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# CHINA LEGAL REPORT

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**subject** **The new Bankruptcy Law:**

**What is new?**

## 1. The background of the New Law

Bankruptcy as a legal system was first introduced into China in 1986, marked by the issuance of the Enterprise Bankruptcy Law of P.R.C (Trial) on December 2 ("the Trial Law"), in response to the economic system reform as well as the practical need to drive out of market or restructure some state-owned companies – in fact almost all companies at that time were state-owned or collective-owned – which were suffering severe financial difficulties due to mismanagement.

The Trial Law, though still valid until 1 June 2007, could not meet the demand of the quickly-changing economic situations immediately after its promulgation, not only because of the rather low-level legislation technique and the planned economy ideology underlying it, but also because of its limited scope of application – it applies only to state-owned enterprises. Due to these flaws, this law, to a large extent, has not been actually implemented, and is therefore taken by some scholars as a good example of "law only on paper".

In light of the emerging non-state-owned enterprises, Civil Procedure Law of P.R.C issued on April 9, 1991 ("Civil Procedure Law") included the bankruptcy procedure for non-state-owned enterprise legal persons as a special civil procedure in Chapter 19 Procedure for Enterprise Legal Persons' Bankruptcy and Liquidation. However, there are only eight articles under Chapter 19 Civil Procedure Law, and each of them is very simple. The Opinions on Various Questions Concerning the Application of Civil Procedure Law issued by Supreme Court on July 14, 1991 ("the Opinions") in Section 16 further elaborates on some provisions of Civil Procedure Law, and provides that "when handling the bankruptcy cases, apart from applying Chapter 19 Civil Procedure Law, court may also consult relevant provisions of the Enterprise Bankruptcy Law of P.R.C. (Trial)". Based on such wording, it is unclear to which extent the Enterprise Bankruptcy Law of P.R.C. applies to non-state-owned enterprises.

To sum up, the current legislation on bankruptcy consists mainly of the Trial Law, Chapter 19 Civil Procedure Law and Section 16 the Opinions. These provisions become increasingly inadequate and disorderly in regulating bankruptcy as the Chinese market-oriented economic become more mature and developed. Therefore, a systematic and market-economy-compatible bankruptcy law becomes imperative.

## 2. What is new of the New Law?

### 2.1. Scope of application

As mentioned above, prior to the promulgation of the New Law, the Trial Law in principle only applies to state-owned-enterprises, however, may under some circumstances also

serve as a reference for handling the bankruptcy cases involving non-state-owned enterprises. The New Law however uniforms the bankruptcy procedures for both state-owned and non-state-owned enterprise legal persons by providing in Art.2 Paragraph 1 that "where an enterprise legal person fails to pay off its debt, and if its assets are inadequate to pay off all the debts or if it is obviously incapable of paying off its debts, its debts shall be liquidated in accordance with the provisions of this Law", without adding in other articles any restriction to the concept "enterprise legal persons". The New Law even applies, though with some restrictions, to financial institutions, such as commercial banks, securities companies and insurance companies, etc.

## 2.2. The criterion for bankruptcy

The criterion for bankruptcy set by both the Trial Law and Chapter 19 of the Civil Procedure Law is that "the enterprise legal person is incapable of paying off due debt because of severe loss". Whereas the New Law lowers the criterion by including the circumstances where an enterprise legal person obviously lacks the capability or is likely to lose such capability of paying off its debt" (Art.2) and thus will presumably encourage the increase of bankruptcy filings.

Furthermore, the New Law for the first time incorporates special provisions governing the cross-border situations (Art. 5), where the validity of a bankruptcy proceeding commenced in accordance with this Law extends to the properties of Chinese bankrupt enterprises outside of China and where a foreigner seeks recognition of a foreign court ruling in China provided a number of requirements such as reciprocity, national security, sovereignty protection etc. are met. Whereas the feasibility of such mechanism remains to be seen in practice, the New Law has made a step forward moving towards the adoption of international standards regarding cross-border insolvency and laid down the relevant theoretical basis.

## 2.3. The basic procedure for bankruptcy

The basic procedure for bankruptcy established by the New Law does not differ much from that by the current provisions. According to the New Law, the basic procedure for bankruptcy is as follows:

a) the insolvent enterprise or any of its creditors may file a bankruptcy application at the court which has jurisdiction over the domicile of such enterprise,
b) the court accepts such application after examination, and within 25 days from the acceptance inform the known creditors of, and publicly announce, the acceptance,
c) the creditors declare their rights at the court, and then constitute a creditors' meeting for handling the important matters, such as examining creditors' rights, voting on settlement agreement if any, approving the assets allocation plan, etc.,

d) if an amicable settlement agreement is reached between the insolvent enterprise and its creditors, the court terminates the bankruptcy procedure,

e) if no amicable settlement agreement is reached, the bankruptcy will be announced by the court and the assets of the bankrupt enterprise will be allocated according to the assets allocation plan subject to a certain priority sequence.

## 2.4. An independent restructuring procedure

Under the current provisions, a state-owned enterprise risking bankruptcy may be restructured, but the restructuring procedure can only be initiated during a bankruptcy procedure already commenced. And it is unclear from legislation whether the restructuring procedure is available to non-state-owned enterprises. In this regard, the New Law introduces an independent restructuring process, which may be initiated without an existing bankruptcy procedure.

According to the New Law, in case that

a) an enterprise fails to pay off due debt, and its assets are inadequate to pay off its debts or it obviously lacks the capability to pay off its debt, or

b) it is evidently likely that the enterprise is going to lose the capability to pay off its debts, the enterprise or any of its creditors may directly apply to the court for restructuring.

Although the New Law does not expressly require, the enterprise to be restructured presumably shall upon the court's order submit related financial and accounting documents for the court to decide whether the criterion for restructuring procedure is met. If the court deems the criterion as being met, it will approve the restructuring and publicly announce its approval. After that, the assets and businesses of the enterprise to be restructured shall be managed by a special person or committee ("the restructuring custodian"), unless the enterprise to be restructured applies for doing the management by itself and the court accordingly grants such application.

Within six months from the court approves the restructuring, the actual manager of the enterprise's assets and business, being the enterprise itself or the restructuring custodian, shall bring up the restructuring plan for the approval of the creditors and subsequently of the court. The restructuring plan, upon approval by both the creditors and the court, shall be implemented by the enterprise to be restructured.

The enterprise may go out of difficult financial situations after the restructuring, but there are various circumstances where the restructuring procedure may be terminated with bankruptcy announced at the same time.

## 2.5. Revocable and invalid acts

Art. 35 Enterprise Bankruptcy Law provides for some revocable or non effective acts concerning the assets of the insolvent enterprise, in order to avoid that the insolvent enterprise improperly takes advantage of the bankruptcy procedure. Art. 35 reads "The following acts of an insolvent enterprise are invalid if they take place during the period running from six months before the acceptance of bankruptcy application by court to the final bankruptcy announcement:

a) concealing, illicitly allocating, or transferring free of charge, assets;
b) selling assets at a unusually reduced price;
c) providing assets guarantee for the debts formerly without assets guarantee;
d) paying off debt before it is due;
e) waiving creditor's right.

In case of any act listed above, the liquidation team may request the court to retrieve the respective assets, and the retrieved assets shall be added to the assets to be liquidated following bankruptcy liquidation procedure".

In this aspect, the New Law makes some changes in respect of the length of the relevant time period, the legal effect, and the description of specific acts.

Art. 31 the New Law provides that "Within one year before the court accepts an application for bankruptcy, the bankruptcy custodian has the right to request the court to revoke the following acts related to the assets of the insolvent enterprise:

1. transferring the assets free of charge;
2. trading at an obviously unreasonable price;
3. providing assets guarantee to the debts formerly without assets guarantee;
4. paying off debt before it is due;
5. waiving the creditor's right." Art. 32 further provides that "within 6 months before the court accepts an application for bankruptcy, if the insolvent enterprise is under any circumstance as prescribed in paragraph 1, Art. 2 of this Law and it still makes payment to individual creditors, the bankruptcy custodian has the right to request the court to revoke it, except that the individual repayment may do good to the insolvent enterprise's assets.". Art. 33 provides for two acts related to the assets of the insolvent enterprises, which may be deemed as invalid, being the concealing or transferring the assets so as to avoid the debts; or fabricating any debt or acknowledging any inauthentic debt. With regard to the assets already obtained from the insolvent enterprise through the improper acts listed in Art. 31 or Art. 32 or Art. 33, the bankruptcy custodian may request the retrieval of such assets according Art. 34.
6. The sequence in allocating the bankrupt enterprise's assets according to Art. 109 and Art. 113, the bankrupt enterprise's assets shall be allocated in the following sequence

a.) creditor's rights secured with the assets of the bankrupt enterprise to the extent of the security assets;

b.) salaries, other compensation, pension, and social insurance premium etc. owed to or for employees;

c.) other social insurance premium and due taxes;

d.) unsecured creditors' rights.

In regard to the sequence of allocation, the New Law does not differ from the Trial Law.

## 3. Conclusion

Apart from the above, the New Law also makes progress in other noteworthy aspects, such as the introduction of the bankruptcy custodian system, the strengthening of protection of creditors' interests, etc. For these reasons, the New Law, though not totally free from criticism, demonstrates a relatively high level of legislative technique and caters for the need to further regulate the economic participants, and therefore can be expected to generate great positive impact on China's development.