

1986

Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice

Henry R. Zheng

Follow this and additional works at: <https://scholarship.law.vanderbilt.edu/vjtl>



Part of the [Bankruptcy Law Commons](#), and the [Law and Economics Commons](#)

Recommended Citation

Henry R. Zheng, Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice, 19 *Vanderbilt Law Review* 683 (2021)

Available at: <https://scholarship.law.vanderbilt.edu/vjtl/vol19/iss4/1>

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Journal of Transnational Law by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

Vanderbilt Journal of Transnational Law

VOLUME 19

FALL 1986

NUMBER 4

Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice

*Henry R. Zheng**

I.	INTRODUCTION	684
II.	BACKGROUND	685
	A. <i>Economic Reform and Bankruptcy Law</i>	685
	B. <i>Socialist Ideology and the Bankruptcy System</i>	689
	C. <i>Present Economic Conditions in the PRC and the Bankruptcy System</i>	690
	D. <i>Drafting of the Domestic Bankruptcy Law</i>	694
	E. <i>Creation of the Bankruptcy Regime for Foreign In- vestment Enterprises</i>	697
III.	THE DOMESTIC BANKRUPTCY SYSTEM OF THE PRC	699
	A. <i>Criteria of Bankruptcy</i>	699
	B. <i>Bankruptcy Proceedings</i>	701
	C. <i>Meetings of Creditors</i>	705
	D. <i>Reorganization</i>	706
	E. <i>Liquidation and Distribution</i>	708
	F. <i>Social Security System</i>	712
IV.	THE FIRST BANKRUPTCY CASE IN THE PRC: SHENY- ANG EXPLOSION-PROOF EQUIPMENT FACTORY	714

* L.L.B. 1982, Beijing University; L.L.M 1984, University of Michigan Law School; S.J.D. 1986, University of Michigan Law School. The author currently serves as an international legal consultant for Graham & James in San Francisco.

V. BANKRUPTCY LAW GOVERNING FOREIGN INVESTMENT ENTERPRISES	719
A. <i>Bankruptcy Proceedings</i>	719
B. <i>Reorganization and Liquidation Under the Corporation Law</i>	720
1. Reorganization Under the Corporation Law .	721
2. Liquidation Under the Corporation Law	723
C. <i>Conciliation Procedure Under the Shenzhen Act</i> . .	725
D. <i>Liquidation Committee and Meeting of the Creditors Under the Shenzhen Act</i>	727
VI. CONCLUSION	728

I. INTRODUCTION

The Enterprise Bankruptcy Law of the People's Republic of China (For Trial Use) (the National Act), promulgated on December 2, 1986,¹ is the first bankruptcy legislation applicable nationwide in the People's Republic of China (PRC or China). At the same time, some regional governments have also enacted regional bankruptcy laws with very limited geographic application.² The National Act applies only to state-owned Chinese enterprises,³ while one regional bankruptcy regulation applies exclusively to foreign investment enterprises.⁴ The PRC thus has developed two parallel bankruptcy regimes. The introduction of a bankruptcy system in China represents a significant development in the economic relationship between enterprises and the state. Foreign business-

1. The Enterprise Bankruptcy Law of the People's Republic of China, adopted on Dec. 2, 1986 by the 18th Session of the Standing Committee of the Sixth National People's Congress and promulgated on Dec. 2, 1986 [hereinafter National Act], *reprinted in* Renmin Ribao [People's Daily], Overseas Ed., Dec. 3, 1986, at 4 [hereinafter People's Daily (unless otherwise indicated, all cites of "People's Daily" are in Overseas Ed.)]. An English translation of the National Act follows this Article.

2. Bankruptcy Regulations of the Shenzhen Special Economic Zones for Foreign-Related Corporations, adopted at the 23d Session of the Standing Committee of the 6th People's Congress of Guangdong Province on Nov. 29, 1986, *reprinted in* Shenzen Tequbao [Shenzhen Special Economic Zone Daily], Dec. 10, 1986, at 2 [hereinafter Shenzhen Act]. An earlier corporation law also contains two chapters relevant to bankruptcy. *See* Regulations of Foreign-Related Corporations of the Special Economic Zones in Guangdong Province, adopted at the 22nd Session of the Standing Committee of the 6th People's Congress of Guangdong Province, on Sept. 28, 1986, *reprinted in* Jingji Daobao [Economic Reporter], Hong Kong, Nov. 10, 1986, at 31-33, Nov. 3, 1986, at 34-35; and Oct. 27, 1986, at 36-38 [hereinafter Corporation Law]. For an earlier bankruptcy regulation by the Shenyang Government, see section IV, *infra*.

3. National Act, art. 2.

4. *See supra* note 2. *See generally infra* notes 271-347 and accompanying text.

men doing business in China will find it useful to have a basic understanding of how the bankruptcy system works, particularly its impact on the legal and economic status of their Chinese business partners.⁵ This article introduces the two parallel bankruptcy regimes and also presents a case study to illustrate the actual operation of bankruptcy law in China.

II. BACKGROUND

A. *Economic Reform and the Bankruptcy Law*

Development of bankruptcy law in China is part of the overall economic reform launched in the early 1980s.⁶ The theme of this economic reform is to diminish the role of state planning, enhance the autonomy of enterprises, increase competition among business entities and provide direct economic incentives for improved performance to both enterprises and employees. The reform has brought the stagnated economy to life and has been in overall terms a success. While the economic reform led most enterprises to improve their performance, it failed to prevent some enterprises from sustaining losses. Actually, the enhanced competition among Chinese enterprises makes it certain that some enterprises must fail while most others prosper. An official report shows that each year about twenty to twenty-five percent of state-owned enterprises sustained losses.⁷ Some incurred losses every year. Indeed, according to the statistics on one Chinese city, seventy-three percent of the enterprises that suffered losses had such a history for six years or more.⁸ Dealing effectively with the enterprises that sustain losses is one of the priorities in the economic reform.

For many years in the past, the prevailing practice in China was either to write off losses through state budget appropriations or take ad-

5. See *infra* notes 352-58 and accompanying text.

6. For information on the Chinese economic reform, see generally J. CADY, ECONOMIC REFORM IN CHINA, REPORT OF THE AMERICAN ECONOMISTS STUDY TEAM TO THE PEOPLE'S REPUBLIC OF CHINA (Nov. 29 - Dec. 15, 1984). See also Huan Xiang, *Zhongguo De Jingji Tizhi Gaige (The Economic Structure Reform in China)*, Economic Reporter, Hong Kong, May 20, 1984, at 25-26; Zhong Cai, *Zhongguo Jingji Tizhi Gaige Qude Tupoxing Jinzhan (China's Economic Reform Achieved Tremendous Progress)*, Economic Reporter, Hong Kong, Oct. 1, 1985, at 18-19.

7. Cao Siyuan, *Zengqiang Qiye Huoli De Falu Cushi (Legal Means That Can Enhance The Vitality of Enterprises - Proposal on the Enactment of "Enterprise Bankruptcy and Reorganization Law")*, 11 MINZHU YU FAZHI [DEMOCRACY & LEGAL Sys.] 7 (1984).

8. *Id.*

ministrative measures against the enterprises.⁹ In the latter situation, the state would either close or merge the enterprise or change its business operation.¹⁰ The employees in these enterprises would not be affected; they continued to receive wages and even bonuses.¹¹ These measures are what Chinese often call "*Guan, Ting, Bing, Zhuan*."¹² As the economic reform progressed in depth, this practice clearly became incompatible with the prevailing economic policy and hindered further progress of the economic reform. The essential defect of this practice was its failure to relate the economic benefit of enterprises or individuals to their business performance, which is one of the basic policies underlying the economic reform. The state budgetary compensation for losses amounted to an encouragement of poor performance; administrative measures such as closing and merging the unprofitable business also failed to impose the direct negative impact on the managerial personnel and other employees directly responsible for the loss. This practice thus undermined the ongoing economic reform, which provides incentives to economic progress primarily through rewarding success and achievements. As a Chinese newspaper commentary stated, under this system

enterprises only shoulder profits, but not losses. Where they sustain loss and more loss, they did not have to bear the responsibility for them. Even though they sustain a loss, they still try to raise wages, bonuses and fringe benefits, without having to worry about the fate and future of the enterprise itself. . . .¹³

Furthermore, budgetary compensation for losses added tremendous financial burdens to the national economy by exhausting a large part of

9. Jing Xue, *Jianli Qiye Pochan Zhidu Shizai Bixing (Establishing Enterprise Bankruptcy System Being Inevitable)*, People's Daily, Aug. 10, 1986, at 3.

Discussing the practice prevailing before the bankruptcy system came into being, the author stated:

Some enterprises inappropriately manage and operate their businesses and sustain significant loss. Their assets are in fact exceeded by their debts and they already become bankrupt in fact. Under the old system, the policy was to 'protect' and 'feed' these enterprises. The loss of the enterprises was simply written off through the state budgetary appropriation. . . . In the past, some of the enterprises that sustained loss on a long term and consistent basis might be closed, terminated, merged, or changed in line of business (*Guan, Ting, Bing, Zhuan*) through administrative means. The workers continued to receive wages and bonus as usual . . .

Id.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

state revenues.

This practice also became an obstacle to the progress of economic reform in other areas. For instance, one goal of the economic reform is to enhance the independence of enterprises in business management.¹⁴ This goal was achieved to an appreciable extent by diminishing the role of state planning and the control of various local governments.¹⁵ While the increased independence of enterprises indeed brought about economic progress, instances of abuse also grew. Some enterprises issued bonuses and increased other fringe benefits when the enterprise sustained a substantial loss.¹⁶ Various administrative penalties did not seem effective,¹⁷ mainly because the existing system did not impose direct financial obligations proportionate to the increased autonomy of enterprises; therefore, no essential economic deterrence to prevent abuse existed. Mr. Cao Siyuan, the head of the working group for drafting the National Act, explained:

Only when an enterprise has to be responsible for its own survival, is there a need and can it be possible to make appropriate use of the autonomy of business management. If an enterprise has to shoulder the economic consequence of the loss, where can it find money for bonuses? If there is a threat of bankruptcy, who dares to issue and receive such a "bonus" to break the rice bowl? Therefore, relying merely on administrative means such as investigation, supervision and penalties does not suffice to prevent abuse by enterprises. The essential remedy is to allow enterprises to bear responsibility for all the consequences of their business operations. Only in this way will an enterprise not damage its long term interests for small benefit, and is there an essential guarantee for the proper use of independence in business management.¹⁸

Another example illustrating that the existing system hindered the economic readjustment is in the area of financial reform. An important development in Chinese banking practice was the adoption of fluctuating interest rates to control borrowing and capital investment, as opposed to the past practice of employing administrative means.¹⁹ The government

14. The State Council issued in May 1984, a "Decision Concerning Further Expansion of Autonomy of Industrial Enterprises", which gave greater authority to enterprises in business planning, marketing, price, capital, personnel. See Zhong Cai, *supra* note 6, at 18.

15. *Id.*

16. Cao Siyuan, *supra* note 7, at 8.

17. *Id.*

18. *Id.*

19. Lao Zhang, *Zhongguo Jingrong Guanli Tizhi Gaige De Tedian He Qushi (Features and Trends of China's Financial Structural Reform)*, Economic Reporter, Hong

was unable to prevent enterprises that were not concerned with losses, however, from borrowing at high interest rates and, as a result, financial reforms were impeded.²⁰

By late 1984, economic reform already had touched every economic sector, and it was clear that unless action was taken in this area, the ongoing reform would be undermined. Beginning in early 1985, the Chinese government began to experiment with a bankruptcy system to deal with enterprises that consistently sustained loss. A bankruptcy system was instituted in three major industrial cities: Shenyang, Chongqing and Wohan and, to a more limited extent, in Taiyuan, a major industrial city in central China.²¹ The PRC government also established a special group of experts to consider the drafting of a bankruptcy code.²² On February 10, 1985, the Shenyang city government promulgated local bankruptcy regulations, the first bankruptcy law in the history of the PRC.²³ Since mid-1984, eight enterprises in the major cities were issued bankruptcy warnings and were ordered to go through reorganization.²⁴ They were informed that unless substantive improvements occurred within one year, they would be declared bankrupt.²⁵ Most of these businesses were able to revive and become profitable under the pressure of a pending bankruptcy order. Only one of the eight enterprises eventually was declared bankrupt,²⁶ and even this enterprise demonstrated limited improvement and became profitable during the period of reorganization.²⁷ The experiments showed that while a bankruptcy system may

Kong, Nov. 25, 1985, at 27.

20. Dong, *Tanqiye Pochanzhi (Discussions on Enterprise Bankruptcy System)*, People's Daily, Oct. 10, 1986, at 2.

21. Renda Fawaihui Jianyi Genggai Pochanfa Mingcheng (*The Legal Committee of the Standing Committee of the National People's Congress Proposing to Change the Name of the Bankruptcy Law*), People's Daily, Sept. 5, 1986, at 1.

22. Cao Siyuan, *Qicao Qiye Pochanfa Xuyao Yanjiu De Rugan Wenti (Several Issues That Need To Be Studied In Drafting A Bankruptcy Enterprise Law)*, 3 FAXIU ZAZHI [J. OF JURISPRUDENCE] 3 (1985).

23. *Woshi Shixing Jiti Qiye Pochan Daobi Chuli Guiding (Our City Implementing Provisions on Bankruptcy of Urban Collective Industrial Enterprises (For Trial Use))*, Shenyang Rebao [Shenyang Daily], Feb. 11, 1985, at 1 [hereinafter *Our City*].

24. *Shenyang Chongqing Wohan San Shi Jinxing Shidian Jianli Qiye Pochan Zhiduo Qude Jingyan (Shenyang, Chongqing, Wohan Three Cities Obtaining Experience by Establishing Bankruptcy Systems)*, People's Daily, June 22, 1986, at 1 [hereinafter *Three Cities*].

25. *Id.*

26. *Id.*

27. Xing Pingan, *Shenyang Fangbao Qixiechang Pochan Xiuwen (Epilogue of the Shenyang Explosion-Proof Machinery Factory Going Bankrupt)*, People's Daily, Sept. 24, 1986, at 3.

indeed provide further incentive for enterprises to strive for excellence, its disruptive impact on the economy and society was de minimis. The experiments also provided important experience for national bankruptcy legislation²⁸ by serving as a testing ground for the national bankruptcy law that was being drafted.

B. Socialist Ideology and the Bankruptcy System

While the experimentation with a bankruptcy system was going on, the legal and economic community engaged in an intense discussion of many theoretical and practical issues surrounding the proposed bankruptcy system. The consistency of a bankruptcy system with the prevailing socialist ideology was a major area of debate. For many years, basic doctrine held that socialist enterprises could not become bankrupt, and this was regarded as an attribute that made a socialist economy superior to its capitalist counterpart.²⁹ In order to introduce a bankruptcy system, a re-examination of the existing ideology and advancement of a theoretical basis was necessary. From early 1985 to the end of 1986, major Chinese newspapers and journals carried a variety of articles and commentaries written by leading economists and jurists discussing this topic.³⁰

The theories proposed merit examination here. One scholar attributed bankruptcy to competition.³¹ Without allowing enterprises to fail, he reasoned, competition is only superficial.³² Since it is already generally recognized that a socialist economy should encourage competition, bank-

28. *Supra* note 1.

29. Dong, *supra* note 20, at 2.

30. Yin Guofeng, *Shilun Jianli Juyou Zhongguo Tese De Pochan Zhidu (Tentative Study of a Bankruptcy System With Chinese Characteristics)*, 5 ZHENGFA LUNTAN [FORUM OF LAW AND POLITICS] 53, 53-56 (1985); Yong Rongxing, *Lun Pochanfa (Study of Bankruptcy Law)*, 6 FORUM OF LAW AND POLITICS 12, 12-15 (1985); Dong, *supra* note 20, at 2; Hu Ge, *Shixing Qiye Pochan Zhidu De Yiyi (Implications of Implementing A Bankruptcy System)*, Guangming Rebao [Bright Daily], July 26, 1986, at 3; Jiang Yiwei, *Shishi Pochan Zhidu De Jiji Yiyi (The Positive Effect of Applying A Bankruptcy System)*, Jingji Rebao [Economic Daily], July 5, 1986, at 3; Jing Xue, *supra* note 9, at 3; Wang Yongjiang, *Qiye Pochan Zhidu De Jingji Gongneng (The Economic Functions of Enterprise Bankruptcy System)*, Economic Daily, July 26, 1986, at 3; Tang Zongkun, *Qiye Pochan Chuli De Jixian He Jichu (Criteria and Foundations of Enterprise Bankruptcy)*, Economic Daily, July 19, 1986, at 3; Yang Guoliang, *Qiye Pochan Lilun Zhong De Suyouzhi Wenti (Issues of Ownership System in Enterprise Bankruptcy Theory)*, Jingji Rebao [Economic Daily], July 5, 1986, at 3; Yuan Mu, *Shishi Pochanfa Shi Lishi De Biran (Implementing Bankruptcy System Is Historically Inevitable)*, Economic Daily, Aug. 2, 1986, at 4.

31. Dong, *supra* note 20, at 2.

32. *Id.*

ruptcy is not necessarily alien to the socialist system.³³ Another theory holds that a socialist economy needs to eliminate backward sectors and enterprises in order to upgrade the economy.³⁴ A bankruptcy system provides an instrument to attain this goal.³⁵ Furthermore, scholars suggested, even if bankruptcy is inherent to capitalism, socialism should not be prevented from making use of it. One writer stated: "Now some people claimed that the word 'bankruptcy' sounds very much like a capitalist phrase. However, not everything in the capitalist system is bad. We need to analyze [a bankruptcy system]."³⁶ He further argued that without benefiting from the fruits of contemporary world civilization, including advanced business management developed by the capitalist system, there will be no way to establish a socialist system.³⁷

C. Present Economic Conditions in the PRC and the Bankruptcy System

A major obstacle to implementing a bankruptcy system in China is the absence of an economic environment compatible to it.³⁸ A rational price system does not yet exist, and enterprises do not enjoy complete business autonomy.³⁹ While many enterprises suffer losses because of bad management and poor performance, a considerable number of enterprises suffer losses caused by factors beyond their control. The price system forces many enterprises to operate at a loss and depend on state appropriations to survive.⁴⁰ This is what the Chinese term "loss due to policy (*Zhengce Kuisun*)," as opposed to "loss because of bad management (*Jingying Kuisun*)."⁴¹ Many enterprises operate below maximum capacity because of inadequate energy and other public utilities.⁴² Many en-

33. *Id.*

34. Yuan Mu, *supra* note 30, at 4.

35. *Id.*

36. *Id.*

37. *Id.*

38. The adoption of the National Act was postponed several times, primarily due to the concern of some lawmakers over the development of a legal and economic environment compatible with and corresponding to the operations of the bankruptcy system. See generally *supra* note 21; see also *Pochanfa Shishi Tiaojian Shangbu Jiubei Jianyi Gaiwei Shixing Huo Zanxing Tiaoli (Conditions for Implementing A Bankruptcy System Have Not Developed; Bankruptcy Law Being Proposed to Change Into 'For Trial Use' or 'Interim')*, People's Daily, Domestic Ed., Sept. 5, 1986, at 1 [hereinafter *Conditions for Implementing*].

39. Dong, *supra* note 20, at 2.

40. *Id.*

41. *Id.*

42. About one-fifth of the industrial capacity in China is idled by power shortages.

terprises are overstuffed and operate at very high labor cost levels.⁴³ Furthermore, the lack of a system to take care of the employees displaced by bankruptcy might add an element of instability to Chinese society.

To remedy this situation, the Chinese government has taken a number of important steps since 1985. First, the ongoing economic reform already has begun to restructure the price system, helping to establish an equal footing on which enterprises may compete.⁴⁴ Second, the Chinese government launched a sweeping labor reform in October 1986 that replaced the old tenure employment in state-owned enterprises with contractual employment, thereby greatly enhancing the personnel power of enterprises.⁴⁵ Third, the Chinese government is considering enacting a new enterprise law that would further enhance the autonomy of enterprises in business management and prevent undue administrative interference from various governments.⁴⁶ Fourth, the new labor reform established a social welfare system which will provide basic living expenses to the workers displaced by bankruptcy and establish institutions and networks to help these workers locate new jobs.⁴⁷ Fifth, the government promulgated a new civil law which expressly accords the status of legal persons to enterprises and provides some basic policy guidelines on bankruptcy.⁴⁸ For instance, under article 48 of the new civil law, the liability

See Well, *Energy Plans Shift Focus*, CHINA BUS. REV., Jul.-Aug. 1986, at 16.

43. Dong, *supra* note 20, at 2.

44. Huan Xiang, *supra* note 6, at 26. The current system basically allows both the state and enterprises to set prices. Many products have negotiable prices.

45. This labor reform is based on the enactment of the four labor regulations. The four regulations are: Interim Regulations on Implementation of Labour Contracts in State-owned Enterprise; Interim Regulations of the Recruitment of Workers by State-owned Enterprises; Interim Regulations on Dismissal of Employees in Violation of Disciplines by State-owned Enterprises; and Interim Regulations of Unemployment Insurance for Employees of State-owned Enterprises [hereinafter RUI]. These regulations appeared in People's Daily, Domestic Ed., Sept. 10, 1986, at 3.

46. The draft Law of Industrial Enterprises Under the Ownership of the Entire People of the People's Republic of China (Enterprise Law) was considered by the legislators and will soon be promulgated. The proposed law provides, among other things, the independent business management rights of enterprises and also provides the protection against infringement upon such a right. *Yuan Baohua Xiang Renda Changwei Shuming Qiyefa Caoan (Mr. Yuan Baohua Explaining the Enterprise Law to the Standing Committee of the National People's Congress)*, People's Daily, Nov. 16, 1986, at 1.

47. RUI, *supra* note 45; see also section III.F, *infra*.

48. General Principles of Civil Law of the People's Republic of China, adopted by the Fourth Session of the Sixth National People's Congress on April 12, 1986 [hereinafter Civil Code], reprinted in People's Daily, April 12, 1986, at 2-3. An English translation of the Civil Code is provided in 34 AM. J. Comp. L. 715-43 (1986). For a comprehensive review of the Civil Code, see Zheng, *China's New Civil Law*, 34 AM. J. COMP.

of a state-owned enterprise extends only to the property it is authorized by the state to manage and operate. Article 49 provides for penalties against both enterprises and their legal representatives for unauthorized disposition of assets after bankruptcy.⁴⁹

These measures, once put into effect, will assist in the implementation of a bankruptcy system. However, it will be some time before measures can be implemented fully and have an impact on the economy. Further, more changes must be made in order for a bankruptcy system to operate effectively and impartially. For example, the National Act provides that an enterprise may be declared bankrupt if, among other things, it cannot repay its debts that become due. Because the ability of an enterprise to refinance its debts often depends on the availability of a fair financial market, some significant changes need to be made in the existing financial system.⁵⁰

For the two years prior to passage of the National Act, an important focus of discussion on bankruptcy law was whether a bankruptcy system should be implemented immediately or should wait until a more favorable economic environment developed. Some lawmakers contended that unless enterprises are in fact free of administrative interference and enjoy full business autonomy, "it is unfair for the enterprises to bear the responsibility for bankruptcy."⁵¹ A commentary published in an official Chinese newspaper, titled "Enterprise Bankruptcy System Should Come Out First," rebutted this view:

Without a bankruptcy system, the losses resulting from administrative interference must be made good through the profits of other enterprises, shifting the burden to other enterprises. While enterprises can never go bankrupt or be closed, undue administrative interference will continue year after year. Implementing a bankruptcy system would force those who are used to imposing restrictions on enterprises to think carefully. . . and en-

L. 669-704 (1986).

49. The relevant part of article 49 reads:

If in respect to an enterprise legal person one of the following situations exists, then in addition to the liability borne by the legal person, its legal representatives may be subject to administrative penalties or fines, or where the acts constitute crimes, investigated in accordance with law with regard to imposition of criminal penalties:

. . .

4. [The enterprise has] dealt with or disposed of property without authorization after being dissolved, cancelled or declared bankrupt.

Civil Code, *supra* note 48, art. 49.

50. See Tang, *supra* note 30, at 3.

51. *Conditions for Implementing*, *supra* note 38, at 1.

terprises facing a life or death threat will also stand up to defend their independence.⁵²

The leader of the working group for drafting the National Act noted that implementing a bankruptcy system would increase the business autonomy of enterprises, an important condition for an effective and impartial bankruptcy system.⁵³ According to him, some enterprises, comfortable under the old system of restricted autonomy, did not favor increased decision-making power in business and management.⁵⁴ Those enterprises prefer, "less power, less trouble and better hours."⁵⁵ There is no "life threat."⁵⁶ If there is a danger of bankruptcy, enterprises definitely will endeavor to expand their power without being afraid of trouble or difficulties.⁵⁷ Discussing the question whether the bankruptcy law should be implemented immediately, a leading Chinese economist stated:

Some comrades proposed that bankruptcy needs to be accompanied by other corresponding developments. I think all the economic reforms have similar needs. But it is difficult to simultaneously enact several laws and then pass a bankruptcy law. I prefer that a bankruptcy law be promulgated first and then speed up other corresponding reforms.⁵⁸

Another line of argument in favor of the immediate implementation of a bankruptcy system emphasized the existence of a fair competitive environment within each line of business or each economic sector within a given geographic area. The rationale is that although even competition in the economy as a whole does not exist because of the lack of a fair price system and adequate utility supply, enterprises in the same line of business and in the same geographic area can compete with one another.⁵⁹ Because they are ordinarily subject to the same price system and

52. *Qiyè Pochanzhidu Kiyi Xianxing (Enterprise Bankruptcy System May Come Out First)*, People's Daily, Aug. 29, 1986, at 2.

53. Cao Siyuan, *supra* note 7, at 8.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. Jiang Yiwei, *supra* note 30, at 3.

59. *Qiyè Pochafa Youli Shehui Fazhan (Enterprise Bankruptcy Law Beneficial to the Development of Society)*, People's Daily, Dec. 6, 1986, at 3. Mr. Cao Siyuan, the head of working group for drafting the National Act spoke to the reporters:

Certainly the price and tax system in our country is not yet rationalized and the price of raw materials is rising and power supply is not sufficient. These factors result in some unfair elements in the competition among enterprises. However, this should not affect the implementing of the bankruptcy system.

For enterprises within the same sector and same line of business; price, raw materials'

system of utility supply, the performance of their managerial personnel and other employees will be the decisive factor that differentiates the profitabilities of those enterprises.⁶⁰ It is therefore fair for businesses demonstrating consistently poor performance to go bankrupt.

Although some influential Chinese lawmakers favored postponing the implementation of the bankruptcy system,⁶¹ by late 1986 the prevailing view was that the immediate promulgation of a bankruptcy law could promote reform in other areas which are of significance to implementation of a bankruptcy system.⁶²

D. *Drafting of the Domestic Bankruptcy Law*

The drafting of the national bankruptcy law started in early 1985.⁶³ The Chinese government established a special drafting group consisting of experts from the Center for Economic Law Research of the State Council, State Economic Committee, State Administration of Industry and Commerce, Ministry of Finance, Ministry of Labor and Ministry of Foreign Economic Relations and Trade and other government departments.⁶⁴ The drafting group in turn established a working group in charge of specific drafting work and related investigation and research.⁶⁵ By early 1986, a draft bankruptcy law that contemplated major elements of the present National Act began to take shape. In June 1986, the drafting group, the Social Science Academy of Liaoning Province and the Shenyang City Government jointly sponsored a conference on bank-

supplies are basically the same. But why is it that some enterprises make money and others cannot but lose money? Thus, there is an issue of management and operation.
Id.

60. *Id.*

61. For an overview on the positions of lawmakers who spoke on the bankruptcy law, see generally, *Conditions for Implementing, supra* note 38.

62. According to a poll conducted by the working group for drafting the National Act, among the 924 responses it received from Shanghai and Chongqing, 84 percent were in favor of an immediate implementation of the bankruptcy law. Nine percent objected to it. See Cao Siyuan, *Guan Yu Qiye Pochan Fa Wenti De Diaocha (Investigations on the Issues Relating to Enterprise Bankruptcy Law)*, Economic Daily, June 4, 1986, at 2. Most Chinese lawmakers were also in favor of an immediate implementation of a bankruptcy law. *Daduoshu Weiyuan Zancheng Shixing Pochanfa (Majority of Members of the Standing Committee Are in Favor of Implementing Bankruptcy Law on a Trial Basis)*, People's Daily, Nov. 17, 1986, at 1.

63. Cao Siyuan, *supra* note 22, at 3.

64. *Woguo Zhengzai Zhiding Qiye Pochanfa (Our Country is Enacting Enterprise Bankruptcy Law)*, People's Daily, Feb. 5, 1986, at 1.

65. Cao Siyuan, *supra* note 22, at 3.

ruptcy law.⁶⁶ The conference was held at Shenyang, one of the four major cities where a bankruptcy system was instituted.⁶⁷ Many leading Chinese economists and scholars participated. The common view among the participants was that "time has already come for China to implement an enterprise bankruptcy law."⁶⁸

On June 16, 1986, the Standing Committee of the National People's Congress considered the draft bankruptcy law, but did not take action.⁶⁹ On August 27, the draft bankruptcy law was submitted once more to the Standing Committee for consideration.⁷⁰ At that meeting, law makers engaged in intense discussion on the feasibility of a bankruptcy system in China. The consensus was that a bankruptcy system would benefit the economy and should be established.⁷¹ The lawmakers also agreed that there had not been adequate experience with the bankruptcy system and therefore the bankruptcy law should be qualified as "interim" or "for trial use," in order to allow revision at a later time.⁷² The lawmakers, however, were divided as to the appropriateness of immediately instituting a bankruptcy system.⁷³ The session continued for a week and, because of the divergence of views among the lawmakers, the Standing Committee decided, upon the suggestion of the Chairman, to defer its decision on the draft bankruptcy law until later sessions.⁷⁴

On November 1, 1986, the Standing Committee and the State Committee of Economy and Finance jointly held a discussion on bankruptcy law.⁷⁵ The discussion lasted for eight days with participation from over

66. *Gedi Zhuanjia Taolun Qiye Pochan Lilun Yu Shijian Renwei Yi Jiubei Shishi Pochanfa Tiaojian (Specialists All Over China Discussing Theory and Practice of Enterprise Bankruptcy Law, Holding Conditions Having Developed for Implementing Bankruptcy Law)*, People's Daily, June 25, 1986, at 4.

67. *Id.*

68. *Id.*

69. *Renda Changweihui Kai Dishiliuci Huiyi (The Standing Committee of the National People's Congress Holding Its 16th Session)*, People's Daily, June 17, 1986, at 1.

70. *Renda Changwei Hui Zuo Qi Juxing Shiqici Huiyi (The Standing Committee Holding the 17th Session Since Yesterday)* (Xinhua News Agency, news release, Aug. 27, 1986).

71. *Woguo Youbiyao Zhiding Qiye Pochanfa (It is Necessary For Our Country to Enact Bankruptcy Law)* (Xinhua News Agency, news release, Aug. 27, 1986).

72. *Renda Faweihui Jianyi Genggai Pochanfa Mingcheng (The Legal Committee of the National People's Congress Proposing Changing the Name of the Bankruptcy Law)*, People's Daily, Sept. 5, 1986, at 1.

73. *Id.*

74. *Renda Changwei Hui Dishiqici Huiyi Bimu (The 17th Session of the Standing Committee of the National People's Congress Concluded)*, People's Daily, Sept. 6, 1986, at 1.

75. *Renda Changweihui Yaoqing Youguan Fangmian Zuotan Jinyibu Zhengqiou*

fifty Chinese officials from both the central and provincial governments.⁷⁶ In the meantime, the Standing Committee dispatched a "bankruptcy investigation group" together with some Committee members to conduct a ten-day investigation in Tianjin and Beijing, two leading industrial cities in north China.⁷⁷ Other Committee members visited over a dozen cities and provinces to conduct investigations.⁷⁸ The Legal Committee of the National People's Congress once more solicited opinions and comments from various departments of local and central governments on the draft law.⁷⁹

On November 15, 1986, the draft bankruptcy law was submitted to the Standing Committee at its eighteenth session.⁸⁰ During the meetings, the lawmakers considered various proposed amendments. Most of the lawmakers supported the immediate implementation of a bankruptcy law, although some influential members still insisted on postponement.⁸¹ After a prolonged session lasting seventeen days, the Standing Committee reached a decision to promulgate the Enterprise Bankruptcy Law.⁸² Apparently, for the purpose of compromise, the lawmakers decided that the National Act should become effective three months after the effective date of a separate statute entitled "Law of Industrial Enterprises Under the Ownership of the Entire People."⁸³ The specific effective date of the National Act was not provided.

The National Act consists of forty-three articles and six chapters. The draft of the National Act was intended initially to apply to all enterprises, including foreign investment enterprises and state-owned enterprises.⁸⁴ At a session held in late August 1986, the Standing Committee

Duiqiyipochanfa Yijian (The Standing Committee of the National People's Congress Holding Discussion to Further Solicit Comments on Enterprise Bankruptcy Law) (Xinhua News Agency, news release, Nov. 1, 1986).

76. *Qiye Pochanfa Jingguo Fanfu Xiugai Zaici Tijiao Renda Changweihui Shenyi (After Many Revisions Enterprise Bankruptcy Law Once More Submitted For Consideration to the Standing Committee of the National People's Congress)*, People's Daily, Nov. 15, 1986, at 3.

77. *Id.*

78. *Id.*

79. *Id.*

80. *Renda Changwei Hui Shenyi Qiyepochanfa (The Standing Committee of the National People's Congress Considering Enterprise Bankruptcy Law)*, People's Daily, Nov. 19, 1986, at 1.

81. *Id.*

82. *Tongguo Qiyepochanfa Deng Sange Falu (Adopting Three Laws Including Bankruptcy Law)* (Xinhua News Agency, news release, Dec. 2, 1986, at 1).

83. National Act, art. 43.

84. *Supra* note 71.

decided to rename the draft the "Bankruptcy Law of State-Owned Enterprises" and have it apply only to state-owned enterprises and other business entities.⁸⁵ Although the final version returned to the original name, article 2 expressly limits the application of the National Act to state-owned enterprises.⁸⁶ The change in the name from "Bankruptcy Law of State-Owned Enterprises" to "Enterprise Bankruptcy Law" (National Act) contemplates the likelihood of future revision to extend the application of the National Act to other enterprises.

E. Creation of the Bankruptcy Regime for Foreign Investment Enterprises

While the changing economic pattern and economic policy in the domestic context has led to the creation of the National Act, the need to develop a similar framework for foreign investment enterprises was also present. As in domestic enterprises, competition also made some foreign investment enterprises sustain losses on a continuing basis and become insolvent. Although the state did not have an obligation to support them financially, these insolvent enterprises often had a serious adverse impact on other businesses dealing with them, particularly creditors. If there were theoretical difficulties in allowing state-owned enterprises to go bankrupt, no similar obstacle existed in the case of foreign investment enterprises. Even the most conservative socialist ideology recognizes that a foreign investment enterprise may go bankrupt. Further, for a foreign investment enterprise located in China, most of its creditors are Chinese banks that provide credit and other Chinese entities that provide supplies. A bankruptcy system would serve to protect the economic interest of these Chinese entities.

The major policy concern in allowing a foreign investment enterprise to go bankrupt is the potential negative impact on the overall foreign investment environment — allowing an enterprise to go bankrupt could affect the general confidence of foreign investors in the profitability of investing in China. Actually a foreign investment enterprise consistently sustaining losses would affect the overall picture of the profitability of foreign investment in the PRC anyway. Therefore it would be wise to create a system to expediently terminate the existence of consistently unprofitable projects and thereby improve the overall picture of foreign investment performance in China. Further, a bankruptcy system could also give a fair opportunity to an insolvent enterprise to revive by protecting

85. *Id.*

86. National Act, art. 2.

it from the harassment of the creditors and allowing it to go through reorganization.

The necessity of a bankruptcy system governing foreign investment enterprises arose from the very time when foreign investment began to appear in the PRC. Until recently, however, the size of overall foreign investment had been small and most of the projects were still in the early stage of development, a time when most projects were expected to sustain losses.⁸⁷ In the last two years, however, the number of foreign investment enterprises significantly increased, and a considerable number of these enterprises began to operate in full capacity after completing several years' construction and preparations. The time came when the profit potential of a business became clearer for both investors and creditors, and when the earlier borrowings to finance the investment projects matured. As insolvency within the debtor and creditor relationship became a practical problem, the need to establish a bankruptcy system increased, particularly in the Special Economic Zones where a large number of foreign investment projects were located.

The government of Guangdong Province began to draft a bankruptcy law in 1984,⁸⁸ about one year before the central government embarked on drafting the National Act. The drafting efforts were apparently put on hold in 1985 and early 1986 when the central government was drafting a general bankruptcy law applicable nationwide in order to prevent duplication of legislative effort. In late August 1986, the central government decided to modify and narrow the scope of the application of the National Act to exclude the foreign-investment enterprises.⁸⁹ Since the upcoming National Act would not help resolve the problems of foreign investment enterprises in the Special Economic Zones, the drafting process of the Guangdong government once more proceeded at full speed.

87. Foreign investment came to the PRC in the late 1970s. The first Sino-foreign equity joint venture was set up in 1979. The large increase in foreign investment projects took place mainly after 1983, the year in which the PRC government promulgated the detailed implementing regulations for the earlier broadly-worded equity joint venture law. By the end of 1985, there were almost 6,800 foreign investment enterprises established in China; however, only one-third of these were actually operating. The remaining two-thirds were still at the stage of construction and development. See CHINA INTERNATIONAL ECONOMIC CONSULTANTS, CHINA INVESTMENT GUIDE 329 (3d ed. 1987).

88. *Schengrendachangwei Jiuxing Huiyi Shenyi Shenzhen Tequ Shewai Gongsi Pochan Tiaoli* (The Standing Committee of the People's Congress of the Province Holding Meetings to Consider Bankruptcy Regulations of Shenyzen Special Economic Zones for the Foreign-Relate Corporations), Shenzhen Tequbao [The Shenzhen Special Economic Zone Daily], Nov. 27, 1986, at. 1.

89. See text accompanying *supra* note 85.

On September 28, 1986, the People's Congress of Guangdong Province promulgated Regulations of Foreign-Related Corporations of the Special Economic Zones in Guangdong Province (Corporation Law) which contains two chapters relevant to bankruptcy of foreign investment enterprises.⁹⁰ One chapter on reorganization applies where a corporation is on the verge of bankruptcy while a separate chapter on liquidation governs where a corporation is dissolved because of bankruptcy.⁹¹ On November 29, 1986, four days before the central government adopted the National Act, the government of Guangdong Province passed the Bankruptcy Regulations of the Shenzhen Special Economic Zone for Foreign Related Corporations (Shenzhen Act).⁹² The Shenzhen Act consists of fifty-nine articles and eight chapters, and is scheduled to take effect on July 1, 1987.⁹³ Many of the principles and procedures of the Shenzhen Act are substantially similar to those of the National Act.

III. THE DOMESTIC BANKRUPTCY SYSTEM OF THE PRC

The domestic bankruptcy system based on the National Act and other related laws consists of six areas: (1) criteria for declaring bankruptcy, (2) bankruptcy proceedings, (3) meetings of creditors, (4) reorganization, (5) liquidation and distributions and (6) the social security system. Each of these areas is discussed below.

A. *Criteria of Bankruptcy*

The criteria for declaring bankruptcy, provided in article 3 of the National Act, consist of two elements: (1) significant losses due to inappropriate management, and (2) inability to pay debts as they mature.⁹⁴ The presence of both factors constitutes grounds for a court to declare an enterprise bankrupt.⁹⁵

The Shenyang Bankruptcy Law uses a different criterion. It provides that bankruptcy may be declared when the debts of an enterprise exceed its total assets (which include capital, cash and accounts receivable).⁹⁶

90. Corporation Law, *supra* note 2.

91. *See id.*, chs. 4, 6.

92. Shenzhen Act, *supra* note 2.

93. *Id.*, art. 49.

94. National Act, art. 3. Article 3 provides in pertinent part that: "Enterprises that sustain serious loss due to inappropriate management and that are unable to pay off debts that mature will be declared bankrupt in accordance with the provisions of this law."

95. *Id.*

96. *Our City*, *supra* note 23, at 1. Shenyang Bankruptcy Law provides two criteria.

This approach was incorporated initially into the draft National Act.⁹⁷ During the deliberations, some lawmakers and representatives of the central and local governments opposed this provision. In their opinion:

[M]any enterprises in our country possess little working capital, depending mainly on bank loans. The larger the business operation, the more they obtain bank loans. This may result in a very high ratio of debt and assets. This ratio may not therefore directly reflect the business performance of an enterprise.⁹⁸

On their suggestions, the draft National Act was amended to use business performance and ability to pay debt as the standard instead of a debt-asset relationship.⁹⁹

The first element of the National Act criteria requires a court to look into the business performance of a given enterprise to determine whether the loss is "significant" and whether the loss is caused by "inappropriate management."¹⁰⁰ This provision is designed to protect enterprises that sustained losses for reasons beyond their control from the reach of the punitive impact of a bankruptcy proceeding. To ensure a uniform and impartial application of this criterion, however, a quantifiable standard to substantiate "significant," a word not readily defineable, must be developed. Some Chinese jurists proposed a more specific standard. In an unofficial draft bankruptcy code proposed and published in late 1984,¹⁰¹ the head of the working group charged with drafting the National Act recommended that when the cumulative losses of an enterprise reach sixty percent of its net assets, a bankruptcy warning should be issued and reorganization begun.¹⁰² This approach was not adopted. Because of the great variety and significant differences among businesses, fixing a uniformly applicable and feasible standard was difficult. Nonetheless, some more specific guidelines, or more preferably, a quantifiable stan-

Another criterion is that an enterprise sustains losses for two consecutive years, with the total losses exceeding 80 percent of the net value of the capital assets of the enterprise. *Id.*

97. *Qiyepochanfa Youliyu Guoying Qiye Gaishan Jingying Guanli (Enterprise Bankruptcy Law Promoting Improvement on Operation and Management of State-Owned Enterprises)*, Economic Daily, Aug. 28, 1986, at 3.

98. *Id.*

99. *Id.*

100. See National Act, art. 3.

101. Cao Siyuan, *supra* note 7, at 7; see also *Qiye Pocha Zhengdunfa (Enterprise Bankruptcy and Reorganization Law)*, reprinted in Cao Siyuan, *supra* note 7, at Appendix A.

102. Enterprise Bankruptcy and Reorganization Law, art. 4, reprinted in Cao Siyuan, *supra* note 7, at Appendix A.

dard for each line of business or each specific sector, needs to be developed for this provision to be applied effectively.

Similar difficulties also exist in connection with determining "inappropriate management." First, it is difficult for a court, with its limited knowledge of business management and specific lines of business, to determine whether a given business decision is appropriate. Though this pitfall can be remedied partially by the assistance of specialists, a practical need exists to establish further guidelines. Second, it can be equally difficult for a court to determine whether a given loss is caused by an inappropriate management decision where other factors, for example, inadequacy of public utility support, also play a role. In this situation, the performance of similarly situated enterprises may help courts to make determinations.

The National Act provides two exceptions to the above rule.¹⁰³ First, public utilities or businesses of significance to the national interest should not be declared bankrupt if the government will provide assistance.¹⁰⁴ The precondition here is that the government provides financial support or adopts other measures to help pay the debts.¹⁰⁵ This provision leaves discretion to the government to control and limit the scale of bankruptcy for public policy purposes by economic means other than administrative measures. It also indicates that the previous practice of subsidizing enterprises sustaining losses through budgetary appropriation will continue but likely will be limited primarily to instances justified by public policy. Second, an enterprise that has provided security or a guarantee and paid back the debt within six months from the date when the petition for bankruptcy is filed will not be declared bankrupt.¹⁰⁶ The two exceptions apply only to involuntary bankruptcy.¹⁰⁷

B. *Bankruptcy Proceedings*

The National Act provides for both voluntary and involuntary bankruptcy.¹⁰⁸ There is no special bankruptcy court in China, and the People's Court where the debtor is located has jurisdiction over these proceedings.¹⁰⁹ Under article 7, creditors may apply to the People's Court for declaring a debtor bankrupt if the debtor is unable to pay the debt as

103. National Act, art. 3.

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

108. National Act, arts. 7-8. See Appendix , *infra*, for full text of articles 7-8.

109. *Id.*, art. 5.

it matures.¹¹⁰ Note that although the criteria for bankruptcy are inability to pay debt as well as sustaining loss due to poor management, the National Act does not require a petitioner in an involuntary bankruptcy proceeding to show that the debtor sustains "serious loss due to inappropriate management" in order to file a bankruptcy petition. The National Act seems to set up a trigger mechanism that allows creditors to initiate bankruptcy proceedings as long as the debtor fails to pay debts as they become due.¹¹¹ A creditor who petitions for bankruptcy needs to provide evidence showing the amount of debt, the collateral, if any, and the inability of the debtor to repay the matured debt.¹¹² The court will then determine whether other requirements for bankruptcy are met. This procedure provides easy access for creditors to courts. The ability of creditors to go to court to initiate a bankruptcy proceeding itself is a practical mechanism that can serve to compel the payment of debts.

The debtor may petition voluntarily for bankruptcy.¹¹³ A voluntary petition first must be approved by the competent department in charge of the debtor.¹¹⁴ To petition for voluntary bankruptcy, the debtor needs to describe the loss of the enterprise, provide the accounts, and a schedule listing all debts and credits.¹¹⁵ The National Act contains some provisions on the procedures to be followed in a bankruptcy proceeding, and expressly provides that procedures contained in the Civil Procedure Law shall be used in the absence of the specific National Act provisions.¹¹⁶

After receiving a bankruptcy petition, the People's Court should notify the debtor, or creditors in the case of voluntary bankruptcy.¹¹⁷ The National Act requires the People's Court to make a public announcement if the bankruptcy proceeding is initiated by the creditor.¹¹⁸ The bankruptcy law also requires the People's Court to schedule the date of the first creditor's meeting in this announcement.¹¹⁹

110. *Id.*, art. 7.

111. *See id.*

112. *Id.*

113. *Id.*, art. 8.

114. *Id.*

115. *Id.*

116. *Id.*, art. 6; *see also* Civil Procedure Law of the People's Republic of China (for Trial Use), adopted at the 22nd Session of the Standing Committee of the Fifth National People's Congress, Mar. 8, 1982 [hereinafter Civil Procedure Law], *reprinted with English translation in* 2 HONG KONG CULTURAL CO., LAWS AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA 209-226 (1984).

117. National Act, arts. 9-10.

118. *Id.*, art. 9.

119. *Id.*

After receiving notice of the bankruptcy proceeding, creditors have one month to report their claims to the People's Court.¹²⁰ When a creditor obtains the information from a notice published by the court, the period in which it must report is three months.¹²¹ The report must set forth the amount of the claims, the collateral, if any, and must be substantiated by evidence.¹²² Failure to report within the time limit is considered a waiver.¹²³ On the receipt of the claim report the court separately records the secured claims and unsecured claims.¹²⁴

When a creditor commences an involuntary bankruptcy proceeding, the debtor is required to surrender, within fifteen days of the notice, the accounts and a schedule listing all debts and credits.¹²⁵ If the debtor acts as guarantor for other businesses, it must inform the parties concerned within fifteen days after it receives notice.¹²⁶

Once a bankruptcy proceeding commences, other civil enforcement procedures against the debtors' property are suspended.¹²⁷ The National Act does not define "civil enforcement procedure (*Mimshi Zhixing Chengxiu*)." According to the Civil Procedure Law, the phrase refers to judicial acts to enforce judgements and judicial decisions.¹²⁸ Furthermore, after the bankruptcy proceeding commences, payments by the debtor to some of its creditors are void.¹²⁹ This rule does not apply to the expenses incurred by the debtor in order to maintain normal business operation.¹³⁰

Article 35 of the National Act provides that certain actions taken by a bankrupt enterprise during the period from six months prior to the commencement of the bankruptcy proceeding to the declaration of bankruptcy are void.¹³¹ These actions include: concealment of property; unauthorized division or transfer of property without adequate consideration; sale at an abnormally low price or pledging property as security for the debt previously unsecured; advance payment for a debt that does not ma-

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*, art. 10.

126. *Id.*

127. *Id.*, art. 11.

128. Civil Procedure Law, *supra* note 116, ch. 4 (*Zhixing Chengxiu* (Enforcement Procedure)).

129. National Act, art. 12.

130. *Id.*

131. *Id.*, art. 35.

ture; and relinquishment of claims.¹³² The property transferred by actions listed above will be reclaimed and included in the bankrupt estate.¹³³

This rule applies only to enterprises that eventually become bankrupt. Actions taken by a debtor in a bankruptcy proceeding will not be void if the debtor is not declared bankrupt because of improvement in its financial situation during reorganization, or through government compensation or other means.¹³⁴ Under the National Act, a bankruptcy proceeding will be suspended upon the commencement of the reorganization, which may last up to two years.¹³⁵ If the enterprise fails to improve, it will become bankrupt at the expiration of the two-year period.¹³⁶ At this point, the above rule may invalidate actions taken by the bankrupt enterprise two-and-one-half years previously and even earlier depending on the length of the bankruptcy proceedings.

This rule is important in two respects to foreign businesses in China as well as to Chinese entities in business dealings among each other. First, it increases the importance of looking into the creditworthiness of business partners, because any bankruptcy proceeding that commences in the next six months possibly could have an impact on the validity of present transactions with a partner. Second, the nature of the transaction should be considered carefully to determine whether the transaction is one of the void actions listed above. Some normal business transactions could be very close to these void actions. For instance, restructuring a debt by acquiring collateral to secure previously unsecured debt could be "providing property as security for the debts not originally secured;" invoking an acceleration clause in a loan agreement could be deemed "providing prepayment [of a] debt not [yet] due."¹³⁷ This rule, however, likely will be interpreted strictly and subject to equitable principles provided for in the General Principles of Civil Law to protect the interests of innocent third parties and maintain the stability of the economic relationship.¹³⁸ Furthermore, this rule clearly is intended to prevent the debtor from taking actions to deliberately evade the debts to the detri-

132. *Id.*

133. *Id.*

134. Article 35 of National Act defines these actions as actions taken by a "bankrupt enterprise," which means an enterprise that is *declared* bankrupt.

135. *Id.*, arts. 3, 17.

136. *Id.*, art. 22.

137. *Id.*, art. 35(iii)-(iv).

138. Civil Code, *supra* note 48, art. 4, reads: "Civil activities must be carried out in accordance with the principles of voluntariness, fairness, exchange of equivalent values, honesty and good faith."

ment of creditors. The intent of the debtor in the business transactions probably will be taken into account. Therefore, if the actions of the debtor result from contractual obligations undertaken previously, the actions probably will not be void. This rule might be clarified further through later revisions of the National Act or the promulgation of related regulations by the State Council.

C. Meetings of Creditors

The meeting of creditors consists of all creditors, each having one vote.¹³⁹ Secured creditors who do not waive their priority rights are not included in the meeting.¹⁴⁰ The guarantors of the debtor who have rendered performance on behalf of the debtor are considered creditors and may participate in meetings.¹⁴¹ The People's Court appoints a chairman of the meeting from among the creditors.¹⁴² The legal representative¹⁴³ of the debtor is required to observe meetings and answer inquiries of the creditors.¹⁴⁴

The National Act empowers the meeting to review the proof of claims to determine the amount of the claim and whether a given claim is secured.¹⁴⁵ The National Act also authorizes the meeting to consider and adopt "conciliation agreement[s]" with the debtor to restructure the debt,

139. National Act, art. 13. See Appendix, *infra*, for full text of article 13.

140. *Id.*

141. *Id.*

142. *Id.*

143. "Legal representative" is a translation of Chinese *Fading Daibiaoren*. The Supreme People's Court's ruling defines *Fading Daibiaoren* as "major executive or administrative personnel in charge of enterprises, institutions, government agencies, associations, and other economic organizations." The ruling further explains that *Fading Daibiaoren* primarily refers to three types of persons:

1) top executive, i.e., head of a factory, chairman of the Board of Directors, or where there is no chairman, the president;

2) where the top executive of an entity is not present, vice-president or persons at the same level who take charge of the business operation; and

3) where the positions of executives are not clear, the person who is actually in charge of the business operations.

The ruling further provides that other persons in the enterprise may not be *Fading Daibiaoren*. See Opinions of the Supreme People's Court on Implementing Civil Procedure Law (For Trial Use) in The Trial of Economic Cases (Sept. 17, 1984), *reprinted in* *Zuigao Renmin Fayuan Gongbao* (Supreme People's Court Bulletin), June 20, 1985, at 16.

144. National Act, art. 13.

145. *Id.*, art. 15.

and the plan for liquidation and distribution of the bankrupt estate.¹⁴⁶ The meeting may pass resolutions by a simple majority vote of the creditors present,¹⁴⁷ but the amount of claims represented by the vote must be more than half of the total unsecured claims.¹⁴⁸ The resolution concerning the "conciliation agreement" must be supported by creditors representing at least two-thirds of the total unsecured claims.¹⁴⁹

The requirement for a "simple majority vote" as one of the two conditions for the meeting of the creditors to take actions allows creditors representing claims of insignificant amounts to block the decision-making of the meeting. An example of this is where there are five creditors, one representing ninety-six percent of the total unsecured claims with the rest representing the other four percent. Under this system, three creditors representing only three percent of the total unsecured claims have enough power to prevent adoption of any resolution. The National Act does not provide remedies for the situation where creditors with large claims are prevented from adopting resolutions in their own interest, but this system seems to prevent creditors with large claims from abusing the process by forcing the meeting to act to the detriment of the creditors with only small claims.

The People's Court convenes the first meeting.¹⁵⁰ Other meetings may be held upon the initiatives of the People's Court, the chairman of the meeting, the liquidation group or the creditors representing twenty-five percent or more of the total claims.¹⁵¹ A resolution of the meeting binds all creditors.¹⁵² Creditors who oppose the resolutions on the ground of a violation of the law may petition the People's Court for a determination within seven days from the date of the resolution.¹⁵³

D. Reorganization

Under the National Act, during the bankruptcy proceeding against the debtor, the competent department in charge of the debtor may petition the People's Court for reorganization. The petition for reorganization

146. *Id.* Note that "conciliation agreement" is a translation of the Chinese phrase *Hejie Xieyi*.

147. *Id.*, art. 16. See Appendix, *infra*, for full text of article 16.

148. *Id.*

149. *Id.*

150. *Id.*, art. 14.

151. *Id.*

152. *Id.*, art. 16.

153. *Id.*

must be filed within three months after the court has received the case.¹⁵⁴ This provision applies only to the involuntary bankruptcy proceeding, that is, the proceeding initiated by the petition of creditors.¹⁵⁵ The maximum period for reorganization is two years.¹⁵⁶ Although the reorganization is based on petition, the National Act does not provide the authority to the People's Court to reject the petition or the right of creditors to challenge the petition.

After the petition for reorganization is filed, the debtor should propose a conciliation agreement to the meeting.¹⁵⁷ The National Act does not define or provide for further requirements on the conciliation agreement. Presumably, the basic objective of the agreement is to restructure the debt to allow the debtor an opportunity to prosper. The National Act requires that the agreement provide the date of maturity of the debt and be confirmed by the court.¹⁵⁸ The court then makes a public announcement of reorganization and suspends the bankruptcy proceeding.¹⁵⁹ The conciliation agreement takes effect on the date of public announcement.¹⁶⁰ The National Act does not provide a remedy where the debtor and creditors fail to reach a conciliation agreement. Whether the court will go ahead to declare bankruptcy or impose a conciliation agreement that the court considers reasonable is unclear.

The reorganization is in control of the competent department in charge of the debtor.¹⁶¹ The National Act requires the department to propose a reorganization plan to be discussed by an assembly of the employees' representatives.¹⁶² This provision was not in early drafts of the National Act¹⁶³ and was added at the last session of the Standing Committee.¹⁶⁴ The department must also inform the meeting of the creditors of the progress of the reorganization on a regular basis.¹⁶⁵

After reorganization, if the debtor can pay off the debt in accordance with the conciliation agreement, the People's Court should terminate the

154. *Id.*, art. 17.

155. *Id.*

156. *Id.*

157. *Id.*, art. 18.

158. *Id.*

159. *Id.*, art. 19.

160. *Id.*

161. *Id.*, art. 20.

162. *Id.*

163. *Daduoshu Weiyuan Zanchang Shixing Pochanfa*, *supra* note 62, at 1.

164. *Id.*

165. National Act. art. 20.

bankruptcy proceeding and make a public announcement.¹⁶⁶ If the debtor is unable to pay off the debt, upon the expiration of the two-year reorganization period, the People's Court will declare the debtor bankrupt and will notify the creditors to reschedule the claims.¹⁶⁷ Upon the petition of the meeting of the creditors, the People's Court has the power to terminate reorganization at any time during the two-year reorganization period if the debtor fails to comply with the conciliation agreement or its financial situation continues to deteriorate.¹⁶⁸ Furthermore, if a debtor in reorganization takes certain action that seriously damages the interest of creditors, the People's Court may terminate the reorganization and declare the debtor bankrupt.¹⁶⁹

E. Liquidation and Distribution

Upon the declaration of bankruptcy, the People's Court will establish a liquidation group within fifteen days to take over the bankrupt enterprise.¹⁷⁰ The group consists of representatives from the competent department in charge of the debtor, governmental departments in charge of finance, and other departments and agencies.¹⁷¹ The group also includes specialists in the pertinent line of business.¹⁷² The People's Court appoints members of the group,¹⁷³ which answers and reports its work to the People's Court.¹⁷⁴

The liquidation group has full power to care for, liquidate, dispose of and distribute the bankrupt estate,¹⁷⁵ a function similar to that of a trustee in United States bankruptcy proceedings. The debtors of the bankrupt enterprises may render their payment only to the group.¹⁷⁶ The group may determine whether or not to perform the executory contracts of the bankrupt enterprise.¹⁷⁷ When a termination of a contract by the group results in losses to the other party to the contract, the party affected may raise bankruptcy claims against the bankrupt estate in an

166. *Id.*, art. 22. See Appendix, *infra*, for full text of article 22.

167. *Id.*

168. *Id.*, art. 21(i)-(ii).

169. *Id.*; see also *id.*, art. 35.

170. *Id.*, art. 24.

171. *Id.*; see *infra* notes 249-51 and accompanying text for discussions on a similar organization in Shenyang.

172. National Act, art. 24.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*, art. 25.

177. *Id.*, art. 26.

amount equal to the damages.¹⁷⁸

The bankruptcy estate consists of three kinds of property: (1) all the assets the bankrupt enterprise managed and operated at time of bankruptcy; (2) assets acquired by the bankrupt enterprise; and (3) other property rights of the bankrupt enterprise.¹⁷⁹ The state is the owner of the bankrupt enterprise and the enterprise itself only has the right of management and operation. The assets "managed and operated" by the bankrupt enterprise refers to the property under its control for business operations. This provision is consistent with article 49 of the General Principles of Civil Law which provides that the liability of a legal person for a state-owned enterprise extends to the property he manages and operates.¹⁸⁰ The bankrupt estate does not include the assets that were used as collateral.¹⁸¹ The part of the collateral that exceeds the amount of the secured debt, however, is part of the bankrupt estate.¹⁸²

The bankruptcy estate does not include property that is in the possession of the bankrupt enterprise but that does not belong to it. Under article 29, the owner may recover such property from the liquidation group without following the liquidation procedure.¹⁸³ This apparently allows the owner to reclaim the property prior to the distribution of the bankrupt estate. The National Act, however, does not provide a standard by which such property may be distinguished from other claims. It seems, however, that property leased to the bankrupt enterprise falls within this category. Bank loans may not be recovered from the cash possessed by the company as "property that does not belong to the enterprise," and neither may property sold to the debtor if the purchase price has not yet been paid. The test in this context is probably where title is vested.

Bankrupt claims include unsecured debts of the bankrupt enterprise and secured debts when the secured creditor has relinquished its priority right.¹⁸⁴ The expenses incurred by creditors for the bankruptcy proceedings may not be considered claims.¹⁸⁵ The debts of a bankrupt enterprise that do not mature at time of bankruptcy are considered due and as scheduled claims.¹⁸⁶ If a creditor is indebted to the bankrupt enterprise,

178. *Id.*

179. *Id.*, art. 28.

180. Civil Code, *supra* note 48, art. 49.

181. National Act, art. 28.

182. *Id.*

183. *Id.*, art. 29.

184. *Id.*, art. 30.

185. *Id.*

186. *Id.*, art. 31.

the debtor can offset the creditor's debts against the creditor's claims prior to the liquidation.¹⁸⁷ If the debt owed to a secured creditor by a bankrupt enterprise exceeds the amount of collateral, the excess is treated as an ordinary bankrupt claim.¹⁸⁸

The secured creditor will be paid first in the liquidation from the collateral.¹⁸⁹ The bankruptcy expenses then are paid out of the bankruptcy estate.¹⁹⁰ Bankruptcy expenses include: (1) expenses for the administration and distribution of the bankrupt estate, including expenses for hiring experts for the administration of the estate; (2) the litigation costs of the bankruptcy proceedings; and (3) other expenses incurred in the bankruptcy proceedings for the common interests of creditors.¹⁹¹ The National Act does not contain provisions that distinguish these three expenses; therefore, these expenses likely have the same priority. If the bankrupt estate is not sufficient for the payment of these bankruptcy expenses, the People's Court will terminate the bankruptcy proceedings.¹⁹²

The next step is the distribution among the unsecured creditors. The liquidation group proposes a distribution plan to be considered and approved by the meeting of the creditors,¹⁹³ and then reported to the People's Court for a decision before its implementation.¹⁹⁴ After satisfying bankruptcy expenses, the rest of the estate is distributed in the following order of priority in accordance with the distribution plan: (1) employees' wages and labour insurance; (2) taxes; and (3) claims of creditors.¹⁹⁵ If the estate is not adequate to satisfy claims of the same priority, the distribution is divided pro rata among the claimants.¹⁹⁶ Upon the completion of the distribution, the bankruptcy proceeding terminates and the liquidation group reports to the registration department of the government to cancel the business registration of the bankrupt enterprise.¹⁹⁷

One purpose of the National Act is to penalize enterprises for poor performance along with those who are responsible for it in order to provide incentives for economic progress. To achieve this goal, the National Act provides that the "supervisory . . . and auditing departments" and

187. *Id.*, art. 33.

188. *Id.*, art. 32.

189. *Id.*

190. *Id.*, art. 34.

191. *Id.*

192. *Id.*

193. *Id.*, art. 37.

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*, arts. 38-39.

the accounting departments of the government shall investigate and determine the responsibility for the enterprise's failure.¹⁹⁸ When the leaders of the enterprise are primarily responsible, administrative penalties will be imposed on them.¹⁹⁹ If the bankruptcy results from a poor decision or interference of a higher-level supervisory department, the person directly responsible is subject to administrative penalties.²⁰⁰ The National Act also incorporates article 187 of the Criminal Law and provides that if a person in charge causes significant damage to the state property through negligence, he may be sentenced to up to five years imprisonment.²⁰¹ The Ministry will set up departments in various parts²⁰² of China to oversee government officials, including leaders in state-owned enterprises.²⁰³ The penalty provisions of the National Act will be strengthened further by the "Law of Industrial Enterprises Under the Ownership of the Entire People" to be enacted as a part of the implementation package of the National Act.²⁰⁴ The draft of this enterprise law imposes specific administrative, economic and criminal penalties on the leaders of enterprises who have caused significant loss to enterprises.²⁰⁵ As in the National Act, it also provides for penalties and liabilities against higher-level government officials whose instructions or

198. *Id.*, art. 42.

199. *Id.*

200. *Id.* The "supervisory . . . and auditing departments (*Jiancha Bumen*)" provided in the National Act refer to a system to be established nationwide and headed by a "Ministry of Supervision and Investigation."

201. *See id.*; *see also* Criminal Law of the People's Republic of China, art. 187, adopted on Jul. 1, 1979 by the second session of the Fifth National People's Congress, *reprinted in English* in 73 J. CRIM. L. & CRIMINOLOGY 138 (1982).

202. *Zhongguo Jiang Sheli Jianchabu (China Will Establish Ministry of Supervision and Investigation)* (Xinhua News Agency, news release, Nov. 27, 1986). The report reads:

The Premier of the State Council, Zhao Ziyang, submitted a bill today to the 18th Session of the Standing Committee of the National People's Congress to establish the Ministry of the Supervision and Investigation of the People's Republic of China.

According to this bill, the State Council will set up the Ministry of Supervision and Investigation and regional governments at the county level or above will set up corresponding supervisory and investigatory departments.

203. *Id.* Vice Premier Qiao Shi explained that the tasks of the supervisory and investigatory departments include but are not limited to: (1) investigation and supervision of the implementation of state policies and laws; and (2) imposition of administrative penalties on those violating the state policies, laws and disciplines.

204. *Qiyefa Ying Jinkuai Shenyi Tongguo (Enterprises Law Should be Considered and Passed As Soon As Possible)* (Xinhua News Agency, news release, Nov. 21, 1986).

205. *Id.*

interference have resulted in significant losses to businesses.²⁰⁶

After liquidation and distribution, the enterprise will cease to exist. The former workers will become unemployed and be covered by a social security system under which they may receive only an allowance for living expenses for a limited period of time or until they find another job.²⁰⁷ Thus, the economic interest of the workers will be related directly to the fate of the enterprises and compel employees to work hard to prevent bankruptcy.

Chinese practice ordinarily distinguishes *Zhigong* (workers) from *Ganbu* (cadres). The latter usually refers to the managerial personnel. Under article 4 of the National Act, workers lose their jobs upon bankruptcy,²⁰⁸ but it is unclear whether the cadres will suffer the same fate. In practice, when an enterprise is in trouble, the leader usually is transferred and a new leader is appointed. If the leader of an enterprise would have to become unemployed if the enterprise went bankrupt, few people would be interested in assuming a position in an enterprise having problems. This probably explains why the National Act left this issue open.

The prevailing view, however, seems to oppose any special treatment for leaders. According to a poll conducted by the working group for drafting the National Act, ninety-five percent preferred that leaders of a bankrupt enterprise be subject to unemployment as well.²⁰⁹ Because leaders are in charge of daily management of the enterprise, it is essential to exert pressure on them as in the case of other employees. In addition, they participate directly in the decision-making and policy implementation of the enterprise. They bear greater responsibility for the poor performance of the enterprises than ordinary workers and therefore should not be immune from the consequences of bankruptcy. Thus, the National Act should make it clear that the cadres have to shoulder the punitive impact of the bankruptcy as well.

F. Social Security System

A major concern of Chinese lawmakers in enacting a bankruptcy system is how to take care of workers displaced by a bankruptcy. Without a fair and effective system, displaced workers could become an element of instability within society, undermining the established social order. The draft National Act contained a special chapter concerning the placement

206. See National Act, art. 4. For a detailed discussion, see section III.F, *infra*.

207. National Act, art. 4.

208. *Id.*

209. Cao Siyuan, *supra* note 62, at 2.

and welfare of the workers of bankrupt enterprises.²¹⁰ Legislation passed during the drafting of the Act rendered this chapter unnecessary. On July 12, 1986, the State Council launched an important labor reform which provided much greater discretion to state-owned enterprises to hire and dismiss employees.²¹¹ In anticipation that the reform would lead to unemployment on a regular basis, the State Council enacted, as part of the reform package, the Interim Provisions on Unemployment Insurance of Employees of State-Owned Enterprises (RUI) which set up a social security system to provide for those who become unemployed either because of resignation, dismissal or bankruptcy. Because RUI is basically identical to the chapter of the draft National Act governing the social security system, the chapter was removed. An article was added to the draft National Act providing that "the state shall appropriately handle the living expenses of the workers in a bankrupt enterprise, and the State Council shall separately make specific provisions."²¹² This provision was revised further to be incorporated into article 4 of the National Act, which obligates the state to guarantee the basic needs for living to the workers of a bankrupt enterprise and to provide various assistance for them to locate new jobs.²¹³

RUI sets up an Unemployment Insurance Fund (Fund) which consists of three items: (1) a payment by the enterprise equivalent to one percent of the total payroll of the workers hired through contracts; (2) the interest accruing on the balance of the Fund; and (3) local government appropriations.²¹⁴ The Fund is in the charge of the labor service company established under RUI as an affiliate of the local labor administrative agencies.²¹⁵ RUI authorizes the Ministry of Labor and the Ministry of Finance jointly to enact the rules for the administration of the Fund.²¹⁶ RUI also states that regional government appropriation shall provide support when the Fund is inadequate.²¹⁷

The Fund grants unemployment compensation to workers who become unemployed because of bankruptcy, reorganizations, dismissal, or termination of their employment contract.²¹⁸ The Fund provides medical

210. This part was provided in chapter 6 of the draft Act prior to August 1986.

211. See *supra* note 45 and accompanying text.

212. See *supra* note 97.

213. National Act, art. 4.

214. RUI, *supra* note 45, art. 3.

215. *Id.*, art. 12.

216. *Id.*, art. 4.

217. *Id.*

218. *Id.*, art. 6.

expenses during the period of unemployment.²¹⁹ The Fund also covers expenses for managing the Fund, training the unemployed, encouraging the unemployed to provide self-help, and compensating for funerals and other related expenses of former employees of a bankrupt or reorganized enterprise.²²⁰ The unemployment compensation is based on the average wages of the person for the two-year period preceding the unemployment,²²¹ and is provided until the worker becomes employed or reaches the maximum compensation period.²²² The amount of compensation for the first twelve months is sixty to seventy-five percent of the average wages and the amount for the following twelve months is fifty percent.²²³ The duration of payment is based on seniority. Persons with a history of employment for five years or more have a compensation period of twenty-four months.²²⁴ For persons with an employment history of less than five years, the maximum compensation period is twelve months.²²⁵ The payment of compensation will cease if the recipient twice declines, without justification, employment offered by the pertinent agencies or the recipient commits a crime and is imprisoned under the criminal law.²²⁶

IV. THE FIRST BANKRUPTCY CASE IN THE PRC: SHENYANG EXPLOSION-PROOF EQUIPMENT FACTORY

Since early 1985, the Chinese government has experimented with a bankruptcy system in some selected regions. A bankruptcy system was first instituted and most systematically implemented in Shenyang. In February 1985, the Shenyang city government promulgated "Provisions on Bankruptcy of Urban Collective Industrial Enterprises (For Trial Use)" (PB).²²⁷ The PB consists of twenty articles which broadly outline a basic bankruptcy framework, substantially similar to the National Act,²²⁸ though differing in some respects.

One difference between the PB and the National Act is that the PB uses different criteria for determining bankruptcy. Under the PB, if the debts of an enterprise exceed its total assets, or the enterprise sustained a

219. *Id.*

220. *Id.*

221. *Id.*, art. 7.

222. *Id.*

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*, art. 9.

227. *Our City*, *supra* note 23, at 1.

228. *Id.*

loss consecutively for two years totaling over eighty percent of its net capital investment, an enterprise is considered to have reached the level of bankruptcy.²²⁹ Unless it improves its financial situation within a year through reorganization, it will be declared bankrupt.²³⁰ The Shenyang city government announced on August 3, 1985 that three enterprises already reached the level of bankruptcy and issued "bankruptcy warnings" and orders of reorganization.²³¹

Shenyang Explosion-Proof Equipment Factory (SEF) was one of the three enterprises. By 1985 the enterprise's cumulative loss was 490,000 yuan and its debts amounted to 492,000 yuan, while the total assets of SEF in book value were only about 300,000 yuan.²³² After one year of reorganization, the other two enterprises began to show improvement while the financial situation of SEF continued to deteriorate.²³³ On August 3, 1986, one year after the bankruptcy warning was issued, the Shenyang government, upon the request of creditors, declared that SEF was bankrupt and revoked its business license.²³⁴ SEF thus became the first enterprise declared bankrupt in the history of the People's Republic of China.²³⁵

SEF failed primarily because of poor management. According to a report from an official Chinese newspaper, the managerial personnel of SEF had little knowledge of basic management skills.²³⁶ A former top executive had served two years in prison for theft.²³⁷ Allegedly, management was more concerned with personal gains than with the interest of SEF.²³⁸ While the company was suffering losses and workers were laid off, the management continued to receive bonuses every month in an

229. *Id.*

230. *Id.*

231. See *supra* note 24 and accompanying text.

232. *Shenyang Fangbao Qixie Chang Xuangao Pochan (Shenyang Explosion-Proof Equipment Factory Declared Bankrupt)*, People's Daily, July 25, 1986, at 1 [hereinafter *Shenyang Explosion-Proof*]. These statistics are cited differently in other news reports. Another report stating that the total debts of SEF is 503,000 yuan. See Xinhua News Agency, news release, Sept. 25, 1986. Less than a month later, the same news agency issued another release stating that the debts of the SEF were 423,900 yuan. Note: one dollar equals about 3.73 yuan in accordance with the current official exchange rate. People's Daily, March 14, 1987, at 3.

233. *Three Cities*, *supra* note 24 at 1.

234. *Shenyang Explosion-Proof*, *supra* note 232, at 1.

235. *Id.*

236. *Shenyang Fangbao Qixie Chang Weihe Pochang (Why SEF Is Going Bankrupt)*, People's Daily, Aug. 7, 1986, at 3.

237. *Id.*

238. *Id.*

amount equivalent to about seven to twelve percent of their regular monthly pay.²³⁹ The poor quality of the work force was also a factor.²⁴⁰ Under the old labor system enterprises did not have the freedom to directly hire and dismiss workers. SEF was forced to hire five mentally-retarded persons who could not work and paid them the same wages as other workers.²⁴¹ None of the employees had a college education.²⁴²

Under the practice prevailing in the past, if the enterprise that suffered loss was a state-owned enterprise, the government would compensate for the loss through state budgetary appropriation.²⁴³ For enterprises under collective ownership like SEF, the government ordinarily provided no direct financial assistance. Borrowing from banks and assistance from other healthy businesses were the major means to keep the enterprise alive. In March 1985, an administrative order assigned SEF to the "custody" of Shenyang No. 3 Car Factory (SCF), a profitable company.²⁴⁴ SCF was asked to provide direct financial assistance in the guise of business transactions. Although SCF did not need workers, SEF sent fourteen workers to SCF to provide "services" and was paid 120 yuan monthly for each.²⁴⁵ SEF also processed components for SCF, and charged a fee ten times that which SCF ordinarily would incur.²⁴⁶ The result was that SCF bore an unfair financial burden while SEF continued to sustain losses. This basically was the prevailing practice until the bankruptcy system was instituted.

Under the PB, once an enterprise is declared bankrupt, all its assets are frozen.²⁴⁷ The departments of industrial and commercial administration take over the assets and serve as a trustee for liquidation and distribution.²⁴⁸ After SEF was declared bankrupt, a "Supervision and Administration Committee" was formed to take charge of SEF's liquidation and distribution, with a power similar to the liquidation group under the National Act.²⁴⁹ The committee consisted of representatives from the de-

239. Wu Xianguang, *Guochi De Renshi (Belated Awareness)*, Shenyang Rebao [Shenyang Daily], Aug. 4, 1986, at 3 [hereinafter *Belated Awareness*].

240. *Why SEF Going Bankrupt*, *supra* note 236, at 3.

241. *Belated Awareness*, *supra* note 239, at 3.

242. *Why SEF Going Bankrupt*, *supra* note 236, at 3.

243. *See supra* notes 9-12 and accompanying text.

244. Meng Xiaoyun, *Pochan Qishi (Enlightenment from a Bankruptcy Case)*, People's Daily, May 12, 1986, at 12.

245. *Id.*

246. *Id.*

247. *Our City*, *supra* note 23, at 1.

248. *Id.*

249. *Fangbao Qixiechang Bei Gongshanjie Chushi Hongpai Xuangao Pochan (SEF*

partments of industrial and commercial administration, labor regulatory departments, and the assembly of employees' representatives.²⁵⁰ The committee scheduled and appraised all of SEF's assets and decided to put the entire factory up for auction.²⁵¹ On September 25, 1986, SEF was sold at a public auction to the Construction Department of Shenyang Gas Supply Company for 200,000 yuan.²⁵² In the meantime, the committee scheduled claims of creditors and prepared for distribution.²⁵³ About 120 creditors filed claims totaling about 423,900 yuan against SEF.²⁵⁴ Proceeds from the sale of the assets plus the realized income from accounts receivable constituted the bankrupt estate, totaling 222,000 yuan.²⁵⁵ The bankrupt estate then was distributed pro rata to the creditors, each receiving approximately fifty percent of its claims.²⁵⁶

The PB directly extends the punitive impact of the bankruptcy to the employees by providing that employees' salaries be reduced for the first six months following bankruptcy; afterwards, they may only receive monthly living allowances.²⁵⁷ The PB also provides that management personnel at the level of general manager or higher do not receive salaries from the date of bankruptcy.²⁵⁸ They receive a living allowance only.²⁵⁹ This general rule was applied to the former employees of SEF. Except for the eleven handicapped and sick employees who were given special treatment and fifteen others who were allowed to retire, all other employees were given seventy-five percent of their regular pay for the first six months after the date of the bankruptcy.²⁶⁰ Thereafter they received only a monthly thirty yuan allowance for the next eighteen months or until they found another job.²⁶¹ If an employee had dependents, he could receive an additional fifteen yuan for one dependent, twenty-five yuan for two dependents, and thirty-five yuan for three de-

Was Shown 'Red Flag' and Declared Bankrupt), Shenyang Rebao [Shenyang Daily], Aug. 4, 1986, at 1.

250. *Id.*

251. *Shenyang Fangbao Qixiechang Zongti Paimai (SEF Being Sold As a Whole)*, (Xinhua News Agency, news release, Sept. 25, 1986).

252. *Id.*

253. *Shenyang Fangbao Qixiechang Kaishi Changhuan Zhaiwu (SEF Starting To Pay Back Debts)* (Xinhua News Agency, news release, Oct. 17, 1986).

254. *Id.*

255. *Id.*

256. *Id.*

257. *Our City*, *supra* note 23, at 1.

258. *Id.*

259. *Id.*

260. Xing Pingan, *supra* note 27, at 3.

261. *Id.*

pendents,²⁶² but the total he received could not exceed his regular monthly pay.²⁶³ The insurance company of the city took charge of the distribution of the allowance.²⁶⁴

It is unclear whether the provision for terminating salary payments to the senior executives actually was implemented. The president serving the last term was assigned to SEF through administrative order when SEF was ordered to go through reorganization.²⁶⁵ The government could not find anyone willing to take care of the mess, and the SEF employees refused to elect a president from the managerial staff because of their lack of trust in management.²⁶⁶ When SEF was advertized for leasing, over thirty people came and looked at SEF, but no one was willing to take over and operate SEF on a leasing basis.²⁶⁷ This last president undertook a very difficult task and should not be penalized. The committee decided to review the performance of the three prior presidents and audit the accounts to determine their responsibilities.²⁶⁸

The experience of SEF is significant to the development of a bankruptcy system in China. It demonstrates clearly to Chinese policy-makers the operation of a bankruptcy system and its potential social and economic impacts. The experience helped to eliminate bias against a bankruptcy system and to persuade most of the Chinese people to accept the notion of bankruptcy. It facilitated the legislative process of the national bankruptcy law that was progressing simultaneously with the bankruptcy proceeding of SEF.²⁶⁹ Many provisions of the national bankruptcy legislation could be tested immediately in the ongoing bankruptcy proceedings. The experience of SEF and the application of the PB to the case of SEF also provide a sound basis for national lawmakers to predict with reasonable certainty whether a given provision of the national bankruptcy law would work. Furthermore, the case of SEF revealed

262. *Id.*

263. *Id.*

264. *Id.*

265. *Id.*

266. *Id.*

267. *Id.* Leasing out the state-owned enterprises to operate and receive rent is another experiment going on in Shenyang to rescue and deal with state-owned enterprises sustaining loss. See *infra* note 349 and accompanying text.

268. *Shenyang Explosion-Proof, supra* note 232, at 1.

269. See *Three Cities, supra* note 24, at 1. The significance of the PB to the progress of the National Act was recognized. According to Mr. Cao Siyuan, the head of the working group for drafting the Act, the experiments in Shenyang as well as other cities already provided the enactment of the National Act with practical experience that would benefit the national legislation. *Id.*

many new issues in the bankruptcy system to the national lawmakers and thus helped them develop a more comprehensive and effective bankruptcy system. The bankruptcy proceedings of SEF terminated around November 1, 1986, after the completion of the distribution.²⁷⁰ About one month later the Central government promulgated the Enterprise Bankruptcy Law.

V. BANKRUPTCY LAW GOVERNING FOREIGN INVESTMENT ENTERPRISES

Bankruptcy law applicable to foreign investment enterprises exists at present only in the Shenzhen Special Economic Zone, and is based primarily on the Shenzhen Act and two pertinent chapters in the Corporation Law. This regime applies to all major foreign investment enterprises such as wholly foreign-owned enterprises, equity and contractual joint ventures, including the "Sino-foreign joint stock company," a foreign investment stock corporation established by issuing shares to the general public.²⁷¹ The bankruptcy system governing foreign investment enterprises is substantially similar to that applicable to purely domestic state-owned enterprises. The following sections highlight special provisions of the bankruptcy system governing foreign investment enterprises that are not found in the domestic system discussed above.

A. *Bankruptcy Proceedings*

The criteria for bankruptcy under the Shenzhen Act are different from those of the National Act, but are similar to those of the PB. The Shenzhen Act uses an asset and debt ratio as the test and provides that a court may declare a foreign investment enterprise bankrupt if all its assets do not suffice to pay off its debts that mature.²⁷² This test apparently excludes enterprises that become insolvent merely because of a shortage of cash, and it thus represents a stricter standard than that of the Na-

270. Xing Pingan, *supra* note 27, at 3.

271. Bankruptcy Regulations of the Shenzhen Special Economic Zones for Foreign-Related Corporations, art. 2, adopted at the 23d Session of the Standing Committee of the 6th People's Congress of Guangdong Province on Nov. 29, 1986, *reprinted in* Shenzhen Tequbao [Shenzhen Special Economic Zone Daily], Dec. 10, 1986, at 2 [hereinafter Shenzhen Act]; Regulations of Foreign-Related Corporations of the Special Economic Zones in Guangdong Province, art. 2, adopted at the 22d Session of the Standing Committee of the 6th People's Congress of Guangdong Province on Sept. 28, 1986, *reprinted in* Economic Reporter, Hong Kong, Nov. 10, 1986, at 31-33 [hereinafter Corporation Law].

272. Shenzhen Act, art. 3.

tional Act which merely requires a showing that an enterprise has sustained serious losses and is unable to pay off debts that mature. Thus, under the Shenzhen Act, a creditor may not apply for the court to declare a debtor bankrupt simply because the debtor is unable to pay off the debts.

Under the Shenzhen Act, the initiation and process of bankruptcy proceedings follow a procedure similar to that of the National Act. The discrepancies exist in the following areas. First, a voluntary bankruptcy may be initiated by the debtor under the Shenzhen Act on the basis of a resolution of the board or the shareholders' meeting without the necessity of obtaining initial approval from the competent authority in charge as provided in the National Act.²⁷³ Second, the Shenzhen Act imposes a time limit on the bankruptcy proceedings; the period from the declaration of bankruptcy to the termination of the bankruptcy proceedings may not last longer than 180 days, unless a court decision provides otherwise.²⁷⁴ The National Act does not have a similar time limitation. Third, the Shenzhen Act defines bankruptcy claims in a way significantly different from that of the National Act. Unlike the National Act, which considers damages for termination of a contract by the liquidation group bankruptcy claims,²⁷⁵ the Shenzhen Act expressly provides that damages and penalties for breach of a contract resulting from a declaration of bankruptcy may not be regarded as bankruptcy claims.²⁷⁶ The Shenzhen Act further provides that interest accrued from claims after the declaration of bankruptcy may not be considered claims.²⁷⁷ This is not clear under the National Act.

B. *Reorganization and Liquidation Under the Corporation Law*

The Corporation Law, which took effect on January 1, 1987, contains chapters on reorganization and liquidations which apply, among other things, where a corporation is on the verge of bankruptcy or is declared bankrupt.²⁷⁸ These rules constitute the only bankruptcy law in this area

273. *Id.*, arts. 7-8. Whether the resolution should be adopted by the board or by the shareholders' meeting depends on the provisions of the articles of association and also the provisions of law. For a stock corporation, the Corporation Law expressly requires that a resolution on reorganization or liquidation must be approved by the shareholders' meeting. Corporation Law, art. 57.

274. Shenzhen Act, art. 28.

275. National Act, art. 26.

276. Shenzhen Act, art. 34.

277. *Id.*

278. Corporation Law, arts. 106, 107, 128.

until July 1, 1987, when the Shenzhen Act becomes effective.²⁷⁹ Afterwards, these rules, particularly the chapter on reorganization, an area not provided for in the Shenzhen Act, will be concurrently effective with the bankruptcy rules provided by the Shenzhen Act. The liquidation procedure of the Corporation Law will probably be preempted by the Shenzhen Act for bankruptcy cases in the Shenzhen Special Economic Zone. This would be the case especially where the procedures of the Corporation Law are different from those of the Shenzhen Act. The liquidation procedures of the Corporation Law, however, have much broader application than those of the Shenzhen Act. Unlike the Shenzhen Act, the Corporation Law applies to all three special economic zones in Guangdong Province.²⁸⁰ Further, the liquidation procedure of the Corporation Law also applies where a corporation voluntarily dissolves for reasons other than bankruptcy.

1. Reorganization Under the Corporation Law

The Corporation Law defines reorganization as adjustments made in order for a foreign-related corporation in financial difficulty and at the verge of bankruptcy to recover from difficulties and reestablish normal business operations.²⁸¹ Corporations allowed to undergo reorganization must meet one of the four conditions: 1) equipment or technology of the corporation is advanced; 2) products are urgently needed in Chinese society; 3) there is a large amount of investment and a comparatively long turn-around period; 4) bankruptcy may result in significant negative consequences.²⁸² These requirements seem to limit reorganizations only to those corporations whose survival is beneficial to the national economy.

Reorganization must be approved by the competent department at a higher level directly in charge of the corporation.²⁸³ To apply for reorganization, the applicant must report the financial situation of the corporation. This includes submitting a balance sheet and statement of losses and profits, and the applicant must explain the justification for the reorganization and propose a plan to carry it out.²⁸⁴ The competent department will render its decision within thirty days after receiving the appli-

279. Shenzhen Act, art. 59.

280. Corporation Law, art. 1.

281. *Id.*, art. 106.

282. *Id.*, art. 107.

283. *Id.*, art. 106.

284. *Id.*, art. 109.

cation.²⁸⁵ The Corporation Law does not seem to provide an opportunity for the creditors to have a voice in whether a corporation should go through reorganization.

Within fifteen days after the reorganization is approved, the shareholders' meeting or the board shall establish a reorganization group consisting of three to five persons.²⁸⁶ The board or the shareholders' meeting shall appoint the head of the group.²⁸⁷ Shareholders, directors and other outside specialists all may become members of the group.²⁸⁸ The reorganization group will take over the management of the corporation, including the power of the board, and represent the corporation in its dealings with third parties.²⁸⁹

The Corporation Law provides that the competent department in charge and the creditors each may appoint one or two reorganization supervisors.²⁹⁰ The supervisors representing creditors are appointed based on the agreement of the creditors.²⁹¹ If such an agreement fails, the creditors that represent a comparatively larger amount of the credits have the right to make the appointment.²⁹² The Corporation Law does not further specify in quantitative terms the meaning of "comparatively larger amount." The reorganization supervisors participate in the reorganization on a regular basis. When the reorganization group disposes of corporation assets or concludes contracts on behalf of the corporation with a third party, it must obtain consent from the reorganization supervisors.²⁹³ Further, the making and implementing of the reorganization plan must also be approved by the reorganization supervisor.²⁹⁴ If reorganization supervisors cannot reach an agreement, the competent department at a higher level shall make a determination.²⁹⁵ Since one of the supervisors is actually appointed by the competent department, this rule in fact allows the opinion of the supervisor appointed by the competent department to prevail. The reorganization plan will provide for restruc-

285. *Id.*, art. 110.

286. *Id.*, art. 111. Whether the board or the shareholders' meeting has the power to elect the reorganization group depends on the articles of association and the pertinent provisions of the law.

287. *Id.*

288. *Id.*

289. *Id.*, art. 113.

290. *Id.*, art. 112.

291. *Id.*

292. *Id.*

293. *Id.*, art. 113.

294. *Id.*

295. *Id.*

turing of the debts including the postponement of repayment and possibly forgiving of debts;²⁹⁶ this procedure, therefore, may actually lead to the modification of creditors' rights without their consent.

The reorganization plan shall provide the financial situation of the company, the modification of the rights of the creditors and shareholders; the disposal of the assets, the recovery of the claims and payment of debts; the method of raising funds; the changes in the scale of production or service; modifications of the articles of association; adjustment in the management and in the number of employees; and other matters.²⁹⁷ The reorganization plan must be approved by the shareholders' meeting or the board as the case may be, and be reported to the competent department for recording.²⁹⁸ The reorganization plan must be carried out within 180 days.²⁹⁹

The persons in charge of the reorganization, including the reorganization supervisors, are liable if they violate laws or are guilty of serious negligence, resulting in economic losses of the corporation.³⁰⁰

2. Liquidation Under the Corporation Law

Under the Corporation Law, liquidation will take place if a corporation is declared bankrupt by a court order.³⁰¹ The liquidation is in the charge of a liquidation group of three persons which shall be established within thirty days after the court order.³⁰² The court appoints the liquidation group.³⁰³ The liquidation group has the power to convene meetings of the creditors and meetings of the board of directors or shareholders, take charge of the assets of the corporation, prepare the balance sheet and schedule of assets.³⁰⁴ It also has the authority to continue to operate the business, prepare the liquidation plan, liquidate and dispose of the company's assets, recover credits and pay off debts, distribute the assets and represent the company in lawsuits and other activities.³⁰⁵ The

296. *Id.*, art. 114.

297. *Id.*

298. *Id.*, art. 115.

299. *Id.*

300. *Id.*, art. 118.

301. *Id.*, art. 128 (iv).

302. *Id.*, art. 130.

303. *Id.* The court appoints the liquidation group only when the liquidation is the result of a court order, such as a bankruptcy order. This rule does not apply if the liquidation results from voluntary dissolution.

304. *Id.*, art. 133.

305. *Id.*

liquidation group's decision-making is based on consensus.³⁰⁶ Where the liquidation group cannot reach consensus, the court will make a decision.³⁰⁷

Within ten days after the group is established, the liquidation group must make a public announcement on the liquidation in the local newspaper and notify the creditors in writing to report claims.³⁰⁸ The liquidation group shall propose a plan of liquidation to be approved by the court.³⁰⁹ The creditors' meeting apparently has the power to consider and comment on the plan, but, unlike the National Act, may not reject the plan.³¹⁰

The liquidated assets of a corporation are to be distributed in an order similar to that of the National Act: 1) expenses incurred during the liquidation; 2) employees' salary and social insurance; 3) tax; 4) debts; and 5) shareholders or other parties holding an equity interest.³¹¹ Where the assets are not sufficient for the distribution among the parties in the same order, the payment shall be pro rata.³¹² Shareholders and other parties holding equity interests may receive a distribution only after all other expenses have been paid.³¹³ The distribution among them can be made either in accordance with their shares of equity interest or the proportion agreed in advance in the contract or in the articles of association.³¹⁴

In the case of a "cooperative corporation," that is, a contractual joint venture, if the debts of the company exceed its assets, each party shall return the cash distributed to pay the debts of the company in accordance with the proportion in which the profits are shared.³¹⁵ It is unclear to what extent the party needs to return distributed cash. Chinese law, however, provides that the cooperative corporation as a rule is a limited liability company, meaning each party to the corporation is liable for the debts of the corporation only to the extent of its capital contribution.³¹⁶ Thus, the above rule probably refers only to the situation where the party has taken cash out of the corporation, with the result that the net

306. *Id.*, art. 134.

307. *Id.*

308. *Id.*, art. 135.

309. *Id.*, art. 138.

310. *Id.*, art. 137; *cf.* National Act, arts. 15-16.

311. Corporation Law, art. 140.

312. *Id.*

313. *Id.*, art. 141.

314. *Id.*

315. *Id.*, art. 149.

316. Civil Code, *supra* note 48, art. 48.

worth of the company is less than the total of both sides' capital contribution.

After the liquidation is completed, the liquidation group will report to the court.³¹⁷ The liquidation group shall register the dissolution with the Administration of the Industry and Commerce within fourteen days after the court approves the liquidation report.³¹⁸

C. Conciliation Procedure Under the Shenzhen Act

The Shenzhen Act does not provide for reorganization, but it contains fairly detailed provisions on conciliation. Under the Shenzhen Act, a debtor may voluntarily apply to the court for conciliation with or without a pending bankruptcy petition against him.³¹⁹ The petition for conciliation under the Shenzhen Act does not have to be approved by the competent authority in charge as required by the National Act, but such a petition needs to be supported by a resolution of the board or the shareholders' meetings.³²⁰ The Shenzhen Act also makes clear that where a bankrupt proceeding is pending, if the debtor and creditors cannot reach a conciliation agreement, the debtor will be declared bankrupt.³²¹

After receiving the conciliation petition, the court is required to render its decision within ten days.³²² Under article 10 of the Shenzhen Act, the court grants conciliation only when debtors and creditors may reach an agreement on the repayment of the debts.³²³ Thus, it seems that the first step after the filing of the petition for conciliation is to seek an agreement with the creditors. If the court grants the petition, the court must make a public announcement of this fact within five days, which shall state the date of the first meeting of the creditors and the date when the claims are to be investigated.³²⁴ The public announcement must also be delivered to the known creditors as well.³²⁵ The National Act does not require this preliminary determination by the court, nor does it contain a similar notice requirement at this stage.

The Shenzhen Act does not specify who is to propose the conciliation

317. Corporation Law, art. 142.

318. *Id.*, art. 143.

319. Shenzhen Act, art. 7.

320. *Id.*, art. 8.

321. *Id.*, art. 10.

322. *Id.*, art. 9.

323. *Id.*, art. 10.

324. *Id.*, art. 19.

325. *Id.*

plan; presumably, it is the debtor's obligation to do so. Unlike the National Act, however, the Shenzhen Act specifically requires that a conciliation plan must provide the names of the debtors and creditors, the amount of the debts; the postponement of payment and the amount of debts forgiven; the reason for the loss and state of the business and the plan to improve business performance.³²⁶ The conciliation plan must be approved by the meeting of the creditors.³²⁷ The Shenzhen Act, however, provides that the conciliation plan is to be approved by creditors representing fifty percent or more of the total claims,³²⁸ whereas the National Act requires that the consenting parties must represent at least two-thirds of the total unsecured claims.³²⁹

Once a conciliation plan is approved by the meeting of the creditors, the court must decide whether to confirm the plan within fifteen days.³³⁰ The creditors that object to the plan must file a lawsuit within seven days,³³¹ a provision identical to that of the National Act.³³²

The implementation of a conciliation plan in fact will lead the corporation into a period of reorganization. The contents of a conciliation plan required under the Shenzhen Act are substantially similar to those of a reorganization plan provided in the Corporation Law. The Shenzhen Act, however, does not expressly provide that after conciliation is approved reorganization will ensue. It is thus unclear what the relationship is between the "reorganization" provided in the Corporation Law and the conciliation procedure under the Shenzhen Act.

During the period when a conciliation procedure is effective, the debtor is prohibited from transferring his assets without consideration and conducting other acts, though with consideration, which are beyond the scope of normal business operations.³³³ The National Act also contains a similar requirement.³³⁴

The Shenzhen Act authorizes the court to revoke its confirmation of the conciliation plan and immediately declare the debtor bankrupt if one of the following occurs. First, the conciliation plan damages the interest of the creditors that do not participate in the meeting of the creditors, and the aggrieved party petitions to the court within ten days after the

326. *Id.*, art. 21.

327. *Id.*, art. 20.

328. *Id.*, art. 18.

329. National Act, art. 16.

330. Shenzhen Act, art. 25.

331. *Id.*

332. *See* National Act, art. 16.

333. Shenzhen Act, art. 24.

334. National Act, arts. 21, 35.

court confirms the plan.³³⁵ Second, the debtor commits fraud in connection with the conciliation, and the fraud is discovered within six months after the plan is confirmed.³³⁶ Third, the debtor refuses to, or is unable to, carry out the conciliation plan, and the revocation of confirmation is based on a petition by the creditors representing fifty percent or more of the total unsecured claims.³³⁷ The National Act reflects a similar approach.³³⁸

D. Liquidation Committee and Meeting of the Creditors Under the Shenzhen Act

Similar to the National Act, the Shenzhen Act authorizes the court to appoint the liquidation committee consisting of three to five members; the Shenzhen Act, however, further requires that one member of the committee must be an accountant registered in the PRC.³³⁹ This is in contrast with the provisions of the Corporation Law that the liquidation group shall consist of only three persons appointed by the court.³⁴⁰ The Shenzhen Act does not provide whether the committee shall include a foreigner. The emphasis on the nationality of the accountant, however, indicates that a foreign party would probably be allowed to serve in the committee.

The Shenzhen Act increases the authority of the liquidation committee by allowing the committee to assume an active role from the very beginning of the bankruptcy proceedings. Under article 22, the court should establish a liquidation committee within ten days after the court decides to hear the case, whereas under the National Act, the court should establish a liquidation group only after the enterprise is declared bankrupt.³⁴¹ Thus, the liquidation group does not exist during the period of conciliation or reorganization under the National Act, but the liquidation committee under the Shenzhen Act is authorized to perform a leading role in the conciliation procedure as well.³⁴² In all other areas, the liquidation committee under the Shenzhen Act performs functions similar to those of

335. Shenzhen Act, art. 26.

336. *Id.*

337. *Id.*

338. *See* National Act, arts. 21, 35.

339. Shenzhen Act, art. 12.

340. Corporation Law, art. 130.

341. National Act, art. 24.

342. The Shenzhen Act authorizes the liquidation committee to supervise the making and implementation of the conciliation plan, and to investigate and examine the business operation of the corporation during the conciliation. *See* Shenzhen Act, art. 14.

the liquidation group under the National Act.

The meeting of the creditors under the Shenzhen Act has a similar role as that of the National Act. The Shenzhen Act does not specify, however, the persons who are qualified to be a member of the meeting of the creditors. Presumably, a meeting of creditors shall include all the creditors. The Shenzhen Act also fails, unlike the National Act, to provide for what kinds of creditors have voting rights, but it implicitly indicates that only the unsecured creditors may vote, a rule identical to that of the National Act.³⁴³ The Shenzhen Act does not provide a quorum requirement, but it does provide a procedural rule: the adoption of a conciliation plan or distribution plan must be approved by the creditors present at the meeting, representing fifty percent or more of the total unsecured claims.³⁴⁴ This rule is in contrast with a similar rule of the National Act requiring that a resolution be adopted by a simple majority of creditors as well as by the creditors representing certain amount of the claims;³⁴⁵ the rule thus enables a relatively larger number of creditors representing a small amount of claims to block a decision imposed by a small number of creditors even though they represent an overwhelming majority in terms of the amount of the claims. The above voting rules of the Shenzhen Act apply only to the adoption of a resolution on the conciliation plan and on the distribution plan.³⁴⁶ It does not expressly provide procedures for the meeting of creditors to adopt other actions.

The Shenzhen Act requires the liquidation committee to obtain consent from the meeting of creditors with respect to the following actions: transfer of real estate, trademark, patents and negotiable instruments; borrowings, performance of contracts, abandonment of claims, and lawsuits concerning the dispute over the bankruptcy estate.³⁴⁷ The National Act does not accord similar veto rights to the meeting of the creditors.

VI. CONCLUSION

The establishment of a bankruptcy system in China represents an important step forward in economic reform. Its effective implementation will provide a greater incentive for enterprises and employees to excel and add new momentum to the progress of the national economy. A bankruptcy system will also stimulate further development of economic reform in many other related areas. Although the bankruptcy system

343. See National Act, art. 13; Shenzhen Act, art. 18.

344. Shenzhen Act, art. 18.

345. National Act, art. 16.

346. Shenzhen Act, art. 18.

347. *Id.*, art. 42.

based on the National Act applies only to state-owned enterprises and other bankruptcy laws only have limited geographic application, developments in the past several years in the area of bankruptcy law suggest that it is only a matter of time before a comprehensive bankruptcy system applicable to all business entities will emerge.³⁴⁸ The limited application of the current bankruptcy system will provide experience and expertise to the benefit of a more comprehensive bankruptcy system to be developed.

While the bankruptcy system definitely will generate telling pressure on enterprises, it probably will not have a disruptive impact on the economic system or cause confusion and instability within Chinese society. Indeed, the bankruptcy system does not totally replace the existing practice. The state remains the owner of state-owned enterprises. The National Act also does not prevent the state from providing financial support to its enterprises to avoid bankruptcy. Nor does the National Act take away the power of the state to close, terminate or change the product line of an enterprise through administrative means. Although the National Act is a clear indication that this practice will be more limited with the operation of a bankruptcy system, the state can continue to use subsidies and administrative means to control and limit the magnitude and the number of bankrupt enterprises, if necessary. This residual power is very important to maintain the viability of the new bankruptcy system. It will prevent the negative elements of the system from developing to an unmanageable extent and will diminish the influence of those opposed to a bankruptcy system.

The Chinese Government is also experimenting with other ways to deal with state-owned business entities that sustain losses on a consistent basis. One method is to lease the enterprise to individuals or other companies and receive rents. By August 1, 1986, over 60,000 state-owned department stores and shops were leased, twelve percent of which were leased to individuals.³⁴⁹ These measures also will help limit the fate of bankruptcy to those enterprises with little hope of survival, and therefore, diminish the possible disruptive impact, if any, on the economy.

The Chinese bankruptcy system serves to protect the interest of creditors through an institutionalized, equitable distribution of assets among creditors, adding certainty and predictability to existing economic rela-

348. The National Act was initially drafted to apply to all enterprises. It was later on revised to apply only to state-owned enterprises. *See supra* notes 84-85 and accompanying text.

349. *Liuwan Yu Guoying Shangdian Shixing Zulinzhi (About Sixty Thousand State-owned Shops were Leased)* (China News Agency, news release, Aug. 1, 1986).

tions in Chinese society. As in the United States bankruptcy system, the Chinese system stresses the rehabilitation of the debtor, but this is achieved through reorganization, not by a discharge of the debtor. A major purpose of the Chinese bankruptcy system is to create a framework which will allow an enterprise that is not viable economically to die expeditiously, an alternative that did not exist before. This will impose a death threat to existing enterprises and allow the state, as a Chinese newspaper report explained,³⁵⁰ to terminate the "life support system" of a "cancer patient" which has absolutely no hope of recovery. Payments to creditors with the assets of the bankrupt enterprise also discharge the state from its obligations to creditors.³⁵¹

The significance of the Chinese bankruptcy system to foreign businesses is at least three-fold. First, the present bankruptcy system has already directly touched a small number of foreign investment enterprises located in the Shenzhen Special Economic Zone. The government likely will expand the scope of the present system in the near future to encompass all foreign investment enterprises as well.³⁵² Some adjustment will be needed, but probably without any significant modifications. Second, the bankruptcy system provides some basic guidelines for handling debtor-creditor relationships and therefore allows more room for business planning. For instance, both the National Act and the Shenzhen Act allow the property that is in the possession of the debtor and that does not belong to the debtor to be recovered prior to the bankruptcy liquidation. This rule clearly indicates that a rent-to-own transaction that allows the lessor to retain title until the purchase price of the property is fully paid in the form of rent gives greater protection to the creditor than direct sale under seller's financing. Third, the bankruptcy system makes clear that Chinese businesses, including state-owned enterprises, are independent business entities and that the state will not shoulder the financial losses of those enterprises that become insolvent. As a high-ranking Chinese official explained to the sixteenth session of the Standing Committee of the National People's Congress, one of the purposes of the National Act is to provide rules for dealing with debt and credit problems in

350. *Belated Awareness*, *supra* note 239, at 3. The author of this report called SEF, an enterprise declared bankrupt, as having a "cancer," the support through administrative means as "blood transmission" from the healthy enterprises and "changing mothers." *Id.*

351. For the obligations of state-owned enterprises, state is only liable to the third party within the limit of the assets the enterprise owns and operates. *See Zheng, supra* note 48, at 680.

352. *See supra* notes 84-86 and accompanying text.

foreign economic relations.³⁵³ The author of an article published in an influential Chinese newspaper reasoned:

Because China has not enacted an enterprise bankruptcy law, Chinese enterprises are often placed in a disadvantageous position concerning foreign related claims. Foreign businesses often demand that the state shoulder unlimited joint liability for a state-owned enterprise. . . . With enactment of a bankruptcy law [and] the limit of bankrupt enterprises' assets, the principles for the compensation to the creditors and liquidation of assets will be clearly provided by law. This will provide laws to be followed in dealing with foreign related claims, which will be of importance to protecting the state's interest and developing international economic exchanges.³⁵⁴

For this reason, the National Act will increase the importance to foreign investors of examining the credit standing of Chinese business partners. Theoretically, problems could arise in three areas. First, article 35 of the National Act makes void certain transactions of a Chinese enterprise that take place six months prior to the bankruptcy proceedings. As discussed above, article 35 is designed to prevent the debtor from evading debts to the detriment of creditors; therefore the article probably will be interpreted strictly where the interest of an innocent third person is involved.³⁵⁵ Second, the National Act authorizes the liquidation group to rescind executory contracts of a bankrupt enterprise, an authority typically entrusted to the trustee under the common law.³⁵⁶ In some instances, this could affect the business transactions of a foreign business in China. Actually, enterprises on the verge of bankruptcy or already bankrupt probably would not be able to perform the contract anyway. Furthermore, the National Act expressly entitles the other party to claim damages for breach of contract from the bankrupt estate.³⁵⁷ Finally, as stated in the quoted newspaper article by Xiao Zhuoji, the National Act will prevent the state from shouldering unlimited liability for enterprises beyond the value of their assets.³⁵⁸ This provision is in fact a restatement

353. *Zhiding Pochanfa Cujin Qiye Gaishan Guanli Youliyu Yifa Chuli Shewai Jingji Wenti (Enacting a Bankruptcy Law Promoting Enterprise to Improve Management and Benefiting Resolving Foreign-Related Economic Problems)* (Xinhua News Agency, news release, June 16, 1986).

354. Xiao Zhuoji, *Zhiding Qiye Pochan Fa Shizai Bixing (Enacting a Bankruptcy Law Being Inevitable)*, *Guangming Rebao* [Bright Daily], Aug. 2, 1986, at 3.

355. See text accompanying notes 136-38.

356. National Act, art. 26.

357. The Shenzhen Act does not provide for damages claims. See text accompanying *supra* note 276.

358. See text accompanying note 354.

of a prior law, article 49 of the General Principles of the Civil Law.³⁵⁹

In general, the National Act indeed raises an issue of significance in understanding the credit standing of business partners. It clarifies an important area of Chinese law, the law governing the debtor-creditor relationship. The National Act, however, does not introduce any significant new concept which entails changes or modifications in existing business practices. As a practical matter, most Chinese companies in the area of foreign trade and investment are supported strongly by the state, which has a great interest in maintaining the credit and reputations of these companies because any problems of these Chinese companies may have significant impact on overall foreign economic relations. Thus, the importance of looking into the credit standing of business partners is of primary concern in the domestic Chinese context.

The Chinese bankruptcy system is at its formative stage. The existing bankruptcy laws establish only a basic framework, leaving many areas to be developed through later legislative and judicial practice. The entire text of the National Act and the Shen Yuan Act each takes only one-half of a page in a Chinese newspaper. Though its length is not unusual in comparison with many other Chinese statutes of comparable significance,³⁶⁰ it does seem short in light of the complexity of a bankruptcy system involving substantive and procedural issues. The brevity of these bankruptcy laws inevitably leaves open many issues, some of which can be significant to the effective and fair implementation of a bankruptcy system. The eventual development of specific rules and a proper interpretation of the existing provisions will be of fundamental importance for the bankruptcy system to serve its intended purpose.

359. Civil Code, *supra* note 48, art. 49; *supra* note 49 and accompanying text.

360. The National Act is considerably shorter than major codes such as the General Principles of Civil Law, the Criminal Law, and Civil Procedure Law. It is comparable in length to Inheritance Law, Marriage Law and longer than most of the tax statutes, contract statutes and most of the statutes in the area of foreign economic relations.