter into Reorganisation before they are insolvent (or obviously likely to become insolvent¹³³¹) – some of my interviewees argued – two major positive outcomes may occur. Firstly, distressed companies would have more time to benefit from the expertise of outside specialists and so save a part of the business or at least provide better-than-liquidation outcome for the parties.¹³³² And secondly, because entering into Reorganisation would no longer signal one's insolvency, it may encourage more voluntary debtor petitions without risking the same degree of reputational damage.¹³³³ Although – strictly speaking – such procedure would no longer be 'insolvency' procedure, it would play a crucial role in the prevention of corporate insolvency, and so should be considered in this context.

¹³²⁸ Interviews C1-c to C7-s, C9-c, E1-c to E3-s, J1-c, J5-s to J9-c, L1-r to L6-s, L9-s to L13-c, R1-r to R4-c, R6-c to R11-c

¹³²⁹ *Ibid.* – in line with Arts 43, 78, 79, 88 EBL

¹³³⁰ This is further aggravated by the slow and unresponsive courts both when deciding whether to accept the petition and when making subsequent decisions in the course of Reorganisation: Interviews C3-c, C5-r, L1-r to L9-s, L15-c, P1-r, R9-c, R10-c

¹³³¹ Chapter 4.3.2.2

¹³³² Interviews B1-c, B2-c, C2-c to C7-s, E1-c to E4-c, J3-c to J9-c, L1-r to L6-s, L8-c to L15-c, P3-r, R1-r, R3-r, R9-c, R10-c

¹³³³ *Ibid.*

Moreover, the international trend is increasingly to focus on the importance of timely intervention, including pre-insolvency collective restructuring.¹³³⁴ The UNCITRAL Guide encourages early intervention in financial distress, but also warns against abusive use of insolvency law.¹³³⁵ If China wanted to prevent abuse, it could introduce provisions to punish strategic use of the EBL where fraud or misuse can be proven by creditors. Alternatively, courts could be given discretion in precisely explained circumstances – details of which would be collated from experience from trial implementation of this provision in several regions – to deny petitions for the reason of abuse and to order the debtor to pay associated costs. This would comply with the UNCITRAL suggestion that ‘it may be desirable that the insolvency law focuses upon discouraging improper use rather than making commencement more difficult to the potential detriment of all eligible applicants.’¹³³⁶

Potential benefits of an earlier use of Reorganisation were also highlighted in a report that accompanied the 1995 draft of the EBL and in many discussions since. The report suggested that financially distressed companies should be allowed and encouraged ‘to explore the possibility for rehabilitation by applying [in a timely manner] for Reorganisation or Composition ... in the new law. Even in case that an enterprise is not recoverable, earlier commencement of bankruptcy liquidation is more beneficial to both creditors and the society in the sense of saving assets and reducing losses as far as

¹³³⁴ See e.g. the European Commission’s proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures – COM (2016) 723

¹³³⁵ Para 46 UNCITRAL Guide

¹³³⁶ Para 47 UNCITRAL Guide

possible.¹³³⁷ Unfortunately, the final version of the EBL retained the requirement of an actual or imminent insolvency. Nevertheless, several politically-connected interviewees suggested that Chinese government and the SPC are slowly realising how important it is to allow companies to restructure in a timely manner, and are slowly recognising that pre-insolvency entry into Reorganisation may be needed.¹³³⁸

It is, therefore, proposed that earlier entry into Reorganisation procedure should be enabled by removing the insolvency requirement and replacing it with courts' discretion to reject the petition where it has grounds to believe – and the petitioner fails to disprove – that allowing the petition would enable abuse of the EBL regime.

7.1.4.2 More guidance about courts' power to cram down dissenting stakeholders in Reorganisation

Several interviewees also argued that Reorganisation is often hindered by courts' inability to apply the cram down powers effectively.¹³³⁹ Similar to the US Chapter 11, China's EBL enables courts to prevent individual creditors from hijacking the process by refusing to cooperate or to make any compromises.¹³⁴⁰ Without it, Reorganisation would lack the ability to bind dissenting stakeholders which is one of the important advantages that differentiate it from out-of-court restructuring.

¹³³⁷ Wang (2000)

¹³³⁸ Interviews C2-c, C5-r, C7-s, J6-s, L14-c, L15-c, P1-r, P3-r to P5-c, R10-c. For more see 7.1.1

¹³³⁹ Interviews C5-r, C7-s, J2-c, J6-s to J9-c, L2-s, L4-r, L6-s, L13-c to L15-c, R3-r, R6-c, R7-c, R10-c

¹³⁴⁰ See Chapter 4.3.2.3.1

It is, therefore, proposed that courts should be given more guidance about when, how and why the cram-down power should be used. This guidance can initially come from the top down, as a document from the SPC. But in time, it should be supplemented or even replaced by a collection of bottom-up insights whereby individual courts share their experiences through an online platform or conferences.¹³⁴¹

7.1.5 Introduce additional provisions

Besides changes to the existing provisions, two new provisions should also be introduced that could improve the functioning of the EBL. Firstly, directors' duty to monitor their company's health should be (re-)introduced to ensure more timely and efficient use of the EBL (7.1.5.1). And secondly, a fast-track option for small companies should be created to enable smaller-scale insolvencies to be resolved more quickly, cheaply and efficiently under the EBL (7.1.5.2). Both of these provisions have been successfully trialled in several pro-market regions in China,¹³⁴² but have not yet been implemented nation-wide.

7.1.5.1 (Re-)Introduce duty to monitor company's health

The EBL should include a provision that company's directors must monitor company's health and submit to one of the EBL procedures once insolvency becomes imminent. When a company is still solvent, owners of the business – whose interests are represented by the directors – are the main financial stakeholders. But as soon as the company becomes

¹³⁴¹ For more, see Chapter 7.3.1

¹³⁴² Interviews J3-c to J9-c, R10-c

insolvent, it is the creditors who bear the losses suffered if debtor continues to trade which makes them the new main financial stakeholders.¹³⁴³ Many other regimes – including Germany and the UK – try to regulate the resulting moral hazard and, even more importantly, the information asymmetry between the debtor and its creditors¹³⁴⁴ by shifting the duty of monitoring and disclosure onto the debtor as the party with the lowest cost and the best access to the necessary information. Thus, insolvent debtors in Germany have a duty to file insolvency petition within three weeks after they become insolvent, failing which they face criminal liability. Similarly, in the UK, debtors' directors¹³⁴⁵ can be criminally liable where they continue to trade when they 'knew, or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation' and they did not take 'every step with a view to minimising the potential loss to the company's creditors.'¹³⁴⁶

On the other hand, some argue that it is not economically efficient to push this responsibility onto directors because welfare gains by creditors are minimal due to the increased costs associated with directors demanding a higher pay for a riskier job.¹³⁴⁷ Instead, they propose, creditors can ascertain and protect themselves contractually because pushing the entire responsibility onto directors over-compensates the lender and does not allow directors to use their judgment and commercial common sense freely.¹³⁴⁸ The US

¹³⁴³ Kraakman et al (2017) Chapter 5.4

¹³⁴⁴ Where directors and owners have a better access to information about the debtor company's financial affairs

¹³⁴⁵ This can include shadow and *de facto* directors

¹³⁴⁶ Known as wrongful trading: s.214 Insolvency Act 1986

¹³⁴⁷ For more see review of literature and rejection of this argument in Whincop in Ramsay (2000) at 44-45 and 54-60

¹³⁴⁸ *Ibid.*

insolvency law follows this rationale and it, therefore, has no insolvent trading provisions. If a creditor wants wrongful-trading-style protection, they have to insert a special term into their contract,¹³⁴⁹ or they have to rely on tortious remedies.

Given that China's corporate legal regime is closer to the UK and Germany, it is proposed that China should introduce a new provision into the EBL to impose a duty on companies' directors to monitor their financial health and to apply to use the EBL once the company becomes insolvent (or it is likely that it will become insolvent). Such duty was included in an early draft of the EBL that was successfully trialled in Shenzhen.¹³⁵⁰ Moreover, China's economy suffers from significant information asymmetries; the sophistication and ability of many players to protect themselves contractually are limited, and enforcement thereof slow; and courts' ability and willingness to investigate directors' activities are also limited.¹³⁵¹ The proposed duty to self-monitor would make it directors' duty to prove that they petitioned to use the EBL as soon as it was reasonable for them to know that the company became insolvent or was about to become insolvent.

¹³⁴⁹ For more, see Oesterle in Ramsay (2000) at 22

¹³⁵⁰ Zhang and Booth (2001)

¹³⁵¹ Therefore, following the US model would most likely not work.

7.1.5.2 Introduce expedited use of the EBL for small companies

Finally, it is argued that a fast-track option should be available to small companies,¹³⁵² similar to a current trial in Shenzhen,¹³⁵³ to enable quicker, more cost-effective solution for small companies. Small companies are special because their distress is usually simpler, it involves fewer stakeholders and concerns fewer assets. Moreover, China's economy contains a large amount of smaller private companies which makes it important that their distress is resolved efficiently. The proposed fast-track option could improve small companies' access to cheaper credit, and it could also enable quicker recycling of resources back into the economy to enable development of other projects.

7.1.6 Practical impact and Conclusion

Reforming EBL provisions alone is unlikely to result in a greater or more efficient use of the law. This is because flaws in the written EBL are only one of many constraints on its use.¹³⁵⁴ Nevertheless, the written EBL can and should be improved so that the rules are the best that they can be for when the shortcomings in enforcement – arguably the major constraint – improve over time.¹³⁵⁵ The proposed reforms of EBL enforcement are discussed next.

¹³⁵² A definition of a small company could be left to local laws, as it will depend on the commercial reality and context in each province.

¹³⁵³ The court in Shenzhen is experimenting with the idea of allowing fast-track hearing for companies whose liabilities amount to 1 million RMB or less: internal court document, early 2017 (a copy with the author). Also in line with the UNCITRAL Guide Recommendation 169

¹³⁵⁴ See Chapters 5.2 to 5.4

¹³⁵⁵ Following the reform proposals in Chapters 7.2 and 7.3

7.2 Reforms aimed at improving EBL enforcement practices and surrounding rules

In order to improve the functioning of the EBL, it is necessary to improve EBL's supporting infrastructure – surrounding rules and practices – which lower parties' payoffs under the EBL or outright prevent the EBL from being used. As such, these reform proposals build on the issues identified in Chapter 5.2.

The reforms that are discussed below focus on three broad sets of issues (Table 7-3).

Table 7-3: Direct reforms of surrounding rules and practices

	Content of reform	Timing of reform
Ameliorate general flaws in debt enforcement (7.2.1) to increase payoffs under the EBL	Strategies for reducing information asymmetries (7.2.1.1)	Any time, but effective only after reforms aimed at enforcers (7.3)
	Introduction of national property rights register (7.2.1.2)	Any time, but more likely to be effective only after reforms aimed at local governments (7.3.3)
	Better protection of property rights (7.2.1.3)	Any time, but effective only after reforms aimed at enforcers (7.3)
	Better enforcement of directors' duties and reversal of transfers to new companies (7.2.1.4)	Any time, but best together with judges' training (7.3.1)
Ameliorate rules and practices that specifically affect the EBL (7.2.2) to remove opposition for local governments	Full implementation of social security system (7.2.2.1)	Any time, but effective only after reforms aimed at local governments (7.3.3)
	Reduce state companies' interconnectedness, triangular debts, and guarantee chains (7.2.2.2)	Any time, but effective only after reforms aimed at local governments (7.3.3)
Clarify and harmonise treatment of the parties engaged in shadow lending (7.2.3)	Clarify and harmonise political and legal approach to shadow market activities	Any time, but effective only after reforms aimed at local governments (7.3.3)

Firstly, several reforms are proposed with the aim to ameliorate general flaws in debt enforcement that also negatively affect recoveries under the EBL (7.2.1). Secondly, several changes are discussed which may ameliorate the rules and practices that specifically affect recoveries under the EBL (7.2.2). And finally, it is argued that the treatment of the parties engaged in shadow market activities should be clarified and harmonised across China (7.2.3).

7.2.1 Ameliorate general flaws in debt enforcement

As was discussed earlier, there are several issues that affect recoveries under both the EBL and general debt enforcement.¹³⁵⁶ The improvements proposed in this section aim to increase payoffs which the parties can expect to receive under the (reformed) EBL.

The discussion first examines possible strategies for reducing information asymmetries (7.2.1.1). It then discusses the need for a fully functional national property rights register (7.2.1.2) and considers how a better protection of property rights may improve the functioning of the EBL (7.2.1.3). It concludes by looking at possible improvements to the Company Law (7.2.1.4). In the aggregate, these proposed reforms are likely to increase actual recoveries under the EBL, and so encourage greater and more efficient use of the EBL.

7.2.1.1 Strategies for reducing information asymmetries

Chinese business environment is negatively affected by the scarcity of reliable, publicly available information.¹³⁵⁷ In the context of insolvency law, this causes several problems which make the EBL process comparatively slow and expensive (v. alternatives). The

¹³⁵⁶ See Chapters 4.1.3 and 5.2

¹³⁵⁷ See Chapters 4.1.3.1 and 5.2.1.1

information asymmetry complicates determination of whether a company is, in fact, insolvent. It hinders proving debtors' assets and liabilities. And it also impedes a proper implementation of the safeguards and procedures contained in the EBL.

Improvements in this area are likely to be slow and gradual because an effective reform requires multiple changes in China's business environment and parties' attitude. The strategies can be divided into two groups. Internal changes come from an *increased understanding* of the parties that a greater amount of reliable information is efficient for the economy at large and so, in time, also for themselves. However, such understanding alone is unlikely to result in any improvements. Therefore, parties must also be *incentivised* – with encouragement and a threat of punishment – to publish (i) truthful information (ii) in sufficient quantity (iii) which is freely and easily accessible. This may be achieved through a creation of online platforms where companies' information could be accessed freely and easily; random checks of the submitted information and severe punishment for submitting untrue information; a requirement that the information must be submitted in a unified form (to facilitate effective comparison); better enforcement of China's Company Law and Corporate Governance Code; and liability for accounting firms which recklessly or fraudulently cover up or allow a cover-up of false information. Effective enforcement of these strategies will be crucial to their success.

7.2.1.2 Introduction of national property rights register

Although Property Register has been formally introduced in 2013-14, its implementation in practice remains incomplete.¹³⁵⁸ As a result, it is often unclear who owns particular property

¹³⁵⁸ See Chapters 4.1.3.2 and 5.2.1.2

and property rights. It is also difficult to protect security rights effectively. This makes the verification of claims and collection of assets in insolvency difficult and enables fraudulent asset stripping at the expense of creditors.

It is, therefore, proposed that national and local governments should prioritise the completion of the Property Register in China. Technically, there should be no significant obstacles to its full implementation. Once implemented, the register would enable quicker, cheaper and more reliable verification of parties' rights and claims, it would help determine their priority and enforceability, and it would increase transparency and ease of doing business in China – all of which are likely to have a positive impact on investment and access to credit. Although independent from other reforms, the implementation is likely to be quicker and more effective after reforms aimed at improving local governments' understanding of the role and importance of insolvency law in China's economic development (see Chapter 7.3.3).

7.2.1.3 Better protection of property rights

The lack of effective protection of property rights – which, *inter alia*, enables asset grabbing and unpunished looting – hinders companies' activities in and out of insolvency. Under the EBL, it negatively affects the value and amount of assets that are available for satisfying stakeholders' claims.

Asset grabbing can be prevented by the police and, under the EBL, by administrators.¹³⁵⁹ Similarly, looting of debtor companies can also be prevented by the police. Nevertheless, as was discussed in Chapter 5.2.1.3, the police often fail to intervene to protect

¹³⁵⁹ More about administrators' role in Chapter 7.3.2.1

debtors' assets from damage or misappropriation. Regardless of whether such failure to act is due to their unwillingness or inability, the police plays a crucial role in property protection. It is, therefore, suggested that the government – both at national and local levels – must force it to act. The ability to protect property may be added to local governments' performance targets to incentivise their proactivity in this matter.¹³⁶⁰

Similarly, courts must also be willing to step in and protect property rights. The impact of this issue goes far beyond individual cases and claimholders. In a system where owners of assets cannot rely on the absolute nature of their right – and its protection where needed – their ability to borrow in the finance market is reduced, which limits their ability to compete and engage in new projects. In the aggregate, the resulting incomplete protection of property rights has a negative impact on economic development.

7.2.1.4 Better enforcement of directors' duties and reversal of transfers to new companies

Similar to the previous issue, there are rules and mechanisms which can prevent unauthorised transfers of assets that aim to defraud claimholders. Besides provisions in the EBL,¹³⁶¹ the Company Law also empowers courts to reverse asset stripping by companies' insiders. Furthermore, it imposes duties of diligence and loyalty on company directors. However, my research suggests that these rules are often ignored and asset transfers are *de facto* permitted due to courts' passivity.

¹³⁶⁰ For more, see Chapter 7.3.3.2

¹³⁶¹ *Ibid.*

It is, therefore, proposed that courts should be directed to pay more attention to these issues and more strictly enforce these provisions in practice. Change will be slow and difficult. China, like many developing countries, is facing difficulties that arise from imperfect law enforcement. However, there is no practical replacement for courts in this context. The success of this particular reform will, therefore, depend on the outcome of the proposed court-related reforms (Chapters 7.3.1 and 7.3.2).

7.2.2 Ameliorate rules and practices that specifically affect the EBL

In order to reduce local governments' opposition to EBL enforcement, it is also important – as was suggested in Chapter 5.2.2 – to address two further issues. Firstly, China's national social security system must be fully implemented (7.2.2.1). And secondly, local governments should be incentivised to reduce state companies' interconnectedness, triangular debts, and guarantee chains (7.2.2.2).

7.2.2.1 Full implementation of social security system

It was argued in Chapter 5.2.2.1 that local governments fear that letting (large) local companies fail may lead to a significant number of redundancies which often leads to social unrest. One of the main reasons why the newly unemployed take to the streets is because – without a functioning social welfare system – losing a job means losing their livelihood. As a result, local governments often interfere or prevent insolvency cases from being tried independently by courts in accordance with EBL procedures to prevent company closures.

In the early stages of China's economic development, when all companies were owned by the state, social welfare was provided through the tradition of 'iron rice bowl' whereby SOEs would provide lifelong employment and take care of people's material needs from birth to death. But the system was abolished during the 1970s economic reforms.¹³⁶² For this reason, the concept of a social security fund was introduced in the 1990s, with further reforms in 2011. However, by 2015, only about a quarter of all companies were contributing to the fund.¹³⁶³ Moreover, there is still no mechanism for paying out unemployment benefits from this fund once a person becomes unemployed. As a result, protectionism of employees continues. As the Chinese Prime Minister, Li Keqiang, said at the end of the annual NPC meeting in 2016: 'We must proceed with reducing industrial capacity, but the great numbers of employees cannot lose their rice bowls, and we must strive to find them new rice bowls.'¹³⁶⁴

However, it is proposed that efficiency cannot be introduced – and economic growth facilitated – without liquidating and restructuring at least some of the distressed companies in China. It is true that corporate closures and restructurings necessarily involve redundancies. But the recycled resources and resulting efficiency also provide further opportunities to grow existing projects and to create new ones. When this happens, new jobs are created, the unemployed are re-employed in more efficient projects, and the economy develops and grows. Nevertheless, there is usually a time gap between an employee's dismissal from a distressed company and re-employment in a new company. For

¹³⁶² See Chapter 3.1

¹³⁶³ For details see Chapter 5.2.2.1

¹³⁶⁴ Buckley and Hernandez (16.3.2016)

this period, there needs to be some support mechanism which provides for the unemployed persons' basic material needs – a *temporary* rice bowl. One such mechanism is unemployment benefits paid out of a social security fund.

It is, therefore, proposed that national and local governments must prioritise the completion of social security system in each region and nation-wide. All companies must be forced to contribute to the fund and each local government must create a mechanism and a publicly accessible set of rules that regulate¹³⁶⁵ and explain the provision of unemployment benefits in their region. Such full implementation of the social security system would remove one of the main reasons for local governments' opposition to insolvency law.

This proposal is crucial to change the attitude of local governments. However, realistically, the change is unlikely to happen until local governments officials *understand* the importance of this project and the EBL for their economy.¹³⁶⁶ The full implementation of the social security system is, therefore, likely to take place only after the implementation of reforms that are aimed at improving the understanding of local governments (as discussed in Chapter 7.3.3). Once local governments understand and their incentives are changed, they will be more likely to allow courts to apply EBL provisions more objectively, without employee protectionism which now hinders enforcement of the EBL.¹³⁶⁷

¹³⁶⁵ The system would ideally be linked to the *hukou* registration system.

¹³⁶⁶ China employment law and tax law experts should be consulted. Strong support from national government, the Party, and their local-level agencies would be crucial, and a lot of political will would be needed for this project to succeed. One way how local government representatives could be encouraged to implement social security system in their region would be to say that successful establishment of social security system in any region is one of the measures in the leaders' career-progression assessment by the central government.

¹³⁶⁷ See Chapters 5.1.1 (employee protectionism by courts), 5.2.2.1 (incomplete social security system), 5.3.3.1 (why the Party-state interferes) and 5.4.2 (politically-driven alternatives)

7.2.2.2 Reduce state companies' interconnectedness, triangular debts, and guarantee chains

Chapter 5.2.2.2 explored another reason why local governments do not allow parties to use the EBL, namely their fear of systemic risk that arises from the interconnectedness of state-sector companies. This interconnectedness originates in the unique ownership structure of the SOEs,¹³⁶⁸ but also in the use of mutual guarantee chains and triangular debts among large companies.¹³⁶⁹ Together, these mechanisms increase the risk of economy-side distress because they increase the likelihood of a domino effect of insolvencies.

Although in the short-term, local governments may see it as a good idea¹³⁷⁰ to rescue individual companies in distress where their insolvency would cause financial distress in many other companies that are connected to it through debts and mutual guarantees, it is proposed that in the long term, it leads to moral hazard because state-sector companies know that they will be rescued and so make limited or no effort to manage their risk. However, this leads to wasteful bailouts and other forms of financial support, which should be discouraged.

It is, therefore, proposed that local governments should be forced to reduce corporate interconnectedness in the state sector. They should not allow companies under their control to become too big and too interconnected so as to avoid the too-big-to-fail dilemma,¹³⁷¹ reduce the risk of systemic distress, and enable healthy competition in the economy. Similarly, triangular debts and mutual guarantees and guarantee chains should be

¹³⁶⁸ See Chapter 3.4

¹³⁶⁹ For details see Chapters 4.2.2.2 and 5.2.2.1

¹³⁷⁰ See Chapter 5.3.3.1 for their reasons

¹³⁷¹ Sorkin (2010)

banned and this ban should be monitored and strictly enforced. Consequently, insolvency of one company would be (comparatively) less likely to affect financial health of the others. These changes are likely to be implemented once local governments' incentives are amended from short- to long-term focus (Chapter 7.3.3.2).

7.2.3 Clarify and harmonise the treatment of the parties engaged in shadow lending

One of the most fundamental changes which is likely to ensure that the EBL becomes used by all eligible companies whose financial distress would be most efficiently resolved under the EBL is the inclusion of shadow lenders and borrowers.¹³⁷² For this to occur, the government needs to change its attitude towards shadow credit, and it needs to clarify and harmonise the rules on how to treat the activities of the shadow market participants – both in and out of insolvency.

There are two major reasons why these changes are necessary. The first reason is connected with the wide use of undesirable enforcement techniques by shadow lenders which is partly caused by the lack of recognition of their claims in Chinese courts.¹³⁷³ Moreover, shadow credit is crucial for China's fast-growing private sector,¹³⁷⁴ but a party's involvement in the shadow market – whether as a lender or a borrower – can give rise to criminal liability, with the maximum penalty (until recently) being capital punishment.¹³⁷⁵ As

¹³⁷² They are mostly excluded under the current system: Chapter 5.2.3

¹³⁷³ For examples, see Chapter 6.1.2.1.

¹³⁷⁴ See Chapter 4.1

¹³⁷⁵ See Chapter 5.1.2

a result, creditors and debtors usually do not wish to use the EBL and instead opt for private enforcement mechanisms¹³⁷⁶ and avoidance of repayment techniques,¹³⁷⁷ respectively. This is problematic because shadow creditors often use violent and otherwise undesirable methods to enforce debt repayment which – many of my interviewees argued – could be significantly reduced if shadow lending contracts were recognised in and enforced by courts.¹³⁷⁸ Similarly, allowing shadow borrowers to use the EBL would be beneficial because there would be a mechanism for debtors to restructure or otherwise resolve their liabilities and have a chance for a fresh start instead of having to fear violence or face exile in order to avoid it.

The second reason why shadow lending and borrowing need to be legalised is that, otherwise, they pose a large threat to the stability of China's financial system. This threat arises from the riskiness and vastness of the shadow lending activities, and the fact that shadow finance is still largely unregulated. Shadow lending is risky because lenders usually do minimal or no background checks and so they lend to sub-prime borrowers – which *ex ante* increases the likelihood of a default. In addition, they charge high interest rates to compensate for the increased risk of default. However, it is often the high interest rates that cause or significantly contribute to borrowers' financial distress.¹³⁷⁹

Moreover, shadow lending permeates China's entire economy. Private as well as state-controlled parties are involved. As was discussed in Chapter 4.1.1 and 5.2.3, shadow

¹³⁷⁶ See Chapter 5.4.1

¹³⁷⁷ See Chapter 6.1.2.2

¹³⁷⁸ Interviews C4-c, C5-r, C7-s, C11-c, E1-c, E2-s, IF1-s, IF2-c, J4-c to J9-c, L2-s, L4-r to L15-c, P1-r, P5-c, R3-r, R7-c, R9-c, R10-c

¹³⁷⁹ Interviews C1-c, C4-c, C5-r, C7-s, C11-c, E1-c to E4-c, IF1-s, J3-c to J6-s, J8-c, J9-c, L1-r to L15-c, R2-r, R3-r, R6-c, R7-c, R9-c, C10-c, R13-c

lending includes any arms-length provision of finance that comes from unauthorised (usually private) entity – e.g. underground banks – or that involves unauthorised activities by an authorised body – e.g. WMPs and unauthorised lending into real estate sector by state banks. Borrowers are usually private sector companies and struggling SOEs which try to conceal their distress from the Party-state.

Furthermore, shadow lending is still largely unregulated. This often leads to unstable lending models and fraud – leading to collapses of underground banks and lending platforms, causing losses to depositors, and sending shock waves through the entire economy because so many players are involved. The government has been trying to contain the risk for years,¹³⁸⁰ but with limited success. Shadow lending is growing and is riddled with fraud, collapses, and quickly-concealed local crises that threaten the stability of China's economy.¹³⁸¹

Shadow lending is unlikely to disappear so long as there is demand – from credit-starved private companies – and supply – from depositors seeking higher-than-bank-provided returns and companies seeking extra profits from their idle funds. Demand will remain so long as banks remain controlled by the state. And supply will remain so long as there is money to be made – mostly through high interest rates.

It is, therefore, proposed that there needs to be clearer national guidelines about the treatment of each type of shadow lending activity.¹³⁸² This is likely to be a staged process. First steps must be taken by the Chinese government through a public statement and

¹³⁸⁰ See e.g. Choyleva (21.6.2017)

¹³⁸¹ See e.g. Collier (26.6.2017)

¹³⁸² Many types of shadow lending activities are treated differently in different provinces: see Chapter 4.1

subsequent specialised legislation that would deal with the permitted and forbidden lending activities, and their consequences. Courts should also receive detailed guidelines on how to deal with non-bank lending activities and shadow debt contracts in general and under the EBL. The drafting of both is likely to take time and should not be rushed. Experience from local courts and governments should be shared in intra-provincial sessions.¹³⁸³

7.2.4 Practical impact and Conclusion

Improving EBL's enforcement environment is as important as improving the EBL itself. The changes proposed in section 7.2.1 are needed for enabling the EBL to offer higher payoffs, and so incentivise the parties to use the law more. On the other hand, the changes in section 7.2.2 are likely to reduce the opposition from EBL's enforcers, and so enable the law's greater use. Finally, the changes in section 7.2.3 affect both the parties' expected payoffs under the EBL and the enforcers' ability and willingness to deal with a particular type of claimants in financial distress. In the short term, the reform efforts should focus on the first two sets of changes – in particular improvement to the quality and quantity of available information (7.2.1.1), completion of the national property rights register (7.2.1.2), and full implementation of social security system (7.2.2.1) – without which the EBL is unlikely to function effectively. In the medium-to-long term, however, the third set of reforms – aimed at shadow lenders and borrowers – will also have to be implemented to enable fuller application of the EBL to all eligible cases.

¹³⁸³ See Chapter 7.3.1

7.3 Reforms aimed at EBL enforcers

The findings in Chapter 5 suggest that reforms aimed at improving efficiency of the EBL in practice also need to focus on ameliorating the ability and willingness of law enforcers to allow greater and more efficient use of the EBL. This chapter, therefore, examines ways to ameliorate the problems associated with EBL's direct enforcers who are involved in EBL procedures – judges, lawyers, and administrators – and indirect enforcers who influence the procedures from behind the scenes, without EBL-derived power – most importantly local governments.¹³⁸⁴

The discussion is structured in a similar way to Chapter 5.3, albeit with more emphasis on the limitations that arise from local governments' biases. It first looks at ways how to improve courts' and lawyers' expertise and experience (7.3.1). It then examines options for ensuring more accurate and objective enforcement of the EBL (7.3.2). It then re-focuses on local governments and discusses how and why to change their incentives to ensure that they understand and are willing to support more efficient use of the EBL by the parties (7.3.3). It concludes with a discussion of how to bring together the first three sets of reforms proposals – judges' and lawyers' training, detailed improvements to judicial and lawyers' practices, and local governments' training – to ensure greater judicial independence (7.3.4).

The reforms proposed in this section are particularly sensitive in terms of timing. Their ultimate aim is to enable courts to apply the EBL with skill and independence. Skills and experience are built over time through actual decision-making and training, but independence requires that local governments permit judges to hear cases without

¹³⁸⁴ See Chapter 5.3

(excessive) political interventions.¹³⁸⁵ To that end, local governments must first be persuaded – through changed incentives, greater understanding, and top-down orders – that the EBL matters and that it has much to offer to their local economy. To this end, seven reform proposals are made, some with particular timing, as summarised in Table 7-4.

Table 7-4: Direct reforms aimed at enforcers

	Content of reform	Timing of reform
Changes that affect courts and lawyers (7.3.1, 7.3.2)	Improve expertise and experience of judges and lawyers (7.3.1)	Any time (staged)
	Ensure that administrators carry out their duties (7.3.2.1)	Any time, but best together with judges' training (7.3.1)
	Ensure that priority of repayment is respected (7.3.2.2)	Any time, but best together with judges' training (7.3.1) and local governments' training (7.3.3)
	Remove judges' internal quotas (7.3.2.3)	Any time, but best with local governments' training (7.3.3)
Changes that affect local governments (7.3.3)	Enhance local governments' understanding of the need for the EBL (7.3.3.1)	Any time
	Change structure and substance of local government officials' incentives (7.3.3.2)	Any time
Changes that affect both courts and local governments (7.3.4)	Enable and safeguard judicial independence (7.3.4)	Implement after reforms aimed at local governments (7.3.3)

7.3.1 Improve expertise and experience of judges and lawyers

Improving judges' and lawyers' knowledge and skills that are necessary for dealing with EBL cases is crucial because – as was discussed in Chapters 4.3.2.6 and 5.3.1 – judges and lawyers play a crucial role in EBL enforcement.¹³⁸⁶ The reforms that are proposed below are

¹³⁸⁵ For details, see Chapters 3.3.3 and 5.3.3

¹³⁸⁶ See Chapters 4.3.2.6 and 5.3.1

aimed at helping them appreciate the importance of insolvency law for China, to know what the EBL says, and to understand how to use it in practice. If implemented successfully, the reforms should help ameliorate one of the key limitations that my interviewees identified in Chapter 5.3.1 – judges’ and lawyers’ lack of expertise and experience in applying the EBL in practice.¹³⁸⁷ This section, therefore, first looks at the challenges that face judges and those that face lawyers. It then examines possible ways of ameliorating them, and considers likely difficulties with implementing the proposed changes.

Much criticism has been levelled against Chinese courts.¹³⁸⁸ However, my interviewees insisted that many judges – particularly in higher courts – are extremely capable and exceptionally hard-working.¹³⁸⁹ Nevertheless, judges’ work is affected by internal and external limitations which make them reluctant or unable to deal with EBL cases more effectively.¹³⁹⁰ Several interviewees also stressed that judges are often unaware of the purpose and procedures in the EBL, which is why they do not use it.¹³⁹¹ Nevertheless, given their central position in EBL enforcement, it is important that they know and understand the law to be able to apply it effectively. In time, as courts’ expertise and experience grow, creditors and debtors will become more likely to entrust their case to a

¹³⁸⁷ See People’s Daily (10.10.2015)

¹³⁸⁸ See Chapter 3.3

¹³⁸⁹ In particular interviews C2-c, C5-r, C7-s, J2-c, L1-r to L7-c, L9-s to L14-c, L16-c, P1-r, R3-r, R6-c to R10-c, R15-s

¹³⁹⁰ *Ibid.* For details see Chapter 5.3

¹³⁹¹ Interviews C4-c, C5-r, C7-s, J1-c, J2-c, J4-c to J8-c, L2-s, L4-r to L7-c, L14-c, L15-c, P1-r, R2-r, R8-s to R10-c

judge.¹³⁹² An increase in courts' expertise and experience is also likely to lead to a decrease in length and cost of insolvency proceedings.¹³⁹³

Improving lawyers' EBL-related expertise and experience is equally important. Lawyers' role in resolving corporate financial distress starts even before debtors submit an EBL petition because companies in distress often rely on advice and knowledge of their legal advisors when deciding *whether* and *how* to deal with their financial problems. Moreover, some lawyers also act as administrators who are central to the day-to-day administration of EBL cases. It is, therefore, crucial that they understand their role in the process and their many duties.¹³⁹⁴

Five ways to ameliorate the situation are proposed. Firstly, China should introduce *specialised insolvency courts*, or specialised branches within existing general courts which would enable judges with relevant education and background (e.g. finance, business, accounting, restructuring) to become experts in dealing with insolvency cases. Thanks to the concentration of the cases in the hands of relatively few judges, specialisation and experience would grow over a relatively short period of time even with a small number of EBL cases. The calls for specialised judges first appeared when the old law came into force in 1988¹³⁹⁵ and have been reiterated in recent years. Finally, in December 2015, China's Central Economic Work Conference decided to make resolution of the insolvent state

¹³⁹² See Chapter 5.3.1.1

¹³⁹³ Interviews B1-c, C3-c to C5-r, C7-s, C8-s, C10-s, E1-c to E5-c, IF1-s, IF2-c, L2-s to L6-s, L9-s to L15-c, R1-r, R3-r, R6-c, R7-c, R9-c, R10-c. See also Chapter 5.3.1.2

¹³⁹⁴ See Chapter 4.3.2.6

¹³⁹⁵ For details see Chapter 5.3.1.1

companies one of its priorities for 2016 (to reverse the economic slow-down).¹³⁹⁶ The SPC responded in June 2016 with a Notice calling for establishing specialised divisions in all of China's Intermediate Courts and increasing the number of insolvency judges.¹³⁹⁷ Zhejiang, Shandong and Shenzhen implemented this change by the end of July 2016, and the rest of the country was supposed to follow by the end of 2016.¹³⁹⁸

Secondly, the government could also call on selected regions – with various degrees of economic development, in different geographical regions, with a different number of EBL cases – to become *pilots for further reform*. Local governments in the selected regions would be encouraged – through incentives and rewards if successful – to experiment with ways how to enable and encourage a more efficient use of the EBL. This would be similar to the 1970s and 1980s' approach to reform where local governments were, successfully, encouraged to achieve large-scale improvements from the bottom up.¹³⁹⁹

Thirdly, the SPC should provide additional *detailed guidance* on the procedural elements of the EBL – such as criminal liability of managers of insolvent companies, a priority of repayment, acceptance or rejection of EBL petitions – to inform judges at lower courts about the likely challenges in the process and SPC's preferred solutions. The SPC could also provide guiding cases – akin to precedents¹⁴⁰⁰ – showing how Liquidation and

¹³⁹⁶ So-called zombie-companies – see Chapter 5.4.2.2 and 6.1

¹³⁹⁷ Notice concerning the plan for establishing liquidation and bankruptcy trial divisions in intermediate courts

¹³⁹⁸ SPCM (30.6.2016)

¹³⁹⁹ See Chapters 3.1 and 4.3.1

¹⁴⁰⁰ See Chapter 3.3.3.2

Reorganisation should be used in different circumstances depending on size, industry, region, and ownership type.

Fourthly, many interviewees suggested that their preferred way of learning about the EBL and its application would be through *conferences and practical training sessions*.¹⁴⁰¹ They suggested that conferences should be led by Chinese and foreign experts and the content should be practical. Expert-led training sessions should then share the guidelines and advice in a workshop-style environment where judges and lawyers could learn from practical examples and problems. Several local courts have already held several sessions and produced reports for local governments and local Party committees about the EBL process.¹⁴⁰² Others have been holding training sessions, either in courts or together with local governments.¹⁴⁰³ Many more of these initiatives are needed across China.

And finally, practical insights and guidelines for hearing EBL cases could also be shared through *online platforms*, which would maximise their practical impact and geographical reach. Several courts have already released guidance on hearing EBL cases. Shenzhen – one of the pilot regions with a specialised insolvency court – released such guidance in May 2015 and again in January 2016, when they also launched an online platform with information about bankruptcy case hearings, announcements, case

¹⁴⁰¹ Interviews C1-c, C3-c to C5-r, C7-s, C9-c to C11-c, J1-c to J9-c, L2-s to L15-c, P1-r, P3-r to P5-c, R2-r to R4-c, R6-c to R10-c, R13-c

¹⁴⁰² E.g. ChinaCourt (5.2.2016)

¹⁴⁰³ E.g. the Changsha Intermediate People's Court (Hunan Province) held a training session in February 2016 with experts from the SPC and Beijing universities: Weixin (1.3.2016)
The local government in Quanzhou (Fujian Province) also organised a cross-institutional EBL training: DongNanWang (18.2.2016)

judgments, petition filing, EBL procedures, etc.¹⁴⁰⁴ Guidelines have also been released for dealing with specific types of cases.¹⁴⁰⁵

Although some changes have been made and implemented with a degree of success in recent years, the increase in the number of EBL cases – most notably to 5,665 cases in 2016 after the government’s call to resolve financial distress in local zombie companies – is likely to be temporary¹⁴⁰⁶ unless more in-depth changes are carried out. After all, the number of cases that were heard under the much-criticised old law temporarily reached to almost 9,000 cases in 2001 when the government put pressure on the courts to use the law just before its accession to the WTO.¹⁴⁰⁷ Similarly, despite the push to create specialised insolvency branches in all Chinese courts, most courts still do not have one even though the deadline passed a year ago.

There appears to be an increase in appetite and willingness to learn about these issues which should make the delivery of the proposed interventions in this section relatively straight-forward. Nevertheless, when implementing the proposed changes, it is important to bear in mind that most court-related changes rely heavily on a change in local governments’ attitude.¹⁴⁰⁸ Training the lawyers, on the other hand, is likely to prove less problematic.

¹⁴⁰⁴ <http://ssfw.szcourt.gov.cn/home> (in Chinese)

¹⁴⁰⁵ E.g. insolvencies of real estate companies (Zhejiang courts in December 2015); further guidelines are being drafted about failures of shipping companies and P2P lending platforms

¹⁴⁰⁶ It is likely that the increase in the number of EBL cases is, indeed, temporary, given that the increase is politically motivated and driven from the top (national Party-state) down (local governments), and so as soon as the top-down pressure disappears (once the bulk of zombie companies is resolved in a few years), the number is likely to drop again unless further changes are implemented successfully.

¹⁴⁰⁷ See Chapter 4.3.3

¹⁴⁰⁸ See Chapters 7.1 and 7.2

7.3.2 Ensure more accurate and objective enforcement of EBL rules

Besides improving courts' and lawyers' expertise, it is also important to ensure that the powers and duties in the EBL are actually carried out. Although it is generally accepted that the EBL is well-written, many of its provisions which have the potential to make it particularly useful are not enforced in practice.¹⁴⁰⁹ Three improvements are proposed. The first two are aimed at ensuring better enforcement of administrator's duties (7.3.2.1) and a greater respect for the priority of repayment order as written in the EBL (7.3.2.2). The final intervention (7.3.2.3) aims to enable courts to consider *all* EBL petitions and to allow greater use of EBL Reorganisation. The success of the second and third intervention are conditional on a change in local governments' attitude (Chapter 7.3.3). It also relies on proactive cooperation from judges and lawyers, and so should be included in the training sessions mentioned in section 7.3.1.

7.3.2.1 Administrator's duties

Chapter 4.3.2.6 pointed out that, besides being in charge of day-to-day management of Reorganisation plan, administrators must also identify and claw back certain preferential payments, hidden or transferred property, fraudulent payments, and they must ask a court to revoke transactions at an undervalue and other transactions the seek to defraud creditors. My interviewees argued¹⁴¹⁰ that these extensive duties and corresponding powers could be one of the greatest advantages of the EBL to creditors because they could help

¹⁴⁰⁹ See Chapters 5.1.1 and 5.3.2

¹⁴¹⁰ See Chapter 5.3.2

increase the total amount of assets available for distribution and lead to greater, less risky recoveries (v. illegal or costly private enforcement). However, despite the importance and in some cases the imperative mode of the provisions,¹⁴¹¹ many of my interviewees suggested that administrators are often unable or unwilling to exercise such powers and duties fully which negatively affects the likelihood of meaningful recovery by creditors.¹⁴¹²

It is, therefore, proposed that this issue should be addressed as a part of judges' and lawyers' training, and that the SPC should direct lower courts to police and enforce administrators' duties more closely. The key obstacles are likely to be administrators' ignorance of the relevant provisions, and lawyers' and judges' fear of being overburdened. However, it is very important that administrators' passivity is reversed in order to make EBL procedures truly collective and efficient.

7.3.2.2 *Priority of repayment in the EBL*

In addition, it is also important that judges respect and apply the law as written, because the parties arrange their affairs and make decisions *ex ante* based on what the law suggests they can expect to happen *ex post*. If the law cannot be trusted, lenders are likely to consider lending risky and, consequently, not lend or make credit more expensive.¹⁴¹³ The EBL stipulates that 'secured creditors are entitled to obtain payment in priority over

¹⁴¹¹ Note the use of 'have to' in Arts 32-33 EBL

¹⁴¹² Interviews B1-c to B3-c, C1-c, C3-c to C5-r, C7-s, C9-c, E2-s, J12-c, J4-c to J9-c, L2-s, L4-r to L7-c, L10-s to L15-c, P1-r, R1-r to R3-r, R9-c, R10-c, R13-c

¹⁴¹³ See discussion in Chapter 4.2.2.2

debtor's specific asset'¹⁴¹⁴ – regardless and ahead of all other claims. However, as was argued in Chapter 5.1.1, courts have afforded preferential repayment to employees' claims by interpreting ancillary EBL provisions as enabling prioritisation of socio-economic interests.¹⁴¹⁵

As above, it is proposed that the rules about priority of repayment and their practical importance should be discussed in judges' training sessions. A shift in courts' practice is only likely to occur after a shift in local governments' understanding and attitude to the issue. The SPC and central Party-state should also support this initiative with further guidelines and orders to lower courts and local governments.

7.3.2.3 Remove judges' internal quotas

It was also proposed earlier that judges' reluctance to accept EBL petitions is partly caused by an internal quota system which obliges each court to hear a certain number of cases per month.¹⁴¹⁶ This crude metric ignores the fact that certain cases – such as insolvency cases – need significantly more time (and resources) to be resolved. As a result, judges often refuse to accept EBL cases which they see as preventing the fulfilment of the quotas (and, consequently, negatively affecting their career).

There are three possible ways how to deal with judges' quotas. Firstly, the quota system can be removed completely. This is the simplest solution, but is unlikely to happen in the short term. Secondly, the quota system can be adjusted to reflect that certain cases are

¹⁴¹⁴ NB Under Art 113 employees' claims enjoyed absolute priority, but this only applies to those claims which occurred prior to the promulgation of the EBL on 27 August 2006 (Art 132), and so is by now inconsequential.

¹⁴¹⁵ See Chapters 4.3.2.7, 5.1.1.3 and 6.1.2.5-6

¹⁴¹⁶ See Chapter 5.3.1.3

more complex and take longer to resolve than others. One possible way is to assign credits to each case whereby resolving a simple case would earn the judge 1 point, while resolving a complex case – like many EBL cases – would earn them 5 points. The advantage of this system is that it considers the complexity of some EBL cases and rewards judges for resolving them. The downside, however, is that it is complicated and prone to subjective interpretation. A third option is to de-emphasise the role of case quotas and incorporate them as one of many metrics of judges' performance. The last option is most likely to succeed in the short term. As above, adjusting the quota system is subject to approval from national and local governments. Without their cooperation – and understanding – the change is unlikely to take place due to the political control of the judiciary.

7.3.3 Change incentives of local governments

Once practitioners and judges know how to use the EBL, the last major obstacle to independent enforcement of the EBL is protectionism and interference from local governments.¹⁴¹⁷ To address this tendency, two sets of changes are proposed that are likely to encourage local governments to allow a greater and more independent use of the EBL. Firstly, it is important to help local governments appreciate that insolvency law holds immense potential for economic development of their regions (7.3.3.1). And secondly, local governments' incentives should be adjusted in order to help encourage their support for a greater use of the EBL (7.3.3.2).

¹⁴¹⁷ Such interference appears to be fairly frequent: Chapter 5.3.3

The interventions proposed in this section must be carried out with utmost respect and sensitivity to the political economy of China and the individual needs of each province.¹⁴¹⁸ Chinese as well as international understanding and expertise in insolvency law, economic theory and practical implications of development will be crucial when determining the details of the project.

7.3.3.1 Enhance local governments' understanding of the need for the EBL

It was argued earlier that local governments prevent courts from accepting EBL petitions,¹⁴¹⁹ and that even where EBL cases are allowed, local governments often interfere in the process.¹⁴²⁰ Some of the reasons why local governments interfere were addressed elsewhere – most importantly those relating to China's social security system (7.2.2.1) and systemic interconnectedness of state companies (7.2.2.2). This section focuses on local governments' attitude towards insolvency law in general, and it proposes that greater willingness to allow local courts to hear EBL cases can be achieved through improving local government officials' understanding of the benefits of using the EBL.

One way to achieve this is to organise a series of local and intra-provincial conferences and sessions led by insolvency-law experts with the aim to explain and persuade local governments to allow greater use of the EBL. A close cooperation should be established with the Party School as well as the SASAC, SAIC, and representatives of local

¹⁴¹⁸ My interviewees (C1-c, C3-c, C5-r to C7-s, C11-c, J1-c to J9-c, L2-s to L6-s, L10-s to L15-c, P1-r, C3-r, R10-c) suggested that the political pressure and protectionism are more pronounced in less developed, inland provinces.

¹⁴¹⁹ See Chapter 5.3.3

¹⁴²⁰ See Chapters 5.3.3.2-3 and 5.4.2

governments in regions where the EBL is widely used (such as Wenzhou, Shenzhen) in order to gather their views and take note of their fears and needs.

The next step would be to deliver a series of training session where an expert would outline why China needs to use the EBL *more* and what are the benefits of faster-paced, more objective judicial involvement (this can focus on private, smaller companies in the first instance, but the rationale is similar to SOEs, too). It is also important that in each province, the sessions address the particular reasons for local government's opposition to the EBL. The key focus is on showing local governments that aside from short-term costs, using the EBL produces many benefits in terms of economic development, increased FDI flows, increased business activity, etc. It is essential to illustrate all claims with case studies from China as well as other (developing) countries.

The sessions should also explain why the (reformed) EBL may be more efficient than alternative solutions to corporate distress such as bailouts and other financial support to ailing companies (as is the case with many SOEs and zombie companies); why debt-for-equity swaps (currently preferred in zombie companies) may be problematic; how to deal with employees (drawing on the issue of implementation of social security system in China and elsewhere); the benefit of better information sharing by companies and what local governments can do about it (drawing on the issue of information sharing and property register in China and elsewhere); the distortions caused by exclusion of shadow finance creditors from insolvency law regime; and the benefit of allowing and encouraging courts to hear more EBL cases – even those concerning non-protected, non-state-controlled companies. My interviewees further suggested that the sessions' impact can be maximised by being as practical as possible. This could involve examples of well-executed Liquidation and Reorganisation cases in other provinces and abroad.

Moreover, it would be very useful to bring representatives from (i) practitioners and judges, (ii) various companies; (iii) state and non-state lenders and possibly also (iv) academics and consultants to talk with local government representatives about the EBL (its challenges and opportunities) from their perspective – why they may want or need to use it (both as creditors and as debtors), why the EBL matters to them, etc.

7.3.3.2 Change structure and substance of local government officials' incentives

Besides persuasion, local governments are also likely to respond to additional pro-EBL incentives. As was discussed earlier, officials in local governments have to fulfil simple targets that measure economic development and social stability in order to progress their career. However, the way that these targets are set up means that officials tend to focus on delivering local, short-term benefits through protectionism, cover-ups of corporate financial distress and inefficient allocation of funds and other resources – at the expense of longer-term, sustainable economic growth and slower, efficiency-enhancing projects.¹⁴²¹

To deal with this, these simple targets should be de-emphasised and changed to include other elements that will be rewarded. These should include, *inter alia*, rewarding innovation and competition-enhancing, long-termist policies. Rewarding innovation would encourage local experimentation and localised risk-taking, including allowing EBL cases to be heard by courts where this would be likely to lead to economic development. Similarly, rewarding local governments for encouraging long-term efficiency and for policing healthy competition among local companies would also most likely encourage greater and more efficient use of the EBL because local governments would be rewarded for permitting hard

¹⁴²¹ See Chapters 3.3.3 and 5.3.3

budget constraints and survival of the fittest – rather than being punished for temporary drops in productivity and economic growth which are natural consequences of using insolvency law.

Such positive encouragements should also be backed up by a credible threat of punishment for certain (clearly defined) types of wrongdoing. This should include, in particular, severe punishments for falsifying data and for cover-ups as well as increased likelihood of discovery through e.g. more checks in order to change the payoffs of officials' options when reporting economic data to their superiors.¹⁴²²

7.3.4 Enable and safeguard judicial independence

So far, this chapter discussed the reasons and methods for ameliorating the ability and willingness of judges, lawyers, and local government representatives to use the EBL.

Chapters 7.3.1 and 7.3.2 proposed ways how to ameliorate courts' and lawyers' limitations and administrators' passivity which, it was argued, would likely increase parties' expected payoffs under the EBL (as identified in Chapters 5.3.1 and 5.3.2). Similarly, Chapter 7.3.3 suggested two ways for adjusting local governments' incentives in order to remove local governments' reluctance to permit the use of the EBL (as identified in Chapter 5.3.3).

Building on these initiatives is likely to *enable (greater) judicial independence* in hearing EBL cases. Chinese judges are not independent and, realistically, any intervention aimed at full judicial independence in China in the short-term is unlikely to succeed. Nevertheless, this section explores several reasons why it is crucial for greater and more efficient use of the EBL to enable and strengthen judicial independence in the medium-to-long-term.

¹⁴²² i.e. make it more costly to lie – see Diagram 3-15 in Chapter 3.3.3.2

Firstly, judicial independence matters because it ensures *objective enforcement* of laws. It was argued in Chapter 6.1.2 that China's economy can benefit from greater and more objective enforcement of the EBL through an improved control of bad debt,¹⁴²³ greater amount of cheaper credit,¹⁴²⁴ more efficient allocation of resources,¹⁴²⁵ better business environment which encourages more investment and entrepreneurship,¹⁴²⁶ and improved rule of law.¹⁴²⁷ Unfortunately, at present, courts cannot enforce the EBL without Party-state's interference. Similarly, creditors and debtors are also influenced by representatives of their local government when deciding whether and how to resolve their or their debtor's financial distress.¹⁴²⁸

On the one hand, state-sector companies benefit from state protectionism, support and subsidies. But, on the other hand, they also have to follow state orders and preferences. State interference may lead to localised short-term gains – such as more employment and social stability – but local protectionism and biased law enforcement is also very costly and potentially damaging to economic efficiency and market development in the long term.¹⁴²⁹ Moreover, state interference makes doing business more unpredictable and risky.¹⁴³⁰ All my interviewees suggested that a withdrawal of local governments'

¹⁴²³ See Chapter 6.1.2.3

¹⁴²⁴ See Chapter 6.1.2.4

¹⁴²⁵ See Chapter 6.1.2.5

¹⁴²⁶ See Chapter 6.1.2.6

¹⁴²⁷ See Chapter 6.1.2.7

¹⁴²⁸ For details, see Chapters 3.3.3, 5.3.3, 5.4.2 and 6.1.2.3

¹⁴²⁹ See Chapter 3.3.3 and discussion below. See also e.g. Heilmann (2017) – Chapter 4; Pei (2006) 126-7; Coughlin, Chrystal and Wood (1988)

¹⁴³⁰ *Ibid.*

interference would allow companies and banks to decide whether to use the EBL depending on economic rather than political reasons. Moreover, they also agreed that it would enable judges to accept and decide EBL cases on their own merit rather than based on local governments' preferred interests. Such development is highly desirable.

Secondly, courts, debtors and creditors obey Party-state's orders, but many *fundamentally disagree with such political interference*. Several of my interviewees suggested that state-sector companies and banks do not like state's interference in law enforcement and in the resolution of their financial affairs, but that they feel unable to do anything about it.¹⁴³¹ Similarly, in another study, many state-sector companies complained that despite recent financial reforms there are 'few fathers-in-law, but still too many mothers-in-law'¹⁴³² – meaning that there is less protectionism from *national* ministries and bureaus than before the marketisation of China's economy commenced, but there are still too many intervening *local* government agencies, regulators and other local governmental bodies which, like proverbial Chinese mothers-in-law, chase SOEs – their daughters-in-law – and make them do their bidding.¹⁴³³ State interventions are also increasingly resented among the judiciary. A recent SPC study stated that over 68 percent of interviewed judges thought that local protectionism was one of the main reasons for unfairness in judicial decisions.¹⁴³⁴

¹⁴³¹ Interviews B1-c to B3-c, C1-c, C4-c, C5-r, C7-s, E5-c, J1-c, J3-c to J9-c, L1-r to L15-c, P1-r, R2-r, R3-r, R6-c, R7-c, R9-c, R10-c, R13-c

¹⁴³² gonggong shaole, popo hai henduo (公公少了, 婆婆还很多): Tang and Ward (2003) at 49

¹⁴³³ This is confirmed in my interviews (n.1431)

¹⁴³⁴ Congressional-Executive Commission on China, "Judicial Independence in the PRC" at www.cecc.gov/judicial-independence-in-the-prc

Finally, without independent judiciary, many parties are forced to use non-EBL alternatives to resolve their financial distress. State-sector companies often have little or no say in how their distress is resolved – and are often forced to use politically-driven alternatives.¹⁴³⁵ Similarly, private-sector companies are often left without a formal mechanism for resolving their financial distress because courts in many provinces are reluctant to accept EBL petition without an express blessing from the Party-state.¹⁴³⁶

However, the available data and my interviewees suggested that debt enforcement through non-EBL alternatives¹⁴³⁷ is often problematic because – as was discussed in Chapter 6.1.2.1 – private alternatives often lead to undesirable behaviour (e.g. violence), and state-led alternatives are often comparatively inefficient (v. the reformed EBL). The state-led alternatives are Party-state’s way of avoiding the use of objectively-enforced EBL and instead imposing their own preferred solution on state sector debtors and their stakeholders. These alternatives as well as the reasons why the Party-state uses them and why the parties accept them were explored in Chapter 5.4.2. Here, the focus is instead on why it is undesirable for the Party-state to continue using these alternatives in most cases,¹⁴³⁸ and why they should instead let courts apply the EBL objectively.

As was discussed earlier, insolvent companies are sometimes merged with healthy ones in order to prevent large-scale redundancies, and so ensure maintenance of social stability. The obvious problem is that this does not resolve the cause of the problem and

¹⁴³⁵ See Chapter 5.4.2

¹⁴³⁶ See Chapter 5.3.3.2

¹⁴³⁷ See Chapter 5.4

¹⁴³⁸ Arguably, there are limited circumstances in which state intervention is desirable – such as to prevent financial crisis or a failure of a core element in financial infrastructure (e.g. a bank). However, such interventions should be exceptional, not regular.

only temporarily removes the symptoms. In addition, in many cases, it also damages the efficiency and productivity of the healthy company. This policy focuses on short-term peace over long-term efficiency which, ultimately, damages China's economy due to the misallocation of resources, the destruction of value through wasted expenditure, the loss of investor confidence, and the support of inefficient players who, in market conditions, would have to address the deficiencies that caused their problems – and so become more efficient – or would have to exit the market and release its opportunities and resources to other, more efficient players.

Furthermore, instead of allowing financially distressed companies to resolve their difficulties in court under an independently-run EBL, the Party-state often forces its banks and other creditors to forgive debtor's debt altogether, to provide a loan extension even where the loan is unlikely to be repaid – i.e. proverbial throwing good money after bad – or to accept debt-for-equity swaps where it is clear that the debtor company is likely to revert back to financial distress soon after the Party-state withdraws its immediate support. Similarly, the Party-state also sometimes bails out ailing companies. It is estimated that the bailouts have, so far, cost the government 100 billion USD in recapitalising its banks and roughly 200 billion USD in NPLs' transfer costs.¹⁴³⁹

Forced loan-extensions, worthless debt-for-equity swaps, and costly bailouts help the Party-state avoid using the EBL, but they fail to resolve the reason why the debtor companies got

¹⁴³⁹ Probably the largest one-off bail-out took place in 2004 when the government set up four asset-management companies (AMCs) – with a capital of 1.2 billion USD each – which bought all bad debts off the Big Four Banks at face value to clean up their accounts. See Chapter 5.4.2.2 for details. For a detailed description, see also McMahon (22.12.2014)

into financial distress in the first place. As a result, they simply shift the problem – and its cost – to creditors and state-funded special-purpose vehicles. The central government – and in particular the Ministry of Finance – are keen to end such financial support,¹⁴⁴⁰ but local governments continue using these politically-driven mechanisms to delay having to solve the cause of the problem. If they delay the distress long enough, they manage to push the problem to the next generation of local leaders.¹⁴⁴¹ However, delaying rather than solving financial problems is likely to further deepen the company's distress. Unfortunately, it is likely that local governments will keep using these alternatives until their incentives and understanding of the matter improve.

Once a company becomes reliant on state's financial support, it becomes known as a zombie company.¹⁴⁴² Its creation is a result of soft-budget constraints and local governments' willingness to keep propping up inefficient companies.¹⁴⁴³ Recently, the problem grew to such an extent that in late 2015 the government – assisted by the SPC – released guidelines on dealing with zombies' overcapacity and bad debt.¹⁴⁴⁴ Fearing that zombie companies are causing China's economy to slow down,¹⁴⁴⁵ the government ordered

¹⁴⁴⁰ See e.g. Zhang (7.11.2016)

¹⁴⁴¹ Provincial leaders change every 5 years: Chapter 3.2

¹⁴⁴² For a discussion, see Chapter 5.4.2.2

¹⁴⁴³ See Chapters 5.3.3 and 5.4.2.2

¹⁴⁴⁴ Yap (12.7.2016)

¹⁴⁴⁵ See e.g. IMF Country Report for China (28.8.2015) at 30: 'The high level of credit could weigh on China's growth and financial stability. Cross-country evidence suggests that episodes of similar credit booms often ended abruptly, accompanied by financial crises or prolonged slowdowns in GDP growth... This risk is still low in China, but it is growing. The steep rise in corporate investment after the global financial crisis has been financed by credit. But the efficiency of investment has been falling, with a commensurate fall in corporate sector profitability. This makes debt servicing costs more difficult and therefore debt more risky. In particular,

that a ‘socialist market-based’ mechanism should be established to identify zombie companies, and that the EBL should be used to restructure or liquidate them. As a result, the number of EBL cases in 2016 doubled compared to the year before. However, neither the selection mechanism nor the resolution mechanism has been allowed to function without the Party-state’s interference, which is why many doubt whether it can improve the situation in the long term.¹⁴⁴⁶

Although EBL Reorganisation is used by the state to ‘resolve’ some of the state-sector cases, the EBL is generally only used to legitimise and enforce a pre-packaged deal (or other state-sanctioned solution) arranged by the state.¹⁴⁴⁷ As a result, the provisions in EBL Reorganisation that are intended to provide safeguards to all stakeholders are ignored, and stakeholders’ interests are subjected to local government’s preferred interests. Moreover, state-driven use of the EBL also artificially inflates the statistics about EBL cases – because it includes cases which were pre-packaged behind closed doors, and so not genuine EBL cases.

7.3.5 Practical impact and Conclusion

The proposals contained in this final subset of direct reforms are likely to pose numerous challenges to the reformers, but their implementation is crucial for achieving efficient use of the EBL in the long term. The key challenge – in particular with regards to judicial

the interest-coverage ratio has been falling in SOEs and in over-capacity sectors (which together account for the bulk of the increase in credit).’

¹⁴⁴⁶ See e.g. Professor Liu Zhibiao, a leading expert in economics, argues that if this is to work, government intervention must be fully excluded: Weixin (3.3.2016)

¹⁴⁴⁷ The deal is usually agreed at a roundtable where all large stakeholders, including the important creditors, are invited to participate and express their views. The final say rests with the Party-state representatives. For more see Chapters 5.4.2.2-3

independence, discussed in section 7.3.4 – arises from the fact that change cannot be effectuated simply by writing more laws or changing existing rules. Instead, change needs to come from an adjustment of enforcers' attitude and understanding – both of which are likely to face opposition and take time.

Some of the proposals in this chapter – in sections 7.3.1-3 – build on recent reform initiatives. Chinese courts have undergone several major reforms¹⁴⁴⁸ – some local, others national – and as a result their level of professionalism and knowledgeability have been increasing steadily over the last few years.¹⁴⁴⁹ However, many issues still remain – including courts' limited familiarity and understanding of the EBL; the need to improve lawyers' EBL-related expertise has been largely ignored; and the need to educate and encourage local governments to allow an independent use of the EBL has also not been addressed.

Nevertheless, with the economy slowing down – particularly since late 2014 – and with the increase in the amount of NPLs, financially distressed companies, and changes in demand patterns (domestically and internationally), China's courts and government have slowly come to admit that the current regime for resolving financial distress is insufficient and that more needs to be done.¹⁴⁵⁰ This set the wheels in motion. China's Central Economic Work Conference, which convened in December 2015 in Beijing¹⁴⁵¹ announced that tackling underproductivity is one of the five big national goals for 2016, leading to a renewed

¹⁴⁴⁸ For a critique of the limitations of the reform see Liebman (2008)

¹⁴⁴⁹ The reforms have been on the agenda since China's entry into the international market in 2001, but has become particularly pronounced since the SPC released its Opinion On Increasing Credibility Of The Judiciary in October 2013 (*Fashi* [2013] No.9). See e.g. Finder (26.3.2015); Peerenboom (2013)

¹⁴⁵⁰ For government reactions see e.g. Lopez (21.12.2015)

¹⁴⁵¹ For a summary see Xinhua (24.11.2015)

interest in insolvency law and its greater use. Their concluding report emphasised that market forces shall play a bigger role in allocation of resources and those struggling to keep up with the forces of demand and supply and those who are unable to manage their finances will be pushed to ‘exit the market.’¹⁴⁵²

Courts have also been instructed to devote more resources to the resolution of zombie companies which ‘occupy valuable credit, land resources and market space. Therefore, it is important to either restructure or liquidate such companies under the bankruptcy law.’¹⁴⁵³ As was discussed earlier, various local courts have now issued guidelines for hearing EBL cases. One of the first official meetings where the new strategy was discussed was the SPC’s 8th National Conference for Civil and Commercial Judges in late December 2015, where senior judges from across China congregated to discuss trends and developments over the past year and in the near future. It was at this conference where Judge Yang Linping of the No.2 Civil Division of the SPC provided some guidance for how the courts should deal with EBL cases.¹⁴⁵⁴ Judge Yang said that the judges should make it easier for (zombie) companies to petition for and go through EBL procedures. Judges must distinguish between real and fraudulent bankruptcies in order to prevent malicious avoidance of debt repayment, and they must always ask whether the financial distress was caused by criminal conduct of those in charge, and if so, punish it. She also said that judges should monitor administrators to make sure that they are recovering assets,¹⁴⁵⁵ and higher courts should monitor lower courts to ensure correct handling of EBL cases. In addition, EBL

¹⁴⁵² Xinhua (21.12.2015)

¹⁴⁵³ Sina (28.1.2016)

¹⁴⁵⁴ For an overview in English see SPCM (16.1.2016)

¹⁴⁵⁵ As discussed above in 5.3.2.1.5

Reorganisation should be used, particularly for large companies with valuable business worth saving. Other-than-zombie companies were, however, not mentioned.

Further guidance was provided in February 2016, when the SPC convened a conference in Zhejiang to discuss how to deal with zombie companies. Judge Du Wanhua, a senior SPC judge in charge of national EBL reform efforts, presided over the proceedings. He echoed Judge Yang in supporting more Reorganisation and Composition cases. He also said that modern technology should be used to inform the people of the possibility of using the EBL, in particular reorganisation mechanism, so as to enable maximum recoveries. Local courts should also establish bankruptcy divisions and provide expert training to its judges to enable them to hear EBL cases. Procedures for hearing an EBL case should be consolidated across courts, and administrators should be given more guidelines and better status. He also added, however, that courts must protect interests of the state, then those of workers, then creditors, and finally investors.¹⁴⁵⁶ He, therefore, also focused solely on zombie companies.

It remains to be seen whether this political push leads to any change in the low volume of use of the EBL in the medium-to-long term. The fact that the recent initiatives focus solely on zombie companies will limit its impact, but in the long term, the improvements in courts' and lawyers' expertise and local governments' first-hand experience in resolving failing enterprises under the EBL may give them useful insights into why and how they should be using the EBL.

The EBL has returned to government's and courts' agenda, and steps have been taken to improve the system for dealing with corporate financial distress. If this trend continues and as a result courts' and lawyers' understanding is improved, courts'

¹⁴⁵⁶ Cf Chapter 4.3.2.7 (priority of distribution under the EBL)

enforcement of the EBL as written is strengthened, and local governments' understanding and incentives are ameliorated to allow greater use of the EBL, then independent judicial enforcement may – one day – become a reality. If that happens – that is, if courts become able to decide each case on its merits, and not based on the Party-state's wishes – it would most likely result in a number of benefits, most importantly greater efficiency of EBL procedures in practice which would, in turn, help deliver the predicted benefits – i.e. greater availability of cheaper credit, better allocation of resources and better business environment.¹⁴⁵⁷ Until then, reform efforts should continue to focus on proposals in Chapters 7.1, 7.2 and 7.3.1-3.

7.4 MedArb: a new opt-in mechanism

Realistically, some of the reform proposals in Chapters 7.1, 7.2, and 7.3 are likely to take time to be implemented, and some are unlikely to be implemented unless they are accompanied by significant shifts in perception and preferences by those in power. At the same time, there are companies whose EBL petitions are ignored by courts, but who wish to use the EBL and whose financial distress may only be efficiently resolved under a formal collective mechanism such as the EBL. It is primarily for them that the newly proposed shift of the EBL enforcement from courts to MedArb¹⁴⁵⁸ – a particular type of alternative dispute resolution mechanism – is proposed as a voluntary opt-in venue. It would allow the parties to apply the EBL in an existing non-court adjudicative forum – mediation and arbitration

¹⁴⁵⁷ See Chapter 2.3

¹⁴⁵⁸ See Chapter 4.2.4.3

bodies – which can make binding decisions in China. The new mechanism would enable a broader range of companies to use the EBL to resolve their financial distress which would benefit them individually and, in the aggregate, it could also be beneficial for the economy due to the increased predictability and recoverability of debts, better allocation of resources, more credit available to non-state companies, and more entrepreneurial activity.

The chapter first explains *who* are the intended users of the new mechanism (7.4.1) and *how* it works (7.4.2). It then looks at the advantages of using the new mechanism (7.4.3) and potential issues and their proposed solutions (7.4.4). It also acknowledges the limitations of the proposed mechanism (7.4.5). And it concludes by assessing the likelihood of its successful implementation (7.4.6).

7.4.1 Target users of the new mechanism

Chapter 3.4 differentiated between companies that fall into the state sector and those that are affiliated with the private sector – depending on their ownership and economic significance. Chapter 5.4 further suggested that a company's affiliation with a particular sector determines the choice of non-EBL alternative that it uses to resolve its financial distress. This division by sector is also relevant for the new mechanism. The discussion below differentiates between three types of companies – depending on their sector affiliation and size – because each group relies on different sources of funding, and so has different needs and possibilities with regards to debt enforcement. Their characteristics are summarised in Table 7-5.

Table 7-5: Target audience of the new MedArb mechanism

	<i>Smaller private-sector companies</i>	<i>Larger private-sector companies</i>	<i>State-sector companies</i>
<i>Origin of finance</i>	<i>Family & friends Shadow banking (small lenders)</i>	<i>Shadow banking (large, more professional lenders)</i>	<i>(State) bank finance</i>
<i>No. of substantial lenders</i>	<i>Few</i>	<i>Many</i>	<i>Few</i>
<i>Type of solution</i>	<i>(1) Informal private alternatives</i>	<i>(2) Informal + formal private alternatives</i> <i><u>BUT some wish to use the EBL</u></i>	<i>(3) Politically-driven alternatives</i>
<i>Target of the proposed opt-in mechanism?</i>	<i>No</i>	<i><u>Yes</u></i>	<i>No</i>

State-sector companies are usually large and economically significant. They tend to rely on a relatively small number of lenders – usually state banks and other state-related sources of funding. They are often linked to other state companies and their transactions are complex. As a result, their creditors usually rely on politically-driven alternatives.

Small private-sector companies usually borrow from family, friends and smaller-scale shadow lenders such as pawnshops, local cooperatives, etc. They also tend to rely on a relatively small number of providers but their transactions are usually quite simple. As a result, their financial distress is resolved under informal private mechanisms that are based on existing relationships (such as reputational process, peer pressure) and simple arms-length alternatives (such as threats, violence).

Finally, *larger private-sector companies* usually borrow from many lenders, including various types of shadow lenders, investment funds (private equity, etc.), local banks, etc. Their

transactions are often complex and their activities tend to extend beyond their city or region. Nevertheless, they are not under state protection and control either because they are deemed insufficiently economically important or because they fall outside of state sector because they belong to one of the young industries – e.g. IT companies – that never developed a tradition of political control.¹⁴⁵⁹ As a result, they use informal and formal private alternatives to resolve their financial distress. My interviewees argued that many of them also wish to use the EBL, but their EBL petitions are often ignored by courts, particularly in less developed regions.¹⁴⁶⁰

The new mechanism does not aim to address the needs of state-sector companies¹⁴⁶¹ because – until the reforms in Chapter 7.3 are implemented – the state, as their major stakeholders or controller, is unlikely to permit them to use it. Smaller private-sector companies can, in theory, use the new mechanism, but they are not its intended target audience because most of the alternatives are relatively efficient for their simple distress and the use of a formal mechanism may be too costly. Instead, the new mechanism is aimed at helping larger private-sector companies resolve their financial distress more efficiently by using the EBL in a non-politicised, out-of-court proceeding. The reason for targeting them is that their distress is often complex due to the number of creditors, the arms-length nature of their financing, and the complexity of their transactions, and so

¹⁴⁵⁹ For details, see Kennedy (2005)

¹⁴⁶⁰ See Chapters 5.3.3 and 7.3.4

¹⁴⁶¹ Albeit, it does not reject such use, either

coordinating a collective solution under non-binding private restructuring or through a series of bilateral contractual arrangements may be too difficult or outright impossible.

The new mechanism is intended to help larger private sector companies in three broad types of situations. Firstly, it aims to help companies that wish to use the EBL but are prevented from doing so, mostly because their EBL petitions are ignored by courts (usually because they are too small to matter in the local economy). Secondly, it aims to help companies that do not want to use the EBL in a court-driven proceeding because they perceive it as (i) too slow; (ii) lacking in experience and expertise to deal with complex scenario or particular commercial context-specific interests that the parties wish to protect by involving informed experts; (iii) too burdensome due to the personal liability often imposed on the management; (iv) too late in cases of reorganisation; and (v) too expensive (especially for the small companies). And thirdly, it aims to help companies that cannot use the EBL because (i) the debtor is from a disallowed sector and using the EBL in court would attract too much attention; or (ii) they rely on or provide credit from shadow finance market and whose debt contracts would not be recognised in courts.

7.4.2 How the new mechanism works

The new opt-in mechanism enables multi-party use of the EBL to resolve debtors' financial distress. The enforcement takes place out of court through an existing adjudicative forum – mediation, arbitration, and a combination of the two. This section looks at its key elements. Its advantages, potential problems and limitations are then examined in sections 7.4.3, 7.4.4 and 7.4.5, respectively.

The new mechanism would work on a voluntary *opt-in basis*. To use it, a company (later a debtor) could voluntarily agree *ex ante* to submit to a mediation-arbitration body for

an *ex post* resolution of debt-related disputes. Such agreement would take the form of a valid arbitration clause.¹⁴⁶²

The name of the new mechanism – MedArb – is derived from a very popular practice in China that combines mediation and arbitration into a single procedure. As was discussed in Chapter 4.2.4.3, MedArb is driven by an independent third-party – or a panel of them – who initially acts as a mediator but turns into an arbitrator if the parties fail to achieve an agreement. Diversified dispute resolution (called alternative dispute resolution elsewhere) is a well-established, powerful and much-used alternative to the slow and politically-driven court system. As will be discussed in section 7.4.3, below, using arbitration provides many advantages, including flexibility, expertise, confidentiality, and speed.¹⁴⁶³

The power of arbitrators and mediators-arbitrators to make binding decisions is derived from statute.¹⁴⁶⁴ The power to hear and rule in a particular case is derived from a valid arbitration agreement to use arbitration or MedArb – and so is contractual in nature.¹⁴⁶⁵ The focus of this chapter is on domestic cases which can be heard by over 200 arbitral institutions all over China. The permitted scope of arbitrations and mediation-arbitrations in China is wide – and it includes hearing debt-related disputes and multi-party claims.

The new mechanism would apply provisions from the EBL and other relevant Chinese laws – in accordance with Article 7 of the Arbitration Law 1995 – but because the

¹⁴⁶² For details, see Chapter 4.2.4.2

¹⁴⁶³ Which is why it is often used by investment funds and in countries with weak courts (e.g. Brazil, Russia)

¹⁴⁶⁴ See Chapter 4.2.4

¹⁴⁶⁵ *Ibid.*

courts are not involved, the application would take place without the interference from the Party-state.¹⁴⁶⁶ As a result, a number of constraints identified in Chapters 5.1 and 5.2 would not arise. Although the parties could choose any of the EBL procedures – Liquidation, Reorganisation and Composition – the MedArb mechanism would be particularly useful for Reorganisation which could be commenced in a timely manner.¹⁴⁶⁷

In addition, the new mechanism would completely replace court’s jurisdiction over the matter.¹⁴⁶⁸ Where there is a valid agreement to use arbitration, the arbitrators or mediators-arbitrators become sole adjudicators.¹⁴⁶⁹ If a claimant subsequently applies to court to open a court-based EBL hearing, the court would refuse to do so because courts can only close existing arbitral proceedings where they have jurisdiction over the case.¹⁴⁷⁰ Similarly, a court could only review the arbitral award under very limited circumstances – most of which relate to procedural irregularities.¹⁴⁷¹

As a result, in summary, using the MedArb mechanism would likely enable more efficient resolution of financial distress and insolvency in larger private-sector companies. As a result, these companies could gain access to credit from official lenders.¹⁴⁷² But its utility

¹⁴⁶⁶ All interviewees agreed that, as a general rule, DDR mechanisms fall outside the scope of local governments’ influence. See also Chapter 7.4.3

¹⁴⁶⁷ By reading ‘about to become insolvent’ (Art 7 EBL) broadly

¹⁴⁶⁸ In a sense, it creates regulatory dualism where the parties choose to stay in the mainstream court-driven enforcement, or they opt into a MedArb-driven enforcement. Regulatory dualism has been used in Brazil to improve the functioning of equity markets: Pargendler (2012)

¹⁴⁶⁹ Art 5 Arbitration Law 1995. See also Chapter 4.2.4.2

¹⁴⁷⁰ Art 20 EBL

¹⁴⁷¹ i.e. insufficient evidence; error; or wrongful application of the law: Art 43 Arbitration Law 1995 and Art 237(2) Civil Procedure Law 2012. See also Chapter 4.2.4.2

¹⁴⁷² See Chapter 2.3.1

would far exceed the benefits associated with access to formal credit. These additional advantages are discussed in the next section.

7.4.3 Advantages of the new mechanism

MedArb offers several advantages which are likely to incentivise the target companies to use it. Besides providing a formal forum in which the parties can reach a collective solution to debtor's distress,¹⁴⁷³ there are further six advantages that are likely to matter to most companies. They are expertise of adjudicators; focus on commercial rather than political issues; privacy and confidentiality of the proceedings; its business-friendly regime; speed; and better ability to signal *ex ante* due to increased ability to enforce *ex post*. Each advantage is discussed in turn.

Firstly, parties are able to choose adjudicators that have *experience and expertise* relevant to their claim.¹⁴⁷⁴ This can include understanding of finance, accounting, commercial law, or particular industry (e.g. shipping, construction, real estate, etc.). Adjudicators' expertise is especially important in more complex or unusual cases where it ensures that the decision-makers appreciate particular problems and envisage practicable solutions in the given industry. It is also likely that such understanding would decrease a chance of imposing excessive liability on management who did not cause debtor company's distress, or who tried their best to prevent it.

Secondly, arbitrators are not politicians and – unlike courts – they are *not politically controlled*. The arbitral bodies have been structurally independent from the state since the

¹⁴⁷³ For structural challenges of non-adjudicated private negotiations, see Mnookin (2003)

¹⁴⁷⁴ Arbitration Law 1995 only states that the arbitrator can be any 'righteous and upright persons' with relevant expertise: Arts 13 and 31

late 1990s. Moreover, the state has little or no interests in the target companies (falling outside the state sector). As a result, the state is unlikely to interfere in the process and arbitrators' primary focus can be on commercial rather than political issues.

Thirdly, in some provinces, the traditional attitude to insolvency remains. As a result, companies are not using the EBL because they fear that their *reputation* would be tarnished in the news of their financial distress became public knowledge.¹⁴⁷⁵ Enforcing the EBL through MedArb would give the parties *privacy* which would prevent such reputation damage. In Liquidation, it could help recover more value in the sale of assets because company's insolvency would not be widely known. But privacy would be particularly useful in Reorganisation because company's reputation would not be affected by its financial distress. The resulting decrease in the likelihood of losing the brand's value and trust in the market – which are often associated with corporate insolvencies in China – could also encourage parties' cooperation, and so their chance of turning the company around. In addition, the ability to use the EBL without reputational damage could also encourage companies to come forward earlier to resolve their distress when it is still possible¹⁴⁷⁶ – before all the assets are dissipated and greater debts created – which would also enhance efficiency and success of the use of the EBL. Moreover, the ability to resolve financial distress without personal reputational damage could also discourage managers from running away when threatened with insolvency¹⁴⁷⁷ and encourage earlier and more open negotiations. In addition, it could also decrease the reliance on violent and otherwise

¹⁴⁷⁵ See Chapter 5.4.1.2

¹⁴⁷⁶ See Chapters 5.1.3 and 7.1.4.1

¹⁴⁷⁷ See Chapter 6.1.2.2

undesirable enforcement methods which are currently used by shadow lenders¹⁴⁷⁸ because their claims would be recognised and dealt with under the MedArb mechanism.

Besides privacy, MedArb would also afford greater *confidentiality* to the parties. This would enable a broader range of debtors and creditors – including those providing or using shadow credit – to resolve their debt-related disputes through out-of-court EBL mechanisms with their benefits (collective solution, cheaper credit, better allocation of resources) but without court-related enforcement problems identified in Chapter 5. Confidentiality can be ensured even if the mediation phase fails and the mediator turns into an arbitrator. Although the confidential information received at the mediation stage may still influence adjudicators' ultimate decision,¹⁴⁷⁹ mediators-arbitrators are not under a duty to disclose the confidential information as is the case elsewhere.¹⁴⁸⁰

Fourthly, enforcing the EBL in MedArb provides comparatively (v. in-court EBL) more *business-friendly* regime for resolving corporate distress thanks to three inter-connected elements. MedArb is less adversarial than court-based hearing which is especially important in Reorganisation where parties wish to maintain good relationships for future cooperation. In addition, MedArb provides greater flexibility because it can involve all stakeholders or, where more efficient for corporate restructuring, only the key stakeholders – similar to the London Approach regime – where large players agree and pay for the restructuring plan and small players continue being paid as usual, often without any knowledge that the company

¹⁴⁷⁸ See Chapter 6.1.2.1

¹⁴⁷⁹ If the parties are worried about this, they can opt in for pure arbitration.

¹⁴⁸⁰ If the proceedings are in Hong Kong the mediator has a duty to disclose to all parties any confidential information obtained during the mediation which he/she considers material to the arbitral proceedings. No equivalent requirements apply in (for example) Singapore or China

is being restructured.¹⁴⁸¹ However, unlike the London Approach, the MedArb empowers independent third-party adjudicators to run the deal. Lastly, the parties remain in control of the company and the process. As a result, debtor company is more likely to enter into Reorganisation in a timely manner, and all parties have a say in the choice of adjudicators – according to the terms of the arbitration clause.

Fifthly, unlike in court-driven EBL proceedings where the parties have to wait for a long time or may never hear back about their petition, in MedArb there is *no excessive waiting time*. Moreover, most arbitral cases are resolved within four to six months from when the arbitral tribunal is formed.¹⁴⁸² Moreover, many arbitral bodies also offer a *summary procedure* – where only one arbitrator is appointed, there are no oral hearings (only written submissions), and the decision must be rendered within three months – and an *expedited procedure* – which takes one and a half to two months and incurs a lower fee. If smaller private-sector companies wish to use MedArb to resolve their distress, one of these special procedures may be appropriate.

And finally, private-sector companies which *ex ante signal* (in a credible manner) that they will use MedArb if they become distressed, they may be able to access more credit at a lesser cost because of the increased likelihood of enforcement. This would in turn enable them to enter into additional projects and would – in the aggregate – lead to greater entrepreneurial activity among non-state players.¹⁴⁸³

¹⁴⁸¹ For details see Chapter 4.2.2.1

¹⁴⁸² The maximum period depends on the chosen arbitral body and its rules

¹⁴⁸³ See Chapter 2.3

7.4.4 Issues and their solutions

However, the proposal that a non-court adjudicator can apply and enforce the EBL and can change pre-existing contractual entitlements that will be binding in a multi-party context is not without problems. This section deals with three such problems that appear most pressing – namely the ways how the mechanism can bind multiple parties (7.4.4.1); enforceability of the final awards (7.4.4.2); and justification for empowering non-court body to apply and enforce the EBL (7.4.4.3). The discussion of each problem is followed by proposals of steps that may reduce or remove them.

7.4.4.1 Multilateral mechanism

One of the great advantages of an insolvency law (v. private ordering) is that it provides a binding tool for collective resolution of all liabilities. To what extent could this be adopted in the proposed mechanism? In other words, how can MedArb – which is a voluntary, opt-in mechanism – bind multiple parties and what would happen if some creditors agreed to use MedArb to resolve their debts but others did not?

How can MedArb bind multiple parties – ex post

In order to bind multiple parties to the same agreement concerning resolution of their claims – i.e. that debt-related disputes when the debtor is in financial distress will be resolved through MedArb – it is first necessary to identify a method through which the parties can opt in and be bound. The most obvious option is for all parties to agree bilaterally with the debtor to use MedArb instead of court-driven EBL *ex post*, that is when

the disputes arise, by voluntarily submitting themselves to a mediation-arbitration body of their choosing.

Likely treatment of claimholders who do not opt in to use the MedArb mechanism

A question then arises as to what would happen if some of the claimholders refused to have their claim resolved through a non-court arbitral body such as the MedArb.

Although relying on an *ex post* agreement may seem problematic – particularly given that opt-in mechanisms generally rely on cooperation of all affected parties¹⁴⁸⁴ – it may not be an unsurmountable hurdle in practice as all claimholders are incentivised to cooperate. If a debtor company falls within the private sector, there is a high probability that the EBL petition would be ignored and there would be no recovery for anyone, or only recovery under a private enforcement mechanism. If a claimholder refused to cooperate and sought to satisfy their own debt independently – in other words did a run on debtor’s assets – the MedArb adjudicators could exercise administrator’s powers and claw back the assets.¹⁴⁸⁵ Moreover, even if such non-cooperating creditor managed to get court’s attention, my interviewees suggested that courts would often refuse to hear the case and instead suggest to the reneging party that they should give their full cooperation to the arbitral body first.¹⁴⁸⁶ In addition, MedArb is likely to enable more efficient exercise of administrators’ powers to claw back improperly diverted assets in a given pre-insolvency period because, in

¹⁴⁸⁴ There may be situations in which this is impossible or too difficult.

¹⁴⁸⁵ See Chapter 7.4.2: Arbitration Law 1995 allows arbitrators to apply statutes in place of courts. Arguably, this includes exercising the powers normally given to administrators (see Chapter 4.3.2.6)

¹⁴⁸⁶ Interviews B1-c, C1-c, C5-r, C7-s, E2-s, J1-c, J3-c to J6-s, J8-c, J9-c, L2-s, L4-r to L6-s, L10s-, L14-c, L16-c, L17-c, R3-r, R9-c, R10-c

court-driven EBL procedures, administrators are often lax with clawing back preferential payments.¹⁴⁸⁷

Even if a court hearing was commenced by the reneging claimholders, but it only took place after the MedArb awarded certain repayment rights to the cooperating claimants¹⁴⁸⁸ who then enforced them, my interviewees suggested that it would be unlikely that the reneging party would be able to get the court to undo the payment, and so would lose out.¹⁴⁸⁹

The above discussion clearly suggests that creditors of private-sector companies are incentivised to cooperate and agree (even *ex post*) to resolve their disputes through the MedArb mechanism. Nevertheless, relying on parties' rational incentives and court's actual refusal to deal with an EBL petition where some of the claimholders agree to use an alternative dispute resolution mechanism is problematic. Because of this uncertainty regarding whether claimholders will all agree to a particular mechanism *ex post*, it is now important to consider the possibility of binding claimholders *ex ante*.

How can MedArb bind multiple parties – ex ante

Although it is possible for claimholders to opt into MedArb *ex post*, a more secure way of ensuring that all potential debt-related disputes are decided under the MedArb mechanism is to include a valid arbitration agreement (or arbitration clause) from the beginning, when the parties start interacting. The key issue here is the extent to which

¹⁴⁸⁷ This is supported by many interviews. For a full discussion see Chapter 5.3.2

¹⁴⁸⁸ This is highly probable because MedArb usually only takes 4-6 months, but waiting times for a court hearing is often much longer: Interviews C1-c, C5-r, C7-s, J1-c, J3-c to J6-s, J8-c, J9-c, L2-s, L4-r to L6-s, L10s-, L14-c, L16-c, L17-c, R3-r, R10-c

¹⁴⁸⁹ Ibid. L16-c suggested that courts' attitude would be driven by a motto: "Too much hustle for the courts – too little gain in the whole scheme of things." Similar views were echoed by other interviewees.

claimholders' *ex ante* opting into MedArb is feasible in practice. In particular, problems may arise when trying to determine whether and how multiple parties with different contracts and sources of entitlements can all agree to use MedArb instead of courts to apply the EBL. There are two possible ways how multiple parties may be bound. First method involves including a valid arbitration clause in every debt and trade contract. That way, a debtor would be bound and would bind its contractual creditors in express bilateral agreements that would ensure enforcement of the EBL (debt recovery in insolvent Liquidation and in Reorganisation) using MedArb rather than courts. A problem arises when the arbitration clause is not included in one of the contracts – by accident or on purpose. There, if the non-bound creditor could file an EBL petition and get it accepted by a court before MedArb adjudicators deliver their award, a court would likely take over the case.¹⁴⁹⁰ Nevertheless, as discussed above, if a court did not take the case over, the non-bound creditor would be incentivised to cooperate with the MedArb adjudicator.

A better solution, however, would be a mechanism that would bind all claimholders impliedly, without the need for individual negotiations and the attendant danger of holdouts or forgetfulness. One possible way of achieving this would be for the debtor company to include the arbitration agreement in its constitutional documents. This possibility relies on Rasmussen's argument that companies should be able to choose their enforcement mechanism in their constitutional documents.¹⁴⁹¹ His argument is made in the context of transnational insolvencies where there is no law that could govern collective resolution. Similar reasoning could be applied to larger private-sector companies in China

¹⁴⁹⁰ Subject to the discussion earlier in this chapter in the context of *ex post* opting in.

¹⁴⁹¹ Rasmussen (1997) and Rasmussen (2000)

whose distress – in practice – also has no law to govern its collective resolution. The argument that companies should be able to express a preference for MedArb-based application of the EBL is further reinforced by the generally accepted view in China that company charter has legal force.¹⁴⁹²

Parties' ability to opt out of court enforcement and into alternative dispute resolution enforcement is also supported by DDR's widely-recognised legitimacy in China. Traditionally, the power to rearrange parties' pre-existing claims – often necessary in corporate insolvency and restructuring – derives from a statute or a contract. The former is exemplified by the EBL which empowers courts to decide insolvency cases and determine each claimholder's entitlements. The latter is exemplified by bilateral contractual agreements between the debtor and each claimholder. An amalgamation of the two forms of power to rearrange pre-existing entitlements is the Arbitration Law 1995 which empowers DDR bodies to apply any law where the parties contractually agree to it. Thus, it can be argued that the statutory power to rearrange parties' pre-existing claims (under the EBL) can be voluntarily assigned to an arbitral body (under a valid arbitration clause, as *per* the Arbitration Law 1995). It is, therefore, legitimate for mediators-arbitrators to rearrange parties' pre-existing claims using EBL provisions in a MedArb setting rather than the court.

Empowering debtors to choose *ab initio* which forum they wish to use for resolving their potential corporate insolvency – in other words, enabling companies to opt out of the court system and into one of the DDR mechanisms – could be authorised through statute. However, statutory intervention may be unnecessary. Given that arbitration and mediation-arbitration – as two widely-used forms of DDR – are already recognised in China as valid fora

¹⁴⁹² Wang J (2014) at 101

for resolving a wide range of disputes and applying a wide range of statutory provisions, it would likely suffice to interpret the requirements for opting into arbitration (or mediation-arbitration) by identifying MedArb as the preferred dispute resolution mechanism in debtor's constitutional documents.

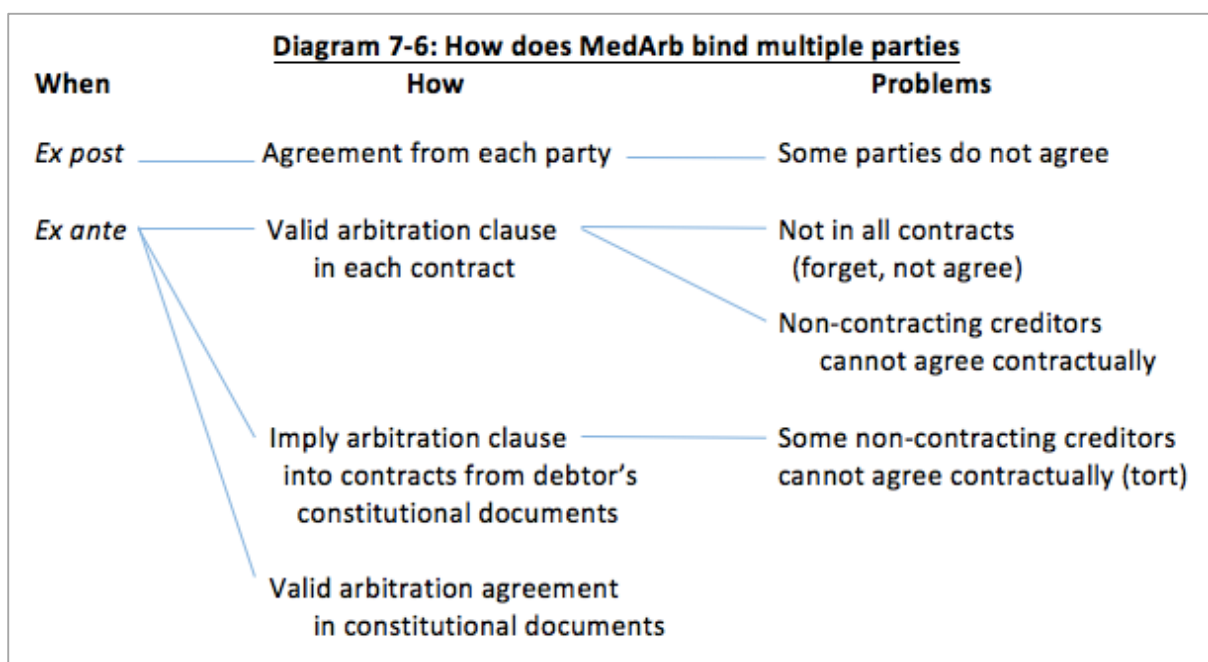
The rules that govern parties' ability to opt into arbitration and mediation-arbitration relies on there being either a valid arbitration clause (a term in a contract) or a valid arbitration agreement (an independent contract). Arbitration clauses and arbitration agreements are only valid if (i) there is a clear expression of the wish to use arbitration; (ii) the chosen arbitral institution is clearly identified; and (iii) the subject matter is capable of being solved through arbitration. In case of arbitration clauses, it also has to be (iv) written and (v) incorporated.¹⁴⁹³ Therefore, the key issue to determine is whether it is possible to say that, as a matter of interpretation, all matters included in a company's constitutional documents are (impliedly) incorporated into all contracts made by that company? If the answer is yes, it would mean that all lenders and investors would have to study borrowers' constitutional documents – which may not be the current practice and may be unreasonable.¹⁴⁹⁴ Alternatively, is it possible to argue that claimholders would be bound if the company included a phrase in each contract that all dealings are subject to its constitution? In that case, it may be possible to say that the use of MedArb has been incorporated by reference – particularly given that companies' constitutional documents are usually available online or at least upon request. But this would take us back to the initial problem of opting into MedArb *ex post*, namely what happens if one contract does not

¹⁴⁹³ Arts 16-17 Arbitration Law 1995

¹⁴⁹⁴ See Chapter 7.4.4.3

include the reference to the company's constitutional documents. Moreover, in either case, there would be a problem with non-contractual creditors, as discussed below.

Probably the best argument then is saying that company's constitutional documents do not incorporate the mandatory use of MedArb, but they instead form a separate arbitration agreement which is contained in a statutory contract which sets out the company's internal and external structure and rules that determine the company's functioning and relationships internally – e.g. with employees – and externally – e.g. with contracting counter-parties. That way, all types of claimholders could be impliedly bound.



How to deal with non-contractual creditors

If the mechanism works on the basis of individual contracts,¹⁴⁹⁵ an additional problem arises when we consider non-contractual claims, such as tort claims, employment

¹⁴⁹⁵ i.e. the *ex post* option and first two *ex ante* options in Diagram 7-6

claims, etc.¹⁴⁹⁶ Such non-contractual claimholders cannot agree in their contract to opt in to the MedArb mechanism *ex ante*.¹⁴⁹⁷ They can, however, voluntarily decide to opt-in to the MedArb mechanism *ex post* – and their incentives to do so are similar to those of contractual creditors, discussed above. Nevertheless, their inclusion may not be necessary. In a way, if their claims are relatively small, it may be better for the contractual parties to agree to pay the non-contractual claimants in full and only concern themselves with the larger contractual claims under MedArb – similar to a London Approach regime. If, on the other hand, the non-contractual claims are relatively large and the claimants refuse to agree to use a MedArb, then the MedArb mechanism may not work.¹⁴⁹⁸

7.4.4.2 Enforceability of awards

In order to be effective, MedArb-based enforcement of the EBL has to be able to render an award that is enforceable. This is not a problem in China, because arbitral awards – whether reached at the mediation or arbitration stage – are enforceable and final, and can be enforced in a simple court proceeding if necessary.¹⁴⁹⁹ Given that the regime would not infringe on the state control or state-controlled companies, the government is unlikely to oppose or interfere with the mechanism and its enforcement.¹⁵⁰⁰

¹⁴⁹⁶ NB: If the mechanism works on the basis of a separate arbitration agreement, such problems do not arise

¹⁴⁹⁷ Unless an arbitration clause can be implied into their basic employment contract or a collateral contract can be implied based on their dealings.

¹⁴⁹⁸ Subject to Rasmussen's argument

¹⁴⁹⁹ See Chapter 4.2.4.1-3

¹⁵⁰⁰ Cf Chapter 5.3.3

7.4.4.3 *Justification for empowering non-court body to apply and enforce the EBL*

Finally, enforcement of laws is traditionally courts' domain. Moreover, insolvency law permits a significant interference with pre-existing contractual entitlements, which is also usually only courts' domain. Why then should a non-court body – such as a mediation-arbitration institution – be allowed to adjudicate statutory matters that allow interference with parties pre-existing rights?

In China, the argument is three-fold. Firstly, with regards to permitting arbitrators to adjudicate statutory matters, Chinese business culture is still influenced by Confucian values – including a preference for harmonious, non-adversarial resolution of disputes.¹⁵⁰¹ As a result, many disputes are resolved through informal negotiations, mediation and arbitration rather than by (adversarial) court proceedings. Secondly, this cultural preference is also reflected in statutory regime which puts arbitration on the same level as court enforcement. And finally, with regards to permitting non-courts to rearrange parties' pre-existing rights under the EBL, MedArb derives its power not only from statute but also from express or implied contracts between the company and its claimholders that designate MedArb as their preferred resolution mechanism in case of debtor's distress or insolvency. In that sense, the justification for non-court enforcement of the EBL under MedArb rests on statutory and contractual authority.¹⁵⁰²

¹⁵⁰¹ For details see Chapter 3.3.1

¹⁵⁰² See Chapter 7.4.4.3 for further discussion

7.4.5 Limitations of the mechanism

In light of the above discussion, it is clear that MedArb may offer an efficient alternative to court-driven enforcement of the EBL. But it also has a number of limitations. Firstly, it cannot be used where the Party-state wishes to interfere. This includes, importantly, cases of distress in state-sector companies.¹⁵⁰³ Similarly, the Party-state would most likely interfere in private-sector companies' distress where it would affect a large number of employees.¹⁵⁰⁴ For these cases, MedArb is most likely not available.

Secondly, if Rasmussen's argument about companies' ability to determine the mode of enforcement in their constitutional documents is rejected and so the justification relies on individual explicit contractual undertakings to use MedArb, there is a clear limitation due to the nature of multi-contractual agreements and due to the existence of non-contractual claimholders. If there is only a small number of claimholders – contractual and non-contractual – who did not or could not contractually opt in to use MedArb *ex ante*, then the mechanism would only work if the claimholders who did opt in and are using MedArb to resolve the distress agree to use London-Approach-style arrangements where they pay in full those who did not opt in or they ignore them and risk their EBL petition before they finalise the MedArb hearings. If there is a large number of non-contracting claimholders – and they refuse to join MedArb *ex post* – then the mechanism would not work. Moreover, although non-contracting claimholders would be incentivised to join MedArb proceedings, this would not be clear until when the distress arises which would create undesirable uncertainty. These issues and their possible solutions are summarised in Table 7-7.

¹⁵⁰³ They are therefore excluded – see Chapter 7.4.1

¹⁵⁰⁴ Albeit state-s interference could be avoided if all employees' claims were satisfied (in Liquidation), or where the company was restructured without it affecting employees (in Reorganisation)

**Table 7-7: Overview of technical issues where some claimholders not bound
(if opting in under individual contractual undertakings)**

How many claimholders not bound	Possible problem(s)	Possible solution(s)
Insignificant number *	MedArb unable to bind all claimholders	London-Approach-style arrangement where bound claimholders pay in full non-bound claimholders, bound claimholders then agree among themselves
	Risk that non-bound claimholders could submit an EBL petition to court	A low risk given that courts will most likely ignore the petition
Significant number*	MedArb unable to bind all claimholders and London-Approach-style arrangement impracticable	<i>MedArb cannot help</i>

* depends on the particulars of each company

Furthermore, the issues identified in Chapter 7.2.1 – aimed at ameliorating general flaws in debt enforcement – are also likely to affect EBL enforcement in MedArb. Information asymmetries (7.2.1.1 and 5.2.1.1) are likely to complicate asset recovery. The lack of national property rights register (7.2.1.2 and 5.2.1.2) is likely to complicate verification of property rights. And unpunished asset stripping, unenforced directors' duties, and improper diversion of assets in a given pre-insolvency period with the resultant creation of ghost companies (7.2.1.4 and 5.2.1.4) may also prove problematic, where used. On the other hand, the gaps in the protection of property rights (7.2.1.3 and 5.2.1.3) may be slightly less problematic in MedArb than in court-driven EBL enforcement thanks to the privacy of the MedArb regime. Similarly, courts' reluctance to recognise shadow lenders' debt contracts (7.2.3 and 5.2.3) is also likely to be reduced in MedArb because most of this

reluctance arises from local governments' direction and policies, but not laws. The issues identified in Chapter 7.1 (and Chapter 5.1) are likely to be overcome by arbitrators' superior expertise and experience in the relevant areas. And the issues identified in Chapter 7.3 (and Chapter 5.3) only affects courts and local governments, and so play no role in MedArb enforcement.

7.4.6 Likelihood of successful implementation and Conclusion

MedArb would connect two well established mechanisms, namely a set of statutory provisions about dealing with corporate financial distress – the EBL – and a successful adjudication mechanism – mediation-arbitration – that has support from Chinese courts, the government and commercial parties. Because it targets companies that fall outside the sphere of the Party-state's interest, it does not compete or clash with the Party-state's power. At the same time, it offers the possibility of a more efficient resolution of private-sector companies' distress – which would benefit local governments as well as the affected stakeholders. Moreover, it is a flexible mechanism which can be contractually adjusted to fit the parties' needs and local variations while enabling the claimholders to achieve a collective solution without the pitfalls of private restructuring.¹⁵⁰⁵

Implementation of MedArb does not require any changes in existing law nor significant shifts in parties' attitude. The only thing that it needs is for the mechanism to be introduced and explained to arbitrators, lawyers and potential users. Once it starts being

¹⁵⁰⁵ Discussed in Mnookin (2003); Kirchner (2003). See also Chapter 7.4.3

used, it is likely to be a popular and effective way of dealing with corporate distress in the target companies.

7.5 Conclusion

The three sets of direct reforms and the new mechanism which were proposed in this chapter aim to address the constraints on the use of the EBL – as identified in Chapter 5 – and enable a greater and more efficient use of the EBL in practice. It is an enormous task because the proposed changes go far beyond the law on the books and require changes in attitude and practices that are deeply ingrained in the minds of EBL’s potential users and enforcers. As was stressed throughout this chapter, timing and right structure of the reforms will be crucial.¹⁵⁰⁶ In any case, improving the EBL and its enforcement environment – i.e. implementing proposals in Chapters 7.1 to 7.3 – is likely to take time. Nevertheless, many companies can benefit from the EBL regime now under the opt-in MedArb mechanism – as proposed in Chapter 7.4 – without any need to change the existing law.

¹⁵⁰⁶ See Tables 7-2, 7-3, and 7-4 in this chapter for proposed timing and sequencing of the reforms

Chapter 8. CONCLUSION

8.1 The key findings

The thesis focused on under-researched and little understood matters concerning the functioning and possible improvements to China's Enterprise Bankruptcy Law. It presented my findings – from original qualitative research and existing literature and data – about three research questions. The first question focused on how the EBL operates and *why it is so rarely used*. It was shown in Chapters 4.3 and 6.1 that China has a comparatively low number of insolvency-law cases – both in absolute terms and when contextualised.

Chapter 5 suggested that the low use of the EBL may be explained by four inter-linked groups of constraints that were identified by my interviewees. They were, firstly, flaws in the EBL; secondly, flaws in the surrounding rules and practices; thirdly, limitations and biases of EBL enforcers; and fourthly, the parties' perception that non-EBL alternatives are better. These constraints were repeatedly identified in my interviews as reducing parties' expected payoffs or preventing them from using the law – both of which are likely to disincentivise the parties from using the EBL.

The second question asked *whether it matters that the EBL is so rarely used*. It was argued in Chapter 6 that it does, and that there are three reasons why a greater, more efficient use of the EBL may be desirable. Firstly, the Chinese government recently admitted that insolvency law is not used enough to deal with corporate financial distress and that a greater use is needed to deal with companies' under-productivity, over-capacity, inefficiency, and bad debt. Secondly, the number of insolvency-law cases in China is significantly lower than elsewhere – both in terms of absolute numbers and when

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contextualised as a ratio of insolvency cases per total number of companies across several reviewed economies. And thirdly, several economic indicators suggest that China's economy is riddled with (nearly) insolvent whose financial distress is either ignored or is dealt with using comparatively less efficient non-EBL alternatives.

Moreover, it was proposed that a greater and more efficient use of the EBL is likely to give rise to several economic benefits. They include comparatively more efficient resolution of financial distress that is currently available under the non-EBL alternatives (particularly for complex cases); fewer cases of debt avoidance; improved control of bad debt; greater amount and lower cost of credit; better allocation of resources; improved business environment, more investment and more entrepreneurship; and a strengthened rule of law in China.

The third question then turned to *China's reform options that would ameliorate the identified shortcomings*. Chapter 7 put forward three sets of direct reforms that would address the first three constraints from Chapter 5.1-3, namely changes aimed at the written provisions of the EBL; changes aimed at improving the surrounding rules and practices; and changes aimed at EBL enforcers. Chapter 7.4 then proposed to introduce a new opt-in mechanism – MedArb – which would enable currently excluded private-sector companies of a certain size to invoke the EBL in a particularly successful Chinese combination of mediation and arbitration to resolve debtors' financial distress without most of the limitations of a court-driven EBL procedure.

8.2 Implications of the findings

Although the EBL has been described in several academic and practitioner's articles, there is very little analysis of the law as written, and practically no analysis of how it works in practice. Consequently, this thesis presents a unique set of insights into how the EBL operates in practice from the perspective of the parties that are entitled to use the law – i.e. debtors and creditors – but also from the perspective of their advisors – i.e. lawyers and consultants – and those who are involved in EBL's enforcement – i.e. judges, lawyers and local government officials. Moreover, the conclusions are based on newly collected qualitative and quantitative data, and analysis of the new and existing information.

The timing of the thesis also means that it comes at a crucial moment for China's economy as it is trying to move away from a developing country status and to stabilise its economic growth at a sustainable rate.¹⁵⁰⁷ The success of government's policies will depend on their understanding of *why* companies fail and *what* national and local governments can – and should not – do to ameliorate the situation. As such, improving our understanding of why the EBL is so rarely used, why it matters, and what can be done about it is a small but important part of the puzzle that the Chinese government has to solve to make China more stable and prosperous in the future.¹⁵⁰⁸

¹⁵⁰⁷ It is likely that further economic development will not result from increases in human capital or external investment, but rather from making the existing institutions and companies more efficient. See Yueh (2013)

¹⁵⁰⁸ I base this conclusion on my personal experience with the reform process in China and on my conversations with those who participated in the reform of insolvency law in China in the 1990s and 2000s.

8.3 Lessons for other developing countries

This thesis was primarily concerned with enriching our understanding of the constraints that prevent efficient operation of insolvency law in China – and the ways of ameliorating them through direct and indirect reform. However, many of the findings from this Chinese case study offer far-reaching insights and lessons that can be of relevance for other developing countries and their economic transition, particularly when introducing or reforming their insolvency laws. Of these interrelated lessons and insights, three stand out the most.

Firstly, the Chinese case study provides further illustration of the *difficulty with legal transplants*. A growing body of literature and empirical evidence suggests that there are numerous problems with transplanting legal norms from one jurisdiction to another. These problems include the impossibility of ‘one size fits all’ approach to reform; the interdependence of local rules; various meanings and levels of development and acceptance of particular legal concepts in different jurisdictions; different roles of courts and professionals which lead to different levels of their engagement in the interpretation and enforcement of law; possible relevance of legal families; etc.¹⁵⁰⁹ This thesis supports these findings and provides further evidence that wholesale legal transplants do not work well in practice. Developing countries seeking to advance their economic development should, therefore, be wary of adopting laws from other countries without, at the very least, considering how similar the mother jurisdiction is to theirs, comparing the power structure and pre-existing rules and concepts in the mother jurisdiction and theirs; and the usual level of engagement of the judge in the mother jurisdiction and theirs.¹⁵¹⁰

¹⁵⁰⁹ See Chapters 3.1 and 6.2.1. See also Myant and Drahokoupil (2011); Dai (2009); Clarke (2006); Berkowitz, Pistor and Richard (2002); La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1998) and (1997); Legrand (1997)

¹⁵¹⁰ NB: This is particularly important when transplanting common law rules into civil law system (or *vice versa*)

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Secondly, the Chinese case study also supports the view that *enforcers' expertise and experience are crucial* for the success of insolvency law reform. All the interviewed parties agreed that one of the important reasons why debtors and creditors in China are reluctant to use the EBL to resolve their debt-related disputes – whether through Liquidation or Reorganisation – relates to the limitations in terms of ability and willingness of courts to enforce the EBL provisions in practice.¹⁵¹¹ This finding is relevant not just to China, but to all jurisdictions which are trying to reform their insolvency law in order to make their debt resolution and corporate restructurings more efficient. The key lesson is that the expertise and experience of the enforcers must be improved¹⁵¹² prior to (or soon after) the insolvency law reform is to take effect.

And thirdly, the Chinese case study also highlights the importance of looking not only at the target country's stage of economic development but also *other indicators and influencers such as socio-economic and political environment* of a given country in order to understand whether and how the new rules and laws would be implemented in practice as well as the types of problems that may arise from the rules' implementation. China's experience has been shaped by a number of issues that set China apart from some or all other jurisdictions that they are often compared or contrasted with – such as India, Russia, Brazil, the US, the UK, or European civil law jurisdictions (especially Germany and France). The important differences include the illegality and severe punishment (until recently a death penalty) of parties' participation in the shadow lending market;¹⁵¹³ Confucianism and

¹⁵¹¹ See Chapter 5.3

¹⁵¹² See Chapter 7.3

¹⁵¹³ See Chapter 4.1

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its particular hierarchical structuring of social interactions and preference for social norms (v. legal norms) and non-adversarial solutions;¹⁵¹⁴ China's particular form of capitalism – often labelled as 'state capitalism with Chinese characteristics,' 'crony capitalism,' '*guanxi* capitalism' – where market forces are combined with state ownership and control;¹⁵¹⁵ particularly strong protection of employment and employees' rights in the short term at the expense of secured creditors and long-term economic efficiency;¹⁵¹⁶ absence or inadequacies of various mechanisms that usually assist debt enforcement;¹⁵¹⁷ and the stigma associated with insolvency (which previously amounted to belief that insolvency law has no role to play in a socialist China).¹⁵¹⁸ The lesson from this thesis is that the success or failure of insolvency law in any given jurisdiction – and particularly in transition economies – will largely depend not only the the quality of the insolvency law itself, but also on that jurisdiction's political and socio-economic background in which the reformed insolvency law would be enforced.¹⁵¹⁹

8.4 Suggested ways forward

There is still much that we do not know about the EBL. Further research is, therefore, called for to improve our understanding of the interaction of Confucianism and the EBL; the details of the EBL reform process; the variations in the attitude and use of the EBL across provinces

¹⁵¹⁴ See Chapter 3.3.1-2, 4.3.1.1, and 7.4.4.3

¹⁵¹⁵ Huang (2008). See also Chapters 3.2, 3.3.3, and 3.4

¹⁵¹⁶ See Chapter 5.1.1

¹⁵¹⁷ See Chapter 4.1.3 and 5.2

¹⁵¹⁸ See Chapter 5.4.1.2

¹⁵¹⁹ For more, see Mrockova in Parry (2015)

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and their causes; the reasons why certain provinces – such as Wenzhou and Shenzhen – proactively and unilaterally make improvements to the EBL while others refuse to cooperate; the ways how the national government can improve its ability to incentivise local governments' cooperation; etc. There is also still much to learn about shadow lending and the best way how to regulate it; local governments' targets and how to improve them; state-led restructuring mechanisms; the real amount of bad debt in China's economy; and the real number of insolvency companies in China.

For now, the next step may be to observe whether any of the proposed changes in Chapter 7¹⁵²⁰ are successfully implemented. The proposals took into account that some changes are more likely to be implemented in current socio-economic climate, while others may take time and extra effort. To assist the reform efforts – and enable effective monitoring of it – a list of possible measures to assess reforms' success in practice is included in Table 8-1. It is not intended to be exhaustive, but rather an illustration of the type of changes that should take place over the next few years. It may also serve as an inspiration for the new targets for local governments.¹⁵²¹

¹⁵²⁰ Many of them were submitted to the government as a part of the reform proposal project – *supra* n.1298

¹⁵²¹ As discussed in Chapter 7.3.3.2

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Table 8-1: Illustrative list of possible measures of reforms' success

	Measures
Supporting institutions established and functional	1. a functioning land registry 2. a publicly-accessible property rights registry 3. a functioning mechanism for distributing unemployment benefits from the social security fund
More EBL cases	4. increase in the number of court-run insolvency cases after the suggested interventions 5. increase in the number of successful reorganisation (i.e. non-liquidation) cases 6. increase in the number of companies that are still in business 5 years after EBL reorganisation procedure
Greater understanding and ability to use the EBL	7. establishment and effective functioning of specialised insolvency divisions in all major courts 8. establishment of local bankruptcy law centres (academic, practitioners) 9. increase in local courts' understanding of insolvency law procedures and their benefits 10. increase in lawyers' understanding of insolvency law procedures and their benefits 11. increase in local governments' understanding of insolvency law procedures and their benefits
Achievement of predicted benefits	12. decrease in the volume of NPLs after the suggested interventions 13. greater availability of credit to companies in the private sector 14. lower cost of credit to companies in the private sector 15. more efficient or market-driven allocation of resources to the most efficient users 16. greater ease of doing business in China (as measure by e.g. the World Bank's Doing Business measure)
Practical improvements	17. greater transparency in dealing with debt-related disputes 18. increase in local courts' willingness to use EBL procedures in all relevant cases 19. increase in lawyers' ability to use EBL procedures 20. increase in local governments' willingness to permit the use EBL procedures in all relevant cases 21. less (or no) interference from central and local governments in court-driven insolvency procedures 22. greater access to Chinese courts to resolve debt-related disputes for domestic and foreign companies

APPENDIX I: List of Interviewees

The conclusions and suggestions contained in this thesis rely, to a significant extent, on original qualitative data from 67 interviews in China, Hong Kong, Asia, Australia, Europe, and the United States. Below is a list of all the interviewees and their short identifier (used throughout this thesis), industry affiliation, method of selection, region, sector, seniority and additional notes that describe their expertise, etc. As was explained in Chapter 1.2, all interviewees are anonymised. Selection methods are abbreviated to ‘C’ (connection through conference, common projects, etc.), ‘R’ (random, no connection) and ‘S’ (snowball, by recommendation).

Table A-1 shows the details of three interviewed bankers. ‘Senior’ denotes top management. ‘Mid’ denotes more than 3-year non-managerial experience in the bank.

Table A-1: Overview of interviewees – banks

<u>Number</u>	<u>Short identifier</u>	<u>Industry identifier</u>	<u>How selected</u>	<u>Region</u>	<u>Sector</u>	<u>Seniority</u>	<u>Notes (experience, scope of interview, etc)</u>
1	B1-c	Bank 1	C	China coastal	national/local, public/private	senior	finance
2	B2-c	Bank 2	C	China coastal, interior	national, public	mid	finance
3	B3-c	Bank 3	C	China	national/local, public/private	senior	finance

Table A-2 shows the details of eleven consultants who were interviewed. ‘Senior’ denotes more than 8 years of providing advice or similarly engaging with finance, business, investors, international relations, etc. ‘Mid’ denotes more than 3 years of relevant experience in the given area. ‘Mid / senior’ denotes significantly more than 3 years but less than 8 years of the relevant experience.

Table A-2: Overview of interviewees – consultants

<u>Number</u>	<u>Short identifier</u>	<u>Industry identifier</u>	<u>How selected</u>	<u>Region</u>	<u>Sector</u>	<u>Seniority</u>	<u>Notes (experience, scope of interview, etc)</u>
4	C1-c	Consultant 1	C	UK/China coastal, interior	national/local, public/private	senior	finance, business, intl, FDI, JV
5	C2-c	Consultant 2	C	Australia/China coastal	national/local, public/private	senior	political, commercial, law
6	C3-c	Consultant 3	C	UK/China	national/local, public/private	mid / senior	political, law
7	C4-c	Consultant 4	C	China coastal	local, private	mid	finance, business, politics, intl
8	C5-r	Consultant 5	R	China all	national/local, public/private	senior	finance, business, law, development, comparative
9	C6-c	Consultant 6	C	China all, HK	national/local, public/private	senior	judicial reform, comparative
10	C7-s	Consultant 7	S	China all	national/local, public/private	senior	law applied, domestic & intl, enforceability of law
11	C8-s	Consultant 8	S	China coastal, ltd interior	national/local, mainly private	senior	political access, domestic & intl issues, business experience in China
12	C9-c	Consultant 9	C	China	national/local, public/private	senior	political, economic, commercial - judicial reform
13	C10-s	Consultant 10	S	China	national/local, public/private	mid	political, economic, commercial
14	C11-c	Consultant 11	C	China/Asia		senior	political, economic, historical

Table A-3 shows the details of five interviewed entrepreneurs who operate in China. ‘Senior’ denotes 10 or more years of business experience. ‘Mid’ denotes more than 3 years of business experience.

Table A-3: Overview of interviewees – entrepreneurs

<u>Number</u>	<u>Short identifier</u>	<u>Industry identifier</u>	<u>How selected</u>	<u>Region</u>	<u>Sector</u>	<u>Seniority</u>	<u>Notes (experience, scope of interview, etc)</u>
15	E1-c	Entrepreneur 1	C	China interior	local, private	senior	commercial, finance, law
16	E2-s	Entrepreneur 2	S	China coastal	local, private	mid	commercial, finance, law
17	E3-s	Entrepreneur 3	S	China coastal, interior	local, private	senior	commercial, finance, law
18	E4-c	Entrepreneur 4	C	China coastal, interior	local, private	senior	commercial, finance, law
19	E5-c	Entrepreneur 5	C	Europe/China coastal, interior	foreign, private/public	senior	commercial, finance, law

Table A-4 shows the details of two interviewed informal finance providers who operate in China. ‘Senior’ denotes managerial position and more than 8 years of experience.

Table A-4: Overview of interviewees – informal finance providers

<u>Number</u>	<u>Short identifier</u>	<u>Industry identifier</u>	<u>How selected</u>	<u>Region</u>	<u>Sector</u>	<u>Seniority</u>	<u>Notes (experience, scope of interview, etc)</u>
20	IF1-s	Informal finance provider 1	S	Wenzhou	local, public/private	senior	commercial, finance, law
21	IF2-c	Informal finance provider 2	C	China	national/local, public/private	senior	commercial, finance, law

Table A-5 shows the details of nine interviewed judges. ‘Senior’ denotes affiliation with the SPC or judicial experience of more than 10 years. ‘Mid’ denotes more than 3 years of judicial experience.

Table A-5: Overview of interviewees – judges

<u>Number</u>	<u>Short identifier</u>	<u>Industry identifier</u>	<u>How selected</u>	<u>Region</u>	<u>Sector</u>	<u>Seniority</u>	<u>Notes (experience, scope of interview, etc)</u>
22	J1-c	Judge 1	C	China coastal	mostly public	senior	Extensive commercial experience
23	J2-c	Judge 2	C	Germany/China	mostly public	mid / senior	training, exchange
24	J3-c	Judge 3	C	China	public/private	senior	EBL and commercial experience
25	J4-c	Judge 4	C	China	mostly private	senior	Extensive EBL experience
26	J5-s	Judge 5	S	China	public/private	senior	Collaboration with other judges on functioning and reform of EBL
27	J6-s	Judge 6	S	China	public/private	mid	Extensive EBL experience, also professional experience
28	J7-c	Judge 7	C	China	public/private	senior	EBL and commercial experience
29	J8-c	Judge 8	C	China coastal	public/private	senior	EBL and commercial experience
30	J9-c	Judge 9	C	China	public/private	senior	EBL and commercial experience

Table A-6 shows the details of seventeen interviewed lawyers with experience of Chinese law. ‘Senior’ denotes a partner in a law firm or more than 8 years of legal experience.

‘Mid’ denotes more than 5 years of post-qualification legal experience.

Table A-6: Overview of interviewees – lawyers

<u>Number</u>	<u>Short Identifier</u>	<u>Industry Identifier</u>	<u>How selected</u>	<u>Region</u>	<u>Sector</u>	<u>Seniority</u>	<u>Notes (experience, scope of interview, etc)</u>
31	L1-r	Lawyer 1	R	HK	national/local, public/private	mid	commercial, domestic & intl
32	L2-s	Lawyer 2	S	HK	national/local, public/private	senior	commercial, domestic & intl
33	L3-r	Lawyer 3	R	HK	national/local, public/private	mid	commercial, domestic & intl
34	L4-r	Lawyer 4	R	China	national/local, public/private	senior	commercial, domestic & intl
35	L5-c	Lawyer 5	C	China	national/local, public/private	mid	commercial, domestic & intl
36	L6-s	Lawyer 6	S	China	national/local, public/private	senior	commercial, domestic & some intl
37	L7-c	Lawyer 7	C	China	national/local, public/private	mid	commercial, domestic & intl
38	L8-c	Lawyer 8	C	China city	national/local, public/private	senior	commercial, domestic & intl
39	L9-s	Lawyer 9	S	China coastal, SEZ	national/local, public/private	senior	commercial, domestic & intl
40	L10-s	Lawyer 10	S	China coastal, SEZ	national/local, public/private	senior	commercial, domestic & intl
41	L11-c	Lawyer 11	C	China city	national/local, public/private	senior	commercial, domestic & intl
42	L12-c	Lawyer 12	C	China coastal, SEZ	national/local, public/private	senior	commercial, domestic & intl
43	L13-c	Lawyer 13	C	China city	national/local, public/private	senior	commercial, domestic & intl
44	L14-c	Lawyer 14	C	China	national/local, public/private	senior	commercial, domestic & intl
45	L15-c	Lawyer 15	C	China	national/local, public/private	senior	commercial, domestic & intl
46	L16-c	Lawyer 16	C	England / China	national/local, private	senior	commercial, domestic & intl
47	L17-c	Lawyer 17	C	England / China	national/local, private	senior	commercial, domestic & intl

APPENDIX I

Table A-7 shows the details of five interviewed politicians. ‘Senior’ denotes 10 or more years (i.e. two five-year plan periods) of political experience. ‘Mid’ denotes more than 5 years of political experience.

Table A-7: Overview of interviewees – politicians

<u>Number</u>	<u>Short Identifier</u>	<u>Industry Identifier</u>	<u>How selected</u>	<u>Region</u>	<u>Sector</u>	<u>Seniority</u>	<u>Notes (experience, scope of interview, etc)</u>
48	P1-r	Political 1	R	China	mostly national	senior	EBL drafting, finance, law
49	P2-s	Political 2	S	coastal China / Europe	local	mid	insider access, cooperation with top leadership
50	P3-r	Political 3	R	China / intl	national and local	senior	commerce, finance
51	P4-c	Political 4	C	China / intl	national and local	senior	commerce, finance, law
52	P5-c	Political 5	C	China / intl	national and local	senior	commerce, finance, law

Table A-8 shows the details of fifteen interviewed researchers who focus on various issues in China. ‘Senior’ denotes a professor of a widely-acknowledged expert in the given field or 8 years of China-related research experience. ‘Mid’ denotes more than 5 years of China-related research experience.

Table A-8: Overview of interviewees – researchers

<u>Number</u>	<u>Short identifier</u>	<u>Industry identifier</u>	<u>How selected</u>	<u>Region</u>	<u>Sector</u>	<u>Seniority</u>	<u>Notes (experience, scope of interview, etc)</u>
53	R1-r	Researcher 1	R	HK	national/local, public/private	senior	comparative, political access
54	R2-r	Researcher 2	R	HK	national/local, mainly private	senior	finance experience in China, insider access
55	R3-r	Researcher 3	R	HK	national/local, public/private	senior	connections with politicians, financiers, entrepreneurs
56	R4-c	Researcher 4	C	Australia/China coastal	national/local, mainly private	senior	political access, commercial experience
57	R5-c	Researcher 5	C	Europe/China coastal, interior	national/local, public/private	senior	political access
58	R6-c	Researcher 6	C	UK/China coastal	national/local, public/private	mid	corporate and political insights
59	R7-c	Researcher 7	C	US/Asia/China	national, public	senior	corporate, commercial, political issues
60	R8-s	Researcher 8	S	US/China coastal, interior	national/local, public/private	senior	political access, judicial reform
61	R9-c	Researcher 9	C	UK/China coastal, interior	national, public	mid	corporate research, law and economics
62	R10-c	Researcher 10	C	China coastal, interior	local, public/private	senior	corporate, insolvency, political access
63	R11-c	Researcher 11	C	China coastal, interior	local, public/private	mid	political access, extensive focused research
64	R12-c	Researcher 12	C	China coastal, SEZ	local, public/private	senior	political access, law-making experience and expertise
65	R13-c	Researcher 13	C	China	national, public	mid	commercial issues, political experience
66	R14-s	Researcher 14	S	China / US / UK	national/local, public	mid	role of state, private-public interaction
67	R15-s	Researcher 15	S	China / UK	national/local, public	mid	role of state, constitutionalism, rule of law

APPENDIX I

The following three diagrams contextualise the data and provide an overview of the sample along three criteria. Diagram A-9 illustrates the spread of interviewees by selection process.

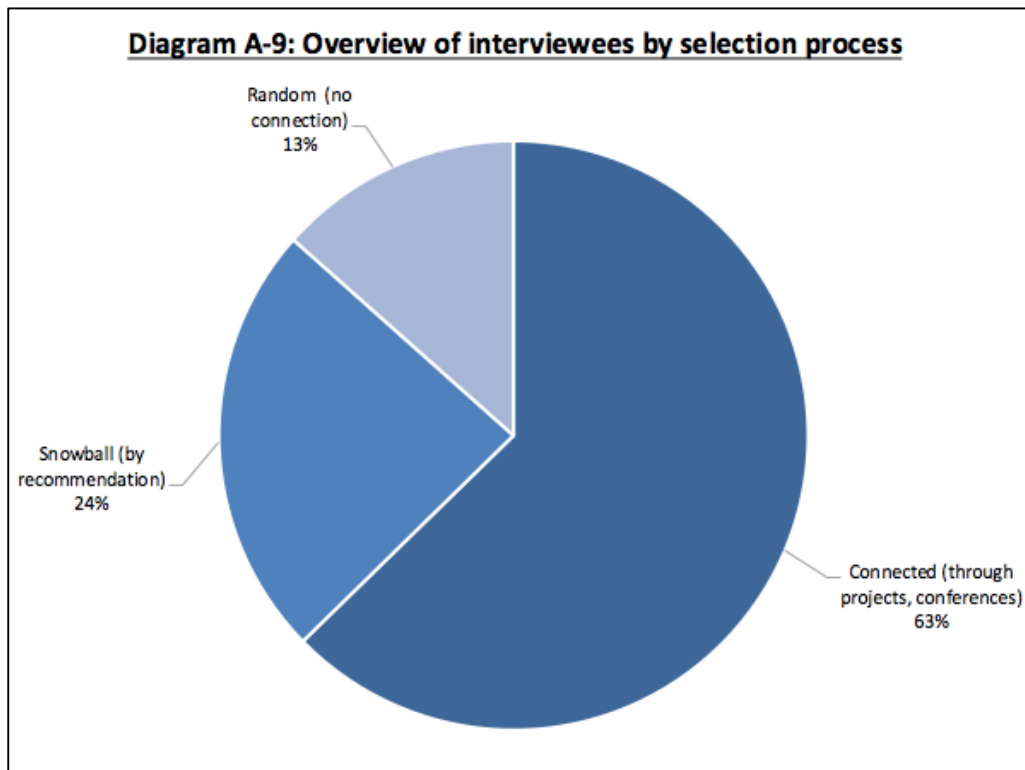
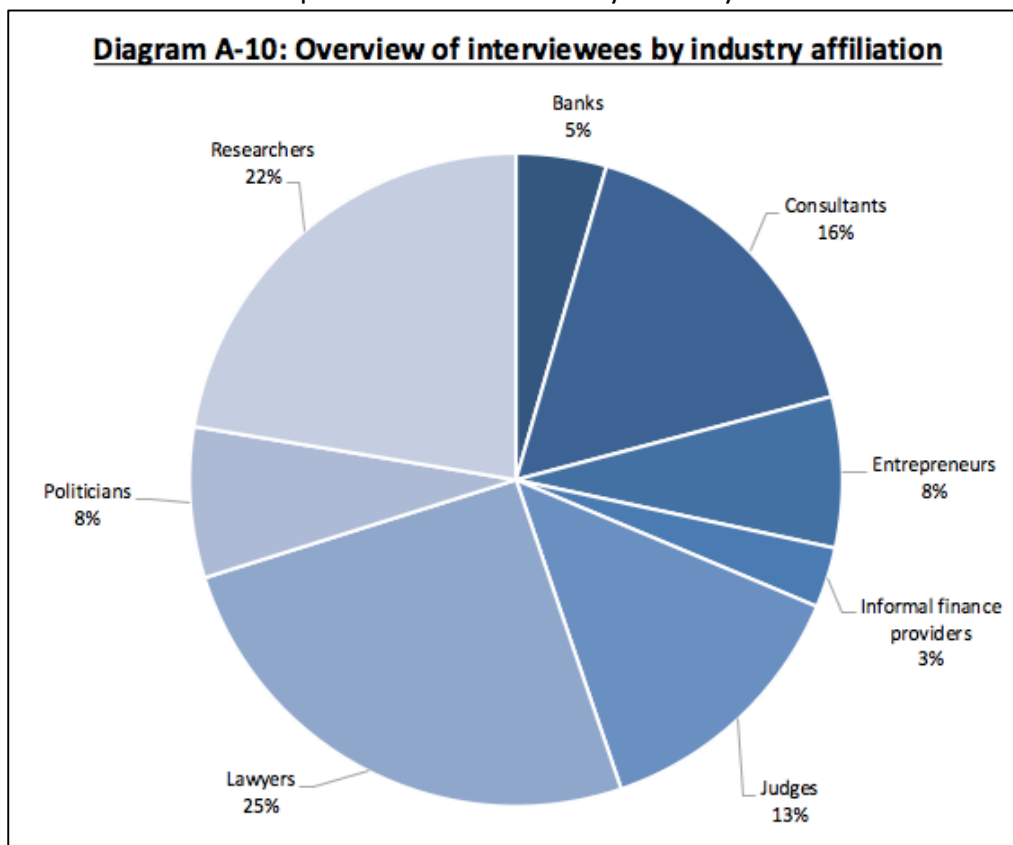
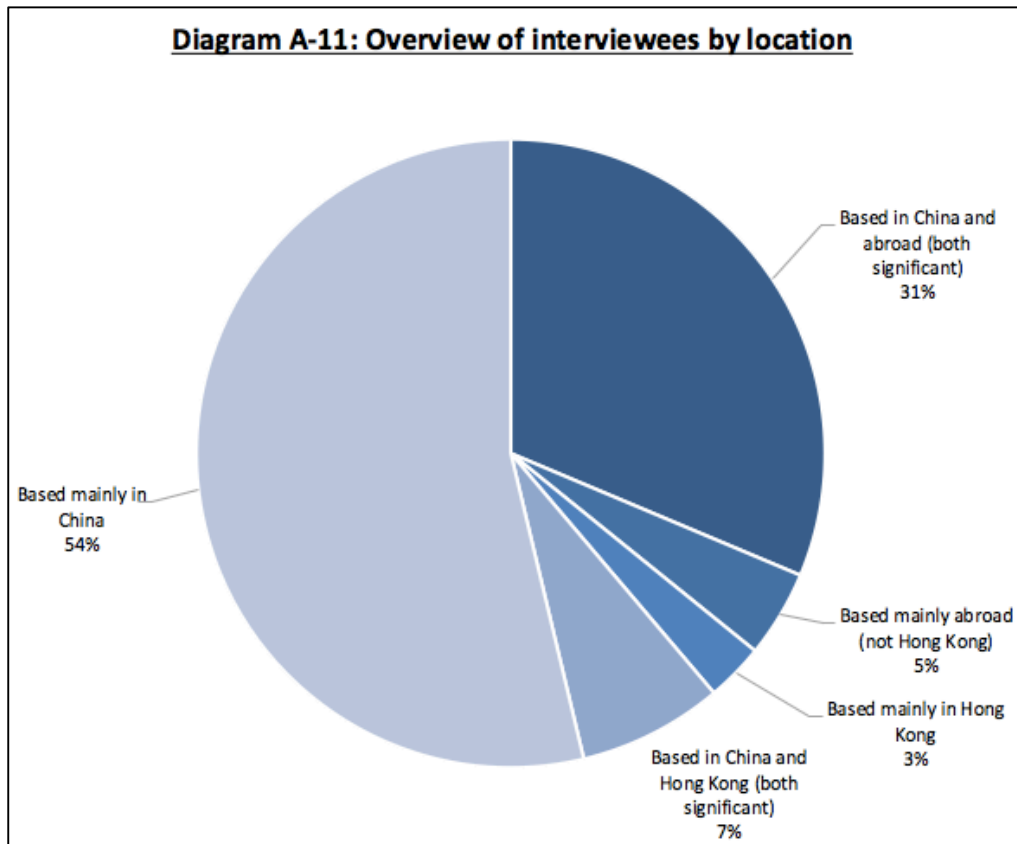


Diagram A-10 illustrates the spread of interviewees by industry affiliation.



And Diagram A-11 illustrates the spread of interviewees by location.



APPENDIX II: Questions to interviewees

Below is a list of questions that I used during the interviews. As the interviews were only semi-structure, the questions only provided a starting point and the conversations with different people often focused on different issues.

1/ Why do you think EBL was introduced in China?

2/ What are the options if a company is financially distressed?

3/

How important is written contracting in China?

How often do you make deals that are oral only?

What do you see as the biggest difference between doing business in China and elsewhere?

Why do you think that the Chinese model works? Does it work better or worse than models elsewhere?

Would you ever consider using EBL? Why / Why not?

Are there any practical impediments to using EBL?

Does the change in China's economy matter for the use of EBL? Is EBL more or less important for China as it becomes a market economy?

4/

How are the EBL procedures viewed in your province?

How many EBL cases have you had in your province?

How many applications and how many live cases are there?

Do you see this as a satisfactory level of use of the law?

What do you think can be done differently to ensure better use of the law?

What is the average length of EBL procedures?

APPENDIX II

Are there any special guidelines that exist nationally/locally that you see as useful for EBL?

Should there be special treatment companies category under EBL? Why?

What is the relationship between courts and government in deciding a fate of a failing enterprise?

Is there a different treatment for different types of companies? What/How? Why?

5/

Who decides how the EBL is used?

Is the EBL used differently in different parts of China?

What is the role of the government [local and central] in the use and application of the EBL procedures?

Does the government get involved in any particular types of bankruptcies?

What is the role of SASAC in the use of EBL?

6/

What would you think of a company that was financially distressed and (i) was bailed out by the government, (ii) went through EBL reorganisation and survived, (iii) was closed down without any resolution of its debts or anything, without court, or (iv) was liquidated under EBL?

If it was your company, what would you decide? Why?

7/

How do banks view EBL and its procedures?

Does EBL offer the options you want / need to help resolve financial distress?

8/ Does guanxi matter in financial distress? Why? How?

9/

Is it good for China to have liquidation/rescue procedure?

Could we improve liquidation/rescue procedure?

Why do you think there are so few cases of EBL use in China?

10/

Does EBL change the old (pre-EBL) practices?

What is used instead of the EBL?

Does Chinese culture have a role to play in the use of the EBL?

What is the role of reputation with regards to using the EBL?

11/ Can you tell me of any particular cases to illustrate the above?

12/ What do you see as a satisfactory outcome in case of financial distress?

13/ What do people care about? (creditors, ordinary people, judges, lawyers)

- Most important factors?
- What is preferable outcome: going concern or piece-meal sale?

14/

How are creditors protected?

How is debtor protected?

How the law/courts deal with creditors?

Mechanisms that give creditors comfort?

How has new system affected behaviour of creditors/debtors in China?

15/ Suggestions for improvements of the system?

16/

Should we have specialised bankruptcy courts in China? Any hint there will be?

Should we have same rules for whole of China? Or just in certain provinces?

Should administrators be required to have special education/certification?

17/

How judges chosen?

What constraints exist on judges?

What constraints exist on their independence?

18/

In the cases you have seen, how much can secured/unsecured creditors (%) expect in EBL procedure? How much can they expect in out-of-court procedure?

Is there a big-firm-first rescue approach?

19/ Questions about out-of-court workouts

- Possible?
- Encouraged?
- How often happen?

20/ Questions about refinancing

- Available?
- Available from whom
- Available from where
- How much is available
- How easy/difficult to get?

21/ Questions about resources

Are there any resources for court decisions in particular cases in your province?

Is there any information on the data re applications, live cases etc in your province?

22/

How do bank officers make their decision to lend or not to lend to a particular company?

Are banks officers responsible for the loans they make?

23/

Would dual track of reforms [as implemented in many other areas in China] make sense for bankruptcy and EBL in China?

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Enterprise Insolvency Law of the People's Republic of China¹⁵²²

CHAPTER 1 GENERAL PROVISIONS

Article 1

This Law is formulated to regulate enterprise insolvency practice and activities, to fairly liquidate claims and debts, to protect the legitimate rights and interests of creditors and debtors, and to maintain the order of the socialist market economy.

Article 2

Where enterprise with legal person status is unable to pay off debts falling due and its asset fails to meet the debts or it obviously lacks of liquidity, it shall be liquidated in accordance with rules prescribed in this Law.

Where enterprise with legal person status meets the abovementioned tests or it is obviously likely to become insolvent, it may be reorganized in accordance with the rules prescribed in this law.

Article 3

Insolvency case shall be heard by the People's Court where the debtor is domiciled.

Article 4

Where there is no relevant rule in this Law applicable to the insolvency case, rules prescribed in Civil Procedure Law could be applied for reference.

Article 5

Insolvency procedures commenced in accordance with this Law is binding on debtor's property located outside the territory of the People's Republic of China (the P.R.C.).

Where the verdict or ruling entered into by foreign court involving the debtor's property within P.R.C.'s territory requires the acceptance and execution by Chinese Court, Chinese Court shall, based upon relevant petition or requests, check the foreign verdict or ruling and render the ruling of acceptance and execution

中华人民共和国企业破产法

第一章 总则

第一条

为规范企业破产程序,公平清理债权债务,保护债权人和债务人的合法权益,维护社会主义市场经济秩序,制定本法。

第二条

企业法人不能清偿到期债务,并且资产不足以清偿全部债务或者明显缺乏清偿能力的,依照本法规定清理债务。企业法人有前款规定情形,或者有明显丧失清偿能力可能的,可以依照本法规定进行重整。

第三条

破产案件由债务人住所地人民法院管辖。

第四条

破产案件审理程序,本法没有规定的,适用民事诉讼法的有关规定。

第五条

依照本法开始的破产程序,对债务人在中华人民共和国领域外的财产发生效力。

对外国法院作出的发生法律效力的破产案件的判决、裁定,涉及债务人在中华人民共和国领域内的财产,申请或者请求人民法院承认和执行的,人民法院依照中华人民共和国缔结或者参加的国际条约,或者按照互惠原则进行审查,

¹⁵²² Translated by the Bankruptcy Law and Restructuring Research Center of China University of Politics and Law under the supervision of Professor Li Shuguang

in accordance with the international agreements to which P.R.C. is a party or based on mutual reciprocity principle after ascertaining that there is no violation of basic principles of P.R.C. Laws, no detriment to state sovereignty, security and social public interests, no harm to the legitimate rights and interests of creditors in P.R.C..

Article 6

Hearing the insolvency case, the People's Court shall safeguard the legitimate rights and interests of the employees of the insolvent enterprise and hold officers of the insolvent enterprise accountable for their liabilities in accordance with law.

CHAPTER 2 PETITION FOR INSOLVENCY AND ACCEPTANCE OF INSOLVENCY CASE

SECTION 1 PETITION FOR INSOLVENCY

Article 7

Where the debtor meets the tests stipulated in Article 2 of this law, it may file petition for Reorganization, composition, or liquidation with the People's Court.

Where the debtor is unable to pay off debts falling due, its creditors may file petition for reorganization or liquidation with the People's Court.

Where enterprise with legal person status is dissolved without being liquidated or with liquidation pending and its assets fail to meet debts falling due, those responsible for liquidating the enterprise shall file bankrupt liquidation petition with the People's Court.

Article 8

When a debtor or creditor files an application for insolvency with the People's Court, the applicant shall submit an Application Form for Insolvency Case and relevant evidences to the court.

Insolvency petition shall include following items:

- (1) Basic situation of petitioner and petitionee;
- (2) Purpose of filing petition;
- (3) Facts of and grounds for petitioning;
- (4) Other matters the People's Court deems necessary to cover.

认为不违反中华人民共和国法律的基本原则,不损害国家主权、安全和社会公共利益,不损害中华人民共和国领域内债权人的合法权益的,裁定承认和执行。

第六条

人民法院审理破产案件,应当依法保障企业职工的合法权益,依法追究破产企业经营管理人员的法律责任。

第二章 申请和受理

第一节 申请

第七条

债务人有本法第二条规定的情形,可以向人民法院提出重整、和解或者破产清算申请。

债务人不能清偿到期债务,债权人可以向人民法院提出对债务人进行重整或者破产清算的申请。

企业法人已解散但未清算或者未清算完毕,资产不足以清偿债务的,依法负有清算责任的人应当向人民法院申请破产清算。

第八条

向人民法院提出破产申请,应当提交破产申请书和有关证据。

破产申请书应当载明下列事项:

- (一)申请人、被申请人的基本情况;
- (二)申请目的;
- (三)申请的事实和理由;
- (四)人民法院认为应当载明的其他事项。

Where the petition is filed by the debtor, the debtor shall also submit to the People's Court a specification on its property, a detailed list of debts and claims, relevant financial and accounting reports, employee's resettlement scheme to be adopted, payment of employees wages and social insurance premium.

Article 9

The petitioner may withdraw the insolvency petition before the case is accepted by the People's Court.

SECTION 2 ACCEPTANCE OF INSOLVENCY CASE

Article 10

In case the creditor files the petition, the People's Court shall notify the debtor within 5 days after receiving the insolvency petition filed by the creditor. If the debtor has objections, he may raise his objections with the People's Court within 7 days after receiving the notification. The People's court shall rule to accept the case or not within 10 days after the expiration of aforesaid 7 days. The People's Court shall rule whether to accept the insolvency petition or not within 15 days after receiving the petition under circumstances other than those prescribed in previous paragraph. Where special circumstances justify the extension of abovementioned case acceptance period, it could be extended by 15 days if approved by the higher People's Court.

Article 11

The People's Court shall serve the ruling of accepting the case to the petitioner within 5 days after making the ruling. Where the petition is filed by creditor, The People's Court shall serve the ruling to the debtor within 5 days after making it. The debtor shall submit to the People's Court a specification on its property, a detailed list of debts and claims, relevant financial and accounting reports, payment of employee's wages and social insurance premium.

Article 12

The People's Court shall serve the ruling of not accepting the case with reasons indicated to the petitioner within 5 days after making the ruling. The petitioner in disagreement with the ruling may bring an appeal to the higher People's Court within 10 days after the ruling is served.

债务人提出申请的,还应当向人民法院提交财产状况说明、债务清册、债权清册、有关财务会计报告、职工安置预案以及职工工资的支付和社会保险费用的缴纳情况。

第九条

人民法院受理破产申请前,申请人可以请求撤回申请。

第二节 受理

第十条

债权人提出破产申请的,人民法院应当自收到申请之日起五日内通知债务人。债务人对申请有异议的,应当自收到人民法院的通知之日起七日内向人民法院提出。人民法院应当自异议期满之日起十日内裁定是否受理。除前款规定的情形外,人民法院应当自收到破产申请之日起十五日内裁定是否受理。有特殊情况需要延长前两款规定的裁定受理期限的,经上一级人民法院批准,可以延长十五日。

第十一条

人民法院受理破产申请的,应当自裁定作出之日起五日内送达申请人。债权人提出申请的,人民法院应当自裁定作出之日起五日内送达债务人。债务人应当自裁定送达之日起十五日内,向人民法院提交财产状况说明、债务清册、债权清册、有关财务会计报告以及职工工资的支付和社会保险费用的缴纳情况。

第十二条

人民法院裁定不受理破产申请的,应当自裁定作出之日起五日内送达申请人并说明理由。申请人对裁定不服的,可以自裁定送达之日起十日内向上一级人民法院提起上诉。

Where the People's Court finds the debtor fails to meet the tests as required by article 2 of this law after accepting the case but before declaring the debtor to be insolvent; it may rule to dismiss the petition. The petitioner may bring an appeal to the higher People's Court within 10 days after the ruling is served where there is any disagreement to the ruling.

Article 13

The People's Court shall appoint an Administrator upon accepting the case .

Article 14

The People's Court shall notify the known creditors within 15 days after the ruling of accepting the insolvency petition is made and make a public announcement of the ruling. The notification and public announcement shall include the following matters:

- (1) Names of the petitioner and petitionee;
- (2) The time when the insolvency case is accepted;
- (3) Time limit, place and points for attention concerning claim declaration;
- (4) Name or title and place of business of the administrator;
- (5) Requirement that the debtor's debtor make payment to the Administrator and the holder of the debtor's property deliver the property to the Administrator;
- (6) Date and place of the first creditor's meeting;
- (7) Other matters that the People's Court deems as appropriate to be notified or announced.

Article 15

From the date when the ruling of accepting the case is served to the debtor to the date when the insolvency procedure is terminated, relevant personnel of the debtor shall bear the following obligations:

- (1) To appropriately keep the property, seal, accounting books, documents, data, and other articles under his possession and management;
- (2) To work as required by the People's Court and the Administrator and respond to inquiries in strict accordance with the facts;
- (3) To attend creditor's meeting as a non-voting delegate and respond to inquiries from creditors in strict accordance with facts;
- (4) Not to leave the place of domicile without obtaining prior consent from the People's Court.
- (5) Not to be director, supervisor, superior officer of other enterprise.

人民法院受理破产申请后至破产宣告前,经审查发现债务人不符合本法第二条规定情形的,可以裁定驳回申请。申请人对裁定不服的,可以自裁定送达之日起十日内向上一级人民法院提起上诉。

第十三条

人民法院裁定受理破产申请的,应当同时指定管理人。

第十四条

人民法院应当自裁定受理破产申请之日起二十五日 内通知已知债权人,并予以公告。通知和公告应当载明下列事项:

- (一)申请人、被申请人的名称或者姓名;
- (二)人民法院受理破产申请的时间;
- (三)申报债权的期限、地点和注意事项;
- (四)管理人的名称或者姓名及其处理事务的地址;
- (五)债务人的债务人或者财产持有人应当向管理人清偿债务或者交付财产的要求;
- (六)第一次债权人会议召开的时间和地点;
- (七)人民法院认为应当通知和公告的其他事项。

第十五条

自人民法院受理破产申请的裁定送达债务人之日起至破产程序终结之日,债务人的有关人员承担下列义务:

- (一)妥善保管其占有和管理的财产、印章和账簿、文书等资料;
- (二)根据人民法院、管理人的要求进行工作,并如实回答询问;
- (三)列席债权人会议并如实回答债权人的询问;
- (四)未经人民法院许可,不得离开住所地;
- (五)不得新任其他企业的董事、监事、高级管理人员。

Relevant personnel prescribed in this article refers to legal representative of the enterprise and, if confirmed by the People's Court, may refer to those financial and accounting personnel as well as other managerial personnel.

Article 16

After the acceptance of the insolvency case by the People's Court payment made to any specific creditor is void.

Article 17

After the People's Court accepts the insolvency case, the debtor's debtor shall make payment to the Administrator and holder of a debtor's property shall deliver the property to the Administrator.

Where debtor's debtor or holder of debtor's property intentionally violate the previous article and make payment or delivery to the debtor, causing harm to creditors, obligation to make payment or delivery to the administrator shall not be discharged.

Article 18

After the People's Court accepts the insolvency petition, the Administrator is entitled to dissolve or accept the contract entered into prior to the acceptance of the case and underperformed by debtor and notify its counterparty. Where the Administrator fails to notify the counterparty within 2 months since the acceptance of the insolvency petition or fails to respond within 30 days from the date of receiving press for respond from its counterparty, the contract shall be deemed as dissolved.

Where the administrator decides to continue to perform the contract, the counterparty should make performance and the counterparty is entitled to demand the administrator to provide guaranty. Where the administrator fails to provide guaranty, the contract deems dissolved.

Article 19

Once the People's court accepts the insolvency petition, all judiciary measures taken against the debtor's property for the purpose of preserving the property shall be removed and execution proceedings shall be stayed.

Article 20

Once the People's court accepts the insolvency petition, pending civil or arbitral cases that the debtor is involved shall be stayed; After the administrator takes over the debtor's property, the stay imposed upon the pending civil or arbitral cases shall be lifted.

前款所称有关人员,是指企业的法定代表人;经人民法院决定,可以包括企业的财务管理人员和其他经营管理人员。

第十六条

人民法院受理破产申请后,债务人对个别债权人的债务清偿无效。

第十七条

人民法院受理破产申请后,债务人的债务人或者财产持有人应当向管理人清偿债务或者交付财产。

债务人的债务人或者财产持有人故意违反前款规定向债务人清偿债务或者交付财产,使债权人受到损失的,不免除其清偿债务或者交付财产的义务。

第十八条

人民法院受理破产申请后,管理人对破产申请受理前成立而债务人和对方当事人均未履行完毕的合同有权决定解除或者继续履行,并通知对方当事人。管理人自破产申请受理之日起二个月内未通知对方当事人,或者自收到对方当事人催告之日起三十日内未答复的,视为解除合同。管理人决定继续履行合同的,对方当事人应当履行;但是,对方当事人有权要求管理人提供担保。管理人不提供担保的,视为解除合同。

第十九条

人民法院受理破产申请后,有关债务人财产的保全措施应当解除,执行程序应当中止。

第二十条

人民法院受理破产申请后,已经开始而尚未终结的有关债务人的民事诉讼或者仲裁应当中止;在管理人接管债务人的财产后,该诉讼或者仲裁继续进行。

Article 21

Once the case is accepted, civil cases involving the debtor shall only be brought before the People's Court accepting the insolvency petition.

CHAPTER 3 THE ADMINISTRATOR

Article 22

The Administrator is designated by the People's Court.

The creditors meeting may request the People's Court to replace the administrator who may not perform functions and duties in accordance with law in an impartial way or cannot live up to functions or duties.

Rules on designating and compensating the Administrator shall be made by the Supreme People's Court.

Article 23

The Administrator shall perform functions and duties in accordance with this Law, report to the People's Court and accept the supervision from creditors meeting and creditors committee. The Administrator shall attend as non-voting delegate and report to creditors meeting on the performance of his duties and answer inquiries from creditors meeting.

Article 24

The liquidating group formed by the members from related sectors or organizations, or the social intermediary institutions such as law firms, accounting firms, and insolvency liquidating firms may act as the Administrator.

In light of the actual situations of the debtor and after soliciting opinions from relevant social intermediary institutions, the People's Court may designate member from it with related professional expertise and practice license to be the Administrator.

Those with the following circumstances disqualify to be the Administrator:

- (1) Ever being imposed criminal penalties due to committing crimes intentionally;
- (2) License ever being revoked ;
- (3) Being an interested party to the case ;
- (4) Other circumstances the People's Court deems as disqualified.

Natural person being the Administrator shall be covered by the Professional Liability Insurance.

第二十一条

人民法院受理破产申请后,有关债务人的民事诉讼,只能向受理破产申请的人民法院提起。

第三章 管理人

第二十二条

管理人由人民法院指定。

债权人会议认为管理人不能依法、公正执行职务或者有其他不能胜任职务情形的,可以申请人民法院予以更换。

指定管理人和确定管理人报酬的办法,由最高人民法院规定。

第二十三条

管理人依照本法规定执行职务,向人民法院报告工作,并接受债权人会议和债权人委员会的监督。

管理人应当列席债权人会议,向债权人会议报告职务执行情况,并回答询问。

第二十四条

管理人可以由有关部门、机构的人员组成的清算组或者依法设立的律师事务所、会计师事务所、破产清算事务所等社会中介机构担任。

人民法院根据债务人的实际情况,可以在征询有关社会中介机构的意见后,指定该机构具备相关专业知识并取得执业资格的人员担任管理人。

有下列情形之一的,不得担任管理人:

- (一)因故意犯罪受过刑事处罚;
- (二)曾被吊销相关专业执业证书;
- (三)与本案有利害关系;
- (四)人民法院认为不宜担任管理人的其他情形。

个人担任管理人的,应当参加执业责任保险。

Article 25

The Administrator performs the following functions and powers:

- (1) To take over the debtor's property, seals, accounting books, documents, data and other articles;
- (2) To investigate and formulate reports on the debtor's property;
- (3) To deal with the internal management affairs;
- (4) To decide on the debtor's routine and other necessary expenditures;
- (5) To decide to continue or close the debtor's business operation prior to the first convention of creditors meeting;
- (6) To manage and dispose of the debtor's property;
- (7) To participate in the litigation, arbitration or other legal proceedings on behalf of the debtor;
- (8) To propose the convention of creditors meeting;
- (9) Other functions and duties deemed appropriate by the People's Court.

Rules regarding the Administrator's functions and duties specifically stated otherwise in this Law shall prevail.

Article 26

Prior consent from the People's Court shall be obtained if the Administrator decide to continue or close the debtor's business operation or circumstances covered under article 69 occur before the first convention of creditor meeting.

Article 27

The Administrator shall perform functions and duties with due diligence and loyalty.

Article 28

The Administrator may appoint necessary working personnel given prior consent obtained from the People's Court.

Compensation paid to the Administrator shall be decided by the People's Court. Disagreement from the creditors meeting over the court-decided compensation could be brought before the People's Court.

Article 29

The Administrator shall not resign without justifications. Resignation requires the approval from the People's Court.

第二十五条

管理人履行下列职责:

- (一)接管债务人的财产、印章和账簿、文书等资料;
 - (二)调查债务人财产状况,制作财产状况报告;
 - (三)决定债务人的内部管理事务;
 - (四)决定债务人的日常开支和其他必要开支;
 - (五)在第一次债权人会议召开之前,决定继续或者停止债务人的营业;
 - (六)管理和处分债务人的财产;
 - (七)代表债务人参加诉讼、仲裁或者其他法律程序;
 - (八)提议召开债权人会议;
 - (九)人民法院认为管理人应当履行的其他职责。
- 本法对管理人的职责另有规定的,适用其规定。

第二十六条

在第一次债权人会议召开之前,管理人决定继续或者停止债务人的营业或者有本法第六十九条规定行为之一的,应当经 人民法院许可。

第二十七条

管理人应当勤勉尽责,忠实执行职务。

第二十八条

管理人经人民法院许可,可以聘用必要的工作人员。

管理人的报酬由人民法院确定。债权人会议对管理人的报酬有异议的,有权向人民法院提出。

第二十九条

管理人没有正当理由不得辞去职务。管理人辞去职务应当经人民法院许可。

CHAPTER 4 THE DEBTOR'S PROPERTY

Article 30

The debtor's property includes property belonging to the debtor when the insolvency case is accepted and acquired after the acceptance of the case before the termination of the insolvency proceeding.

Article 31

The Administrator shall request the People's Court to revoke the following activities involving the debtor's property performed within 1 year PRIOR TO the acceptance of the insolvency case:

- (1) Transferring property without consideration;
- (2) Transacting property at obviously unreasonable prices;
- (3) Providing security for unsecured debt;
- (4) Paying undue debts;
- (5) Waiving claims.

Article 32

The Administrator shall request the People's Court to rescind payment to the specific creditor made within 6 months before the acceptance of the insolvency case when the debtor is in such situation as stated in paragraph 1 of article 2 unless specific payment is beneficial to the debtor's property.

Article 33

The following activities involving the debtor's property is void:

- (1) Hiding, transferring property for the purpose of evading debts;
- (2) Fabricating debts or recognizing fabricated debts.

Article 34

The Administrator shall recover the debtor's property obtained through activities stipulated in Article 31, Article 32 or Article 33.

Article 35

Where capital contributor of the debtor fails to completely contribute to the share he subscribed for after the case being accepted, the Administrator shall require the capital contributor to make up the balance without being restricted to the limit of capital contribution period.

Article 36

The Administrator shall recover any inappropriate income acquired and property misappropriated by the director, supervisor and other managerial officers of the debtor by taking advantages of their positions.

第四章 债务人财产

第三十条

破产申请受理时属于债务人的全部财产,以及破产申请受理后至破产程序终结前债务人取得的财产,为债务人财产。

第三十一条

人民法院受理破产申请前一年内,涉及债务人财产的下列行为,管理人有权请求人民法院予以撤销:

- (一)无偿转让财产的;
- (二)以明显不合理的价格进行交易的;
- (三)对没有财产担保的债务提供财产担保的;
- (四)对未到期的债务提前清偿的;
- (五)放弃债权的。

第三十二条

人民法院受理破产申请前六个月内,债务人有本法 第二条第一款规定的情形,仍对个别债权人进行清偿的,管理人有权 请求人民法院予以撤销。但是,个别清偿使债务人财产受益的除外。

第三十三条

涉及债务人财产的下列行为无效:

- (一)为逃避债务而隐匿、转移财产的;
- (二)虚构债务或者承认不真实的债务的。

第三十四条

因本法第三十一条、第三十二条或者第三十三条规定的行为而取得的债务人的财产,管理人有权追回。

第三十五条

人民法院受理破产申请后,债务人的出资人尚未完全履行出资义务的,管理人应当要求该出资人缴纳所认缴的出资,而 不受出资期限的限制。

第三十六条

债务人的董事、监事和高级管理人员利用职权从企业获取的非正常收入和侵占的企业财产,管理人应当追回。

Article 37

The administrator may recover the pledged assets and assets under lien either by paying off the pledged or lien debts or providing security acceptable to the creditor after the case being accepted.

Where the value of the pledged or lien assets is below that of the secured claim, the value of payment and substitute security stated in previous paragraph shall be calculated by its market value.

Article 38

Owner of the property occupied by the debtor may take back its property from the Administrator unless provided otherwise in this Law.

Article 39

Where when the insolvency case is accepted and the subject matter which the seller has already dispatched and for which the debtor has not paid the full price is not received by the debtor, the seller may take back the subject matter that is under delivery. Also the Administrator may pay off the full price and request the seller to deliver the subject matter.

Article 40

Creditor who owes debt to the debtor prior to the acceptance of the petition for insolvency may offset his claim against his debt to the Administrator.

Offset shall not be made under any of the following circumstances:

- (1) The debtor's debtor obtains third party's claim to the debtor after petition for insolvency is accepted;
- (2) Creditor runs into debt to the debtor with the knowledge that the debtor fails to pay debts falling due or petitions for insolvency; unless debts incurred due to reasons provided in law or occurred one year before petitioning for insolvency;
- (3) Debtor of the debtor acquires claim to debtor with the knowledge that the debtor fails to pay debts falling due or petitions for insolvency; unless debts incurred due to reasons provided in law or occurred one year before petitioning for insolvency;

第三十七条

人民法院受理破产申请后,管理人可以通过清偿债务或者提供为债权人接受的担保,取回质物、留置物。

前款规定的债务清偿或者替代担保,在质物或者留置物的价值低于被担保的债权额时,以该质物或者留置物当时的市场价值为限。

第三十八条

人民法院受理破产申请后,债务人占有的不属于债务人的财产,该财产的权利人可以通过管理人取回。但是,本法另有规定的除外。

第三十九条

人民法院受理破产申请时,出卖人已将买卖标的物向作为买受人的债务人发运,债务人尚未收到且未付清全部价款的,出卖人可以取回在运途中的标的物。但是,管理人可以支付全部价款,请求出卖人交付标的物。

第四十条

债权人在破产申请受理前对债务人负有债务的,可以向管理人主张抵销。

但是,有下列情形之一的,不得抵销:

- (一)债务人的债务人在破产申请受理后取得他人对债务人的债权的;
- (二)债权人已知债务人有不能清偿到期债务或者破产申请的事实,对债务人负担债务的;但是,债权人因为法律规定或者有破产申请一年前所发生的原因而负担债务的除外;
- (三)债务人的债务人已知债务人有不能清偿到期债务或者破产申请的事实,对债务人取得债权的;但是,债务人的债务人因为法律规定或者有破产申请一年前所发生的原因而取得债权的除外。

CHAPTER 5 INSOLVENCY COST AND DEBT OF COMMON INTEREST

Article 41

Costs incurred hereunder after case being accepted are insolvency cost:

- (1) Litigation cost of the insolvency case;
- (2) cost for administration, appraisal and distribution of the debtor's property;
- (3) Remuneration and compensation for the Administrator to perform functions and duties as well as costs for employing working personnel by the Administrator.

Article 42

The following debts incurred herein after case being accepted are debts of common interest:

- (1) Debts incurred due to requesting the contractual counterparty by the Administrator or debtor to perform debts underperformed by both sides;
- (2) Debts incurred from voluntary service to the debtor's property;
- (3) Debts incurred from unjust enrichment to the debtor's property;
- (4) Labor compensation and social insurance expenses paid for continued operation of the debtor's business and other debts incurred as a result thereof;;
- (5) Physical injury debt caused by the Administrator or relevant personnel during their performance of functions and duties;
- (6) Physical injury debt caused by the debtor's property.

Article 43

Insolvency costs and debts of common interests shall be paid off instantly from the debtor's property.

Where a debtor's property is insufficient to pay off the insolvency costs and debts of common interests, the costs for insolvency shall be paid off in priority.

Where the debtor's property is insufficient to pay off all the insolvency costs or debts of common interests, payments should be made on pro rata basis.

Where the debtor's property is insufficient to pay off the insolvency costs, the Administrator shall apply to the People's Court for termination of the insolvency proceeding. The People's Court shall rule to terminate the insolvency proceeding within 15 days after receiving the application and make announcement accordingly.

第五章 破产费用和共益债务

第四十一条

人民法院受理破产申请后发生的下列费用,为破产费用:

- (一)破产案件的诉讼费用;
- (二)管理、变价和分配债务人财产的费用;
- (三)管理人执行职务的费用、报酬和聘用工作人员的费用。

第四十二条

人民法院受理破产申请后发生的下列债务,为共益债务:

- (一)因管理人或者债务人请求对方当事人履行双方均未履行完毕的合同所产生的债务;
- (二)债务人财产受无因管理所产生的债务;
- (三)因债务人不当得利所产生的债务;
- (四)为债务人继续营业而应支付的劳动报酬和社会保险费用以及由此产生的其他债务;
- (五)管理人或者相关人员执行职务致人损害所产生的债务;
- (六)债务人财产致人损害所产生的债务。

第四十三条

破产费用和共益债务由债务人财产随时清偿。

债务人财产不足以清偿所有破产费用和共益债务的,先行清偿破产费用。

债务人财产不足以清偿所有破产费用或者共益债务的,按照比例清偿。

债务人财产不足以清偿破产费用的,管理人应当提请人民法院终结破产程序。人民法院应当自收到请求之日起十五日内裁定终结破产程序,并予以公告。

CHAPTER 6 CLAIM DECLARATION

Article 44

The creditor to whom the debtor owes when the case is accepted shall exercise his right in accordance with proceedings prescribed in this Law.

Article 45

After the case being accepted the People's Court shall confirm a time limit for claim declaration. The time limit shall be calculated since the date when the court announces its acceptance of the insolvency petition and be no less than 30 days and no more than 3 months.

Article 46

Claims immature at the time of the case being accepted shall be deemed mature. Interests on the claims shall cease to be counted when case is accepted.

Article 47

Conditional claim, claim with time limit and pending claims under litigation or arbitration can be declared.

Article 48

Creditor shall declare claim to the Administrator within the time limit confirmed by the People's Court.

Wages, medical fee, injured and disability compensations, compensations for a bereaved family owed by the debtor to the employees, basic pension and medical insurance premium payable by the debtor to the employees' private account, other compensations payable by the debtor to the employees in accordance with law and administrative rules and regulations are exempt from being declared but shall be listed and announced by the Administrator after investigation. Employee in disagreement as to the labor claim list may require the Administrator to correct it. Where the Administrator refuses to correct it, employee may bring lawsuit to the People's Court.

Article 49

The creditor shall explain in written form the amount and security conditions of the claim with relevant evidences submitted. Joint and several claims shall be particularly indicated.

Article 50

Joint and several claims could either be declared jointly or by one creditor on behalf of all creditors.

第六章 债权申报

第四十四条

人民法院受理破产申请时对债务人享有债权的债权人,依照本法规定的程序行使权利。

第四十五条

人民法院受理破产申请后,应当确定债权人申报债权的期限。债权申报期限自人民法院发布受理破产申请公告之日起计算,最短不得少于三十日,最长不得超过三个月。

第四十六条

未到期的债权,在破产申请受理时视为到期。附利息的债权自破产申请受理时起停止计息。

第四十七条

附条件、附期限的债权和诉讼、仲裁未决的债权,债权人可以申报。

第四十八条

债权人应当在人民法院确定的债权申报期限内向管理人申报债权。

债务人所欠职工的工资和医疗、伤残补助、抚恤费用,所欠的应当划入职工个人账户的基本养老保险、基本医疗保险费用,以及法律、行政法规规定应当支付给职工的补偿金,不必申报,由管理人调查后列出清单并予以公示。职工对清单记载有异议的,可以要求管理人更正;管理人不予更正的,职工可以向人民法院提起诉讼。

第四十九条

债权人申报债权时,应当书面说明债权的数额和有无财产担保,并提交有关证据。申报的债权是连带债权的,应当说明。

第五十条

连带债权人可以由其中一人代表全体连带债权人申报债权,也可以共同申报债权。

Article 51

Guarantor or joint debtors of the debtor, after paying off the debts owed by the debtor, may declare claims within the paid-up amount. Guarantors or joint debtors of the debtor may declare the future subrogation claim without paying off the debts for the debtor, unless the creditor has declared the full amount of claim to the Administrator.

Article 52

Where insolvency proceedings are ruled to be applied to several and joint debtors, creditors may separately declare, in each insolvency case, claims in full amount

Article 53

Where the Administrator or debtor dissolve the contract in accordance with provisions of this law, damages claim arising thereof may be declared by the aggrieved party.

Article 54

Where the agent of the debtor is without the knowledge of the application of insolvency proceeding to the debtor, claims arising out of dealing with the entrusted business may be declared.

Article 55

Where procedure prescribed in this Law is ruled to be applied to the debtor as the bill drawer, payment or acceptance of the bill by the drawee may be declared as claims.

Article 56

Claims without being declared within the time limit confirmed by the People's Court may be supplementarily declared prior to the final distribution of insolvent property; however, distribution made prior to the declaration will not be affected. Costs arising out of checking and confirming the supplementarily declared claims shall be borne by the declaring party. Creditor failing to declare claim in accordance with this law is prohibited from exercising rights prescribed herein.

Article 57

After receiving materials of declarations of creditor's rights, the Administrator shall register the materials on claims declaration, examine the declared claims and formulate the claims list. The claim list and the materials on claims declaration shall be kept by the Administrator for interested parties to refer to.

第五十一条

债务人的保证人或者其他连带债务人已经代替债务人清偿债务的,以其对债务人的求偿权申报债权。
债务人的保证人或者其他连带债务人尚未代替债务人清偿债务的,以其对债务人的将来求偿权申报债权。但是,债权人已经向管理人申报全部债权的除外。

第五十二条

连带债务人数人被裁定适用本法规定的程序的,其债权人有权就全部债权分别在各破产案件中申报债权。

第五十三条

管理人或者债务人依照本法规定解除合同的,对方当事人以因合同解除所产生的损害赔偿请求权申报债权。

第五十四条

债务人是委托合同的委托人,被裁定适用本法规定的程序,受托人不知该事实,继续处理委托事务的,受托人以由此产生的请求权申报债权。

第五十五条

债务人是票据的出票人,被裁定适用本法规定的程序,该票据的付款人继续付款或者承兑的,付款人以由此产生的请求权申报债权。

第五十六条

在人民法院确定的债权申报期限内,债权人未申报债权的,可以在破产财产最后分配前补充申报;但是,此前已进行的分配,不再对其补充分配。为审查和确认补充申报债权的费用,由补充申报人承担。

债权人未依照本法规定申报债权的,不得依照本法规定的程序行使权利。

第五十七条

管理人收到债权申报材料后,应当登记造册,对申报的债权进行审查,并编制债权表。

债权表和债权申报材料由管理人保存,供利害关系人查阅。

Article 58

The claims list made in accordance with Article 57 shall be submitted to the first creditors meeting for verification.

Where there is no disagreement from the debtor and creditors on claims listed, the People's Court shall rule to confirm claims list.

Where there is dispute over claims listed by debtor or creditor, complaint could be brought before the People's Court accepting the case.

CHAPTER 7 CREDITORS MEETING

SECTION 1 GENERAL PROVISIONS

Article 59

Members on the creditors meeting refer to creditors with their claims declared in accordance with law and they are entitled to attend the creditors meeting with right to vote.

The creditor whose claim being unconfirmed is prohibited from exercising voting right unless the People's Court could confirm his claim amount temporarily for the purpose of his exercising voting right.

The secured creditor has no voting right over matters listed in item (7) and (10) in first paragraph of article 61 before right to be paid in priority is waived.

The creditor may entrust his agent to attend the creditors meeting and exercise the voting right. The agent shall submit certificate of authority to the People's Court or chairman of creditors meeting while attending creditors meeting.

Representatives of the employees and labor union shall attend the creditors meeting and voice their opinions on matters of their concern.

Article 60

A creditors' meeting shall have one chairman. The chairman shall be designated by the People's Court from the creditors with voting right.

Chairman of the creditors meeting is empowered to preside over the creditors meeting.

Article 61

The creditors meeting perform the following functions and powers:

- (1) To check claims;
- (2) To request the People's Court to replace the Administrator, check the remuneration and compensation of the Administrator;

第五十八条

依照本法第五十七条规定编制的债权表,应当提交第一次债权人会议核查。

债务人、债权人对债权表记载的债权无异议的,由人民法院裁定确认。

债务人、债权人对债权表记载的债权有异议的,可以向受理破产申请的人民法院提起诉讼。

第七章 债权人会议

第一节 一般规定

第五十九条

依法申报债权的债权人为债权人会议的成员,有权参加债权人会议,享有表决权。

债权尚未确定的债权人,除人民法院能够为其行使表决权而临时确定债权额的外,不得行使表决权。

对债务人的特定财产享有担保权的债权人,未放弃优先受偿权利的,对于本法第六十一条第一款第七项、第十项规定的事项不享有表决权。

债权人可以委托代理人出席债权人会议,行使表决权。代理人出席债权人会议,应当向人民法院或者债权人会议主席提交债权人的授权委托书。

债权人会议应当有债务人的职工和工会的代表参加,对有关事项发表意见。

第六十条

债权人会议设主席一人,由人民法院从有表决权的债权人中指定。

债权人会议主席主持债权人会议。

第六十一条

债权人会议行使下列职权:

- (一)核查债权;
- (二)申请人民法院更换管理人,审查管理人的费用和报酬;

(3) To supervise the Administrator;
(4) To select and replace members of the creditors committee;
(5) To decide to continue or close the debtor's business;
(6) To adopt Reorganization plan;
(7) To adopt composition agreement;
(8) To adopt management plan on the debtor's property;
(9) To adopt realization plan on the insolvent property;
(10) To adopt distribution plan on the insolvent property;
(11) Other matters the People's Court holds to be decided by the creditors' meeting.
A creditors' meeting shall formulate resolutions upon the discussed matters in the form of memorandum.

Article 62

The first creditors meeting shall be convened by the People's Court within 15 days after expiration of the time limit for the claim declaration.
Meetings afterwards are convened as the People's Court deems necessary or upon proposals made to the chairman of the creditors meeting by the Administrator, the creditors committee, creditors with claim amounting to more than one-fourth of the total.

Article 63

The Administrator shall notify the known creditors fifteen days in advance of the convention of creditors' meeting.

Article 64

Resolutions made at a creditors meeting may be deemed as being adopted provided more than half of the creditors with voting right and present at the meeting whose claim exceeds half of the total unsecured claims adopt it, unless provided otherwise in this Law.
Creditor with the belief that resolution made at creditors meeting violates the law and impairs his interests may, within fifteen days upon the adopting of the resolution, apply to the People's Court to revoke the resolution and order the creditors meeting to remake a resolution in accordance with law.
Resolution adopted at creditors meeting is binding on all creditors.

Article 65

Matters listed in Item 8, 9, Paragraph One of Article 61 without being resolved by the creditors meeting shall be ruled by the People's Court.

(三) 监督管理人;
(四) 选任和更换债权人委员会成员;
(五) 决定继续或者停止债务人的营业;
(六) 通过重整计划;
(七) 通过和解协议;
(八) 通过债务人财产的管理方案;
(九) 通过破产财产的变价方案;
(十) 通过破产财产的分配方案;
(十一) 人民法院认为应当由债权人会议行使的其他职权。债权人会议应当对所议事项的决议作成会议记录。

第六十二条

第一次债权人会议由人民法院召集,自债权申报期限届满之日起十五日内召开。以后的债权人会议,在人民法院认为必要时,或者管理人、债权人委员会、占债权总额四分之一以上的债权人向债权人会议主席提议时召开。

第六十三条

召开债权人会议,管理人应当提前十五日通知已知的债权人。

第六十四条

债权人会议的决议,由出席会议的有表决权的债权人过半数通过,并且其所代表的债权额占无财产担保债权总额的二分之一以上。但是,本法另有规定的除外。
债权人认为债权人会议的决议违反法律规定,损害其利益的,可以自债权人会议作出决议之日起十五日内,请求人民法院裁定撤销该决议,责令债权人会议依法重新作出决议。

债权人会议的决议,对于全体债权人均有约束力。

第六十五条

本法第六十一条第一款第八项、第九项所列事项,经债权人会议表决未通过的,由人民法院裁定。

Matter listed in Item 10 Paragraph One of Article 61 without being resolved by the creditors meeting after second vote shall be ruled by the People's Court.

The People's Court may announce its ruling on matters prescribed in the previous two Paragraphs at the creditors meeting or notify the creditors later.

Article 66

The creditors unsatisfied with the ruling made by the People's court according to the first paragraph of article 65, or the creditors whose claims amounting to more than half of the unsecured claim in disagreement with the ruling made by the People's Court according to the second Paragraph of article 65 may apply to the same People's Court for reviewing the ruling within 15 days after the announcement of the ruling or receiving the ruling. The implementation of the ruling is not pending during the review.

SECTION 2 CREDITORS COMMITTEE

Article 67

The creditors meeting may decide to establish creditors committee. The creditors committee shall be composed of creditor's representative appointed by creditors meeting and one representative from the debtor's employees or labor union. There shall be no more than 9 members in the creditors committee.

The appointment of members of the creditors committee is subject to approval by the People's Court in written form.

Article 68

The creditors committee exercises the following powers and functions:

- (1) To supervise the management and disposition of the debtor's property;
- (2) To supervise distribution of the insolvent property;
- (3) To propose the convention of creditors meetings;
- (4) Other powers entrusted by the creditors meeting.

The creditors committee in the course of performing powers is entitled to require the Administrator or relevant personnel of the debtor to make explanations or provide relevant documents within the scope of their functions and duties as required by the creditors committee.

本法第六十一条第一款第十项所列事项,经债权人会议二次表决 仍未通过的,由人民法院裁定。对前两款规定的裁定,人民法院可以在债权人会议上宣布或者另 行通知债权人。

第六十六条

债权人对人民法院依照本法第六十五条第一款作出的裁定不服的,债权额占无财产担保债权总额二分之一以上的债权人,对人民法院依照本法第六十五条第二款作出的裁定不服的,可以自裁定宣布之日或者收到通知之日起十五日内向该人民法院申请复议。 复议期间不停止裁定的执行。

第二节 债权人委员会

第六十七条

债权人会议可以决定设立债权人委员会。债权人委员会由债权人会议选任的债权人代表和一名债务人的职工代表或者 工会代表组成。债权人委员会成员不得超过九人。

债权人委员会成员应当经人民法院书面决定认可。

第六十八条

债权人委员会行使下列职权:

- (一)监督债务人财产的管理和处分;
- (二)监督破产财产分配;
- (三)提议召开债权人会议;
- (四)债权人会议委托的其他职权。

债权人委员会执行职务时,有权要求管理人、债务人的有关人员对其职权范围内的事务作出说明或者提供有关文件。

Where the Administrator or relevant personnel of the debtor in violation of this Law refuses to accept supervision, the creditors committee may request the People's Court to render the ruling regarding the supervision issue; The People's Court shall make a ruling within 5 days upon receiving the request.

Article 69

The Administrator shall report the following matters to the creditors committee without undue delay:

- (1) To transfer the ownership of real estate such as land or house;
- (2) To transfer such property rights as mining right, tenure and intellectual property rights;
- (3) To transfer all the stock or business;
- (4) To grant a loan;
- (5) To provide security;
- (6) To assign claim or transfer securities;
- (7) To perform contract unperformed by the debtor and its counterparty;
- (8) To disclaim rights;
- (9) To bring the secured property back;
- (10) Other matters in relation to property disposition having a material effect on creditor interest.

Activities in relation to the previous paragraph shall be reported to the People's Court without undue delay where there is no creditors committee.

CHAPTER 8 REORGANIZATION

SECTION 1 PETITION FOR AND PERIOD OF REORGANIZATION

Article 70

Either the debtor or the creditor may file the reorganization application with the People's Court in accordance with provisions prescribed in this law. Where the creditor file the liquidation application, the debtor or capital contributor holding more than one tenth of the debtor's registered capital may file the reorganization application after the People's Court accepts the insolvency case but before the debtor is declared insolvent.

Article 71

Where examination reveals that the application for Reorganization satisfies the Provisions of this law, the People's Court shall rule the debtor to be reorganized and make announcement accordingly.

管理人、债务人的有关人员违反本法规定拒绝接受监督的,债权人委员会有权就监督事项请求人民法院作出决定;人民法院应当在五日内作出决定。

第六十九条

管理人实施下列行为,应当及时报告债权人委员会:

- (一)涉及土地、房屋等不动产权益的转让;
- (二)探矿权、采矿权、知识产权等财产权的转让;
- (三)全部库存或者营业的转让;
- (四)借款;
- (五)设定财产担保;
- (六)债权和有价证券的转让;
- (七)履行债务人和对方当事人均未履行完毕的合同;
- (八)放弃权利;
- (九)担保物的取回;
- (十)对债权人利益有重大影响的其他财产处分行为。

未设立债权人委员会的,管理人实施前款规定的行为应当及时报告人民法院。

第八章 重整

第一节 重整申请和重整期间

第七十条

债务人或者债权人可以依照本法规定,直接向人民法院申请对债务人进行重整。债权人申请对债务人进行破产清算的,在人民法院受理破产申请后、宣告债务人破产前,债务人或者出资额占债务人注册资本十分之一以上的出资人,可以向人民法院申请重整。

第七十一条

人民法院经审查认为重整申请符合本法规定的,应当裁定债务人重整,并予以公告。

Article 72

The Reorganization period commences from the date when the People's Court rules the debtor to be reorganized to the date when the Reorganization is ruled to be terminated.

Article 73

During the Reorganization period, the debtor may, upon the debtor's request and approved by the People's Court, manage its property and handle its business affairs under the Administrator's supervision.

The Administrator taking over the debtor's property and business affairs shall transfer the property and business affairs to the debtor once the debtor in possession stated in the first paragraph occur with the accompanying result that functions and powers of the administrator are performed by the debtor.

Article 74

Where the property and business affairs are handled by the Administrator, the Administrator may employ managerial and business personnel of the debtor to manage the business affairs.

Article 75

During the Reorganization period, the secured creditors over the specific asset are stayed from realizing secured claims. Where the secured asset is at the risk of being destroyed or its value is at the risk of being reduced dramatically to the extent of impairing the rights of secured creditors, the secured creditors may request the People's Court to be exempt from the stay.

During the Reorganization period, the debtor or the Administrator may provide security to the loan obtained for the purpose of continuing business.

Article 76

Where the owner of the property under debtor's possession on legitimate grounds requests to take back the property during the Reorganization period, previously agreed requirements shall be met.

Article 77

During the Reorganization period, the debtor's capital contributor is prohibited from demanding for the distribution of investment interests. During the Reorganization period, directors, supervisors and other senior managerial personnel of the debtor shall not transfer shares they hold issued by the debtor unless approved by the People's Court.

第七十二条

自人民法院裁定债务人重整之日起至重整程序终止,为重整期间。

第七十三条

在重整期间,经债务人申请,人民法院批准,债务人可以在管理人的监督下自行管理财产和营业事务。

有前款规定情形的,依照本法规定已接管债务人财产和营业事务的管理人应当向债务人移交财产和营业事务,本法规定的管理人的职权由债务人行使。

第七十四条

管理人负责管理财产和营业事务的,可以聘任债务人的经营管理人员负责营业事务。

第七十五条

在重整期间,对债务人的特定财产享有的担保权暂停行使。但是,担保物有损坏或者价值明显减少的可能,足以危害担保权人权利的,担保权人可以向人民法院请求恢复行使担保权。

在重整期间,债务人或者管理人为继续营业而借款的,可以为该借款设定担保。

第七十六条

债务人合法占有的他人财产,该财产的权利人在重整期间要求取回的,应当符合事先约定的条件。

第七十七条

在重整期间,债务人的出资人不得请求投资收益分配。
在重整期间,债务人的董事、监事、高级管理人员不得向第三人转让其持有的债务人的股权。但是,经人民法院同意的除外。

Article 78

During the Reorganization period, upon the request of managers or interested parties, the People's Court shall rule to terminate the Reorganization procedure and declare the debtor bankrupt if the following circumstances occur:

- (1) The business and financial situation of the debtor further deteriorate and chances of being saved are rather slim;
- (2) The debtor act with fraud, decrease its property in bad faith, or commit other acts which are apparently disadvantageous to creditors;
- (3) The Administrator is unable to perform his functions and duties due to the debtor's act.

SECTION 2 FORMULATION AND ADOPTION OF THE REORGANIZATION PLAN

Article 79

The debtor or the Administrator shall submit Reorganization plan to the People's Court and the creditors meeting within 6 months since the People's Court makes the ruling to reorganize. The People's Court may rule to extend 3 months upon the expiration of 6 months prescribed in preceding paragraph based on the request made by the debtor or the Administrator.

Where the debtor or the Administrator fails to submit the reorganization plan in accordance with the required time limit, the People's Court shall rule to terminate reorganization procedure and declare the debtor to be bankrupt.

Article 80

Where the property and business affairs are handled by the debtor, the Reorganization plan shall be drafted by the debtor.

Where the property and business affairs are handled by the Administrator, the Reorganization plan shall be drafted by the Administrator.

Article 81

The draft plan of the Reorganization shall include the following matters:

- (1) Management scheme of the debtor;
- (2) Classification of the claims;
- (3) Adjustment scheme of the claims;
- (4) Repayment scheme of the claims;
- (5) Implementation time limit of the Reorganization plan;
- (6) Supervision time limit of the Reorganization plan;
- (7) Other schemes conducive to the Reorganization.

第七十八条

在重整期间,有下列情形之一的,经管理人或者利害关系人请求,人民法院应当裁定终止重整程序,并宣告债务人破产:

- (一)债务人的经营状况和财产状况继续恶化,缺乏挽救的可能性;
- (二)债务人有欺诈、恶意减少债务人财产或者其他显著不利于债权人的行为;
- (三)由于债务人的行为致使管理人无法执行职务。

第二节 重整计划的制定和批准

第七十九条

债务人或者管理人应当自人民法院裁定债务人重整之日起六个月内,同时向人民法院和债权人会议提交重整计划草案。

前款规定的期限届满,经债务人或者管理人请求,有正当理由的,人民法院可以裁定延期三个月。

债务人或者管理人未按期提出重整计划草案的,人民法院应当裁定终止重整程序,并宣告债务人破产。

第八十条

债务人自行管理财产和营业事务的,由债务人制作重整计划草案。

管理人负责管理财产和营业事务的,由管理人制作重整计划草案。

第八十一条

重整计划草案应当包括下列内容:

- (一)债务人的经营方案;
- (二)债权分类;
- (三)债权调整方案;
- (四)债权受偿方案;
- (五)重整计划的执行期限;
- (六)重整计划执行的监督期限;
- (七)有利于债务人重整的其他方案。

Article 82

The creditors holding the following classes of claims participate in creditors meeting to discuss the draft reorganization plan.

The claims are classified into following groups for the purpose of voting on the reorganization plan in group:

- (1) Secured claims over the debtor's specific asset;
- (2) Labor claims with the reference made to the wage, medical fee, injured and disability compensations, compensations for a bereaved family owed by the debtor to the employees, basic pension and medical insurance premium payable by the debtor to the employees' private account, other compensations payable by the debtor to the employees in accordance with law and administrative rules and regulations;
- (3) Tax claims;
- (4) General claims.

The People's Court may set up small claims group within general claims group for the purpose of voting on the reorganization plan when necessary.

Article 83

The reorganization plan shall not affect the social insurance premium payable by the debtor other than those included in item 2, first paragraph of article 82. These creditors are excluded from voting on reorganization plan.

Article 84

The People's Court shall convene creditors meeting within 30 days after receiving the reorganization draft plan for the purpose of voting on the reorganization plan.

Where more than half of the creditors present at the meeting within the same voting group agree with the draft reorganization plan with their claims amounting to more than two-thirds of the sum of the group claims, the draft Reorganization plan shall be deemed as being adopted by this group. The debtor or the Administrator shall make explanations about the draft Reorganization plan to the creditors' meeting and answer inquiries.

Article 85

The investors of the debtor may appoint a representative to attend creditors meeting as non-voting delegate where reorganization draft plan is discussed.

Where the draft reorganization plan involves the adjustment of investor's equities, separate group of investors shall be set up for the purpose of voting on the draft plan.

第八十二条

下列各类债权的债权人参加讨论重整计划草案的债权人会议,依照下列债权分类,分组对重整计划草案进行表决:

- (一)对债务人的特定财产享有担保权的债权;
- (二)债务人所欠职工的工资和医疗、伤残补助、抚恤费用,所欠的应当划入职工个人账户的基本养老保险、基本医疗保险费用,以及法律、行政法规规定应当支付给职工的补偿金;
- (三)债务人所欠税款;
- (四)普通债权。 人民法院在必要时可以决定在普通债权组中设小额债权组对重整计划草案进行表决。

第八十三条

重整计划不得规定减免债务人欠缴的本法第八十二条第一款第二项规定以外的社会保险费用;该项费用的债权人不参加重整计划草案的表决。

第八十四条

人民法院应当自收到重整计划草案之日起三十日内召开债权人会议,对重整计划草案进行表决。出席会议的同一表决组的债权人过半数同意重整计划草案,并且其所代表的债权额占该组债权总额的三分之二以上的,即为该组通过重整计划草案。债务人或者管理人应当向债权人会议就重整计划草案作出说明,并回答询问。

第八十五条

债务人的出资人代表可以列席讨论重整计划草案的债权人会议。重整计划草案涉及出资人权益调整事项的,应当设出资人组,对该事项进行表决。

Article 86

The reorganization plan is deemed as being adopted provided each voting group adopts the draft reorganization plan.

The debtor or the Administrator shall petition the People's Court to approve the reorganization plan within 10 days after the adoption of reorganization plan. The People's Court shall rule to approve the reorganization plan and terminate the reorganization proceeding within 30 days since receiving the application and ascertaining that the plan meets the requirements stated in this law and make announcement accordingly.

Article 87

Where the draft reorganization plan fails to be adopted by some voting groups, the debtor or the Administrator may negotiate with the voting group that does not adopt the draft reorganization plan. This voting group may vote again after negotiation. The compromise reached by the two sides in negotiation shall not impair the interests of other voting groups.

Where the draft reorganization plan fails to be adopted by revote after negotiation or the disagreeing group refuses to revote, the debtor or the Administrator may petition the People's Court for approval of the draft reorganization plan if the following condition is met:

- (1) Based on the draft reorganization plan the secured claims listed in item (1), paragraph 1 of article 82 are fully paid off over the specific asset, the losses incurred by delayed repayment are fairly compensated and the secured right does not suffer material infringements or the secured creditors adopt the draft reorganization plan.
- (2) Based on the draft reorganization plan the labor claim and tax claim listed in item (2), paragraph 1 of article 82 are fully paid off, or the labor creditors and tax creditors adopt the draft reorganization plan.
- (3) Based upon the draft reorganization plan the general creditors receive no less than what they could expect to receive in the liquidation procedure when draft plan is submitted for approval or the general creditors adopt the draft reorganization plan;
- (4) The adjustment of investor equities involved in the draft reorganization plan is fair and impartial or the investor group adopts the draft plan;
- (5) The draft reorganization plan treats creditors within the same voting group fairly and payment order provided in the draft plan does not violate article 113 of this law;
- (6) The management scheme put forward by the debtor is feasible.

第八十六条

各表决组均通过重整计划草案时,重整计划即为通过。自重整计划通过之日起十日内,债务人或者管理人应当向人民法院提出批准重整计划的申请。人民法院经审查认为符合本法规定的,应当自收到申请之日起三十日内裁定批准,终止重整程序,并予以公告。

第八十七条

部分表决组未通过重整计划草案的,债务人或者管理人可以同未通过重整计划草案的表决组协商。该表决组可以在协商后再表决一次。双方协商的结果不得损害其他表决组的利益。

未通过重整计划草案的表决组拒绝再次表决或者再次表决仍未通过重整计划草案,但重整计划草案符合下列条件的,债务人或者管理人可以申请人民法院批准重整计划草案:

(一)按照重整计划草案,本法第八十二条第一款第一项所列债权就该特定财产将获得全额清偿,其因延期清偿所受的损失将得到公平补偿,并且其担保权未受到实质性损害,或者该表决组已经通过重整计划草案;

(二)按照重整计划草案,本法第八十二条第一款第二项、第三项所列债权将获得全额清偿,或者相应表决组已经通过重整计划草案;

(三)按照重整计划草案,普通债权所获得的清偿比例,不低于其在重整计划草案被提请批准时依照破产清算程序所能获得的清偿比例,或者该表决组已经通过重整计划草案;

(四)重整计划草案对出资人权益的调整公平、公正,或者出资人组已经通过重整计划草案;

(五)重整计划草案公平对待同一表决组的成员,并且所规定的债权清偿顺序不违反本法第一百一十三条的规定;

(六)债务人的经营方案具有可行性。

The People's Court shall rule to approve the draft reorganization plan and terminate the reorganization procedure after ascertaining that the draft plan meet the requirement of previous paragraph based upon examination within 30 days after receiving application and make announcement accordingly.

Article 88

Where the draft reorganization plan fails to be adopted and be approved by the People's Court in accordance with article 87 or the adopted reorganization plan fails to be approved by the People's Court, the People's Court shall rule to terminate the reorganization procedure and declare the debtor to be bankrupt.

SECTION 3 IMPLEMENTATION OF REORGANIZATION PLAN

Article 89

The debtor shall implement the adopted reorganization plan.

The Administrator in charge of managing the property and business affairs shall transfer the property and business affairs to the debtor after the People's Court rule to approve the reorganization plan.

Article 90

The Administrator shall supervise the implementation of the Reorganization plan during the supervising period provided for in the Reorganization plan commencing from the date when the People's Court rules to approve the Reorganization plan.

The debtor shall report the implementation of the Reorganization plan and its financial status to the Administrator during the supervising period.

Article 91

The Administrator shall submit the supervision report to the People's Court upon the expiration of the supervising period. The Administrator will not be discharged from its duties until the supervision report is submitted to the People's Court.

The interested parties are entitled to check the supervising report submitted by the Administrator to the People's Court.

The People's Court may decide to extend the supervision period of the Reorganization plan upon the application filed by the Administrator.

人民法院经审查认为重整计划草案符合前款规定的,应当自收到申请之日起三十日内裁定批准,终止重整程序,并予以公告。

第八十八条

重整计划草案未获得通过且未依照本法第八十七条的规定获得批准,或者已通过重整计划未获得批准的,人民法院应当裁定终止重整程序,并宣告债务人破产。

第三节 重整计划的执行

第八十九条

重整计划由债务人负责执行。

人民法院裁定批准重整计划后,已接管财产和营业事务的管理人应当向债务人移交财产和营业事务。

第九十条

自人民法院裁定批准重整计划之日起,在重整计划规定的监督期内,由管理人监督重整计划的执行。在监督期内,债务人应当向管理人报告重整计划执行情况和债务人财务状况。

第九十一条

监督期届满时,管理人应当向人民法院提交监督报告。自监督报告提交之日起,管理人的监督职责终止。管理人向人民法院提交的监督报告,重整计划的利害关系人有权查阅。经管理人申请,人民法院可以裁定延长重整计划执行的监督期限。

Article 92

The Reorganization plan approved by the People's Court is binding on both the creditors and the debtor.

Creditors failing to declare claims in accordance with the Provisions as required by this law are prohibited from realizing claims during the implementation of the Reorganization plan and may realize claims on the same repayment terms as enjoyed by the creditor group he belongs to provided in the Reorganization plan after the implementation of the Reorganization plan.

The repayment liability of the guarantor or other joint debtors of the debtor to the creditor is not affected by the Reorganization plan.

Article 93

Where the debtor is unable or refuses to implement the Reorganization plan, the People's Court shall rule to terminate the implementation of the Reorganization plan as requested by the Administrator or interested parties and declare the debtor to be bankrupt.

Where the People's Court rules to terminate the implementation of the Reorganization plan, the claim adjustment agreed by the creditors in the reorganization plan loses its effect. Payment obtained by the creditor owing to the implementation of the Reorganization plan remains in force and the unpaid portion of the claim deemed as bankrupt claims.

The creditors prescribed in the preceding paragraph may continue to receive distribution only if the other creditors within the same priority are paid to the extent of the same proportion.

Where the situation described in the first paragraph of this article occurs, security provided for implementing the reorganization plan remain effective.

Article 94

The debtor is no longer obligated to pay the debts reduced or discharged in conformity with the reorganization plan after the implementation of the reorganization plan.

CHAPTER 9 COMPOSITION

Article 95

The debtor may file composition application either directly with the People's Court in accordance with this law or after the case being accepted by the People's Court but before the debtor being declared to be bankrupt.

第九十二条

经人民法院裁定批准的重整计划,对债务人和全体债权人均有约束力。债权人未依照本法规定申报债权的,在重整计划执行期间不得行使权利;在重整计划执行完毕后,可以按照重整计划规定的同类债权的清偿条件行使权利。

债权人对债务人的保证人和其他连带债务人所享有的权利,不受重整计划的影响。

第九十三条

债务人不能执行或者不执行重整计划的,人民法院经管理人或者利害关系人请求,应当裁定终止重整计划的执行,并宣告债务人破产。

人民法院裁定终止重整计划执行的,债权人在重整计划中作出的债权调整的承诺失去效力。债权人因执行重整计划所受的清偿仍然有效,债权未受清偿的部分作为破产债权。

前款规定的债权人,只有在其他同顺位债权人同自己所受的清偿达到同一比例时,才能继续接受分配。

有本条第一款规定情形的,为重整计划的执行提供的担保继续有效。

第九十四条

按照重整计划减免的债务,自重整计划执行完毕时起,债务人不再承担清偿责任。

第九章 和解第

九十五条

债务人可以依照本法规定,直接向人民法院申请和解;也可以在人民法院受理破产申请后、宣告债务人破产前,向人民法院申请和解。

The debtor shall submit its draft composition agreement to the People's Court when applying for composition.

Article 96

After ascertaining that composition application satisfies requirements provided for in this Law, the People's Court shall rule to approve the composition, announce to the public and convene the creditors meeting to discuss the draft composition agreement.

The secured creditors may realize its claims over the debtor's specific asset after the People's Court rule to approve the composition.

Article 97

The composition agreement discussed at the creditors meeting is deemed as being adopted provided that over half of the creditors with voting right present at the meeting and the claims they hold represent more than two-thirds of the total unsecured claims adopt it.

Article 98

The composition agreement adopted by the creditors meeting is subject to the approval of the People's Court. Once the composition agreement is approved, the People's Court shall rule to terminate the composition procedure and make a public announcement. The Administrator shall transfer the property and business affairs to the debtor and submit working report concerning his performance of duties and functions to the People's Court.

Article 99

Where the draft agreement of composition fails to be adopted by the creditors meeting or the adopted composition agreement fails to be approved by the People's Court, the People's Court shall rule to terminate the composition procedure and declare the debtor to be bankrupt.

Article 100

The composition agreement approved by the People's Court is binding on both all the conciliated creditors and the debtor.

The conciliated creditors refer to the unsecured creditors when the case is accepted by the People's Court.

Conciliated creditors failing to declare claims in accordance with the Provisions required in this law are prohibited from realizing claims during the implementation of composition agreement and may realize claims under the repayment terms provided in the composition agreement after the composition agreement is implemented.

债务人申请和解,应当提出和解协议草案。

第九十六条

人民法院经审查认为和解申请符合本法规定的,应当裁定和解,予以公告,并召集债权人会议讨论和解协议草案。

对债务人的特定财产享有担保权的权利人,自人民法院裁定和解之日起可以行使权利。

第九十七条

债权人会议通过和解协议的决议,由出席会议的有表决权的债权人过半数同意,并且其所代表的债权额占无财产担保债权总额的三分之二以上。

第九十八条

债权人会议通过和解协议的,由人民法院裁定认可,终止和解程序,并予以公告。管理人应当向债务人移交财产和营业事务,并向人民法院提交执行职务的报告。

第九十九条

和解协议草案经债权人会议表决未获得通过,或者已经债权人会议通过的和解协议未获得人民法院认可的,人民法院应当裁定终止和解程序,并宣告债务人破产。

第一百条

经人民法院裁定认可的和解协议,对债务人和全体和解债权人均有约束力。

和解债权人是指人民法院受理破产申请时对债务人享有无财产担保债权的人。

和解债权人未依照本法规定申报债权的,在和解协议执行期间不得行使权利;在和解协议执行完毕后,可以按照和解协议规定的清偿条件行使权利。

Article 101

The creditor's claim against the guarantor and other joint debtors of the debtor are not affected by the composition agreement.

Article 102

The debtor shall pay off his debt in accordance with the terms prescribed in the composition agreement.

Article 103

The composition agreement formed by the debtor's fraud or other unlawful activities shall be ruled by the People's Court to be invalidated and the debtor shall be declared to be bankrupt.

Where the circumstances prescribed in the preceding paragraph occur, the repayment the conciliated creditors obtain based on the composition agreement need not to be returned to the extent of the same proportion of payment as other creditors obtain.

Article 104

Where the debtor is unable or refuses to implement the composition agreement, the People's Court shall rule to terminate the implementation of the composition agreement as requested by the conciliated creditors and declare the debtor to be bankrupt.

Where the People's Court rules to terminate the composition agreement, the claim adjustment agreed by conciliated creditors in the composition agreement loses its effect. Payment obtained by conciliated creditors owing to implementation of the composition agreement remains in force with the unpaid portion of the claim deemed as bankrupt claims.

The creditor prescribed in the preceding paragraph may continue to receive distribution only if the other creditors are paid to the extent of the same proportion as he has been paid.

Where the situation described in the first paragraph of this article occurs, security provided for implementing composition agreement will not be affected remain as effective.

Article 105

Where the debtor and all the creditors reach unanimous agreement as to the disposal of debts and claims after the insolvent application being accepted by the People's Court, they may request the People's Court to rule to approve the composition agreement and terminate the insolvency procedure.

第一百零一条

和解债权人对债务人的保证人和其他连带债务人所享有的权利,不受和解协议的影响。

第一百零二条

债务人应当按照和解协议规定的条件清偿债务。

第一百零三条

因债务人的欺诈或者其他违法行为而成立的和解协议,人民法院应当裁定无效,并宣告债务人破产。

有前款规定情形的,和解债权人因执行和解协议所受清偿,在其他债权人所受清偿同等比例的范围内,不予返还。

第一百零四条

债务人不能执行或者不执行和解协议的,人民法院经和解债权人请求,应当裁定终止和解协议的执行,并宣告债务人破产。

人民法院裁定终止和解协议执行的,和解债权人在和解协议中作出的债权调整的承诺失去效力。和解债权人因执行和解协议所受清偿仍然有效,和解债权未受清偿的部分作为破产债权。

前款规定的债权人,只有在其他债权人同自己所受的清偿达到同一比例时,才能继续接受分配。

有本条第一款规定情形的,为和解协议的执行提供的担保继续有效。

第一百零五条

人民法院受理破产申请后,债务人与全体债权人就债权债务的处理自行达成协议的,可以请求人民法院裁定认可,并终结破产程序。

Article 106

The debtor is no longer obligated to pay the debts reduced or discharged in conformity with the composition agreement after the implementation of the composition agreement.

CHAPTER 10 LIQUIDATION

SECTION 1 BANKRUPTCY DECLARATION

Article 107

Where the People's Court declare the debtor to be bankrupt in accordance with this Law, it shall serve the ruling to the debtor and the Administrator within 5 days after rendering the ruling and within 10 days after rendering the ruling notify the known creditors and make an announcement. After the debtor is declared to be bankrupt, the debtor becomes the bankrupt, its property becomes bankrupt property and claims to the debtor when the People's Court accept the insolvency petition become bankrupt claims.

Article 108

The People's Court shall rule to terminate the bankrupt procedure and make an announcement if one of the following events occurs prior to the declaration of bankruptcy:

- (1) A third party either provides security or pays off the debts that fall due for the debtor;
- (2) The debtor pays off in full all the debts that fall due.

Article 109

Secured creditor is entitled to obtain payment in priority over debtor's specific asset.

Article 110

Claims without being realized by creditors referred to in article 109 shall be treated as general ones; secured claims whose priority is being waived shall be treated as general ones.

SECTION 2 APPRAISAL, DISPOSITION AND DISTRIBUTION

Article 111

The Administrator shall formulate disposition plan of bankrupt property without undue delay and submit it to the creditors meeting for discussion.

第一百零六条

按照和解协议减免的债务,自和解协议执行完毕时起,债务人不再承担清偿责任。

第十章 破产清算

第一节 破产宣告

第一百零七条

人民法院依照本法规定宣告债务人破产的,应当自裁定作出之日起五日内送达债务人和管理人,自裁定作出之日起十日内通知已知债权人,并予以公告。

债务人被宣告破产后,债务人称为破产人,债务人财产称为破产财产,人民法院受理破产申请时对债务人享有的债权称为破产债权。

第一百零八条

破产宣告前,有下列情形之一的,人民法院应当裁定终结破产程序,并予以公告:

- (一)第三人为债务人提供足额担保或者为债务人清偿全部到期债务的;
- (二)债务人已清偿全部到期债务的。

第一百零九条

对破产人的特定财产享有担保权的权利人,对该特定财产享有优先受偿的权利。

第一百一十条

享有本法第一百零九条规定权利的债权人行使优先受偿权利未能完全受偿的,其未受偿的债权作为普通债权;放弃优先受偿权利的,其债权作为普通债权。

第二节 变价和分配

第一百一十一条

管理人应当及时拟订破产财产变价方案,提交债权人会议讨论。

The Administrator shall dispose the bankrupt property in accordance with the bankrupt property disposition plan adopted by the creditors meeting or ruled by the People's Court in accordance with first paragraph of article 65.

Article 112

Bankrupt property shall be sold off by auction unless otherwise provided in resolutions made by the creditors meeting.

The bankrupt enterprise may be sold either as a whole or in parts. Intangible assets and other assets may be sold separately while selling off the enterprise.

Property not allowed to be auctioned or restricted fin transfer as required by state law shall be disposed of in accordance with ways allowable under state law.

Article 113

After the prior deduction of insolvency costs and debts of common interest from the bankrupt property, payment shall be made in the following order:

- 1) Wages, medical fees, injured and disability compensations, compensations for a bereaved family owed by the debtor to the employees, basic pension and medical insurance premium defaulted by the debtor to the employees' private account, other compensations payable by the debtor to the employees in accordance with law and administrative rules and regulations;
- 2) Social insurance premiums other than those stated in previous paragraph defaulted by the bankrupt and tax payable by he bankrupt;
- 3) General bankrupt claims.

Where the bankrupt property is insufficient to pay off all the debts within a payment order, distribution shall be made on a pro-rata basis. Wages of directors, supervisors and senior managerial personnel of the bankrupt enterprise shall be calculated on average wage basis of the general employees of the enterprise.

Article 114

The distribution of bankrupt property shall be made in cash unless otherwise resolved by the creditors meeting.

Article 115

The Administrator shall formulate the distribution plan of the bankrupt property without undue delay and submit it to the creditors meeting for discussion.

The distribution plan of bankrupt property shall include the following items:

管理人应当按照债权人会议通过的或者人民法院依照本法第六十五条第一款规定裁定的破产财产变价方案,适时变价出售破产财产。

第一百一十二条

变价出售破产财产应当通过拍卖进行。但是,债权人会议另有决议的除外。

破产企业可以全部或者部分变价出售。企业变价出售时,可以将 其中的无形资产和其他财产单独变价出售。

按照国家规定不能拍卖或者限制转让的财产,应当按照国家规定 的方式处理。

第一百一十三条

破产财产在优先清偿破产费用和共益债务后,依照下列顺序清偿:

- (一)破产人所欠职工的工资和医疗、伤残补助、抚恤费用,所欠的应当划入职工个人账户的基本养老保险、基本医疗保险费用,以及 法律、行政法规规定应当支付给职工的补偿金;
- (二)破产人欠缴的除前项规定以外的社会保险费用和破产人所 欠税款;
- (三)普通破产债权。 破产财产不足以清偿同一顺序的清偿要求的,按照比例分配。 破产企业的董事、监事和高级管理人员的工资按照该企业职工的平均工资计算。

第一百一十四条

破产财产的分配应当以货币分配方式进行。但是,债权人会议另有决议的除外。

第一百一十五条

管理人应当及时拟订破产财产分配方案,提交债权人会议讨论。

破产财产分配方案应当载明下列事项:

- 1) Name or address of creditors participating in the distribution;
- 2) Total amount of the claims qualified for the distribution;
- 3) Total amount of the distributable bankrupt property;
- 4) Order, proportion and amount of the distribution of bankrupt property;
- 5) The method of distributing the bankrupt property.

After the distribution plan is adopted by the creditors meeting, the Administrator shall submit the plan to the People's Court for approval.

Article 116

The Administrator implements the distribution plan approved by the People's Court.

In terms of many distributions implemented by the Administrator in accordance with distribution plan the Administrator shall announce each amount of distributed property and that of claim to which the distribution is made. In terms of final distribution the Administrator shall make public announcement including items listed in paragraph 2, Article 117.

Article 117

Distributions to the conditional creditors shall be deposited by the Administrator.

Distributions deposited by the Administrator for conditional creditors shall be distributed to other creditors provided the initiation condition is not met or termination condition is met upon the public announcement of final distribution; should the initiation condition be met or the termination conditions not met upon the public announcement of final distribution distributions deposited by the Administrator for conditional creditors shall be delivered to them.

Article 118

The Administrator shall deposit the unclaimed distribution of the bankrupt property. Deposited unclaimed distribution without being claimed by creditors within 2 months after the public announcement of the final distribution shall be deemed as disclaimed distribution which the Administrator or People's Court shall distribute to other creditors.

Article 119

The Administrator shall deposit the share of distribution to which pending claims under litigation or arbitration are entitled when the bankrupt property is distributed. Deposited distribution without being claimed by creditors within 2 years after the termination of bankruptcy procedure shall be distributed to other creditors.

(一)参加破产财产分配的债权人名称或者姓名、住所;

(二)参加破产财产分配的债权额;

(三)可供分配的破产财产数额;

(四)破产财产分配的顺序、比例及数额;

(五)实施破产财产分配的方法。

债权人会议通过破产财产分配方案后,由管理人将该方案提请人民法院裁定认可。

第一百一十六条

破产财产分配方案经人民法院裁定认可后,由管理人执行。

管理人按照破产财产分配方案实施多次分配的,应当公告本次分配的财产额和债权额。管理人实施最后分配的,应当在公告中指明,并载明本法第一百一十七条第二款规定的事项。

第一百一十七条

对于附生效条件或者解除条件的债权,管理人应当将其分配额提存。

管理人依照前款规定提存的分配额,在最后分配公告日,生效条件未成就或者解除条件成就的,应当分配给其他债权人;在最后分配公告日,生效条件成就或者解除条件未成就的,应当交付给债权人。

第一百一十八条

债权人未受领的破产财产分配额,管理人应当提存。债权人自最后分配公告之日起满二个月仍不领取的,视为放弃受领分配的权利,管理人或者人民法院应当将提存的分配额分配给其他债权人。

第一百一十九条

破产财产分配时,对于诉讼或者仲裁未决的债权,管理人应当将其分配额提存。自破产程序终结之日起满二年仍不能受领分配的,人民法院应当将提存的分配额分配给其他债权人。

SECTION 3 TERMINATION OF BANKRUPTCY PROCEDURE

Article 120

Where the debtor has no available property to distribute, the Administrator shall request the People's Court to terminate the bankruptcy procedure.

Following the final distribution of the bankruptcy property, the Administrator shall without undue delay submit distribution report to the People's Court and request the People's Court to terminate the bankruptcy procedure.

The People's Court shall rule whether to terminate the bankruptcy procedure or not within 15 days since the Administrator's application. The People's Court shall make a public announcement of the termination ruling is made.

Article 121

The Administrator shall within 10 days after the termination of bankruptcy procedure apply for cancellation of registration to the incorporation registration authority with the ruling of termination entered into by the People's Court.

Article 122

The Administrator shall terminate his duties and functions after the next day of applying for cancellation of registration unless there is pending litigation or arbitration.

Article 123

Two years after the termination of bankruptcy proceeding as per the paragraph 4 in Article 43 or Article 122 of the Law, creditors are entitled to petition the People's Court for additional repayment in conformity with the distribution plan under any of the following circumstances:

- (1) Property which should be recovered in accordance with Article 31, Article 32, Article 33 and Article 36 of this law is discovered;
- (2) Other distributable property of the bankrupt is discovered.

Where the discovered property is insufficient to cover distribution expenses, additional repayment will not be made and the property shall be turned over to the State treasury.

Article 124

The guarantor and other joint debtors of the bankrupt are not discharged from paying the unpaid debts in accordance with liquidation procedure after the termination of the bankruptcy procedure.

第三节 破产程序的终结

第一百二十条

破产人无财产可供分配的,管理人应当请求人民法院裁定终结破产程序。

管理人在最后分配完结后,应当及时向人民法院提交破产财产分配报告,并提请人民法院裁定终结破产程序。

人民法院应当自收到管理人终结破产程序的请求之日起十五日内作出是否终结破产程序的裁定。裁定终结的,应当予以公告。

第一百二十一条

管理人应当自破产程序终结之日起十日内,持人民法院终结破产程序的裁定,向破产人的原登记机关办理注销登记。

第一百二十二条

管理人于办理注销登记完毕的次日终止执行职务。但是,存在诉讼或者仲裁未决情况的除外。

第一百二十三条

自破产程序依照本法第四十三条第四款或者第一百二十条的规定终结之日起二年内,有下列情形之一的,债权人可以请求人民法院按照破产财产分配方案进行追加分配:

- (一)发现有依照本法第三十一条、第三十二条、第三十三条、第三十六条规定应当追回的财产的;
- (二)发现破产人有应当供分配的其他财产的。

有前款规定情形,但财产数量不足以支付分配费用的,不再进行追加分配,由人民法院将其上交国库。

第一百二十四条

破产人的保证人和其他连带债务人,在破产程序终结后,对债权人依照破产清算程序未受清偿的债权,依法继续承担清偿责任。

CHAPTER 11 LEGAL LIABILITIES

Article 125

Where the violation of fiduciary duty by the director, supervisor or other senior managerial personnel of the enterprise result in the bankruptcy of the enterprise, they shall bear civil liabilities. Persons with the previous record are prohibited from acting as director, supervisor or senior manager of any other enterprise within 3 years after the termination of bankruptcy procedure.

Article 126

Where relevant personnel of the debtor obliged to attend the creditors meeting as non-voting delegate refuses to attend the meeting without justifications after summon is served by the People's Court, the People's Court may summon them for detention and impose fine in accordance with law. Relevant personnel of the debtor refusing to make statements or answer inquires or making false statements or giving fake answers in violation of provisions of this law are subject to being fined by the People's Court.

Article 127

Where debtor in violation of provisions in this Law refuses to submit or submits false statements on property specification, detailed list of debts and claims, financial and accounting reports, payment of employees' wages and social insurance premium, the People's Court may impose fine upon the directly responsible personnel.

Where debtor refuses to hand over the materials such as property, seal, accounting books, documents to the Administrator, or fabricates, destroys relevant evidences about the property to the extent of obscuring the property status, the People's Court may impose fine upon the directly responsible personnel.

Article 128

Where debtor commits acts stated in article 31, 32, 33 of this law to the extent of impairing the creditors' interests, the legal representative and other directly responsible personnel of the debtor are subject to compensatory liabilities.

Article 129

Where relevant personnel of the debtor in violation of this Law leave place of domicile without obtaining prior consent, the People's Court may admonish or detain him and, in addition, impose fine on him in accordance with law.

第十一章 法律责任

第一百二十五条

企业董事、监事或者高级管理人员违反忠实义务、勤勉义务,致使所在企业破产的,依法承担民事责任。有前款规定情形的人员,自破产程序终结之日起三年内不得担任任何企业的董事、监事、高级管理人员。

第一百二十六条

有义务列席债权人会议的债务人的有关人员,经人民法院传唤,无正当理由拒不列席债权人会议的,人民法院可以拘传,并依法处以罚款。债务人的有关人员违反本法规定,拒不陈述、回答,或者作虚假陈述、回答的,人民法院可以依法处以罚款。

第一百二十七条

债务人违反本法规定,拒不向人民法院提交或者提交不真实的财产状况说明、债务清册、债权清册、有关财务会计报告以及职工工资的支付情况和社会保险费用的缴纳情况的,人民法院可以对直接责任人员依法处以罚款。

债务人违反本法规定,拒不向管理人移交财产、印章和账簿、文书等资料的,或者伪造、销毁有关财产证据材料而使财产状况不明的,人民法院可以对直接责任人员依法处以罚款。

第一百二十八条

债务人有本法第三十一条、第三十二条、第三十三条规定的行为,损害债权人利益的,债务人的法定代表人和其他直接责任人员依法承担赔偿责任。

第一百二十九条

债务人的有关人员违反本法规定,擅自离开住所地的,人民法院可以予以训诫、拘留、可以依法并处罚款。

Article 130

Where the Administrator fails to perform functions and duties in loyalty or with due diligence as required by this Law, the People's Court may impose fine on him. The Administrator shall compensate for losses arising thereof suffered by the creditors, the debtor or the third party in accordance with law.

Article 131

If any acts in violation of this law is serious enough to constitute a criminal offence, criminal liability shall be pursued in accordance with this law.

CHAPTER 12 SUPPLEMENTARY PROVISIONS

Article 132

Labor claims such as Wages, medical fees, injured and disability compensations, compensations for a bereaved family owed by the debtor to the employees, basic pension and medical insurance premium defaulted by the debtor to the employees' private account, other compensations payable by the debtor to the employees in accordance with law and administrative rules and regulations unrealized in accordance with article 113 shall be paid from the specific asset prior to the secured claims enjoyed by secured creditors stated in article 109 provided these labor claims occur prior to the promulgation of this Law and exist until this Law goes into effect.

Article 133

The insolvency of the state-owned enterprises within the time limit and to the extent stipulated in regulations issued by the State Council before this law goes into effect shall be dealt with in accordance with the relevant regulations made by the State Council.

Article 134

Where financial institutions including but not limited to commercial banks, securities companies, insurance companies meet the tests of article 2 of this law, the financial supervisory and regulatory institution under State Council may petition the People's Court for reorganization or liquidation.

第一百三十条

管理人未依照本法规定勤勉尽责,忠实执行职务的,人民法院可以依法处以罚款;给债权人、债务人或者第三人造成损失的,依法承担赔偿责任。

第一百三十一条

违反本法规定,构成犯罪的,依法追究刑事责任。

第十二章 附则

第一百三十二条

本法施行后,破产人在本法公布之日前所欠职工的工资和医疗、伤残补助、抚恤费用,所欠的应当划入职工个人账户的基本养老保险、基本医疗保险费用,以及法律、行政法规规定应当支付给职工的补偿金,依照本法第一百一十三条的规定清偿后不足以清偿的部分,以本法第一百零九条规定的特定财产优先于对该特定财产享有担保权的权利人受偿。

第一百三十三条

在本法施行前国务院规定的期限和范围内的国有企业实施破产的特殊事宜,按照国务院有关规定办理。

第一百三十四条

商业银行、证券公司、保险公司等金融机构有本法第二条规定情形的,国务院金融监督管理机构可以向人民法院提出对该金融机构进行重整或者破产清算的申请。

Where the financial supervisory and regulatory institution under State Council takes over the financial institution with material business risks or take it under custody, it may petition the People's Court to stay the civil litigation procedure or execution procedure in which the financial institution is the defendant or the party against which the execution procedure is filed as the case maybe.

The insolvency of financial institutions shall be dealt with pursuant to the implementation measures formulated by the State Council in conformity with this law and provisions of relevant laws.

Article 135

Other laws may refer to this law in formulating liquidation procedures of entities other than enterprises with legal person status.

Article 136

This Law shall enter into effect as of June 1, 2007. The Enterprise Insolvency Law of the People's Republic of China under Trial Implementation shall be abolished from the date when this law enters into effect.

国务院金融监督管理机构依法对出现重大经营风险的金融机构采取接管、托管等措施的,可以向人民法院申请中止以该金融机构为被告或者被执行人的民事诉讼程序或者执行程序。

金融机构实施破产的,国务院可以依据本法和其 他有关法律的规定制定实施办法。

第一百三十五条

其他法律规定企业法人以外的组织的清算,属于破产清算的,参照适用本法规定的程序。

第一百三十六条

本法自 2007 年 6 月 1 日起施行,《中华人民共和国企业破产法(试行)》同时废止。