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## China's Emerging Bankruptcy Law

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## China's Emerging Bankruptcy Law

When China embarked on the "Four Modernizations" (in industry, agriculture, defense, and science and technology) and an "open door" to foreign trade and investment in the late 1970s, it would have been difficult to forecast just how far the reforms might go. Nearly ten years after the reforms began, they have proven to be both broad and deep, affecting virtually every aspect of Chinese politics and economics.<sup>1</sup> China has opened areas almost identical to the old treaty ports to foreign investment and greatly expanded the number of privately owned businesses. China has also, very tentatively, dipped its collective toes into the waters of a legal code.

Among the legal innovations under way are the beginnings of a taxation system, a criminal code, and a bankruptcy law. This article is concerned with the last of these legal innovations.

Bankruptcy presents both theoretical and practical difficulties for the Chinese political and legal system. Bankruptcy conflicts, as a matter of theory, with communist doctrine and in theory could occur only in capitalist countries. As a practical matter, it is difficult for the state to allow state-owned enterprises to go under, since this event could be interpreted as evidence of improper planning or policy implementation by the state. This is a particularly significant problem because a high percentage of Chinese enterprises are state-owned. Private enterprises are the fastest-growing segment of Chinese industry, averaging production growth rates of 80 percent per year between 1980 and 1986.<sup>2</sup> Even as late as 1985,

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1. For an excellent recent examination of the scope of these reforms, see H. HARDING, *CHINA'S SECOND REVOLUTION: REFORM AFTER MAO* (1987).

2. *Id.* at 129.

however, some 70 percent of urban industrial output was the product of state-owned enterprises.<sup>3</sup>

As the economy has undergone reform, the degree of business risk for both state-owned and privately owned enterprises has increased. Market decisions have replaced centrally planned production quotas to a degree unprecedented in post-1949 China. Many enterprises are dealing poorly with this change in direction. In 1985, one-fifth of China's factories were operating in the red.<sup>4</sup> As a result, China has cast about for methods of saving concerns that have failed to anticipate demand for their products or operated inefficiently. Bankruptcy is only one of these methods. For example, China has experimented with a variant of the corporate takeover. In the Chinese version, while ownership of the failing concern has remained with the state, management responsibility has been transferred to the purchasing factory.<sup>5</sup>

Despite experimentation with alternatives such as corporate takeovers, the need for a bankruptcy remedy remains. As an experiment, the city of Shenyang, a major industrial city in Shandong Province, was allowed to draw up regulations early in 1985 stipulating that factories must be declared bankrupt if debts surpass assets or if accumulated losses are more than 80 percent of fixed assets. The cities of Wuhan in central China and Chongjing in southwest China also instituted bankruptcy regulations in 1986.<sup>6</sup>

China's actual experience with bankruptcy is quite recent and limited. The Shenyang Explosion-Proof Equipment Factory in Shenyang was declared bankrupt on August 3, 1986, the first such declaration since the 1949 Communist takeover.<sup>7</sup> Bankruptcy proceedings were terminated in November 1986.

About one month after the Shenyang bankruptcy, on December 2, 1986, a national bankruptcy law was promulgated by the Standing Committee of the Sixth National People's Congress. In March of 1987 the law was put on hold indefinitely by the Congress,<sup>8</sup> but in 1988 the law was approved and will go into effect in 1989.<sup>9</sup> This law has appeared in two different English translations.<sup>10</sup>

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3. A. RABUSHKA, *THE NEW CHINA: COMPARATIVE ECONOMIC DEVELOPMENT IN MAINLAND CHINA, TAIWAN, AND HONG KONG* 78 (1987).

4. Fung, *China Tests Something New: Bankruptcy*, Wall St. J., Aug. 1, 1986, at 16.

5. Ignatius, *One State-Run Company Buys Another in China's Latest Economic Experiment*, Wall St. J., Sept. 1, 1987, at 37.

6. Fung, *supra* note 4.

7. *Id.*

8. Ignatius, *supra* note 5.

9. Ignatius, *As Factory's Forced Bankruptcy Shows, China Won't Easily Accept Insolvencies*, Wall St. J., Apr. 15, 1988, at 20.

10. Boshkoff & Song, *China's New Bankruptcy Law: A Translation and Brief Introduction*, 61 AM. BANKR. L.J. 359, 362-72 (1987) (translating the Law of Bankruptcy for EN- VOL. 22, NO. 4

The bankruptcy law, coming as it does in the midst of great changes in China's economic system, allows the capitalist concept of bankruptcy to operate within the context of a centrally planned economy. The state controls access to the bankruptcy process through the People's Court, which must approve bankruptcy filings.<sup>11</sup> Approved plans for debt repayment are administered by the governmental department in charge of supervising the bankrupt enterprise.<sup>12</sup>

The following paragraphs discuss other provisions under this "trial implementation"<sup>13</sup> of bankruptcy law in China.

## I. Eligibility for Bankruptcy

Eligibility for bankruptcy is limited in scope. Bankruptcy is prohibited to: (a) individuals; (b) private enterprises; and (c) collective enterprises.<sup>14</sup> The only entities that may go into bankruptcy are state-owned enterprises.<sup>15</sup>

The law does not classify state-owned enterprises by eligibility for bankruptcy "chapters." Unlike U.S. law, China's law creates no subclassifications, such as amount of indebtedness, with which to classify eligible debtors. Rather, the disparate treatment of bankrupt enterprises discussed below in Section II and III flows from: a. provision for both voluntary bankruptcy and involuntary bankruptcy; and b. provision for reorganization as an alternative to liquidation.

As a general rule, state-owned enterprises are eligible for both voluntary bankruptcy and involuntary bankruptcy. The law imposes certain restrictions upon involuntary filings, however. Not eligible for involuntary filings are state-owned public utilities and "enterprises of major concern to the national economy and the general welfare of all the people whose debts are to be repaid by governmental subsidies or through other arrangements with appropriate governmental departments."<sup>16</sup> Essentially, the government has retained the power to forestall involuntary filings against enterprises of "major concern" by extending subsidies or making other

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terprises of the People's Republic of China); Zheng, *Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice*, 19 VAND. J. TRANSNAT'L L. 683, 733-40 (1986) (translating the Enterprise Bankruptcy Law of the People's Republic of China); see also Chang, *The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process*, 28 HARV. INT'L L.J. 333 (1987); Peng, *Characteristics of China's First Bankruptcy Law*, 28 HARV. INT'L L.J. 373 (1987) (both articles discuss the law but do not present an English translation).

11. Boshkoff & Song, *supra* note 10, at 364 (translating art. 9).

12. *Id.* at 369 (translating art. 29).

13. The law becomes effective "on a trial basis" three months after the effective date of the Law of Enterprises Under the Ownership of the Whole People. Zheng, *supra* note 10, at 740 (translating art. 43).

14. Boshkoff & Song, *supra*, note 10.

15. *Id.* at 362 (translating art. 2).

16. *Id.* at 362 (translating art. 3).

arrangements. A second exception to eligibility for involuntary bankruptcy is made for enterprises that obtain a guaranty and are able to repay their debts within six months after initiation of bankruptcy.<sup>17</sup>

## II. Bankruptcy Initiation

The bankruptcy process is begun by filing a petition with the People's Court. The petition can be filed by creditors. The petition can also be filed by the debtor enterprise, if it obtains the consent of the governmental department in charge of supervising the enterprise.<sup>18</sup>

### A. DEBTOR-INITIATED PROCESS

The law sets out no standards for determining when a state-owned enterprise can file a petition or for determining when the supervising department is likely to consent. The petition is subject to approval of the People's Court, yet again no standards for approval or disapproval appear.

Through what may be a drafting error, voluntary filings do not offer the option of reorganization; the only course is liquidation of assets. Both the debtor and the supervising governmental department are therefore unlikely to file voluntarily for bankruptcy. Not only are jobs at stake, but liquidation exposes the leaders of both the supervising department and the debtor to sanctions if they are found to be "primarily responsible" for the debtor's bankruptcy.<sup>19</sup>

### B. CREDITOR-INITIATED PROCESS

The creditor-initiated bankruptcy process is more complex than the voluntary process. A reading of the statute, however, suggests that it is more likely to be employed because: a. it offers the possibility of reorganization; b. the process is more accessible because the consent of the supervising department is not required; and c. the process is more clearly laid out.

When "creditors"<sup>20</sup> file a bankruptcy petition, the petition is subject to approval of the People's Court. The law sets out no guidelines for granting approval of a petition beyond the statutory exceptions to eligi-

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17. *Id.* Although the statute is phrased to prohibit commencement of bankruptcy proceedings against such an enterprise, presumably the bankruptcy process must begin in order to evaluate the debtor's ability to repay debts within six months.

18. *Id.* at 364 (translating art. 8).

19. *Id.* at 372 (translating art. 42). The liquidation process is identical for voluntary and involuntary cases, and is discussed *infra* at text section III.

20. The term "creditors" is not defined. Additionally, the statute contains no provision regarding the number of creditors or size of the claims required to initiate the petition.

bility discussed above, and the requirement that the creditor provide evidence that the debtor is failing to repay matured debts.<sup>21</sup> The consequences of the People's Court withholding approval are not addressed.

When the People's Court approves the involuntary petition, the governmental department supervising the debtor may intervene within three months and request "reorganization" of the debtor.<sup>22</sup> In the absence of such a request and its successful pursuit, the case apparently proceeds directly to liquidation. Involuntary cases also proceed directly to liquidation without opportunity to reorganize when the enterprise cannot pay maturing debts because "poor operation and management" have inflicted "severe losses."<sup>23</sup> This provision effectively limits the opportunity to reorganize to debtors not suffering from poor management and severe losses.

The request of the supervising governmental department for "reorganization" of the debtor triggers a procedure somewhat akin to the development of a chapter 11 plan in the United States. The procedure is as follows:

- (a) the debtor enterprise "shall propose a draft conciliation agreement [plan] to the meeting of the creditors."<sup>24</sup>
- (b) The conciliation agreement shall propose repayment of debt in a period not exceeding two years.<sup>25</sup>
- (c) The creditors' committee (excluding secured creditors, who cannot vote) meets to approve the conciliation agreement.<sup>26</sup>
- (d) When the debtor and the creditor's committee agree upon a conciliation agreement, the People's Court, "following its confirmation of the agreement," suspends the bankruptcy proceeding to permit execution of the conciliation agreement.<sup>27</sup> The governmental department supervising the debtor administers the reorganization under the conciliation agreement.<sup>28</sup>

A successful reorganization under the conciliatory agreement leads to termination of the case.<sup>29</sup>

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21. "The creditor, when filing a bankruptcy petition, shall provide evidence of . . . the failure of the debtor to repay its matured debts." Boshkoff & Song, *supra* note 10, at 363 (translating art. 7). Boshkoff and Song conclude from the interplay of several articles that the creditor must also provide that the debtor's inability to repay debts is due to "poor operation and management." *Id.* at 363 n.31. We do not agree, because such a construction imputes to a petitioning creditor the proof needed to obtain a "declaration of bankruptcy" from the People's Court prior to any reorganization attempt. In fact, a petitioning creditor is empowered to initiate an involuntary bankruptcy without proving that a declaration of bankruptcy is justified. See Boshkoff & Song, *supra* note 10, at 363, 366, 367 (translating arts. 7, 17 & 21).

22. *Id.* at 366 (translating art. 17).

23. *Id.* at 362, 368 (translating arts. 3, 23(1)).

24. Zheng, *supra* note 10, at 736 (translating art. 18).

25. *Id.* (translating art. 17).

26. *Id.* at 735, 736 (translating arts. 15, 19).

27. Boshkoff & Song, *supra* note 10, at 366-67 (translating art. 19).

28. *Id.* at 367 (translating art. 20).

29. *Id.* (translating art. 22).

### III. Liquidation

If the debtor is unable to implement or complete the conciliatory agreement, the court is required to issue a "declaration of bankruptcy" that triggers liquidation of the assets.<sup>30</sup> Additional grounds for issuance of a "declaration of bankruptcy" include: a. "poor operation and management" leading to "severe losses" and inability to pay maturing debts (discussed above); b. post-petition deterioration of financial status together with a request from the creditor's committee for termination of the reorganization;<sup>31</sup> and c. misconduct of the kind set out in article 35,<sup>32</sup> which seriously impairs the creditors' interests. If a "declaration of bankruptcy"<sup>33</sup> is issued by the court, a liquidation panel is appointed within fifteen days to take control of, manage, and distribute the debtor's assets. The panel is composed of personnel from the supervisory governmental department, government finance departments, and other professionals.<sup>34</sup> Interestingly, the law makes no provision for representation of workers.<sup>35</sup> The liquidation panel has the power to reject executory contracts. The panel may also request the court to recover property transferred before the declaration of bankruptcy but within six months preceding the bankruptcy petition, provided that the transfer was: a. a concealed, secret, or gratuitous transfer of assets; b. a sale of assets at an unusually low price; c. a grant of security to previously unsecured creditors; d. prepayment of debts not due; or e. relinquishment by the debtor of its claims.<sup>36</sup> No provision is made for recovery of pre-petition payments on existing unsecured debts, the "preferential payment" of U.S. bankruptcy law.<sup>37</sup> Yet payments made to some of the creditors after

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30. *Id.* at 368 (translating art. 23).

31. *Id.* at 367, 368 (translating arts. 21(2), 23(2)).

32. Article 35 lists the following acts: (a) a concealed, secret, or gratuitous transfer of assets; (b) a sale of assets at an unusually low price; (c) a grant of security to previously unsecured creditors; (d) prepayment of debts not due; or (e) relinquishment by the debtor of its claims. *Id.* at 370.

33. The "declaration of bankruptcy" has no direct counterpart in United States bankruptcy law. Its closest analog may be an order of conversion to chapter 7 pursuant to 11 U.S.C. §§ 1112(b) or 1307(c) (1982 & Supp. IV 1986), or an order refusing to confirm a chapter 11 plan of reorganization and soliciting ch. 11 liquidating plans. *See generally id.* §§ 1128, 1129(a), 1141(d)(3)(A).

34. Boshkoff & Song, *supra* note 10, at 368 (translating art. 24).

35. The high point of worker involvement occurs during reorganization, when the workers' representative assembly "shall be kept informed of the status of the reorganization and its opinion concerning the reorganization should be respected." *Id.* at 367 (translating art. 20). Compare Zheng, *supra* note 1, at 736 ("The state of the reorganization shall be reported to and comments shall be solicited from the assembly of the employee representatives.").

36. Boshkoff & Song, *supra* note 10, at 370 (translating art. 35).

37. *See* 11 U.S.C. § 547 (1982 & Supp. IV 1986).

approval of the bankruptcy petition are “invalid” except as “essential” for ordinary business operations.<sup>38</sup>

The liquidation panel prepares a plan for distribution of the debtor's assets. The plan, “following discussion and approval by the creditors' committee,”<sup>39</sup> is submitted to the court for confirmation. After the plan is executed and all assets distributed, the court closes the case.<sup>40</sup>

#### IV. Automatic Stay, Claims, and Priority of Claims

Several concepts found in U.S. bankruptcy law are also found in China's bankruptcy law. Among them are the automatic stay, a bar date for claims, and priority among claims competing for limited funds.

A limited automatic stay is set out in article 11. This provision establishes protection for the debtor from “other civil execution”<sup>41</sup> after the People's Court approves the bankruptcy petition. No provision is made for relief from the stay. No provision stays action prior to the court's approval of the petition.

Claims are filed after the People's Court approves the bankruptcy petition and notifies known creditors by mail and other creditors by publication. Known creditors who receive actual notice of the bankruptcy must file their claims within one month of receipt of notice. All other creditors have three months from the date of publication by the court (or its notice of approval of the petition) within which to file claims.<sup>42</sup> Claims not timely filed are deemed abandoned.

A secured creditor is entitled to payment “from its collateral” in the event of liquidation.<sup>43</sup> A partially secured creditor participates in the general asset distribution to the extent its claim exceeds the value of the collateral.<sup>44</sup> Claim priority, the order in which assets are distributed to unsecured creditors in liquidation, is set out in articles 34 and 37. First priority is granted to the expenses of liquidation, including sale and management expenses, legal expenses, and other expenses incurred in the common interest of creditors during the bankruptcy proceeding.<sup>45</sup> All these

38. Boshkoff & Song, *supra* note 10, at 365 (translating art. 12).

39. *Id.* at 371 (translating art. 37); *cf.* Zheng, *supra* note 10, at 739 (the plan “will be discussed and adopted by the meeting of the creditors” (emphasis added)) (translating art. 37).

40. Boshkoff & Song, *supra* note 10, at 371 (translating art. 38).

41. *Id.* at 365 (translating art. 11); *cf.* Zheng, *supra* note 10, at 735 (“Upon the acceptance of a bankruptcy case by the People's Court, all other civil enforcement procedures against the debtor's property must terminate.”)

42. Boshkoff & Song, *supra* note 10, at 364 (translating art. 9).

43. *Id.* at 370 (translating art. 32).

44. *Id.* at 369, 370 (translating arts. 30, 32).

45. *Id.* at 370 (translating art. 34).

expenses of liquidation share common priority. If the assets are insufficient to pay these expenses, the bankruptcy proceeding “shall” be terminated by the court.<sup>46</sup> Remaining claims are granted priority in the following order: a. salaries and labor insurance benefits owed by the debtor to its employees; b. taxes owed by the debtor; and c. general unsecured claims.<sup>47</sup> If assets are insufficient to completely satisfy claims in any class, they are distributed pro rata to holders of claims in that class. Claims remaining unpaid after closing the bankruptcy case will “no longer be satisfied.”<sup>48</sup>

## V. Disciplinary Sanctions

China’s bankruptcy law assigns more responsibility for failure than does U.S. bankruptcy law. It provides in some cases for administrative disciplinary sanctions for parties found primarily responsible for the bankruptcy and for criminal sanctions when negligence leads to great loss of state property.

In the case of liquidation, supervising and auditing departments of the government inquire into responsibility for the bankruptcy. If the legal representative of the debtor, usually the debtor’s director, is found “primarily responsible” for the bankruptcy, he is subject to “administrative disciplinary sanctions.”<sup>49</sup> The nature of such sanctions is not specified. If the governmental department supervising the debtor is primarily responsible, its leaders are likewise subject to administrative disciplinary sanctions.<sup>50</sup>

Criminal liability will be imposed on the debtor’s legal representative and the leaders of the supervisory department if the bankruptcy is caused by their “neglect of duty” resulting in “great loss to state property.”<sup>51</sup> Article 187 of the Criminal Law of the People’s Republic of China, the relevant criminal statute, provides for a maximum of five years of imprisonment.<sup>52</sup>

In addition, if the debtor has committed any of the acts outlined in article 35<sup>53</sup> (for example, fraudulent conveyances), the debtor’s legal representative *and* the persons directly responsible for the act are subject

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46. *Id.*

47. *Id.* at 371 (translating art. 37).

48. Zheng, *supra* note 10, at 739 (translating art. 38).

49. Boshkoff & Song, *supra* note 10, at 372 (translating art. 42).

50. *Id.*

51. *Id.*

52. *Id.* (translating the relevant criminal statute).

53. *See supra* note 32.

to administrative disciplinary sanctions. If the act amounts to a crime, they are subject to criminal liability.<sup>54</sup>

## VI. Status of Workers

The state assumes responsibility for reemploying the debtor's workers and providing for their basic needs until such workers are reemployed.<sup>55</sup> These arrangements are made by the State Council.<sup>56</sup>

## VII. English Translation

The two English translations currently available contain a number of discrepancies. Some are likely to be of little import. For example, Zheng notes that enterprises sustaining serious loss due to "inappropriate management" are to be declared bankrupt, while Boshkoff and Song translate this as "poor operation and management."<sup>57</sup>

Other discrepancies are possibly more serious. For example, in defining property of the bankruptcy estate, Zheng translates one of the definitional phrases as "other property rights that the bankrupt enterprise should be vested with."<sup>58</sup> Boshkoff and Song render the same phrase as "other property rights belonging to the debtor."<sup>59</sup>

## VIII. Deadlock

The statute as drafted is unfortunately silent concerning the consequences of refusal or inability to participate in the manner indicated by the statute. Many of these potential confrontations or shortcomings could stop the bankruptcy process completely. Examples include the inability of the debtor to propose a conciliation agreement; refusal by a creditors' committee to approve a reorganization or liquidation plan; or refusal by the court to approve a proposed reorganization or liquidation plan. Because no provision is made for any deviation from the narrow statutory scheme, the process is extraordinarily vulnerable to deadlock.

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54. Boshkoff & Song, *supra* note 10, at 372.

55. *Id.* at 363 (translating art. 4). In the case of the Shenyang Explosion-Proof Factory, the workers were to get wages at progressively reduced rates for up to two years. Those workers who did not retire were to register with the City's Labor Service Bureau for new jobs. Fung, *supra* note 4.

56. The State Council is the executive branch of the central government, headed by the Premier, currently Premier Li Peng.

57. Boshkoff & Song, *supra* note 10, at 362; Zheng, *supra* note 10, at 733 (both translating art. 3).

58. Zheng, *supra* note 10, at 738 (translating art. 28).

59. Boshkoff & Song, *supra* note 10, at 369 (translating art. 28).

## **IX. Conclusion**

Neither the translation difficulties nor the obvious incompleteness of the law in comparison with its U.S. counterpart are as important as the law's adoption. The law is an important component of China's ongoing economic reform movement. It introduces a requirement of fiscal discipline on China's managers. Also, it provides, for the first time, for the orderly demise of nonviable enterprises.