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# *Corporate Reorganization Reform in China: Findings from an Empirical Study in Zhejiang*

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## Abstract

In 2006, China enacted its first rescue-oriented *Enterprise Bankruptcy Law* with the aim of establishing its corporate rescue culture. But the corporate reorganization procedure that is at the heart of the new bankruptcy law has not been used frequently. It is appropriate to ask why the use of China's new corporate rescue law has been so low. Meanwhile, in the existing corporate reorganizations under the 2006 *Law*, most debtors were excluded from the reorganization process, so that the Chinese new debtor-in-possession model, which seems to be a desirable control format, was largely shelved. Why so? This article explores these two issues through the use of empirical data collected from Zhejiang, a province with a significantly larger number of reorganizations than most other Chinese provinces.

This article seeks to examine the main characteristics of China's new corporate reorganization regime enshrined in its newly-enacted *Enterprise Bankruptcy Law of 2006* (the EBL 2006). Specifically, it explores two questions. First, it asks why China's new rescue law has not been widely used to rehabilitate troubled companies so as to save jobs and preserve going concern value.<sup>1</sup> Second, it asks why the administrator-in-possession approach rather than the legislated debtor-in-possession approach continues to be preferred in the majority of China's corporate reorganizations.<sup>2</sup>

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1. Earlier versions of this article were presented at the East Asian Law & Society Conference (Shanghai, Shanghai Jiaotong University, 22 March 2013) and the 6th Insolvency Research Conference (London, The Insolvency Service and University College London (UCL), 19 April 2012). Roman TOMASIC and Zinian ZHANG, "From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergence in Implementation: The Case of Corporate Reorganizations in China" (2012) 12 *Journal of Corporate Law Studies* 295 (noting that reorganization is only used for a small number of large companies in China).

2. Zhang has found that the debtor-in-possession model was only used in twenty-six percent of reported Chinese reorganizations; see further: Zinian ZHANG, *Corporate Reorganization Under the Enterprise*

These issues are examined through the use of empirical data collected from Zhejiang province. Zhejiang was chosen for this detailed case study for the simple reason that nearly a quarter of China's corporate rescue cases between 2007 and 2010 were heard in this province;<sup>3</sup> as a result, Zhejiang offers a rich supply of data that allows generalizations about the use of China's new reorganization procedure to be made more confidently. Moreover, Zhang conducted twenty face-to-face interviews with actors who were directly involved in Zhejiang corporate rescues.

The remainder of this article is organized as follows: Part I introduces the main features of China's new corporate rescue law; Part II reviews the literature; Part III describes the methodology used here; Part IV sets forth the fieldwork findings; and Part V discusses the implications of these findings for debates regarding China's new corporate rescue regime. Our conclusion is to be found in Part VI.

## I. AN OVERVIEW OF CHINA'S CORPORATE REORGANIZATION REGIME

China did not enact a modern corporate rescue law until 2006, when it promulgated the EBL 2006 as its first rescue-oriented bankruptcy law.<sup>4</sup> While the previous law, the *Enterprise Bankruptcy Law 1986 (For Trial Implementation)* (EBL 1986), contained several provisions governing the reorganization of state-owned-enterprises (SOEs) in bankruptcy, these provisions were too simple to be recognized as a modern corporate rescue regime.<sup>5</sup> More importantly, as many Chinese bankruptcy scholars have noted,<sup>6</sup> the EBL 1986's over-simplified reorganization provisions were never used to rehabilitate bankrupt SOEs.

To address these issues, China enacted the EBL 2006, which took effect on 1 June 2007. The EBL 2006 now comprehensively addresses the bankruptcy reorganization procedure.<sup>7</sup> Not only is it rescue-centred,<sup>8</sup> but many pro-rescue mechanisms derived from abroad have also been adopted. In particular, as mentioned by one of its draftsmen, Professor Zou Hailin, the EBL 2006 has given prominence to the corporate bankruptcy reorganization procedure by locating the chapter on reorganization before

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*Bankruptcy Law of the People's Republic of China – The Relevance of Anglo-American Models for China* (PhD Thesis, Durham University, 2014) at 131.

3. *Ibid* at 115.
4. See Rebecca PARRY and Haizheng ZHANG, "China's New Corporate Rescue Laws: Perspectives and Principles" (2008) 8 *Journal of Corporate Law Studies* 113.
5. Shihu WANG, "Woguo Gongsi Chongzheng Zhidu De Jiantao Yu Jianyi (我国公司重整制度的检讨与建议) [An Examination of China's Corporate Reorganization Regime]" (2006) 28 *Xiandai Faxue (现代法学)* [Modern Legal Science] 131 at 132 (noting that there was no modern corporate rescue regime in the EBL 1986).
6. *Ibid* at 133 (noting that the EBL 1986 had never been used to rescue troubled SOEs). See also Weiguo WANG, "Adopting Corporate Rescue Regimes in China, A Comparative Survey" (1998) 9 *Australian Journal of Corporate Law* 234 at 238 (noting that the oversimplified rescue regime in the EBL 1986 was not used at all).
7. See Charles D BOOTH, "The 2006 PRC Enterprise Bankruptcy Law: The Wait Is Finally Over" (2008) 20 *Singapore Academy of Law Journal* 275 at 300.
8. See John J RAPISARDI and Binghao ZHAO, "A Legal Analysis and Practical Application of the PRC Enterprise Bankruptcy Law" (2010) 11 *Business Law International* 49 at 50.

the chapters on conciliation and liquidation; this arguably reflects the lawmakers' intent to use reorganization as the first option for companies in difficulty.<sup>9</sup> This preference for reorganization can be seen in several areas of regulation. For instance, the new law certainly makes filing for reorganization easier: Article 7 allows both debtor and creditor to file a petition with the court without advance governmental approval, while Article 70 permits the debtor company, or any shareholder holding more than ten percent of the company's equity, to apply to the court to convert the liquidation into a reorganization procedure even after liquidation has begun.<sup>10</sup> Similarly, the EBL 2006 gives greater leverage to troubled companies and enables them to enter into a safe harbour and keep aggressive creditors at bay: Article 2 stipulates that a company voluntarily filing for reorganization need not be bankrupt,<sup>11</sup> in contrast to the bankruptcy requirements for conciliation and liquidation procedures;<sup>12</sup> and Articles 19 and 75 automatically impose a moratorium once the court accepts a reorganization petition, staying the debt collection actions of all creditors, including secured creditors,<sup>13</sup> and creating a breathing space for the troubled debtor.

With regard to control of the company during the reorganization procedure, Article 13 of the EBL 2006 authorizes the court to appoint an administrator, usually a local-government-organized liquidation committee, a law firm, an accounting firm, or a professional liquidating firm to take over the company's affairs and properties when the reorganization procedure commences. To help ensure that creditors' views are heeded, Article 22 allows a meeting of creditors to request the replacement of the administrator if they have evidence that the latter is not even-handed or incompetent. Article 73 allows the courts to transfer control of the company back to a debtor in certain instances; if approved, the debtor will then administer the company's affairs and properties by itself, with the court-appointed administrator continuing to monitor the rescue process in a supervisory capacity. However, where the debtor either does not request to regain control or has his or her request rejected, the administrator will continue to control and to manage the company.<sup>14</sup>

The reorganization is administered through an approved reorganization plan. According to Article 79, a plan should be proposed within six months, although the court has the discretion to grant an extension for a further three months. Article 80

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9. Hailin ZOU, "Woguo Qiye Zaisheng Chenxu De Zhidu Fenxi He Yinyun (我国企业再生程序的制度分析和适用) [China's Corporate Rehabilitation System – Theories and Application]" (2007) 25 *Zhongguo Zhengfa Daxue Xuebao* (中国政法大学学报) [Journal of China University of Political Science and Law] 48 at 50-51.
  10. *Ibid* at 54 (arguing that the reason for allowing shareholders to file for reorganization is to protect minority shareholders).
  11. See Shujie QI, "Woguo Xing Pochanfa Zhi Chongzhen Zhidu Ruogan Shupin (我国新破产法之重整制度若干述评) [Corporate Reorganization Under the New Corporate Bankruptcy Law]" (2007) 1 *Fujian Faxue* (福建法学) [Fujian Journal of Legal Science] 37 at 38.
  12. Liming WANG, "Pochan Lifa Zhong De Ruogan Yinan Wengti Tantaos (破产立法中的若干疑难问题探讨) [Problems of Amending the Bankruptcy Law]" (2005) 3 *Faxue* (法学) [Legal Science] 3 at 11 [Wang, "Amending the Bankruptcy Law"].
  13. Xinxin WANG, "Xing Pochanfa Lifa Zongheng Tan (新破产立法纵横谈) [The New Bankruptcy Law]" (2005) 4 *Shoudu Shifan Daxue Xuebao* (首都师范大学学报) [Journal of Capital Normal University (Social Sciences Edition)] 34 at 40 [Wang, "The New Law"].
  14. See Booth, *supra* note 7 at 303.

requires that the plan be proposed by the debtor where the debtor-in-possession approach is used or by the administrator if the administrator remains in control.<sup>15</sup> Creditors are, surprisingly, not given a right to propose a plan. However, Article 82 grants them a right to vote on the plan, and requires the support of over half of the company's secured, employee, revenue, and unsecured creditors, who must also represent over two-thirds of the amount of claims in each class of creditor, before it is approved.<sup>16</sup> Moreover, Article 85 makes clear that shareholders should also be allowed to vote on the plan if their equity is either adjusted or cancelled.<sup>17</sup>

Once accepted by all classes of impaired parties through the vote, the plan can be sent to the court for confirmation.<sup>18</sup> In cases where one or more classes of impaired parties reject a plan, a "cram-down" procedure might also be requested so as to force the reluctant parties to accept the plan, provided that the court ensures that three tests are satisfied: the creditor-best-interest test, the fair and equitable test, and the feasibility test.<sup>19</sup> Where agreement is reached and the plan confirmed by the court, the court will then terminate the judicial reorganization procedure, and the company will be returned to the debtor who is then required to implement the plan.<sup>20</sup>

## II. A REVIEW OF PREVIOUS RESEARCH

### A. *Is a Company Rescue Worthwhile?*

Two general criteria are recognized and used to assess whether a company deserves a rescue effort.<sup>21</sup> The first is a company's going concern value. Tene has argued that for a company to be eligible for reorganization it should have going concern value that is worth preserving.<sup>22</sup> A company's going concern value lies in its diverse relationships with its stakeholders, and may be destroyed in the event of a piecemeal liquidation.<sup>23</sup> This test, however, is not uncontroversial. For example, Baird and Rasmussen argue that the going concern value that may exist within multiple relationships between a company's assets and its human resources will be worthless if it could not enable the company to effectively compete with its rivals in the market, so that the going concern value of a bankrupt company could not justify its reorganization if it could not be used

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15. See Xinxin WANG, "Shilun Chongzhen Zhidu Zhi Lifa Wangshan (试论重整制度之立法完善) [Improving the Corporate Reorganization Regime]" (2010) 10 Kunming Ligong Daxue Xuebao (昆明理工大学学报) [Journal of Kunming University of Science and Technology] 28 at 30.
  16. See Xinxin WANG, "Practices of the Enterprise Bankruptcy Law 2006" (2009) 3 Journal of Law Application 7 at 14.
  17. See Wang, "Amending the Bankruptcy Law", *supra* note 12 at 11.
  18. *Zhonghua Renming Gongheguo Qiye Pochanfa (中华人民共和国企业破产法) [The People's Republic of China Enterprise Bankruptcy Law]* (2006), art 86 [EBL 2006].
  19. *Ibid*, art 87.
  20. *Ibid*, art 89.
  21. Both are understood as originating in the US. See generally Charles Jordan TABB, "The History of the Bankruptcy Laws in the United States" (1995) 3 America Bankruptcy Institute Law Review 5.
  22. Omer TENE, "Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations" (2003) 19 Bankruptcy Developments Journal 287 at 295.
  23. See generally Lynn M LOPUCKI, "The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's *The End of Bankruptcy*" (2003) 56 Stanford Law Review 645.

to defeat its rivals and to generate a profit for the company.<sup>24</sup> Therefore, a second criterion – the distress model – is also used.

Distress can be categorized as either financial or economic in nature. While financial distress refers to the question of whether the company's business operations are still viable and can still generate a profit after meeting operating costs, even though the company is over-indebted for various reasons and becomes bankrupt, economic distress addresses those companies whose business cannot yield a profit and continually lose money. Baird argues that only companies in financial distress are suitable for reorganization, while liquidation represents the only valid option for companies in economic distress.<sup>25</sup> Distinguishing companies in financial distress from those in economic distress is therefore an essential first step in the successful use of corporate reorganization. Nevertheless, there are often many problems in applying this criterion in practice. For example, a financially-distressed company may still be liquidated in practice if it can generate a profit but the profit is not as high as expected by its investors. Nor is it always easy to identify financial from economic distress. Indeed, Kahl argues that insufficient information about a company's operations often leads to many wrong bankruptcy reorganization decisions.<sup>26</sup>

In view of the difficulties arising from the application of these two technical criteria, some jurisdictions tend to broadly define eligibility for reorganization. For example, the UK adopts a rather broadly-defined, subjective principle to apply to any assessment of a company's eligibility for reorganization. McCormack notes that a company that is subject to a reorganization (administration) application should have "a real prospect" of being rescued.<sup>27</sup> Obviously, the establishment of "a real prospect" is a subjective exercise. Similarly, while Frisby argues that "insolvency law should address the question of rescue selectively," she offers no objective principles that could be referred to in selecting UK companies that may be appropriate for reorganization.<sup>28</sup> Even the Insolvency Service, an official body regulating insolvency issues in the UK, adopts a subjective view, noting that only "efficient" companies that are in trouble may avail themselves of the reorganization procedures<sup>29</sup> but leaving the question about what constitutes an efficient organization unanswered. This somewhat open-ended criterion is probably intended to provide more leeway to businesses themselves, which in turn may lower the entry hurdles for companies seeking to utilize the company reorganization procedures in the UK.

In China, two prevailing views are in circulation. The first argues that whether a company can enter the formal reorganization procedure depends on whether it has a chance of surviving the distress that it is currently suffering. Upheld by scholars such as

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24. See generally Douglas G BAIRD and Robert K RASMUSSEN, "The End of Bankruptcy" (2002) 55 *Stanford Law Review* 751.
  25. Douglas G BAIRD, "Bankruptcy's Uncontested Axioms" (1998) 108 *Yale Law Journal* 573 at 580.
  26. Matthias KAHL, "Economic Distress, Financial Distress, and Dynamic Liquidation" (2002) 57 *The Journal of Finance* 135 at 136.
  27. Gerald MCCORMACK, *Corporate Rescue Law – An Anglo-American Perspective* (Glos: Edward Elgar, 2008) at 122.
  28. Sandra FRISBY, "In Search of a Rescue Regime: The Enterprise Act 2002" (2004) 67 *The Modern Law Review* 247 at 248.
  29. The Insolvency Service, *A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group* (London: HMSO, 2000) (The 2000 Report) at para 24.

Wang,<sup>30</sup> this view posits that a company should face liquidation rather than reorganization if it is unlikely to survive in the future, and appears to be somewhat subjective and close to attitudes found in the UK. The second view argues that the potentially huge costs suggest that reorganizations should only be used for large companies, and that small and medium-sized companies ought to be excluded. Advocated by those such as Li,<sup>31</sup> this “reorganization-only-for-large-companies” standard seems to be untenable. Indeed, two empirical studies from the US, the first undermining the belief that that liquidation costs less than reorganization and should therefore be preferred,<sup>32</sup> the second reporting that the vast majority of US companies in reorganization are actually small to medium-sized and that only six percent of companies in rescue could be identified as large or held over \$100 million in assets,<sup>33</sup> demonstrate the controversy behind this view. Both studies suggest that, while it may still be premature to assert that China’s infrequent use of corporate reorganizations so far is attributable to the “reorganization-only-for-large-companies” view, reorganization should be open to all companies, regardless of size.

### B. *Investigation into the Small Number of Corporate Reorganizations in China*

Despite the new law, reorganizations remain rare in China. One source reports that China’s courts only handled about 105 corporate reorganization cases in the first three years following the implementation of the EBL 2006, citing data revealed in a Beijing lawyer’s conference presentation.<sup>34</sup> This figure remains questionable, as the lawyer did not disclose the source of his data, nor did the analysts go on to look more closely at the reasons for the small number of corporate reorganizations. However, other studies have also shown an awareness of the fact that the new corporate rescue law was infrequently used, usually without quantifying their assessment. Wang, for example, offers no quantitative support for his assertion that corporate reorganization is infrequently used in China, relying instead on a series of personal observations.<sup>35</sup> Similarly, Han and He have noted that the new rescue law has not been well implemented, but do not support their conclusion with empirical evidence.<sup>36</sup>

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30. Liming WANG, “Several Issues of Amending China’s Bankruptcy Law” (2002) 5 *China Legal Science* 78 at 83.
  31. Yongjun LI, “Xing Pochanfa Jiaodian Wenti Toushi (新破产法焦点问题透视) [Focal Problems of the New Enterprise Bankruptcy Law]” (2006) 10 *Caikuai Xuexi (财会学习)* [Accounting Studies] 14 at 16.
  32. Arturo BRIS, Ivo WELCH, and Ning ZHU, “The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization” (2006) 61 *The Journal of Finance* 1253 at 1301.
  33. Elizabeth WARREN and Jay Lawrence WESTBROOK, “The Success of Chapter 11: A Challenge to the Critics” (2009) 107 *Michigan Law Review* 603 at 609.
  34. Shuguang LI and Zuofa WANG, “Zhongguo Pochanfa Shishi Sannian De Shizhen Fenxi (中国破产法实施三年的实证分析) [An Empirical Study of the Implementation of China’s Enterprise Bankruptcy Law During the First Three Years]” (2011) 22 *Zhongguo Zhenfa Daxue Xuebao (中国政法大学学报)* [The Journal of China University of Political Science and Law] 58 at 60 (this figure was derived from data revealed in a conference presentation by a Beijing lawyer) [Li and Wang, “First Three Years”].
  35. See Xinxin WANG, “Lun Pochan Anjian Shouli Nan Wenti De Jiejue (论破产案件受理难问题的解决) [Difficulties in Commencing Corporate Bankruptcy Processes in China]” (2011) 3 *Falu Shiyun (法律适用)* [Journal of Law Application] 29 [Wang, “Difficulties of Commencing”].
  36. Changyin HAN and Huan HE, “Pochan Jixian De Lifa Gongneng Wenti (破产界限的立法功能问题) [Bankruptcy Tests and Practices]” (2013) 2 *Zhenzhi Yu Falu (政治与法律)* [Politics and Law] 2.



Previously, we reported on a detailed empirical study regarding the number of corporate reorganizations in China, indicating that 105 enterprises entered the corporate reorganization procedure in China between June 2007 and November 2010.<sup>37</sup> Interestingly, this figure of 105 reorganization cases parallels the findings reported by Li and Wang. However, our earlier study did not take steps to further investigate why the new rescue law was not widely used in China. This article aims to address this gap.

### C. Control in Reorganization

With respect to control in corporate reorganizations, Booth notes that there are two typical models in use worldwide: the debtor-in-possession approach (mainly used in the US) and the practitioner-in-possession approach or the administrator-in-possession approach (used in the UK and some other countries). China has adopted a hybrid approach, under which the practitioner-in-possession<sup>38</sup> model serves as the default option under the EBL 2006, but which can be converted to the debtor-in-possession approach at the request of the debtor and subject to court approval.<sup>39</sup>

As the name suggests, the debtor-in-possession model leaves the debtor in charge of the company after it has entered the formal bankruptcy reorganization procedure. In contrast, the practitioner-in-possession model requires that the debtor (especially its directors and managers) be replaced by an outside practitioner, usually a qualified insolvency professional; therefore, the practitioner-in-possession model will lead to the automatic resignation or displacement of the debtor's management.<sup>40</sup>

In explaining why US companies prefer the debtor-in-possession approach, Roache offers four reasons that may help to better understand this: first, the debtor's experience and information in running the company are vital for an effective rescue; second, it is more costly to install an outside third party to administer the rescue process, such as an insolvency practitioner, as they are not familiar with the company; third, the debtor would be motivated to work harder in the rescue procedure because of its own interests; and finally, the debtor may be more comfortable using the reorganization law since it can remain in control of the process.<sup>41</sup> Importantly, the debtor-in-possession model is not guaranteed in all US corporate (Chapter 11) reorganizations, as an outside trustee may still be appointed if the company's distress is caused by fraud.<sup>42</sup> Moreover, even where the debtor-in-possession model is applied, the debtor remains subject to fiduciary duties and will be under heavy scrutiny and supervision from both the court and the creditors.<sup>43</sup>

37. Tomasic and Zhang, *supra* note 1 at 311.

38. This article uses the practitioner-in-possession and administrator-in-possession model interchangeably.

39. Booth, *supra* note 7 at 303.

40. See generally Gerard MCCORMACK, "Control and Corporate Rescue – An Anglo-American Evaluation" (2007) 56 *International and Comparative Law Quarterly* 515 [McCormack, "Control and Corporate Rescue"].

41. John T ROACHE, "The Fiduciary Obligations of a Debtor in Possession" (1993) 1993 *University of Illinois Law Review* 133 at 140-141.

42. See Michael BRADLEY and Michael ROSENZWEIG, "The Untenable Case for Chapter 11" (1992) 101 *Yale Law Journal* 1043 at 1044.

43. See generally Raymond T NIMMER and Richard B FEINBERG, "Chapter 11 Business Governance: Fiduciary Duties, Business Judgement, Trustee and Exclusivity" (1989) 6 *Bankruptcy Developments Journal* 1.



With regard to the UK's practitioner-in-possession approach, McCormack argues that there are a host of considerations that have led the country to choose a management-replacement regime. For example, it is widely held in Britain that failing business managers should not be allowed to continue to run failed businesses, that a group of UK qualified insolvency practitioners is better equipped to run bankrupt businesses with impartiality and integrity, and that bank-centred lending markets in the UK make debtor companies quite weak before their main creditors, such as powerful banks; he also asserts that path dependency or the force of convention might also help to explain prevailing attitudes in the UK.<sup>44</sup> However, the harsh treatment of debtors under the practitioner-in-possession model has given to debtors is often seen to be detrimental to effective rescue. Armour and others have used this point to argue that the UK's corporate rescue law may eventually move more closely towards the US's debtor-in-possession approach.<sup>45</sup>

Ultimately, it may be overly simplistic to label the US's Chapter 11 procedure as the debtor-in-possession approach and the UK's administration procedure as the practitioner-in-possession approach. Finch has suggested that doing this has polarized views, and that this has resulted in a failure to fully and adequately appreciate the roles played by other parties such as creditors and directors in corporate rescues.<sup>46</sup> Indeed, in a process that looks more like a bargaining platform in which all interested parties table their claims and pursue their own agendas, it would seem that creditors repeatedly play a decisive role. McCormack uses this point to argue that there has in fact been a functional convergence of control in corporate rescues, as creditors in both the UK and the US are able to substantially determine the fate of troubled debtors under their respective corporate reorganization procedures.<sup>47</sup> In other words, regardless of whether the debtor-in-possession or the practitioner-in-possession approach is used, creditors will always have a big say regarding the outcomes of rescues.

In terms of corporate rescues in China, Wang believes that, in principle, the debtor should be allowed to remain in control after the formal rescue procedure has begun; this is both because the debtor's experience and information is vital to ensuring that the company's business needs are met, and because lawyer and accountant administrators lack the expertise to turn troubled companies around.<sup>48</sup> Wang also emphasizes that China's version of the debtor-in-possession approach should be placed under the supervision of a court-appointed administrator, so as to fill the assumed supervision gap left by the US debtor-in-possession approach and prevent the debtor from abusing its control.<sup>49</sup> And he stresses that experience shows that if the

44. McCormack, "Control and Corporate Rescue", *supra* note 40 at 521.

45. John ARMOUR, Brian R CHEFFINS, and David A SKEEL, Jr, "Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom" (2002) 55 *Vanderbilt Law Review* 1699 at 1782.

46. Vanessa FINCH, "Control and Co-ordination in Corporate Rescue" (2005) 25 *Legal Studies* 374 at 375.

47. McCormack, "Control and Corporate Rescue", *supra* note 40 at 544.

48. Xinxin WANG, "Xing Pochanfa De Tupo (新破产法的突破) [Innovations in the New Bankruptcy Law]" (2006) 2 *Faren (法人)* [Legal Entity Journal] 20.

49. Weiguo WANG, "Xing Pochanfa Caoan Yu Gongsu Faren Zhili (新破产法草案与公司法人治理) [The Draft of the New Bankruptcy Law and Bankruptcy Corporate Governance]" (2005) 2 *Faxuejia (法学家)* [The Jurists] 5 at 7 [Wang, "The Draft"].

administrator-in-possession approach is used, the court should consider appointing management professionals as administrators rather than lawyers or accountants, who have often been proven to be incompetent in their roles.<sup>50</sup>

One distinctive feature of corporate rescue in China is that Article 24 of the EBL 2006 also allows the court to rely on an older method and appoint a local-government-organized liquidation committee as the administrator. However, Wang argues that debates over draft versions of the EBL 2006 in the China's National People's Congress show that this provision was only retained in order to deal with the bankruptcy reorganization of SOEs.<sup>51</sup> This view is also held by Li and Wang, who believe that the use of liquidation committees is reserved as a transitional mechanism for the "policy" bankruptcy of SOEs so as to bridge the old EBL 1986 with the new EBL 2006.<sup>52</sup>

All this suggests that a consensus among academics seems to be emerging on the issue of control in Chinese corporate reorganizations. According to this emerging agreement, the debtor-in-possession approach will represent the norm rather than the exception, and that a third party administrator would be appointed only in cases where the debtor has committed fraud or has engaged in dishonest activities before bankruptcy. Moreover, only the reorganization of an SOE would permit the appointment of a local-government-organized liquidation committee as administrator.

#### D. Control of Corporate Reorganizations in China

Li and Wang note that most of the existing listed company reorganizations in China have involved the appointment of a local-government-organized liquidation committee as the administrator, and that such committees were also used in some non-listed company reorganizations;<sup>53</sup> while they indicate that China's newly qualified insolvency practitioners were often not hired to do the job, they fail either to quantify the number of administrator appointments from both local-government-organized liquidation committees and from qualified insolvency practitioners or to investigate sufficiently whether and to what extent the debtor-in-possession model was subsequently used. Wang also observes that in many corporate reorganizations courts have appointed administrators from local-government-organized liquidation committees rather than qualified insolvency practitioners, but does not provide any data supporting his observation, let alone to further survey the use of the debtor-in-possession model.<sup>54</sup> And, again, our own 2012 paper reports the statistical results concerning the administrator appointment from liquidation committees and insolvency practitioners, as well as the use of the debtor-in-possession, but does not investigate the causes of the phenomenon.<sup>55</sup>

50. Xinxin WANG, "Lun Pochan Guanliren Zhidu Wanshan De Ruogan Wenti (论破产管理人制度完善的若干问题) [Improving the Insolvency Practitioner System]" (2010) 9 *Fazhi Yanjiu* (法治研究) [Legal Research] 14 at 15.

51. Wang, "The New Law", *supra* note 13 at 39.

52. Li and Wang, *supra* note 34 at 62.

53. *Ibid* at 67.

54. Wang, "The Draft", *supra* note 49 at 15.

55. Tomasic and Zhang, *supra* note 1 at 311-315.

To sum up, then, three main points can be made from the above review of the literature. First, given the way in which it is designed, corporate reorganization should only be open to companies that have a going concern value which is above their liquidation value and that are financially rather than economically distressed. Second, the debtor-in-possession approach is intended to be the primary control model in China's corporate reorganization procedures. Finally, there has not been enough research into why China's new corporate rescue law is not frequently used as well as why most of the existing corporate reorganizations have preferred to use the practitioner-in-possession instead of the expected debtor-in-possession approach. Before presenting the findings from our Zhejiang case study in this regard, the next part outlines the methodology used to collect the data on these issues.

### III. METHODOLOGY

In seeking to better understand the implementation of China's new corporate rescue law, twenty corporate reorganization cases<sup>56</sup> that were accepted by Zhejiang courts between 1 June 2007 and 31 December 2011 were examined; they are set out in Table 1. These twenty cases involved the rescue of the thirty-five companies, since, in some cases, several companies in a company group were consolidated into one reorganization procedure.<sup>57</sup>

The data was collected in two stages. In the first, the cases were identified and drawn from the online sources publicized by newspapers and relevant legal institutions including courts and law firms. Almost all Chinese newspapers have online versions, making data collection much easier; and many law firms and courts also have their Internet websites reporting some cases that are deemed to be very valuable and important. But the difficulty arising during this stage was that the data collected was likely to be incomplete, largely because some information sought for the current analysis was not of sufficient interest to the agencies concerned; much of this missing information had to be obtained through fieldwork.

Thus, in the second stage, interviews with twenty people who were involved in seventeen out of these twenty reorganizations were conducted by Zhang in Zhejiang from January to February 2012. Not only did these interviewees help answer the unresolved questions, they also provided detailed information about the cases, as examined in greater detail in this article. In particular, the reorganization plans of sixteen reorganizations in either electronic format or hard copy were generously provided by these interviewees. As Table 2 shows, these interviewees comprised eight

56. The reorganization case of Zhejiang Wei'er Trade Limited and its four subsidiaries, which was accepted by Yongkang Lower People's Court, Zhejiang on 2 September 2009, was not included, because this case was not found by this study due to the limit of the methodology.

57. This table is based on the data collected by Zinian Zhang in 2012-13. Most of these cases were also mentioned in an official report issued by Zhejiang Supreme People's Court. For western scholars, there are two databases, LawinfoChina and Westlaw China, which collect a huge number of China's court cases. Zhang tried to use these two databases to verify the collected cases in Zhejiang. Unfortunately, largely because only a small proportion of China's court cases is included in these two databases, these Zhejiang cases could not be found there.

Table 1. Zhejiang Corporate Reorganization Cases  
(Accepted between 1 June 2007 and 31 December 2011)

	Company	Court	Date of acceptance (yyyy/mm/dd)	Miscellaneous
1	Haina Science	Hangzhou Intermediate People's Court, Zhejiang	2007/09/14	Listed company
2	Dadi Paper	Fuyang Lower People's Court, Zhejiang	2009/06/01	
3	Hualun Group	Fuyang Lower People's Court, Zhejiang	2009/06/01	Consolidated with its five subsidiary companies
4	Guangsai Energy	Hangzhou Intermediate People's Court, Zhejiang	2008/05/20	
5	Nanwang Group	Hangzhou Intermediate People's Court, Zhejiang	2008/05/20	
6	International Hotel	Xiaoshan Lower People's Court, Zhejiang	2010/07/01	
7	Yijiaxiang Food	Hangzhou Intermediate People's Court, Zhejiang	2010/07/15	
8	Nongji Manufacture	Hangzhou Intermediate People's Court, Zhejiang	2010/07/15	
9	Jiamei Travel	Hangzhou Intermediate People's Court, Zhejiang	2010/07/15	
10	Medier Food	Hangzhou Intermediate People's Court, Zhejiang	2010/07/15	
11	Jinxing Trust	Jinghua Intermediate People's Court, Zhejiang	2009/10/26	
12	Huachen Development	Beilun Lower People's Court, Zhejiang	2009/04/29	
13	Tianting Paper	Pujiang Lower People's Court, Zhejiang	2009/09/01	
14	Yalun Paper	Longyou Lower People's Court, Zhejiang	2009/06/22	Converted to liquidation
15	Huatai Oil	Putuo Lower People's Court, Zhejiang	2010/01/08	
16	Zonghen Group	Shaoxing Intermediate People's Court, Zhejiang	2009/06/12	Consolidated with its five subsidiary companies
17	Jiande Steel	Jiande Lower People's Court, Zhejiang	2010/10/09	
18	Ouweibao Retail	Putuo Lower People's Court, Zhejiang	2011/08/29	Consolidated with its two subsidiary companies and converted to liquidation eventually
19	Hengyu Ship-Building	Putuo Lower People's Court, Zhejiang	2011/10/21	Consolidated with its three subsidiary companies and pending at the time of writing
20	Yongji Ship-Building	Putuo Lower People's Court, Zhejiang	2011/11/29	Pending at the time of writing

Table 2. Reorganization Interviewees in Zhejiang\*

Interviewees	Number of Interviewees	Number of Cases Involved
Lawyer	8	13
Accountant	2	3
Creditor	5	5
Judge	3	13
Debtor	1	1
Government Official	1	1

\* Interviews were conducted in Zhejiang from January to February 2012

lawyers, two accountants, three judges, five creditors or their representatives, one debtor, and one government official.

All interviews took place in the offices of the interviewees, and no electronic recorder was used. So as to better preserve confidentiality, no third party was present during the interviews. The notes initially taken by Zhang in Chinese were later translated into English.

#### IV. FINDINGS

##### A. *Company Dissolution, Bankruptcy, and Reorganization Rates in Zhejiang*

To gain a deeper understanding of the use of the enterprise bankruptcy law in Zhejiang, three percentages were calculated. The first was the annual company dissolution rate, which was generated by dividing the annual number of company dissolutions by the number of companies registered at the start of each year; this rate reflects market forces in culling weak businesses. The second was the annual company bankruptcy rate, which was generated by dividing the annual number of company bankruptcies (including all bankruptcy reorganization, compromise, and liquidation procedures) by the annual number of company dissolutions; this rate reflects the extent to which the corporate bankruptcy law as a whole has been applied. Lastly, the third was the annual company reorganization rate, which was calculated by dividing the number of corporate reorganizations by that of company dissolutions, and is used to determine the extent to which the bankruptcy reorganization procedure is used.

By applying the above methods to the figures reported in Table 3 below, it can be calculated that in Zhejiang the annual company dissolution rate was 9.56 percent in 2007, 9.43 percent in 2008, 8.06 percent in 2009, 6.69 percent in 2010, and 6.26 percent in 2011, with a mean company dissolution rate of 7.84 percent over the four-year period; the annual company bankruptcy rate was 0.05 percent in 2007, 0.06 percent in 2008, 0.07 percent in 2009, 0.07 percent in 2010, and 0.14 percent in 2011, with a mean company bankruptcy rate of 0.06 percent over the entire period; and the annual company reorganization rate was 0.0017 percent in 2007, 0.0032 percent in 2008, 0.0122 percent in 2009, 0.0134 percent in 2010, and 0.0056 percent in 2011, with a mean corporate reorganization rate of 0.0070 percent.

Table 3. Company Dissolutions, Bankruptcies, and Reorganizations in Zhejiang (2007-2011)

Year	Number of Registered Companies	Number of Companies Dissolved	Number of Corporate Bankruptcies	Number of Corporate Reorganizations
2007	608,871	58,222	35	1
2008	666,624	62,841	42	2
2009	711,701	57,372	41	7
2010	782,639	52,378	36	7
2011	862,395	53,993	77	3

Sources: The Zhejiang Provincial Company Registration Office, The Zhejiang Supreme People's Court, Siyuan Think-Tank, Beijing, and Zinian Zhang's PhD Data Collection.

While the figures in Table 3 illustrate the situation in Zhejiang, an international comparison can identify the gaps Zhejiang may need to bridge in the future. Therefore, corresponding figures from England and Wales and the US were also obtained from official sources in each country. Table 4 gives the related statistics of England and Wales; by using the same methods, it can be determined that, during the same period between 2007 and 2011, England and Wales' mean company dissolution rate was 12.76 percent, the mean company bankruptcy rate was 8.40 percent, and the mean company reorganization rate was 1.36 percent. In regard to figures from the US, because of the statistical interval, the US Census Bureau had not produced the national numbers of companies and dissolutions for the years 2010 and 2011 at the time of writing. To address this, the figures between 2005 and 2009 were used as substitutes; these are shown in Table 5. These numbers generated a mean company dissolution rate was 10.57 percent, a mean company bankruptcy rate was 6.14 percent, and a mean company reorganization rate was 1.23 percent.

The contrast between these three jurisdictions is further illustrated and compared in Figure 1. In regard to the company dissolution rate, clearly, there is a great similarity between all these three jurisdictions – about ten percent of companies exited the market annually, indicating that market forces generally function similarly in culling inefficient companies, no matter where these companies are located. Zhejiang's company dissolution rate of 7.84 percent is slightly lower than that in England and Wales and the US, and this might be attributed to the higher economic growth rates in China: between 2007 and 2011, China's annual GDP growth rate was 10.54 percent, whilst the UK's growth rate (England and Wales included) was 0.28 percent, with the US's growth at only 0.52 percent.<sup>58</sup>

With respect to the annual company bankruptcy and reorganization rates, however, similarities only exist between England and Wales and the US, where about five to ten percent of dissolved companies entered bankruptcy procedures, and approximately

58. The GDP growth rates were obtained from the World Bank statistics. See The World Bank, "GDP Growth (Annual %)", online: The World Bank <<http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>>.

Table 4. Company Dissolutions, Bankruptcies, and Reorganizations in England and Wales (2007-2011)

Year	Number of Registered Companies	Number of Companies Dissolved	Number of Corporate Bankruptcies*	Number of Corporate Reorganizations**
2007	2.10 m	214,500	22,490	4,016
2008	2.41 m	223,200	22,928	3,139
2009	2.54 m	288,900	29,338	5,876
2010	2.58 m	489,000	29,339	4,380
2011	2.44 m	324,000	25,207	3,569

\*All bankruptcy procedures under the *Insolvency Act 1986*.

\*\*Reorganization includes administration and company voluntary arrangement in England and Wales. Source: The UK Insolvency Service

Table 5. Company Dissolutions, Bankruptcies, and Reorganizations in the US (2005-2009)\*

Year	Number of Registered Companies	Number of Companies Dissolved	Number of Corporate Bankruptcies	Number of Corporate Reorganizations
2005	5.19 m	492,686	31,952	6,250
2006	5.23 m	532,987	35,292	5,701
2007	5.29 m	560,312	21,960	4,668
2008	5.24 m	566,379	30,741	6,274
2009	5.09 m	600,109	49,091	10,846

\* In the US, they use the concept “firm” rather than “company”. For the sake of convenience and consistency, the concept company is used in this article. Sources: The US Census Bureau and the US Courts

one percent of dissolved companies chose to reorganize in an effort to remain in business. Both figures contrast sharply with those from Zhejiang. While data from the US would suggest that roughly 6.14 percent of dissolved companies in Zhejiang would rely on bankruptcy procedures to tackle debt problems at a time when they were dissolved, in fact only 0.08 percent of them actually did this. Indeed, the Zhejiang courts only handled 1.30 percent of corporate bankruptcies, which are liable to be dealt with annually as a whole under the EBL 2006. In other words, the Zhejiang courts only fulfilled 1.30 percent of their corporate bankruptcy trial duties, which are legally required by the statute. Apparently, the vast majority of companies that were bankrupt did not use – or could not access – formal bankruptcy procedures in Zhejiang. The same conclusion can also be drawn in regard to the company reorganization rate: the Zhejiang courts only fulfilled 0.57 percent of the corporate reorganization trial duties imposed upon them by the EBL 2006.

One may ask whether the low company bankruptcy rate in Zhejiang is because the majority of dissolved Zhejiang companies were financially healthy and able to fully pay their debts at the time of dissolution, so that no bankruptcy procedures were needed.



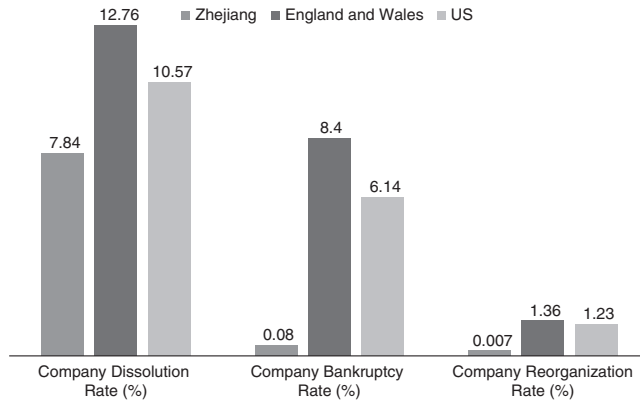


Figure 1. Company Dissolution, Bankruptcy, and Reorganization Rates in Zhejiang, England and Wales, and the US.

This assumption is unlikely to be the case. According to a report released by the Zhejiang Supreme People's Court, we can estimate that in Zhejiang at least 20.10 percent of dissolved companies were unable to pay their debts and were financially bankrupt but did not enter bankruptcy procedures in the five-year period surveyed.<sup>59</sup> The real situation would probably be far worse.

Moreover, some may ask whether a higher corporate bankruptcy or reorganization rate leads to a more efficient bankruptcy system. This is probably wrong. Bankruptcy procedures must step in as far as companies are unable to pay the debts when dissolved; by this token, in theory, the bankruptcy rate must remain at zero in the situation where all companies can still fully honour their debt upon being dissolved, but this assumed situation is in reality non-existent.

This strikingly similar contrast can also be drawn if comparing Zhejiang with England and Wales regarding both the annual bankruptcy and reorganization rates, the Zhejiang courts being largely paralysed in their handling of corporate bankruptcy and reorganization cases. Therefore, it was very rare for the new Chinese corporate reorganization law to be used in Zhejiang, even though Zhejiang has clearly taken the lead in using this law when compared with other provinces in China. It is therefore legitimate to ask why the reorganization

59. According to a report of Zhejiang Supreme People's Court, in Wenzhou, one of eleven prefectures of Zhejiang, there were 3,122 judgement debtor companies which were unable to pay their judgement debts from 2010 to 2013, and the local Wenzhou courts had to drop the judgment enforcement procedures because there were not company assets which could be found. In other words, these companies were bankrupt, but the bankruptcy procedures were not used, and these companies just disappeared without being formally investigated through bankruptcy processes. Arithmetically, it could be estimated that there might be about 11,447 companies  $((3,122 \times 11)/3)$  that were dissolved and were bankrupt in Zhejiang as a whole annually during this three-year period, but they did not enter the formal bankruptcy procedures. Given the annual 56,961 company dissolutions in Zhejiang as shown in Table 3, the real company bankruptcy rate should be at least 20.10 percent. See The Zhejiang Supreme People's Court, "2012 Zhejiang Fayuan Qiye Pochan Shenpan Baogao (2012年浙江法院企业破产审判报告) [2012 Report on Trying Corporate Bankruptcies]" (6 May 2013), online: Xing Lang <[http://blog.sina.com.cn/s/blog\\_45c1e92a0101mxyd.html#commonComment](http://blog.sina.com.cn/s/blog_45c1e92a0101mxyd.html#commonComment)>.

provisions of the EBL 2006 have been so little used. We will explore this question in the next section.

### B. *Obstacles to Entering into the Corporate Reorganization Procedure*

Three major parties – court, debtor, and creditor – play decisive roles in determining the shape of corporate reorganization activity in Zhejiang. This is especially true with regard to the commencement of company reorganizations. The concerns of these three parties regarding the company reorganization procedure may largely explain the factors that hinder the use of the new law. This section reports the concerns raised by each of these three parties respectively.

#### 1. *Difficulties faced by the courts*

With a provincial population of 55 million, Zhejiang has 102 law courts, including the Zhejiang Supreme People's Court, eleven intermediate people's courts, and ninety lower people's courts.<sup>60</sup> In theory, all 102 courts can handle corporate reorganizations. But, the fact that only twenty corporate reorganizations occurred between 2007 and 2011 means that the vast majority of Zhejiang courts never accepted corporate reorganization petitions during this period.

The scarcity of corporate reorganizations can largely be attributed to the hesitation of courts in accepting reorganization filings. One judge interviewed for this research mentioned that when a corporate reorganization petition is lodged in his court, it is always treated as a very sensitive issue, and the final decision to accept it would usually be made by the court's deputy president.<sup>61</sup> This pattern can be understood by reference to the context within which Chinese courts operate.

When Chinese courts face ordinary commercial litigation such as a contract dispute, it is the court's registry which usually assesses and decides whether to accept the filing. However, in some cases deemed difficult to handle, such as an administrative litigation where a government department is sued, the registry tends to refer the filing to the director of an adjudicating chamber to assess its merits and to decide whether it can be accepted. In exceptional cases, it is the deputy president in charge of trial affairs or the court's top decision-making body, the judicial committee, who decides whether to accept an individual case filing. Since a corporate reorganization filing is considered to be exceptional, and without a decision from the top, the registry would not accept it. In refusing to accept corporate reorganization filings, courts have their own internal concerns, which we will now turn to consider.

(a) *Manpower*: Asked why courts in Zhejiang were so hesitant in accepting corporate reorganization filings, nearly half of the interviewees, including lawyers and judges, said that courts do not have enough judges to deal with corporate reorganization

60. See The Zhejiang Supreme People's Court, "Zhejiang Fayuan Jieshao" (浙江法院介绍) [An Introduction to the Zhejiang Courts], online: The Zhejiang Supreme People's Court <<http://www.zjcourt.cn/20060320000004/>>.

61. Personal Interview, Administrator 2, an accountant, Zhoushan, Zhejiang, China, 12 January 2012.

matters if all such petitions are accepted without restrictions.<sup>62</sup> Indeed, most Chinese courts are known to be understaffed. As in other provinces, Zhejiang does not have special bankruptcy courts;<sup>63</sup> as a result, corporate bankruptcies, including reorganizations, are assigned to the second civil chambers of courts. Judges in all chambers are already saddled with too many lawsuits, and one official report states that it is not unusual for a judge in Zhejiang to handle over 200 cases a year,<sup>64</sup> meaning that a judge must organize and sit in at least one court hearing and write at least one verdict every working day. As a result, judges do not want to be bothered with more cases, especially time-consuming corporate bankruptcies. It should also be noted that after the EBL 2006 took effect in 2007 there was no facilitative increase in the number of judges in Zhejiang courts.

Apart from the deficiency in the number of judges, one of the judges interviewed emphasized that most existing judges are not experienced and skilled in dealing with corporate bankruptcies including reorganizations;<sup>65</sup> this is probably true.<sup>66</sup> Two factors may have contributed to this incapacity on the part of the judges. First, Zhejiang judges are not specifically trained in terms of handling corporate bankruptcy and reorganization, and no special training courses have been developed for judges in Zhejiang since the EBL 2006 came into force. Similarly, although many lawyers and accountants were officially designated as insolvency practitioners in Zhejiang in 2007, no tailored training courses or qualification exams were required.<sup>67</sup> Second, most Zhejiang judges have neither had prior bankruptcy cases to gain experience from nor gained relevant experience from prior legal practice. Indeed, only forty-six corporate bankruptcy cases a year are heard by Zhejiang's 102 courts (see Table 3 above), suggesting that more than half of the Zhejiang courts have not had a single corporate bankruptcy case to gain experience from. Together, these two factors seems to create a vicious circle, where the lack of experience makes judges hesitate in handling corporate bankruptcies, while the absence of prior legal experience in practice further undermines their confidence in handling reorganization cases.

62. Personal Interview, Administrator 3, a lawyer, Zhoushan, Zhejiang, China, 12 January 2012.

63. In the 1990s, foreign experts advised China to establish a special bankruptcy court system to deal with corporate bankruptcies, but this proposal was rejected. See generally Terence C. HALLIDAY, "The Making of China's Corporate Bankruptcy Law" (2007) Oxford Series in Law, Justice and Society 2 at 7.

64. In 2012, Zhejiang courts as a whole handled 148 cases per judge. See Jianhua YU and Huanliang MENG, "Zhejiang Fayuan Banan Faguan Renjun Jianliang Wei Quanguo Pingjunsu Liangbei (浙江法院办案法官人均结案量为全国平均数两倍) [Zhejiang Judges Handled Double the National Average Number of Cases]" *Zhejiang Fayuan Xinwen Wang* (浙江法院新闻网) [*Zhejiang Courts Net*] (18 January 2012), online: Zhejiang Courts Net <<http://court.gmw.cn/public/detail.php?id=83910>>.

65. Two personal interviews: Administrator 2, an accountant, Zhoushan Zhejiang, China, 12 January 2012, and Administrator 3, a lawyer, Zhoushan, Zhejiang, China, 12 January 2012.

66. See also Andrew MCGINTY and VC LEOW, "China's Insolvency Law Two Years On: Are Government-Driven Restructurings the New Trend" (2009) 11 *Journal of International Banking and Financial Law* 689.

67. In January 2013, Zinian Zhang had a talk with Mr Hongzhu Zhang, the director of the second civil chamber of the Zhejiang Supreme People's Court, who is in charge of designating all insolvency practitioners in Zhejiang. During the talk, Mr Zhang confirmed that no training courses or qualification exams were made.

In brief, most courts in Zhejiang do not have a sufficient number of judges to deal with bankruptcy proceedings, nor do they have the expertise needed to handle corporate reorganizations properly. In other words, they are not ready – or not adequately equipped – to fulfil the duties imposed by the new reorganization law. Nevertheless, by comparison to these internal difficulties, greater challenges might have come from outside the court system.

(b) *Government support*: Many interviewees believed that the unwillingness of courts to accept corporate reorganizations is due to the lack of government support.<sup>68</sup> Unlike the handling of day-to-day cases, the court needs administrative services or cooperation from many government departments when dealing with a corporate reorganization case. For example, the revenue authorities need to agree to provide tax-approved receipts to the company if the company's business operations continue during the reorganization procedure, and the utility authorities should not cut water and electricity supplies simply on the grounds that the company has unpaid bills. In reality, however, courts alone are unable to persuade local government departments to cooperate or to facilitate these aspects of corporate reorganization procedures.

Law courts are weak institutions in China's present political system. One judge interviewed in this study revealed that in his experience "local government departments will not listen to us unless the local government is officially involved in an individual bankruptcy case."<sup>69</sup> This judge gave an example to demonstrate the difficulties that the court faced when handling a reorganization procedure.<sup>70</sup> In a case supervised by him, the local police department played a key role in investigating the company's assets, because the lawyer administrator was denied access to the company's asset records held by banks and many government agencies; without the police investigation, it was impossible even to know the whereabouts of the company's key assets, let alone to reorganize the company's business. However, this judge interviewee emphasized that in that case the local police department was actively involved mainly because the police were ordered by the local government to do so and that, in this case, the deputy mayor of the city had chaired a committee in support of the reorganization process.

However, the fact is that government support is not always available to assist courts. Local governments have the discretion, and not an obligation, to back individual reorganizations handled by courts. One lawyer interviewee held a similar view.<sup>71</sup> This lawyer disclosed that, in the reorganization case in which he was involved, the court had asked for and received a written guarantee from the local district government promising to ensure that all government departments would provide effective and efficient administrative services if needed,<sup>72</sup> adding that the court was not confident in accepting the filing without the government's guarantee.

68. Personal Interview, Administrator 2, an accountant, Zhoushan, Zhejiang, China, 12 January 2012.

69. *Ibid.*

70. *Ibid.*

71. Personal Interview, Administrator 3, a lawyer, Zhoushan, Zhejiang, China, 12 January 2012.

72. See Haiqing TANG and Yinghua SHI, "Mingyin Qiye Pochan Chongzhen Zhi Sifa Tansuo (民营企业破产重整之司法探索) [Private Company Reorganization]" (2011) 12 *Fazhi Yanjiu (法治研究) [Legal Research]* 102 and 105 (noting that the government guarantee in writing was obtained in that case).

(c) *Mass petitions by employees or creditors*: Most interviewees believed that courts most worry about potential mass petitions.<sup>73</sup> This could only be appreciated in the unique context of China, where it is well documented that most Chinese courts try to distance themselves from categories of cases that are very likely to generate protests by refusing to accept them.<sup>74</sup> Corporate reorganizations are highly related to mass-petitions; this article found that mass petitions occurred in at least eleven out of the twenty Zhejiang corporate reorganization cases studied here, and that in each case the mass petition had been made by unpaid employees. Assembling in large numbers, the unpaid employees laid their grievances before the local governments, probably because Article 85 of the *China Labour Law 2005* holds the local government liable for enforcing the labour law and ensuring that employees are paid under their labour contracts. (Fortunately such mass petitions all took place before the commencement of these reorganizations; otherwise, the judges in charge of these cases would have faced enormous pressure.)

The problem is that, in spite of governmental support in all of these cases, the judges were still very anxious, or highly vigilant, about the reorganization procedure. This is probably out of fears about potential protests. One lawyer interviewee disclosed that about 800 riot police officers were deployed to monitor the creditors' meeting in a case that he was involved with so as to pre-empt protests by the creditors, even though only 600 creditors or so attended the meeting.<sup>75</sup> Similarly, a second lawyer interviewee in another city mentioned that each creditor was physically flanked with two police officers during a meeting in which he was involved.<sup>76</sup> In other cities in Zhejiang, many interviewees also noted that riot police were present at the creditors' meetings. All these measures were intentionally made to avoid or suppress any form of protests. Some creditors complained that they were in fact intimidated when attending creditors meetings.<sup>77</sup>

## 2. *Unwillingness of debtors to reorganize in courts*

Ideally, reorganizations are more successful where they are initiated by the debtors themselves, since they have the requisite knowledge and experience gained from running their own businesses. In Zhejiang, however, it is rare to see debtors voluntarily filing for reorganization.

One interviewee explained that most debtor companies try to avoid in-court reorganizations for fear of losing control to third parties. This is because under Article 13 of the EBL 2006 the entry into the formal bankruptcy reorganization procedure leads to the automatic resignation of the debtor's directors and management team, an unacceptable outcome for most of a company's officers.<sup>78</sup> And although Article 73 of

73. Personal Interview, Administrator 3, a lawyer, Zhoushan, Zhejiang, China, 12 January 2012.

74. Benjamin L LIEBMAN, "A Populist Threat to China's Courts?" in Margaret YK WOO and Mary E GALLAGHER, eds, *Chinese Justice: Civil Dispute Resolution in Contemporary China* (Cambridge: Cambridge University Press, 2011), 269 at 282.

75. Personal Interview, Administrator 2, an accountant, Zhoushan, Zhejiang, China, 12 January 2012.

76. *Ibid.*

77. See Zihang XIA, "Cheng Jianlong Bei Xingju ST Jingding Chongzu Xian Zhuanji (陈建龙被刑拘ST金顶重组现转机) [Hopes Arise After the Arrest of Cheng Jianlong]" *Meiri Jingji Xingwen (每日经济新闻) [National Business Daily]* (10 July 2009), online: National Business Daily <<http://www.nbd.com.cn/articles/2009-07-09/225422.html>>.

78. Personal Interview, Administrator 1, a lawyer, Hangzhou, Zhejiang, China, 5 January 2012.

the EBL 2006 allows the debtor to regain control under the debtor-in-possession approach, this interviewee emphasized that this is more a theoretical possibility than a practical certainty, and that debtors see this as an unreasonably dangerous gamble.<sup>79</sup>

This fear is not unreasonable. As will be reported below, in most existing reorganizations, the debtor-in-possession model has not been applied. This suggests that, for debtors, once managerial control is lost, it is more likely to be lost forever. Moreover, as observed by one accountant interviewed in this field work, at the heart of debtors' concerns over losing control is the potential exposure of company books to a third party, as these books almost inevitably contain evidence of tax evasion.<sup>80</sup> This can be a real problem, especially against the backdrop of China's tax collection system. For example, one study has shown that between twelve to thirty-seven percent of value added tax, the main business tax for China's central government revenue, was evaded between 1995 and 2003.<sup>81</sup> Indeed, tax evasion is so rampant in China that no company will be comfortable surrendering its books to outsiders, let alone to hand them over in their entirety to a court-appointed administrator. For a debtor, losing control to a third party largely equals exposing its own criminal conduct to others; it is not only unacceptable but dangerous.

In addition, debtors also have few financial incentives to file for reorganization, because the absolute priority principle, according to which creditors are to be paid before shareholders, applied in the vast majority of the reorganizations (87.5 percent) in Zhejiang. Shareholders received nothing in these cases, since even unsecured creditors were not paid in full because of the bankruptcy of these companies, meaning that shareholders or shareholder-managers could not financially benefit from the formal reorganization procedure. To put it another way, in anticipation of zero distribution, instead of pursuing an in-court reorganization, most debtors would try to avoid filing for reorganization before a court.

### 3. *The frustration of creditors with reorganizations*

China's new corporate rescue regime does not appear to be debtor-friendly. However, even in the US, where there is a pro-debtor corporate rescue regime, it has been found that most debtor-filed formal rescues are in effect commenced because of imminent liquidation pressure from creditors.<sup>82</sup> This means that the effective use of the corporate bankruptcy rescue regime is also dependent on a rigorous debt enforcement system in which creditors can easily choose liquidation to collect debt.

Generally speaking, creditors in Zhejiang only have one option available: namely, to collect debt through individual debt enforcement. While liquidation exists on paper, it does not in practice. And without a real threat of creditor-initiated liquidation

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79. *Ibid.*

80. *Ibid.*

81. Wen XU, "The Size of Value Added Tax Evasion and Anti-Evasion Measures in China" (2006) 5 *Journal of China University of Finance* 1.

82. Lynn M LOPUCKI, "The Debtor in Full Control – Systems Failure under Chapter 11 of the Bankruptcy Code?" (1983) 57 *American Bankruptcy Law Journal* 99 at 100 [LoPucki, "Full Control"].

proceedings, there is no urgency for defaulting debtors to seek the formal reorganization procedure as a safe haven to avoid aggressive creditors. This was confirmed by one lawyer interviewee, who said that it is quite naïve for a creditor to file for a debtor's liquidation in a court by solely relying on the written rules embedded in the EBL 2006, and that lawyers who go to courts to lodge bankruptcy petitions on behalf of their creditor clients would be seen as inexperienced and could be snubbed by court officials.<sup>83</sup> This lawyer further lamented the fact that in order to open a corporate bankruptcy procedure, creditors must persuade the local government where the debtor is domiciled to provide support, which is almost an insurmountable task for most creditors, making such an action even more unlikely where the creditors are from a different region or outside the province.<sup>84</sup>

These observations are supported by a typical case recently handled in Zhejiang. On 6 October 2008, Shaoxing City-based Jianglong Textile Group Limited ceased trading because it suffered a sudden illiquidity. After it was found that the chief executive officer (CEO) had previously absconded for days, a panic among creditors led to a total of 803 individual debt enforcement actions, in the form of litigation, being brought against Jianglong, most of them taking place in the Zhejiang courts. Unfortunately, however, no bankruptcy liquidation procedure was entered into, even though the debtor company was clearly bankrupt; while some creditors did submit liquidation petitions to the Shaoxing Intermediate People's Court, which handled most of the Jianglong litigations, these petitions were simply ignored – indeed, the Court did not even bother to register them. Later, the company's assets were auctioned to satisfy these judgement debts, but as predicted, its assets were not sufficient to meet them all. As a result, creditors who sued were paid *pari passu*, while creditors who did not were excluded from the distribution.<sup>85</sup>

The above case illustrates the reality that it is unlikely for creditors to conveniently commence a corporate bankruptcy case in Zhejiang. Interestingly, some Zhejiang reorganization cases examined in this study were actually filed by company creditors. As a result, it is reasonable to ask if the odds against creditors in using the bankruptcy law have been exaggerated. On closer examination, however, it was found that they were not. In such circumstances, on the face of it, the reorganization procedure was filed by a creditor, but it soon became apparent that these creditors were insiders or related parties. For example, in the reorganization procedure of Nanwang Group Limited, the filing creditor, Sanhua Group Limited, is one of the company's shareholders.<sup>86</sup> Quite often, after a local government stepped in and decided to support a court-involved reorganization effort, it was largely to fulfil the formality in choosing which party should sign a filing document. In real terms, then, it was the local

83. Personal Interview, Administrator 2, an accountant, Zhoushan, Zhejiang, China, 12 January 2012.

84. *Ibid.*

85. Qing WANG, Lingling CHAI, and Lingyang DING, "Jingji Handong Li De Yiqu Jiekun Ge (经济寒冬里的一曲解困歌) [A Relief Song Sung in an Economic Winter]" *Shaoxing Ribao (绍兴日报) [Shaoxing Daily]* (26 February 2009) at 6.

86. Hejuan ZHAO, "Nanwang Jituan Chongzhen Fangan Weihuo Tongguo (南望集团重整方案未获通过) [Nanwang Reorganization Plan Failed]" *Caijing Wan (财经网) [Caijing]* (29 October 2008), online: The Caijing Magazine <<http://www.caijing.com.cn/2008-10-29/110024211.html>> .



government rather than a filing party that substantially initiated an in-court reorganization project.

Another lawyer interviewee said that it had been repeatedly proved in practice that the corporate bankruptcy procedure, including corporate reorganization, is unavailable to both creditors and debtors unless a local government intervenes.<sup>87</sup> A natural consequence is that, in China, the absence of a robust corporate bankruptcy system leads to a situation in which creditors are only protected on a first-come-first-served basis, since only individual debt enforcement in the form of litigation is practically available. Hence, a collective action between creditors could not be initiated in their interest as a whole, because of the inaction of the state, especially of its court system.

To sum up, then, while courts in Zhejiang are legally and constitutionally liable to accept corporate reorganization filings, they hesitate to do so; debtors possess information and knowledge but are unwilling to file for fear of losing control to outsiders; creditors may force defaulting debtors to enter reorganization earlier but are largely denied the most powerful legal weapon: liquidation. The combination of these factors may largely explain why there have been such a small number of reorganizations in Zhejiang. It is noteworthy in this regard that in Anglo-American jurisdictions, law courts are bound to accept bankruptcy filings, regardless of the social and political impacts of individual cases,<sup>88</sup> as a result, the difficulties facing Chinese law courts described above do not arise. Interestingly, the mindset of debtors in China towards the use of reorganization is similar to that of their counterparts in both the UK and the US – all try to evade reorganization in order to avoid the loss of control. But existing research also suggests that, at least in the US, debtors will voluntarily file for reorganization in the face of imminent liquidation pressures from creditors.<sup>89</sup> Unfortunately, the threat of liquidation used by creditors in Anglo-American jurisdictions is largely unavailable in China. This is a tough struggle for both China and Chinese businesses.<sup>90</sup>

Nevertheless, there are still a certain number of companies entering into the reorganization procedure in Zhejiang. Therefore, one may ask what the real criteria are for a Chinese company to be allowed to use reorganization in practice. An important part of the answer to this question lies in the attitude of governments at either local or central levels. Indeed, if the continued existence of a company is significant enough to draw the government's attention, a local court may be guided, if not manipulated, by the government to initiate a reorganization procedure to try to revive the distressed company. Otherwise, the statutory rules in the written EBL 2006 appear to be largely irrelevant to reorganization practice.

87. Personal Interview, Administrator 2, an accountant, Zhoushan, Zhejiang, China, 12 January 2012.

88. See generally Charles G GEYH, "Rescuing Judicial Accountability from the Realm of Political Rhetoric" (2005) 56 Case Western Reserve Law Review 911.

89. LoPucki, "Full Control", *supra* note 82 at 100.

90. See the World Bank, *Doing Business in China 2011: Making a Difference for Entrepreneurs* (Washington, DC: The World Bank, 2010) at 2 (ranking China as seventy-nine out of all 183 economies in respect of ease of doing business, which means China still faces the challenge of building a business-friendly legal environment).

### C. Control of Zhejiang Corporate Reorganizations

As noted above, while debtors are, in theory, able to regain control from administrators if the debtor-in-possession model is applied, in reality there is only a small chance of this occurring. Indeed, the debtor-in-possession option was granted in only four out of fourteen reorganizations, and it is clear that even here the return of control was in name only, as the key right of proposing the reorganization plan remained in the hands of the administrators in all four cases.

Administrator control took different forms in these four cases. In the first two cases, the reorganization plan was actually proposed by the administrator,<sup>91</sup> while the plan was jointly proposed by the debtor and the administrator in the third case.<sup>92</sup> Indeed, only in the last case was the debtor-in-possession model used. This was done in order to use the debtor's name to propose the reorganization plan;<sup>93</sup> however, it is apparent that the structure and content of the reorganization plan is almost identical to other administrator-proposed reorganization plans in cases of group reorganizations,<sup>94</sup> even though the lawyer interviewee and administrator insisted that the plan was made by the debtor.<sup>95</sup>

As a result, it seems that the real debtor-in-possession model has yet to be used in Zhejiang. This raises the immediate question as to what the real motives behind the symbolic use of the debtor-in-possession model in these four Zhejiang cases actually were. One court document may provide a partial answer to this question. According to this internally-circulated report made by a law court which handled several reorganizations in Zhejiang, approving the debtor-in-possession model is mainly aimed at retaining the old management so as to maintain the company's business operations where the administrator does not have the skills to do the job, in consideration of the importance of continuing the company's normal business operations to building and maintaining creditors' confidence in the reorganization efforts and to attracting potential buyers.<sup>96</sup> However, the court also clearly stated that, in this case, the administrator, a local accounting firm, must still propose the reorganization plan, in spite of already approving the debtor-in-possession model of reorganization.<sup>97</sup>

Arguably, much could be done to improve the understanding of the debtor-in-possession model by both judges and insolvency practitioners in Zhejiang and in China as a whole. Turning to the central question as to why debtors were

91. They were one company from Jinghua and another one from Pujiang.

92. The company was from Hangzhou.

93. It was a company from Hangzhou, where the reorganization plan was proposed by the debtor itself, and the absolute priority rule was bypassed in that case.

94. The Dadi reorganization case was part of a group reorganization procedure of Hualun Group Limited in the Fuyang City, Zhejiang.

95. Personal Interview, Judge 2, a judge, Hangzhou, Zhejiang, China, 18 January 2012.

96. Pujiang Lower People's Court, "Zhejiang Tianting Zhiye Youxian Gongsi Pochan Chongzhen Gongzuo De Jingyan Zongjie (浙江天听纸业股份有限公司破产重整工作的经验总结) [Experience in Handling the Reorganization Procedure of Tianting Paper Limited]" 89 (on file with authors).

97. *Ibid.*

overwhelmingly excluded from reorganization procedures in Zhejiang, the causes are as follows.

### 1. *The lack of sympathy for failed companies*

The attitudes of stakeholders towards business failure might be one of the main factors leading to the automatic removal of debtors. Most of the interviewees considered that the main contributor to business failure is debtor mismanagement.<sup>98</sup> As a result, most stakeholders have little confidence in the use of the debtor-in-possession model in the formal reorganization procedure.

Apart from the perceived culpability of management, many interviewees believed that, in most of the existing reorganizations, business failure was also attributable to overexpansion by the company.<sup>99</sup> These companies had borrowed excessively to fund their expansion projects, and a sudden fall in liquidity led to the collapse of the companies.

Interestingly, the stakeholders interviewed seem to be ambivalent about management's motives. When asked to what extent the company's failure was due to the debtor's dishonesty or fraud, all interviewees clearly replied that they did not think that this was a cause; instead they believed that it was a matter of competence rather than of dishonesty or fraud on the part of management.<sup>100</sup> Put differently, there may still be chances to reconcile the debtor and other stakeholders regarding the use of the debtor-in-possession model. Nevertheless, the overall situation makes the potential use of the debtor-in-possession seemingly unacceptable.

### 2. *Where company management teams are disbanded*

The absence of the debtor in most reorganizations was also a result of the management being disbanded prior to the commencement of the formal rescue procedure, thereby making resort to the debtor-in-possession model unrealistic. It was found that in at least twelve out of seventeen rescue cases the company ceased trading before its entry into formal rescue procedures, and that, to a large extent, the debtor's management team had stopped operating or had been dissolved once trading had ceased. Importantly, it was found that the CEO reportedly absconded or was missing in at least ten out of these twenty reorganizations. Therefore, given the departure or disappearance of the debtor's management team, it seems impractical to seek to rely on the debtor to run the company during the subsequent formal rescue process.

The disbandment of debtors' management teams not only makes the use of the debtor-in-possession model impossible but also imposes even greater challenges for rescue efforts. One lawyer interviewee said that bringing the company's business operations back to a working state is essential for the achievability of a rescue, but in his case nearly all the old senior managers including the CEO had left by the time he was appointed as the administrator, so that he had to hire a manager from the company's major supplier to restore the operations in an effort to win the confidence of

98. Personal Interview, Administrator 1, a lawyer, Hangzhou, Zhejiang, China, 5 January 2012.

99. *Ibid.*

100. *Ibid.*

both the employees and creditors; in this case, this person happened to be a close friend of the former CEO and was very familiar with the company's business.<sup>101</sup>

In a word, in most cases, with the disappearance of the debtor's management team, the likelihood of the debtor-in-possession model being invoked is considerably remote.

### 3. *Business sale rescues*

The exclusion of debtors from the corporate reorganization process in Zhejiang may also be due to the wide use of business sale rescues. Specifically, in fourteen out of the sixteen Zhejiang reorganizations, the rescue was conducted through a business sale.<sup>102</sup> The sale leaves the new owner to form a new management team to run the company, making the old team unnecessary. Indeed, in some business sale rescues, the removal of the old management team has often been a precondition to attracting buyers. One lawyer interviewee recounted how one buyer in a case he was involved in was particularly concerned over whether future control of the company would be undermined if some members of the old management team remained in office.<sup>103</sup>

Furthermore, in the remaining two cases, which did not resort to the use of business sales, it was found that since there was no business buyer emerging, creditors had to use a debt/capital swap to carry out the rescues. This meant that it was left to the creditors to establish their own management teams to operate the companies, an event that also made the old management redundant.

### 4. *Application of the absolute priority rule*

The absolute priority rule requires that debt be paid before equity, but under Article 87 of the EBL 2006 this rule can be relaxed through a vote by creditors. Where shareholders and shareholder managers sit behind a debtor, few if any assets will remain if this rule is fully applied, given that in most cases even creditors could not be fully paid. In such circumstances, the debtor would not have any incentives to engage in a formal reorganization procedure.

This was often the case in Zhejiang. As we have seen above, the absolute priority principle was applied in fourteen out of sixteen Zhejiang corporate reorganizations, with the debtor losing everything. Arguably, in anticipation of the stringent application of the absolute priority rule, debtors may deliberately decline the debtor-in-possession offer. In general, from the point of view of creditors, granting the debtor possession seems to be too lenient for debtors, but from the point of view of debtors, it can be an empty privilege that they do not really need.

More importantly, it seems that Zhejiang judges and lawyers tend to favour the strict application of the absolute priority rule in reorganizations. Asked whether relaxing this rule can be considered in favour of the old management,

101. Personal Interview, Judge 2, a judge, Fuyang, Zhejiang, China, 17 January 2012.

102. See generally Xinxin WANG, "Chongzheng Zhidu Lilun Yu Shiwu Xinglun (重整制度理论与实务新论) [Theories and Practices of Corporate Reorganization]" (2012) 11 *Falu Shiyun (法律适用)* [Journal of Law Application] 10 (discussing the widely-used going concern sale rescues in China).

103. Personal Interview, Administrator 2, an accountant, Zhoushan, Zhejiang, China, 12 January 2012.

especially shareholder managers, in exchange for their experience and information in running the business, almost every judge and lawyer interviewee said that this would be very unfair to creditors, and that they would not consider relaxing absolute priority.<sup>104</sup>

To summarize, the infrequent use of the debtor-in-possession approach in Zhejiang corporate reorganizations can be attributed to the lack of sympathy for business failures, the departure of debtors' management teams before reorganizations commenced, the wide use of business sale rescue, and the strict application of the absolute priority rule in distributing the remaining company value.

## V. DISCUSSION

Over the years after the commencement of the EBL 2006, the corporate reorganization provisions have not been regularly used as expected; as shown by the data in this article, the vast majority of troubled companies were in fact denied the chance to use this law. (It is worth noting that similar reasons or obstacles have resulted in the liquidation and conciliation procedures sharing a similar fate.) From our discussion of the reasons for this, it seems that one of the root causes is China's weak judicial system and its less-developed rule of law.

### A. *Judicial Independence and Accountability*

Generally speaking, China's courts have a certain degree of judicial independence, especially when handling commercial cases.<sup>105</sup> For commercial issues, at least in theory, there is little government intervention,<sup>106</sup> although it should be noted that courts may be vulnerable to pressures if well-connected parties are involved.<sup>107</sup> Corporate bankruptcy reorganizations fall into the category of commercial cases, since most parties are businesses. Hence, courts are assumed to accept reorganizations in the way they accept other commercial litigation.

However, one aspect of corporate reorganization makes most Chinese judges anxious – they always involve a large number of people who are either employees or creditors, which is likely to generate mass petitions or protests.<sup>108</sup> The real problem here is that courts and the judges in charge will be negatively assessed and may even be disciplined by local Communist-Party-controlled governments where such protests arise,<sup>109</sup> even if these

104. Personal Interview, Administrator 8, a lawyer, Hangzhou, Zhejiang, China, 6 January 2012.

105. It would be quite difficult for Chinese courts to remain independent when handling administrative cases in which government authorities are challenged by citizens. See generally Kevin J O'BRIEN and Lianjiang LI, "Suing the Local State: Administrative Litigation in Rural China" in Neil J DIAMANT, Stanley B LUBMAN, and Kevin J O'BRIEN, eds, *Engaging the Law in China* (Stanford: Stanford University Press, 2005), 31.

106. See Xin HE, "The Recent Decline in Economic Caseloads in Chinese Courts: Exploration of a Surprising Puzzle" (2007) 190 *The China Quarterly* 352 at 371.

107. See generally Ling LI, "Performing Bribery in China: Guanxi-Practice, Corruption with a Human Face" (2011) 20 *Journal of Contemporary China* 1 (noting the rampant bribe-taking of judges in China).

108. Liebman, *supra* note 74 at 282.

109. Nicholas C HOWSON, "China's Judicial System and Judicial Reform" (2011) 54 *Law Quadrangle* 62 at 64.

protests are not essentially caused by judges.<sup>110</sup> The unwritten Chinese social stability assessment system seems to be irrationally made and enforced.<sup>111</sup>

In reality, most Chinese courts face a dilemma. On the one hand, courts must do what the law says; in the context of the new corporate reorganization law, this means that courts must accept corporate reorganization filings if the statutory requirements are met, whether or not a large number of individuals are involved.<sup>112</sup> On the other hand, Chinese courts must make local Communist-Party-controlled governments happy, although what the latter impose may not be in line with what the law explicitly stipulates.<sup>113</sup> This lack of judicial independence from local governments reflects one of China's deep-rooted constitutional problems and results in the courts' refraining from handling many corporate reorganization cases.<sup>114</sup>

Furthermore, the lack of judicial independence also raises serious concerns about the lack of judicial accountability. According to constitutional theories,<sup>115</sup> as public authorities courts must be held accountable if they violate the law.<sup>116</sup> But this does not look to be the case in China. One typical example pertains to the filing of a corporate reorganization under Article 10 of the EBL 2006. While the court must either accept or reject the filing according to the law, in reality, the court does not even register the filing in most cases,<sup>117</sup> let alone respond to it.<sup>118</sup> This is clearly a violation of this Article.<sup>119</sup>

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110. Liming Wang also mentions that Chinese courts are anxious in accepting petitions of minority shareholders against Chinese listed companies, because plaintiffs are usually very large in numbers. See Liming WANG, "Security Tort Remedies for Minority Shareholders in Chinese Stock Markets" (2012) 6 *Securities Law Review* 6.
111. Professor Xinxin Wang also argues that courts are usually unfairly treated by governments when handling corporate reorganization matters in China. See Wang, "Difficulties of Commencing", *supra* note 35 at 30. See also Jiaolong TAO and Jian CHEN, "Xingfang Zhidu De Fansi Yu Chonggou (信访制度的反思与重构) [Problems and Perspectives of the Xing Fang System]" (2006) 5 *Falu Shiyun (法律适用) [Journal of Law Application]* 76 at 78 (noting that courts and judges will be disciplined even if a mass petition is not because of their fault).
112. See generally Carl F MINZNER, "China's Turn Against Law" (2011) 59 *American Journal of Comparative Law* 935.
113. See the Social Development Research Team of Tsinghua University, "China's Sustainable Social Security Should be Based on Freedom of Expression" (April 2010) (this report criticizes China's current social stability assessment systems, warning that these systems are counterproductive and unsustainable).
114. See generally Paul GEWIRTZ, "Independence and Accountability of Courts" (2002) 1 *Global Law Review* 7.
115. See generally Margaret Jane RADIN, "Reconsidering the Rule of Law" (1989) 69 *Boston University Law Review* 781 (arguing that the rule of law requires that all public authorities must be held accountable). See also UNSC, "The Rule of Law and Transitional Justice in Conflict and Post-Conflict Societies: Report of the Secretary-General", UN Doc S/2004/616 (23 August 2004), online: The United Nations, Inter-Parliamentary Union <<http://www.ipu.org/splz-e/ungao7/law.pdf>>.
116. See William J WOODWARD, Jr, "'Control' in Reorganization Law and Practice in China and the United States: An Essay on the Study of Contrast" (2008) 22 *Temple International & Comparative Law Journal* 141 at 144 (arguing that the court acceptance procedure may cause delay and inefficiency in corporate reorganizations in China).
117. Wang, "Difficulties of Commencing", *supra* note 35 at 32.
118. Weiguo WANG, Hailin ZOU, and Yongjun LI, "Pochanfa Shinian (破产法十年) [Ten Years of Drafting the Enterprise Bankruptcy Law]" (Seminar of the Civil and Commercial Law Centre, China University of Political Science and Law, 12 March 2004), online: The Civil and Commercial Law Centre of China University of Political Science and Law <[http://www.cupl.edu.cn:81/html/msjifxy\\_xsw/col531/2011-11/19/20111119110131584730800\\_1.html](http://www.cupl.edu.cn:81/html/msjifxy_xsw/col531/2011-11/19/20111119110131584730800_1.html)>.
119. See generally Guillermo O'DONNELL, "Why the Rule of Law Matters" (2004) 15 *Journal of Democracy* 32.

But while it may be shocking from the view of people in advanced jurisdictions, this practice is repeated time and again in China. And while this is arguably caused by the lack of checks on power in general and on the judiciary in particular, there are no reports of any court officials having been disciplined or prosecuted because of these failures or violations. In this way, China's courts can be said to be both victims and offenders.

To a certain degree, this problem is unique to China. Global indicators may help capture just how severe China's rule of law deficit actually is. According to The World Justice Project,<sup>120</sup> China is ranked 82<sup>nd</sup> out of all 97 surveyed countries across the world with respect to the efficiency of delivering civil justice (implementing corporate bankruptcy law can be largely included in this category) – almost at the bottom – while noting that the country's major challenge is that law courts are not free from government intervention. Even within middle-income countries, The World Justice Project suggests that China is still ranked 27<sup>th</sup> out of a total of 30 jurisdictions,<sup>121</sup> clearly suggesting that it is largely China's political system rather than its economic development that has led to the country's stunted development of the rule of law.<sup>122</sup>

Of course, apart from the entrenched weakness of its judicial system, Chinese law courts do have other difficulties, such as understaffing, but these difficulties could be easily overcome without resorting to institutional reforms. Reforming the Chinese judicial system is a formidable task and is beyond the scope of this article. Realistically, however, under the current legal framework, some technical issues can be improved or clarified with the aim of promoting the use of the corporate reorganization law in China.

## B. *Encouragement of Debtors and Creditors*

### 1. *The automatic debtor-in-possession model*

To encourage more rescues, debtors should be given certainty with regard to the use of the debtor-in-possession model. As examined earlier, at the top of most debtors' concerns is a fear of losing control to outsiders under the administrator-in-possession model if an in-court reorganization solution is sought. To incentivize debtors to use the reorganization procedure, and to make reorganizations more feasible by taking advantage of their experience and knowledge in running their businesses, it seems desirable to establish the debtor-in-possession model as the default approach in corporate reorganization. This can be done for a number of reasons.

First, according to Professor Zou Hailing, one of the EBL 2006's draftsmen, Chinese lawmakers initially intended to set up the debtor-in-possession model as the default control structure in reorganizations.<sup>123</sup> However, such an intention has not been clearly embodied or demonstrated in the new law. This is partly due to flaws in the design of the EBL 2006. For example, Article 13 places both reorganization and liquidation procedures together, and both are commenced with the automatic

120. Mark David AGRAS *et al.*, *Rule of Law Index 2012-2013* (Washington, DC: The World Justice Project, 2012-2013).

121. *Ibid.*

122. See generally Pitman B POTTER, "Legal Reform in China: Institutions, Culture, and Selective Adaptation" (2004) 29 *Law & Social Inquiry* 465.

123. Zou, *supra* note 9 at 50-51.



appointment of an administrator without taking into account the differences between the two procedures. And although Article 73 allows a debtor to apply for the use of the debtor-in-possession model after the commencement of the procedure, this often seems too late, since the debtor has already lost control of the company and must face uncertainty whether the debtor-in-possession model can be granted in the meantime. All this suggests that there is a gap between what the lawmakers genuinely intended and what is actually stipulated in the EBL 2006.<sup>124</sup>

Second, the data reported here from fieldwork interviews show that allowing debtors to remain in control seems to be socially acceptable to many stakeholders in China. It should not be forgotten that in the interviews no debtors were accused of being fraudulent or dishonest, although most business failures were perceived as the result of the debtor's mismanagement. Thus, most debtors are probably still trustworthy, since business failures are more likely to result from mistakes. This paves the way for the use of the debtor-in-possession model in China's corporate reorganizations.<sup>125</sup>

Third, the lessons learnt from abroad can also convince us of the usefulness of the debtor-in-possession model in encouraging voluntary rescue filings. In the US, for example, before 1939, this model was the default control model for all debtor companies, whether they were large or small companies. However, for fear of abuses, the *Chandler Act* of 1939 removed the debtor-in-possession model in the reorganization procedure of large companies, which led to the situation that the new procedure for these companies immediately "fell into disuse."<sup>126</sup> Decades later, in the light of the hostility of large debtor companies towards the automatic practitioner-in-possession model, the US *Bankruptcy Reform Act* of 1978 eventually restored the debtor-in-possession model for large companies,<sup>127</sup> and history suggests that this was the right approach to take. South Korea's experience with transplanting the debtor-in-possession model of corporate reorganization also suggests the utility of leaving the debtor in control of corporate decision-making, the number of reorganization filings in South Korea soared from seventy-six in 2006 – the time South Korea adopted the model – to 670 in 2009, almost a tenfold increase over only four years.<sup>128</sup>

Overall, the legal landscape of China's corporate reorganization law may be remarkably improved if the debtor-in-possession model is embraced as a default option. Of course, a fair balance should be struck between debtor and creditor, with creditors empowered to challenge the debtor-in-possession in cases where fraud has been committed.

124. Jiaolong TAO and Hexing SHI, "Sifa Shiwu Shiye Xia Pochan Chongzheng Zhidu Ruogan Wenti Yanjiu (司法实务视野下破产重整制度若干问题研究) [Challenges of Corporate Reorganization in Judicial Practice]" (2012) 11 *Falu Shiyun (法律适用)* [Journal of Law Application] 30.

125. See generally Laurence G WEINZIMMER and Jim MCCONOUGH, *The Wisdom of Failures* (San Francisco: Jossey-Bass, 2013).

126. Lynn M LOPUCKI and William C WHITFORD, "Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies" (1993) 141 *University of Pennsylvania Law Review* 669 at 675. See also Theodore EISENBERG, "Baseline Problems in Assessing Chapter 11" (1993) 43 *University of Toronto Law Journal* 633 at 664.

127. Lawrence P KING, "Chapter 11 of the 1978 Bankruptcy Code" (1979) 53 *American Bankruptcy Law Journal* 107 at 114-115.

128. The World Bank, *supra* note 90 at 75.

## 2. *Empowering creditors with the threat of liquidation*

Prioritizing the debtor-in-possession model is necessary but not enough to incentivize debtors to file for reorganization in a voluntary and early manner. This is especially true given that filing for a bankruptcy reorganization will, among other things, damage a debtor's reputation.<sup>129</sup> Thus, consideration should also be given to empowering creditors to pressure defaulting debtors to enter reorganization earlier.

Technically, a lack of information means that most creditors are unable to pursue an in-court reorganization on behalf of the debtor. This suggests that it is better for the reorganization to be initiated by the debtor itself.<sup>130</sup> Of course, in exceptional instances, some long-term suppliers and bank creditors may possess sufficient information to launch a viable reorganization petition; however, bearing in mind the collective action problems faced by these creditors,<sup>131</sup> relying on them to bring a debtor into a complex reorganization procedure in the interest of creditors as a whole seems unrealistic.

In order to promote more feasible debtor-initiated corporate reorganizations, what creditors can do, and are really expected to do, is to use the threat of liquidation to force debtors to file for (an early) reorganization. An empirical study from the US indicates that although debtors could use the debtor-in-possession model under Chapter 11 to retain control in the corporate reorganization procedure, seventy-three percent of reorganization filings are substantially triggered by creditors threatening liquidation.<sup>132</sup> Without this threat of liquidation, the vast majority of debtors will continue to delay action until business conditions deteriorate past the point of no return. In China, however, equipping creditors with this powerful fulcrum remains a great challenge. For various reasons demonstrated in this article, the threat of liquidation<sup>133</sup> is unavailable to creditors,<sup>134</sup> resulting in the threat of liquidation enshrined in the EBL 2006 remaining a paper tiger.

## VI. CONCLUSION

While Zhejiang has pioneered the use of the new corporate reorganization law to rehabilitate distressed local companies, the implementation of this law in a well-developed Chinese province such as Zhejiang remains far below expectations, especially when compared to other developed jurisdictions such as the UK or the US.

129. See David A SKEEL, Jr, "Bankruptcy Phobia" (2009) 82 Temple Law Review 333.

130. See Kenneth B AXE, "Penetrating the Iron Curtain: Representing Secured Creditors in Chapter 11" (1984) 67 Marquette Law Review 421 at 423.

131. See Lemma W SENBET and James K SEWARD, "Financial Distress, Bankruptcy and Reorganization" in RA JARROW, V MAKSIMOVIC, and WT ZIEMBA, eds, *Handbooks in Operation Research and Management Science*, vol 9 (Amsterdam: Elsevier, 1995), 921 at 933.

132. LoPucki, "Full Control", *supra* note 82 at 100.

133. See Donald C CLARKE, "The Execution of Civil Judgements in China" (1995) 141 The China Quarterly 65. See also Donald C CLARKE, "Power and Politics in the Chinese Court System: The Enforcement of Civil Judgements" (1996) 10 Columbia Journal of Asian Law 1.

134. See Changyin HAN and Huan HE, "Pochan Jiexian De Lifa Gongneng Wenti (破产界限的立法功能问题) [Problems of the Bankruptcy Tests]" (2013) 2 Zhenzhi Yu Falu (政治与法律) [Politics and Law] 2 at 9.

This article has demonstrated that this failing can be linked to the lack of judicial independence<sup>135</sup> and accountability,<sup>136</sup> as well as the hostility of debtors towards the administrator-in-possession procedure.<sup>137</sup> It has also suggested four reasons explaining the surprisingly limited use of the debtor-in-possession procedure in China, mostly linked to perceptions about the regime's treatment of debtors.

Yet it should also be remembered that this process remains in its infancy, and that no formal court-supervised corporate reorganization regime existed in China before 2006. Moreover, the fact that most reorganized companies in Zhejiang were large and of economic and social importance has resulted in intense local media attention, both locally and nationally, which has raised considerable awareness of the corporate reorganization procedure among the business community and the general public and helped address concerns about the lack of information. Armed with this new information, one might well expect the number of reorganizations to increase.

In the meantime, the existing reorganizations in Zhejiang continue to raise a number of important legal questions for academic researchers. For example, in response to the reorganization procedure for company groups, some Zhejiang courts have boldly consolidated company reorganization cases, whereas some have acted more cautiously and handled them separately.<sup>138</sup> Given the difficulty or impracticality of separating the assets and liabilities of related companies within a group, the issue of how best to balance fairness against feasibility in group reorganizations remains.

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135. See generally Lily L. TSAI, *Accountability Without Democracy: Solidary Groups and Public Goods Provision in Rural China* (Cambridge: Cambridge University Press, 2007).

136. Peter H. SOLOMON Jr., "Courts and Judges in Authoritarian Regimes" (2007) 60 *World Politics* 122.

137. See Elizabeth C. ECONOMY, "The Great Leap Backward? The Costs of China's Environmental Crisis" (2007) 86 *Foreign Affairs* 38 at 39.

138. There have already been some debates in Chinese academic circles, but more in-depth and empirical research is needed. See for example Yongjun LI and Dahe LI, "Chongzhen Chenxu Kaishi De Tiaojian Ji Sifa Shencha (重整程序开始的条件及司法审查) [The Conditions of the Beginning of the Reorganization Procedure and Its Judicial Review: A Query Into the Merger Reorganization]" (2013) 26 *Beijing Hangkong Hangtian Daxue Xuebao (北京航空航天大学学报) [Journal of Beijing University of Aeronautics and Astronautics (Social Sciences Edition)]* 48, and Xinxin WANG and Wei ZHOU, "Guanlian Qiye De Hebin Pochan Chongchen Qidong Yanjiu (关联企业的合并破产重整启动研究) [Entry to Consolidated Reorganization of Related Companies]" (2011) 29 *Zhenfa Luntan (政法论坛) [Tribune of Political Science and Law]* 72. See also Gilbert J. STEPHEN, "Substantive Consolidation in Bankruptcy: A Primer" (1990) 43 *Vanderbilt Law Review* 207 (discussing bankruptcy consolidation in the US), and The Jones Day LLP, "Substantive Consolidation and Non-debtor Entities: The Fight Continues" (May/June 2011), online, The Jones Day LLP <<http://www.jonesday.com/Substantive-Consolidation-and-Nondebtor-Entities-The-Fight-Continues-06-01-2011/?RSS=true>>.