

# Bankruptcy and Insolvency in the PRC: A Myth?



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The European Union in 2008 refused to recognize China's status as a 'full market economy' because, in their opinion, shortcomings remain in certain areas of governance. One such shortcoming was the lack of sound insolvency laws appropriate to a market

economy and also general international practice. The Enterprise Insolvency Law of the PRC, which took effect on June 1st, 2007, introduced some changes, most notably in relation to greater transparency and creditor involvement in insolvency proceedings. In practice, few Chinese enterprises have officially declared bankruptcy in accordance with the new law. This article aims to provide you with an overview of the Chinese insolvency and bankruptcy system.

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## Definitions

In this article, the term "insolvency" will refer to a situation where a business enterprise is unable to pay its debts as and when they come due, whilst "bankruptcy" will refer to a similar situation in relation to any entity (including an individual person). In western jurisdictions, the term "bankruptcy" usually refers to a situation where the insolvency of an entity (including an individual) has been legally declared in some form; thus, where we discuss the declaration of insolvency we will also use this term and note whether the reference is restricted to business enterprises or not.

## Many Enterprises Close, but Few Declare Bankruptcy

Since the entry by the People's Republic of China (the "PRC" or "China") into the World Trade Organization in 2001, China has played an increasingly important role in the global economy. With the increase of foreign direct investment into China, legal issues relating to corporate insolvency in the PRC have assumed greater significance and importance to such foreign investors, as well as foreign countries in general and organizations such as the World Bank, IMF, OECD, and INSOL.

The following statistical chart was issued by the Beijing Siyuan Merger and Bankruptcy Consulting Company which is a well-known local firm that deals with mergers and bankruptcies. According to the chart, there were a total of 2,955 bankruptcy cases accepted by the Chinese courts by the end of 2008. Of these 2,955 bankruptcy cases, 153 occurred in Guangdong province. However,

### Statistical Chart of Enterprises Bankruptcy Cases in China from 1989 to 2008



北京思源兼併與破產諮詢事務所·破產數據庫製作  
Beijing Siyuan Merger and Bankruptcy Consultancy·Database of Bankruptcy

according to a government website (<http://www.gxdy.gov.cn/news/shownews.asp?newsid=6729>), an official of the Administration Bureau of Small and Medium-Sized Enterprises in Guangdong told a reporter that a total of 15,661 businesses had closed down from January 1, 2008 to the end of October 2008. In other words, in Guangdong only 153 businesses declared bankruptcy in accordance with the related laws and regulations; presumably, the rest just closed their doors with their related debts and liabilities remaining. The question that must be asked is why Chinese enterprises are so reluctant to declare bankruptcy, and whether such reluctance relates in some way to the Chinese insolvency procedures.

#### Insolvency Laws in China (and the lack thereof)

The first insolvency-related law of the PRC (titled the *Provisional Insolvency Act on State-owned Enterprises* was enacted in 1986 and applies to state-owned enterprises only. The *Civil Procedural Law of the PRC* and *The Company Law of the PRC* were enacted in 1991 and 1993 respectively. Corporate insolvency legal issues were initially covered by the above three laws. However, as of 2007, the *Provisional Insolvency Act on State-owned Enterprises* was removed, and the elements directly relating to insolvency and bankruptcy contained in the Civil Procedure Law of the PRC were removed and placed into the *Enterprise Insolvency Law of the PRC* (hereinafter the “**Insolvency Law**”).

The Insolvency Law came into effect on June 1, 2007. The Insolvency Law applies to all enterprises and bodies with some notable exceptions, such as those otherwise provided for under different laws and regulations (such as for partnership enterprises and household enterprises).

Another exception is regarding personal bankruptcy – there are still no personal bankruptcy laws in China, and there are a number of reasons for this. Firstly, consumption on credit amongst Chinese people is becoming more common but still remains at levels much lower than those found in the West; secondly, credit checking facilities (in relation to personal credit ratings) remain limited in China; and thirdly, the lack of a unified network amongst the Chinese commercial banks that would allow them to share the relevant credit information. However, personal bankruptcy has recently become a contentious issue in China, and even more so after the 2008 Sichuan Wenchuan Earthquake. This is because many people’s houses collapsed during the earthquake but the house owners remain theoretically liable for the balance of their mortgages. This is still a pending matter for the Chinese government and one which has attracted attention of both the Chinese government and the Chinese people to the issue of personal bankruptcy in general.

#### The Bankruptcy Process under Current Insolvency Laws

The general steps for filing for bankruptcy are as follows:

1. The bankruptcy application is filed with the relevant Chinese court (both the insolvent party (debtor), and the creditors of the insolvent party (creditors), can file an action on the insolvent party's behalf);
2. The court makes the decision on whether to accept the bankruptcy case. Where the application is for voluntary bankruptcy (*ie* the debtor makes the application) the court takes 15 days to decide; for passive bankruptcy applications (*ie* the creditor makes the application) the court takes 22 days;
3. Within 25 days upon its acceptance of the insolvency matter, the court will publish an announcement of its acceptance, and will also inform the known creditors;
4. The creditors shall file a claims report with the court within the relevant time restriction (which is between 30 days and three months of the court's acceptance date as per point 3 above);
5. The court holds the first meeting between the insolvent party's creditors;
6. A bankruptcy trustee is appointed by the court;
7. The insolvent party is declared bankrupt by the court;
8. The bankrupt party's assets are liquidated by the bankruptcy trustee;
9. The bankrupt party's assets are distributed by the bankruptcy trustee; and
10. The insolvency assets distribution report is submitted to the court by the bankruptcy trustee.

After the asset distribution, the bankruptcy procedure is officially terminated by the court via a judgment. The bankrupt party then files for dissolution.

Not every insolvency case will end with liquidation. Under the current Insolvency Law, there are two alternatives to liquidation, namely, insolvency restructuring/reorganization and insolvency reconciliation arrangements. These two procedures provide the creditors more protection because the debtor is able to keep its business operation going and the creditors may also get a much higher percentage of their debts repaid.

Insolvency restructuring/reorganization can be thought of as a middling approach between the interests of the creditor(s) and the debtor. The creditors agree to the debtor continuing its business and the debtor will pay its debts according to the new payment arrangements as provided in the new restructuring plan (such plan is provided

by the debtor). This whole process is under the supervision of the Chinese courts. Whenever the debtor is incapable of fulfilling (or fails to fulfill) its obligations under the restructuring plan, the entire process will be terminated by the Chinese courts, who will then declare the debtor bankrupt in accordance with the Insolvency Law.

Insolvency reconciliation is also introduced by the Insolvency Law, and allows the creditors and debtors to reach an agreement on the issue without the direct involvement of a court. However, when such agreement is reached, it must be submitted to the court for its review and approval. The court will confirm that the terms of the agreement are in compliance with any relevant rules and regulations, and will issue a bulletin to the public in relation to the agreement.

A bankruptcy declaration is made by the courts to legally confirm that the debtor has been declared bankrupt. Such declaration of bankruptcy occurs after the avenues of insolvency restructuring/reorganization and insolvency reconciliation have either been exhausted or considered inappropriate. Once this has occurred, and all of the assets have been liquidated and then distributed by the



bankruptcy trustee, and the insolvency assets distribution report has been submitted to the Chinese court, the court shall make final judgment whether to finalize bankruptcy proceedings within fifteen (15) days upon its receipt of the bankruptcy trustee's application for finalizing the bankruptcy proceedings.

### The Bankruptcy Trustee

Pre-2007, there was a similar system under the *Provisional Insolvency Act on State-owned Enterprises* which employed a "liquidation committee." However, the liquidation committee consisted of people appointed by the Chinese courts from various government departments, such as administrative departments and finance departments. Such law applied to state-owned enterprises only. However, such system obviously could not adapt to the current insolvency practices and was not in accordance with international practice.

The Insolvency Law prescribes that if a Chinese court hears the matter it will appoint a bankruptcy trustee as stated in item 6 of the above list. A bankruptcy trustee is usually a law firm or

an accounting firm (but can be an individual) and is selected by the list system created by the courts. The bankruptcy trustee is useful as an independent party that can act as a "buffer" between the interests of the creditors and the debtor as well as among the interests of individual creditors.

### Priority of Distribution for the Insolvency Assets

The secured debts are regarded as part of the insolvency assets, and a creditor with secured debts will of course enjoy priority in getting his or her secured debts repaid. As a result, creditors with secured debts have no voting rights on issues such as the distribution plan of insolvency assets and in the insolvency reconciliation negotiations. This is because such decisions will not influence secured debts. The right of the secured debtor to 'bypass' the asset division rules and processes is referred to as the "exemption right" under the Insolvency Law.

After the secured debts are repaid, the insolvency expenses (which largely consists of court expenses) will be deducted and then (providing there is money remaining), the communal liabilities (which consist of, for example, unjustified benefits, as well as more 'petty' expenses, such as the employment of a guard at the insolvent company's office or factory) will be deducted, and the remaining priority order of distribution will be as follows:

1. Employee expenses (salary, social insurance, severance pay, *etc*);
2. Payable taxes; and then
3. General debts (*ie*, unsecured debts).

### Pros and Cons of the PRC's Insolvency Practice

As mentioned above, the Insolvency Law absorbed some key concepts for the first time which are in accordance with international practice such as, for example, the "bankruptcy trustee," "insolvency restructuring" and "extraterritorial insolvency" (which permitted Chinese courts to recognize foreign bankruptcy orders and vice versa, as explained further below). This update to the Chinese law was regarded as a big leap for the area of Chinese insolvency law because such concepts are more focused on the protection of the creditor's interests. However, insolvency law in China cannot be regarded as a complete bankruptcy law because as mentioned above, there are no laws relating to personal bankruptcy.

There were two judicial interpretations issued



by the Supreme Court of the PRC in 2007 regarding the appointment and remuneration of the bankruptcy trustee. These judicial interpretations (judicial interpretations of the Supreme Court of the PRC are regarded as mandatory instructions for all Chinese courts) provide that the bankruptcy trustee shall be selected from the lists created by the relevant Chinese primary and secondary courts.

There are three different selection methods for choosing the bankruptcy trustee for each bankruptcy case (note that all potential trustees are already listed on the list):

1. Random (the potential trustees are selected in a form of lottery);
2. Through invitation bidding (only where more than three potential trustees apply); and
3. Through appointment (this selection method applies to certain specific types of cases such as bankruptcy of financial institutions).

A method of choosing bankruptcy trustees whereby the initial ‘shortlist’ is not created by the court may ensure the efficiency and equity of the insolvency process. Many Chinese lawyers have argued that the Chinese courts hold too much power over the selection process of the bankruptcy trustee—from compiling the list of bankruptcy trustees to determining their remuneration—a fact which, in the opinion of many, will inevitably bring opportunities for judges to act in their own best interests. Owing to the sensitive relationship between bankruptcy trustees and judges (in insolvency cases), many argue that selection of bankruptcy trustees should be handled by an independent third party.

The Insolvency Law, for the first time in China, provides rules for the “extraterritorial jurisdiction” of bankruptcy judgments made by the Chinese courts. Regarding judgments made by the courts of foreign countries which involve assets contained inside the territory of the PRC, a creditor may file

for the recognition and enforcement of the above judgments in the PRC, and the Chinese courts will review the judgments in accordance with the related international treaties and then decide whether to enforce such judgments. In practice, it is a lengthy and complicated process for Chinese courts to recognize and enforce judgments and decrees made by foreign courts, and such recognition depends on the bilateral treaties between countries, international private laws, notarization and admissibility of evidence, and even Chinese public interests or national security elements. Many local secondary courts in China have not even dealt with such cases yet.

### Conclusion

Effective company laws of a jurisdiction should include effective incorporation laws, operation laws, and also ‘exit laws.’ Effective ‘exit laws’ should include appropriate insolvency and bankruptcy laws that can enable those enterprises which have ‘crashed’ the ability to exit from the market in a manner which is both legal and equitable for all concerned.

The promulgation of the 2007 Insolvency Law is regarded as a major turning point in the Chinese business law sphere, which can possibly bring a heightened sense of confidence to both domestic and foreign investors through the regulation and clarification of how an enterprise can exit from the market legally in China, and what liabilities and obligations it must incur and fulfill. However, as there has been, until recently, a lack of related laws and regulations regarding the winding up of (non state-owned) enterprises, most Chinese enterprises (especially small and medium-sized enterprises) prefer to choose effective abandonment as the solution to their financial woes. While this might be a cost-effective and easy solution for particular enterprise owners, such activities impact negatively on the economy and the business reputation of Chinese enterprises as a whole.