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We are pleased to present the 24th technical paper under the INSOL Technical Papers Series written by Dr. Yin Zhengyou, senior partner W&H Law Firm and Mr. Alan CW Tang, partner and head of specialist advisory services, SHINEWING (HK) CPA Limited.

For cultural and other reasons China did not have a bankruptcy law until 1906. The reform process of the bankruptcy law commenced about twenty years ago and finally the Enterprise Bankruptcy Law came into effect in June 2007.

Five years on, the effectiveness of the bankruptcy regime was discussed at the 4th China Bankruptcy Forum in Beijing last year. In this paper authors refer to the comments and conclusions drawn in respect of key issues that were discussed in this forum.

The authors then look ahead to future initiatives and challenges in the profession before finally concluding that, while resolution of many of these key issues facing the Chinese bankruptcy law system will not be an easy task, China's bankruptcy professionals including those in the Government and the judiciary are devising pragmatic, workable solutions to drive forward development of the system through patient collaborative work and persistent collective efforts.

INSOL would like to thank By Dr. Yin Zhengyou and Mr. Alan Tang for writing this excellent paper.

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Bankruptcy Regime in China - Confronting Practical Challenges and Pursuing Creative Solutions

By Dr. Yin Zhengyou*[1] and Alan CW Tang[2]

Abstract

The China Bankruptcy Law Forum has reached national prominence in bringing together key figures in the insolvency field – including judges, court officials, scholars, practitioners and policymakers – to share views on the current state and outlook of Chinese bankruptcy law and practice. At the 4th session in November 2011, speakers offered their views on significant recent developments, highlighted a number of challenges confronting the profession, and proposed ways and approaches to formulate the future direction of bankruptcy practice. Issues ranged across the field and covered a wide spectrum, including limitations on People's Courts to handle bankruptcy cases, the special situation of state-owned enterprises, enterprise reorganization rules, the lack of a system of personal bankruptcy, cross-border issues, and measures to strengthen the bankruptcy profession.

After providing an outline of the background and context that led to the passage of the current Enterprise Bankruptcy Law in 2006, this article analyses each of the above key issues discussed at the Forum. The authors then look ahead to future initiatives and challenges in the profession before finally concluding that, while resolution of many of these key issues facing the Chinese bankruptcy law system will not be an easy task, China's bankruptcy professionals (including those in the Government and the judiciary) are devising pragmatic, workable solutions to drive forward development of the system through patient collaborative work and persistent collective efforts.

I. Introduction

In the preceding half-decade since the Enterprise Bankruptcy Law of the People's Republic of China ("EBL") was enacted, judges from the People's Courts, especially the Supreme People's Court ("SPC"), were working tirelessly with government officials, scholars, and practitioners in the profession to smooth out the rough edges of China's bankruptcy system, then based on the old law. These judges have also been kept busy since the introduction of the new law. The process of implementation has given rise to a plethora of challenges regarding the proper scope, orientation, operation and function of the new law. Encouragingly, the bankruptcy profession has responded enthusiastically to the work of refining the system, contributing to the formulation of fairer and more efficient ways for debtors in financial distress to rehabilitate their businesses or make an orderly exit from the market.

The exchange of ideas and dissemination of information among professionals has played an instrumental role in facilitating progress in the development process. Academic platforms and discussion forums have fostered more effective communication between judges, court officials, scholars, practitioners and policymakers. Among these, the annually hosted China Bankruptcy Law Forum has reached national prominence, bringing together members of various professions to share views on the current state and future outlook of China's bankruptcy law and practice. Hosted by the SPC, the All-China Lawyers Association, and China Renmin University School of Law, the China Bankruptcy Law Forum inaugurated its 4th session on November 5, 2011 at the Beijing Friendship Hotel. In attendance were key figures in bankruptcy practice, including approximately 300 senior judges of the People's Courts at different levels throughout the country, nearly 100 high-ranking government officials, nearly 100 eminent scholars and professors, and over 100 senior practitioners. Distinguished speakers included Judge Song Xiaoming (宋晓明), Chief Judge of the 2nd Civil Division of the Supreme People's Court, Judge Zhang Yongjian (张勇健), Deputy Chief Judge of the same court, and Mr. Li Bing (李冰), Director of the Restructuring Bureau of the State-owned Assets Supervision and Administration Commission ("SASAC").

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* **The views expressed in this article are the views of the authors and not of INSOL International, London.**

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Discussions at the Forum revolved around a number of pertinent bankruptcy-related themes and topics. Presenters offered their views on significant recent developments in the law and practice, highlighted a number of challenges confronting the profession, and proposed various ways and approaches to formulate the future direction of bankruptcy practice. The core theme of their message was a call to collaborate and persevere. Despite the daunting nature of the work ahead, they emphasized that China is slowly but surely making progress towards a more comprehensive, efficient, and fair system of bankruptcy. This article introduces the most relevant insights and arguments presented at the Forum and sets out current thoughts on the "way forward" for many pertinent issues.

II. The Current State of China's Bankruptcy System and Practice

A. Background

China's current bankruptcy system is in its early developmental stage. The law on which it is based, the Enterprise Bankruptcy Law, replaced the previous law in 2006. Prior to that time, China had in place a limited insolvency framework dedicated almost exclusively to the liquidation of state-owned enterprises ("SOE"). By 1994, Chinese officials, faced with high levels of non-performing loans made to SOEs, had recognized the need for a bankruptcy regime more firmly rooted in market-oriented principles. They decided to initiate a two-pronged strategy of reform. Firstly, the Financial and Economic Committee of the National People's Congress ("NPC") established a Working Group for Drafting the New Enterprise Bankruptcy Law. At the same time, the State Council issued a series of policy decrees to facilitate the restructuring of distressed SOEs. Significantly, these measures provided special treatment and protection of the "resettlement" rights of workers.[3] In his presentation, Professor Wang Weiguo[4] commented that the State Council's simultaneously launched policy directives were seen as necessary measures by Chinese policymakers to immediately address the then urgent generally unhealthy financial state of the SOEs. Interestingly, although the original intention of driving the formulation of the new EBL was also to assist the debt-laden SOEs, the fact is that the majority of such enterprises had already been successfully restructured (or otherwise disposed of) through the State Council's mandated administrative procedures by the time the law was adopted in 2006.[5]

When the "new" EBL was enacted, it unified and replaced the old patchwork of insolvency legislation; and it applies to all legal person enterprises, both state-owned and private. The current law incorporates provisions and best practices from the old Chinese code and other modern corporate rescue laws, although further supporting "working" rules are needed to supplement its provisions. While the EBL clearly improves upon the old insolvency framework and regime, implementing the new law in practice has encountered many complex challenges. The next section of this article will focus on some key areas of concern. These issues are many, but gradual progress is being made as the corresponding procedures, practices and institutions of the new system are tested and further developed in practice.

B. Limitations on the Ability of the People's Courts to Handle Bankruptcy Cases[6]

In September 2011, the SPC issued the First Judicial Interpretation ("First Interpretation") of the EBL[7], which set regulatory guidelines on the application of the new law's case acceptance[8] provisions. Issued in response to and counter many local courts' practice of willfully ignoring bankruptcy petitions, the First Interpretation clarified the law's case application and eligibility requirements and introduced a special procedure for frustrated applicants to apply directly to the next higher level court in the event that a local court fails to issue a timely ruling to accept or decline a case. According to Professor Wang Xinxin[9], the purpose of the guidelines is to deter local courts from relying on procedural ambiguity to refrain from "accepting" and trying insolvency cases and to compel them to accept (register) and process all eligible petitions that come before them.

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3 In practice, this typically involves finding other replacement work positions for workers, providing compensation and unpaid wage arrears, as well as other related benefits.

4 Professor Wang Weiguo (王卫国) is Dean of the Civil and Commercial Law Institute of the China University of Politics and Law. He was a member of the drafting group for the New Enterprise Bankruptcy Law.

5 More details on this point are provided in section IIC below.

6 e INSOL Newsletter (January 2012) update by the Authors

7 2011 Supreme People's Court First Judicial Interpretation of the Enterprise Bankruptcy Law. Note that earlier 'interpretations" have been issued since April 2007 to deal with the office of the "Administrator" as well as some transitional issues and arrangements.

8 Note that not all cases are "automatically" accepted (or registered) for handling by a PRC court.

9 Professor Wang Xinxin (王欣新) is Chairman of the China Bankruptcy Law Forum. He serves as Director of the China Bankruptcy Law Research Center based at China Renmin University School of Law. He was a member of the drafting group for the New Enterprise Bankruptcy Law.

The First Interpretation offers only a limited solution to the broad spectrum of bankruptcy-related challenges confronting China's judiciary. It resolves some important legal and procedural matters, but there are additional fundamental issues of a practical nature which the People's Courts are not well equipped to handle. In his presentation, Judge Song Xiaoming identified some points of concern. One is the enormous pressure courts face to preserve social stability in handling bankruptcy cases. Judge Song estimates that 370,000 to 400,000 enterprises withdraw from the market annually. Although only a small proportion of these seek formal bankruptcy relief, even one of these cases would potentially involve the interests of hundreds, perhaps thousands of workers and personnel. It is often impossible for a court, using its limited resources, to devise a solution[10] that satisfactorily protects these interests.

As alluded to above, the second issue concerns the judiciary's lack of financial resources. In numerous SOE bankruptcy cases, courts have had to liquidate assets owned by the state, such as land use rights, factories, machines and other equipment, to help pay and resettle workers of the insolvent enterprise. In cases involving enterprises with no assets to liquidate, however, courts are often unable to provide these payments. Regional and local governments have contrived a variety of solutions, but the fact remains that the People's Courts lack the ability to handle these matters on their own and must rely on government resources and support. In addition, there is an urgent need for greater numbers of professionally trained judges who are able to handle complex bankruptcy matters, as well as a more systematic evaluation system for assessing judicial efficiency and performance. These institutional shortcomings increase the reluctance of courts and judges to accept bankruptcy cases. The roles of courts and judges generally (as compared to those of an "administrator" and creditors in general) in a bankruptcy process would need to be reconsidered, determined and clarified.

C. State-owned Enterprises

As mentioned in section IIA, the 2006 EBL applies to all legal person enterprises, both state-owned and private. During the drafting process of the new law, however, an assortment of SOEs was designated to undergo "policy bankruptcy" proceedings under diverse and different legal provisions. Chinese lawmakers at the time feared that strict application of the new law to distressed SOEs could result in high unemployment, leading to social unrest and destabilization of the banking sector. In light of this concern, drafters debated whether the new law should apply to all SOEs or whether certain older SOEs should be exempted. Starting with the 2002 and 2004 drafts, lawmakers adopted the position that all SOEs established after the law's promulgation would be subject to its provisions, while certain older SOEs which have already been in "restructuring" would continue to undergo parallel administrative bankruptcy proceedings (so called "Policy Bankruptcy") under separate relevant regulations to be issued by the State Council.[11] According to Mr. Li Bing, Director of the Restructuring Bureau of SASAC, over 5,000 SOEs have exited the market through these Policy Bankruptcy procedures pursuant to the SOE reform programme.

Whether governed under the new EBL or the State Council's parallel closure track, SOE bankruptcy cases are a matter of great concern because they have the potential to cause pervasive societal effects. "Bankruptcy is a legal issue," observed Mr. Li Bing, "but it is also an economic and social issue. When looked at from the point of view of stability, it is also a political issue." SOEs often play a vital role in the communities where they are based, fulfilling "semi-social" functions and providing a limited means of social security for employees and residents. Failure of the enterprise is likely to have destabilizing effects not just on the lives of employees and residents of the community, but also on the health of related enterprises and business sectors. Therefore, SOE bankruptcy cases must be handled with great care. Steps must be taken not only to develop legal solutions, but also to promote better business management practices and improved monitoring mechanisms. SASAC, for example, has taken steps to implement a bankruptcy early warning system for SOEs. Working through supervisory offices set up in different provinces and cities, the system has helped raise awareness of SOE bankruptcy risks in the market. Additional preventive measures should be

[10] If a court puts an enterprise into bankruptcy, it will be seen as formally triggering the unemployment of the employees and demands for compensation will arise. Often, the local government (who funds the payroll of the court) is required to "bail out" these employees' claims. Hence, there is enormous pressure on the courts not to bankrupt any enterprise unless a "pre-packed" solution has been found for the employees.

[11] Article 133, 2006 Enterprise Bankruptcy Law of the People's Republic of China

introduced and incorporated into the overall insolvency framework. When bankruptcies do occur, judges and policymakers must ensure that social stability is preserved and that the rights and interests of redundant workers are protected.

D. Enterprise Reorganization

In contrast to the old law, the 2006 EBL contains robust provisions on reorganization procedures. The new law allows either the debtor or creditor to initiate reorganization proceedings by filing a petition. Furthermore, debtors or shareholders holding more than 10% of a debtor's registered capital may apply to convert a liquidation proceeding into reorganization procedures. In some instances, this allows the debtor to retain control of his business. As Professor Li Shuguang[12] explained, this is particularly the case if the debtor applies for "debtor-in-possession" treatment under Article 73.

China's reorganization practices should take into account fundamental characteristics of the national economy. In the U.S., for example, the movement of capital through capital markets (especially the securities markets) drives much of the country's economic activity. Reorganization procedures in the U.S. reflect this characteristic and are designed to produce outcomes within this specific economic context. While lessons can be drawn from the U.S. experience, a wholesale import and transplant of American reorganization practices to China would be inappropriate. In contrast to the U.S., the Chinese economy is driven primarily by manufacturing and banking activitivies. Nearly 95% of the total assets in the financial sector are held by banking institutions. Capital markets, though not insignificant and steadily growing in importance, play a relatively smaller role. Reorganization rules must take these factors into account; they must be adapted to China's specific economic context.

E. Insolvency Procedures for Financial Institutions

Article 134 of the 2006 EBL provides that for bankruptcies of financial institutions, the State Council may formulate implementing measures in accordance with the provisions of the EBL and other laws. To date, China has only implemented rules for insolvent securities companies.[13] Nearly 30 distressed securities companies have been handled pursuant to these rules[14]. Furthermore, research and drafting work on insolvency regulations for the banking and insurance sectors are currently underway. The State Council has commissioned the China Banking Regulatory Commission ("CBRC") to draft the bankruptcy and related regulations for banking institutions. The process is nearly complete, but consensus has not been reached on some fundamental points and further preparatory work is needed. In light of the vital role banking institutions play in the economy, the State Council is paying particularly close attention to this sector. In addition to insolvency regulations, for instance, the State Council has tasked relevant officials from the People's Bank of China to draw up regulations for a deposit insurance system that will be implemented concurrently with the bankruptcy regulations for banks. As for the insurance sector, the China Insurance Regulatory Commission ("CIRC") has taken preliminary steps to draw up regulatory measures for insurance companies in financial distress, but this project appears unlikely to be complete in the near future.

F. Personal Bankruptcy

To date, a system of personal, or individual, bankruptcy has not been established in the PRC. There are a number of reasons for this. First, although the growth of a middle class in China has led to increased consumer financing and credit card spending, China has not yet established a reliable unified system of credit for individuals. Courts and lending institutions lack the means to obtain thorough and consolidated information on the credit history and financial background of individual consumers. This makes it difficult to determine, for example, whether certain "cause of bankruptcy" requirements have been met in any apparent personal insolvency situations. Regional disparities in economic conditions also complicate the formulation of uniform standards for issues such as exempt property. Despite these

[12] Professor Li Shuguang (李曙光) is Executive Dean of the Graduate Program at the China University of Politics and Law. He also serves as Director of the Bankruptcy Law and Restructuring Research Center of the China University of Politics and Law. He was a member of the drafting group for the New Enterprise Bankruptcy Law.

[13] Settlement Regulations regarding Risky Securities Companies of the People's Republic of China

[14] See INSOL Technical Series Issue No. 9 (September 2009) written by Alan CW Tang, as supplemented by an update paper presented at the INSOL Singapore Conference in March 2011. See also INSOL Case Study No. 5 (March 2011) and Newsletter update in April 2011.

concerns, however, officials have reached a consensus that a system of individual insolvency must be established. Personal bankruptcy protection plays an important role in any society. Without it, individuals with unmanageable levels of debt have few means of getting their liabilities settled or waived and becoming productive members of society again. Often, they have little choice but to abscond or resort to activities that result in harm to themselves and society. Therefore, it is important that China introduce a system of individual bankruptcy protection as soon as practicable.

G. Cross-border Insolvency Issues

Cross-border insolvency refers to the petitioning of a local court to recognize and enforce the extra-territorial ruling of a foreign court in a bankruptcy proceeding. The intention is usually to obtain cooperation in securing the debtor's assets located in the local court's jurisdiction. Article 5 of the 2006 EBL sets forth the principle that the People's Courts will cooperate in cross-border cases, subject to certain conditions. In outbound cases, the law provides that domestic bankruptcy procedures shall apply to the debtor's property located outside of the PRC. For inbound cases, Article 5 makes co-operation and recognition compulsory[15] for local courts hearing inbound applications if the application is grounded in an international treaty or reciprocal agreement, and the foreign judgment does not contradict the following:

1. the basic principles of the law of the PRC;

2. violate China's sovereignty, security, and social and public interests; and

3. infringe upon the lawful rights and interests of creditors within the PRC.[16]

While Article 5 provides a legal basis for cross-border co-operation, its impact is likely to be minimal until China enters into relevant treaties and reciprocal arrangements on cross-border insolvency. Furthermore, courts are likely to encounter difficulty in applying the law in the absence of concrete procedural "working" rules specifying, for example, the proper court to handle the application, the specific standards to be applied, the documents to be submitted, the procedures and conditions under which the court will examine the application, etc. Court officials have deliberately adopted a cautious approach with regard to these issues. One of their major concerns is that Chinese judges and related professionals have not dealt with many complex insolvency cases from abroad, especially those eminating from different legal systems involving complex financial and security arrangements and corporate structures. In light of this lack of experience, Court officials are skeptical of the ability of local judges and other professionals to adequately protect the rights and interests of relevant parties in major cross-border cases, particularly those of less sophisticated Chinese parties.

Although their approach has been cautious, Court and government officials are eager to expedite China's integration into the global cross-border insolvency system. Persistent economic growth in past decades has led to increasing levels of Chinese investment in other jurisdictions. Outbound cross-border insolvency issues have become a business reality for many major PRC operations. Cross-border protocols and agreements on insolvency are needed to adequately protect these interests abroad. Creating an environment conducive to effective international cooperation will require further development of China's cross-border procedures and training of more capable judges and other professionals to become able to handle the complex issues involved.

H. Strengthening the Bankruptcy Profession

A well-functioning bankruptcy regime requires high-quality professionals working in the system. China should take steps to further develop and improve the quality of its bankruptcy judges and practitioners. In keeping with this objective, one of the major functions of the China Bankruptcy Law Forum is to consolidate and strengthen the bankruptcy profession. Participants at the Forum offered many recommendations as to how this could be accomplished. Some argued that setting a more competitive level of remuneration for bankruptcy administrators would help attract more qualified candidates, as the current

[15] Article 5, 2006 Enterprise Bankruptcy Law of the People's Republic of China ("… the people's court *shall*… decide to reorganize and enforce the judgment or ruling") (emphasis added).
[16] *Id.*

statutory financial incentives for undertaking the role are small. Furthermore, there were calls for the implementation of an administrator certification system. A plan for such a system is in the drafting stage, but no specific mechanism has been established and no department has been assigned to implement the task. The plan has been deferred for the moment, but a basic consensus has been reached on the necessity of moving this important task forward. Relevant government bodies are expected to work together with the SPC to produce a tentative plan in the near future. Finally, opportunities for international communication and exchange should be actively promoted. Conferences and symposiums held by organizations such as INSOL International are a valuable professional resource. Practitioners in the PRC stand to benefit from the wisdom and experience of foreign insolvency professionals.

III. Looking Ahead

Court officials, judges, policymakers, and members of China's bankruptcy profession are making great efforts to devise workable solutions to the challenges identified above (and otherwise). Relevant research groups and drafting committees are taking patient, measured steps to carefully scrutinize each issue, and the government is contributing financial and administrative support. At this early stage in implementation of the new EBL, the government is likely to continue to play an active role in the development process. Although bankruptcy is a judicial procedure traditionally within the domain of the judiciary, the People's Courts currently lack the ability and resources to handle the social and economic problems associated with major enterprise insolvency. Government co-operation and support are necessary to the continued operation and improvement of the system.

Government support takes a variety of forms. Local governments, for example, have played a key role in the bankruptcy process, assisting with debtor-creditor negotiations, providing interim funding to help pay aggrieved workers' claims, and helping with worker rehabilitation. Meanwhile, the Ministry of Finance is conducting research on a fiscal support framework to address some of these urgent funding needs on a national basis. The proposed framework would provide for and cover basic administrative expenses, and designate funds for the payment of workers' claims. Furthermore, it would set a minimum level of remuneration for the bankruptcy administrator in cases where insufficient assets exist to pay the administrator for his services.

The central government is also looking into a series of proposals to bolster China's insolvency system. One proposal advocates the creation of a semi-independent government agency to handle insolvency-related matters in cooperation with the People's Courts. The agency would liaise with courts and relevant government bodies to facilitate the smooth co-ordination and handling of bankruptcy cases. Responsibilities would include providing necessary supervision of cases and exercising oversight over the administrator. Furthermore, relevant government departments are working to implement an enterprise bankruptcy early warning system. Unlike SASAC's early warning system for SOEs referred to in section IIC above, this mechanism would monitor both SOE and non-SOE enterprises. The system would require designated government agencies, assisted by relevant businesses professionals and insolvency practitioners, to provide the market with significant information and professional analysis of important trends and developments.

Government agencies are also exploring ways to raise the likelihood of successful business reorganization by relaxing certain administrative requirements. As a comparison, certain procedural rules and legal obligations in U.S. reorganization proceedings are sometimes waived or exempted, to the extent that doing so would improve the enterprise's chances of a successful turnaround. Along similar lines, the SPC recently recommended that policymakers consider and establish certain tax exemption arrangements in reorganization procedures, such as forgiveness of taxes on book profit arising from discharged debt. Establishing such mechanisms in the PRC would provide judges and administrators with useful tools to facilitate the reorganization process and help debtors successfully revive their troubled businesses.

Additionally, the government is in the process of formulating policy guidelines regulating the direct involvement of the state in rescuing particular enterprises. The guidelines will specify the circumstances under which the government will be allowed to participate directly in insolvency cases. The aim of this measure is to systematize and make transparent the degree of government involvement in the bankruptcy process, and to mitigate the effects of any personal influence. In formulating the relevant rules, the government will consider four main principles. Firstly, there must be a clear necessity for government intervention. Secondly, there must be proportionality

between the amount of resources the government expends and the potential benefits that are likely to result. Thirdly, procedural fairness must be upheld. Finally, the government will also take into account the availability of market-based solutions to assist the problem enterprises.

The goal moving forward, as recommended by Professor Wang Weiguo, should be to gradually reduce the scope and extent of the state's intervention in enterprise insolvency. This is critical to preserving the independence of the judiciary and upholding the neutrality of bankruptcy administrators. Concerns about the extent of state/government involvement in bankruptcy administration also highlight broader issues related to the balance between fairness and efficiency. Although the immediate needs of the new EBL development sometimes require practical as well as pragmatic approaches, officials should take precautions not to sacrifice interests of fairness in pursuit of workable solutions.

IV. Conclusion

As speakers at the 4th session of the China Bankruptcy Law Forum emphasized, China currently faces many practical challenges implementing the recently enacted EBL. At the moment, the bankruptcy system suffers from a host of problems such as unclear or unsettled procedures, resource and personnel constraints, and a lack of designated supporting institutions. Resolving these issues will not be an easy task, but China's bankruptcy professionals are hard at work, patiently and rigorously devising pragmatic and workable solutions. Through persistent collective efforts, China will continue to drive forward development of the bankruptcy system.