

Rule of Law in China: Chinese Law and Business

The Enforcement of Commercial Judgments in China

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Executive Summary

- The enforcement of commercial judgments in China has long been regarded as notoriously difficult. Recent studies, however, show that enforcement has significantly improved in urban areas, but remains a problem in rural areas.
- Changes in the nature of the economy are the main reason for the improvement in urban courts. Private enterprises, individual business operators, and limited liability companies have become the major driving force of the economy. The ideology-based discrimination against private enterprises has been overcome. As a result, litigants are more or less on an equal footing.
- Local protectionism is less serious in urban courts for a number of reasons. The economy in many cities and more developed areas is more diversified; financial reforms have decreased the incentive of the courts to engage in local protectionism; higher courts, rather than local government or party officials, have played a more determining role in court appointments and promotions; court procedures have been streamlined so that judges have little time or energy to pay extra attention to routine disputes.
- Many reforms aiming at institution building and improving enforcement have had a positive impact on urban courts. The establishment of a relatively independent enforcement bureau within the courts has resulted in greater resources for enforcement. The courts have also encouraged plaintiffs to take preemptive action to protect themselves. Some courts have also increasingly relied on judicial imprisonment to enhance compliance. More generally, judges in the courts have become more professionalized.
- While enforcement in urban areas has improved, the situation remains difficult in rural areas, mainly because rural courts generally lack adequate funding and the economy of rural areas is less developed and diversified.
- To address the problems, adequate funding should be provided for rural courts. Alongside this, the authorities should develop reforms that suit local circumstances, rather than simply relying on reforms that have worked in more economically developed urban areas. More generally, China should establish a credit evaluation system to facilitate the development of social trust.

The Enforcement of Commercial Judgments in China

Introduction

A credible, cost-effective legal system capable of enforcing contract rights has long been viewed as crucial for rule of law and economic development. Despite many positive aspects, Chinese judicial reforms are generally portrayed as weak and ineffective. In particular, the enforcement of commercial judgments has been regarded as notoriously difficult. Recent studies, however, show that enforcement has significantly improved in urban areas, but remains a problem in rural areas.

In urban courts, more than half of the creditors/plaintiffs receive 100 per cent of the amount owed, and three-quarters are able to receive partial enforcement. The main reasons for the improvements are changes in the nature of the economy, general judicial reforms aiming at institution building and increasing the professionalism of the judiciary, and specific measures to strengthen enforcement.

In contrast, enforcement in rural areas remains problematic. Enforcement rates are low, and plaintiffs are generally dissatisfied with the performance of the courts. The primary reasons for the continued problems in rural areas are the lack of funding for the rural courts and the less developed and diversified nature of the rural economy.

Judicial enforcement capacity is closely related to China's changed economic environment. But institution building and staff professionalism are also important. To comprehensively improve judgment enforcement, it is crucial to provide sufficient funding to rural courts.

Urban areas

Enforcement results

To investigate the enforcement capacity of the courts, one cannot simply focus on the cases that

need compulsory court enforcement, because some defendants will, for various reasons, have paid their debts before the courts take compulsory action.

Recent studies demonstrate that a significant proportion of commercial cases are voluntarily withdrawn by the plaintiffs or settled through judicial mediation. In a study based on sixty-six randomly selected commercial cases in the Pearl River Delta, twenty-two cases, or 33 per cent, were voluntarily withdrawn or settled through mediation.¹ In other studies, these figures range from 20 to 50 per cent.² In such cases, creditors usually recover in full the amount owed or agreed in the settlement.

Among the cases that go to final judgment, some will result in voluntary compliance with the judgment; some will result in applications for compulsory enforcement. Of the sixty-six total cases surveyed in the Pearl River Delta, thirty-seven cases, or 56 per cent, resulted in applications for compulsory enforcement. In another study in Shanghai, 77 per cent of the winning plaintiffs applied for compulsory enforcement.³

The majority of plaintiffs who seek compulsory enforcement are able to recover all or part of the judgment amounts. In the Pearl River Delta study,

1. Xin He (2007) 'The Enforcement of Commercial Cases in the Pearl River Delta', *Journal of Justice* (Sifa), pp. 72-109.

2. Susan Whiting's research based on seventy-six cases in Nanjing found 50 per cent of the cases were voluntarily withdrawn or settled through mediation. See Clarke, D. C., Murrell, P. and Whiting, S. H., 'The Role of Law in China's Economic Development' (January 27, 2006). GWU Law School Public Law Research Paper No. 187. Available at SSRN: <<http://ssrn.com/abstract=878672>>. A survey of 190 cases in Shanghai found that about 20 per cent of cases were voluntarily withdrawn or settled. See Minxin Pei et al., 'A Survey with Corporate Litigants in Shanghai', on file with author, 2007.

3. See He, *op. cit.*; Pei et al., *op. cit.*

seven such cases were fully enforced; twenty-one such creditors, or 57 per cent, recovered something. In a Shanghai-based study, 21 per cent of the cases that asked for court enforcement were fully enforced, and 81 per cent of the creditors gained something.⁴ In a Nanjing-based study, among twenty-five cases for which the enforcement results were recorded, 55.5 per cent were successful while 18.5 per cent failed.⁵

These results are indeed better than what have been found in American, British, and Russian courts. Overall, 70 to 80 per cent of plaintiffs in the studies based on urban China recover something through court, while in the United States, the figure could be 30 per cent or even lower.⁶ Though it is dangerous to jump to conclusions solely based on these results, it is fairly safe to say that China's situation in urban areas is not all that bad.

These results raise many questions: what explains the recent improvements? what are the remaining inadequacies? what more can be done?

The rise of the private sector

It seems that many factors have contributed to this change. An obvious reason is the changed nature of the economy. In urban and more developed areas, many state-owned enterprises (SOEs) and collective enterprises have been privatized in the restructuring and transformation processes, and private enterprises, individual business operators, and limited liability companies have become the major driving forces of the economy. Economic activities among them have multiplied and they have thus been involved more in commercial disputes.

This change can be clearly indicated by court users, most of which are private and small enterprises. In the Pearl River Delta study, 59 per cent of the litigants were private enterprises and limited liability companies. While many litigants were SOEs or controlled by SOEs, most of them were banks or credit unions. No party or government agency was found in the data.⁷

The change in the nature of the economy and in the court users has significant implications for the adjudication and enforcement of commercial litigation. For one thing, litigant parties are more or less on an equal footing in litigation. The original discrimination against private enterprises in court based on ideology has been overcome. In addition, local protectionism has diminished.

Diminished local protectionism

Local protectionism has long been regarded as a major obstacle in enforcing judgments in China. It exists mainly because local governments have to rely on local enterprises, especially local SOEs, for financial resources. Moreover, the salaries, bonuses, benefits, and even jobs of court staff also rely on the financial income of local governments. Furthermore, the appointments of directors of some courts are controlled by local government and party officials.

But recent studies show that local protectionism is not very widespread in urban areas. In the Pearl River Delta study, for example, there was generally no difference in the court decisions and the final enforcement outcomes between cases initiated by local and non-local plaintiffs.⁸ Almost no creditors interviewed in the research mentioned that local protectionism was a big problem. Indeed, many non-local creditors emphasized that the working style of the court was much better than what they had encountered in hinterland areas. Similar results have been found in studies conducted in big cities such as Beijing and Shanghai.⁹

4. Pei et al., op. cit.

5. Quoted from Clarke et al., op. cit., p. 42. It is unclear, however, whether the success or failure of enforcement refers to the complete success or failure.

6. Best, A. et al. (1994) 'Peace, Wealth, Happiness, and Small Claim Courts: A Case Study' *Fordham Urban Law Journal* 28: 2, p. 365. Committee on Post-Judgment Collection Procedures in the Special Civil Part (1993) 'Report to the Supreme Court of New Jersey' *New Jersey Law Journal*, November, p. 2.

7. See He, op. cit.

8. See He, op. cit.

9. Peerenboom, R. (2001) 'Seek Truth from Facts: An Empirical Study of the Enforcement of Arbitral Awards in the People's Republic of China' *American Journal of Comparative Law*, 49: 277-8. See also, Mei Ying Gechlik (2006) 'Judicial Reform in China: Lessons from Shanghai' *Columbia Journal of Asian Law*, 19: 100.

Local protectionism has become less serious for a number of reasons. Firstly, the economy in many cities and the more developed areas is more diversified: SOEs have lost their traditional dominant role. Local governments' income comes more from taxing the private sector than from SOEs and collective enterprises. For similar reasons, there is little danger of social instability if SOEs are pushed into bankruptcy. Local governments are thus less dependent on SOEs and have less incentive to assist them in their disputes in court.

Secondly, financial reforms of the judiciary have decreased the incentive of the courts to engage in local protectionism. Under the reformed financial policy, the courts submit all their administrative income, including litigation fees, to local governments, and get their expenses from the governments through a separate budget. In more developed areas, local governments usually provide courts with adequate funding. Thus, the courts there have no direct financial reliance on local enterprises and they also need not provide special protection for these enterprises in return, as they did before.

Thirdly, higher courts, rather than local government or party officials, have played a more determinative role in court appointments and promotions. Although formally the candidates recommended by higher courts must obtain the final approvals of local party committees and people's congresses, the candidates are directly controlled by the higher courts. They therefore have to be concerned more with the requirements of the judiciary, which means that they would not always bow to the pressures of local government or party officials and offer protection to local enterprises.

Finally, many courts in urban areas have been inundated by a huge amount of cases, and as a result, court procedures have been streamlined. The courts now have little time or energy to devote extra attention to relatively insignificant disputes of mid- or small-sized enterprises.

Local protectionism still remains a problem in some cases, especially in disputes where the amount in dispute is very large and in cases involving large

SOEs, particularly in cities where the local economy is not very diversified. The latter reason also explains why local protectionism is more of a problem in rural areas, where the economy is less developed and the private sector is smaller.

The positive impact of enforcement reforms

Under pressure to improve the situation of judgment enforcement, the courts have adopted various measures to address this issue. The first step was to set up a relatively independent enforcement bureau within the courts. The enforcement bureau used to be a division equal in the administrative hierarchy to other divisions. Elevation to a bureau, where the director is usually of the same rank as a vice director of the courts, means that more resources will be available for enforcement.

The courts have also encouraged plaintiffs to take preemptive action to protect themselves. To make the enforcement easier, the enforcement bureau of some courts requires judges in the petition filing and adjudication divisions to inform plaintiffs of the availability of asset preservation procedures, whereby plaintiffs, by providing security, can ask the courts to freeze the assets of the other party. This procedure has been very useful, both during the enforcement phase and prior to enforcement, because litigation parties are more likely to resolve their disputes through mediation or voluntarily withdraw their suits when the defendants know that they will not be able to delay or avoid enforcement should a judgment be rendered against them.

Some courts have also increasingly relied on judicial imprisonment to enhance compliance with judgments. According to the law, whether judicial imprisonment can be imposed depends on whether the debtor 'has the capability to pay but refuses to pay'. Some courts have chosen to interpret the term, 'capability' in its broadest sense, while others tend to exercise more discretion in taking such action. The measure has forced some debtors and their relatives to do everything possible to get the debts paid. This measure is more widely used when local banks and credit unions are the plaintiffs, since they usually maintain a very close relationship with the courts.

Professionalism of court staff

Increased professionalism of court staff has also had a positive impact on enforcement. The Judges Law, amended in 2001, requires all judges to pass the National Uniform Judicial Exam, leading to more qualified judges. In addition, judges' salaries have generally increased, in part due to sufficient financial resources supplied by local financial departments. The income level of judges has generally been higher than the local gross domestic product (GDP) per capita. Becoming a judge has become attractive to many law graduates who prefer to have a stable income but a less demanding workload than they would have in a law firm. Subsequently, many courts have been able to recruit graduates and postgraduates of law school.

The judiciary has also imposed strict requirements on the behaviour of court staff. The courts have issued detailed measures for holding judges to account for wrongfully decided cases. There are also various internal requirements for the working style of court staff, some of which are quantified by the complaint and appeal rates. In many courts, a judge's career and income will be directly affected by these rates. Some courts, for example, will deduct the salaries of judges when the timelines of handling cases specified in the Civil Procedure are not maintained. According to the Pearl River Delta study, over 98 per cent of judgments are rendered within the time limits stipulated by the Civil Procedure Law.¹⁰

Evidence from surveys and interviews with litigants has suggested that their impression of the courts is very positive: over 63 per cent of litigants in the Shanghai-based study believed that judges deserved high ratings ('dignified conduct and high professional quality').¹¹ Many also said that the judges were patient and clear in explaining court procedures.

Reasons for ongoing problems

While the situation is much improved, enforcement remains an issue; one-quarter of the plaintiffs in the Pearl River Delta study did not recover a penny for the following reasons.

Firstly, many businessmen are concerned only with short-term interests rather than their long-term business reputation. Some debtors have assets, but they evade the obligations through a limited liability company, which takes only a small amount to set up. Many companies operate as shell companies with few assets. If business is good, they follow the normal rules and behave well; when conditions become less favourable, many simply disappear to avoid their liabilities. The law does not impose any penalty on these shell companies, and the company registration authorities do not record such behaviour. The investors of such companies can register new companies immediately following the closure of the shell company. As a result, it is very difficult to solve some problems of enforcement, because the real reason lies in the general social, economic, and legal environment, in which many enterprises and individual business operators do not value building trust and reputation in the long term, whilst those who do are not sufficiently rewarded. In such circumstances, parties must conduct due diligence or seek other ways to reduce their risk, such as requiring full payment in advance in sales contracts or third party guarantees where feasible.

Secondly, many courts do not have sufficient enforcement staff. In some courts, one staff member has to handle more than 200 cases each year, or one case each working day. Since the enforcement process often involves considerable paperwork and many inquiries with other institutions, it is unrealistic to require that all cases be closed without any delay.

Thirdly, the courts do not have enough supervision over court staff. The staff quality in the enforcement bureau is usually not as high as that in the adjudicating divisions, and staff are more susceptible to corruption.

Policy recommendations

Accordingly, there is a need to establish a credit evaluation system that encourages the society to value the development of trust and reputation within business. The state should also strengthen the administration of company registration, which would allow the authorities to have a nationally connected system to identify those who have used shell companies to evade liabilities.

10. See He, *op. cit.*

11. See Pei et al., *op. cit.*

The courts should also have more flexibility in recruiting staff, especially for the understaffed enforcement bureau. At the same time, the courts should introduce a better supervision mechanism to control the behaviour of court staff.

Rural areas

While the situation in urban areas has improved, enforcement remains difficult in rural areas for the following reasons.

Firstly, rural courts generally lack adequate funding. They still rely heavily on their litigation fees, enforcement fees, and criminal monetary penalties (*fajing*) to survive. Subsequently, each court division, and even individual judges in some courts, are assigned a financial goal to meet. Under this pressure, some judges have to persuade or cajole potential litigants to file lawsuits.

In addition, rural courts often rely on the resources and facilities provided by the litigants who ask the courts to enforce their judgments. As a result, the courts have little incentive to aggressively enforce cases that have little potential to enhance their own bottom line. But the courts will aggressively enforce cases filed by some institutional plaintiffs, such as local banks, for the sake of litigation and enforcement fees. Naturally, these institutional players and others who can provide potential financial income for the courts are favoured in this process.

Secondly, the professionalism of these courts is adversely affected by the dire financial situation. Lacking adequate funding, the courts have resisted recruiting new employees, since funding has been more or less constant every year. As a result, professionally trained law school graduates are rarely recruited, though time and again some 'blue blood', with influential connections but no professional law training, inveigle their way into the courts in one way or another. At the same time, as a natural result of the courts' remuneration being much lower than that of its coastal counterparts or the average income of practising attorneys, many seasoned judges have left the courts. Thus, the

overall professional quality and morale of the courts' personnel in these areas has been declining, further exacerbating the problems of enforcement.

Thirdly, some reforms toward formalization of civil procedure have increased the functioning cost of the courts. For example, after the adjudication is separated from the petition filing and judgment enforcement, a case must be examined twice or three times inside the courts, which certainly involves further costs. Formalization of civil procedure also increases the complexity and the cost of the adjudicating procedures, which used to be done in an informal, convenient, and economical way.

Moreover, as part of the judicial reforms, the formalization of civil procedure leads to some unintended consequences that may not be conducive to effective judgment enforcement. Originally, when both the adjudication and enforcement were conducted by one person, whether the judgment could be executed was a consideration that was brought to bear on the adjudication. To a certain extent, this made the enforcement easier. After this separation of duties, however, the judge who awards the judgment is less concerned about the enforcement, because it is, by and large, not their responsibility. While formalization of civil procedure, including the separation between the adjudication and the enforcement, was partly designed to reduce corruption, corruption may well, in fact, have increased as a result. This is because, when the judgment enforcement becomes more difficult, the enforcement officers have more bargaining chips when rent seeking.

In this context, many factors that help improve the enforcement situation in urban areas are not very useful in rural areas. Since the economy in rural areas has not been fully developed or diversified, and local governments still rely heavily on a few SOEs for financial income, local protectionism remains. The courts also have to maintain a close relationship with local governments for the sake of more funding. As a result, it is difficult for the courts to resist the pressure of local governments and SOEs, even though the appointments of court staff have been controlled mainly by higher courts.

Policy recommendations

To improve the enforcement situation in rural areas, it is crucial to provide adequate funding for the courts. It is also important to reconsider some current judicial reforms that are not suitable for rural areas. For example, strict requirements for civil procedure need to be loosened, and mediation should be encouraged. In the longer term, the state should further develop and diversify the economy of rural areas.

Conclusions and implications

China's record with regard to the enforcement of commercial cases is mixed. Many improvements have occurred in urban areas, such as diminished local protectionism, increased professionalism, and improved enforcement. Various factors have contributed to the improvement, including the diversified economy, streamlined court procedures, and adequate funding for the courts. With the introduction and implementation of the same institutional reforms in rural courts, the situation in rural areas is less sanguine.

Until the government increases funding for rural courts, reconsiders its plans for rural reform measures, and sets about encouraging further development and diversification of the rural economy, improvement is likely to be slow. The state should also introduce a system of company registration, which would close the loopholes of using shell companies to evade liabilities. But besides these measures, a more fundamental change to the society

is needed, such that the qualities of trust and reputation within business are valued more highly. This could be encouraged through the establishment of a credit evaluation system that would foster a culture of corporate social responsibility.

Will rural areas grow their way out of the problem, as seems to be the case in urban areas? As proven by many other countries, there is a strong correlation between economic growth, wealth and social governance, including rule of law. But this change would require a rather long period of time, if economic factors alone are to be relied upon. In the short term, the difficulty of enforcement in rural areas is likely to persist, with recent state policy initiatives doing little to avert the problem. The recent reduction of litigation fees under the slogan 'the judiciary for the people', for example, has indeed exacerbated the precarious financial situation of many rural courts. It remains to be seen whether China will be able to overcome the economic, financial, and ideological obstacles it faces in this regard.

What is certain, is that the contrast between China's rural and urban areas in judgment enforcement will provide an interesting testing ground for the two schools of thought on the relationship between judgment enforcement and economic development: whether effective judgment enforcement is essential for China's economic development, or whether economic development generates more demand for a mature contract enforcement.



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