Rule of Law in China: Chinese Law and Business

The Making of China’s Corporate Bankruptcy Law

Terence C. Halliday

The Foundation for Law, Justice and Society

in collaboration with

The Centre for Socio-Legal Studies,
University of Oxford

www.fljs.org
Executive Summary

For the past 20 years, China has embarked on a multi-track programme of reforms to build a bankruptcy system. The passage of an Enterprise Bankruptcy Law in 2006 (2006 EBL) represents a milestone, but there is still a long way to go.

The fundamental tension can be captured by the contrast between a socialist market economy and a socialist market economy. Advocates of the former (that is, a Chinese economy resembling other advanced capitalist economies) have sought to absorb all enterprises into a bankruptcy law that protects domestic and foreign financial creditors, in situations where enterprises cannot compete profitably. Workers are invariably laid-off, but their protection must be outside bankruptcy law, and not harmful to prospects of enterprise reorganization.

Advocates of a socialist market economy, by contrast, have sought modernization of the economy without completely drifting away from China’s socialist past. Their vision of a market with Chinese characteristics would protect within the confines of a bankruptcy regime both state-owned enterprises (SOEs) and workers from the full force of the market.

The tension was resolved as follows in the 2006 EBL:

- All SOEs are subject to the law, except 2116 SOEs which are either at particular financial risk or in a sensitive industry.
- With respect to workers, the EBL appears on the surface to prioritize worker claims, whereas in practice, it prioritizes banks.
- By emphasizing conciliation and reorganization, the 2006 EBL seeks the restructuring of enterprises without the severe dislocation and unrest that would accompany wholesale liquidations of unprofitable firms.

China faces severe challenges as it seeks to implement this law. The implementation phase will determine whether the law will effectively provide for casualties of a competitive market economy. The following factors pertain:

- The 2006 EBL has been drafted in broad brush strokes. Many gaps and ambiguities remain.
- Unresolved conflicts: it is not at all clear that the Standing Committee’s final resolution of the struggle between workers and bankers has settled underlying social conflicts.
- Whether China’s institutions and service professionals have the competence and independence to implement the new law remains an open question.
- While the 2000 EBL may signal to foreign observers that China’s bankruptcy system has come of age, the most fundamental issue is the orientation of political authorities towards the new law.
The Making of China’s Corporate Bankruptcy Law

All countries moving from command to market economies face the challenge of failing enterprises. Under a command economy, commercial enterprises are guided by policy decisions. They fulfill multiple functions beyond the production of goods and services. A political ideology of full employment, and the correlative provisions of housing, education, medical and welfare services through state-owned enterprises (SOEs) make failure unimaginable, unless by policy decision. Yet a market economy cannot smoothly function without an orderly way of handling firms that cannot compete in the marketplace.

China is no exception. Its transition from a command economy to a socialist market economy has required reformers to confront both the ideological and practical challenge of envisioning and executing the prospect of enterprise failure.

The magnitude of this problem cannot be overstated. As late as 2003, a senior government official responsible for SOEs hazarded that all medium and small SOEs in China were technically insolvent. Dissolving these enterprises would produce shockwaves in multiple directions. On the one hand, the knock-on effects of widespread enterprise failure would put banks at risk. It would demonstrate the high proportion of non-performing loans banks were carrying, thereby their financial vulnerability. On the other, the dismissal of workers, and attendant deprivation of jobs and income would detach workers from the social welfare system provided by SOEs. In the absence of an effective social safety net, Party leaders have feared more than economic consequences. Disaffected workers could spark social and political protest. Handling China’s failing SOEs is therefore a major economic, social and political problem.

Meantime, the burgeoning private market also requires commercial rules. The more China’s domestic economy becomes intertwined with international business, the greater the imperative for foreign investors to be able to predict what protections are available to them, if firms with assets inside China should fail. Some degree of certainty about a bankruptcy system better enables investors to price risk and reassure the foreign investors needed to fuel China’s continued economic growth.

For the past 20 years, China has embarked on a multi-track reform programme to build a bankruptcy system. The passage of an Enterprise Bankruptcy Law in 2006 (2006 EBL) represents a milestone. But there is still a long way to go.

Bankruptcy reform cycles

China’s bankruptcy reforms can be conveniently grouped into three cycles, with a fourth about to begin.

From the ‘iron rice bowl’ to the financial accountability of enterprises

A remarkable legal entrepreneur, the economist Cao Siyuan, led the charge for the People’s Republic of China (PRC) first bankruptcy law in 1986. According to Cao, China’s workers had become accustomed to eating from a ‘big pot of rice’, whether or not they worked industriously, or at all. Without clear connection between effort and income, China’s 93,000 SOEs operated in an economy that dampened productivity, suppressed competition, and impeded economic growth. Managers satisfied their political masters without accounting for the financial health of their enterprises.

Cao vigorously advocated the threat of closing down unprofitable SOEs in order to energize managers and workers, and motivate technological and operational improvement. ‘Bankruptcy’, said Cao, ‘would provide the revival of the nation’s economy’. Some experiments in Wuhan and Shenyang demonstrated that the threat of closing an SOE could in fact sharply increase the financial viability of
enterprises. Armed with this limited evidence, and fortified with promises of an economic turnaround, Cao enlisted Premier Zhou Ziyang and other top leaders to sponsor an Enterprise Bankruptcy Law (EBL).

The proposed law met with heavy opposition. Some objections were ideological: a bankruptcy law was inconsistent with socialism and broke with the social contract and lifelong guarantees of welfare support. Others said managers could hardly be held financially accountable if they were carrying out instructions from higher officials, or conceded that China did not have an adequate safety net in place.

Nevertheless the reformers won the day. The 1986 EBL had six principal features applying to all SOEs. An enterprise was defined as bankrupt if it could not pay due debts. As an alternative to liquidation, the law opened up the prospect of ‘reconciliation and readjustment’, whereby an enterprise could restructure and begin repaying its debts after two years. If this failed, and an enterprise was declared bankrupt, it would sell its assets and dismiss its employees. In the ranking of creditors to be paid from the surplus remaining after the sale of assets, workers had highest priority after administrative expenses. The law also made managers liable for administrative or criminal penalties in certain circumstances. Significantly, in a precedent carried into the present, various exceptions and administrative loopholes could prevent the declaration of bankruptcy by an enterprise that was technically insolvent.

As a symbolic gesture, the 1986 EBL may have signalled a turn towards the market. But as a practical matter, the law turned out to be just a ‘flower pot: pretty on the outside but meaningless’. From 1989 to 1993, the number of bankruptcies averaged 277 per annum, a tiny number in an economy replete with insolvent enterprises.

Resistance sprang up on all sides: from local municipalities and banks, from workers and managers. Since SOEs accounted for some 70 per cent of urban employment, the potential volume of dislocated employees put an enormous strain on local and central government services. Courts were not adequate to task either. Untrained judges were little prepared for decisions of such consequence, and highly vulnerable to local political pressures. And so the law languished.

**Following the administrative track**

If the 1986 EBL was not the solution, then another policy option was required. China’s leaders turned to an administrative approach. In 1993, Premier Zhu Rongji pressed the State Economic and Trade Commission (SETC), primarily responsible for managing SOEs, to coordinate with other agencies to cope with the huge number of unprofitable SOEs. The SETC consulted widely within China and solicited technical advice from the Asian Development Bank (ADB).

The first step came when the State Council authorized administrative steps to improve the capital structure of ailing SOEs. Officials would select weak SOEs to be merged with a stronger SOE. If workers needed to be laid-off, the land-use rights of the weak SOE could be sold, and the proceeds used to pay workers a lump sum of up to three years of salary. To protect banks, the government allocated moneys for potential bad loan write-offs. The experiment began in 1994–5 in 18 large cities, spread to 56 cities by 1996 and by 1996, 2291 failing SOEs were being restructured, mostly through mergers.

This programme ran into many difficulties. Enterprise abuses transpired. Banks complained that their interests had been subjugated to those of workers. Worse, many enterprises appeared to be concocting schemes to evade their obligations to banks, including the declaration of false bankruptcies.

In 1997, the SETC responded with a policy shift in favour of banks. Tighter controls were exercised over enterprises, which were encouraged to merge or be acquired. ‘Whole takers’ were discouraged. The government widened the experiment to 111 cities. In 1997, it pumped 30 billion yuan into the write-off quota for banks; and in 1998, 40 billion yuan. By 1998, the number of cases approved for write-off quotas had risen to 2721.
In response to complaints that the government was being too heavy-handed and that land rights had to be used primarily for just one creditor, the workers, the government changed course again. Bankruptcy returned as the government’s preferred restructuring mechanism. To prevent local collusion, administrative control was shifted upward from the municipal to the provincial level.

Throughout these policy shifts one constant remained. A World Bank report stated that a ‘key concern of policymakers’ remained ‘sociopolitical instability from mass unemployment without adequate social protection’. This observation echoed the ADB’s report to the SETC. The bankruptcy reforms were pursuing two potentially incompatible goals: the restructuring or liquidating companies as viable economic enterprises, while at the same time maintaining those enterprises as safety nets for workers.

**Searching for a comprehensive solution**

While the government was seeking to restructure the public sector of the economy, the private sector was booming, raising the question of regulation. In the decade following the 1986 EBL, the government patched together several regimes to deal with failed enterprises. Firstly, for private enterprises that had the status of ‘legal entities’, the government included some limited liquidation provisions in its 1991 Civil Procedure Law. By the late 1990s, these led to the bankruptcy of several thousand private firms. Secondly, for enterprises in special economic zones, such as Shenzhen, it created special bankruptcy provisions. Finally, for liquidation of foreign-invested companies, it adopted regulations issued by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). For other enterprises, including the vast number of small business that were not ‘legal entities’, or for collectively owned township and cooperative enterprises, no law or legal regulation existed, either for reorganization or liquidation.

In 1994, the National People’s Congress (NPC) took up the challenge to create a comprehensive bankruptcy law. The NPC Finance and Economy Committee (FEC) was charged with drafting legislation that would serve the domestic purpose of saving jobs and turning companies around, together with the international purpose of removing impediments to foreign investment. The law was intended to encourage orderly credit procedures, support the modernization of secured transactions, and ‘marketize’ bankruptcy processes to reduce direct administrative involvement by the state.

In its first phase, 1994–6, the seven-person drafting team, comprising three scholars, three officials and a judge, studied the major problems with the 1986 law. The team hosted a conference on policy options, and drew on technical assistance from the ADB. But the drafts circulated widely within government ministries and agencies ran into heavy opposition over the potential impact on workers. By 1996, opposition had mounted sufficiently that further work was suspended indefinitely.

During the second, quieter phase, 1996–2000, the drafting team informed itself more fully of developments outside China. Members participated in international conferences, learned about new international protocols, such as the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency, and convened further consultations inside China. They observed closely the experiments undertaken in the SETC’s capital restructuring programme, and the government began to lay the foundation for a social security system that would complement a bankruptcy regime likely to produce unemployment.

Several drafts were presented to symposiums inside China and to international organizations. Debates intensified when the draft was introduced to the FEC and then passed to the Legal Affairs Committee. At several points, the process stalled for months at a time. By mid-2006, it was not clear that differences could be reconciled. The draft law confronted the bleak prospect of needing to be re-introduced again in the next five-year plan.

With considerable pressure from outside China (principally from the European Union) and a growing sense of frustration among law-makers, a final
compromise was reached in the enduring struggle between the factions more supportive of workers and those of financial creditors. The 2006 EBL was adopted by the NPC Standing Committee to come into force on 1 June 2007.

Recurring issues
The protracted 12-year gestation of this law reflects both fundamental tensions already apparent with the 1986 EBL and classic struggles over bankruptcy law anywhere – albeit with Chinese characteristics.

The fundamental tension is captured by the overly stylized contrast between a socialist market economy, and a socialist market economy. Advocates of a Chinese economy that would resemble most advanced capitalist economies have sought to absorb all enterprises into a bankruptcy law that would protect financial creditors. Workers would invariably be laid-off, but their protection would need to be outside bankruptcy law, and not harm the prospects of enterprise reorganization. Government administrators should withdraw from direct guidance of SOEs, and subject them to the same market forces as private firms.

Advocates of a socialist market economy, by contrast, sought modernization of the economy without drifting entirely away from China’s socialist past, most importantly by protecting SOEs from the full force of the market. The touchstone was workers. How could China give priority to bankers, in a supposedly socialist society, when workers would be cut loose from employment, and the social contract torn up? Furthermore, privatization of SOEs was all very well, if new investment and management would reinrogate enterprises. But dissolving SOEs where no other work was available was quite different.

That this was not only a matter of ideology was apparent much earlier in the struggles surrounding the 1986 law. Top leaders have been acutely aware that casualties of a market economy pose a volatile threat to social and political stability. President Hu Jintao’s slogan of a ‘harmonious society’ represents more than an appeal to the residues of Confucian culture in contemporary China. It reflects anxiety about the effervescence of disharmony in mounting social protests across the country. An ill-conceived bankruptcy law could at the very least heighten uncertainty, even fuel unrest and threaten Party control.

Scope and eligibility
The most difficult problem from the outset was determining which enterprises should be covered by bankruptcy law. The final compromise of the 2006 EBL was to make all SOEs subject to the law, except for 2116 SOEs that were either at particular financial risk or in a sensitive industry. In theory these will be restructured in 2008, although some insiders remain sceptical that this deadline can be met.

Earlier drafts variously excluded financial institutions, partnerships, smaller legal-person enterprises and natural-person enterprises. In principle, the 2006 EBL applies to financial enterprises but they will need to obtain regulatory permissions to have access to the courts. Partnerships were excluded in earlier drafts, but might be able to use the law under certain conditions. And whereas legal-person enterprises with less than eight employees were excluded in some earlier drafts, these are now all eligible. The law excludes the millions of small individual or family businesses, not formally incorporated.

Access
What is the test for access to bankruptcy law?
This is a key provision, because too easy access may produce a flood of liquidations, overwhelming the courts. Access that is too difficult would obviate the value of the law. Access was contentious right up to the end of NPC negotiations. The drafting team and FEC initially proposed the ‘cash-flow test’, commonly used in Anglo-American countries, and recommended by the UNCITRAL Legislative Guide on Insolvency.

Wary of an onslaught of bankruptcy applications, the Legal Affairs Committee proposed a double test: of cash flow, plus ‘balance sheet’, whereby an enterprise would have to show it could not pay its debts on time, and that the firm’s liabilities
exceeded its assets. This is more time consuming and expensive to demonstrate, and requires more judicial discretion and competence.

Since the cash-flow test alone clearly was not going to win support, bankruptcy experts persuaded the Standing Committee to agree to two alternative tests: cash flow plus the balance sheet, and a clever second test: cash flow plus a judgment by the court that an enterprise was ‘obviously incapable of paying its debts’ (Article 2). This fusion of a global standard with a distinctively ‘Chinese characteristic’ can be read in two ways. Most optimistically, it gives the judiciary discretion, essentially to only apply the cash test. More pessimistically, it makes a non-independent court vulnerable to political or economic pressures to guard certain enterprises from bankruptcy.

Priority

If an enterprise must be liquidated, the question arises over which creditors are prioritized for payment. The 1996 draft gave unlimited priority to workers and the state for unpaid taxes. While this satisfied advocates of SOEs, regulatory agencies, such as the SEC, and representatives of workers, it threatened a backlash from financial creditors. By 2004 the FEC had agreed to the following ranking: first, secured claims by creditors (favourable to banks); second, administrative costs to professionals and others involved in bankruptcy; third, worker claims within limits; fourth, taxation claims without limits; and fifth, unsecured creditors.

This proposal came up against a powerful workers’ coalition, which asserted ‘because we are a socialist country we should be in favour of workers’. Led by a senior official of the Standing Committee, the Ministry of Labour and social security officials, the workers’ bloc insisted the claims of workers displace those of banks and secured creditors. ‘The top leaders are still worried about social unrest’, noted a member of the FEC drafting team. ‘Because the production of workers’ benefits is a key to the whole society, when problems appear to the public they are under pressure to protect worker benefits.’

The Standing Committee accordingly reshuffled priorities to give top priority to administrative costs; second priority to worker claims; third priority to secured creditors, fourth, to tax; and fifth, to ordinary creditors.

By the second review in the NPC Standing Committee, the Central Bank had mobilized on behalf of financial institutions. Ironically, the top leadership had been insisting that banks act responsibly according to commercial, rather than policy, criteria, with the result that they were compelled to act as a political interest group. The banks were fully aware that ‘some SOEs owe workers wages for several years, even five or more, so if the priority of the workers wages comes before secured creditors, they won’t get anything’. The banks declared that if workers retained first priority, then banks would refuse to lend money to enterprises that had heavy debts to workers, a decision that would kill companies. The banking bloc obtained support from economists and academics, but the worker bloc in the NPC remained predominant.

The debate brought proceedings to a halt: reportedly, China’s Premier Wen Jiabao favoured priority for secured creditors, thus taking the side of the banks, while a high-ranking NPC official favoured workers, thus taking their side and that of the union advocates. In the meantime the NPC Legal Affairs Committee consulted with the ADB, which convened a panel of international experts. At the meeting, foreign bankruptcy specialists were each asked to report on priorities in their countries: did any advanced economy give workers first priority? While this question is partly misplaced — most advanced countries have extensive social insurance programmes for unemployed workers — the overwhelming response was ‘no’.

After months of stalemante, the 2006 EBL produced an artful solution. The most salient provision in the law, Article 113, makes it appear that the workers won: after administrative expenses ranked first, workers’ claims ranked second, and extensive tax and social security claims ranked third. But Article 132, in the final Chapter XII on Supplementary Provisions,
The effect is to make it appear that the law prioritizes worker claims, whereas in practice it prioritizes banks. It is anticipated that the government will move more quickly to expand a social insurance system for workers, including retirement benefits.

**Court jurisdiction**

A further question concerns the powers given to government agencies to administer the law. Confidence in a bankruptcy system ultimately depends on the government agencies and courts that administer them. No matter how finely drafted the substantive and procedural law, an incompetent judiciary that lacks capacity, allows delay, multiplies jurisdictional confusions, or is corruptible, will subvert the law. Advanced economies distribute these functions in various ways among government agencies, the courts and the private market for professional services.

From the earliest drafts there was never any doubt that the courts would not serve as the primary overseer of bankruptcy. International organizations emphatically recommended either specialized courts or more powerful higher level courts, presumably, with higher quality judges who were less subject to local protectionism. Top leaders rejected specialized courts as too expensive, and as a precedent that might lead to a proliferation of other proposals. However, experts do not preclude the possibility of a de facto specialized court, emerging in busy jurisdictions with established bankruptcy divisions. The FEC drafting team initially preferred intermediate courts with putatively more authority and better judges. But it was persuaded by the Supreme People’s Court (SPC) that this should be at the SPC’s discretion.

As for jurisdiction, the law states that jurisdiction will be that of the domicile of the debtor, a solution that may create problems because ‘domicile’ might be the locus of a head office, whereas the real decisions and assets of an enterprise might be elsewhere. No consideration or discussion appears to have occurred over the need for a government agency to handle no-asset bankruptcies, and serve as a regulator. This problem may yet surface.

**Professional services**

Who undertakes corporate restructuring and liquidation? State officials? Private lawyers? Accountants? Or specialized private professionals, such as insolvency practitioners? On what basis will they be paid? These questions are critical, because they affect the competency, costs and regulation of a process with high economic and human stakes.

At no stage have reformers seriously considered placing any of these responsibilities with a state agency. The 2006 EBL envisaged the work would be done by a law or accounting firm, or possibly by a specialized bankruptcy firm. There is no immediate plan to create a specialized insolvency profession.

**Rehabilitation**

Will the law enable companies to be rehabilitated as an alternative to liquidation? This option has been appealed to Chinese leaders since the 1980s because it offers the promise of keeping companies alive and workers employed. How reorganization should take place is another matter. The 2006 EBL permits two options: one more similar to the English concept of conciliation; the other to the US concept of reorganization.

Conciliation is intended for smaller enterprises. Reorganization is intended for larger enterprises, and extends from financial to operational restructuring. Under the protection of the court, creditors, the debtor, the bankruptcy administrators and experts can seek to streamline the firm – restructure its finances, reduce its workforce, sell unprofitable assets, attract new capital, modify its operations in accordance with a new business strategy – and make this binding on all parties. The new law intends to empower creditors to be more vigilant and involved in debtor affairs, especially during reorganizations.
By emphasizing conciliation and reorganization, the 2006 EBL seeks the restructuring of enterprises without the severe dislocation and unrest that would accompany wholesale liquidations of unprofitable firms.

Implementation issues
The recursive theory of legal change observes that putting law on the books is not the end of reform. Nor is it even the beginning of the end; rather it is the end of the beginning. China faces severe challenges as it seeks to implement this law. The implementation phase will determine whether the law will effectively provide for the casualties of a competitive market economy or not. What are the likely problems that China will confront in this phase?

Ambiguity and unresolved conflicts
The 2006 EBL has been drafted in broad brush strokes. Many ambiguities, gaps and provisions in the procedures of courts remain undefined. It is not at all clear that the Standing Committee’s final resolution of the struggle between workers and bankers has settled underlying social conflicts. Before 1 June 2007, the treatment of workers’ claims was particularly opaque. The way in which workers are treated by an underdeveloped social security system may well determine the readiness of the government to allow the 2006 EBL to function at arm’s length from political interference.

Institutional incapacities and autonomy
Corporate bankruptcy always involves high financial stakes. Immense pressure on judges and courts can therefore be anticipated from the market (e.g., bribery and corruption) and from political authorities (e.g., through local pressures on jobs, salaries, loyalties and promotion). The ability of courts to act with the neutrality required will be severely tested, particularly if jurisdiction resides in the lower level courts. The most complex bankruptcies also require a competency in finance and business that most judges do not possess. A steep learning curve will be necessary, including in the business divisions of higher courts.

Professional competencies and compensation
Comparative research shows that bankruptcy systems can falter if professional expertise is not available, and professional integrity not assured. Two matters will be paramount. Firstly, how professionals are regulated in order to forestall corruption and collusion with courts and debtors. Secondly, how professionals will be paid. If the compensation method does not attract commensurate expertise and experience, then creditors and debtors will avoid the law.

Political economy
The most fundamental issue, however, concerns the orientation towards the new law of both political authorities, from the top leadership to local officials and regulators. While the 2000 EBL may signal to international observers that China’s bankruptcy system has come of age, those most closely associated with its drafting make clear that it is contingent on all sorts of points of entry and influence that can be opened and shut by authorities and regulators. In short, the political bargain that permitted the passage of this law appears to be a compromise in which the law can be allowed to work, so long as it does not threaten particularly sensitive national or local political interests.

Implementation therefore confronts two deep-seated challenges. Systemically, until the elements and relations in the system are defined, it is impossible to predict how effectively the law will function. On a case-by-case basis, in the foreseeable future, it will prove difficult for any debtor or creditor, especially those outside a jurisdiction, to predict whether the law will be applied competently by neutral and honest judges, whose decisions are binding.
The Foundation

The mission of the Foundation is to study, reflect on and promote an understanding of the role law plays in society. This is achieved by identifying and analysing issues of contemporary interest and importance. In doing so, it draws on the work of scholars and researchers, and aims to make its work easily accessible to practitioners and professionals, whether in government, business or the law.

Rule of Law in China: Chinese Law and Business

The main objective of the programme is to study the ways in which Chinese law and legal institutions encounter and interact with the social environment, including economic and political factors, at local, regional, national, and international levels. The Foundation’s perspective in pursuing this objective is that of entrepreneurs considering investment in China, the lawyers advising them, executives of an international institution or non-governmental authority, or senior public officials of another country. The combination of this objective and our particular perspective constitutes a unique approach to the study of the role of law and its relationship to other aspects of society in China.

Terence Halliday is Co-Director, Center on Law and Globalization, American Bar Foundation and University of Illinois College of Law; Senior Research Fellow, American Bar Foundation, and Adjunct Professor of Sociology, Northwestern University. Halliday specializes in law-making and institution-building. He has published widely on bankruptcy law-making and implementation, including Rescuing Business: Reform of Bankruptcy Law in England and the United States (Oxford University Press, 1999, with Bruce Carruthers). He is currently writing a book entitled Globalization, Law, Markets which includes an analysis of global law-making in the insolvency field and the design of bankruptcy systems in China, Indonesia and Korea. He has served as a consultant to the State Council Office on Restructuring the Economic System, China, the World Bank and OECD.

For further information please visit our website at www.fljs.org or contact us at:

The Foundation for Law, Justice and Society

Wolfson College
Linton Road
Oxford OX2 6UD
T  +44 (0)1865 284433
F  +44 (0)1865 284434
E  info@fljs.org
W  www.fljs.org