INSOL International

Review of the PRC Bankruptcy Law in 2009

March 2010

Technical Series Issue No. 11

Review of the PRC Bankruptcy Law in 2009

Contents

INSOL International
6-7 Queen Street, London, EC4N 1SP
Tele: +44 (0) 20 7248 3333 Fax: +44 (0) 20 7248 3384

Acknowledgement

Since the new bankruptcy law came into effect two years ago, the idea of bankruptcy is gradually gaining social recognition in China.

The new reorganization system that was introduced appear to be more readily accepted as the current economic and financial crisis deepened and it had an adverse impact on local businesses. By contrast, the relatively few bankruptcy cases during this period indicate that the new bankruptcy legislation is not well utilised in practice. Overall the general application of the new legislation is considered not as effective as expected, with the exception of the new reorganisation system that seems to be working well.

In this paper the authors discuss the current position and effectiveness of the new laws in respect of reorganisation, compromise and liquidation including five actual case examples. The paper also identifies the causes for the lack of use of bankruptcy laws, the limitations in the new statutory provisions and the problems and challenges that may be encountered when implementing the new laws. It also identifies some issues that law reformers would have to address in the future.

INSOL would like to thank Professor Li Shuguang, (Director) and Wang Zuofa (Research fellow) both from the Bankruptcy Law and Restructuring Research Centre, China University of Politics and Law for writing this excellent paper that gives a good insight into the practical working of the current legislation.

March 2010

Review of the PRC Bankruptcy Law in 2009

Li Shuguang & Wang Zuofa*

Introduction

China's bankruptcy regime is mainly composed of two sections: the statute and the related judicial interpretations. The statute is made by the National People's Congress (NPC) while the judicial interpretations are formulated by the Supreme Court. The existing statute is the bankruptcy law (hereinafter called "the new law") passed by the NPC in August 2006 and became effective since June 2007.[1] In order to co-ordinate with the implementation of the new law, the Supreme Court has formulated several related judicial interpretations such as the Supreme Court Rules on: -

- Some Problems in the Application of Law in Enterprise Bankruptcy Cases Which Are Pending when The Enterprise Bankruptcy Law of PRC Becomes Effective;[2]
- The Designation of Administrator in Hearing Bankruptcy Cases;[3]
- The Compensation of Administrator in Hearing Bankruptcy Cases;[4]
- Some Problems Concerning Time Limits in Hearing Civil Cases[5]etc. and

- The Supreme Court order on How to Handle the Cases when the Creditor Files a Liquidation Case against the Debtor Whose Whereabouts or Assets are Unclear;[6]

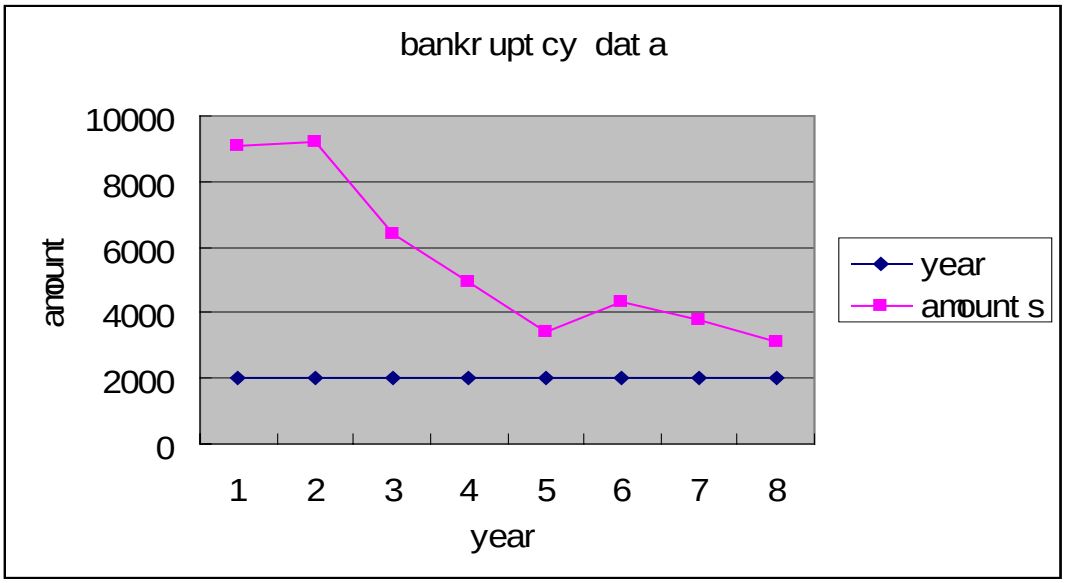
Besides, as a response to some problems arising in the two-year implementation of the new law, the Supreme Court is drafting a comprehensive judicial interpretation of bankruptcy law. It is expected to be published in 2010.

The new law applies to all the enterprise legal persons.[7] It provides for reorganization system similar to the chapter 11 proceedings under the U.S. Bankruptcy Code where it allows for an administrator system; and also enhances the protection of creditors in its stipulations concerning the creditors' meeting and creditors' committee. These new provisions in the law provide it with many characteristics of a modern business bankruptcy regime.

However, while it introduces advanced market-orientated bankruptcy mechanics, the new law has not brought an increase of bankruptcy cases as expected. The following chart reflects the data of annual bankruptcy cases adopted by the courts in mainland China since the beginning of this century:

* Li Shuguang, Professor & Director of Bankruptcy Law and Restructuring Research Center, China University of Politics and Law. Professor Li was also a member of the drafting group of 2006 Bankruptcy Law of China.
Wang Zuofa, Research fellow of Bankruptcy Law and Restructuring Research Center, China University of Politics and Law. He currently teaches in Jilin Normal University.

1 Before June 2007, the statute regulating business bankruptcy was the bankruptcy law enacted by the NPC in 1986.
2 Fashi (2007) 10, Apr.23, 2007.
3 Fashi (2007)8, Apr.4, 2007.
4 Fashi (2007)9, Apr.4, 2007.
5 Fashi (2008) 11, Aug.11, 2008.
6 Fashi (2008) 10, Aug.4, 2008.
7 The bankruptcy liquidation of other economic organizations other than enterprise legal persons can refer to the new Law.



Source of Information: the Supreme Court and Bankruptcy Law and Restructuring Research Center, China University of Politics and Law. The numbers on Horizontal axis represent years from 2001 to the 2008 and the numbers on the vertical axis indicates the amount of cases adopted by the courts.

Years	2001	2002	2003	2004	2005	2006	2007	2008
Amounts	9110	9200	6380	4593	3419	4300	3810	3139

According to the chart, the year 2001 witnessed 9110 bankruptcy cases, and in the year 2002 there was a slight increase to 9200. From 2002 to 2005, the amount of annual bankruptcy cases dropped sharply from 9200 to 3419. Then in the year 2006 there was a considerable increase from 3419 to 4300. The annual amount of cases adopted by courts since the implementation of the new law in 2006 dropped to 3810 in 2007 and to 3139 in 2008.

Another data comparison further highlights the lack of use of the new law after it was implemented. There were 3139 enterprise bankruptcy cases in 2008 while there were 780 thousand enterprises stepped out of the market in the same year. Among the 780 thousand enterprises 380 thousand exited the market through the path of deregistration (*zhuxiao*) and 400 thousand through the path of license cancellation (*diaoxiao*). [8]

Under China's company law, bankruptcy law and relevant administrative regulations, an enterprise may step out of the market through two ways. One way is the bankruptcy liquidation by the court, the other is to windup under company law provisions outside the court. For liquidation outside the court, some enterprises choose to wind up voluntarily in accordance with its charter; some liquidate involuntarily because of cancellation of its business license by the Industrial and Commercial Bureau (ICB). The enterprise still has legal entity status if its business license is cancelled but without going through the winding up process. The enterprise must be deregistered before losing its legal entity. But it must go through the winding up process before deregistration. The problem is that in practice some enterprises step out of the market without going through the appropriate winding up process in order to evade debts.

In the year 2008, China was also affected by economic depression, leading to recession in certain trades and many enterprises falling into financial difficulty. Many enterprises chose to circumvent applying bankruptcy law while stepping out of the market: They either filed for deregistration straight without going

[8] The data is collected by Bankruptcy Law and Restructuring Research Centre, China University of Politics and Law, based on relevant media reports and information disclosure of Supreme Court.

through bankruptcy liquidation or even stepped out of the market directly after their licenses were cancelled without filing for deregistration. This further explains why there were so few bankruptcy cases in year 2008.

Despite the general application of China's bankruptcy law, is not as good as expected, the newly introduced reorganization system seems to be working well. There appear to have some reorganization cases since the enactment of the new law, especially that of some large listed corporations. There have been 16 reorganization cases adopted by the courts of listed corporations till June 2009. There are also some reorganization cases of close corporations.

The new law provides three procedures for an insolvent business: reorganization, compromise, and bankrupt liquidation. Chapter 8 of the new law provides for reorganization, chapter 9 provides for compromise, and chapter 10 provides for bankrupt liquidation. The structure of the new law implies that its focus is on enterprise rescue and turnaround. The new law encourages insolvent businesses to choose restructuring methods as first choice. Only when there is no business viability should the bankrupt liquidation process be adopted as the last resort. In addition, the new law makes specific stipulations for the bankruptcy of financial institutions. The financial supervision of organizations that are authorized to file for reorganization or bankrupt liquidation when the financial institutions such as banks, securities corporations or insurance corporations are insolvent.[9]
The following of this article will illustrate some new changes brought by the new law by examining typical cases, and the real use of those new bankruptcy systems brought by the new law. Further, the general influence of financial crisis on the creditors and businesses in China will also be discussed briefly.

Part I - The Implementation of China's Bankruptcy Law

A. Business Reorganization

Chapter 8 of the new law regulates business reorganization. Chapter 8 is formulated on the basis of drawing lessons from chapter 11 of the U.S. Bankruptcy Code.

1. The Basic Legal Framework of Business Reorganization

The new law stipulates low threshold of reorganization. The court will accept the filing of reorganization as long as one of the following three conditions are met.

1. When the debtor fails to settle its debt as due and if its assets are not enough to pay off all the debts.
2. If it is obviously incapable of clearing off its debts.
3. If it is obvious that it is unable to pay off its debts[10].

A debtor or creditor may, according to the provisions of the law, apply directly to the people's court for reorganization against the debtor. Where any creditor applies for bankrupt liquidation against its debtor, after the people's court accepts the application for bankruptcy and before the debtor is announced bankrupt, the debtor or its capital contributor whose capital contribution makes up 1/10 or more of the debtor's registered capital may apply to the people's court for reorganization.[11] The reorganized corporation can be managed by the Debtor-in-Possession (DIP) under the supervision of the administrator or directly by the administrator. But the plan of reorganization shall be carried out by the debtor under the supervision of the administrator.[12]

The new law provides for a market-orientated administration system to replace the liquidation group under the 1986 bankruptcy law.[13] In order to co-ordinate with the provisions of the new

[9] Article 134 of the new law (the articles cited below all refer to the new law unless otherwise specified).
[10] Article 2.
[11] Article70.
[12] Article 73,74,89,90.
[13] There was no administrator in 1986 bankruptcy law. Instead, the liquidation group mainly composed of administrative officials controls the bankruptcy procedure under that law.

law, the Supreme Court has formulated two judicial interpretations regulating administrators as a supplementary of the new law in March 2007. Under the judicial interpretation, qualified social intermediaries and individuals can apply to register as administrator candidates on the registration list formulated by the court under whose jurisdiction they are subject to. The court generally designates the administrator from the list for a specific bankruptcy case. The administrator may come out by competitive bid among different jurisdictions in influential cases. In some cases, the liquidating group may convert into the administrator. [14] It should be clarified that the new law allows the liquidating group to convert into the administrator only for the purpose of compromise to the current practice in real life, which is intended to be a minor and supplementary transition from the current practice to market-orientated practice. But the transitional arrangement becomes dominant in practice, especially in the bankruptcy of large corporations. In addition, the compensation of administrators is also covered by the judicial interpretation.[15]

2. Typical Reorganization Cases

a. Reorganization of Listed Corporations

The new law brings much impact on China's securities market. There are many insolvent listed corporations in China's securities market labeled as ST corporations.[16] Since the listing cost in China's securities market is quite high, the ST corporations still remain considerable "shell value". ST corporations become attractive targets of acquisition for outside investors. But since the out-of-court restructuring negotiation involves high costs and uncertainty, there have been very few successful cases of out-of-court restructure. Some ST corporations were dragged long on the road of restructuring and ended with failure and being delisted. The reorganization system under the new law provides the ST corporations with a low cost alternative of preserving the shell. This is also a good business opportunity for some investors.

Another incentive of reorganizing the ST corporations comes from the local governments. Since reserving a license of listed corporation indicates good administrative performance, more job rates and a good image for the local governments; the local government officials have strong incentives to impose influences on the courts, the debtors, and the creditors to reorganize those ST corporations. These factors lead to a comparative brisk market for reorganization of ST corporations.

Until June 2009, there have been 16 ST corporations filing for reorganization.[17] All the plans of reorganization have been approved by the courts.[18] This article will select typical cases among those to describe the reorganization of ST corporations according to the category of the mode of management.

(i) DIP Mode

The new law provides for a DIP mode similar to the DIP management under Chapter 11 of the U.S. Bankruptcy Code. In practice, however, DIP mode accounts for very few proportions in China's listed corporation reorganizations. Among the 16 reorganized listed corporations, there are only 3 DIP cases.[19]

---

[14] See supra note 2.
[15] See supra note 3.
[16] ST means 'special treatment'. It's a special warning system formulated by the securities exchanges in China against listed companies suffering severe losses for the protection of investors. According to the rules of Shenzhen and Shanghai stock exchange, listed corporations suffering losses for two continuous years shall be marked *ST before the name of the corporation to warn the investors the potential risk that the corporation may be de isted if the losses continue. If the *ST corporation remain losing money for two years, it will become S*ST corporation in the third year. If it still cannot recover by the end of the third year, it will be de listed.
[17] They are: ST Haina, ST Jinhua, ST Lanbao, ST Zhaohua, ST Baoshuo, ST Xingmei, ST San-an, ST Tianfa, ST Hualong, ST Beiya, ST Changling, ST Huayuan, ST Beisheng, ST Xin-an, ST Dixian.
[18] Of course, with the threshold of IPO of listed companies tends to be lower, the shell value might decrease.
[19] They are: ST San-an, ST Tianfa, ST Changling.

Case 1: The Reorganization of S*ST Tianyi (San-an)

Background of Reorganization

The debtor was suspended to trade on the stock market on 25 May 2007 by the Shanghai Stock Exchange due to its three-year continuous loss record. One of its creditors filed reorganization against it in July 2007. The court ruled to reorganize the debtor on 13 August 2007.

Management Mode of the Reorganization

The debtor applied to the court to manage the business and assets during the reorganization. The court approved its application. The administrator worked out specific rules to supervise the DIP. Later the investor as the restructuring party removed the management of the debtor, transferring DIP management into the restructuring party management.

Composition of the Administrator

The court designated the liquidating group as the administrator of reorganization. The liquidating group was composed of the State Assets Supervision and Administration Committee (SASAC) of Jingzhou City, the Labor and Social Security Bureau of Jingzhou City, the People's Bank of China Jingzhou Central Branch, China Banking Supervision and Administration Committee (CBSAC) Jingzhou Branch, Hubei Chengxin Accounting Firm, and Beijing Deheng Law Firm.

The Role of Court

The court played an active role in arranging the auction and buyout of the corporate shares in the reorganization process, including entrusting auction company, enforcing the results of auction and buyout transaction in the form of civil adjudication etc.

Method of Reorganization

The reorganization of the debtor includes three parts: debt restructure, equity restructure, and asset restructure. The debtor's business condition makes it impossible to complete the three-part reorganization by itself. Only by introducing an outside investor to resolve its huge debts and inject sound assets can the debtor recover and relist. The outside investor was San-an Group.

In October 2007, San-an Group and its subsidiary obtained 5.4 million and 297 thousand shares of the debtor with the expense of 16 million and 780 thousand Yuan RMB through auction bid, which accounted for 45.43% of the total share capital of the debtor. At the same time, Hainan Yedao Corporation bought out the major business assets from the debtor, leaving San-an Group with a clean shell. San-an then reshuffled the debtor's board of directors and removed the management. In March 2008, the debtor's second temporary shareholder's convention approved the asset restructure plan proposed by San-an: the debtor issued 115 million shares directly to San-an (*Ding Xiang Zeng Fa*) and the latter injected good quality assets such as LED chips valued at $500 million as consideration. After the restructure, San-an and its subsidiary owned 72.19% of the total share capital of the debtor. The name of the listed corporation was changed from S*ST Tianyi to S*ST San-an after the restructure.

Reorganization Progress

On 23 January 2009, the Shanghai Stock Exchange approved the application of S*ST San-an to remove its label S*ST. S*ST San-an became a normal listed corporation: San-an Electronic Corporation.

ii) Administrator Mode

Administrator Management dominates the reorganization cases of China's listed corporations. *ST Huayuan is a typical case.

Case 2: The Reorganization of *ST Huayuan

Background of Reorganization

The debtor was suspended to trade on the stock market by the Shanghai Stock Exchange due to its three-year continuous loss from 2005 to 2007. In August 2008, a creditor of *ST Huayuan, Shanghai Taishengfu Enterprise Development Corporation applied to the second intermediate court of Shanghai to reorganize the debtor. The court ruled to accept the case in September. What's noteworthy is that Shanghai Taishengfu Enterprise Development Corporation is a subsidiary of *ST Huayuan and they are both subject to the same controller—China Resource Group of Hong Kong which means it is the debtor who actually applied for reorganization.

Management Mode of the Reorganization

Considering that the debtor is the first listed corporation filing a reorganization petition in Shanghai, and the debt relations were rather complicated, the court designated the liquidating group as administrator and ordered the administrator to manage the business of the debtor during the reorganization process.

Composition of the Administrator

The parties of the liquidating group include: CBSAC Shanghai Bureau, China Securities Supervision and Administration Committee Shanghai Bureau, Shanghai Financial Office, SASAC Shanghai Branch, some staff from China Resource Medical Group, King & Wood Law Firm of Beijing.

The Role of the Court

The court dominated the process of selecting the administrator.

Method of Reorganization

The plan of reorganization was approved by all the voting classes on 1 December 2008. The plan was composed mainly of two basic parts: (1) All the existing shareholders transfer about 186 million and 504 thousand shares to compensate claims of creditors to the restructuring party as consideration. (2) To inject sound net assets with certain profitability valued no less than one billion Yuan RMB in the form of direct issuance of stocks to investors, enabling *ST Huayuan to restore sustained operation and profitability.

Reorganization Progress

The restructuring party that China Resources designated before was a real estate company. The real estate business was not recognized by the market at that time and China Resources had to re designate a restructuring party. The reorganization is still pending and *ST Huayuan is still being de listed as of the date this paper is written.

b. The Reorganization of Close Corporations

Due to lack of shell value, the reorganization of close corporations is more difficult than that of listed corporations. The following case is presented to reflect a general picture of how a close corporation is reorganized.

Case 3: The Reorganization of Yaxin

Background of Reorganization

Yaxin Electronics and Yaxin Circuit Board (hereinafter referred to as Suzhou Yaxin) are two enterprises in Wuzhong District of Suzhou city. These enterprises were financially very sound. Their parent company, Taiwan Yaxin Corporation however was to be re organised by a ruling given by the Taiwan Shilin Court. The bankrupt reorganization of the parent corporation brought a heavy blow to Suzhou Yaxin. The cash receivables could not be collected, cash flow failed, and the business plunged into financial difficulties.

At that time, there were nine domestic banks and six foreign banks that had given loans to Suzhou Yaxin, totaling 1.46 billion Yuan RMB. These bank creditors were divided about the future of the debtor. Some banks demanded winding up of the debtor, while others were confident with the debtor's market potential and called for reorganization.

The local government negotiated with the fifteen banks to reorganize the debtor. The government's intervention led to the final consensus to reorganize the debtor. On 25 April 2008, a banking group composed of the fifteen banks filed a reorganization petition in the local court.

Management Mode of the Reorganization

The administrator managed the reorganized corporation. The local court didn't have a list of administrators at that time. So the bank creditors proposed an administrator and the court examined and approved the proposal.

The Composition of the Administrator

Ernst & Young Huaming Accounting firm was appointed as the administrator.[20]

The Role of Court

The local court respected the creditor's right of selecting the administrators. It only exercised its authority of judicial examination and approval in the appointment of the administrator.

Method of Reorganization

The administrator created a global platform for competition of investors. Tiger Builder Consultant Ltd. (hereinafter referred to as Tiger Builder) won the competition.

Tiger Builder contributed 35 million Yuan RMB and got 100% equity interests and control right of Suzhou Yaxin. The legal entity of Suzhou Yanxin remained unchanged and the claims confirmed by the court were to be repaid at the rate of 100%. The plan of claims compensation to be carried out within eight years.

This is a case of reorganizing an enterprise with its legal entity while its business remains unchanged. This case however leaves a controversial problem: the outside investor promised to pay out the debtor's confirmed claims at the rate of 100% but on the condition of obtaining 100% of the old equity of the reorganized corporation as consideration of its payment. Thus the old equity holders were wiped out of their equity interests completely under the judgment confirmation of the court and several questions arise from such a ruling. On what legal grounds did the court confirm this kind of equity transaction in reorganization? Are there any flaws in the procedure of confirming such a kind of transaction?

[20] Ernst & Young Huaming is a joint venture of Ernst & Young in China established in 1992. It is noteworthy that sino-foreign joint venture accounting firms registered in China are allowed to act as administrator in bankruptcy cases in China under the judicial interpretation of Supreme Court in 2007.

Progress of Reorganization

Suzhou Yaxin has restored operations.

Interim Summary

(a) Since the reorganization of ST corporations in China mainly focus on the shell value, the financing of reorganized corporations in China is quite unique. We hardly see any debt financing (DIP financing) either by old creditors or new investors. Rather, the financing of reorganized corporations is mainly through a kind of equity financing named direct issuance of stocks (Ding *Xiang Zeng Fa*) to the investors who also serve as financiers. For listed corporations, since the stock sometimes are still trading during the reorganization process, the price of *Ding Xiang Zeng Fa* may affect the interests of other traders in the stock market. In fact, there is a litigation launched by other stock traders concerning the price of *Ding Xiang Zeng Fa* against the local securities watch dog and the investor who got the control rights of the reorganized corporation by equity financing.[21] It seems detailed rules should be established to connect the bankruptcy law and securities law for the bankruptcy of listed corporations.

(b) There are excessive speculations in the reorganization of listed corporations in China. Reorganization has become a subject matter of blind speculation for the stock market investors, especially amongst small and medium investors.

(c) The new law intends to introduce administrators so that the strong administrative interference under the 1986 bankruptcy law may be avoided. However, the liquidating group has become the major mode of the administrator and the administrative staffs dominate the liquidation group in many large business bankruptcies, which weakens the effectiveness of the new law's implementation.

(d) The judges handling reorganization cases lack experience in making appropriate balances between different interests in the reorganization process. For instance, the judge in the Yaxin reorganization case made a judgment of depriving the old equity holders of their equity interests as the consideration for the outside investor to participate in the reorganization. But no sufficient legal reasons were provided for such a judgment.

B. The Legislation and Judicial Practice of Compromise

The new law provides for bankruptcy compromise in chapter 9. The debtor may choose to file for compromise. A draft of compromise agreement should be presented when the debtor applies for a compromise. The compromise agreement will not be approved by the court until the consent of 1/2 or more of the creditors with the right to vote who attend the creditors' meeting representing 2/3 or more of the total credit amount free from property guarantee. The compromise agreement does not bind secured creditors.[22]

There have been rather few compromise cases since the implementation of the new law.

Interim Summary

The legislators intended to provide compromise as an alternative system of turning around the business to reorganization. But the two systems seem to overlap, and in practice, most people choose reorganization.

[21] This litigation arouse during the reorganization of ST Jiufa. According to the regulation of China Securities Supervision and Administration Committee, the price of *Ding Xiang Zeng Fa* during reorganization should be approved by the shareholders' meeting by those shareholders present holding more than two thirds of the voting rights and those social public shareholders present holding more than two thirds of the voting rights. But the *Ding Xiang Zeng Fa* in this case was not subject to the double measurements of votes. The plaintiff accused that the price issued to the investor through *Ding Xiang Zeng Fa* was too low and the procedure violated the regulation. The defendant argued that since the *Ding Xiang Zeng Fa* was done after the plan was confirmed and should not be subject to the regulation. But since the price of ST Jiufa rose amazingly, the plaintiff dropped the litigation in the end.

[22] Article 95,96,97,98.

C. The Legislation and Judicial Practice of Bankruptcy Liquidation

1. The Basic Legal Framework of Bankruptcy Liquidation

The bankruptcy liquidation system is the process under which the legal entity of the enterprise is completely wiped out and the creditors share the debtor's assets in accordance of their priorities. The new law also makes strict stipulations on the transactions of the debtor's assets. The administrator drafts the plan of assets distribution and submits it to the creditors' meeting for discussion. If the plan is passed by the creditors' meeting and approved by the court, it shall be executed by the administrator.[23] In a liquidation distribution, priority does not bind secured creditors who may enjoy the priority right to be repaid by means of the particular assets.

Under article 113 of the new law, the insolvent assets shall, after the costs for bankruptcy proceedings and community liabilities are repaid in priority, be liquidated according to the following sequence:

(a) The wages and subsidies for medical treatment and disability, comfort and compensatory expenses as defaulted by the bankrupt, the fundamental pension premiums, fundamental medical insurance premiums that shall have been transferred to the employees' personal account, as well as the compensation for employees as prescribed by the relevant laws and administrative regulations;

(b) The social insurance premiums and tax fees as defaulted by the bankrupt other than those as prescribed by the aforesaid provisions; and

(c) The general claims of bankruptcy.

Where the insolvent assets are not enough to satisfy the requirements for liquidation in the same sequence, it shall be distributed in a proportionate manner.

The acts of the directors, supervisors as well as senior managers of an insolvent enterprise shall be under strict restriction during the liquidation process.

2. Typical Cases of Bankruptcy Liquidation

Case 4: The Bankruptcy of Sanlu Group

Background of the Case

Sanlu Group (Sanlu) was the largest enterprise that produced children's milk powder in China. When the scandal that it added lethal melamine to its product was disclosed in September 2008, many victims and their relatives filed suits against it and its sale of milk powder fell drastically. On 18 December 2008, its creditors filed a bankruptcy petition with the Shijiazhuang intermediate court and the court accepted the case. On 12 February 2009, the court declared the bankruptcy of Sanlu. Until December 2008, the total assets value of Sanlu was 1.56 billion Yuan RMB, and its total debt value was 2.66 billion Yuan RMB. Thus, Sanlu, one of the largest milk production enterprises in China with its brand assets valued at over 14 billion Yuan RMB, suddenly collapsed, leading to a bankruptcy with far-reaching domestic and foreign consequences.[24]

Administrator

The court designated the liquidating group as administrator. The administrative organs in charge of Sanlu and the local government dominated the liquidating group. This kind of administrator composition cast a strong shadow of government influence on the bankruptcy case.

[23] Article 115,116
[24] See *The Government of Shijiazhuang City Announces the Bankruptcy Case of Sanlu Group*, at China News Net, on Dec.25, 2008.

Creditors' Committee and Creditors' Meeting

The court designated representatives of the state-owned Shijiazhuang Development and Investment Limited Corporation, one of the three largest creditors of Sanlu, as the chairman of creditors' committee. The first creditors' meeting was held on 12 February 2009, in which the plan of assets management and liquidation was passed.

The Plan of Bankruptcy Liquidation and Its Implementation

The Plan of Bankruptcy Liquidation mainly contained three parts:

(a) Public Auction of Assets

Four rounds of assets auctions have been held from March to April 2009. There was no bidder in the fourth round.

(b) Claims Transfer

Hebei Guoxin Assets Management Corporation, one of the largest creditors of Sanlu, bought claims from many supplier-creditors with 80% discount. Besides, many distributors of Sanlu also sold their claims to the wholly owned subsidiary of Sanlu— Sanlu Commerce and Trade.

(c) Settlement of Employees

The assets of Sanlu were sold to companies like Beijing Sanyuan Corporation (Sanyuan) via auction after it was declared bankrupt. The settlement of employees was linked with the assets auction during the bankruptcy process. Sanyuan who bought the core assets of Sanlu in the first auction has promised to employ all the employees of Sanlu. Those having labor contracts with Sanlu and volunteering to join Sanyuan were guaranteed to be employed by Sanyuan. Those having no labor contract with Sanlu could make mutual choices with Sanyuan. Those who chose to leave Sanlu would go through formalities to terminate the labor contract.

The bankruptcy case of Sanlu leaves a question unsolved: How to guarantee those future victims of melamine with adequate medical help and compensation? Until now, some local governments provided some money to pay the bill. But this method is not sustainable. A systematic legal solution must be found to solve this problem with equity and efficiency in the future modification of this law.

The Role of Court

The role of the court is undermined by the interference of government in many aspects in this case. For instance, the designation of the administrator was decided by the government and the auction of assets was arranged by the government.

Case 5: The Bankruptcy Liquidation of Huaxia Securities Corporation

Background of the Case

Huaxia Securities Corporation (Huaxia) used to be one of the three largest securities corporations in China. It lacked sustained operations and was in financial risk because of mismanagement. On 15 December 2005, China Securities Supervision and Administration Committee (CSSAC) and Beijing municipal government co-ordered to terminate all the securities businesses of Huaxia and all its branches as well as business departments, and cancelled its business license. Beijing municipal government entrusted China Cinda Assets Management Corporation to liquidate Huaxia. The liquidation proved that Huaxia met the requirements of bankruptcy. On 28 April 2008, CSSAC issued a letter to approve the bankruptcy application of Huaxia. On 30 April 2008, the liquidation group of

Huaxia applied the court to declare the bankruptcy of Huaxia. The court ruled to accept the case on 31 July. On 12 August the court declared Huaxia bankrupt.

Administrator

The court designated the liquidating group, the Cinda Assets Management Corporation, as the administrator.

Creditors' meeting and committee

The first creditors' meeting was held on 17 November 2008, in which the creditors' committee was established. The court designated the Investors Protection Fund Corporation as the chairman of creditors' committee.

Plan of Bankruptcy and Its Implementation

The plan provided three forms of assets realization:

(a) To realize the assets at a flexible time when the price is appropriate, including securing the best market price of the day by the administrator, or by entrusting the work to a securities dealer. This method mainly fits for the securities-type assets like stock, fund, and claim which can be realized on the open securities market.

(b) Public realization, including auction of individual assets or packaged assets. This method mainly fits for the claims other than the securities-type assets described in section (a) and equities, realty and valuable rights etc. which are not publicly circulated.

(c) Those assets the auction or transfer of which is prohibited by law, rules or relevant policies shall be disposed in accordance with related laws or regulations.

The Role of Court

Since financial supervision authorities play important roles in the bankruptcy of financial institutions, the court mainly assumes the role of a passive watchdog in the procedures like selecting and approving administrators.

Interim Summary

a. From the above cases we find that there are still many gaps in China's bankruptcy law demanding further improvement, such as the treatment of future claims.

b. The new law entrusted the bankruptcy of financial institutions to financial watchdogs. Until l now there are still no detailed regulations concerning the bankruptcy of financial institutions. For instance, we still cannot tell if some financial contracts such as derivative swap contracts are subject to the automatic stay of the bankruptcy law.

Part II - The Impact of the International Financial Crisis (IFC) on China's Businesses and Creditors

The IFC has affected China's businesses and creditors in different aspects and levels. First, some of China's state-owned enterprises suffered huge losses in financial derivative transactions. For instance, CITIC Pacific lost more than 15 billion HK dollars in its investment of leveraged foreign exchange swap contract. Second, some of China's state owned investment companies suffered huge losses from investing equity securities in the U.S. For instance, China Investment Corporation lost more than 700 million dollars just in its equity investment in Blackstone. Third, some domestic enterprises got bankrupt because of the financial difficulties caused by IFC. For example, one of the largest aluminum corporations in China, Asia Aluminum Industry, went into bankruptcy caused by the breakage of cash flow due to

financing difficulty. Fourth, some domestic enterprises suffered heavy losses in their international acquisition transactions. The typical case is the equity acquisition of Fortis by China's Ping-an group, causing losses of more than 15 billion Yuan RMB. Last but not least, some foreign bankruptcy cases also have had impacts on China's domestic enterprises and individuals. For example, the bankruptcy cases of GM and Chrysler have affected some domestic enterprises. The bankruptcy of Lehman Brothers caused some domestic investors huge losses on their foreign investment. There are however some Chinese enterprises benefiting from it, for instance, a local mechanical enterprise in Sichuan province of China is engaging in the buyout of the sector of Hummer from GM.

Interim Summary

In view of the growing important role that China's economy plays in the world, a more detailed and clear cross-border bankruptcy regulation should be established in China's bankruptcy regime in order to provide more certainty for both domestic and foreign investors.

Summary

The two years enforcement of China's bankruptcy law has promoted China's market economy to a certain extent. The idea of bankruptcy is gradually gaining social recognition and the reorganization system, especially under the background of economic depression, seems to be more readily accepted. The IFC and the international bankruptcy under its background have also brought some impact on China's businesses and creditors, highlighting the importance of China's economy as an important section of the international economic chain. But the relatively few bankruptcy cases reflect that the function of bankruptcy law is not appropriately used in practice. We attribute the causes of the inactive use of bankruptcy law to four factors:

(a) An important reason is that the local government has much influence in deciding whether a business should step out of the market through bankruptcy process. For example, there is generally a large percentage of state shares in the equity structure of listed corporations and the number of listed corporations under the governance of a local government is generally connected with the local economic prosperity and the officials' performance. This makes the local governments dislike seeing the number of listed corporations under their regime to drop. The result is, the local governments tend to promote reorganization and the function of courts is undermined.

(b) The policy bankruptcy ended in 2008. The employee settlement enjoys government subsidiaries and bad loans of banks can be reversed under policy bankruptcy. While normal bankruptcy doesn't enjoy these preferences, the cost of bankruptcy is increased while the benefit is reduced and the initiative of local enterprises to apply for bankruptcy is negatively affected.

(c) Chinese culture does not accommodate bankruptcy. Bankruptcy signals bad luck in traditional Chinese culture. Many people do not expect to see their enterprises become bankrupt.

(d) China has no independent and professional bankruptcy courts and lacks qualified bankruptcy judges. Most of the judges in China are not yet familiar with the innovations of the new law such as appointing administrators and reorganization. The administrator however is still under the inappropriate control of court and not well known.

Upon further analysis, we find that because of the restrictions of the law making and law enforcement environment this law faces the following problems and challenges in its future implementation which require further consideration and reaction of law makers:

(a) The new law introduces the administrator system for the purpose of transferring China's bankruptcy law from administrative-orientated law to market-orientated law. But the liquidating group mode dominates the bankruptcy liquidation and reorganization of large corporations in practice and government officials dominate the liquidating group, undermining the effectiveness of the administrator system.

(b) Given the present conditions of China's market economy, the successful reorganizations of some enterprises depend on the support of local governments. Thus the proper role that the government plays and how the government volunteers to succeed from intervening corporate bankruptcy procedures with the gradual improvement of China's market economy are challenges the new law faces thereafter.

(c) There are excessive speculations in the reorganization of listed corporations in China. Reorganization has become a subject matter of blind speculation for the stock market investors, especially small and medium investors.

(d) The theory and practice of bankruptcy law is still comparatively backward in China, making it hard for the new problems emerging in practice to be resolved under the legal framework. These problems tend to be left with the government. The problem of compensating and protecting the future claimants in the case of Sanlu bankruptcy is a typical example. This kind of problems must be re-examined and a legal solution must be found. Otherwise, the market-orientated law may fall into another vicious circle of government dependence.

(f) Finally, the lack of professional bankruptcy judges renders too many court verdicts that lack strict legal statements and reasoning. For example, in the case of the reorganization of Inner Mongolia Haiji Cloric Alkali Chemical Industry Corporation, the court made a cram down verdict on a case with the face value of several billions Yuan RMB. But the length of the verdict was less than two pages! We cannot see the basic issues such as the court's reasoning on the viability of the plan and why the major unsecured creditors object to the plan on the less-than-two-page verdict. That is, the verdict doesn't show the court's reasoning and analysis, only with a conclusion. This kind of rough bankruptcy adjudication mode might be a serious obstacle for the sound development of China's bankruptcy law as well as her market economy.

In conclusion, the implementation progress of China's bankruptcy law is rather slow since its implementation in 2007. The slow progress is caused by many factors such as ideology, culture, system, market environment and government interference etc. However, China's bankruptcy law has made its first step forward towards a market economy. No matter what happens, China's bankruptcy law should strengthen the protection of creditors' interests and make good the balance of the interests of different parties in practice. At the same time, its articles should be further detailed and broadened in order to make it more operative.