

THE PRACTICE OF REORGANIZATION IN CHINA

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TABLE OF CONTENTS

I. INTRODUCTION.....	276
II. OUTLINE.....	276
A. Characteristics in Recent Years	276
B. Situation over the Past Few Years.....	277
C. The Number of Bankruptcy Cases in China is Limited	277
D. “Run-away” Cases and “No Asset” Cases	278
E. The Reluctance of Crises Investors	279
1. Reorganization Investors Engage Unclear Selecting Mechanisms	279
2. Hesitation of Reorganization Lenders.....	279
F. High Tax Burden of Reorganizing Enterprises.....	280
G. Few Financial Institutions Filed for Bankruptcy	280
III. PRACTICE.....	280
A. Factors Affecting the Practice of Reorganization	280
1. Lack of Motivation to File for Bankruptcy	280
2. Negative Attitude of the Government	281
3. Inactive Attitude of the Court.....	282
4. Trustees’ Practicing Ability is Not Strong.....	282
5. Lack of Tax Authority’s Permission Power.....	282
IV. SUGGESTIONS	283
A. Suggestions to Improve the Reorganization System.....	283
1. The Change of Local Government’s Attitude	283
2. The Improvement of the Judges’ Performance Evaluation System	283
3. The Enhancement of Bankruptcy Practitioners’ Professional Training.....	283
4. Necessary Tax Preference for Bankruptcy Protection	284
B. The Improvement of Reorganization	284
1. Reasonable Bankruptcy Limits	284
2. Debtors’ Self-Management as a Principle.....	285
3. Introduction of Pre-Reorganizing System.....	285
4. Speeding up Financial Institutions’ Bankruptcy Legislation	285

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I. INTRODUCTION

Bankruptcy reorganization system, also known as bankruptcy prevention system, is a necessary part of modern bankruptcy legal system. The purpose of bankruptcy protection, unlike bankruptcy liquidation, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and provide a return for its stockholders.¹ This paper will give a brief description of bankruptcy reorganization system's implementation status in China, analyze the influencing factors, and give some concrete suggestions on the perfection of China's bankruptcy reorganization systems.

II. OUTLINE

A. Characteristics in Recent Years

Objectively speaking, since the 2006 Enterprise Bankruptcy Law of China came into effect, the implementation status of bankruptcy protection system has not been satisfactory and is characterized as follows:

- (1) Frequent occurrence of bankruptcy crisis in industries such as steel, real estate, and financial guarantee companies. Regional imbalance of bankruptcy law practice is clear: most cases took place in the Yangtze River Delta and the Pearl River Delta, such as Zhejiang Province and Guangdong Province, which belong to the developed regions of the southeast coastal area.²
- (2) The bankruptcy of state-owned and private enterprises shows different situations in different regions: in the above-developed areas, the bankruptcy of state-owned enterprises has been resolved; however, in the northeast and northwest, the bankruptcy of state-owned enterprises is still a major concern.³
- (3) Listed companies' bankruptcy is featured by reorganization. These cases attracted the public's extensive attention and also received substantial support from the government.⁴

¹ Still, there is another kind of bankruptcy protection in China, bankruptcy reconciliation, which is designed to be less expensive and only deals with unsecured debts. However, bankruptcy reconciliation has turned out to be a failure, with very few petitions for it, if any.

² See 3 CORPORATE REORGANIZATION L. REV., 520-21 (Shuguang Li & Zhibin Zheng eds., Chinese ed. 2013) [hereinafter Li & Zheng].

³ See 10 BANKRUPTCY FORUM, 1-5 (Xinxin Wang & Zhibin Zheng eds., Chinese ed. 2015).

⁴ Shuguang Li & Zuofa Wang, *An Empirical Analysis of Chinese Bankruptcy Law's Three Years Implementation: An Approach to Resolving Differences Between*

- (4) The attitude of the courts and the government toward the acceptance of bankruptcy cases is changing in different levels. The Supreme Court has amended performance evaluation system for judges hearing bankruptcy cases.⁵

B. Situation over the Past Few Years

Since the implementation of the 1986 Enterprise Bankruptcy Law, the low number of bankruptcy cases has been one obvious and tough problem. Many enterprises that should have exited the market failed to enter bankruptcy proceedings, and simply closed their doors. In 2008, dozens of Dongguan businessmen had absconded, abandoning their homes and firms.⁶ The number of annual national revoked enterprises and the number of concluded bankruptcy cases from 2006 to 2013 are shown in the following table.⁷

	2006	2007	2008	2009	2010	2011	2012	2013
Revoked enterprises	672,000	814,600	871,400	774,700	780,700	790,900	735,000	N/A
Bankruptcy cases	4253	3817	3139	3128	3567	2531	2100	1998

C. The Number of Bankruptcy Cases in China is Limited

Of all the bankruptcy cases, the number of reorganization cases is even smaller.⁸ According to the statistics, before October 28, 2009, only about 80 non-

Legislative Expectation and Judicial Practice, 2 J. OF CHINA U. OF POL. SCIENCE AND L., 6 (2011).

⁵ “Opinions of the Supreme People’s Court on Comprehensively Deepening the Reform of the People’s Court,” <http://www.court.gov.cn/fabu-xiangqing-13520.html> (last visited Feb. 8, 2016).

⁶ Li & Wang, *supra* note 4.

⁷ Regarding the statistics of annual national revoked enterprises and the number of concluded bankruptcy cases, *see also id.*

⁸ *Id.*

listed companies filed for bankruptcy reorganization.⁹ Although in 2012 the non-listed company reorganization cases increased rapidly, there were only 116 cases.¹⁰ By the end of 2012, only about 40 listed companies filed for reorganization.¹¹ Moreover, the regional distribution of bankruptcy cases is extremely uneven.¹² Taking the non-listed companies' reorganization cases in 2012 for example, 116 cases were distributed in 15 provincial-level administrative regions, which means that besides Taiwan, Hong Kong, and Macao, there are 16 provincial administrative regions that did not accept any reorganization cases. Of the 15 provincial administrative regions, Guangdong accepted 35 bankruptcy reorganization cases, Zhejiang 34 cases, and Jiangsu 20 cases, which amounted to 75% of the reorganization cases.¹³

D. "Run-away" Cases and "No Asset" Cases

Corresponding to the low number of bankruptcy cases, two phenomena are very common in China. First, the "run away" of business owners and executives is a widespread phenomenon.¹⁴ For example, in Qingdao City, 206 enterprise owners left abruptly between 2003 and 2008, almost 26,000 workers lost their jobs.¹⁵ By the end of October 2011, 228 business owners fled and nine committed suicide in Zhejiang Province alone.¹⁶ Second, the "no asset" cases are common, and liability-asset ratios in bankruptcy cases are extremely high.¹⁷ According to the statistics of 11 listed companies in reorganization, 5 companies' liability-asset ratio exceeded 200%, 5 companies between 100-200%, and only 1 company was less than 100%.¹⁸ For those listed companies whose liability-asset ratios were extremely high, the reason for reorganization is that China's stock market adopted an approval system for the issue of securities (instead of a

⁹ *Id.*

¹⁰ Li & Zheng, *supra* note 2, at 519.

¹¹ *Id.* at 518.

¹² *Id.*

¹³ *Id.* at 520-21. Zhejiang Province is worthy of special mention. There were altogether 346 cases and 259 concluded bankruptcy cases in 2013 in Zhejiang Province, whereas the whole country concluded 1,998 bankruptcy cases in the year 2013. *2014 Work Report of the High People's Court of Zhejiang Province* (Jan. 18, 2014), <http://www.zjcourt.cn> (follow links for Zhejiang Court, select "Work Report" from the "Court Overview" drop-down menu, then select the 2014 Report).

¹⁴ 8 BANKRUPTCY LAW FORUM 389-90 (Xinxin Wang & Zhengyou Yin eds., Chinese ed., 2013).

¹⁵ *Id.*

¹⁶ XIULU YIN, *A Research of Run-away Corporations Bankruptcy*, in 8 BANKRUPTCY LAW FORUM, *supra* note 14, at 389-90.

¹⁷ See 10 BANKRUPTCY FORUM, *supra* note 3.

¹⁸ ZHIBIN ZHENG, *An Empirical Research of Chinese Corporate Reorganization*, in 1 CORPORATE REORGANIZATION LAW REVIEW 75-76 (Shuguang Li & Zhibin Zheng eds., Chinese ed., 2011).

registered system). Thus, the “shell resource” of listed companies has a special value.¹⁹

E. The Reluctance of Crisis Investors

1. Reorganization Investors Engage Unclear Selecting Mechanisms

Because the bankruptcy reconciliation relates only to the unsecured debt relief or extension, the question of crisis investors’ enthusiasm may only appear in reorganization. There are two kinds of common crisis investors: reorganization investors and reorganization lenders. The former refers to the investors who purchase all or significant assets to participate in or even dominate reorganization proceedings; the latter refers to financial institutions that provide loans for the restructuring of the debtor to maintain its continued operation.

With respect to reorganization investors, the pertinent problem is that the selecting mechanism is unclear. The law states nothing about reorganization investors, let alone their selecting standards or the identification of the entity exercising such selecting power, so the courts have to develop their own rules. In other words, the courts have a great discretion in selecting reorganization investors, which can be dispute-provoking, such as in the Jianghu Ecology case.²⁰

2. Hesitation of Reorganization Lenders

For the reorganization debtor, one difficulty is how to quickly get the operating fund because banks consider whether the loan applicant has the ability to repay debt. Indeed, reorganization investors could provide operating capital for the restructured debtor during the implementation of the reorganization plan, but the operating capital during the reorganizing period is equally important, and it helps to maintain or improve the management status of the debtor enterprise.²¹

In order to encourage lenders to provide loans for the debtor, the U.S. Bankruptcy Code provides many incentive measures such as administrative priority, super-priority, and even priming lien.²² Article 75 of China’s Enterprise Bankruptcy Law provides that “during the period of reorganization, if debtors or trustees borrow to continue their business, they can set the security for the loan.”²³

¹⁹ Shells have their own value under the restricted approval-based initial public offering (IPO) system in China. For more information, please see *Shell Resource and IPO Underpricing: An Empirical Study in China’s Stock Market*, USA-China Business Review 2003.2.

²⁰ See Changyin Han, *Property Disposal Rules in Bankruptcy Procedure, Politic and Law* 12 (2011) (Renmin Univ. of China Reproduction).

²¹ See 10 BANKRUPTCY FORUM, *supra* note 3.

²² See 11 U.S.C § 364 (2015).

²³ Zhongguo Zhonghua Renmin Gongheguo Qiye Pochan Fa

This provision is too simple. There is no provision concerning the approval of reorganization financing or the coordination of the sequence between original secured creditors and reorganization lenders, which makes the provision less practical.²⁴

F. High Tax Burden of Reorganizing Enterprises

When bankruptcy reorganization is accepted by the court, the debtor may have unpaid tax debt, and the bankruptcy protection procedures may also generate tax and tax penalty. In practice, the tax authorities often require the debtor to repay full tax claims, or they will not agree to the plan of reorganization.²⁵ In order to solve this problem, in many areas the court or superior court now consults with the tax authorities on a case-by-case basis.²⁶ This practice could have a certain impact, but after all, it can not provide clear expectations for all parties in interest.

G. Few Financial Institutions Filed for Bankruptcy

Insolvent financial institutions often withdrew from the market through administrative means instead of bankruptcy. In addition to regulatory agencies, local governments often will be involved in the bailout of a distressed bank. In the Chinese financial industry, only a few securities companies, such as Guangdong International Trust and Investment Company, are resolved through judicial bankruptcy procedures. There have been no bank bankruptcy cases so far.

III. PRACTICE

A. Factors Affecting the Practice of Reorganization

1. Lack of Motivation to File for Bankruptcy

A deeply rooted problem within the bankruptcy system is that the related parties have little motivation to apply for bankruptcy. Creditors will try all they can to seek for individual recovery instead of filing for bankruptcy. Only those

(中国中华人民共和国企业破产法) [Enterprise Bankruptcy Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), art. 75, 2006 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ.

²⁴ *Id.*

²⁵ See 3 CORPORATE REORGANIZATION L. REV., *supra* note 2, at 520-21.

²⁶ See 10 BANKRUPTCY FORUM, *supra* note 3.

left behind in the competition are likely to file for bankruptcy protection. For debtors, there will be nothing left in the liquidation procedure; it is the same even in some reorganization cases. Debtors will not necessarily take the initiative to apply for bankruptcy protection but may wish to rely on their own strength to achieve the regeneration. In addition, according to Article 13 of the Enterprise Bankruptcy Law, all bankruptcy cases should appoint a trustee.²⁷ In the case of reorganization, the debtor could manage the property and business without help only in exceptional circumstances, which also affects the debtor's decision in filing for bankruptcy protection.²⁸ In fact, the vast majority of China's listed company reorganization cases were commenced by creditors.²⁹ Generally speaking, the law does not seem to provide effective incentive for the parties to file for bankruptcy.

2. Negative Attitude of the Government

The government's attitude toward bankruptcy cases depends on the types of debtors—listed company or non-listed company.

a. Listed Companies

If there are no other ways to save them, local governments will often actively promote the reorganization of listed companies.³⁰ This is because the number of listed companies is often an index to measure local government's performance.³¹ As can be seen in some cases, (1) the listed company's trustee is often led by the main local government officials, and the lawyer only works as an advisor, and (2) the regional distribution of listed company reorganization cases is rather random, unlike the gathering of non-listed company reorganizations in coastal areas.

b. Non-Listed Companies

The local government's attitude is different from area to area. In the area where the private economy is relatively developed and plays a greater role in local

²⁷ Zhongguo Zhonghua Renmin Gongheguo Qiye Pochan Fa (中国中华人民共和国企业破产法) [Enterprise Bankruptcy Law of the People's Republic of China] (promulgated by the Standing Comm. of the Tenth Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), art. 13, 2006 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ.

²⁸ See 10 BANKRUPTCY FORUM, *supra* note 3, at 1-5.

²⁹ CHENGWEN LI, INNER LOGIC AND SYSTEM SELECTION OF CHINESE LISTED COMPANIES 58-59 (Peking: China Legal Publishing House 2012).

³⁰ Li & Wang, *supra* note 4.

³¹ *Id.*

development, the local government tends to hold a more liberal attitude for bankruptcy cases. But in other areas, due to the resettlement of employees and other reasons, the local governments often have negative attitudes toward bankruptcy cases.³²

3. Inactive Attitude of the Court

Bankruptcy cases are different from general civil and commercial cases. Bankruptcy procedure is complicated, time-consuming, and laborious. The court's internal performance evaluation has not formed an encouraging mechanism for bankruptcy hearings. Coupled with the social problems caused by some enterprise bankruptcy cases, the court's attitude toward bankruptcy protection is relatively inactive, even in the southeastern coastal provinces.³³

4. Trustees' Practicing Ability is Not Strong

In the majority of listed company reorganization cases, the government officers lead trustees.³⁴ Although the administrative intervention in bankruptcy cases has certain rationality, this kind of trustees' practicing ability is questionable. Due to the unbalanced regional distribution of bankruptcy protection cases, many trustees may have limited experience with bankruptcy protection cases. The Supreme People's Court Regulations on trustee's remuneration only specify the trustee's reward in bankruptcy liquidation cases. For bankruptcy reorganization cases, the regulation only provides that the trustee's practical contribution should be taken into account in deciding the remuneration, which obviously will also affect the trustee's efforts to achieve reorganization value.

5. Lack of Tax Authority's Permission Power

According to Article 3 of the Provisions of the Tax Collection and Management Law, the local taxation authority has no power to grant tax deduction or installment. In practice, if the debtor does not consult with the tax authorities on tax claims and propose a solution accepted by both parties, the court can refuse to accept voluntary reorganization application.³⁵ Therefore, for tax collection

³² *Id.*

³³ See Zhejiang Provincial Higher People's Court, *2012 Zhejiang Court Trial Report on Corporate Bankruptcy*, http://www.360doc.com/content/14/0311/16/13158802_359600961.shtml (last visited Feb. 8, 2016).

³⁴ Li & Wang, *supra* note 4.

³⁵ Yihui Zhao, *The Barrier of Tax Debt Has Been Successfully Cleared Away and St. Zhonghua Entered into Bankruptcy Reorganization Relief Period*, SHANGHAI SECURITIES

during the bankruptcy protection period, the biggest problems are the absence of authorizing regulations and the tax authorities' lacking of appropriate permissions.

IV. SUGGESTIONS

A. Suggestions to Improve the Reorganization System

1. The Change of Local Government's Attitude

The local government's attitude should change. The development of bankruptcy would not do harm, but rather would bring great benefit to the local economy. The local government can be neither too active nor too passive in bankruptcy protection. The market should guide the bankruptcy system.³⁶ The local government should be neutral in bankruptcy cases and provide the necessary support for the development of bankruptcy cases, such as the introduction of reorganization investors in the early stage of cases.

2. The Improvement of the Judges' Performance Evaluation System

As mentioned earlier, bankruptcy cases require a longer period and occupy more judicial resources. As long as the judges' performance evaluation system takes into consideration the number of bankruptcy cases, the court's attitude toward bankruptcy cases will tend to be negative.³⁷ Therefore, it is necessary to improve the judges' performance evaluation system to promote the implementation of bankruptcy protection system.

3. The Enhancement of Bankruptcy Practitioners' Professional Training

This proposal aims to improve bankruptcy protection practitioners' professional skills (including judges and trustees). Because of the small number of bankruptcy cases, many courts and trustees may not have enough experience. Taking the Shanxi Liansheng reorganization case as an example, the financial

NEWS (Oct. 16, 2012).

³⁶ On the hazards of local governments' playing a leading role in bankruptcy reorganization, see DAN HE, REORGANIZATION OF LISTED COMPANIES: EMPIRICAL ANALYSIS AND THEORETICAL RESEARCH 83-85 (2012).

³⁷ On demands of bankruptcy reorganization for courts and judges, see ZHIBIN ZHENG & TING ZHANG, CORPORATE REORGANIZATION: ROLES AND RULES 5-6 (2013).

liabilities in the case reached nearly \$30 billion RMB, and yet the court is Liulin County People's Court, which is only a primary court.³⁸

4. Necessary Tax Preference for Bankruptcy Protection

Currently, the bankruptcy protection procedures require the debtors to pay full tax, which could cause two consequences:

- (1) It negatively affects the initiatives of the enterprises to apply for bankruptcy protection.
- (2) It reduces the possibility of successful reorganization, so it is necessary to amend the Tax Collection and Management Law and authorize the tax authorities with reasonable discretion in tax reduction or exemption during the bankruptcy protection period.

B. The Improvement of Reorganization

1. Reasonable Bankruptcy Limits

To improve the bankruptcy system, the first need is to set a reasonable limit for bankruptcy to avoid unreasonable cases of application and acceptance barriers. Judicial Interpretation I establishes mandatory bankruptcy filing rules.³⁹ As long as a creditor can prove that a “debtor-creditor relationship established by law, debt performance period has expired and the debtor has failed to fully pay off,” the debtor is presumed to research the bankrupt limit, and the burden of proof has thus transferred to the debtor.⁴⁰ But for voluntary application, according to the interpretation of the Supreme Court, the bankruptcy limit is when a “debtor can not repay debts due” and “assets are insufficient to pay off all debts, or apparently lack of liquidity.”⁴¹ For the voluntary application, especially the voluntary application of reorganization, the bankruptcy limits should be lower.⁴²

³⁸ See Zhang Yueguang Shanxi, *Shanxi Liansheng Intention of Reforming Suspended Three Surfaced War Vote*, LIKE-NEWS.US (Dec. 25, 2013), <http://www.like-news.us/?i51761-Shanxi-Liansheng-intention-of-reforming-suspended-three-surfaced-war-vote>.

³⁹ See *Judicial Explanation of Supreme People's Court on Enterprise Bankruptcy Law*, <http://www.lawtime.cn/info/paimai/pmfq/201408183306430.html> (last visited Feb. 9, 2016).

⁴⁰ *Id.* art. 2.

⁴¹ *Id.* art. 2.

⁴² In the United States, a voluntary petition can automatically constitute the order for relief, while creditors filing for bankruptcy have to show required grounds. But in China, the reverse is true. For involuntary application, there is a presumption that once creditors prove that the debtor doesn't repay debts the court should accept the application, while for voluntary application, the debtor must prove that its assets are not enough to pay

On one hand, considering the enormous consequences of bankruptcy, no debtors will file bankruptcy petitions without certain reasons. On the other hand, for avoiding the debt and the improper transfer of property, including bankruptcy fraud, a better approach is to be addressed by the bankruptcy procedure, not excluded from the bankruptcy procedure.⁴³

2. Debtors' Self-Management as a Principle

In cases of reorganization, debtors in the United States generally could manage their own assets and affairs (i.e., Debtor in Possession (DIP)). DIP is an important incentive mechanism for bankruptcy protection application in United States bankruptcy law. In China, as noted above, trustees will be appointed in every bankruptcy case. That means once the case is commenced, the debtor will be deprived of possession of its assets and businesses, which also means the debtor will not have the right to propose reorganization plan as a norm.⁴⁴

3. Introduction of Pre-Reorganizing System

In the United States, many debtors restructure their debt outside bankruptcy proceedings, which saves a great deal of time and money. "Pre-reorganizing" refers to a system of drafting a restructuring plan and negotiating the drafted plan with the main creditors before the formal reorganization application is filed. The purpose of application is simply to obtain the court's confirmation of the reorganization plan.

4. Hastening Financial Institutions' Bankruptcy Legislation

The current Enterprise Bankruptcy Law has been in effect for more than eight years. Many problems of the bankruptcy protection system have been

off all the debts or it is obviously likely that it is unable to pay off all the debts. See Changyin Han & Huan He, *Legislative Function of Bankruptcy Limits: A Comment on Practical Effect of the First Judicial Interpretation of Enterprise Bankruptcy Law*, 2 POLS. L. 7 (2013).

⁴³ *Id.* at 7.

⁴⁴ Under Article 73 of The Enterprise Bankruptcy Law, however, upon application, the debtor itself may manage its property and business affairs. Zhongguo Zhonghua Renmin Gongheguo Qiye Pochan Fa (中国中华人民共和国企业破产法) [Enterprise Bankruptcy Law of the People's Republic of China] (promulgated by the Standing Comm. of the Tenth Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), art. 73, 2006 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ.

exposed. Financial institutions' distress is not uncommon in modern China, which has already enacted a set of supervision regulations for financial institutions. Now, it is time to expand the applying scope of bankruptcy protection systems in order to standardize market exit procedures of financial institutions.

