Towards a Better Future for Chinese Bankruptcy Law: Problems and Potential

by

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Towards a Better Future for Chinese Bankruptcy Law: Problems and Potential[§]

Liu Mingkang[*] and Wei Chuyi[†]

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Abstract: In the past, Chinese bankruptcy law has been underused: companies are usually dissolved without going through the bankruptcy procedure. However, since 2014, the number of bankruptcy cases in China has surged, with bankruptcy law being used to facilitate supply-side reforms that aim to cut overcapacity and close down 'zombie companies' in the country. Against such a backdrop, this article will evaluate Chinese bankruptcy law and propose reforms in governmental intervention, debt evasion in bankruptcy and cross-border insolvency. We argue that despite all its problems, Chinese bankruptcy law is potentially effective if enforced properly and can be made more so if further reforms are carried out. The laws in this article are up to date on 10 May 2017.

I. Introduction

To counter declining economic growth, the Chinese government initiated a 'supply-side reform' in 2015, which aims at reducing industrial overcapacity and closing down 'zombie companies'.[1] According to the government, bankruptcy law will be essential for carrying out the supply-side reform. In November 2013, the Central Committee of the Communist Party of China (CCCPC) adopted the *Decision on Some Major Issues Concerning Comprehensively Deepening the Reform*, which states, "we

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[1] 'China to Press Ahead with Supply-Side Reform' (*chinadaily.com.cn*, December 2016) <http://www.chinadaily.com.cn/business/2016-12/27/content_27784692.htm> accessed March 2017.

will improve the market exit system in which the good eliminates the bad, and perfect the enterprise bankruptcy system".[2] In 2015, the State Council also stressed in the *Opinions on Developing Mixed Ownership Economy by State-owned Enterprises* that it is imperative to conduct research on the bankruptcy law so as to make amendments.[3] The State Council further pointed out in the Government Work Report in 2016 that the government would reduce capacity and address the issue of 'zombie companies' using measures such as mergers, reorganisations, debt restructuring and bankruptcy liquidation.[4]

All these mark a new era for Chinese bankruptcy law, which was largely unused in the 20 years following its original passage in 1986 and the seven years after its replacement with a new law in 2006. Since 2014, however, the number of bankruptcy cases in China has surged, and various efforts have been taken to improve the implementation of the bankruptcy law. For example, in June 2016, the Supreme People's Court (SPC) issued ten example cases on bankruptcy to guide the adjudication and stated that bankruptcy law should be used to facilitate the supply-side reform.[5] However, despite such efforts, Chinese bankruptcy law still has many problems that remain to be solved. On the one hand, the legislation has left out gaps on important fronts including financial institution insolvency and cross-border insolvency. On the other hand, local governments have widely intervened in the bankruptcy procedure and shielded many insolvent companies from the formal bankruptcy. Local protectionism and governmental intervention have also contributed to massive debt evasion on the pretense of bankruptcy. Additionally, in recent years, it has become increasingly popular for Chinese companies to issue bonds to overseas investors. When some of them slipped into insolvency, problems arose as to the coordination of the bankruptcy procedures across borders and the balance of interests between domestic and foreign creditors.

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[2] 'Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform' (*china.org.cn*, January 2014)
<http://www.china.org.cn/chinese/2014-01/17/content_31226494.htm> accessed March 2017.

[3] '*Opinions on Developing Mixed Ownership Economy by State-Owned Enterprises*' (*gov.cn*, September 2015) <http://www.gov.cn/zhengce/content/2015-09/24/content_10177.htm> accessed March 2017.

[4] 'Report on the Work of the Government' (*mofcom.gov.cn*, March 2016)
<http://www.mofcom.gov.cn/article/i/jyjl/l/201603/20160301282908.shtml> accessed March 2017.

[5] SPC, 'SPC Example Cases on Adjudicating Bankruptcy Cases and Facilitating Supply-Side Reform [关于依法审理破产案件 推进供给侧结构性改革典型案例]' (*court.gov.cn*, June 2016) <http://www.court.gov.cn/zixun-xiangqing-22051.html> accessed 29 November 2016.

Focusing on these conundrums, this article will evaluate Chinese bankruptcy law and propose future reforms. It begins with a comparison of US and Chinese bankruptcy law, proceeds to discuss problems in the practice of Chinese bankruptcy law, and concludes with possible solutions to those problems.

II. A Comparative Review of US and Chinese Bankruptcy Law

The current bankruptcy legislation in China, the Enterprise Bankruptcy Law (EBL), was promulgated in 2006. It replaced the Interim Enterprise Bankruptcy Law of 1986 that only applied to state-owned enterprises (SOEs). EBL provides for three bankruptcy procedures—liquidation, reorganisation, and conciliation. Its provisions on liquidation and reorganisation are analogous to those in Chapter 7 and Chapter 11 of the US Bankruptcy Code of 1978 (USBC). Although EBL resembles USBC in terms of the basic framework, they diverge on specific issues. Here a brief analysis will be made to illustrate the point.

A. Financial Standards for Entering Bankruptcy

USBC defines insolvency by reference to the balance sheet. It states that insolvency under the code refers to the financial condition that the sum of an entity's debts is greater than all of its property.[6] If a company is insolvent, it can apply for Chapter 7 liquidation. However, a company does not need to be insolvent to apply for USBC Chapter 11 reorganization: simply being unable to service its debts is sufficient.[7] The threshold for entering the bankruptcy procedure under EBL in China is much higher than under USBC in the US. In order to apply for voluntary bankruptcy, the debtor must both be unable to service debts and have the value of its debts exceeding the value of its assets. In other words, the debtor must be both illiquid *and* insolvent, lacking both the cash to service debts and failing the balance sheet test. In an

[6] 11 USC § 101 (32): "The term 'insolvent' means—
(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of this title."
[7] DG Baird, *The Elements of Bankruptcy* (4 edn, New York Foundation Press 2006), p 65.

involuntary EBL bankruptcy filed by a creditor, however, only the cash flow standard is used. If the debtor chooses to apply for reorganisation, then an additional circumstance can be considered: the debtor 'clearly lacks the ability to pay off debts'. The guidance book on adjudicating bankruptcy cases edited by SPC explains that if the court is unable to ascertain the financial situation of the debtor based on formal evidence (e.g. the balance sheet), it may accept the petition concerning debtors that 'clearly lack the ability to pay off debts'.[8]

Stringent financial standards for entering bankruptcy can constrain the abuse of bankruptcy protection; however, such benefits may be outweighed by the downside that they cause delays in liquidating or restructuring distressed companies. The EBL standard for applying for reorganisation is problematic as it gives the courts too much discretion over whether or not to accept the application for both voluntary and involuntary bankruptcy.

B. The Automatic Stay

The automatic stay (or moratorium) is the central provision of bankruptcy law as it stays claims of all creditors and forces them to pursue their claims through the bankruptcy procedure. It gives a breathing space for the debtor while striving to ensure equitable distribution for creditors.[9] Under USBC, a petition for bankruptcy will trigger an automatic stay on claims of creditors. In contrast, under EBL, a stay on creditors' actions against the debtor will only be triggered by acceptance of the court. As the court has 15 days to decide whether to accept the bankruptcy case,[10] when the decision of the court is still pending, creditors may act individually to seize the debtor's assets. The 15-day interval may also allow the management to behave opportunistically against creditors by diverting assets—i.e., fraudulent transfer or fraudulent conveyance.

Further, the effects of the automatic stay are different under US and Chinese bankruptcy laws. The automatic stay under USBC will stay all litigation and

[8] Supreme People's Court (ed), Judicial Guidance on Enterprise Restructuring, Bankruptcy and Reorganisation Cases [企业改制、破产与重整案件审判指导] (Law Press China 2015), p 80.
[9] 'UNCITRAL Legislative Guide on Insolvency Law' (*uncitral.org*, 2005) <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> accessed 1 September 2013.
[10] EBL 2006, Article 10

enforcement of judgements and security. The stay is effective during the time the case is pending except for limited cases where the court allows creditors to lift the stay.[11] By comparison, the stay under EBL has only limited effect in that actions or arbitration are only suspended and can continue when the administrator takes over the bankrupt estate. Also, new actions filed against the debtor after the commencement of the bankruptcy are permitted as long as they are filed with the court that accepts the bankruptcy case.[12] This means that along with the bankruptcy procedure, creditors may pursue the debtor through the court actions and arbitration that have started before the initiation of the bankruptcy procedure, possibly reaching conflicting judgements.

C. Avoidance Actions

Creditors pursuing claims against a debtor in an ELB bankruptcy cannot confidently rely on the automatic stay provision: they should take avoidance actions against fraudulent transfer and preferences to constrain irregularities in asset distribution and to recover transferred assets for the benefit of all creditors. Under USBC, the trustee is empowered to avoid any transfer of an interest of the debtor in property that constitutes a preference.[13] This is intended to address the problem that a debtor can selectively pay some of its creditors to the detriment of the interests of other creditors, for example, repaying connected persons before other creditors.

In addition, USBC has promulgated the fraudulent transfer provision to constrain directors or shareholders from transferring or concealing corporate assets. The difference between the fraudulent transfer provision and the preference provision is that the former applies to any transaction that will unfairly reduce corporate assets available to creditors, while the latter is aimed at preventing unfair treatment among creditors.[14] There are two categories of fraudulent transfers under USBC. One is ‘actual

[11] 11 USC §362
[12] EBL 2006, Article 21
[13] 11 USC § 547 (b) provides that a transfer is deemed a preference if it is (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the filing of the petition; or between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; (5) a transfer that enables the creditor to receive more than such creditor would otherwise receive in a Chapter 7 liquidation.
[14] 11 USC § 548 provides that the trustee can void any transfer of an interest of the debtor in property or any obligation incurred by the debtor that constitutes fraudulent transfer and was made or incurred on or

fraud', which means that the transfer is made with actual intent to hinder, delay or defraud any creditor.[15] If the intent to defraud cannot be proved, a transaction can also be deemed as 'constructive fraud' when the debtor transfers an asset or incurs an obligation without receiving a reasonably equivalent value in exchange and at the time when the transferor was rendered insolvent or left with unreasonably small capital.[16]

In contrast to the detailed provisions under USBC, EBL contains crude provisions for void and voidable transactions without differentiating between fraudulent transfer and preference payment.[17]

The provisions on void and voidable transactions under the Chinese bankruptcy law derive from Chinese contract law. Also, EBL fails to provide for 'constructive fraud', which is easier for creditors to claim, as it does not require the proof of the intent to defraud.

D. The Reorganisation Procedure

The major difference between US and Chinese reorganisation procedure is that the former allows directors to continue to be in charge (Debtor-in-Possession)[18], while the latter generally requires a court-appointed administrator to take over as soon as the bankruptcy case is accepted by the court.[19] The exception is that in the reorganisation

within 2 years before the date of the filing of the petition. In the US, fraudulent transfer law also exists at the state level. The state law on fraudulent transfer is similar to that under the Bankruptcy Code and usually modelled on the model uniform law.

[15] 11 USC § 548 (a)(1)(A)

[16] 11 USC § 548(a)(1)(B)

[17] EBL 2006, Articles 31 and 32. Article 31 states that an administrator shall have the right to request the court to avoid the following actions taken by the debtor within one year before the people's court accepts the application for bankruptcy: (1) transferring assets for no consideration; (2) trading at an obviously unreasonable price; (3) set a charge on its assets for an unsecured creditor; (4) abandoning claims. Further, Article 32 provides that payments to creditors within six months before the people's court accepts the application for bankruptcy and when the debtor was insolvent are also voidable. Two actions that can severely undermine interests of creditors are deemed as void under Article 33: (1) concealing or transferring assets to evade payment of debts; (2) fabricating debts or acknowledging debts that do not exist. It is necessary to distinguish the voidable and void actions, although both can nullify actions of the debtor and restore its property. The most important difference is that the voidable actions are binding unless being voided by the court, while the void actions are deemed to have no legal effects from the start. In addition, voidable actions must be challenged within a time limitation, while void actions have no such limitation.

[18] During the reorganisation process provided by Chapter 11 of USBC, directors will remain in control, and the firm will be referred to as the debtor-in-possession (DIP).

[19] EBL 2006, Article 24

process, the debtor may manage its property by itself under the supervision of an administrator upon approval by the court.[20] However, in practice, the reorganisation is almost always managed by the administrator, and as will be discussed later, the role of an administrator is usually assumed by officials of the local governments.

The administrator-dominated reorganisation is justified insofar as most companies in China have concentrated ownership,[21] and therefore directors' interests are likely to be aligned with shareholders' and against creditors' in a reorganisation procedure.[22] The unique circumstances in Chinese SOEs, the major listed companies in the country, make this even more likely. Creditors of SOEs are frequently forced to relinquish their interests for the sake of social stability. Moreover, directors of SOEs are not sufficiently monitored and asset diversion is prevalent.[23] Before the shareholder value is depleted, the state shareholder is the principal victim of asset diversion by directors. If, when a company is insolvent, the directors continue to be in control, its creditors, who typically lack the resources to monitor effectively the directors, would become the victims of the directors' misbehaviour.

E. Priority Rule

As in the US,[24] secured creditors rank highest in priority of repayment under EBL, followed by holders of priority claims including administrative expenses, employees' compensation and tax claims (from high to low).[25] The rest of the bankrupt estate would go to the unsecured creditors. EBL, however, makes an exception to this order of seniority for employees' claims that occurred before 2006, the year that EBL

[20] EBL 2006, Article 73
[21] F Jiang and KA Kim, 'Corporate Governance in China: A Modern Perspective' (2015) 32 Journal of Corporate Finance 190–216.This article has found that on average, the largest shareholder of Chinese listed companies owns one-third of the shareholding, while the largest five shareholders together own more than half.
[22] D Hahn, 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 Journal of Corporate Law Studies 117–154.
[23] The National Audit Department conducted an audit on 1,290 key enterprises in 2000 and found that losses of state assets arising from escaping bank debts and irregularities in reform amounted to 29 billion yuan. See M Li, 'On Supervisory Committee in SOEs [论国有企业监事会制度]' (2005) 27 Journal of Shanxi Finance and Economics University [山西财经大学学报] 89–93. Also see W Zhang, 'China's SOE Reform: A Corporate Governance Perspective' (2006) 3 Corporate Ownership and Control 132–150.
[24] 11 USC § 507(a)
[25] EBL 2006, Article 113

replaced the Interim Bankruptcy Law of 1986. Reflecting the government's concern that social instability might be caused by unemployment that followed bankruptcy, employee claims incurred before 2006 are grandfathered to rank above secured creditors.[26]

F. Bankruptcy for Financial Institutions

The bankruptcy of financial institutions in the US is governed by specialised laws such as the Federal Deposit Insurance Act (FDIA), the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and the Securities Investor Protection Act (SIPA). These statutes lay down the framework for financial institutions, and particularly banks, to be handled outside of USBC.

Given the externalities of bank insolvency, bank resolution is initiated by the chartering agency or the institution's primary federal regulatory agency, or the FDIC, unlike corporate bankruptcies that are filed by the debtor or its creditors. Further, the grounds for initiating bank resolution are distinct; for example, if the relevant authority believes that the bank is not being operated in a safe and sound manner, or that the bank is unlikely to meet its deposit obligations. Bank resolution can also be initiated if the bank is becoming 'critically undercapitalized', defined as a minimum of two percent of equity capital to total assets under the FDICIA. Moreover, the FDIC will be in charge of the bank resolution procedure as the receiver or conservator.[27]

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in response to the latest financial crisis has reshaped the process to resolve large, complex financial companies, especially those systemically important financial institutions (SIFIs) as defined by Title I of the Dodd-Frank Act. Such institutions are required to develop a resolution plan that explains how a company would conduct a rapid and orderly resolution in case of financial distress or failure. Further, Title II of

[26] EBL 2006, Article 132

[27] RR Bliss and GG Kaufman, 'U.S. Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation' (*users.wfu.edu*) <http://users.wfu.edu/blissrr/PDFs/Bliss-Kaufman%20-%202005%20-%20Insolvency%20Declaration%20and%20Resolution.pdf> accessed 30 April 2017.

the Dodd-Frank Act provides for an alternative to bankruptcy for resolving financial companies, in which the FDIC will act as a receiver and liquidate the company.[28]

Compared with the complex legal apparatus in the US, the bankruptcy law for financial institutions in China is still nascent. In the past, resolution of financial institutions was usually carried out by regulatory authorities on an *ad hoc* basis rather than on clearly based laws and regulations.[29] EBL provides that upon the application of regulatory authorities, financial institutions can enter the bankruptcy procedure.[30] Also, China has paved the way for bank bankruptcy by passing the Deposit Insurance Regulation in 2015, which requires deposit-taking institutions to insure all accounts for up to 500,000 yuan (US$72,574).[31] Further, the big four commercial banks in China have been identified as global SIFIs by the Financial Stability Board (FSB) and have promulgated the rescue resolution plan (RRP) in compliance with the requirements of the China Banking Regulatory Commission (CRBC).[32]

G. Cross-Border Insolvency

The US has incorporated the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency (UNCITRAL Model Law) through the enactment of Chapter 15 of USBC in 2005. Upon application by a foreign representative, the US court will recognise a foreign proceeding as a foreign main or a foreign non-main proceeding if certain requirements are met.[33] The recognition of a foreign main proceeding will trigger an automatic stay on the debtor and its property within the US, while the relief for non-main proceeding is much more limited.[34] A foreign main proceeding is one pending in a country where the debtor has the centre of

[28] DA Skeel, 'The New Synthesis of Bank Regulation and Bankruptcy in the Dodd-Frank Era' (*papers.ssrn.com*) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2628694> accessed 30 April 2017.
[29] T Huang, 'The Power Struggle of the Exit Mechanism for Financial Institutions [我国金融机构市场退出法律机制中的"权力版图"]' (2009) 21 Peking University Law Journal 867–884.
[30] EBL 2006, Article 134
[31] 'Deposit Insurance Regulation' (*lawinfochina.com*, February 2015) <http://lawinfochina.com/display.aspx?id=19762&lib=law> accessed March 2016.
[32] 'China's Banks Adopt "Living Wills" to Plan for Less Predictable Future' (*blogs.wsj.com*, January 2014) <https://blogs.wsj.com/chinarealtime/2014/01/01/chinas-banks-adopt-living-wills-to-plan-for-less-predictable-future/> accessed March 2017.
[33] 11 USC § 1517
[34] 11 USC § 1520

its main interests (COMI). The analysis of COMI by the US court is flexible and involves lots of controversies.[35]

In contrast, the jurisprudence of cross-border insolvency in China is just starting to develop. For the first time, EBL has dealt with the extraterritorial application of Chinese bankruptcy law and recognition of foreign bankruptcy judgements. It provides that bankruptcy proceedings made under EBL are binding on the debtor's property situated outside of China. Also, EBL provides that Chinese courts shall recognise and enforce judgements or rulings made by foreign courts on the basis of applicable international treaties or the principle of reciprocity. The precondition is that such judgements or rulings do not violate the basic legal principles of China, do not jeopardise the sovereignty, security or public interests of the country, and do not undermine the legitimate rights and interests of the creditors within the country.[36]

Although EBL has made a significant step forward, it remains vague on the enforceability of foreign bankruptcy judgements in China. In addition, it fails to incorporate the UNCITRAL Model Law, which provides a framework for international cooperation in insolvency proceedings and has been adopted by many countries including the US. The uncertainty on cross-border insolvency under Chinese bankruptcy law has adverse effects on both inbound foreign investments and Chinese companies that are expanding overseas. The following section will discuss cross-border insolvency cases after considering governmental intervention and debt evasion, which are major implementation problems of Chinese bankruptcy law.

III. Problems of Chinese Bankruptcy Law in Practice

A. Governmental Intervention

The annual number of bankruptcies in China peaked at 8,900 in 2001 during the restructuring of SOEs.[37] In the years following the passage of EBL in 2007, annual

[35] J Luna, 'Thinking Globally, Filing Locally: The Effects of the New Chapter 15 on Business Entity Cross-Border Insolvency Cases' (2007) 19 Florida Journal of International Law 671–696.
[36] EBL 2006, Article 5
[37] Tomasic and Zhang, 'From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China', p 308. The restructuring of SOEs will

bankruptcies substantially declined to 1,998 in 2013.[38] A report by the SPC pointed out that from 2003–2012, the total number of bankruptcy cases amounted to around 4,000, with SOEs accounting for 80% of the total.[39]

Court-based bankruptcy cases continued to account for a very small proportion of all company dissolutions in China prior to 2014.[40] From 2014, however, the number of bankruptcy cases has risen sharply as economic growth slowed in China.[41] In 2016, the bankruptcy cases accepted by the Chinese courts surged to 5,665, a 53.8% year-on-year increase.[42]

The main difficulty for companies to access the bankruptcy procedure is the intervention by local governments. As local governments have the dual objectives of maintaining social stability and driving economic growth,[43] they are unwilling to let local SOEs or large private companies go bust. Bankruptcy cases are governed by the court at the place where the debtor resides.[44] A local court is often subject to the influence of the local governments[45] and may reject a bankruptcy case due to the opposition of the local government.

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be further discussed.

[38] 21st Century Business Herald, 'SPC Report Claims That SOEs Account for 80% of the 40,000 Bankruptcy Cases [最高法报告称 4 万起破产案中国企集体企业占 8 成]' (*finance.sina.com.cn*, September 2014) <http://finance.sina.com.cn/china/20140904/030720206424.shtml> accessed 15 November 2016.

[39] 21st Century Business Herald, 'SPC Report Claims That SOEs Account for 80% of the 40,000 Bankruptcy Cases [最高法报告称 4 万起破产案中国企集体企业占 8 成]'.

[40] For example, in 2008, the ratio of court-based bankruptcy cases to all company dissolutions was only 0.37%, much lower than that in the UK (8.17%) and US (10.16%) in the same year. See R Tomasic and Z Zhang, 'From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China' (2012) 12 Journal of Corporate Law Studies 295–332.

[41] Tsinghua PBCSF, 'Report on Improvement of Bankruptcy Law and Market Exit by Law [加强破产法实施 依法促进市场出清(总报告)]' (*pbcsf.tsinghua.edu.cn*, June 2016) <http://www.pbcsf.tsinghua.edu.cn/content/details226_12442.html> accessed 15 November 2016.

[42] 'SPC: Putting Employees' Rights First in Bankruptcy Cases [最高法：审理破产案件优先保护职工权益]' (*news.xinhuanet.com*, June 2016) <http://news.xinhuanet.com/politics/2016-06/15/c_129064782.htm#pinglun> accessed 15 November 2016.

[43] W Maliszewski, S Arslanalp, J Caparusso, J Garrido, S Guo, JS Kang, WR Lam, TD Law, W Liao, N Rendak, P Wingender, J Yu, and L Zhang, 'Resolving China's Corporate Debt Problem ' (*imf.org*, October 2016) <https://www.imf.org/external/pubs/ft/wp/2016/wp16203.pdf> accessed March 2017.

[44] EBL 2006, Article 3

[45] R Peerenboom, 'Judicial Independence in China: Common Myths and Unfounded Assumptions,' *La Trobe Law School Legal Studies Research Paper* no. 2008/11 (2008), p 17.

Besides influencing the initiation of bankruptcy cases, a local government can also dominate the bankruptcy process by assuming the role of the administrator. EBL provides that the role of administrator can be assumed by a liquidation team, a law firm, an accountancy firm, a bankruptcy firm, or any other public intermediary agency.[46] Liquidation teams consist mostly of governmental officials because a court is required to choose members of the liquidation team from the standing, regional 'interim emergency team' established by the local government to deal with distressed companies.[47] It has been estimated that 45% of administrators are liquidation teams.[48] Further, one study has found that out of 25 reorganisation cases of special treatment (ST) listed companies,[49] 24 cases were found to have liquidation teams serving as the administrator, and only one case was administrated by a professional firm.[50] These liquidation teams are exclusively comprised of governmental officials, not professionals, and are usually headed by a vice major or other senior official.

Admittedly, governmental involvement can stabilise the situation after a large company collapses and can facilitate the bankruptcy process to an extent. Local governments can take action to protect a debtor's assets from creditors. In some cases, local governments have even paid outstanding wages in order to suppress potential upheavals. Also, local governments can introduce new investors into the distressed business. For example, the local government of Changshu City, as well as the government at the provincial level, played an instrumental role in the reorganisation of the subsidiaries of FerroChina Ltd after directors of these companies had fled. This was one of the largest bankruptcy cases in China, with more than 1,400 creditors and the debt claimed by creditors amounting to 11 billion yuan. The local government established an *ad hoc* team to handle the case and took immediate actions to preserve the corporate assets and pacify the angry creditors. It also paid for part of the workers' salaries. In the end, China Minmetals Corporation and Zhejiang Materials Industry

[46] EBL 2006, Article 24
[47] Supreme People's Court (ed), Judicial Guidance on Enterprise Restructuring, Bankruptcy and Reorganisation, p 125.
[48] Tomasic and Zhang, "From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China," p 316–317.
[49] ST companies refer to Chinese listed companies that receive special treatment by the stock exchanges because of abnormal financial conditions.
[50] S Li and Z Wang, 'Empirical Study on Chinese Bankruptcy Law in Its Third Year of Application [中国破产法实施三年的实证分析]' (*civillaw.com.cn*) <http://www.civillaw.com.cn/article/default.asp?id=53480> accessed 27 March 2014.

Group, the two major creditors, injected one billion yuan into the distressed companies through a debt-for-equity swap. Under the reorganisation plan, the funds would be used to pay off part of the debts and restart the manufacturing operations. The rest of the debts would be paid in instalments from 2010 to 2013. At the end of 2013, the Changshu court approved the reorganisation plan and declared the end of the FerroChina reorganisation procedure.[51]

However, although the governmental involvement can have positive effects on social stability, it has undermined the functioning of the market mechanism and conflicts with the rule of law. First, in the absence of bankruptcy threat, local SOEs actually have a 'soft budget' that enables them to continue to receive financing and make investments regardless of failures.[52] This is in contrast with a 'hard budget', under which a company has to pay for its failures with its own income. The lack of a hard budget constraint creates perverse incentives for managers, who are prone to overlook the need for cash as they assume they can always maintain liquidity through governmental subsidies or bank loans.[53]

The 'soft budget' problem exists not only in SOEs but also in private enterprises that are supported by the government. This has led to overcapacity of policy-supported industries and engenders moral hazard on the part of both companies and their creditors. On the one hand, companies may take excessive risks and pursue highly leveraged strategies. They will reap the benefits if they succeed and transfer costs to the government (in fact, taxpayers) in the event of failure. On the other hand, creditors will be less cautious and lend to companies that are implicitly guaranteed by the government. Excessive investments have led to overcapacity in many industries in China and created 'zombie companies' that live on subsidies. This occurs not only in heavy industries such as steel, coal, and cement; it has also become an acute problem in high-tech industries including the solar power industry.[54] The fall of Suntech and LDK, two giant solar

[51] 'The Largest Bankruptcy Case That Spanned Five Years and Involved 11 Billion Debts [最大破产重整案历时 5 年终结 债务记录达 110 亿]' (*Boznews.com*, January 23, 2014) <http://www.boznews.com/2014/0123/30469.shtml>.
[52] J Kornai, 'The Soft Budget Constraint' (1986) 39 Kyklos 3–30.
[53] JY Lin and Z Li, 'Policy Burden, Privatization and Soft Budget Constraint' (2008) 36 Journal of Comparative Economics 90–102.
[54] L Zhang, 'Rebalancing in China—Progress and Prospects' (*imf.org*, September 2016) <http://www.imf.org/en/Publications/WP/Issues/2016/12/31/Rebalancing-in-China-Progress-and-

power companies, is evidence of such a problem. Both of them have been 'bailed out' through reorganisation with the support of the local government.[55]

Third, the government can sacrifice creditors' interests to save local companies in order to preserve local tax bases and prevent social instability caused by unemployment. In the late 1990s, the restructuring and closing down of local SOEs was relatively successful because of the funds provided by the central government to compensate redundant workers. However, debt evasion through bankruptcy was endemic during the period and was usually supported by local governments. With the introduction of the reorganisation procedure by EBL, new ways of 'debt evasion' have emerged. The next section will focus on the problem of debt evasion.

B. Debt Evasion in Bankruptcies

(a) Debt Evasion During the SOE Restructuring

A surprising fact about Chinese bankruptcy law is that the number of bankruptcy cases has significantly declined from the peak in 2001.[56] The predecessor of EBL, the Interim Bankruptcy Law enacted in 1986, was promulgated in order to facilitate the restructuring (*gaizhi*) of SOEs and thus applied only to SOEs. Why was the enactment of EBL in 2006, which applies to all enterprises, followed by a decrease not an increase in bankruptcy cases?

To answer this question, we need first to examine the underlying reason for the peak in bankruptcy cases around 2001. It is often neglected that SOE bankruptcies in China, which have always accounted for the major portion of all bankruptcies in the country, are closely associated with the SOE restructuring (*gaizhi*) reform in the late 1990s, during which bankruptcy was used as a means to close down unprofitable SOEs, resulting in a sharp rise in bankruptcies. It can also be argued that the supply-side reform initiated in 2015 is a continuation of the SOE restructuring reform and likewise will stir up a wave of bankruptcies.

Prospects-44225> accessed April 2017.

[55] These cases will be further discussed later.

[56] 21st Century Business Herald, 'SPC Report Claims That SOEs Account for 80% of the 40,000 Bankruptcy Cases [最高法报告称 4 万起破产案中国企集体企业占 8 成]'.

In 1994, to solve the problem that many SOEs were heavily indebted to banks, the State Council launched the Capital Structure Optimisation Program (CSOP), which assigned to state-owned banks (SOBs) debt write-off quotas for SOE bankruptcies and mergers.[57] SOBs were instructed to use funds provided by the state to write off debts up to specific quotas owed by SOEs. Workers and retirees were paid primarily using land use rights and employee housing, and other social assets were excluded from the bankruptcy estates.[58] Further, under the programme, merger, not bankruptcy was initially the main restructuring tool to be applied to distressed SOEs.

However, the balance sheets of SOEs did not improve. In 1995, a survey found that 37% of non-financial SOEs were insolvent based on their book values of assets and liabilities. In 1998, industrial SOEs incurred estimated aggregate losses of 80 billion yuan and profits of 120 billion yuan.[59] In order to meet targets to reduce the number of loss-making SOEs within three years (1999–2001),[60] bankruptcy took priority over mergers, and the number of bankruptcy cases surged. In 1999, 133 major bankruptcy cases were approved and acquired an average write-off quota of 135 million yuan or a total of 18 billion yuan.[61] With such concerted efforts made to close down unprofitable SOEs, the peak of bankruptcy cases in 2001 is hardly surprising.

The concepts and policies of CSOP were carried on and continued to be applied to SOEs until EBL was enacted in 2006. SOE bankruptcies directed by the government were described as 'policy bankruptcies' as they were supported by governmental

[57] State Council, 'Notice of the State Council on the Relevant Issues Concerning the Pilot Implementation of Bankruptcy of a State-Owned Enterprise in Some Cities
[关于在若干城市试行国有企业破产有关问题的通知] (Guofa 1994 No.59)' (*lawinfochina.com*, 1994) <http://www.lawinfochina.com/> accessed April 2017.

[58] State Council, 'Supplementary Notice of the State Council on the Relevant Issues About the Pilot Implementation of the Merger and Bankruptcy of State-Owned Enterprises in Some Cities and the Reemployment of Workers [关于在若干城市试行国有企业兼并破产和职工再就业有关问题的补充通知] (Guofa 1997 No.10)' (*lawinfochina.com*, 1997) <http://www.lawinfochina.com/> accessed April 2017.

[59] World Bank, 'Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System' (*documents.worldbank.org*, 20 September 2000)
<http://documents.worldbank.org/curated/en/2000/09/14451105/bankruptcy-state-enterprises-china-case-agenda-reforming-insolvency-system> accessed 1 September 2013.

[60] 'The Central Economic Working Conference in 1998 [中央经济工作会议在京召开 (1998 年)]' (*people.com.cn*, 1998) <http://www.people.com.cn/GB/channel5/21/19981210/333568.html> accessed March 2017.

[61] World Bank, 'Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System'.

policies, funded by the state and put employees' claims before bank loans. EBL has addressed the conflict between ordinary bankruptcies and policy bankruptcies by stating that 'special issues' relating to the SOE bankruptcies that are carried out within the period and scope as prescribed by the State Council shall be handled according to the relevant regulations of the State Council.[62] As the restructuring of SOEs was completed, policy bankruptcies were put to an end in 2008.[63]

Without a knowledge of the historical background, one may assume that a large number of bankruptcy cases during the SOE restructuring reform indicated progress in the bankruptcy law. However, in fact, many SOEs applied for bankruptcy in order to obtain state funding for reorganisation, avoiding transferral of assets to creditors. Typically, bankrupt SOEs continued to operate on the same site with the same management,[64] while their bank debts were written off with the funds provided by the central government.

Debt evasion was supported by local governments,[65] and bankruptcy became an administrative procedure with courts playing a rubber-stamp role.[66] Local governments were most at risk from social instability caused by massive lay-offs, and local governments owned most non-key SOEs that closed during the restructuring reform. On the other hand, the central government retained controlling shareholdings in key

[62] EBL 2006, Article 133

[63] R Li, 'Report on Supervision of State Assets and SOE Reform [关于国有资产监管和国有企业改革情况的报告]' (*npc.gov.cn*, 26 April 2005) <http://www.npc.gov.cn/wxzl/gongbao/2005-05/30/content_5341707.htm> accessed 2 November 2016.

[64] There were various means of escaping bank debts through bankruptcy. For example, an enterprise could merge with others to form a new company, transferred its assets to the new company, and then went into bankruptcy. It could also distribute the proceeds of the sale of assets regardless of the bank's claim as a secured creditor. At the same time, the enterprise would tamper with the asset/debt ratio, inflate the bankruptcy fees, and reduce the value of the bankruptcy estate. See State Council, 'Notice on Evading Bank Debts by PBC (Forwarded by State Council) [国务院办公厅转发人民银行关于企业逃废金融债务有关情况报告的通知]' (*chinaacc.com*, 2001) <http://www.chinaacc.com/new/63/69/110/2001/4/ad980719301112141002210 60.htm> accessed 15 November 2016.

[65] For example, the officials of Pingu, a county in Beijing, even proclaimed, 'By getting rid of debts through bankruptcy, enterprises could continue to operate with the existing factory and equipment.' As a result, some enterprises in the county, which had relatively good performance, went into bankruptcy to escape bank debts. They changed their names and continue their operations in the old site. It had been found that 88.51% of the restructured enterprises in the county had escaped bank debts, resulting in bad debts comprising 78.19% of the bank loans extended to the local restructured enterprises. See ibid.

[66] ibid.

SOEs that were reorganised in part by transferring shares to private investors.[67] These key SOEs were concentrated in banking, telecommunication, energy and natural resource sectors.[68] With SOBs still controlled by the central government, the debts owed by key SOEs to SOBs were effectively owed to the central government and could be written off. Top management of *gaizhi* enterprises were more concerned about employees' claims than about bank debts. A survey has found that 90% of CEOs of SOEs reckoned bankruptcy could be used to resolve debt problems.[69]

As a result, banks clearly incurred substantial losses during the restructuring of SOEs as they could only recover only 3–10% of their claims, while laid off employees of large SOEs were usually entitled to a substantial amount of compensation.[70] Debt evasion explains why debtors applied for bankruptcy voluntarily in most bankruptcy cases during the restructuring. Rarely did banks file bankruptcy applications, and some actually tried to stop SOEs from going into bankruptcy.[71]

After the central government tightened the reins on bankruptcy, the number of bankruptcies slightly decreased in the late 1990s and then increased in 2000–2001 when *gaizhi* was at the peak.[72] To address the problem of debt evasion by '*gaizhi*' enterprises, the central government adopted several measures. It required each g*aizhi* enterprise to commit to a schedule for paying its debts. Failure to meet the schedule would result in

[67] The report by the former director of the SASAC in 2005 pointed out that nationally, 1,464 out of 2,903 large SOEs have been converted into corporations with outside investors. And 48% of SOEs owned by the central government has completed the corporatisation reform. Also see R Li, 'Report on Supervision of State Assets and SOE Reform [关于国有资产监管和国有企业改革情况的报告]'.

[68] It has been estimated that the number of SOEs was 238,000 in 1998 and reduced to 119,000 in 2006. The number of SOEs owned by the central government was reduced to 151 in 2007, and 82.8% of their assets are concentrated on oil, electricity, national security, telecommunication and other curtail sectors. See S Huang, 'Analysis of the Evolution and Experience of SOEs' Reform [国有企业改革的实践演进与经验分析]' (2008) Research on Economics and Management [经济与管理研究] 20–31.

[69] BM Fleisher, NC Hope, AA Pena, and DT Yang, *Policy Reform and Chinese Markets: Progress and Challenges* (Edward Elgar 2008), p 54.

[70] World Bank, 'Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System'.

[71] S Cao, 'Legislation and Implementation of Chinese Bankruptcy Law in a Decade [十年来中国破产法的立法与实施]' (*modernchinastudies.org*, 1997)
<http://www.modernchinastudies.org/cn/issues/past-issues/57-mcs-1997-issue-2/400-2011-12-29-17-45-11.html> accessed 28 November 2016.

[72] As of the end of 2000, 51.29 % of all the restructured (*gaizhi*) enterprises had evaded bank debts, according to the survey on those that had bank accounts with the major SOEs. The bad debts they incurred amounted to 31.96% of the entire bank loans (plus interests) allotted to restructured enterprises. It was commercial banks owned by the state that had suffered most from the wave of debt defaults. See ibid.

being registered as a debt-escaping firm subject to a bank credit downgrade ineligible to receive new loans.[73] In 2002, the SPC stated that applications for bankruptcy protection by companies seeking to escape bank debts would not be accepted.[74] Subsequently, the China Banking Association (CBA), the self-regulatory association of banks in China, issued Guidance on the Register of Debt Evasion Institutions in 2006 (amended in 2013).[75]

(b) Debt Evasion through Reorganisation

Implementation of the supply-side reform of 2015 to close down 'zombie companies' and reduce overcapacity has led to the number of bankruptcy cases rising sharply. Many cases involve large industrial and manufacturing enterprises that had been stimulated by massive subsidies to overproduce. For example, two local SOEs, the Nonferrous Metals and the Special Steel Group, went into bankruptcy after defaulting in the interbank bond market.

Again, the rising number of bankruptcy cases comes with increasing cases of abuse. And this time, not only SOEs but also private companies are using bankruptcy to escape debts.[76] The discussion here will focus on the abuse of reorganisation, a procedure introduced by EBL in 2006. The purpose of the reorganisation procedure is to enhance creditors' value and give the debtor a 'second chance'.[77] However, under governmental intervention, the reorganisation procedure in China has been misused to prolong the lives of unprofitable companies and to effect debt evasion.

Misuse can occur in three main ways. First, local government dominates the creditors' meeting, which is supposed to represent the interests of creditors, and forces banks to extend further credit to the debtor. This effectively changes the creditors'

[73] ibid.
[74] SPC, 'SPC's Urgent Notice on Preventing Debt Evasion in Adjudicating Bankruptcy and Gaizhi Cases [最高人民法院关于人民法院在审理企业破产和改制案件中切实防止债务人逃废债务的紧急通知]' (*chinacourt.org*, 2001) <http://www.chinacourt.org/law/detail/2001/08/id/40952.shtml> accessed 8 November 2016.
[75] CBA, 'China Banking Association's Guidance on the Register of Debt Evasion Institutions [中国银行业协会 "逃废银行债务机构" 名单管理办法] (2013 Revision)' (*china-cba.net*, 2006) <http://www.china-cba.net/bencandy.php?fid=88&id=10978> accessed 8 November 2016.
[76] Tsinghua PBCSF, 'Report on Improvement of Bankruptcy Law and Market Exit by Law [加强破产法实施 依法促进市场出清]' .
[77] RM Goode, *Goode on Principles of Corporate Insolvency Law* (4 edn, Sweet & Maxwell 2011), p 314.

meeting into a bank syndicate to provide loans to the debtor. For example, when LDK Solar went into financial difficulties, the local government of Jiangxi province called for banks to establish a syndicate to provide LDK with loans worth 2 billion yuan. The interest on the syndicated loans is at a discount of 10%, and new loans were unsecured loans ranking *pari passu* with ordinary creditors.[78]

Second, the reorganisation plans usually involve debt-for-equity swaps, which carry great uncertainties for creditors and are often driven by political factors rather than economic ones. For example, Sinosteel, an SOE mired in financial difficulties, with a debt-to-asset ratio of around 90%, became the first Chinese steel company to default in the interbank bond market. In September 2016, Sinosteel reached an agreement with its creditors on a debt-for-equity swap and therefore avoided going into bankruptcy.[79] It was probably saved because its controlling shareholder was the national State-owned Assets Supervision and Administration Commission (SASAC), and therefore it had the support of the central government. The good fortune of Sinosteel stands in stark contrast to Special Steel Group, which was a local SOE and had no choice but to apply for bankruptcy after failed negotiations for a debt-for-equity swap with its creditors.[80]

Third, it is relatively common for reorganisation plans that do not significantly improve the repayment rate for creditors to be crammed down by the courts. For a reorganisation to be approved by the court, it must be passed by each of the creditors' groups by a double majority.[81] If the reorganisation plan is not approved by all of the creditors' groups, the court can use its power to cram down the reorganisation plan, i.e.

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[78] Sina, 'Jiangxi LDK's Reorganisation Plan Crammed Down by the Court [江西赛维重整计划被法院强裁 12 家债权银行成冤大头]' (*finance.sina.com.cn*, October 2016) <http://finance.sina.com.cn/money/bank/bank_hydt/2016-10-09/doc-ifxwrhpm2717413.shtml> accessed November 2016.

[79] Y Jin, 'Debt-for-Equity Swap of Sinosteel [中钢千亿负债破冰债转股 "钢铁煤炭很难大规模推行"]' (*epaper.21jingji.com*, August 2016) <http://epaper.21jingji.com/html/2016-08/17/content_45212.htm> accessed 10 January 2017.

[80] 'Will State Council Guidance on Debt-to-Equity Swap Lead to "Forced Marriages" [国务院债转股意见再否 "拉郎配"]' (*news.ifeng.com*, October 2016) <http://news.ifeng.com/a/20161011/50083374_0.shtml> accessed 27 November 2016.

[81] To be specific, a reorganisation plan is deemed to be passed by a creditors' group if it is approved by more than half (simple majority) of the creditors in each group, as well as those who represent more than two-thirds (absolute majority) of the total debts of the group. See EBL 2006, Article 86.

force creditors to accept the plan.[82] The repayment rate in most reorganisation cases that have been carried out is estimated to be below 20%.[83] Under the reorganisation plan of LDK, the average repayment rate for its creditors was 6.62%.[84] Despite strong opposition from creditors, that reorganisation plan was crammed down by the court.

However, there are reasons to believe that in the future there will be more restraints on debtor companies than in the past. First, with the diversification of their ownership, Chinese banks are no longer merely instruments for channelling funds to SOEs. Rather, many of them are listed companies that need to improve shareholder value.[85] They are no longer willing to yield to local governments and have become more active in the bankruptcy procedures. For example, when the Special Steel Group proposed a debt-for-equity plan, creditors vehemently opposed it and forced the company to go into liquidation. Second, the central government is taking measures to address debt evasion in bankruptcy and the underlying problem of governmental intervention and local protectionism. For example, although the State Council has urged using debt-for-equity swaps to deleverage SOEs, it forbids 'zombie companies' in a bankruptcy from using the debt-for-equity swap to evade debts and requires that banks lead the debt-for-equity process.[86] Unlike in the past, the government will no longer select those enterprises that are to be restructured, and local governments are forbidden to interfere with the decisions of banks.

C. Cross-Border Insolvency

Due to the high cost and stringent regulatory requirements of the domestic bond market,[87] the number of Chinese companies issuing bonds abroad has been on the

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[82] ibid.

[83] S Li and Z Wang, 'Empirical Study on Chinese Bankruptcy Law in Its Third Year of Application [中国破产法实施三年的实证分析]'.

[84] Sina, 'Jiangxi LDK's Reorganisation Plan Crammed Down by the Court [江西赛维重整计划被法院强裁 12 家债权银行成冤大头]'.

[85] D Zhang, J Cai, DG Dickinson, and AM Kutan, 'Non-Performing Loans, Moral Hazard and Regulation of the Chinese Commercial Banking System' (2016) 63 Journal of Banking & Finance 48–60.

[86] State Council, 'State Council's Opinions on Lowering the Leverage of Enterprises [国务院关于积极稳妥降低企业杠杆率的意见] and Guidelines on Market-Based Debt-to-Equity Swap [关于市场化银行债权转股权的指导意见]' (*gov.cn,* October 2016) <http://www.gov.cn/zhengce/content/2016-10/10/content_5116835.htm> accessed 27 November 2016.

[87] G Ma and W Yao, 'Can the Chinese Bond Market Facilitate a Globalizing Renminbi?' (*www.bof.fi*, 6 February 2016) 1 <http://www.bof.fi/bofit.> accessed 15 October 2016.

increase. In 2015, the dollar-denominated bonds sold by Chinese companies totalled $60.3 billion, more than six times the 2010 figure.[88] This has given rise to concerns of how offshore creditors would fare in a bankruptcy, as cross-border insolvency issues are not clearly addressed by the current law.

EBL has provided that Chinese courts shall recognise and enforce a foreign judgement based on international treaties of mutual recognition or the principle of reciprocity, provided that it does not contravene the basic legal principles of China, not jeopardise the sovereignty, national security or public interests of the country, and not undermine the legitimate rights and interests of the creditors within the country.[89]

However, China has only concluded mutual recognition treaties with a few countries,[90] and there is no clear guidance on how courts should decide under the principle of reciprocity. Further, the conditions imposed on recognition of foreign judgements may be interpreted broadly by Chinese courts, so local protectionism is likely to come into play. For example, public interests may be interpreted to include social stability, and therefore a foreign judgement may be denied by a Chinese court on the grounds of threatening social stability.

In addition to the uncertainties of law and local protectionism, foreign creditors have to face the fact that they are structurally subordinated to domestic creditors. To circumvent regulations on issuing debts to foreign creditors, Chinese companies usually issue debts through offshore entities, e.g. by incorporating a company in 'tax havens' such as the British Virgin Islands (BVI), the Cayman Islands or Bermuda. The offshore company is typically listed in a jurisdiction such as Hong Kong and issues bonds to foreign creditors, injecting funds into domestic companies, which are typically subsidiaries or associates of the offshore company.[91] If it is a holding company, the

[88] 'Moody's: Lower Offshore Funding Costs Are Credit Positive for Chinese Property Developers' (*moodys.com*, June 2015) <https://www.moodys.com/research/Moodys-Lower-offshore-funding-costs-are-credit-positive-for-Chinese--PR_339884> accessed 27 April 2017.
[89] EBL 2006, Article 5
[90] W Zheng, 'Strategic Choice for Cross-Border Issues in China [中国应对跨国破产法律问题的策略选择]' (2012) 1 Contemporary Law Review 18.
[91] D Kidd and J Warboys, 'Extracting Value for Offshore Creditors Either Side of the Chinese Wall: Restructuring PRC Financing Structures' (*blogs.lexisnexis.co.uk*, May 2016) <http://blogs.lexisnexis.co.uk/loanranger/wp-content/uploads/sites/9/2016/06/extracting-value.pdf> accessed March 2017.

offshore company would not have assets or real business operations and depends on the dividends received from the domestic companies to meet the claims of foreign bondholders. If the domestic companies slipped into financial difficulty, the offshore parent would be unable to repay foreign bondholders. Further, foreign bondholders would not be able to make direct claims against the domestic companies, as the bondholders would have lent through the offshore parent. As creditors of the equity holding parent (offshore company), foreign bondholders' claims would be subordinated to the onshore creditors of the domestic companies, including domestic banks, suppliers, employees, and tax authorities. Therefore, the foreign bondholders would probably get little or nothing, receiving only the leftovers after domestic creditors were paid.

The complexities faced by offshore bondholders of Chinese companies were highlighted by Suntech and LDK Solar, both of which were Chinese companies with holding companies registered in the Cayman Islands. In these cases, offshore bondholders found themselves excluded from the domestic insolvency proceedings and could recover little after domestic creditors were paid.

In the case of Suntech, its domestic creditors, mainly Chinese banks, applied for reorganisation on March 21, 2013. At that time, the debts owed by Suntech consisted of US$541 million of convertible bonds and RMB7.1 billion (US$1.1 billion) of loans issued by Chinese banks.[92] On November 15, 2013, the Intermediate People's Court of Wuxi approved the reorganisation plan of Suntech and declared the termination of the reorganisation procedure. In September 2013, Suntech reached a scheme with offshore bondholders in the Cayman Islands and was subsequently taken over by Joint Provisional Liquidators (JPLs). On the application of the JPLs, the bankruptcy proceeding in Cayman was recognised by the US Bankruptcy Court as the main bankruptcy proceeding that has the effect of automatic stay on the debtor's property in the US. The sequence of events in Suntech's case shows that the restructuring of offshore bonds and domestic reorganisation proceedings were conducted separately from the domestic reorganisation.

[92] A Wang and C Yi, 'Suntech Power: Challenges Under PRC Bankruptcy' (*business-finance-restructuring.weil.com*, April 2013) <https://business-finance-restructuring.weil.com/international/suntech-power-challenges-under-prc-bankruptcy/> accessed March 2017.

Unlike Suntech, LDK Solar entered into bankruptcy proceedings in China after the completion of the restructuring of offshore bonds. It implemented parallel schemes under the law of the Cayman Islands and Hong Kong in November 2014.[93] Subsequently, the US court recognised the Cayman Islands bankruptcy proceeding as the main bankruptcy proceeding and at the same time approved the pre-packaged reorganisation plan for LDK's US subsidiary (offshore senior note guarantor) pursuant to Chapter 11. After these steps to restructure LDK's offshore bonds, its domestic creditors applied for reorganisation in China. LDK's main domestic creditors were banks, with 12 banks holding a total of $27.1 billion of loans. After the creditors' meeting failed to reach the requisite majority to pass the reorganisation plan, the Intermediate People's Court in Xinyu crammed down a reorganisation plan and put an end to the reorganisation procedure. The domestic reorganisation procedure failed to involve offshore bondholders and in fact rendered their previous agreements void as they were left almost nothing after domestic creditors were paid. Hence, upon the joint application of offshore creditors, the Cayman Court ordered the liquidation of LDK on 11 February 2016.[94]

IV. Proposals for Future Changes

In order to resolve the problems in legislation and practice, this section will make proposals on the future reform of Chinese bankruptcy law. First, the legislation should be revised or further interpreted to ensure the fairness and impartiality of the bankruptcy procedure. For example, the effect of automatic stay and avoidance actions should be strengthened so as to achieve fair distributions among creditors. Further, specific guidance should be given as to how Chinese courts should recognise foreign bankruptcy judgements and involve foreign creditors in domestic bankruptcy proceedings. This will help to improve the situation of foreign creditors who should be treated fairly vis-à-vis domestic creditors.

[93] Harneys, 'Parallel Schemes of Arrangement' (*insol.org*, May 2015) <http://www.insol.org/emailer/May_2015_downloads/Document%201.pdf> accessed March 2017.
[94] 'LDK Solar Investors Press Release' (*investor.ldksolar.com*, April 2016) <http://investor.ldksolar.com/phoenix.zhtml?c=196973&p=irol-newsArticle> accessed March 2017.

Second, local governments should refrain from intervening the bankruptcy procedure, respecting the decisions of creditors' meetings and courts. The objective of the 2015 supply-side reform is to ensure that 'zombie companies' exit the market in a lawful and orderly manner. As shareholders of local SOEs, local governments should prevent the misappropriation of state assets and hold management accountable. Moreover, local governments should facilitate the bankruptcy process by providing public services and coordinating the compensation of laid off workers.

Third, an important factor that undermines the function of Chinese bankruptcy law is the lack of judicial independence of local courts. To solve this problem, it is advisable for the country to emulate the bankruptcy courts in the US, which are federal courts established by USBC and have exclusive jurisdiction over cases arising from USBC. [95] China has already begun to establish bankruptcy chambers within intermediate courts, which are reported to have improved the efficiency in the adjudication of bankruptcy cases. [96] Although they differ from the centralised bankruptcy courts under USBC, they have acquired some independence from the local governments. It is possible and desirable to establish a fully-fledged national bankruptcy court system in China that would provide opportunities for judges to become specialised in bankruptcy cases, which require extensive knowledge in different areas including contract, property rights, and financial law. With an increasing number of complex cases, especially cross-border ones, well-trained bankruptcy judges are essential for the future development of Chinese bankruptcy law.

Finally, it is urgent for China to establish a bankruptcy regime for financial institutions, given the rising level of bad loans in the country.[97] Following the Deposit Insurance Regulation coming into effect in 2015, a formal regime for bank bankruptcy in China should be enacted. In 2017, the CBRC announced that it is contemplating regulations for bank bankruptcy and will accelerate the pace of their implementation.[98]

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[95] EG Behrens, 'Stern v. Marshall: the Supreme Court's Continuing Erosion of Bankruptcy Court Jurisdiction and Article I Courts' (2011) 85 American Bankruptcy Law Journal 387–428.

[96] Xinhua News, 'China to Set Up More Bankruptcy Courts' (*news.xinhuanet.com*, August 2016) <http://news.xinhuanet.com/english/2016-08/11/c_135587198.htm> accessed March 2017.

[97] W Maliszewski, S Arslanalp, J Caparusso, J Garrido, S Guo, JS Kang, WR Lam, TD Law, W Liao, N Rendak, P Wingender, J Yu, and L Zhang, 'Resolving China's Corporate Debt Problem'

[98] 'Central Government Permits Banks to Go Bankrupt [中央今日允许银行破产]' (*sohu.com*, April 2017) <http://www.sohu.com/a/133931518_715549> accessed April 2017.

However, the promulgation of rules for the bankruptcy of financial institutions can be particularly challenging in China considering the political and economic realities of the country. Most importantly, as the deposit insurance only pays maximum compensation of 500,000 yuan (US$725,74) per depositor in the event of bank bankruptcy, it is imperative to adopt further measures, such as setting up compensation funds, in order to protect depositors. In addition, with the fast development of financial conglomerates, the existing regulatory regime, consisting of different authorities for insurance, banking, and securities, is being challenged.[99] Increased coordination of regulators is essential for resolving large financial institutions efficiently and without causing systemic damage. Moreover, the growing shadow banking sector, including the Internet financing platforms, should be taken into account when drafting the rules for the bankruptcy of financial institutions.[100]

V. Conclusion

This article has examined the main problems of Chinese bankruptcy law, of which the most crucial one is the inappropriate intervention of local governments. Further, detailed rules for cross-border insolvency and bankruptcy of financial institutions are still missing in the picture. However, with the governmental efforts to implement the supply-side reform, initiatives to reform the bankruptcy law are well underway. In a word, despite all the challenges, it is foreseeable that Chinese bankruptcy law will make strides in the near future and assume a greater role in the Chinese society.

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