

**Making an efficient and well functioning corporate rescue  
system in Chinese bankruptcy laws: from the perspective of a  
comparative study between England and China**

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**Abstract**

This research aims at identifying the inadequacies and weaknesses of the current Chinese corporate rescue laws by doing a comparison between England and China, and learning from the advanced experience and legal institutions of the English rescue laws. The study commences with a conceptual approach to the legal concept of corporate rescue, which considers the corporate rescue culture from a theoretical perspective and provides a necessary preparation for the following comparative analysis. It then identifies the underlying factors in relation to the bankruptcy and rescue laws of the two states from several aspects: different cultures and ideologies, historical development of bankruptcy legislation, internal economic reform and external pressure prompting the Chinese insolvency law reforms. The exploration of particular contextual factors enables the differences of rescue laws in each legal system to be appreciated on the one hand; and to a large degree determines whether or not China could borrow the advanced rescue-oriented mechanisms and policies from the UK on the other hand. Subsequently, the thesis makes a comprehensive comparison of the formal corporate rescue regimes, identifies the philosophy and policy aims underlying the legal rules, and analyses the balance and control of power of all the stakeholders and the redistribution of bargaining power of every player in each rescue network. The consideration of the balance of the power of each interested group in a rescue attempt aims to resolve a key issue as to how to design the rules to bring all the interested parties to the negotiation table and approve a reorganization plan. The study attempts to explore the potential problems in China's corporate rescue laws, envisage future trends and come up with some appropriate solutions which may facilitate the construction of an effective and efficient corporate rescue system in China's bankruptcy legal framework.

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## **List of abbreviations**

Insolvency Act 1986 (IA 1986)  
Insolvency Rules 1986 (IR 1986)  
Enterprise Act 2002 (EA 2002)  
Companies Act 2006 (CA 2006)  
United Kingdom (UK)  
United States (US)  
European Union (EU)  
Transfer of Undertakings (Protection of Employment) Regulation 2006 (TUPE)  
Insolvency Practitioner (IP)  
Company Voluntary Arrangements (CVAs)  
Debtor-In-Possession (DIP)  
Practitioner-In-Possession (PIP)  
Department of Trade and Industry (DTI)  
The Institute of Chartered Accountants in England and Wales (ICAEW)  
Insolvency Practitioners Association (IPA)  
The Law Society England and Wales (LSEW)  
The Institute of Chartered Accountants of Scotland (ICAS)  
Association of Chartered Certified Accountants (ACCA)  
The Institute of Chartered Accountants in Ireland (ICAI)  
The Law Society of Scotland (LSS)  
United Nations Commission on International Trade Law (UNCITRAL)  
National Insurance Fund (NIF)  
Trade Union Congress (TUC)  
People's Republic of China (PRC)  
Chinese Communist Party (CCP)  
State-Owned Enterprises (SOEs)  
Supreme People's Court (SPC)  
Standing Committee of National People's Congress (SCNPC)

Assets Management Companies (AMCs)  
Non-Performing Loans (NPLs)  
People's Bank of China (PBOC, the central bank)  
Bank of China (BOC)  
China Construction Bank (CCB)  
Industrial and Commercial Bank of China (ICBC)  
Agricultural Bank of China (ABC)  
Purchasing-Sale Restructuring (PSR)  
National Bankruptcy Liaison Group (NBLG)  
Capital Structure Optimization Programme (CSOP)  
China Banking Regulatory Commission (CBRC)  
China Insurance Regulatory Commission (CIRC)

## Chapter I: Introduction

Corporate rescue has become increasingly a fashionable topic, which has long been a subject of global interest. The most notable formal corporate rescue regime was established by Chapter 11 of the US Bankruptcy Code in 1978 which has had far-reaching influence on the bankruptcy law reforms of other countries.<sup>1</sup> During the past thirty years, a series of reforms to domestic corporate bankruptcy<sup>2</sup> and rescue laws have been scheduled into the legislative agenda of many countries, and aimed at building up a well-tailored and efficacious corporate rescue system by way of summarizing the experiences and lessons from other countries and taking full consideration of their own unique domestic situations. In the present decade, a wide range of jurisdictions in different legal systems have considered the reformulation of their bankruptcy legal frameworks towards a rescue culture.<sup>3</sup> Conceptually, corporate rescue is a well-functioning method which can provide a ground for financially distressed but potentially still viable companies to take a breath free from the deadly enforcement of individual creditors, to negotiate with all the stakeholders and eventually to rehabilitate to its former healthy operation. Even where the attempt to rescue is not successful, the business of the insolvent company can be sold as a going concern, and this may enable the creditors' claims to be satisfied to a greater extent than would be possible in an immediate liquidation in which the assets of the debtor are usually disposed by a piecemeal sale for the purpose of a quick realization to creditors. The key understanding of the rescue notion is to take drastic and efficient measures at a time when the debtor company falls into financial trouble or is likely to be insolvent. In addition, it is indispensable to impose an automatic stay on creditors' claims for a

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<sup>1</sup> For a broad discussion of the US Chapter 11, see P Lewis, "Corporate Rescue Law in the United States", in K Gromek Broc and R Parry (eds), *Corporate Rescue: An Overview of Recent Developments from Selected Countries* (2<sup>nd</sup> edn, Kluwer Law International, 2006), p333.

<sup>2</sup> Chinese government authorities adopt the American legal terminology "bankruptcy", which is called "insolvency" in the UK. The term "bankruptcy" in England specifically refers to personal insolvency. This thesis will use the term "bankruptcy" to cover English corporate insolvency and Chinese enterprise bankruptcy. In addition, one thing should be borne in mind that, although the thesis will have always mentioned the terms "the UK" or "Britain", the analysis of insolvency laws applies only to England and Wales.

<sup>3</sup> To understand the recent development of corporate rescue worldwide, see Gromek Broc and Parry (eds), above n.1.

breathing space in which new finance can be obtained, and a reorganization plan also drafted under the external assistance of insolvency professionals and approved by the vote at a creditors' meeting and possibly also by a court order.<sup>4</sup>

Legally and procedurally, corporate rescue laws provide a worldwide welcome rescue-oriented approach to the companies in plight outside the traditional liquidation regime, and they are usually placed at the heart of the bankruptcy law system in different jurisdictions. Corporate rescue aims to reorganize the company which is in actual or impending insolvency and enable it to turn its business around in order to avoid insolvent liquidation. Not only could it maximize the wealth of economic value and save the unnecessary waste, but also it can contribute to the stability of the society and promote the economic prosperity of the state. The Cork Report observed:

“We believe that a concern for the livelihood and well-being of those dependent upon an enterprise which may well be the lifeblood of a whole town or even a region is a legitimate factor to which a modern law of insolvency must have regard. The chain reaction consequences upon any given failure can potentially be so disastrous to creditors, employees and the community that it must not be overlooked.”<sup>5</sup>

In this regard, it is pressing required to build a modern and well-tailored corporate rescue regime to avoid the detrimental consequences which may be caused by corporate failure. From the perspective of an individual successful rescue activity, the debtor company could continue to run its business as a going concern as before and keep its legal identity and market share. Meanwhile, all the stakeholders could benefit from the preservation of the company and its business, such as the maximum level of repayment to creditors, job retention for employees and investment reward to shareholders. The chained enterprises whose prosperity is closely tied with that of the debtor could avoid a “domino effect”.<sup>6</sup> The preservation of jobs could undoubtedly not only stabilize the

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<sup>4</sup> United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law*, 2004, p217-230.

<sup>5</sup> *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) (“Cork Report”), para.204.

<sup>6</sup> This situation usually happens to small sized enterprises, suppliers which may fall into cash-flow problem or immediate insolvency by the bankruptcy of its closely related enterprises and trade suppliers. Especially in China, huge amount of triangular debts exists among SOEs. The bankruptcy of one enterprise would lead to bankruptcy of the others in the chain. See RW Harmer, “Insolvency Law and Reform in the People’s Republic of China” (1996) 64 *Fordham L.*

concerns of employees, which would be in favour of increasing the possibility of rescue success, but also avoid potential social chaos. In addition, from the perspective of the entire corporate sector of the state, an efficient and well-functioning rescue system could enhance the productivity and competitive capacity of domestic industrial and commercial enterprises. Non-performing assets could be cleared away from the corporate and banking sector through formal or informal arrangements, which definitely strengthen the vigour of enterprises and eradicate the potential risks for financial turbulence. An important lesson can be drawn from East Asia Financial Crisis which happened at the end of 1997. Because of the weak bankruptcy and rescue law system, it was impossible for the corporate sector to rehabilitate in the face of a high volume of enterprise distress and long term economic recession.<sup>7</sup> This was why some countries which had seriously been affected by the impacts of the crisis started reconsidering and improving their domestic corporate rescue regimes, especially through informal workouts. As the typical model of the informal rescue arrangements, the “London Approach” which was first created and promoted by the Bank of England in the mid-1970s has played a significant role in contributing to corporate recovery outside formal insolvency proceedings.<sup>8</sup>

In order to reach these objectives, modern corporate rescue regimes incorporate two devices. First of all, formal corporate rescue proceedings could shield a financially struggling company from debt enforcement of individual creditors by providing an automatic stay, and reorganization will take place in the rescue legal framework under protection of the stay.<sup>9</sup> In a specified period of moratorium, the debtor is able to keep the assets away from creditors, especially the creditors with strong power like the banks and other financial creditors. The debtor could also assess its financial situation,

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Rev 2563, 2582-2583.

<sup>7</sup> Gromek Broc and Parry (eds), above n.1, p4.

<sup>8</sup> J Armour and S Deakin, “Norms in Private Insolvency: the ‘London Approach’ to the Resolution of Financial Distress” (2001) 1 JCLS 21. It is worth noting that some Asian countries, like Korea, Malaysia, Thailand and Indonesia, adopted the “London Approach” and improved their informal rescue arrangements. For more details, see M Pomerleano and W Shaw (eds), *Corporate Restructuring: Lessons from Experience* (the World Bank, 2005), p104-107.

<sup>9</sup> UNCITRAL, above n.4, p28.

evaluate its property and produce a disclosure statement which might be required by court.<sup>10</sup> Most importantly, the moratorium could create a stable environment for the possible investors to consider providing new funds by investment or lending which is crucial for a successful rescue attempt, because they do not have to worry about the legal action of creditors during the moratorium.<sup>11</sup> Under the protection of the automatic stay, the debtor can negotiate with creditors and produce a reorganization plan for the vote of all the creditors in different classes. Under the approval of every class of creditors and confirmation of court, the reorganization plan will bind the debtor and all the creditors. It may be argued that the automatic stay might seem illegal to impose restrictions on creditors, especially secured creditors, who are able to realize their debts at any time in other legal procedures as long as their legal actions follow contract terms. It should be noted, however, that the sacrifices of the interests of certain parties in rescue regimes are employed to pursue much higher goals and better consequences, including the satisfaction of the general interests of all the stakeholders, the maximum value of economic life of the community and social stability.<sup>12</sup> More attention should be paid to the social goals of rescue theory which are more convincing, especially to China, currently in an emerging market economy, because social stability is not only the prerequisite of a successful rescue attempt, but also a significant factor which involves political risks to the executive party.<sup>13</sup> This is why the Chinese Communist Party has long been contending that social policy goals overwhelm everything.<sup>14</sup>

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<sup>10</sup> The World Bank, *Principles for Effective Insolvency and Creditor Rights Systems* (Revised Draft, 2005), p11.

<sup>11</sup> Gromek Broc and Parry (eds), above n.1, p3.

<sup>12</sup> V Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP, Cambridge, 2002), p192.

<sup>13</sup> W Wang, "Adopting Corporate Rescue Regimes in China: A Comparative Survey" (1998) 9 *AJCL* 234, section 3.2.

<sup>14</sup> The former party leader Jiang Zemin launched a speech at the Fifth Plenum of the 14<sup>th</sup> Central Committee of the Communist Party in 1995, defining the state's mission for the next 15 years as "to grasp the opportunities, deepen the reforms, open up further, promote development and maintain stability". It contends economic reforms and meanwhile emphasizes social stability which is the foundation and precondition for the development of economy. This viewpoint also reflects the legislative initiative and policy aims that the Chinese Communist Party has consistently been advocating. Knowing this point will be very helpful to understand the underlying philosophies of Chinese bankruptcy and corporate rescue laws and policies. See: L Wong, "Market Reforms, Globalization and Social Justice in China" (2004) 13 *Journal of Contemporary China* 151, 157.



Secondly, a well-functioning rescue framework should structure a fair and reasonable balance on bargaining powers of all the relevant interested groups, and this balance may contain three aspects. First, there should be a balance between the debtor and its creditors. Since formal rescue procedures provide the debtor with an automatic stay to freeze the claims of creditors, a remedy should be available for creditors to protect their interests. For example, secured creditors may apply to the court for resuming their rights of enforcement under reasonable cause.<sup>15</sup> Ordinary unsecured creditors should be entitled to apply to the court for converting the debtor from reorganization to liquidation in the circumstances where the reorganization plan is not approved or the debtor fails to implement the reorganization plan.<sup>16</sup> Second, corporate rescue laws, as a collective approach, should achieve a good balance between the secured creditors and unsecured creditors. Secured creditors, normally banks and financial creditors with strong power to realize their secured debts by simply selling collateral, will be restricted in formal rescue regimes, which purport to restore the debtor and achieve a better result for all the creditors. Therefore, corporate rescue laws enable every interested group to be involved in the rescue process, have a chance to discuss the restructuring-related issues and vote on the approval of a reorganization plan. This may encourage the collectivity of a modern rescue culture and provide incentives to all the creditors who may continue to offer support for a rescue attempt.<sup>17</sup> Third, there should be a good balance between the controller in the corporate governance of a rescue regime and all the stakeholders in respect of the debtor. During reorganization, the existing management of the debtor may remain in control over the ailing company, or the existing management may be replaced by an outside insolvency professional, or the existing management may remain in control but subject to the supervision of an outside insolvency professional. No matter who is the controller (also called as “reorganizer”),<sup>18</sup> the controller should act for the

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<sup>15</sup> UNCITRAL, above n.4, p94-95.

<sup>16</sup> Ibid at 232.

<sup>17</sup> S Frisby, “In Search of a Rescue Regime: The Enterprise Act 2002” (2004) 67 MLR 247, 249-251.

<sup>18</sup> BG Carruthers and TC Halliday, *Rescuing Business: The Making of Corporate bankruptcy Law in England and the United States* (Clarendon Press, Oxford, 1998), p154.

interests of all the creditors and undertake his functions as quickly and reasonably as possible. His decisions are open to challenges from any interested party, who may apply to the court for rectifying the controller's conduct. Such mechanisms make the rescue system more transparent and accountable.<sup>19</sup>

It should be noted that the World Bank has been concerned with the efficiency and effectiveness of the bankruptcy law systems and the protection of creditors' rights from the domestic and international level since 1999, shortly after the East Asia financial crisis took place. The World Bank has set out a series of principles which aim to consolidate the legal framework of corporate insolvency system. These principles set benchmarks to examine the effectiveness and adequacy of bankruptcy and corporate rescue systems in a wide range of jurisdictions categorized into different legal families. In terms of formal rescue proceedings, the principles designed by the World Bank stipulate that:

“The system should promote quick and easy access to the proceedings, assure timely and efficient administration of the proceedings, afford sufficient protection for all those involved in the proceedings, provide a structure that encourage fair negotiation of a commercial plan, and provide for approval of the plan by an appropriate majority of creditors.”<sup>20</sup>

These principles are consistent with the legislative guidelines on insolvency laws set by UNCITRAL.<sup>21</sup> It should be noted, however, that these principles merely provide general recommendations for the structure of a reorganization regime which should be based on the comprehensive considerations of the unique political structure, legal culture, economy and social issues of each country. The “one size fits all” approach is not wise and workable in this area of law for different jurisdictions.<sup>22</sup>

## 1.1 Research aims and the need for this analysis

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<sup>19</sup> DTI/Insolvency Service, *Productivity and Enterprise: Insolvency—A Second Chance*, (Cm 5234, 2001); S Davies QC (ed), *Insolvency and the Enterprise Act 2002* (Jordans, Bristol, 2003), p38-39.

<sup>20</sup> The World Bank, above n.10, para.C 14.1; for a further explanation, see the following paras.C14.2-14.6.

<sup>21</sup> For more details, see UNCITRAL, above n.4, p209.

<sup>22</sup> Gromek Broc and Parry (eds), above n.1, p7.

In terms of insolvency law reforms, the UK government has long been concerned with the innovation and formulation of a modern and efficient corporate rescue system. Its first effort began in 1977 when the Cork Committee was organized under the appointment of the Secretary of State for Trade.<sup>23</sup> Two entirely new procedures, respectively company voluntary arrangements (CVAs) and administration, were introduced by the Insolvency Act 1986 on the basis of recommendations given by the “Cork Report”. The birth of CVAs and administration was hailed as the first arrival of corporate rescue culture in the UK insolvency legal framework.<sup>24</sup> For over twenty years since the Act of 1986, the focus of reforms has increasingly been on the avoidance of corporate failure and improvement of the rescue culture. For instance, a statutory moratorium has been introduced by the Insolvency Act 2000, which makes the CVAs more attractive to small eligible companies that require salvage. In addition, dramatic reforms have been brought about by the Enterprise Act 2002, the legislative tenet of which is to reformulate a more rescue-oriented and efficient administration regime that should reach the underlying aims of fairness, efficiency, accountability and collectivity by the abolition of administrative receivership.<sup>25</sup> As a pioneer in the promotion of the rescue culture in the western world, England has structured a relatively advanced corporate rescue system which is being referred to by other countries worldwide.<sup>26</sup>

Comparatively, insofar as bankruptcy legislation is concerned, China had undergone a quite long period in which there was no bankruptcy law in the entire national legal system. This period ended in 1986 when the first Enterprise Bankruptcy Law (here after the 1986 law) was promulgated.<sup>27</sup> In the meantime, the first enterprise rescue regime,

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<sup>23</sup> Cork Report, para.1.

<sup>24</sup> M Hunter, “The nature and functions of a rescue culture” [1999] J.B.L. 491, 497-498.

<sup>25</sup> Finch, above n.12, p294; S Leinster, “Policy Aims of the Enterprise Act” (2003) *Recovery* (Autumn) 27, 28.

<sup>26</sup> Such as South Africa, Italy, Australia, Hong Kong (China), New Zealand and so on. For more details, see the relevant chapters in Gromek Broc and Parry (eds), above n.1.

<sup>27</sup> It should be noted that historically the first Chinese Bankruptcy Law, which mainly referred to Japanese Bankruptcy Law, was introduced in late Qing Dynasty of Imperial China in 1906 and then repealed by Emperor Guang Xu after two years. Subsequently in the ruling period of Northern Warlords from 1915 to 1927, the government drafted a bankruptcy law which was nearly the copy of the former 1906 law, and was rarely implemented because of social

named “reorganization”, was established and set in Chap 4 of the 1986 law<sup>28</sup>, but this reorganization regime was completely different from the reorganization of the US model on the nature, objectives, functions and detailed procedures. When China was intending to draft the 1986 law, its economy was in a transition period from a previous highly centralized planned economy to a liberty-oriented market economy. Although competitive market mechanisms had been introduced since the 1978 reforms, they were not completely developed. In other words, the 1986 law was not established on the basis of a market economy, and the legislative goal at that time was to promote the reform of state-owned enterprises (SOEs) rather than the large scale bankruptcy of SOEs, because such bankruptcies were not feasible in light of the social role of SOEs. Therefore, it was inevitable that the state would readily step in in the bankruptcy proceedings. It has been observed that the 1986 law “is essentially a procedure to be applied by the Government, not invoked at the opinion of debtors or creditors.”<sup>29</sup> Eventually, the awkward procedures and infinite state intervention caused the failure of the first formal rescue regime.<sup>30</sup> It is noteworthy that the Chinese government made ceaseless effort on the reforms to the existing bankruptcy law system since the 1986 law came into force; especially in 1994 a bankruptcy law review committee was organized.<sup>31</sup> The mission of

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turbulence and war. Later in the era of Nationalist Government, an entirely new bankruptcy law was drafted and implemented since 1935. Although this law was annulled in the scope of mainland by the Communist Party in 1949, it still has been in force in Taiwan at present. For the details, see R Tomasic (ed), *Insolvency Law in East Asia* (Ashgate Publishing Ltd, 2006), p93-124; J Xie, *Theory of Chinese Bankruptcy Legal System* (People Court Press, Beijing, 2005), p22-27 (in Chinese); A Tang, *Insolvency in China and Hong Kong: A Practitioner's Perspective* (Sweet & Maxwell Asia, 2005), paras.1.08-1.12; S Li, “Bankruptcy Law in China: Lessons of the Past Twelve Years” (Winter 2001) *Harvard Asia Quarterly*, Volume V No.1 <<http://www.asiaquarterly.com/content/view/95/40/>>. (last visit on 31 August 2008)

<sup>28</sup> For an authoritative interpretation of the 1986 law, see DG Boshkoff and Y Song, “China’s New Bankruptcy Law: A Translation and Brief Introduction” (1987) 61 Am. Bankr. L. J. 359.

<sup>29</sup> DC Clarke, “Regulation and its Discontents: Understanding Economic Law in China”, (1992) 28 Stan.J.Int’l. L. 283, 299-300.

<sup>30</sup> There were rare reported cases which applied this procedure. See Wang, above n.13, section 3.1; the comments on <<http://www.asianrestructuring.com/>>. (last visit on 31 August 2008)

<sup>31</sup> One historical event which should be borne in mind was the former Chinese leader Deng Xiaoping’s south tour in 1992. He made a speech in Shenzhen which had a remarkable influence on the strategy of the Communist party, which subsequently sanctioned a document, named “Decisions on a number of questions on the establishment of a socialist market economy structure” in 1993. Concomitantly, the decision of establishing socialist market economy was endorsed by the following constitution amendment. See: Article 7 of the Chinese Constitution Amendment 1993.

the review committee was to draft a modern bankruptcy law which would embrace efficient and effective corporate rescue proceedings by taking into account the cases that had been heard by courts, and the experience and lessons from developed countries which had already built up a well-functioning rescue system. Due to a series of obstacles to the drafting process, such as the potential widespread bankruptcies of the debt-laden SOEs, the huge amount of non-performing loans in the banking sector and inadequacies of social security system, the revised draft of the new enterprise bankruptcy law on several occasions failed to pass the deliberation by the Standing Committee of National People's Congress (SCNPC) until the summer 2006 in which a unified and advanced Enterprise Bankruptcy Law was eventually promulgated.<sup>32</sup> One remarkable feature of the new law is the establishment of a rescue culture which has improved to a large degree, although this new law inevitably still has some weaknesses substantively and procedurally which need to be addressed.

This thesis is formulated upon a thorough exploration of theoretical and practical issues of current corporate rescue laws in England and China. The key objectives of this research are to identify the similarities and differences between the English and Chinese corporate rescue laws through a comprehensive comparison substantively and procedurally, to explore the underlying factors which may cause the differences in these systems, to examine the weaknesses and inadequacies of the current rescue regimes and structure a more effective and well-functioning corporate rescue system which could well influence the development of the Chinese socialist market economy by reference to the advanced experience, principles and lessons from the UK in various rescue regimes, including informal arrangements. It is of great importance to do this analysis especially in the current circumstance where England has undergone two dramatic reforms to its rescue regimes in the new millennium under the IA 2000 and EA 2002, and China has taken a big step to build an almost entirely new bankruptcy law system on the basis of

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<sup>32</sup> For more details about the drafting process and deliberation of the new law, see: J Shi, "Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy" (2007) 16 *Norton Journal of Bankruptcy Law and Practice* 645.

the recently passed Enterprise Bankruptcy Law, which includes an internationally accepted enterprise rescue regime that has attracted comprehensive focus all over the world.<sup>33</sup> In other words, to some degree, doing an extensive study on rescue laws between these two nations at present will have some value theoretically and practically. Firstly, although the new law has to a large extent improved the previous one, the Chinese corporate bankruptcy and rescue structure is still at a rudimentary stage on account of the underdevelopment of bankruptcy law theory, the inconsistent judicial practice and the limited professional experience in corporate bankruptcy and rescue cases.<sup>34</sup> In this regard, this thesis will identify the advanced and valuable rescue mechanisms of English insolvency laws from a Chinese perspective, and explore the potential problems of China's new corporate rescue law on the basis of comparative analysis. This study can at least enrich the corporate rescue theory for the Chinese academic circle which has neglected the development of the rescue culture of England for a long time. In addition, this thesis will open a window for British insolvency professionals, who can, through their experience assist in the development of the emerging corporate rescue system in China.<sup>35</sup>

## **1.2 How are these aims being achieved?**

### **1.2.1 Research Methodology**

This thesis has been conducted through library-based research, which primarily relies on a comprehensive review of existing literature, legislation, case decisions and official documents. The thesis title indicates that this research is constructed upon a comparative study between the UK and China. Two important methodological questions are required to be addressed prior to the commencement of detailed analysis.

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<sup>33</sup> Ibid at 666.

<sup>34</sup> R Parry and H Zhang, "China's New Bankruptcy Law: Notable Features and Key Problems of Enforcement" (forthcoming).

<sup>35</sup> Particularly from the perspective of practice, there will be a potential big market in China in the wake of the new law implemented for the UK insolvency practitioners, because China lacks enough well-qualified and competent insolvency professionals to satisfy current and future need. See the comments on: X Lan, "Outdated Bankruptcy Law Upgraded", <[http://www.bjreview.com.cn/200430/Business-200430\(B\).htm](http://www.bjreview.com.cn/200430/Business-200430(B).htm)>. (last visit on 31 August 2008)

### **1.2.1.1 Is it appropriate to carry out a comparative research on the topic of corporate rescue?**

It is well-known that corporate rescue laws are an indispensable component of the bankruptcy laws of each state, which “is a defining characteristic of a market economy”.<sup>36</sup> A market economy emphasizes the optimal use of resources and competitive mechanisms which encourage companies to compete for the maximum of economic value. It is usual to see some companies which fall into financial trouble and are on the slide into insolvency in the ordinary course of business. The companies which cannot be saved will be liquidated and the resources of the failing firms will be redeployed swiftly to the firms where they can be better used.<sup>37</sup> Therefore, corporate failure is a common problem which countries based on a market economy will encounter. This is why corporate rescue laws are created and developed as a solution to rescuing the firms which are financially distressed but economically viable. Since most of the jurisdictions have been focusing on reforming domestic corporate insolvency law and building an effective corporate rescue regime under the influence of the US Chapter 11, this common trend provides the foundation of this comparative analysis. Different functions of legal rules and different attitudes towards legal institution of corporate rescue might be found out through the comparative study, which is particularly in favour of understanding the contextual factors that the legal institutions and mechanisms are based. Since corporate rescue culture does not exclusively belong to one jurisdiction, any one country does not have a monopoly over the creation and contribution to developing corporate rescue laws.<sup>38</sup> It is appropriate to do a comparative analysis in relation to corporate rescue, which perform similar functions in different jurisdictions whether they are based on a capitalist or a socialist market

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<sup>36</sup> Carruthers and Halliday, above n.18, p1.

<sup>37</sup> According to the Darwinian approach, “a capitalist economy will acknowledge that a certain level of corporate demise is both inevitable and necessary to the efficient functioning of the market”, see J Argenti, *Corporate Collapse: The Causes and Symptoms* (McGraw-Hill, London, 1976), p170; recited by Frisby, above n.17, p248.

<sup>38</sup> K Ong and CR Baxter, “A Comparative Study of the Fundamental Elements of Chinese and English Company Law” (1999) 48 Int'l & Comp. L. Q. 88, 89.

economy. This is to say that a comparative study of corporate rescue can be properly carried out, even though the underlying factors of two countries, such as economy, politics, culture and ideology, may be very different. In addition, corporate rescue is not only a legal discipline which is situated at the heart of bankruptcy law, but also a concept which is related to the economic life of enterprises. Understanding corporate rescue through a comparative study will be of academic value and practical significance.

#### **1.2.1.2 Why does this thesis choose England and China as research objects?**

As far as England is concerned, it has enjoyed a relatively long history of bankruptcy law among western industrialized countries since a statute of Henry VIII was enacted in 1542.<sup>39</sup> In addition, it should be noted that the schemes of arrangement approach, the first rescue-oriented regime, was introduced by the Victorian legislation in 1870, and it had great influence on the insolvency law reforms of other industrialized nations.<sup>40</sup> In the wave of reforming corporate rescue laws initiated by Chapter 11 of the US Bankruptcy Code, the UK government has been a pioneer, using corporate rescue practice to promote its insolvency law reforms towards a modern corporate rescue culture. The widespread acceptance and reference of the English rescue regimes in other jurisdictions undoubtedly shows that England is an optimal jurisdiction with which to make comparisons when taking into account the central rules and policies in rescue regimes. The reason why this thesis does not choose the US as a comparative object is not because the American rescue laws are not as advanced and influential as those of England, but because the Chinese government has paid too much attention to the US Chapter 11 and to some degree neglected the essence and advantage of the corporate rescue culture of England which is the real root of the Anglo-American legal family. It should be noted that there are two major differences regarding corporate insolvency and rescue laws between America and England. First, traditionally, the American

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<sup>39</sup> R Goode, *Principles of Corporate Insolvency Law* (3<sup>rd</sup> edn, Sweet & Maxwell, London, 2005), para.1.05.

<sup>40</sup> For more details of the schemes of arrangement approach, see s 3.2.1.1.1.



bankruptcy laws adopt a debtor-friendly approach which is strongly oriented to rescuing the financially troubled firms and the reorganization procedure in Chapter 11 is created under such culture.<sup>41</sup> In contrast, the English corporate insolvency laws are established under a creditor-friendly approach, which favours the interests of creditors, especially secured creditors like banks and financial lenders.<sup>42</sup> Second, in the American reorganization procedure, the directors and managers of a struggling firm could remain in control over the corporate governance during the rescue procedure under the debtor-in-possession (DIP) model.<sup>43</sup> However, in the English administration regime, an outside insolvency practitioner will take over the debtor from the existing board and have full control in the proceedings.<sup>44</sup> This fundamental difference derives from the divergence of insolvency legal culture. In England, insolvency is deemed as disgrace. The general attitude of insolvency law is to punish the risk takers and irresponsible behaviour of directors, and a good example is the introduction of wrongful trading provision as s 214 in the Insolvency Act 1986. However, in America, the corporate failure is regarded as misfortune and the bankruptcy law is extremely sympathetic to the financially ailing company.<sup>45</sup> Since there are fundamental differences between English and American corporate insolvency and rescue laws, it might be worth considering and examining the legal institutions and policies of the English corporate rescue laws, which may attract the attention of the Chinese academics and legal reformers.

In addition, this research also rejects comparison with Russia and other Eastern European countries which shared the Marxist-Leninist legal framework before the political and economic revolutions started in 1989. The failure of the communist regimes and the “big bang” approach to high privatization and rapid economic structural transition led to a fundamental and shocking change of the societal nature to

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<sup>41</sup> S Franken, “Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited” (2004) 5 *EBOR* 645, 650.

<sup>42</sup> Davies, above n.19, p12.

<sup>43</sup> D Hahn, “Concentrated ownership and control of corporate reorganizations” (2004) 4 *JCLS* 117, 122.

<sup>44</sup> V Finch, “Control and Co-ordination in Corporate Rescue” (2005) 25 *Legal Studies* 374.

<sup>45</sup> Finch, above n.12, p196-197.

capitalism. In contrast, China initiated its economic reform in 1978 and adopted a gradual approach to transform from a highly centralized planned economy to a market economy with unique Chinese socialist characteristics.<sup>46</sup> The experiences from Russia and East Europe did provide a mirror for China to examine its legal system, but diverse approaches have determined that China may not learn too much from them, and their bankruptcy and rescue regimes are not as influential as those of England, which are more worth exploring.

The reasons for selecting China as the other research object are not only because the author comes from China and has a strong incentive to make some contribution to Chinese legal construction, but also because China has long played an increasingly significant role in the world economy and trade system.<sup>47</sup> It has been commented that any world trading system without the involvement of China would be “odd”.<sup>48</sup>

Although, with the intense transformation of the social and political structure in the former Soviet Union and other Eastern European countries since the late 1980s, the socialist legal family which was represented by the Soviet legal framework collapsed, the new Chinese legal structure has gradually been set up in the wake of the successful economic structure reforms and the establishment of the emerging market economy.<sup>49</sup> Even though China has borrowed legal concepts and institutions heavily from Germany, China cannot be simply categorized as a member of the Roman-Germanic family because of the peculiar characteristics of political structure and socialism.<sup>50</sup> Economic

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<sup>46</sup> For more details, see: R Pomfret, *Constructing a Market Economy: Diverse Paths from Central Planning in Asia and Europe* (Edward Elgar Publishing, 2002), p26; NR Lardy, *China's Unfinished Economic Revolution* (Brookings Washington, D.C. 1998), p1-20.

<sup>47</sup> Surely, the author is able to take the advantage of linguistic skills which are strongly required to do comparative legal study. They are in favour of collecting and understanding the first hand materials of the both countries which could avoid misunderstanding the foreign laws from the imprecise translations and drawing wrong conclusion based on the unreliable information of the second hand materials. See: JC Reitz, “How to do comparative law” (1998) 46 *American Journal of Comparative Law* 617, 631-633.

<sup>48</sup> JS Mo, “China, the World Trade Organization, and the Agreement on Trade-Related Investment Measures” (1996) 30 *J. World Trade* 89.

<sup>49</sup> M Hoecke and M. Warrington, “Legal Cultures, Legal Paradigms and Legal Doctrine: Towards a New Model for Comparative Law” (1998) 47 *International and Comparative Law Quarterly* 495, 499.

<sup>50</sup> R Porta; F Lopez-de-Silanes; A Shleifer and RW Vishny, “Law and Finance” (1998) 106

development and comprehensive cooperation with other countries mean that China's legal system cannot be ignored. In addition, the analysis of China's bankruptcy reforms and the establishment of corporate rescue culture would be useful reference for other East Asian countries which enjoy the very similar cultures and customs, like South Korea and Japan. Furthermore, as the representative of the developing nations, the achievement and failure of China's new bankruptcy law has set a good example for them to learn.

### **1.2.2 Summary of Chapters**

This thesis makes comprehensive reviews of bankruptcy laws and reforms to rescue regimes in the two countries to explore how England and China have shaped their own bankruptcy and rescue laws for their respective systems on the basis of differing circumstances and how they have balanced the bargaining power of every interested group in a rescue activity. Similarities and differences of corporate rescue rules and policies in respective rescue regimes can be found out through comparisons. In addition, attention should be devoted to the design of the rules which may bring all the competing interested parties to the negotiation table to decide the destiny of debtor. In this regard, the research will identify the situation of all the corporate stakeholders, and explore their relationships among the company, its directors and employees, the financial creditors, ordinary unsecured creditors and consumers in respect of the company in the corporate governance of rescue. Meanwhile, different attitudes of the two governments to some specific interested classes may have far-reaching influence on the structure of rescue rules. For instance, Britain has long adopted a creditor-friendly approach in corporate bankruptcy proceedings, which has made secured creditors, normally the floating charge holders, have very strong bargaining power.<sup>51</sup> In addition,

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*Journal of Political Economy* 1113, 1118-1119.

<sup>51</sup> It should be noted that the economic interests in respect of an insolvent company have been transferred from the floating charge holders to the creditors as a whole under the reforms promoted by the EA 2002 which has nearly abolished Administrative Receivership. J Armour and R Mokal, "Reforming the Governance of Corporate Rescue: The Enterprise Act 2002" [2005] LMCLQ 28, 28-30; V Finch, "Re-invigorating Corporate Rescue" [2003] J.B.L. 527, 531-533.

it has always tended in attitude to blame the directors and managers of the insolvent corporations and to unduly rely upon external insolvency professionals. Comparatively, the Chinese government has always tended to put the employees' claim in the first place in the bankruptcy cases of SOEs.<sup>52</sup> The employees were conferred special privilege in the reorganization activities and priority in the distribution of the bankruptcy estate, even at the price of other interested groups, including creditors with securities.<sup>53</sup> Such a legislative tenet echoed the spirit of the Constitution which deems the worker class as the ruling class,<sup>54</sup> and reflected the fundamental line of the Communist Party which attaches more importance to social goals than other goals.

In addition, it would be naïve to formulate legal rules of corporate rescue without considering historical, cultural, economic and political issues.<sup>55</sup> The differences in such underlying factors explain why the two states have adopted particular rescue-oriented approaches which are only suitable for and crucial to the situations of respective structures. In addition, identifying the fundamental background and matters peculiar to each jurisdiction will be useful in understanding the particular institutions and mechanisms of rescue laws and policies of each.<sup>56</sup> In this respect, as one commentator said "economic law in the post-Mao era cannot be understood without an understanding of the meaning of economic reform itself."<sup>57</sup> Notably the World Bank could only provide the general principles and guidelines of corporate rescue proceedings for reference, and could not establish detailed models and procedures for all the countries

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<sup>52</sup> This reflects the China's consistent focus on social stability in considering bankruptcy law reforms. It is noteworthy, however, that the EA 2002 has shed light on the super-priority status of the employees' wages and salary in the distributional order. See Insolvency Act 1986, Sch B1, para.99(4)(5)(6); L Sealy and D Milman, *Annotated Guide to the Insolvency Legislation 2006/2007* (9<sup>th</sup> edn Sweet & Maxwell London 2006), Vol 1, p560-561.

<sup>53</sup> This is the so-called "Planned Bankruptcy" which will be analyzed in Chapter III. For a brief introduction about this regime, please see: W Wang, "The Bad Assets of Banks & Corporate Rescue in China", (Dec 2002) a paper presented on the Second Forum for Asian Insolvency Reform (FAIR) in Thailand, p6-10.

<sup>54</sup> Chinese Constitution 1982, article 1.

<sup>55</sup> Gromek Broc and Parry, above n.1, p6.

<sup>56</sup> Ong and Baxter, above n.38, at 90.

<sup>57</sup> Clarke, above n.29, at 285.

because their particular circumstances vary.<sup>58</sup> It would be dangerous to transplant the entire English rescue laws or those of any other country into the Chinese legal system without identifying the underlying elements, even though England has developed a mature and advanced corporate rescue system.<sup>59</sup>

To realize the research aims, Chapter II resolves the theoretical issues of corporate rescue which will provide the prerequisite preparation for the following chapters. It briefly examines two fundamental concepts closely related to corporations and rescue institutions, respectively property rights and corporate failure. Then, it clarifies the definition of corporate rescue, explores its nature, functions, and policy aims at the heart of rescue laws, and introduces significant features of a corporate rescue regime. Subsequently, it examines the origin and historical development of the rescue culture, which is helpful in developing an understanding of the initial incentives to create such rescue institutions parallel to liquidation in bankruptcy laws.

Extensive comparisons are constructed in Chapters III to V which encompass three main areas, respectively the underlying factors and contexts of the bankruptcy and rescue law of each system, the detailed corporate rescue procedures and the balance of bargaining power of every interested group in corporate rescue governance. Chapter III builds on a comprehensive identification of background issues which include the differing cultures and ideologies, historical development of bankruptcy law reforms and establishment of a modern rescue culture of the two nations, and describes the Chinese market-oriented reforms which led to lobbying for an advanced bankruptcy law in accordance with international standards and China's unique situations. Chapter IV provides an overview of the English company voluntary arrangements and administration regimes and the Chinese modified reorganization procedure. It constructs a comprehensive comparison on the issues of substantive rights and detailed

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<sup>58</sup> The World Bank, above n.10, para.C 14.1.

<sup>59</sup> R Parry and H Zhang, "China's New Corporate Rescue Laws: Perspectives and Principles" (2008) 8 JCLS 113.

procedures from the perspective of rescue mechanisms and principles set by the World Bank and UNCITRAL. Given that corporate rescue is universal, similarities, divergences and main features of both systems can be explored when both governments face the common problem of business failure and key challenges to rescue. Chapter IV also explores the problems and deficiencies of China's new rescue laws, which may negatively affect the implementation in judicial practice, by reference to the legal institutions and policies of the English corporate rescue laws, and comes up with some appropriate solutions to the potential weaknesses which may enable the Chinese legal reformers to revise the existing ineffective corporate rescue legal framework. Chapter V discusses the balance of power and control of each class of stakeholders, explores the outcomes of insolvency law reforms and identifies the entitlements of each interested group. It aims to resolve a central question on how to design the rules which govern all the stakeholders at the negotiation table in order to successfully salvage the financially ailing but potentially profitable companies and in the meantime to achieve the goals of fairness, accountability and collectivity.

## Chapter II: Theoretical and functional issues of corporate rescue

### Introduction

This chapter is primarily aimed at examining the rationale and philosophy of corporate rescue in order to pave the way for the analysis and comparisons in subsequent chapters. First of all, it identifies two crucial concepts which are closely associated with bankruptcy and the rescue culture, namely property rights and corporate failure. Property rights can be seen as the backbone of a market economy which is built upon the free exchange of private property and its ownership.<sup>1</sup> In addition, one of the main characteristics of a “legal person” is the ability to exercise its civil rights and assume relevant liabilities on the basis of the property that it personally owns.<sup>2</sup> The most important aspect of property rights in the context of corporate insolvency is that the main function of traditional bankruptcy laws is to deal with the creditors’ claims against the bankruptcy estate of the debtor company. Moreover, the bargaining powers of different actors who are entitled to participate in the bankruptcy and corporate rescue regimes are determined by the differing property rights that they hold.<sup>3</sup> Last but not the least, the exploration of the Chinese property rights institutions will assist in understanding the Post-Mao economic reforms, the corporatization process of state-owned enterprises (SOEs) and the historical evolution of the Chinese bankruptcy and rescue laws.<sup>4</sup> It should be noted that, in terms of corporate rescue, corporate failure is also an important concept that cannot be ignored. It is the prerequisite of the creation of a rescue culture which takes drastic measures to prevent the eventual failure and avoid the unnecessary losses and

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<sup>1</sup> BG Carruthers and TC Halliday, *Rescuing Business: The Making of Corporate bankruptcy Law in England and the United States* (Clarendon Press Oxford, 1998), p16.

<sup>2</sup> PL Davies, *Gower and Davies’ the Principles of Modern Company Law* (7<sup>th</sup> edn, Sweet & Maxwell, London, 2003), p33.

<sup>3</sup> Carruthers and Halliday, above n.1, p16.

<sup>4</sup> For general understanding of Chinese corporate property rights and ownership, see A Tang, *Insolvency in China and Hong Kong: A Practitioner’s Perspective* (Sweet & Maxwell Asia, 2005), para.1.13; J Xie, *Theory of Chinese Bankruptcy Legal System* (People’s Court Press, Beijing, 2005), p34-41.(in Chinese)

detrimental effects brought about by the failure.<sup>5</sup> Prior to deciding to salvage the distressed company, it would be wise and rational to analyze what type of failure this company has fallen into. Corporate rescue regimes merely open the doors to a company which is in a financial plight but potentially still profitable.<sup>6</sup> In respect to the company where there is no reasonable prospect that it can be rescued, a business sale or asset sale followed by immediate liquidation would be the best alternative.

Secondly, it comprehensively identifies the legal concept of corporate rescue and explores the policy aims, value-orientations and ideologies of the corporate rescue culture. Then it answers the question of what constitutes a successful rescue attempt, and examines two significant features of corporate rescue. Thirdly, it describes the historical development of corporate insolvency law, especially the functional transformation from the conventional sole liquidation model to the preventative and reinvigorating rescue institutions laid at the heart of bankruptcy laws. Corporate rescue is deemed to be an alternative to winding up proceedings when a company is in actual or impending insolvency, and can be employed to cure unhealthy enterprises at an early stage by formal procedures as well as informal workouts. In short, the key objective of this chapter is to eliminate the obstacles to the theoretical issues of corporate rescue and to structure a full and comprehensive understanding of the concept of a rescue culture.

## **2.1 Identification of two fundamental concepts central to corporate rescue**

### **2.1.1 Property rights<sup>7</sup>**

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<sup>5</sup> A Belcher, *Corporate Rescue: A Conceptual Approach to Insolvency Law* (Sweet & Maxwell, London, 1997), p12.

<sup>6</sup> S Frisby, "In Search of a Rescue Regime: the Enterprise Act 2002" (2004) 67 M.L.R. 247, 248.

<sup>7</sup> For general understanding of property rights, see P Garnsey, *Think about Property: From Antiquity to the Age of Revolution* (CUP, Cambridge, 2007), p177; JE Penner, *The Idea of Property in Law* (OUP, Oxford, 1997), p68.



Capitalist economies are constructed upon the structure of property rights, the owners of which are capable of enjoying absolute possession, control, use and disposal of property based on their own will. That means that when an owner exercises his property rights or enforces his claims over the specific property, any other individual will be excluded from imposing illegal intervention on the owner's exercise or enforcement.<sup>8</sup> The property right-holder can do what he likes with his property in the most absolute manner as long as he does not act against laws and regulations.<sup>9</sup> For example, an owner of a store is entitled to sell all kinds of goods and enjoy benefit from sales, but he is not allowed to sell alcohol to people under the age of 18. The proprietor can build a factory on his land, but this action may not be taken without planning permission with intention to protect the interests of residents near the land. Both examples indicate that property right-holders can enjoy the right to use and dispose of property, but should be under the limits of law. Capitalist society advocates freedom of contract and private property structures which underpin the market economy. It should be noted that private property rights institutions formulate the concept of the legal person and lie at the foundation of corporate insolvency laws. Enterprises with legal personality are entitled to bear the risk and reward according to how much property they actually own. Shareholders could readily resist claims from creditors by the principle of limited liability which emphasizes that shareholders only assume liabilities to the extent of their contributions to the company,<sup>10</sup> and the bankruptcy assets pool is strictly restricted to the property that the debtor company privately has.<sup>11</sup>

According to the above analysis, it can easily be understood why China did not have a real and effective bankruptcy law in quite a long period until 1986. In the ancient imperial era of China, which ended in 1911, all property, including the land and

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<sup>8</sup> Carruthers and Halliday, above n.1, p17.

<sup>9</sup> P Garnsey, *Think about Property: From Antiquity to the Age of Revolution* (CUP, Cambridge, 2007), p177.

<sup>10</sup> Davies, above n.2, p176-180.

<sup>11</sup> TH Jackson, *The Logic and Limits of Bankruptcy Law* (BeardBooks, Washington, D.C. 2001), p89.

houses, belonged to the emperor, who had a monopoly over everything.<sup>12</sup> Because of the lack of the concept and institution of private property, the market, which is usually built upon free exchange of property rights, could not be developed. The bankruptcy laws, which traditionally deal with the debt/credit disputes, were not developed; and matters were settled by local customs and culture in ancient China.<sup>13</sup> From 1911 to 1949, the Chinese economy and society was in the half colonial and half feudal stage in which China underwent a series of wars. Millions of people who suffered deep misery at that time could not imagine how to survive, let alone envisage the development of private property rights and a market economy.<sup>14</sup> After the new China was established by the Communist Party in 1949 under Chairman Mao Zedong, a gigantic and vigorous revolution, which aimed at transforming the previous agriculture, handicraft, and capitalist industries and commerce to have socialist attributes, occurred in the national level in the 1950s.<sup>15</sup> The direct result of this socialist transformation was that all the firms and businesses were owned by the state. A highly centralized planned economy was established following the former Soviet Union model. Before the former party leader Deng Xiaoping came up with the economic structure reform and opening up policy in 1978, the state seemed like “one giant vertically-integrated productive firm: ‘China Inc.’”.<sup>16</sup> All of the economic activities were conducted upon the administrative order rather than the rule of demand and supply and market competitive mechanisms. It is obvious that there were no disputes between debtor and creditor because all the property of the two parties was completely owned by the state.<sup>17</sup> It has therefore been observed that the economic environment did not require the establishment of bankruptcy law in the

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<sup>12</sup> L Burton, “An Overview of Insolvency Proceedings in Asia” (2000) 6 Ann. Surv. Int’l & Comp. L. 113, 117; there is another reason which could also explain the bankruptcy legislative lacuna in the ancient feudal society of China from the perspective of unique culture and custom which is that “a son has to repay his father’s debts”. This reason will be elaborated in Chapter III.

<sup>13</sup> S Baister, “Efficiency versus Ideology—The Insolvency Law of the People’s Republic of China” (1993) 8 *Insolvency Law & Practice* 166.

<sup>14</sup> Tang, above n.4, para.3.03.

<sup>15</sup> Ibid at para.3.04.

<sup>16</sup> DC Clark, “Regulation and Its Discontents: Understanding Economic Law in China” (1992) 28 Stan. J. Int’l L. 283, 287.

<sup>17</sup> Burton, above n.12, at 118.

Mao era, let alone the introduction of the Western corporate rescue culture.

#### **2.1.1.1 Property rights in the context of bankruptcy and rescue regimes**

It has been discussed that property rights confer absolute “property and freedom of exchange” on the right-holders. However, it does not mean that such property rights will never be restricted, especially in the case of bankruptcy.<sup>18</sup> If a company is placed into bankruptcy proceedings, distributional problems arise in the liquidation where the remaining assets of the debtor are not enough for the satisfaction of enormous claims based on different types of property rights. Some creditors who hold the exclusive and preferential property rights are able to realize their claims at the expense of others.<sup>19</sup> The function and policy aims of bankruptcy laws are to empower differing classes of claimants according to their property rights against the debtor and to balance every interested party in the zero-sum circumstance fairly and reasonably. Similar troubles need to be resolved when legislatures of different countries design the rules of corporate rescue.

#### **2.1.1.2 Chinese corporate property rights structure after 1978**

In the traditional planned economic structure, because all the enterprises and their property belonged to the state, the state was the sole shareholder of every SOE. The relationships of two SOEs which made transactions with each other were not built upon the commercial contracts which, from the perspective of Western civil law, are supposed to be concluded by the principle of liberty according to the rules of the market, but rather were decided by administrative order and control from the central government.<sup>20</sup> Therefore, there were no real debt/credit disputes which existed among enterprises. Because the state had the absolute control over all the property of enterprises and banks, the ownership structure was quite simple and no private property existed in them.<sup>21</sup> No creditor had the incentive to enforce its claims

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<sup>18</sup> Carruthers and Halliday, above n.1, p16-17.

<sup>19</sup> Ibid

<sup>20</sup> Clark, above n.16, at 305.

<sup>21</sup> Nearly all the enterprises were SOEs. Although there were a small number of

because the state was not only the owner of the debtor, but also the owner of the creditor. Enforcing such claims seemed like taking out the money from the left pocket and putting it into the right one. Moreover, in the central planning economic system, there were no concepts of limited liability and separate legal personality due to the lack of private property institution. Theoretically, as the sole shareholder, the state had to assume unlimited liability for the debts of enterprises, which meant that the government had to repay the debts incurred by the SOEs by using the state-owned assets and had to maintain the existence of the legal entities of the SOEs. The bankruptcy of one SOE could incur the collapse of the state, which would never happen in reality.

The key milestone in the establishment of a new Chinese corporate property structure was the commencement of reforms to the economic system which started from December 1978.<sup>22</sup> In the three decades since then, China has undergone an economic transition from the central planning structure to the market-oriented structure based on competitive institutions with Chinese characteristics. As the door increasingly opens up, large amounts of foreign capital flow into China, which has a substantial influence on the acceptance of the concepts of private property and corporate personality. During the initial years of the economic reforms, the Chinese government showed its hesitation and ambivalence to the introduction of private property.<sup>23</sup> The theory of private property was marked as the unique outcome of the

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collectively-owned enterprises, their governance structure was exactly the same as that of the SOEs. Enterprises with other ownerships did not exist at all. For more details, see: G Yang, "An Institutional Analysis of China's State Power Structure and its Operation" (2006) 15 *Journal of Contemporary China* 43, 44.

<sup>22</sup> The watershed document was "Communique of the Third Plenum of the 11<sup>th</sup> Central Committee of the Communist Party of China" on Dec 22, 1978. The turning point which would decide the destiny of the people and the nation was that the Communist Party treated economic development as the number one priority, rather than the class struggle.

<sup>23</sup> It could be found that China and the Western world hold differing attitudes to private property rights. A classic example is the 1789 French *Declaration of Rights* (the preface to the French Constitution of 1793), the article 17 of which announces the sanctity of private property which shall not be infringed unless for the legitimate needs of the public, and fair compensation in advance. Comparatively, China just recently established the principle of sanctity of citizens' private property in article 22 of the Chinese Constitution Amendment 2004.

capitalist revolution and the peculiar feature of capitalist society. Adopting private property rights might violate the principle of public ownership which was built upon the classic Marxism Theory.<sup>24</sup> However, the experience and practice of Western developed countries proved that the economy could benefit from the private property structure. The Chinese government finally decided to borrow the Western private property institution for the benefit of economy, although the private property concept was doubtful and debate was intense.

In terms of building a corporate property structure, the central government took two steps. First of all, the highly centralized absolute control over the firms and their assets was slightly decentralized, which expressed the separation of ownership and managing power. It can be explained that even though all property was still owned by the state, the enterprises were entitled to manage and operate on their own will. In the meantime, the enterprises were allowed to withhold the profits that they made, and only part of them were required to be submitted to the government in the form of tax.<sup>25</sup> Such reforms empowered the enterprises to design strategy and operate flexibly and autonomously, on the one hand; and encouraged them to engage in competition and pursue their maximum interests, on the other hand. Secondly, the government accepted the legal concepts of “legal person” and “corporate property rights”, and stipulated the two institutions in the first civil law of Communist China, General Provisions of Civil Law 1986, article 36 of which introduced the concept of a legal person and set four conditions for an eligible legal person, that reflected that the government was very wary and cautious to grant to an enterprise legal person status. Article 82 articulated that SOEs were permitted to incur possible civil

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<sup>24</sup> At the beginning stage, the central government showed hesitation and doubt regarding the import of the concept of private property. “...the leadership remains deeply ambivalent about whether private businesses affirmatively benefit Chinese society or are at best a necessary evil”. See Clark, above n.16, at 305.

<sup>25</sup> The enterprises were entitled to keep the rest of profits to enlarge the production scale, purchase new equipment, and raise funds for social insurance of their employees. This is the so-called “Decentralizing Powers, Ceding Profits”. (*FANG QUAN RANG LI*) see: S Guo “The Ownership Reform in China: what direction and how far?” (2003) 12 *Journal of Contemporary China* 553, 556.

liabilities through their management of any assets that they were authorized by the state to manage and operate.<sup>26</sup> That meant that although the assets were not owned by the enterprises, they could be employed to repay the due debts as long as the enterprises were entitled to do so. This is the unique characteristic of Chinese corporate property rights which represents part of the process of “corporatization” of SOEs.<sup>27</sup> Not only does it settle the theoretical obstacles to the rationales of limited liability and corporate personality, but also it lays a good foundation for the advent of bankruptcy and corporate rescue laws.

### 2.1.2 Corporate failure

It is normal for companies to encounter financial crises and survive them routinely and periodically under competitive market institutions, which would brutally knock out the irredeemably failing companies and pursue the most optimal redeployment of resources and employees according to the market rules. Therefore, it is inevitable for competitors to take risks and overcome troubled times in the business world under market forces in order to reach the aim of the best use and the highest value of the assets and human resources.<sup>28</sup> Since corporate failures may bring about enormous negative effects, not only to the companies themselves but also to the community and the state, it is pressing and necessary to design legitimate and appropriate rules to salvage the distressed but viable companies. Although it is important to understand the causes, nature, warning signs and regular patterns of corporate decline which are useful to enable the directors, insolvency practitioners (IP) and turnaround specialists<sup>29</sup> to make quick response to the potential danger and prevent failure at an

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<sup>26</sup> For further understanding of the civil law, see WC Jones, “Introduction to the General Provisions Civil Law of People’s Republic of China” (1987) 13 Rev. Socialist L. 357; Z Wei, *Civil Law* (Peking University and Higher Education Press, Beijing, 2000), p230-231. (in Chinese)

<sup>27</sup> L Miles and Z Zhang, “Improving Corporate Governance in State-Owned Corporations in China: Which Way Forward?” (2006) 6 JCLS 213, 216.

<sup>28</sup> V Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP, Cambridge, 2002), p121-122.

<sup>29</sup> “Turnaround specialists” could play an effective role in the pre-insolvency monitoring stage and make a contribution to avoid corporate failure at an early stage. See V Finch, “Doctoring in the Shadows of Insolvency” [2005] J.B.L. 690.

early stage, these issues, which involve complicated expertise in accounting, economics and management, are out of the scope of this study.<sup>30</sup>

Although corporate rescue laws are created to rehabilitate distressed companies, that does not necessarily mean that any company in troubled times is suitable for rescue regimes. “Corporate rescue mechanisms are not intended to maintain inefficient firms that are not economically viable.”<sup>31</sup> One thing that should be borne in mind is that both winding up laws and rescuing laws are able to play an effective role in promoting the best use of resources. The former is used to liquidate the company which is economically distressed and cannot be resurrected, and comparatively the latter provides a legal platform for financially distressed but economically viable companies to reinvigorate.<sup>32</sup> When a company fails to repay its due debts, should it be wound up immediately or put into rescue proceedings? To answer this question, it is necessary to distinguish two concepts: financial distress and economic distress, both of which express the business failure of a company. The problem is to identify to what extent the company is failing and whether there is a reasonable prospect of rescue?

A company in financial distress will typically encounter a cash-flow problem, which means that it is unable to pay its debts when they become due.<sup>33</sup> This is the so-called cash-flow test of insolvency which highlights three aspects: “only due debts are to be taken into account; insufficiency of liquid assets does not necessarily indicate inability to pay; and default in payment is sufficient evidence of inability to pay”.<sup>34</sup> It is noteworthy that cash-flow insolvency does not necessarily determine the

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<sup>30</sup> For broad knowledge of these issues, see Finch, above n.28, p123-144; R Morris, *Early Warning Indicators of Corporate Failure* (Ashgate, 1997); J Argenti, *Corporate Collapse: The Causes and Symptoms* (McGraw-Hill, London, 1976).

<sup>31</sup> *A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group*, The Insolvency Service (London: HMSO, 2000) (The 2000 Report), para.24.

<sup>32</sup> R Mokal, “Administrative Receivership and Administration—An Analysis” (2004) 57 *Current Legal Problems* 355, 357-359.

<sup>33</sup> IA 1986, s 123(1).

<sup>34</sup> R Goode, *Principles of Corporate Insolvency Law* (3<sup>rd</sup> edn, Sweet & Maxwell, London, 2005), paras.4.15-4.23.

irreversible failure of the company. Illiquidity of assets and large debt repayment in a short term may occur routinely and normally in business life, and both of these factors could lead to a temporary inability of a company to repay its due debts. It has therefore been observed that a financially distressed company may still be economically viable, and the assets of it could potentially realise their highest value. Winding it up immediately without thinking would to some degree be to the detriment of the interests of the company's stakeholders; could result in unnecessary loss of job preservation and move assets which are supposed to be employed to the best use in the debtor company to inferior projects.<sup>35</sup> In this situation, this company should be put into corporate rescue regimes to survive the financial trouble and rehabilitate back to the form of a healthy operation. Consequently, the identification of such companies is the logical threshold and real need of corporate rescue laws.

If a company falls into economic distress which can be defined as occurring where "the net present worth of the troubled company's business as a going concern is less than the value of the assets broken up and sold separately"<sup>36</sup>, that means that the company cannot be salvaged. The purposes of the winding up proceedings are to liquidate and dissolve completely failed firms, to realize the remaining assets by whatever going concern sale or breakup sale is appropriate, and to distribute among creditors in different classes under the distributional order and follow the *pari passu* principle in each class of creditors. The resources of an insolvent company, which is hopeless to save, will be redeployed by the market swiftly for more productive use.<sup>37</sup> This is to say that the assets of a failed firm will be redeployed to other firms where they can be used optimally, and the redundant workers will find other jobs.<sup>38</sup> Rescue laws are not appropriate to such companies, and any delay in dissolving such

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<sup>35</sup> Mokal, above n.32, at 358.

<sup>36</sup> Ibid; this definition is drawn from the perspective of a purely economic viewpoint. See E Ehlers, "Statutory Corporate Rescue Proceedings in Germany: The Insolvenzplan Procedure" in K Gromek Broc and R Parry (eds), *Corporate Rescue: An Overview of Recent Developments from Selected Countries*, (2<sup>nd</sup> edn, Kluwer Law International, 2006), p151.

<sup>37</sup> Finch, above n.28, p189.

<sup>38</sup> G Lightman, "Voluntary Administration: 'The New Wave or the New Waif in Insolvency Law'" (1994) 2 *Insolvency Law Journal* 59, 62.



companies would incur further loss to creditors and devalue the assets which could play their best use in other firms. This is why it is necessary to emphasize the avoidance of the abusive use of rescue regimes and the establishment of easy and flexible access from rescue regimes to liquidation procedures if a rescue attempt is not successful.<sup>39</sup> Just as one commentator said, “not all lame ducks can, or should be rescued, and the appropriate procedure for the genuinely doomed is immediate liquidation.”<sup>40</sup>

## **2.2 Basic theory of corporate rescue**

### **2.2.1 Definition and ideology**

#### **2.2.1.1 What is “corporate rescue”?**

Corporate rescue aims at providing a ground outside liquidation proceedings for financially ailing but economically viable companies to take a breath by freezing the enforcement of creditors’ claims for a prescribed period and to enable such companies to recover from the temporary cash flow difficulties.<sup>41</sup> Outside insolvency professionals may be involved in the rescue activity and take control over the assets and management of the company, or the existing management of the company may remain in control of the company, either unsupervised or subject to supervision which will be undertaken by an outside insolvency professional who can be appointed by the entitled creditor or court under the terms of relevant legislation.<sup>42</sup> Typically a reorganization plan should be drafted and proposed within a specified period of time for approval after the corporate rescue procedure commences.<sup>43</sup> Whoever controls the company during the rescue period, will be encouraged legitimately to pursue the best return to the company and to act for the interests of all

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<sup>39</sup> Goode, above n.34, para.10.16.

<sup>40</sup> Frisby, above n.6, at 248.

<sup>41</sup> United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law*, 2004, p27.

<sup>42</sup> The World Bank, *Principles for Effective Insolvency and Creditor Rights Systems* (Revised Draft 2005), p24.

<sup>43</sup> Ibid at 43.

the stakeholders.<sup>44</sup>

Corporate rescue regimes provide alternatives to the traditional voluntary and compulsory winding up proceedings, and enrich the bankruptcy legal framework. Even though the concept and nature of corporate rescue culture was obscure three decades ago, it has been accepted worldwide.<sup>45</sup> It is defined as “a major intervention necessary to avert eventual failure of the company”.<sup>46</sup> In order to fully understand this definition, three aspects need to be clarified. Firstly, what is a major intervention? Intervention usually indicates that unpleasant things occur involuntarily. From the standpoint of creditors, whether secured or unsecured creditors, there is an automatic stay on their rights of enforcement under the common rules of rescue laws.<sup>47</sup> In other words, their legitimate rights in other legal structures such as contract and property are suspended legally in rescue regimes. From the perspective of company directors and managers, either they are replaced by an outside insolvency practitioner<sup>48</sup> or their actions are supervised by an outside insolvency practitioner even though they remain in control of the company after the commencement of rescue proceedings.<sup>49</sup> In other words, the existing management will concede the power of control to an outside insolvency professional partly or wholly. In addition, this intervention does not include gradual or incremental changes in the normal business life, but drastic measures taken to change the fundamental structure of the company, the so-called “structural shift”.<sup>50</sup> Furthermore, these drastic measures should be indispensable in a rescue attempt which may involve changes in the management and operational scenarios, part sale of assets for refinancing and

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<sup>44</sup> GD Pont and L Griggs, “A Principled Justification for Business Rescue Laws: A Comparative Perspective (Part II)” (1996) 5 *International Insolvency Review* 47, 51-60.

<sup>45</sup> M Hunter, “The Nature and Functions of a Rescue Culture” [1999] J.B.L. 491.

<sup>46</sup> Belcher, above n.5, p12.

<sup>47</sup> UNCITRAL, above n.41, p28.

<sup>48</sup> This is the so-called “practitioners in possession” (PIP) model. See: V Finch, “Control and Co-ordination in Corporate Rescue” (2005) 25 *Legal Studies* 374, 375.

<sup>49</sup> J Westbrook, “The Control of Wealth in Bankruptcy” (2004) 82 *Texas.L.R.* 795.

<sup>50</sup> Belcher, above n.5, p12.

unemployment of redundant workers.<sup>51</sup>

Secondly, when a company falls into cash-flow distress, it should be placed into a rescue regime in a timely manner. Any delay to access to rescue proceedings will undoubtedly reduce the successful rate of reorganization and rehabilitation. If the financially ailing company has already been subject to winding up procedures, relevant rescue mechanisms should be available for the distressed company to enter into a rescue regime freely and flexibly from winding up procedures.<sup>52</sup> Since the company in this stage is very fragile, urgent turnaround is needed, rather than moderate or gradual recovery.<sup>53</sup> On the one hand, even though there is always a moratorium for the protection of the debtor in rescue proceedings, this protection is temporary and short-term; on the other hand, the progressive or gradual turnaround does not belong to the study of corporate rescue which only focuses on urgent turnaround.<sup>54</sup> Thirdly, it is necessary to consider what is eventual failure? As far as a company is concerned, eventual failure means that this company as a legal entity has reached a stage in which it cannot be rescued, even though the entire or part of the business can be sold as a going concern. In other words, the company cannot avoid liquidation. Therefore, corporate rescue principally aims at avoiding the dissolution of the legal entity rather than merely saving the business which is carried on by the company as a legal person.<sup>55</sup>

### **2.2.1.2 Formulating a corporate rescue culture**

The ideal of corporate rescue is to try every reasonable possibility to rejuvenate the viable company encountering financial trouble rather than to let it “go to the wall

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<sup>51</sup> Finch, above n.28, p188.

<sup>52</sup> Insolvency Act 1986, Sch.B1, paras.37 and 38, to which para.8 is subject. L Sealy and D Milman, *Annotated Guide to the Insolvency Legislation 2006/2007* (9<sup>th</sup> edn, Sweet & Maxwell, London, 2006), Vol 1, p523.

<sup>53</sup> Belcher, above n.5, p12; P Nueno, *Corporate Turnaround: A Practical Guide to Business Survival* (Nichols, 1993), p160.

<sup>54</sup> Belcher, above n.5, p12.

<sup>55</sup> Ibid at 23; Frisby, above n.6, at 248-249. This question will be fully developed subsequently.

unnecessarily”.<sup>56</sup> There are a series of positive outcomes accompanying a successful rescue attempt, including the operation of the business still under the same ownership, preservation of jobs, better results for all the creditors and the avoidance of unnecessary loss and waste to the community as a whole. In order to reach the central objective of rescuing the company as a going concern, it is indispensable to take into account an array of policy aims which lie at the heart of corporate rescue legal frameworks and are always the impetus to reform domestic bankruptcy and rescue laws. First of all, the rescue culture could provide all the stakeholders with necessary incentives. It has been observed that:

“[Under Chapter 11] [s]hareholders, who know they will get peanuts if the firm is wound up, want the firm to keep trading in the hope that it will come good. Creditors, on the other hand, can be damaged every day that the firm trades without a rescue package...Managers have two good motives to avoid a deal with creditors for as long as they can: they keep their jobs longer, and they work for shareholders, who do not want a deal either”.<sup>57</sup>

The availability of corporate rescue regimes is able to change the shareholders’ over-risky opportunism, which would lead to further loss to the creditors. They could still retain control by a successful turnaround. Creditors, as the real owners of the company when it is insolvent, are able to obtain a better return from a successful rehabilitation, which could also provide a benefit for directors and enable employees to keep their jobs. Any delay to the entry into a rescue regime will diminish the possibility of recovery and result in unnecessary loss to every party. In addition, viewed from the other extreme, the risks of reorganization should not be transferred to the creditors unreasonably. The failure of a rescue attempt could pose much more loss than would be effected in an immediate winding up.

In addition, the rules of rescue should be designed to bring all the parties who hold the real interests in the company’s undertaking to the negotiation table. This collective feature has become an indispensable element of insolvency proceedings and is able to promote fairness and justice in rescue structures. Collectivity emphasizes the participation of every stakeholder and restricts the unilateral

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<sup>56</sup> S Leinster, “Policy Aims of the Enterprise Act” (Autumn 2003) *Recovery* 27.

<sup>57</sup> “The kindness of Chapter 11”, *The Economist*, 26 May 1991, at 97.

enforcement of claims amongst creditors.<sup>58</sup> The corporate rescue regimes will reshape the enforcement of security interests and other property rights against the company's undertaking which differ from those in the winding up proceedings.<sup>59</sup> In this regard, the restructuring of property rights and interests will effect the redistribution of bargaining powers and resources in line with the rescue philosophies and relative abilities to bear cost.<sup>60</sup> An effective balance is required to coordinate the bargaining powers of all the players who are cooperators in a rescue attempt, because they have common interests in a successful turnaround. The relationship among them can be described as interdependence of lips and teeth. If the lips are gone, the teeth will be cold.<sup>61</sup> This approach could promote the development of the incentive of collectivity and inhibit individual actions. In addition, all the participants in the rescue institutions are also competitors in the zero-sum situation where satisfaction of some interested group will be at the expense of the others. The making of an efficacious trade-off in the treatment of interested groups under the rescue framework is the key reorganization strategy of balancing the powers of control and coordinating conflicts of interest.<sup>62</sup>

Whether the rescue attempt is under the control of the outside insolvency practitioners or the directors in the debtor-in-possession (DIP) model, they should act

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<sup>58</sup> It should be noted that in the corporate rescue structure of the UK, the pre-packaged administration is an exception of this collective approach. A pre-pack deal of business transfer is normally agreed prior to the administration proceedings and the administrator is entitled to dispose of the company's business before the approval of the creditors' meeting without seeking a court direction. Although the pre-pack deal has become popular in the UK, it may undermine the functions of the creditors' meeting. The insolvency practitioners, banks and directors of financially distressed firms may obtain benefits at the expense of ordinary unsecured creditors. This issue will be developed in s 4.2.7. For more details, see V Finch, "Pre-packaged administrations: bargains in the shadow of insolvency or shadowy bargains" [2006] J.B.L. 568.

<sup>59</sup> Frisby, above n.6, at 250.

<sup>60</sup> Pont and Griggs, above n.44, at 61.

<sup>61</sup> This description comes from an old Chinese saying which can be looked up in G Wu (ed), *Chinese-English Dictionary*, (Shanghai Jiao Tong University Press, Shanghai, 1993), Vol I, p379.

<sup>62</sup> For more details, see V Finch, "Control and Co-ordination in Corporate Rescue" (2005) 25 *Legal Studies* 374.

for the interests of creditors and the debtor as a whole.<sup>63</sup> They are required to take account of whether any party's interest is infringed inappropriately, when making every decision. They are liable to report the process of the reorganization and accept the oversight of the creditors' meeting and the courts, and they are accountable to answer the questions and disagreements of the dissenting creditors and to defend their decisions as legitimate by enough evidence. Such initiatives and strategies are in favour of transparency and accountability. It has been observed that:

“...the time has come to make changes which will tip the balance firmly in favour of collective insolvency proceedings—proceedings in which all creditors participate, under which a duty is owed to all creditors and in which all creditors may look to an office holder for an account of his dealings with the company's assets.”<sup>64</sup>

Another aim which should not be ignored is the issue of efficiency which emphasizes the optimal use of resources without unnecessary loss, the efficacious dynamics of the organizational institutions and the maximal reduction of transaction costs in rescue activities. It is concerned with “achieving desired results with the minimal use of resources and costs and the minimal wastage of effort.”<sup>65</sup>

From the perspective of the entire rescue law structure, it can be observed that a well-functioning rescue legal framework could enable different types of companies with differing sizes to be rescued. The obvious differences, such as the management strategy, employees and turnovers, productivity, the number of creditors and the amount of debts between a one-shareholder private company and a multinational giant may influence their different responses and dynamics towards reorganization proceedings.<sup>66</sup> It has been commented that:

“The current [Bankruptcy] Code is required to handle both the corporate reorganizations of a multi-billion dollar international company and that of the small, rural grocery store. Trying to

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<sup>63</sup> For more knowledge of DIP model, see G McCormack, “Control and corporate rescue – an Anglo-American evaluation” (2007) 56 I.C.L.Q. 515.

<sup>64</sup> *Productivity and Enterprise: Insolvency—A Second Chance* Cm 5234 (London: HMSO, 2001), para.2.5.

<sup>65</sup> Finch, above n.28, p53; for further understanding of “efficiency”, see R Mokal, “On Fairness and Efficiency” (2003) 66 M.L.R. 452.

<sup>66</sup> Pont and Griggs, above n.44, at 71-72.

make the same set of laws apply to vastly different corporate enterprises has created problems and inefficiencies in the handling of individual bankruptcy cases.<sup>67</sup>

However, many countries still persist in rescuing distressed companies in a formal single rescue regime, such as the US Chapter 11, the Australian Part 5.3 A of the Corporations Law and the Canadian Bankruptcy and Insolvency Act 1992, while comparatively the UK has set a good example of multiple rescue regimes. For example, small financially struggling firms which are eligible could apply for and benefit from a company voluntary arrangement.<sup>68</sup> In addition, the schemes of arrangement under Part 26 of the Companies Act 2006 can be used as an effective approach for the restructuring of large public companies, whether they are solvent or insolvent.<sup>69</sup> It has also provided a rescue vehicle for the reorganization of distressed insurance companies in the circumstances where the administration regime was unavailable to them, especially before the Financial Services and Markets Act 2000 became effective.<sup>70</sup> The administration regime can be initiated by either the out of court appointment which can be made by an entitled appointer or the court order under application. It should be noted that this analysis does not fragment the whole corporate rescue system of the UK. All financially distressed companies can petition for administration including small eligible firms.<sup>71</sup> The company which has been put in administration is allowed to apply for CVAs and schemes of arrangement.

### **2.2.1.3 To rescue the business or the company?**

There is an argument about whether the company or the business of the company should be rescued. Obviously, a company is a legal entity which carries the business

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<sup>67</sup> American Bankruptcy Institute, Press Release, 19 November 1991, as referred to in G Pont and L Griggs, above n 39, p72.

<sup>68</sup> NR Pandit, GA Cook, D Milman and FC Chittenden, "Corporate rescue: Empirical evidence on company voluntary arrangements and small firms" (2000) 7 *Journal of Small Business and Enterprise Development* 241; especially after the Insolvency Act 2000 came into force, the small eligible firms could enjoy a short term moratorium.

<sup>69</sup> For more details, see R Parry, *Corporate Rescue* (Sweet & Maxwell, London, 2008), para.17-01; J Townsend, "Schemes of Arrangement and the Asbestos Litigation: In *Re Cape Plc*" (2007) 70 *MLR* 837.

<sup>70</sup> *Re Osiris Insurance Ltd* [1999] 1 BCLC 182; *Re Hawk Insurance* [2001] BCC 57; D. Milman, "Schemes of Arrangement: Their Continuing Role" [2001] *Insolv. L.* 145.

<sup>71</sup> For more details about administration regime, see R Mokal, *Corporate Insolvency Law: Theory and Application* (OUP, Oxford, 2005), p225.

that is constituted by its productive assets and human resources. All the economic activities are created and accomplished by the actual business rather than the company which is only an “artificial person”. Without the operational and practical business, the company is merely a shell which cannot create any economic value. If the company is wound up, its business can be sold as a going concern to another legal entity. The business could continue to trade and play its role with the same production line and work force under a new ownership. This is the so-called “corporate recycling” which highlights redeployment of the productive part of the company and the avoidance of splitting apart cohesive assets by piecemeal sale, from the perspective of optimal use of resources regardless of the survival of the legal entity.<sup>72</sup> It has been indicated from the perspective of the British corporate insolvency law practice that the entire or partial sale of a business as a going concern is common.<sup>73</sup>

It is necessary to distinguish corporate rescue and business rescue in order to avoid conceptual confusion and ambiguity.<sup>74</sup> Some commentators argue that corporate rescue literally involves the implication of rehabilitation of the legal entity to a healthy state as well as its business, which is called “pure rescue”.<sup>75</sup> It has been observed that

“In my opinion the true meaning of a company rescue is the saving of an entity in whole or in part by satisfying in some measure its unsecured creditors and enabling the company to continue in business. This will also in some measure preserve employment.”<sup>76</sup>

This approach could enable the entire or substantial business of a corporate entity to continue to create its value by the same employees on their familiar production line or working unit under the same ownership. An advantage of this approach is that it is in favour of stabilizing the emotion of the employees who will not be influenced by

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<sup>72</sup> Frisby, above n.6, at 249.

<sup>73</sup> The Association of Business Recovery Professionals (R3), *Corporate Insolvency in the UK: A Decade of Change* (2002), p20.

<sup>74</sup> Mokal, above n.32, at 361.

<sup>75</sup> Frisby, above n.6, at 248.

<sup>76</sup> N Davis, “The Rescue Culture in the United Kingdom” (1997) 2 *Insolvency Litigation and Practice* 1, 3-4.



the panic of mergers or acquisitions which usually arise upon a change of owners and entrepreneurial culture. It could encourage the employees to consolidate together to assist the company to overcome the financial troubles in a desperate fight, which is an important factor of a successful corporate rescue attempt that should not be neglected.<sup>77</sup> In addition, corporate rescue laws pay attention to the always forgotten class, the company's shareholders, and provide directors with incentives to take action when the company falls into trouble at an early stage.<sup>78</sup> It should be noted that Chinese rescue laws do not require proof of the actual insolvency of the company before the rescue regime can be invoked.<sup>79</sup> Similarly, there is no such requirement in schemes of arrangement under Part 26 of the Companies Act 2006<sup>80</sup>, CVAs and the out-of-court appointment of administration by a qualifying floating charge holder.<sup>81</sup> That means the rescue proceedings open the door to solvent companies in which the shareholders have real interests that can be recognized by rescue procedures. Particularly in private companies, shareholders in most cases are also the directors. They tend to have the incentive to take over-risky activities to turn the business around when the company is in financial difficulties. This may incur further loss at the expense of the interests of creditors and cause the abuse of limited liability because the shareholders' liability is limited to the amount of capital which they have contributed or have agreed to contribute to the company.<sup>82</sup> Corporate rescue laws provide a ground to the shareholders who may consider reorganizing their ailing company and seek assistance at an early stage for their own benefit. Similarly,

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<sup>77</sup> Especially in China, there may be several generations of a family working in the same state-owned enterprise. They had strong feelings towards the enterprise, and they even treated the enterprise as a big family, which discharged the social security functions for the employees in the last century. For more details, see A Tang, above n 4, para.3.22.

<sup>78</sup> Mokal, above n.32, at 362-363.

<sup>79</sup> There is no such statutory requirement on the entry into administration in the Insolvency Act 1986 Sch B1, and similarly in China according to article 2 of the newly promulgated bankruptcy law, it can be concluded that the solvent company can be put into the reorganization regime if it is demonstrated that there is an obvious possibility of the debtor to lose the ability to pay off all the debts. See R Parry and H Zhang, "China's New Corporate Rescue Laws: Perspectives and Principles" (2008) 8 JCLS 113, 127.

<sup>80</sup> This section has been replaced by the Part 26 of Companies Act 2006.

<sup>81</sup> IA 1986, Sch.B1, para.14.

<sup>82</sup> Davies, above n.2, p176.

directors and managers could also benefit from a successful rescue attempt. They are able to retain control over the company if it can be revitalized. It has therefore been observed that rescuing the company could encourage directors and managers, who are the most likely persons to sense the danger of financial difficulties in the first place, and to initiate a rescue regime in timely fashion. By comparison, rescuing the company's business as a going concern or a takeover of the company can not necessarily save their directorships and managing positions in the new ownership.<sup>83</sup> It should be noted that in the UK revamped administration regime, company rescue is treated as the primary objective in the hierarchy of statutory purposes.<sup>84</sup> However, in practice, rescuing company as a going concern is rare.<sup>85</sup>

#### **2.2.1.4 What constitutes a successful rescue attempt?**

A problem in relation to the definition of corporate rescue is to what extent a rescue attempt can be deemed as successful? This question involves the extent of a successful rescue that can be reasonably achieved. A complete successful corporate rescue means that a company can be restored to its former healthy state. All the employees retain their jobs, and the entire assets and business activities are under the control of the same management following a completely successful rescue. However, in practice, this ideal outcome is unlikely to be pursued. According to the definition of corporate rescue, drastic actions will be taken at the time of crisis to involve the management, operational scenarios, new financing, disposal of assets and the size of workforce. For instance, new equity investors may inject capital and accordingly change the ownership structure. The interests of the previous shareholders may

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<sup>83</sup> Mokal, above n.32, at 362.

<sup>84</sup> IA 1986, Sch B1, para.3(1); Sealy and Milman, above n.52, p503-504; J Goldring and M Phillips, "Rescue and Reconstruction" (2002) 15 *Insolv. Int.* 75, 76. It was argued that saving the company as the primary purpose of administration was chosen deliberately to incentivise directors. It was observed that "if the objective of administration were to rescue the company's business rather than the company itself, frankly there would be little incentive for directors of the company to enter into administration, which is one of the intentions of the [Act]." See HC Standing Committee B, 9 May 2002, col.549. For more details, see s 4.2.3

<sup>85</sup> J Armour, A Hsu and A Walters, *The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings*, A Report Prepared for the Insolvency Service in December 2006, p22.

reduce to nothing. The management team may be changed and the directorship of some directors may be terminated. The company may be downsized and accordingly some employees may lose their jobs. From a perspective of a particular position, some parties are likely to be winners and some parties may be losers in the process of rescue.<sup>86</sup> Any rescue activity will inevitably incur a loss to some interested parties or to the company itself.<sup>87</sup> Therefore, it has been observed that “all rescues can be seen as, in some sense, partial.”<sup>88</sup>

In addition, it is necessary to understand the importance of a reasonable time scale which can be employed to assess the failure or success of a rescue attempt.<sup>89</sup> The circumstance, in which a financially troubled company, revitalized after a rescue attempt, falls into difficulties again in a short-term, cannot be deemed as a successful rescue. Prof Zimmerman emphasized that “the endurance of the recovery should also be considered in determining whether success or failure has been achieved.”<sup>90</sup> A successful rescue can be assessed by two goals: stability and sustainability. Stability points out the survival of the company and its business activities in a reasonable term. Sustainability means that the economic activities could last for a long term. In other words, rescue efforts should produce stable and sustained results.<sup>91</sup> There may be cases, however, where a short period of survival yields economic benefits. For example, a financially ailing company is rehabilitated by a rescue attempt, but does not subsequently last long before it is eventually liquidated. It cannot be treated as a failure because the short period of continued trading may result in a better outcome for creditors than would have been possible if the company had been immediately liquidated.

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<sup>86</sup> Finch, above n.28, p188.

<sup>87</sup> UNCITRAL, above n.41, p27-28.

<sup>88</sup> Belcher, above n.5, p23.

<sup>89</sup> Finch, above n.28, p188.

<sup>90</sup> FM Zimmerman, *The Turnaround Experience: Real-world Lessons in Revitalizing Corporations* (McGraw Hill Inc, 1991), p48.

<sup>91</sup> Belcher, above n.5, p23.

## 2.2.2 Crucial elements to a corporate rescue activity

### 2.2.2.1 Moratorium

The term “moratorium” describes an automatic stay on the enforcement of creditors’ claims against a company and its assets. Normally it also has a freezing effect on other parties who hold property rights to assets which are under the possession of the debtor legally, such as those under a lease, or another commercial contract that does not entail an exchange of ownership. In addition, all ongoing civil litigation and the execution of legal proceedings against the debtor’s property are suspended. It aims to provide a breathing space for the debtor to avoid unilateral claims against its property which could be still under the debtor’s control for continued trading. The introduction of a moratorium can redress bargaining powers of every interested party and concomitantly the redistribution of resources.<sup>92</sup> Thus “the only effective and efficient way of influencing creditor behaviour was through the imposition of the mechanism which denies creditors other alternative choices of conduct.”<sup>93</sup> A moratorium could enable a financially distressed company to take a short breath and recover from the temporary cash flow problem, negotiate with creditors for debt restructuring, seek new financing and keep its assets away from the debt enforcement.<sup>94</sup> The protected assets and new financing will be indispensable capital for the intended rescue attempt. It is observed that a moratorium introduces a debtor-oriented mechanism, which is also enjoyed by the unsecured creditors who hold weak bargaining power and normally have a low rate of repayment in bankruptcy proceedings, because the moratorium prevents powerful creditors from dismembering the company’s estate through their enforcement efforts. It may be argued that a moratorium might bring about a negative effect on the unsecured creditors because they are disabled from enforcing their claims in a specified period. It is noteworthy that the unsecured creditors are usually ranked at the last position in the distributional order and the whole or substantial parts of assets of a company may

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<sup>92</sup> Pont and Griggs, above n.44, at 67.

<sup>93</sup> Ibid

<sup>94</sup> UNCITRAL, above n.41, p27.

be subject to security. The petition of unsecured creditors could cause the initiation of bankruptcy proceedings in which they may gain little or nothing. To some degree, the imposition of a moratorium may not be detrimental to the real interests of the unsecured creditors, and such creditors do not need to worry that they will lose any more. From the perspectives of the creditors, especially the secured creditors, a moratorium undoubtedly may increase the risks of further loss. The longer the stay lasts, the greater risks that the creditors have to bear.<sup>95</sup> Therefore, the legislative initiatives of imposing a moratorium need to convince the creditors from two aspects. Firstly, the corporate rescue-oriented value is held as the number one priority which could benefit all the stakeholders and the general public interests. Secondly, there is a reasonable prospect that the creditors could at least receive as much in the reorganization after the moratorium as they would in liquidation. It can be concluded that the rationale of a moratorium is to sacrifice the immediate and partial repayment of creditors for the long term objective of corporate turnaround and a high rate of recovery to creditors. The interests of a few parties, especially the secured creditors who hold strong power, may need to suffer from the freezing on their claims in order to achieve a better outcome for all the stakeholders than that might be effected in an immediate liquidation.<sup>96</sup> Legislatively, care should be taken in designing a moratorium in rescue laws, especially the entrance and length, in order to avoid the abuse.

#### **2.2.2.2 New finance**

New financing is always a crucial element and a big challenge to the success of a rescue attempt in respect of a financially ailing company which is suffering cash-flow problems. After the corporate rescue procedures commence, the financially troubled debtor must have access to enable it to obtain sufficient funds for continued trading, the income from which could enable the debtor to pay the debts of existing

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<sup>95</sup> Pont and Griggs, above n.44, at 67.

<sup>96</sup> D Milman, "Moratoria on enforcement rights: revisiting corporate rescue" [2004] *Conveyancer and Property Law* 89, 90.

creditors, to obtain the indispensable supplies of goods and services, and to spend other necessary expenses in order to maintain the continued operation of debtor and its business activities.<sup>97</sup> It is desirable for a company which is in financial distress to obtain new money at an early stage, especially prior to the commencement of formal rescue proceedings, because the company is able to get recovery from its temporary liquidity difficulties swiftly. In addition, the availability of new finance is crucial for the approval of a reorganization plan.<sup>98</sup> In order to obtain new finance for a rescue attempt, corporate rescue laws should provide the debtor with some options which could enable the debtor to negotiate with potential lenders; otherwise, the lenders are unwilling to advance a loan. That is because when a company is in actual or impending insolvency, in most cases there will be no surplus, or not enough, assets which can be used to provide security for further borrowing. The banks and other financiers are reluctant to take risks to lend in the unsecured or under-secured situations where the full repayment will fully depend on the successful turnaround of the borrower.<sup>99</sup>

New financing in post-commencement has been recognized as a crucial factor for a rescue attempt by insolvency law reforms, which may consider conferring priority or providing security to encourage a lender to advance new funds. Priority can be created to attract new financing of a lender who will rank in priority to the existing creditors. It should be noted that the scope of power and the extent of priority which can be offered to the lender should be taken into account according to the specific situations of different jurisdictions, because the establishment of priority will have a significant impact on the rights of existing creditors, and the balance between the new lender and existing creditors. In the circumstances where the debtor does not have assets available to provide a security for new borrowing, priority becomes an effective option. The lender who advances money in post-commencement can be

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<sup>97</sup> S Davies QC (ed), *Insolvency and the Enterprise Act 2002* (Jordans, Bristol, 2003), p21.

<sup>98</sup> UNCITRAL, above n.41, p114.

<sup>99</sup> *A Review of Company Rescue and Business Reconstruction Mechanisms*, The Insolvency Service, (London: HMSO, 1999), paras.6(t)-6(v).

conferred a super-priority status which means that the lender will be ranked at the top of the distribution order prior to any existing creditors. There is no doubt that the new lenders bear the biggest risk in the period of reorganization, therefore, they should deserve distribution prior to the other claimants.<sup>100</sup> It is submitted that the introduction of super-priority for such lenders has the effect of reshaping the map of redistribution, which should arguably be in line with the policy aims of rescue and ensure the legitimate interests of every party to be treated carefully. For instance, in the US the new lender could not obtain priority to an existing security interest unless the debtor and the new lender could show that the existing security interest is sufficiently protected.<sup>101</sup> However, it is important to note that the UK government has rejected the super-priority financing proposal which was proposed to the House of Lords for discussion, and in China the newly enacted bankruptcy law is also silent to the super-priority financing approach.<sup>102</sup>

In addition to granting priority, another approach which could encourage the lender to advance new funds is to provide security on the unencumbered assets or encumbered assets which still have sufficient value in excess of the amount of the pre-commencement secured obligation. In other words, if there are surplus assets available or sufficient value left in the property even though this property has already been subject to a security, there will be no need for super-priority financing. In this circumstance, the pre-existing secured creditors will not be concerned with their rights to the collateral unless the economic value of the collateral begins to diminish

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<sup>100</sup> Davies, above n.97, p20-25; V Finch, “Re-invigorating Corporate Rescue” [2003] J.B.L. 527, 538.

<sup>101</sup> S 364 (d) of the US Bankruptcy Code; G McCormack, “Super-priority new financing and corporate rescue” [2007] J.B.L. 702, 707.

<sup>102</sup> It can be found that England ever took a conditional attitude to the institution of super-priority financing. It agreed that the new lenders should enjoy the priority to the old creditors, but this new credit should not override the secured creditors. *A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group*, The Insolvency Service (London: HMSO 2000), para.118. For a comparative analysis of post commencement financing between the UK and US, see L Qi, “Availability of continuing financing in corporate reorganizations: the UK and US perspective” (2008) 29 Comp. Law. 162.

in the process of reorganization.<sup>103</sup> Providing security for new lending may not have an adverse influence on the rights of pre-existing secured creditors, but it may increase the exposure to unsecured creditors. The more the remaining unencumbered assets are used to provide security, the less they will be available for distribution to unsecured creditors especially if the rescue attempt fails.<sup>104</sup>

It should be noted that in most instances, when a company is in financial trouble, there will be no unencumbered assets available for further borrowing. It is important to consider whether or not an insolvency practitioner, who is in charge of a rescue attempt, should have the right to dispose of the encumbered assets in order to maintain the continued operation of the debtor. In the UK, the valuable assets which are covered by a floating charge can be employed by the administrator to borrow extra money regardless of the opposition of the floating charge holder in the administration regime.<sup>105</sup> In contrast, if the assets are subject to a fixed charge, they cannot be disposed without the court's approval.<sup>106</sup> Therefore, the fixed charge holder enjoys a higher level of confidence in the insolvency proceedings and greater level of control over the value of the security assets.<sup>107</sup> In this sense, the greater the proportion of assets subject to fixed charges, the less financing will be available to the company, because the lenders are reluctant to advance money against encumbered assets covered by fixed charges.<sup>108</sup>

In addition, in terms of new finance, it is always significant and useful for the firms to formulate a good relationship with banks which could make as enormous contribution to corporate rescue as they have in England. The British Bankers

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<sup>103</sup> UNCITRAL, above n.41, p116.

<sup>104</sup> Ibid at 115.

<sup>105</sup> IA 1986, Sch B1, para. 70 (1).

<sup>106</sup> IA 1986, Sch B1, para. 71 (1)

<sup>107</sup> R Parry, "Floating Charge Over Book Debts" (2005) 16 KCLJ 347.

<sup>108</sup> Ibid at 348; Note that the decision of *Spectrum* had a great influence on the distinction and characterization of a charge as fixed or floating. See *Re Spectrum Plus Ltd* [2005] UKHL 41; L Gullifer and J Payne, "The Characterization of Fixed and Floating Charges", in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (OUP, Oxford, 2006), p51.



Association issued a paper in 1997 which emphasized the importance of effective cooperation between the banks and their customers and encouraged the bankers to provide financial support to help their distressed customers to survive the financial difficulties towards an ideal rescue structure.<sup>109</sup> It is evident that banks have made a great contribution to assist financially troubled companies out of formal insolvency proceedings.<sup>110</sup>

## **2.3 Functional transformation of corporate insolvency law**

### **2.3.1 Historical evolution of rescue-oriented mechanisms**

When reviewing the historical development of corporate insolvency legislation from an international perspective, it could be readily found that the creation of corporate rescue regimes was closely linked to the high prosperity of the market economy in the Western world. It is well-known that the market-oriented mechanisms push forwards increasingly drastic competition, which would lead to the eventual failure and dissolution of some competitors, and the survival and continuous trading of the others in the routine life of business. In contrast, the insolvent liquidation could undoubtedly give rise to negative effects economically and socially. For instance, one failed enterprise could result in the financial trouble of tightly associated enterprises, especially small businesses, such as customers and suppliers. In addition, serious social issues may be posed by large-scale redundancies of workers, who would increase the burden of social security, and potentially threaten stability through protests or crimes which could invoke political crisis and social chaos. Particularly, when a financial crisis breaks out, the spontaneous functions of regulation and adjustment of the market by the invisible hand will malfunction. In these circumstances, an unexpected scale of enterprises falling into financial distress

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<sup>109</sup> Hunter, above n.45, at 507-508; the British Bankers Association (BBA), “Banks and Businesses: Working Together When You Borrow”, March 1997; “A Statement of Principles—Banks and Businesses Working Together to Manage Borrowing”, July 2005.

<sup>110</sup> S Frisby, *Report on Insolvency Outcomes*, presented to the Insolvency Service in August 2006, p21-22.

simultaneously may exceed a level at which the market can adjust and redeploy, and bring about unanticipated loss which the state cannot afford.

Obviously, the traditional corporate insolvency laws, which merely discharged the function of liquidation before the mid-19<sup>th</sup> century, failed to settle the financial difficulties and rejuvenate the corporate entity and its business as well. However in 1870 the Victorian legislation in England,<sup>111</sup> and at nearly the same time in 1883 the Belgian legislation, introduced an innovative non-liquidation regime. It broke through the monopoly of the liquidation regime over corporate insolvency proceedings; and allowed the debtor company to renegotiate the terms of contracts with its creditors and to formulate new arrangements, with low oversight by the judiciary under the composition proceedings, in line with the principles of creditors' autonomy and contractual liberty.<sup>112</sup> This approach, which was contributed to by both English and Belgian reformers, was the so-called "Anglo-Belgian" model.<sup>113</sup> This innovative composition regime introduced rescue-oriented mechanisms which promoted the formation of a debtor self-restructuring alternative outside the traditional winding up proceedings for troubled companies to settle their crises and bring a better result for creditors. The focus of bankruptcy laws has been gradually shifting from pure liquidation to a rescue culture since then. The Anglo-Belgian model set a good example for both the Anglo-Saxon and Continental systems, and some countries still use this regime as one of their bankruptcy law procedures at present, such as the British schemes of arrangement under the Part 26 of the Companies Act 2006<sup>114</sup> and the Italian insolvency reforms to its new composition

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<sup>111</sup> The Joint Stock Companies Act 1870 could "facilitate compromises and arrangements between creditors and shareholders of Joint Stock and other Companies in Liquidation". See the Public General Statutes, passed in the 33-34 years of the Reign of her Majesty, Queen Victoria, 1870, p682.

<sup>112</sup> Jérôme Sgard, "Bankruptcy Law, Creditors' Rights and Contractual Exchange in Europe, 1808-1914", Paper presented at the CEPR 'Past, Present, and Policy' on 'International Financial Integration' Vienna, 30 Sep—1 Oct 2005, p11.

<sup>113</sup> Ibid; it should be noted that this model dominated Europe, where ten countries adopted this approach in the late 19<sup>th</sup> century or the early 20<sup>th</sup> century, namely England, Belgium, Spain, France, Switzerland, Portugal, Italy, Russia and Denmark.

<sup>114</sup> D Milman, "Schemes of Arrangement: Their Continuing Role" [2001] *Insol. L.* 145,

with creditors in 2005.<sup>115</sup>

### 2.3.2 Origin and development of modern corporate rescue culture

It can be found that the well-established Anglo-Belgian composition proceedings had far-reaching influence on the development of corporate rescue laws. To some degree, it implied the inter-borrowing and incorporation of the two legal families in the field of bankruptcy laws. However, the traditional composition regime could not play an efficient role in rescuing distressed companies to the extent that the modern rescue proceedings are doing. The rescue-oriented mechanisms of the composition regime were very weak and fragile. Sometimes, these procedures were used by the debtor and creditors as the tools to enable compromises and arrangements for debts repayment to be reached rather than attempts to rescue the company and reconstruct its business. Therefore, the traditional composition proceedings could not represent the real meaning of corporate rescue culture, but they demonstrated a significant transition from the old, single-function bankruptcy legal framework to the era of the modern corporate rescue culture and twin-track bankruptcy legal structure.

The modern corporate rescue culture was first established by the US Chapter 11 in 1978. Historically, America suffered a great economic depression during its most influential economic crisis which broke out in October 1929 and then engulfed the entire capitalist world. The huge business failure and long term recession of the corporate sector demonstrated the weakness of the existing corporate rescue approaches and called for reforms to its bankruptcy laws. In this context, the well-known s 77B of the Bankruptcy Act came out in 1934.<sup>116</sup> Even though it was replaced by the Chapters X and XI of the Chandler Act of 1938 in the short term, it made great contributions to the rationales of the modern Chapter 11. Because of the ineffectiveness and inadequacies in the 1938 Act, there was a strong need for

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<sup>115</sup> Jorio, above n.36, p241-255.

<sup>116</sup> J Weiner, "Corporate Reorganization: Section 77B of the Bankruptcy Act 1934" (1934) 34 Colum L Rev. 1173.

recasting of its bankruptcy laws and redrafting of its rescue laws in the 1970s.<sup>117</sup> In this context, the Chapter 11 “Reorganization” was born and it set a good model for other jurisdictions, especially the Western European states at the beginning stage of the flood of national bankruptcy law reforms, such as in the UK, Germany and France, which introduced reforms in response to the oil shocks in the 1970s.<sup>118</sup> Since then, the wave of corporate rescue permeated a wide range of countries, whether industrialized or developing, of every continent and from different legal families. Particularly in recent years, the rate of reform has reached the highest level by far since the Asian Financial Crisis broke out in 1997, and the modern corporate rescue culture has been eventually established worldwide.<sup>119</sup>

The US reorganization procedure has four notable features. Firstly, there is an automatic stay on the creditors’ enforcement against the debtor and its property. The debtor can take a breath from the temporary cash flow difficulty, restructure debts, arrange its business affairs, seek new financing and produce a reorganization plan in this protection period. Secondly, there is no requirement that the debtor is actually insolvent or likely to become insolvent before the reorganization procedures can be triggered.<sup>120</sup> This facilitates easy and quick access to rescue procedures which could prevent the further deterioration of the financial status and cure the sickness at an early stage. Thirdly, the directors could remain in control over the management of the company under the DIP model which could be in favour of financing the company rescue and business reconstruction, and could encourage directors to initiate rescue

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<sup>117</sup> Lewis, above n.36, p336-338; I Domowitz and E Tamer, “Two Hundred Years of Bankruptcy: A Tale of Legislation and Economic Fluctuation”, IPR Working Paper 97-25, Institute for Policy Research at Northwestern University.

<sup>118</sup> See P Omar, “Reforms to the Framework of Insolvency Law and Practice in France: 1996-2006” and E Ehlers, “Statutory Corporate Rescue Proceedings in Germany: The Insolvenzplan Procedure”; in Gromek Broc and Parry (eds), above n.36, Chap.6 and 7.

<sup>119</sup> The 1997 crisis exposed the deficiencies and inefficiencies in many countries’ bankruptcy legal frameworks which largely promoted the reforms to their domestic bankruptcy laws and the need of a powerful corporate rescue system against the financial distress of corporate sector. See: B Eichengreen, *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*, (Institute for International Economics Washington, D.C. 1999), p28-30.

<sup>120</sup> McCormack, above n.63, at 517.

procedures in a timely manner without the fear of losing their directorships in the process of reorganization.<sup>121</sup> Fourthly, creditors in respect of debtor are classified into different voting groups according to the nature and interests of their claims, and a successful reorganization plan needs the approval of every voting class which can be reached by majority in number, and two-thirds in value of claims. If a reorganization plan is rejected by a majority of creditors in a voting class, the judges have a wide discretion to approve the plan by an extraordinary power which is called “cram down”. The judges are required to take account of the interests of dissenting creditors and ensure that the affected parties are treated fairly and reasonably. For example, the dissenting secured creditors might be crammed down if they can realize their claims from the proceeds of collateral.<sup>122</sup> Fundamentally, the judges shall consider whether the objecting creditors can get recovery under the reorganization plan at least as much as they would in liquidation proceedings.<sup>123</sup> After a reorganization plan is approved by creditors and confirmed by the court, it will have a binding effect on the debtor and all the creditors who are entitled to vote, including dissentients. Fundamentally, this rescue-oriented approach marks the era of company rescue in its true meaning and represents the modern corporate rescue culture. It has had a far-reaching influence on the insolvency law reforms of a wide range of jurisdictions, such as the UK, France, Germany, Italy, China, etc.

## Concluding remarks

Both bankruptcy and corporate rescue laws are established upon private property rights which structure the foundation of the market economy. The bargaining powers are determined by what property rights the participants hold in respect of the company’s property and undertakings in the bankruptcy proceedings. While, in

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<sup>121</sup> D Skeel, “The Past, Present and Future of Debtor-In-Possession Financing” (2004) 25 Cardozo L. Rev. 1905; D Hahn, “Concentrated ownership and control of corporate reorganizations” (2004) 4 JCLS 117, 123.

<sup>122</sup> J Friedman, “What courts do to secured creditors in Chapter 11 cram down” (1993) 14 Cardozo L. Rev. 1495.

<sup>123</sup> McCormack, above n.63, at 518.

rescue proceedings the bargaining powers of all the interested parties will be reshaped according to their property rights to the company's assets and different value-orientations. The exploration of corporate failure could be in favour of distinguishing which companies can be put into rescue regimes and which cannot, because not every distressed company can be rescued. From the perspectives of risk-bearing and optimal use of resources, it is concluded that corporate rescue regimes cannot benefit all distressed companies.

From the history of a global perspective, rescue-oriented mechanisms were first introduced by the Anglo-Belgian composition proceedings in the late 19<sup>th</sup> century providing a voluntary debt restructuring framework for the ailing company to settle its financial difficulties. Since then the function of insolvency laws has transformed from the traditional single liquidation proceedings to a twin-track bankruptcy legal framework. However, the promulgation of the US Chapter 11 eventually marked the establishment of the modern corporate rescue culture, and it had a remarkable influence on insolvency law reforms in a wide range of jurisdictions which highlighted the institutions and policy aims of the US reorganization regime, and referred to the principles and guidelines provided by the World Bank and UNCITRAL as well. In contrast to China, the UK has established an effective corporate rescue legal framework. It would be naive to simply transplant institutions of corporate rescue laws from the UK to China because of the fundamental differences of contextual factors between two nations. Therefore, it is necessary to identify the background issues of two jurisdictions prior to exploring their corporate rescue laws and policies.

## **Chapter III: Identifying the contextual factors and historical development of the English and Chinese corporate insolvency and rescue law systems**

“Law cannot be understood without understanding the society governed by it, and in ignorance of patterns of behaviour, of thought and of feeling among the members of that society”—from *Traité élémentaire de droit civil comparé*, Paris, LGDJ 1950, p17 (translated by Nick Foster)

### **Introduction**

The formulation of law is on the basis of various societal factors, and on the reverse the law regulates the society, the patterns of thought and behaviour of the citizens. The understanding of law requires more than the mere consideration of statutes and judicial decisions. It involves the knowledge of broad legal history, culture, political and economic issues and so on, which largely determine the process of legal construction.<sup>1</sup> It should be noted that between law and society exists a dynamic relationship of action and reaction which interacts and promotes the progress of society and gradual perfection of legislation. When doing a comparative analysis between two countries, especially two countries with two different legal systems, it is necessary not only to examine the different legal approaches and solutions to similar problems, but also to explore the differing contextual factors underlying their societies which could help further understand the similarities and differences of legal rules, find out what reasons cause the similarities and differences, and eventually achieve a successful borrowing of ideas between two countries, or some other useful conclusion. Consequently, this chapter aims to identify the background issues which are closely related to corporate insolvency and rescue laws in the English and Chinese legal frameworks before fully examining the detailed legal rules.

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<sup>1</sup> M Hoecke and M Warrington, “Legal Cultures, Legal Paradigms and Legal Doctrine: Towards a New Model for Comparative Law” (1998) 47 *International and Comparative Law Quarterly* 495, 496.

First of all, this chapter focuses on the differing cultures and underlying ideologies which could explain why there was no effective bankruptcy law legislation and judicial practice in China's long history prior to the economic reform in 1978. Different ideologies and attitudes towards the role and status of law determine that England and China have shaped their bankruptcy and corporate rescue laws in different ways. On the basis of the articulation of cultures, ideologies and people's mindset of thoughts, this chapter then discusses the historical development of bankruptcy and corporate rescue laws of both countries. The British corporate rescue culture is built upon a well developed corporate insolvency legal framework and a free market economy that has existed for hundreds of years. Comparatively in China, the bankruptcy law reforms are on the basis of the market-oriented reform and economic transition from a highly centralized planned economy to a socialist market economy. Thus, it is necessary to pay attention to the Chinese unique economic reform which is conducive to further understanding the legislative progress of bankruptcy law and eventual achievement of corporate rescue rules in the new Enterprise Bankruptcy Law which was promulgated in August 2006.<sup>2</sup>

### **3.1 Different cultures and ideologies**

#### **3.1.1 Legal cultures and ideologies regarding the role of law**

The legal culture is defined as "a specific way in which values, practice, and concepts are integrated into the operation of legal institutions and the interpretation of legal texts".<sup>3</sup> Differing legal cultures determine divergent ideologies and people's patterns of thought. Specific legal culture and custom may cause the establishment of unique political regimes, legal structures, economic patterns and social communities. The most important aspect of legal culture is that it largely affects people's mindsets and their attitudes to the role and status of law. The deep exploration of the British

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<sup>2</sup> For some details of the new law, see C Booth, "The 2006 PRC Enterprise Bankruptcy Law: The Wait Is Finally Over" (2008) 20 SAclJ 275. An unofficial translation is available at: <http://www.lehmanlaw.com/resource-centre/laws-and-regulations/company/the-enterprise-bankruptcy-law-of-the-peoples-republic-of-china.html> (last visit on 31 August 2008)

<sup>3</sup> See J Bell, "English Law and French Law—Not So Different?" (1995) C.L.P. 69, 70.



and Chinese legal cultures and differing ideologies is a necessary precondition to gaining a full understanding of the origin, evolution and development of bankruptcy legal rules and different attitudes of people towards the legal institutions of bankruptcy and corporate rescue.

### *In the UK*

It is noteworthy that individualism is one of the most remarkable characteristics of the British legal culture which to some extent could represent the entire Western legal culture.<sup>4</sup> Individualism emphasizes the conception of individual liberty and autonomy which “is diametrically opposed to the notion of collectivism, or the idea of the submission of the individual to the community”.<sup>5</sup> However, it does not necessarily mean that the individual liberty is absolutely superior. When personal interests conflict with the community life, the individuals need to be subordinate to the community, because the individuals cannot live and develop in the vacuum.<sup>6</sup> The deep-rooted mindset of individual autonomy paves the way for the establishment of two principal legal institutions, namely private property rights and the liberty of contract, which largely encourages the free exchange of property on the basis of market forces and promotes the building of a free market economy which is hostile towards the government’s interference.<sup>7</sup> Although the British government has intervened in economic activities in a variety of ways, it has also played a primary role in safeguarding private ownership and the order of society, and resolving disputes between individuals. Another potential aspect of autonomy is legal autonomy which emphasizes that law is the principal form of dispute resolution between individuals.<sup>8</sup> This legal thought reflects the people’s attitude towards the role and status of law which is placed in the highest position and pushes the UK to

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<sup>4</sup> Hoecke and Warrington, above n.1, at 503.

<sup>5</sup> Ibid. For a discussion about the concept of community, see R Cotterrell, *Law, Culture and Society: Legal Ideas in the Mirror of Social Theory* (Ashgate, 2006), p65.

<sup>6</sup> Ibid.

<sup>7</sup> K Ong and CR Baxter, “A Comparative Study of the Fundamental Elements of Chinese and English Company Law” (1999) 48 Int’l & Comp. L. Q. 88, 94.

<sup>8</sup> Hoecke and M Warrington, above n.1, at 503.

become a rule of law country. The institution of bankruptcy is built upon private property, and as an outcome of individualism, it can be easily understood and accepted by the English people. The transaction of private property, liberty of contract and a free market economy gave rise to the growth of credit which fuelled the need for the development of bankruptcy law.<sup>9</sup> A company as the owner of its assets can be wound up and its assets can be distributed among creditors to realize their debts in the event of insolvency. Notably, the first official procedure of bankruptcy law was introduced by a statute of Henry VIII in 1542, and it stipulated collection of debtor's estate and distribution among his creditors for the first time in the British legal history.<sup>10</sup> Although the first bankruptcy statute in the UK regulated personal insolvency, it could indicate that the legal concept of bankruptcy was recognized and deeply-rooted in people's mind several centuries ago.

### *In China*

The development of Chinese legal culture can clearly be divided into three stages. In the ancient Chinese empire, it was built upon the Confucian theory which was involved in every aspect of people's lives including the politics, economy, law, culture and morality. When the Chinese Communist Party (CCP) took control over the new China in 1949, people were living under the strong influence of Maoism which was formulated through the combination of Marxist theory and unique Chinese situations. In contemporary China, the legal culture and ideology have been developing towards a rule of law since the government carried out the economic reform and opening up policy in 1978.

Confucianism emphasized the natural harmony of the society that motivated the approach of collectivism and opposed individual rights which were deemed to be

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<sup>9</sup> BG Carruthers and TC Halliday, *Rescuing Business: The Making of Corporate bankruptcy Law in England and the United States* (Clarendon Press Oxford 1998), p16.

<sup>10</sup> R Goode, *Principles of Corporate Insolvency Law* (3<sup>rd</sup> edn, Sweet & Maxwell, London, 2005), para.1.05.

contrary to the natural order.<sup>11</sup> There was no autonomy for individuals who only assumed obligations to the community. Under Confucian theory, the ancient legal system was comprised by propriety (*li*) and law (*fa*). It was noteworthy that propriety was more preferred for use as a conflict resolution than law.<sup>12</sup> Confucius advocated that “If people are guided by *fa*, and order among them is enforced by means of punishment, they will try to evade the punishment, but have no sense of shame, but if they are guided by virtue, and order among them is enforced by *li*, they will have the sense of shame and also be reformed.”<sup>13</sup> In this conception, law played a less important role than morality in dispute resolution between individuals. In addition, the disputants may feel shamed and embarrassed to resolve the conflict through judicial process. The out-of-court reconciliation was preferably adopted.<sup>14</sup> From the Western eyes, the Chinese ancient legal culture was not individualist. The most significant point was that Confucianism was adopted by the ruling class since the Han Dynasty as the principal guideline which strongly influenced the ruling strategy of each emperor, enforcement of laws and people’s pattern of thought in the feudal society.<sup>15</sup>

It is also important to note that the Confucian theory established “three tenets”, respectively that subjects should unconditionally comply with the order or will of the emperor; a son should unconditionally comply with the order or will of his father; and a wife should unconditionally comply with the order or will of her husband.<sup>16</sup> Such basic principles reflected the unshakable power of the rulers, absolute leadership of father in a family and supreme authority of husband in a couple. A conception that a “son should repay the debts of his father” was deduced from the

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<sup>11</sup> Hoecke and Warrington, above n.1, at 506.

<sup>12</sup> LT Lee and WW Lai, “The Chinese Conceptions of Law: Confucian, Legalist, and Buddhist” (1978) 29 Hastings L.J. 1307, 1308.

<sup>13</sup> Confucian Analects, bk.II, ch.III. as quoted in Lee and Lai, above n.12, at 1310.

<sup>14</sup> Hoecke and Warrington, above n.1 at 506.

<sup>15</sup> J Zhang, *Chinese Legal History* (2<sup>nd</sup> edn, Higher Education Press, 2007), p72-73.(in Chinese)

<sup>16</sup> Ibid.

second tenet which had a negative impact on the legislation of bankruptcy law.<sup>17</sup> Since the debts could pass from one generation to another, it is submitted that there was no need of setting of rules to bankrupt the insolvent individuals because the creditors could enforce their debts by claiming against the debtor's children who had the ability to repay. In addition, another three passive effects resulted from the Confucian theory, respectively authoritarianism, inequality between the classes of landlord and peasant, and restrictions on the individual autonomy of will and liberty. It can be perceived that the Confucian theory had far-reaching influence on the ideology and legal construction. Just as Friedrich Hirth said that "for even at the present day, after the lapse of more than two thousand years, the moral, social and political life about one-third of mankind continues to be under the full influence of his (Confucius) mind".<sup>18</sup>

When the new China was founded in 1949, the people became the "real masters" of the state under the leadership of CCP which developed the traditional Marxist theory on the basis of the peculiar characteristics of China. In terms of legal culture in the Maoist era, law was treated as a tool of the ruling class and all the legal rules were politicized, whether criminal or civil law.<sup>19</sup> Particularly private law in the West is utilized to facilitate the exchange of private property rights and transactions, while in the Maoist China, private law, which mainly referred to civil law, was "far from the autonomous and semiautonomous institutions that bear similar labels in the west".<sup>20</sup> The legal system under Mao emphasized the functions of mediation as a fundamental means of dispute resolution, which was primarily carried out extra-judicially. One major distinction between the mediation under Mao and the reconciliation under Confucius was that the former was strongly marked by its political colour. In that era, the ideological debate was intense and sensitive, and the line should be drawn

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<sup>17</sup> A Tang, *Insolvency in China and Hong Kong: A Practitioner's Perspective* (Sweet & Maxwell Asia, 2005), para.1.07.

<sup>18</sup> Ibid at para.1.02.

<sup>19</sup> SB Lubman, *Bird in a Cage: Legal Reform in China after Mao* (Stanford University Press, 1999), p88-89.

<sup>20</sup> Ibid at 91.

between capitalism and socialism. It can be generalized that the Maoist legal framework focused on the collectivist approach and neglected the protection of individual rights.<sup>21</sup> Fundamentally, this system led to a serious problem, equalitarianism, which was metaphorically called as “eating from the big pot” (equal claim to state and enterprise largesse).<sup>22</sup> It largely influenced people’s attitudes and incentives to produce and innovate, and impeded the enhancement of productivity.

China has been on its way to pursue a socialist market economy since the CCP initiated the economic reform and opening up policy in 1978. The development of the economy was in need of an efficient and well-functioning legal system to facilitate the commercial transactions and protect the order of the market. The government bravely introduced market-oriented mechanisms and borrowed Western legal institutions to promote the legal reforms and change people’s traditional views and attitudes towards legal rules. The CCP was determined to transfer the focus from class struggle to national economy. Theoretically, the party leadership developed the traditional Marxism which viewed the market mechanism and the legal concepts of “private property, company and bankruptcy” as the unique characteristics of capitalist society. It should be noted that the former party veteran Chen Yun came up with a metaphor, known as “bird in a cage” theory.<sup>23</sup> “In this metaphor, the market is the bird and the plan is the cage. The cage can be enlarged to give greater freedom to the bird, but without the cage, the bird will fly away—which is analogous to disorder in the market.”<sup>24</sup> It ingeniously resolved the ideological argument and influenced people’s attitudes towards the Western advanced legal institutions. Actually,

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<sup>21</sup> Ibid at 64-65.

<sup>22</sup> “Eating from the big pot” was a vivid description of equalitarianism. Literally, it meant that people who worked in a state-owned enterprise or a rural collective shared food from the same pot. In essence, it criticized people’s backward thought in pursuit of equality of living standards. Under this thought, people who worked or did not work and people who worked well or worked badly enjoyed the same treatment and social distribution. It eroded people’s attitudes and creativity. From Western people’s eyes, the Chinese equalitarianism in the Maoist era was unbelievable. L Wong, “Market Reform, Globalization and Social Justice in China” (2004) 13 *Journal of Contemporary China* 151, 156.

<sup>23</sup> EF Vogel, “Chen Yun: his life”, (2005) 14 *Journal of Contemporary China* 741, 759.

<sup>24</sup> MW Bell, HE Khor, and K Kochhar, *China at the Threshold of a Market Economy* (International Monetary Fund Washington, D.C. 1993), p2.

“planning” and “market” are not the fundamental distinctions between capitalism and socialism but economic tools. Capitalist economy cannot operate well without macroeconomic regulation in fiscal policy, and government still plays some significant roles in order to avoid the economic recession, inflation, high unemployment and to safeguard the order of the market economy. Socialist economy is unlikely to be prosperous without a market base.<sup>25</sup> This viewpoint effectively harmonized the “planning” and “market” in the Chinese economy and motivated the reforms of marketization, legal construction and individuals’ pattern of thought which paved the way for the acceptance and establishment of a bankruptcy and corporate rescue legal framework.

### 3.1.2 Entrepreneurial cultures and ideologies

It is important to note the distinctions of the entrepreneurial cultures and ideologies between England and China which will be conducive to analysing how the enterprises incorporated on different bases operate in each specific economic environment. In this sense, this comparison to some degree will be helpful to understand the major differences of the legal rules in the rescue regimes between the two nations.

#### *In the UK*<sup>26</sup>

A British enterprise, incorporated in a free market economy, acts like an elementary particle which is always moving according to the market rules of demand-and-supply, rather than the administrative orders. Two enterprises make transactions and exchange property rights based on the principle of liberty of contract which opposes

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<sup>25</sup> S Guo, “The Ownership Reform in China: what direction and how far?” (2003) 12 *Journal of Contemporary China* 553.

<sup>26</sup> The UK business is dominated by enterprises under private ownership, rather than public ownership. The bulk of state-owned enterprises were privatized under Mrs Thatcher’s reforms. For more details, see R Floud and P Johnson (eds), *The Cambridge Economic History of Modern Britain: Structural Change and Growth 1939-2000* (CUP, Cambridge, 2004), p99.

the government's intervention.<sup>27</sup> An enterprise is encouraged to take risky activities in pursuit of the maximization of profit. The entrepreneurs hire a labour force by contracts of employment, and they do not hold responsibility for issues of social security payments for which the government should be responsible, other than through collections of PAYE, National Insurance and occupational pension contribution. The investors fund an enterprise in which the shareholders elect directors and organize a board, and accordingly the board is entitled to hire senior management staff who perform specific functions in every department.<sup>28</sup> It should be noted that the principal-agent problem has long been a problem in the British corporate governance structure because the shareholders and directors do not always have the same objectives. As early as more than 200 years ago, it was argued that "the directors of such companies, however, being managers rather of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance which the partners in a private copartnery frequently watch over their own".<sup>29</sup>

### *In China*<sup>30</sup>

A Chinese enterprise, formulated upon the state-owned assets, is like a cell which "performs a specific function in order to contribute to the efficient functioning of the whole organism".<sup>31</sup> Particularly in the era of the planned economy, the production

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<sup>27</sup> One exception is that the state will be involved in the case where an agreement, which is concluded by two parties, is anti-competitive. The state shall discharge the duty of maintaining fair competition and resisting monopoly, because competition could not only provide consumers with lower price, and better goods and services, but also deliver better allocation of resources and enhance efficiency. For more details, see R Whish, *Competition Law* (5<sup>th</sup> edn, LexisNexis, 2003), p2-4.

<sup>28</sup> D French, S Mayson and C Ryan, *Mayson, French & Ryan on Company Law* (24<sup>th</sup> edn, OUP, Oxford, 2007), p409.

<sup>29</sup> A Smith, *The Wealth of Nations* (Bantam Dell, New York, Reprinted in 2003), book V, part III, p941.

<sup>30</sup> Although during the three decades economic reform, some of the state-owned assets have been privatized and the private sector has made great contribution to the GDP, the SOEs still play an important role in the national economy and they continue to comprise 60-70% of the economy in almost every key respect. See Guo, above n.25, at 558. Here only discuss the entrepreneurial culture and ideology in SOEs.

<sup>31</sup> DC Clarke "Regulation and its Discontents: Understanding Economic Law in China" (1992) 28 Stan. J. Int'l L. 283, 306.

and sales were arranged by the government authority under public ownership and one SOE cannot trade with other enterprises freely. In addition, the banks supported finance to enterprises at the behest of government agencies, rather than the market rules on a commercial base. In short, political connections between the state and the enterprises outweighed market considerations.<sup>32</sup>

It should be noted that in general there are four remarkable features of the SOEs. Firstly, a SOE is not merely a legal-economic entity, but also a political entity which involves the political power of the CCP. In this context, “the enterprise’s motivation was not only confined to the pursuit of profits and innovation; the political motivation is also added”.<sup>33</sup> It is impossible for the state to seek the maximization of profits at the expense of political interest. The CCP tends to pay more attention to the special concerns over the laid-off workers, social security and stability which may slow down the speed of the economic reform, and the bankruptcy or debt-restructuring of distressed enterprises.<sup>34</sup>

Secondly, although the state has decentralized some autonomy of management to enterprises and loosened its control over propaganda and press with the development of the market-oriented reform, it has never relaxed the power over the nomination and dismissal of personnel of the SOEs.<sup>35</sup> The board of directors is appointed by the CCP, which also elects the managers of every department, directly or indirectly. The state owns the enterprise and the relevant government agencies act as the shareholders. Because of the triple roles of the state as the real owner of the enterprise, the regulator of business affairs and the appointer of directors and senior management staff, political intervention is easily exerted by the state over the

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<sup>32</sup> RD Ewing “Chinese Corporate Governance and Prospects for Reform” (2005) 14 *Journal of Contemporary China* 317, 322.

<sup>33</sup> G Yang, “An institutional analysis of China’s state power structure and its operation” (2006) 15 *Journal of Contemporary China* 43, 44.

<sup>34</sup> Guo, above n.25, at 572.

<sup>35</sup> Yang, above n.33, at 52; L Tan and J Wang, “Modelling an effective corporate governance system for China’s listed state-owned enterprises: issues and challenges in a transitional economy” (2007) 7 *JCLS* 143, 155.



business life of the enterprise. Undoubtedly, the enterprise may not have the right incentives to pursue profits. As the shareholders, the government agencies are reluctant to force the enterprise to take risky activities, because the officials of such agencies are concerned with the political risk more than commercial risk. In addition, “managers and boards of directors tend not to resist arbitrary government intrusion into all areas of business operations.”<sup>36</sup> They do not expect to have any debate or conflict with their appointer, since this could jeopardize their job and leadership in the enterprise. Therefore, this is also a big challenge to the corporate governance structure of the SOEs which may reduce the competitiveness of SOEs against the private enterprises.

Thirdly, it is noteworthy that every enterprise has a labour union. A certain number of representatives of the labour union should be appointed to be directors or supervisors who are able to be involved in the decision-making process or the supervision of the management in the corporate governance structure, which enables the workers to exert their influence on the big commercial activities through their representatives in the two boards.<sup>37</sup> This arrangement reflects a unique Chinese characteristic that the workers are the real masters of the enterprise. In addition, in the old corporate rescue regime of the outdated bankruptcy law 1986, the worker’s congress in the enterprise was entitled to discuss the reorganization plan issued by the superior department of the debtor enterprise and supervise the implementation of the plan.<sup>38</sup> Moreover, the

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<sup>36</sup> S Tenev and C Zhang, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (World Bank and the International Finance Corporation Washington, D.C. 2002), p99.

<sup>37</sup> The corporate governance of Chinese enterprises, whether SOEs or private enterprises, adopts the two-tier board system similar to the German structure. Directors are the members of the management board which is in charge of managing the company’s property and business affairs. Supervisors are the members of the supervisory board which primarily undertakes the statutory functions of monitoring the financial situation and business operation of the company and directors’ conduct. A diagram of the Chinese two-tier board structure is available at s 5.3.2. For more details, see L Miles and Z Zhang, “Improving corporate governance in state-owned corporations in China: which way forward?” (2006) 6 JCLS 213.

<sup>38</sup> Bankruptcy Law 1986, article 20. The “superior department” means a specific government agency which is in charge of SOEs.

new bankruptcy law also stipulated that there should be one representative of the labour union in the creditors' committee which is authorized to perform a series of important functions in the bankruptcy and corporate rescue proceedings.<sup>39</sup>

Fourthly, under the state-planned economy, the SOEs were responsible for the provision of social welfare to the workers. This social security system was very different from that under the UK system, in which the government provides welfare benefits to the employees. In China, each SOE was a self-sufficient "welfare society" which offered the medical care, life-long employment and houses.<sup>40</sup> Chinese government adopted the social policy of "high employment, low wage, high subsidy and high welfare" which meant that the SOEs had to raise huge amounts of social security funds from annual profits. The government provided a limited amount of subsidy only in the circumstances where the SOEs failed to raise sufficient social welfare funds.<sup>41</sup> In addition, the SOEs were also liable to take care of the livelihood of the workforce by means of providing basic facilities such as hospitals, nurseries, schools, and canteens which catered for the need of workers and their family members.<sup>42</sup> This was why the people who worked in the SOEs were regarded as holding an "iron rice bowl". It was undeniable, however, that this enterprise-financed social security system did cause many negative issues. Firstly, it created a heavy financial burden on the SOEs which constrained the enlargement of production scale and enhancement of productivity. In addition, the employees might not have the right incentives to innovate and improve efficiency under the coverage of the "iron rice bowl" which could lead to laziness and equalitarianism.<sup>43</sup> Furthermore, there was a troublesome issue about whether the facilities like hospitals and schools should be categorized into the bankruptcy estate when the SOE was placed into bankruptcy

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<sup>39</sup> Bankruptcy Law 2006, articles 67 and 68. Further discussion about creditors' committee will be developed in section 4.3.4.

<sup>40</sup> J Leung, "Social security reforms in China: issues and prospects" (2003) *Int J Soc Welfare* 73, 77.

<sup>41</sup> K Lin and O Kangas, "Social policymaking and its institutional basis: Transition of the Chinese social security system" (2006) 59 *International Social Security Review* 61, 63-65.

<sup>42</sup> Tang, above n.17, at para.3.22.

<sup>43</sup> For anecdotal evidence, see T Clissold, *Mr. China* (Robinson, London, 2004), p12-13.

proceedings. Although these facilities belonged to the debtor enterprise, they were closely related to the daily lives of the workers. Law was silent as to this sensitive issue which was usually resolved by administrative measures.<sup>44</sup> Finally, the over-tight connection between SOEs and employees inevitably had a great impact on the implementation of the 1986 law and the drafting process of the new law. The bankruptcy of a SOE meant the termination of the high welfare provision which had the potential to invoke social unrest under the old system.<sup>45</sup>

## **3.2 Historical developments of bankruptcy and corporate rescue laws in England and China**

### **3.2.1 England—consistent reforms towards a modern rescue culture in the past three decades**

#### **3.2.1.1 Corporate rescue legal framework prior to the reforms in the 1980s**

Radical and dramatic reforms to English insolvency law did not take place in more than a century until the 1980s when the Insolvency Act 1986 was enacted under the recommendation of the Cork Committee.<sup>46</sup> The committee, which was established in January 1977, conducted a comprehensive review of the existing insolvency law and insolvency-related matters, envisaged two remarkable corporate rescue regimes, respectively the CVAs and administration, which represented the first formulation of the rescue culture in the UK.<sup>47</sup> Prior to the legal reforms brought by the Cork Committee, there were limited aspects in some laws which provided non-bankruptcy solutions to ailing enterprises. For instance, schemes of arrangement regime was created by the company law legislation in the late 19<sup>th</sup> century, and was intended to provide a ground for the company and its creditors to make a composition for debt

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<sup>44</sup> F Chen, “Chinese Bankruptcy Law: Milestones and Challenges” (2000) 31 St. Mary’s L.J. 49, 58-59.

<sup>45</sup> The reforms and developments to the social security system will be briefly mentioned in section 3.2.2.4.3.

<sup>46</sup> *Insolvency Law and Practice: Report of the Review Committee* (Cmnd 8558, 1982) (Here after “Cork Report”), para.1975.

<sup>47</sup> M Hunter, “The Nature and Functions of A Rescue Culture” [1999] J.B.L. 491.

restructuring. Since corporate rescue procedures in insolvency legal framework were unavailable at that time, schemes of arrangement offered a rescue-oriented alternative outside existing insolvency law to a financially troubled firm which could reach an agreement with creditors for reorganization and avoid insolvent liquidation. However, this regime was criticized as complicated, cumbersome and expensive.<sup>48</sup> In addition to schemes of arrangement, administrative receiverships also had some rescue-oriented aspects; especially in the cases where the claim of the floating charge holder was under-secured, the receiver and manager would continue trading and restore the ailing company rather than do a quick sale and realize the claim of the floating charge holder.<sup>49</sup> It should be noted that the rescue mechanisms in administrative receiverships were limited.

After the Second World War, the social and economic conditions in the UK underwent dramatic changes which prompted insolvency law reforms. The oil crisis and economic recession in the 1970s urged the government to review the existing insolvency law which was unsatisfactory and ineffective. Numerous enterprises, which were terminated by insolvent liquidation, would be restored if corporate rescue laws were available. The introduction of the “London approach” was an appropriate and effective reaction to the oil crisis and corporate decline of the 1970s. This well-established voluntary procedure normally proceeded under the consensual support of banks and was originally brokered by the Bank of England in the mid 1970s. In the field of informal rescue arrangements, the “London Approach” is the major alternative of extra-judicial debt-restructuring for the large-scale companies which are usually incorporated on the multi-banked base, and hitherto it is still a well-functioning rescue-oriented solution to corporate failure in the modern British corporate rescue legal framework.<sup>50</sup>

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<sup>48</sup> Goode, above n.10, at para.10-136.

<sup>49</sup> Cork Report, para.495.

<sup>50</sup> V Finch, “The Recasting of Insolvency Law” (2005) 68 M.L.R. 713, 727.

### 3.2.1.1.1 Schemes of arrangement

The schemes of arrangement regime, which is set out in the Part 26 of Companies Act 2006, enjoys a long legislative history which can be traced back to the late 19<sup>th</sup> century.<sup>51</sup> This approach provides a rescue-oriented alternative outside traditional winding up proceedings, especially when the procedures of CVA and administration were unavailable. It has been used notably for the reorganization of large companies, such as Cape plc and British Energy plc.<sup>52</sup> It has played a significant role in particular in the restructuring of insurance companies.<sup>53</sup> An advantageous feature of schemes of arrangement is that there is no statutory requirement that the company is insolvent or likely to be insolvent. Thus, a scheme of arrangement can be produced, approved and carried out at an early stage. It is a collective procedure in which all the interested parties will be taken into account by court.<sup>54</sup> In order to avoid schemes being exploited at the mercy of the majority and at the expense of the minority, it is prescribed that the proposed schemes should be discussed and approved in each distinct class of creditors or members of the company, and the approval requires a majority in number and three-quarters in value of every class.<sup>55</sup> The scheme, which

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<sup>51</sup> The provisions of schemes of arrangement can date back to the Joint Stock Companies Act 1870. The current procedure of schemes of arrangement comes from the successive legislation in company law: respectively s 24 of the Companies Act 1900, s 38 of the Companies Act 1907, s 120 of the Companies (Consolidation) Act 1908, s 53 of the Companies Act 1928, s 153 of the Companies Act 1929, s 206 of Companies Act 1948 and s 425 of the Companies Act 1985. For more details, see R Parry, *Corporate Rescue* (Sweet & Maxwell, London, 2008), Chap 17.

<sup>52</sup> *Re Cape plc* [2007] Bus LR 109; J Townsend, “Schemes of Arrangement and Asbestos Litigation: In *Re Cape plc*” (2007) 70 MLR 837; S Phillips, “Shareholders Rights in the UK Public Companies Restructurings—the Case of British Energy Plc” (2006) 3 *International Corporate Rescue* 22.

<sup>53</sup> *Re Hawk Insurance Co Ltd* [2002] BCC 300; *Re Anglo American Insurance Co Ltd* [2001] 1 BCLC 755.

<sup>54</sup> *A Review of Company Rescue and Business Reconstruction Mechanisms*, The Insolvency Service, (London: HMSO, 1999) (here after “IS 1999”), para.6 (l). It should be noted that there is no statutory requirement that all the creditors and members of the company must attend the meeting of their class and vote. A low turnout in the meetings in the process of approving a scheme may happen. The court shall consider not only the proportion of creditors and members who actually vote by person or proxy, but also the value of their claims. See *Re British Aviation Insurance Co Ltd* [2006] BCC 14; Parry, above n.51, at para.17-01.

<sup>55</sup> CA 2006, s 899 (1); it is noteworthy that Company Law Review suggested whether the requirement of majority in number should be abolished in order to simplify the procedure. See: Company Law Review Steering group, *Modern Company Law for a Competitive*

has been approved by meetings of creditors and members of the company, still needs the sanction of court, before it comes into effect. Once a scheme becomes effective, it will have a binding effect on the company and all the affected parties, even on the dissentient ones. An important feature of schemes of arrangement is the level of court's involvement which makes the procedure expensive. First of all, the court is liable to convene the meetings of creditors and members under an application.<sup>56</sup> In addition, the court is required to give sufficient concern to the interests of the dissenting creditors to ensure fairness and legitimacy.<sup>57</sup> It is important to note that the court has a wide discretion to refuse to sanction an arrangement if the court believes that some interested party is not being treated fairly and reasonably, even though the scheme has been approved by the meetings of creditors and members in every class.<sup>58</sup> Moreover, the court is also entitled to nullify a scheme which has been sanctioned earlier, if fraud is established.<sup>59</sup> Another feature of schemes of arrangement is that insolvency practitioners are not involved in the procedure, in which the directors remain in control in the extended period to push the scheme through. It is noteworthy, however, that there is no moratorium available to enable the debtor company to restrain the individual creditors from enforcing their claims against the company, and the court is not empowered to enforce an informal moratorium to protect the financially struggling company from debt enforcement.<sup>60</sup> Moreover, the Cork Committee noted that the procedure is complex, time-consuming and costly, for which reason it is not suitable for small firms.<sup>61</sup> Therefore, the unsuitability of the schemes of arrangement as a main corporate rescue procedure promoted the insolvency law reforms and led to the introduction of the other rescue regimes.

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*Economy: Completing the Structure* (November 2000), para.11.34.

<sup>56</sup> CA 2006, s 896 (1).

<sup>57</sup> *Re NFU Development Trust Ltd* [1972] 1 WLR 1548; *Re RAC Motoring Services Ltd* [2000] 1 BCLC 307; V Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP, Cambridge, 2002), p325.

<sup>58</sup> D Milman, "Schemes of Arrangement: Their Continuing Role" [2001] *Insol. L.* 145.

<sup>59</sup> But in realistic commercial circumstances, it can be imagined that it must be very difficult to establish fraud. See *Fletcher v RAC Ltd* [2000] 1 BCLC 331.

<sup>60</sup> Cork Report, para.406.

<sup>61</sup> *Ibid* at para.496.

### 3.2.1.1.2 Administrative receiverships<sup>62</sup>

Administrative receivership is a process for debt enforcement by a secured creditor with a floating charge over the entire or substantial part of a company's assets, both present and future. It was created and developed alongside the peculiar creature of the English floating charge, which was first introduced in the late part of the 19<sup>th</sup> century and has long been a fundamental pillar of the English financial structure.<sup>63</sup> The floating charge holder is entitled to appoint an administrative receiver to take over the assets and business affairs of the company, and this may be done with a view to trading the company out of financial trouble and benefiting all the stakeholders. However, it is certainly not always the case, because the administrative receiver owes primary duties to the appointer and may attempt a quick realization of assets, as long as the remaining assets are sufficient for the claim of the floating charge holder. In other words, the objective of an administrative receiver is to ensure that the charge holder obtains better return.

It should be noted that the scope of the “rescue” mechanism of administrative receiverships was recognized by the Cork Committee:

“Such receivers and managers are normally given extensive powers to manage and carry on the business of the company. In some cases, they have been able to restore an ailing enterprise to profitability, and return it to the former owners. In others, they have been able to dispose of the

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<sup>62</sup> Administrative receiver was first introduced by the Insolvency Act 1985, and then carried forward in the Insolvency Act 1986. Prior to the enactment of Insolvency Act 1985, an administrative receiver was termed as a receiver and manager. The wording of “receivership” in English insolvency law should be distinguished from the similar and confusable expression “Equity Receivership” which was a corporate rescue device in the US especially in the era prior to 1934, and which primarily had the railways as the rescue targets. The policy aims, functions and procedures of the Equity Receivership are almost completely different from those of Receivership. For more understanding of this rescue vehicle, see A Martin, “Railroads and the Equity Receivership: An Essay on Institutional Change” (1974) 34 *The Journal of Economic History* 685. Another two concepts, which should be distinguished in English corporate insolvency law, are fixed charge and floating charge, which have different characteristics. For more details, see L Gullifer and J Payne, “The Characterization of Fixed and Floating Charges”, in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (OUP, Oxford, 2006), p51.

<sup>63</sup> S Davies QC (ed), *Insolvency and the Enterprise Act 2002* (Jordans, Bristol, 2003), p37-38. For the historical development of receiverships, see G McCormack, “Receiverships and the Rescue Culture” (2000) 2 *Company Financial and Insolvency Law Review* 229.

whole or part of the business as a going concern. In either case, the preservation of the profitable parts of the enterprise has been of advantage to the employees, the commercial community, and the general public.”<sup>64</sup>

This recognition directly resulted in the innovations of Company Voluntary Arrangements (CVAs) and Administration Orders for use in the circumstances where there was an absence of a floating charge. It was recommended by the Cork Report that major reform be taken to deflect the administrative receiver’s primary duties away from the floating charge holder to the general body of creditors and make the administrative receiver more accountable, whereas the legislation failed to adopt this approach.<sup>65</sup>

During the past two decades, the administrative receivership procedure has suffered from a plethora of criticisms which are mainly concerned with several issues. Firstly, it is not a collective approach and the floating chargee is empowered to appoint an administrative receiver at any time that the contract allows.<sup>66</sup> In addition, because the administrative receiver owes primary duties to his appointor and few obligations to the ordinary creditors, he normally discharges his duties without adequate consideration of the interests of the general body of creditors, unless in certain circumstances where the implementation of a rescue attempt is encouraged in which case the administrative receivership may operate for the benefits of all the stakeholders if the charge holder is under-secured. In this regard, the administrative receiver does not have sufficient incentives to maximize the realization of the assets as long as the value of the remaining assets could satisfy the repayment to the secured lender.<sup>67</sup> It is noteworthy that “receiverships tend to be characterized by poorer returns to creditors than those in CVAs but better than in liquidations.”<sup>68</sup> Furthermore, another main concern with the flaw of the administrative receivership is that the administrative receiver is substantially unaccountable to other creditors,

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<sup>64</sup> Cork Report, para.495.

<sup>65</sup> Ibid at para.110.

<sup>66</sup> IS 1999, para.6 (g).

<sup>67</sup> DTI/Insolvency Service, *Productivity and Enterprise: Insolvency—A Second Chance*, (Cm 5234, 2001), paras.2.2 and 2.3; Davies, above n.63, p38.

<sup>68</sup> IS 1999, para.6 (g).



who have no voice in the process. The interests of the unsecured creditors are at the mercy of the unilateral action of the floating charge holder.<sup>69</sup> This mechanism is unfair to the ordinary creditors who are in a weak bargaining position and who may be illegitimately prejudiced.<sup>70</sup>

### **3.2.1.1.3 The “London Approach”**

The London Approach has been defined as: “[a] non statutory and informal framework introduced with the support of the Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring”.<sup>71</sup> The origin of the London Approach can be traced back to the early 1970s, when a large number of companies, especially multi-bank based companies, were encountering financial difficulties during the economic recession and concomitantly the crisis had a bad impact on the secondary banking sector of the UK.<sup>72</sup> Because of the lack of formal effective rescue proceedings at that time and the complexity of the multi-bank and multi-jurisdictional problems, the Bank of England was involved in achieving an approach to the rehabilitation of a distressed company which largely relied on the cooperation, understanding, consensus and continuing support amongst the bank creditors.<sup>73</sup> The London Approach has achieved a great success in rescuing the ailing large firms out of court which normally have a large number of bank creditors. It has been observed that, in the cases where, the London Approach is utilized, the number of banks ranges from 6 to 106 in different cases and 30 is the normal figure.<sup>74</sup> It should be noted that the success of the London Approach has not only created a

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<sup>69</sup> Goode, above n.10, at para.9-04.

<sup>70</sup> For more knowledge about receiverships, see R Mokal, “The Harm Done by Administrative Receivership” (2004) 1 *International Corporate Rescue* 248; J Armour and S Frisby, “Rethinking Receivership” (2001) 21 OJLS 73.

<sup>71</sup> British Banker Association, *Description of the London Approach*, unpublished memo (1996), 1.

<sup>72</sup> J Armour and S Deakin, “Norms in Private Insolvency: the ‘London Approach’ to the Resolution of Financial Distress” (2001) 1 JCLS 21.

<sup>73</sup> C Bird, “The London Approach” (1996) 12 *Insolvency Law & Practice* 87.

<sup>74</sup> J Flood, R Abbey, E Skordaki and P Aber, *The Professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach*, ACCA Research Report No.45 (1995), p28.

flexible and cooperative informal rescue arrangement for corporate recovery, but it has also provided a useful pattern of form which has been learned and imitated in many countries even though there are legal and cultural differences.<sup>75</sup>

When a large publicly held company falls into financial difficulties, the disclosure of its financial status may erode the prospect of rehabilitation and invoke the fear of creditors who intend to trigger individual debt enforcement. The London Approach provides a ground where the informal restructuring can be carried out without the bad impact of publicity and related disadvantages.<sup>76</sup> The London Approach is a set of principles rather than legal rules, in other words, the London Approach aims to offer a flexible pattern of debt restructuring which relies on negotiation with banks and their collective financial support.<sup>77</sup> There is a standstill which covers all the debts and this standstill is a voluntary rather than a statutory process. This freezing, which restricts the lenders from taking individual action for debt enforcement or improving their positions relative to other creditors in terms of debt repayment or by way of security, must take place over only a short period of time under agreed limits which should be measured by months.<sup>78</sup> The standstill enables a team of investigating accountants to gather information on the company's affairs. This information is crucial for the collective decision making of the lenders, who will assess whether or not the restructuring can be done on these reliable findings. During the negotiation, a lead bank is identified to act as a mediator, which plays the key role of resolution of any disagreement amongst banks, since there is no legal arbitration process for their disputes. After a successful negotiation, all the lenders will reach consensus on a new financing agreement, which typically requires the lenders to advance loans pro rata for continued trading of the company experiencing

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<sup>75</sup> RE Floyd, "Corporate Recovery: 'The London Approach'" (1995) 11 *Insolvency Law & Practice* 82.

<sup>76</sup> A Belcher, *Corporate Rescue: A Conceptual Approach to Insolvency Law* (Sweet & Maxwell, 1997), p118.

<sup>77</sup> P Kent, "The London Approach: Distressed Debt Trading" (1994) 34 *Bank of England Quarterly Bulletin* 172.

<sup>78</sup> Armour and Deakin, above n.72, at 35.

financial trouble. In addition, it is commonly proposed that all the lenders will share the costs and expenses for the expertise and negotiation on an equitable basis. The proposal of restructuring may include a variety of measures to reorganize the debt structure of the ailing company, such as the reduction of claims pro rata or a debt-equity swap. It should be noted that the London Approach has significant influence over the informal reorganization of multi-banked large corporations domestically and internationally since its birth. It has been observed that the Bank of England “has been actively involved in over 160 cases since 1989, but this is only a small proportion of the company workouts which have taken place”.<sup>79</sup>

### **3.2.1.2 Two innovative rescue regimes in the Insolvency Act 1986 towards a modern corporate rescue culture**

#### ***3.2.1.2.1 Company Voluntary Arrangements (CVAs)***

The CVA regime was first introduced by Part I of the Insolvency Act 1986, based on the recommendations of Cork Report which attempted to formulate a “quick, user-friendly and inexpensive” rescue device that could enable financially ailing companies to draft a reorganization plan and reach a binding composition or arrangement of indebtedness between the company and its creditors.<sup>80</sup> One important feature of this pro-debtor approach is voluntariness, which provides easy access for the directors of the debtor to the rescue regime and enables them to ease the fear of wrongful trading liabilities.<sup>81</sup> In this regard, the financially distressed but still viable company can potentially be cured at an early stage. Another attraction of the CVA is that the directors remain in control of the company’s affairs under the assistance and supervision of the proposed nominee, who later becomes the supervisor after the proposal is approved by the creditors’ meeting and shareholders’ meeting.<sup>82</sup> This mechanism is quite close to the “debtor-in-possession” model of the

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<sup>79</sup> P Kent, “Corporate Workouts—A UK Perspective” (1997) 6 *International Insolvency Review* 165.

<sup>80</sup> A Smith and M Neill, “The Insolvency Act 2000” (2001) 17 *Insolvency Law & Practice* 84; Cork Report, paras.428-430.

<sup>81</sup> Finch, above n.57, p333-334.

<sup>82</sup> “Before recommending to the court that the statutory meetings be held, the nominee

US Chapter 11.<sup>83</sup> In contrast to the court-driven schemes of arrangement approach, the CVA procedure is simple, quick and unitary. The vote structure in CVA regime is simple because the creditors who are entitled shall vote on the proposed voluntary arrangement in a single class of meeting. It should be noted that the nature of a CVA is a contract-based agreement, which is normally reached out of court. However, it does not mean that the court never involves itself in the procedures. Fundamentally, the court performs an overall supervisory function over the approval or implementation of the proposal. The primary role for the court is to prevent unfair prejudice. The court's involvement could facilitate the approval of rescue arrangements because the court is able to remove difficulties and avert unnecessary delay and litigation.<sup>84</sup>

The CVA procedure did not play the expected role in rescuing companies in financial difficulty, because the official statistics have shown that it was largely under-used. A series of shortcomings which may block the use of the CVA were explored.<sup>85</sup> It was indicated that the principal weakness was the lack of a moratorium. The struggling debtor was normally exposed to the debt enforcement of individual creditors who intended to get ahead of the game between the petition for a CVA and the approval of the proposal. Other interested parties who hold property rights against the debtor's

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should satisfy himself that the scheme is supported by the major creditors, that the company has the cash flow and resources necessary to survive if the scheme is approved and the scheme complies with the Insolvency Act and, in particular, does not unfairly prejudice any dissenting creditor." See A Wilkinson, A Cohen, and R Sutherland, C Chance, "Creditors' Schemes of Arrangement and Company Voluntary Arrangement", in H Rajak (ed), *Insolvency Law: Theory and Practice* (Sweet & Maxwell, London, 1993), p338. It also should be noted that if there is a difference or conflict on the approval of the proposal between creditors' meeting and shareholders' meeting, the decision of the creditors' meeting prevails, but the dissenting shareholders are entitled to petition to the court as a remedy. See IA 2000, Sch.2, para.5 (6).

<sup>83</sup> IF Fletcher, "UK Corporate Rescue: Recent Developments—Changes to Administrative Receiverships, Administration, and Company Voluntary Arrangements—The Insolvency Act 2000, The White Paper 2001, and the Enterprise Act 2002" (2004) 5 EBOR 119, 127.

<sup>84</sup> K Gromek Broc, "England and Wales: The Impact of the Revised Company Voluntary Arrangement Procedure", in K Gromek Broc and R Parry (eds) *Corporate Rescue: an overview of recent developments from selected countries* (2<sup>nd</sup> edn, Kluwer Law International, Hague, 2006), p98-99.

<sup>85</sup> *Company Voluntary Arrangements and Administration Orders: A Consultative Document*, The Insolvency Service, October 1993. (here after "DTI 1993")

assets, such as assets which are transferred by a sale on retention of title terms or which are subject to a lease, are entitled to repossess their property.<sup>86</sup> In the absence of protection in the form of a moratorium, the CVA regime proved to be unstable and vulnerable. Even though this problem could be resolved by applying for an administration order, such a course of action would be extremely costly especially for small firms which cannot afford the expenses.<sup>87</sup> Therefore, reform to the perceived deficiency of the existing lack of a moratorium became a focus of the Insolvency Act 2000.<sup>88</sup>

#### ***3.2.1.2.2 Major reforms to the original CVAs---Insolvency Act 2000<sup>89</sup>***

The Insolvency Act 2000 effected the long-awaited introduction of a moratorium which could make the CVAs more attractive to the financially ailing companies which could stay away from the enforcement of creditors under the protection of a moratorium and get recovery from temporary liquidity problems.<sup>90</sup> It is noteworthy that not every company could obtain the benefit of the 28 day moratorium, which is only available to the small “eligible” companies that should at least satisfy two or more conditions specified in the s 382 (2) of Companies Act 2006 which replaced s 247 (3) of Companies Act 1985. The effect of a moratorium will not only impede any petitions for winding up and administration and the appointment of administrative receivers, but will also restrain the enforcement action of individual creditors and repossession of property which is legally possessed under a conditional sale or lease. Undoubtedly, from the perspective of creditors, the imposition of a moratorium will increase risk which may lead to more loss than immediate liquidation if the attempted CVA fails to rescue the financially troubled company. It should be noted

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<sup>86</sup> For more discussion, see K Pranai and R Miller, “Company Voluntary Arrangements: the landlord position” (2003) 19 I.L. & P. 87; M Davey and D Milman, “Debtor rehabilitation: implications for the landlord-tenant relationship” [1996] J.B.L. 541.

<sup>87</sup> Smith and Neill, above n.80, at 84.

<sup>88</sup> J Tribe, “Company Voluntary Arrangements and Rescues: A New Hope and a Tudor Orthodoxy” [2008] J.B.L. (forthcoming)

<sup>89</sup> Schedule 1 of the Insolvency Act 2000 inserted a new schedule, named A1, into the Insolvency Act 1986, and it works alongside the provisions contained in the Part 1 of the IA 1986.

<sup>90</sup> IA 1986, Sch.A1, para.12.

that the law needs to set a mechanism to ease the creditors' concern regarding possible exploitation. To a large extent, reliance is placed on the independent insolvency practitioners to filter out the non-viable proposals.<sup>91</sup> The nominee is required to scrutinize the company's assets, indebtedness and business affairs, and examine its financial status based on the information submitted by the directors. A vital judgment should be made by the nominee to assess whether there is a reasonable prospect that the proposed CVA can be approved and implemented, and whether the company is likely to have sufficient funds available to it during the moratorium to enable it to continue trading.<sup>92</sup> In addition, in terms of disposal of assets under the period of protection, the company is allowed to deal with its assets as long as there are reasonable prospects that any such transaction could benefit the company and the attempt to deal has been approved by the creditors' committee, or the nominee in the circumstance of there being no creditors' committee.<sup>93</sup> This could ensure adequate funding to enable the company to carry on its business. In general, the reforms to the original CVA aim to be more cost-effective and efficient for small firms.<sup>94</sup> However, the changes effected by the 2000 Act have imposed more duties on the nominee, which may force the nominee to liaise with the directors.<sup>95</sup>

### ***3.2.1.2.3 Administration Orders***

The administration regime was another innovation which was contained in part II of the Insolvency Act 1986 under the inspiration of Cork Report. The creation of administration procedure aimed to make up for the lacuna where there was an absence of a floating charge holder to initiate administrative receivership, which was viewed as a rescue vehicle by the Cork Committee.<sup>96</sup> It has been aforementioned

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<sup>91</sup> V Finch, "The Recasting of Insolvency Law" (2005) 68 M.L.R. 713, 727-728.

<sup>92</sup> Smith and Neill, above n.80, at 85

<sup>93</sup> Because of the ambiguous provisions about the disposal of the assets subject to a floating charge, it seems that the company could deal with such assets in the ordinary course of business during the moratorium with no reference to the charge holder. See Smith and Neill, above n.80, at 85.

<sup>94</sup> Fletcher, above 83, at 133.

<sup>95</sup> Smith and Neill, above n.80, at 85-86.

<sup>96</sup> Cork Report, para.496.

that the schemes of arrangement was long-drawn and expensive, and the informal workout could not bind dissenting creditors, for which reasons the introduction of administration purported to fill the shortcomings of schemes of arrangement and informal rescue arrangement, and intended to act as a collective rescue-oriented approach. It should be noted that administration was created in the shadow of the floating charge, and the powers of an administrator were similar to those of an administrative receiver.<sup>97</sup> The petition for an administration order could be presented by the company (shareholders in the general meeting), the directors (majority resolution of board), or any creditor or creditors in respect of the company.<sup>98</sup> The creditors include the contingent and prospective creditors.<sup>99</sup> The main attraction of an administration order was the effect of the statutory moratorium, which enabled the debtor to step away from legal actions.

However, the implementation of the administration regime suffered from a series of perceived flaws which seriously affected its effectiveness and meant that it failed to realize expectations of it as the intended “flagship” of the rescue culture. First of all, the entry to procedure was inefficient. It could be easily impeded by the veto of a floating charge holder by means of appointing an administrative receiver. The applicant needed to prove that the company was insolvent or likely to become insolvent, and that there was a reasonable prospect that at least one of the four statutory objectives was likely to be realized.<sup>100</sup> In this regard, a heavy burden of proof was imposed in the preliminary stage, in which the professional fee for the consultant and preparation of the application documents for the judicial hearing were extremely costly.<sup>101</sup> In addition, the court was very cautious to sanction an order, requiring deep investigation of the petition files and the professional advices, which

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<sup>97</sup> Finch, above n.57, p278.

<sup>98</sup> D Prentice, F Odiah and N Segal “Administration: Part II of the Insolvency Act 1986”, in J S Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford, 1994), p75-76.

<sup>99</sup> *Re Consumer and Industrial Press Ltd* [1988] 4 BCC 68; *Re Imperial Motors (UK) Ltd* [1989] 5 BCC 214.

<sup>100</sup> IA 1986, s 8 (3).

<sup>101</sup> Fletcher, above n.83, at 125.

made the process slow and expensive.<sup>102</sup>

In addition, the administration regime offered a rescue alternative to the company in times of financial crisis and provided the directors in the existing management with a continuing role in the business affairs of the company after the administration order was made by the court. Directors could avoid wrongful trading liabilities and potential disqualification by applying for an administration order when the company is in financial trouble. An outside insolvency and restructuring expert could interfere, in a timely manner, with the management of the troubled company under court's appointment and furnish an effective and feasible solution to its plight.<sup>103</sup> It was perceived that four out of five financially troubled companies could be rehabilitated if they were put into rescue proceedings at an appropriate time.<sup>104</sup> It is noteworthy, however, that the appointment of an administrator meant that the powers of the existing directors would be displaced. Moreover, the administrator was entitled to remove the directors and to appoint any new person to be a director of the company.<sup>105</sup> The ceding of powers would affect the psychology and decision-making of directors who might be reluctant to venture into the uncertain administration procedure. Such incentive would have a negative impact on the success rate of the administration regime, since Fletcher notes that in many instances "administration was not even attempted or, if attempted, was resorted to only after the company had passed beyond the point of salvation"<sup>106</sup>

Furthermore, there were still other shortcomings existing in the drafting and legislative implementation of the administration order. For instance, the moratorium

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<sup>102</sup> "Figures as high as 20, 000 GBP have been cited as minimum starting cost, with the money having to be provided in advance in order to secure the services of necessary IPs." See Finch, above n.57, p283; D Milman and C Durrant, *Corporate Insolvency: Law and Practice* (3<sup>rd</sup> edn, Sweet & Maxwell, London, 1999), p51.

<sup>103</sup> Finch, above n.57, p280.

<sup>104</sup> BG Carruthers and TC Halliday, *Rescuing Business: The Making of Corporate bankruptcy Law in England and the United States* (Clarendon Press, Oxford, 1998), p286.

<sup>105</sup> IA 1986, s 14 (2).

<sup>106</sup> Fletcher, above n.83, at 126.



was not completely watertight because certain creditors could avoid the legal effect of the freeze.<sup>107</sup> In addition, the provisions were unclear about the exit routes from administration.<sup>108</sup> Just as Sir Kenneth Cork said “[the legislature] ended up by doing the very thing we asked them not to do. They picked bits and pieces out of [the Cork Report] so that they finished with a mishmash of old and new.”<sup>109</sup>

#### ***3.2.1.2.4 The recasting of administration regime---Enterprise Act 2002***

The original administration procedure was reinvigorated by the reforms contained in the Enterprise Act 2002, Section 248 of which has in most instances replaced the old part II of the Insolvency Act 1986 and inserted a substantially revamped administration regime as Schedule B1 into the 1986 Act. Massive changes were carried out to the outdated and inefficient rescue vehicle by the Blair Government. The reforms aimed to foster a more desirable rescue culture so as to restore financially distressed enterprises, maximize the preservation of jobs, avoid the detrimental effects of the chain reaction of corporate failure and formulate a healthy entrepreneurial risk taking environment.<sup>110</sup> It is praiseworthy that the achievements of the reforms went beyond a mere recasting of legal rules including substantive rights and procedures. They reshaped the property rights and bargaining powers of different actors whose attitudes and incentives had to change automatically in the new rescue network.<sup>111</sup> The most important point is that the reforms may strengthen the foundations of the enterprise economy, change the traditional director-blaming attitudes and offer honest but unfortunate or unsuccessful entrepreneurs a second chance in order to avert unnecessary loss.<sup>112</sup> Compared with the old regime, the newly reinvigorated administration regime virtually abolished administrative

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<sup>107</sup> Ibid.

<sup>108</sup> D Milman, “The Courts and the Administration Regime: Supporting Legislative Policy” (2001) 6 *Insolvency L.J.* 208; S Frieze, “Exit from Administration” (2001) 14 *Insolvency Intelligence* 41.

<sup>109</sup> Sir Kenneth Cork, *Cork on Cork: Sir Kenneth Cork Takes Stock* (McMillan, London, 1988) 197.

<sup>110</sup> V Finch, “Re-invigorating Corporate Rescue” [2003] *J.B.L.* 527, 529.

<sup>111</sup> Ibid at 530.

<sup>112</sup> HC Deb. April 10, 2002, col.44.

receivership. It has accomplished the introduction of an out-of-court appointment mechanism which creates easy and quick access to rescue procedures. In addition, the abolition of Crown preference and the establishment of a ring fence fund could enable more assets to be available to unsecured creditors whose weak position has been improved.<sup>113</sup> Moreover, the original complicated and awkward proceedings for coming out of administration have been streamlined by the new exit routes which are more fitting to carry out and could save time and money.<sup>114</sup> All the aforementioned are the significant features of the new regime. The detailed legal rules, core mechanisms, and the impacts on different players will be fully explored in the Chapter IV and V.

### 3.2.2 China—long march towards an entirely new bankruptcy and corporate rescue system

#### 3.2.2.1 Legislative lacuna of bankruptcy laws in the centrally planned command economy

It has been previously mentioned that in the 1950s the Chinese Communist Party swiftly and successfully accomplished the “socialist transformation” in which all the private enterprises and factories were transferred to public ownership. Replacing capitalism was the tenet of this political and economic campaign, the result of which was that all the private property in enterprises and businesses was owned by the state.<sup>115</sup> The completely public ownership and state-owned property structure paved the way for the construction of a highly centralized planned economic system and a socialist institutional framework which formulated the almighty and unshakable leadership of the Communist Party on the nationalized economy and the operation of enterprises. The deployment of resources and the transactions between enterprises were in line with the order of the central or local government rather than the

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<sup>113</sup> EA 2002, s 251 (1) states that the Crown preference shall cease to have effect. The EA 2002, s 252 introduces a new s 176A into the IA 1986 which fully stipulates the new creature of ring fence.

<sup>114</sup> Davies, above n.63, p171.

<sup>115</sup> Chinese Constitution 1954, article 10.

demand-and-supply rule of the market.<sup>116</sup> It has therefore been observed that “politically, conceptually and ideologically, it was impossible at the time to bankrupt any ailing or failing business enterprise. Any and all failing enterprises would have the support and back up of the State.”<sup>117</sup>

In the first decade since “liberation” in 1949, Communist China experienced the increasing development of economy and the full construction of socialism. Then a large-scale economic campaign, which was launched by the central government in 1958 named the “Great Leap Forward”, put the healthy economy into trouble.<sup>118</sup> The partial pursuit of incredibly high goals and “catch up strategy” (*ganchao zhanlue*) in heavy industry and the production of steel caused an imbalance of industrial structure and chaos for the economic order.<sup>119</sup> The subsequent Cultural Revolution, which invoked political campaigns, mass mobilization and class struggle at the national level from 1966 to 1976, resulted in deterioration of the national economy. Many state-owned enterprises fell into financial difficulties or reached the brink of bankruptcy during these events. Because the state-owned enterprises were unlikely to be wound up at that time, the state adopted a compulsory administrative approach to deal with the distressed enterprises, which was called a programme of “closures, stoppages, mergers and transfers” (*guan ting bing zhuan*). Administrative orders of closure or provisional stoppage could be imposed on the ailing enterprises or factories which consumed excessive natural resources, caused extremely high costs or produced products that were inferior in quality. In regard to weak enterprises which severely lacked equipment and technologies, the government could amalgamate such an enterprise with a strong one doing the same business by means of mergers. As for the enterprises which operated under the wrong productive strategy, or where the product of the enterprises could not be readily sold, such

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<sup>116</sup> L Wong “Market Reform, Globalization and Social Justice in China” (2004) 13 *Journal of Contemporary China* 151, 153.

<sup>117</sup> Tang, above n.17, at para.3.04.

<sup>118</sup> Yang, above n.33, at 45-47.

<sup>119</sup> Vogel, above n.23, at 753-755.

enterprises could be ordered to change their strategy or transfer to other areas. The workers made redundant under the “closures, stoppages, mergers and transfers” programme were reallocated to the rural commune to contribute to the rural economy.<sup>120</sup> It should be noted that even though this centralized programme was a temporary administrative process to handle the ailing enterprises, it did play a significant role in closing completely failing enterprises, rehabilitating financially distressed enterprises which could still be rescued and enhancing the efficiency of the operation of enterprises in the era of the planned command economy where there was no bankruptcy legislation, let alone corporate rescue laws.<sup>121</sup>

### **3.2.2.2 First bankruptcy law and corporate rescue regime in Communist China in 1986**

Historically, the legal concept of bankruptcy was categorized into the domain of capitalism which was ideologically resisted by the Chinese people in the Maoist era. Since all the enterprises and their property were completely owned by the State, bankrupting the enterprises indirectly meant the insolvency of the State, which was unlikely to be understood and accepted by the people whose families were working in the SOEs from one generation to another. The ideological mindset that Western bankruptcy law theory and Communism could not co-exist dominated in the traditional planned economy.<sup>122</sup> It is praiseworthy that the central government launched the striking reform and opening up policy in 1978 and since then China was placed on the track of economic structural transition. The economic reform created the relaxation of the government’s control over the SOEs, which to some degree were conferred operational and managerial autonomy. As the door gradually opened to the outside world, China bravely introduced market-oriented competitive mechanisms and closely related legal concepts which encouraged swift and continuous growth of its economy, even though they were traditionally identified as

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<sup>120</sup> J Xie, *Theory of Chinese Bankruptcy Legal System* (People’s Court Press, Beijing, 2005), p30-31 (in Chinese).

<sup>121</sup> Tang, above n.17, at para.3.04.

<sup>122</sup> Ibid at para.5.13.

capitalist characteristics. With the deepening of the reform, the Chinese leadership released the previous constraint of ideological debate and viewed market and related legal institutions like bankruptcy as economic tools to resolve the economic problems in the Communist context.<sup>123</sup> The importation of market-oriented rules intensified the competition among enterprises, urged the poorly operational enterprises to improve management and reduce cost, and redeployed the limited resources. In this sense, the winding up of insolvent enterprises without any hope of turnaround was a necessary outcome of the reform of marketization, since competitive market forces could act as a “detergent” to expose the uneconomic and inefficient enterprises.<sup>124</sup>

#### ***3.2.2.2.1 Prelude for the promulgation of the 1986 bankruptcy law***

Bankruptcy had been considered to be an effective approach to deal with the problems of financially ailing and loss-making enterprises by the government at the beginning stage of the economic reform, even though the government was reluctant to bankrupt the distressed enterprises due to the concerns of large-scale unemployment and the threat to the nature of Communism.<sup>125</sup> On 27 February 1984, an article named “A discussion on the bankruptcy of long-term loss-making enterprises” was published in an official journal, which for the first time at the national level discussed the legal concept of bankruptcy, of which most of citizens never heard before.<sup>126</sup> Prior to drafting a national bankruptcy law, the central government selected three significant industrial cities, respectively Shenyang, Wuhan and Chongqing, to formulate a bankruptcy system on a trial basis at the beginning of 1985. The local governments of the three cities were delegated to produce local bankruptcy regulatory rules. Shenyang issued its local bankruptcy regulation known

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<sup>123</sup> Economic development overrode ideology. Just as the former party leader Deng Xiaoping said, “it did not matter if the cat was black or white; it was a good cat if it caught the mouse.” Vogel, above n.23, at 756.

<sup>124</sup> Z Xiao “China’s Bankruptcy Law: Socialist in Characteristics, Capitalist in Methods” (1989) 10 Comp. Law. 58; *China Daily*, 6 December 12.

<sup>125</sup> Tang, above n.17, at para.5.01.

<sup>126</sup> Ta-kuang Chang “The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process” (1987) 28 Harv. Int’l. L.J. 333, 336.

as “Bankruptcy of Urban Collective Industrial Enterprises” on 9 February 1985, which only applied to the collective enterprises owned by the Shenyang city.<sup>127</sup> It is noteworthy that the government’s effort could change the people’s patterns of thoughts and attitudes of hostility to bankruptcy gradually. In addition, the enactment of the Chinese General Principles of Civil Law 1986 for the first time mentioned the term “bankruptcy” in a national law,<sup>128</sup> and introduced the legal institutions of legal person and corporate property right which paved the way for the promulgation of a bankruptcy law. After two years of efforts by the State Council, it was praiseworthy that the first enterprise bankruptcy law, which was only applicable to SOEs, was eventually adopted by the State in 1986.<sup>129</sup> From the perspective of judicial practice, although the 1986 law failed to perform its expected functions in the specific period of economic transition, it was of great importance to accumulate legislative experience and lessons for future reforms.<sup>130</sup>

### ***3.2.2.2.2 The first corporate rescue regime in the 1986 bankruptcy law***

It is important to note that the 1986 bankruptcy law introduced the first formal corporate rescue approach, which was comprised by joint proceedings, namely conciliation and reorganization.<sup>131</sup> Although this rescue-oriented approach was not formulated within a free market economy and was not effective in implementation, significant legislative experience was accumulated, as well as lessons for the establishment of a modern rescue culture. This is why it is worth mentioning the features and legal rules of the joint proceedings, even if they seem anomalous and illegitimate by comparison with the counterparts of the Western rescue regimes.

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<sup>127</sup> Xiao, above n.124, at 59. For the detailed typical bankruptcy cases which happened in the three cities at the initial stage, see Tang, above n.17, at para.5.02; *People’s Daily*, 10 November 1986.

<sup>128</sup> General Principles of Civil Law 1986, article 45; RW Harmer “Insolvency Law and Reform in the People’s Republic of China” (1996) 64 *Fordham L. Rev.* 2563, 2569.

<sup>129</sup> For more knowledge of the 1986 law, see: Chen, above n.44, at 49; Ta-kuang Chang “The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process” (1987) 28 *Harv. Int’l. L.J.* 333. The English version of the 1986 bankruptcy law is available at <http://www.chinacourt.org> and DG Boshkoff and Y Song “China’s New Bankruptcy Law: A Translation and Brief Introduction” (1987) 61 *Am. Bankr. L.J.* 359.

<sup>130</sup> Appendix 1: the incidence of bankruptcy cases in China from 1989 to 2007.

<sup>131</sup> Bankruptcy Law 1986, Chapter 4.

In terms of the initiation of the rescue procedures, it can be observed that it was not easy to get access to the joint conciliation and reorganization regime. First of all, the petition for bankruptcy proceedings was to be presented by the creditors rather than the debtor, and the creditors were required to prove that the debtor enterprise had incurred severe losses and cannot repay its due debts due to poor operation and management.<sup>132</sup> In addition, the right to apply for the rescue proceedings was held in the hands of the superior government department in charge of the debtor. If the superior department intended to place the debtor in rehabilitation procedures, it needed to apply to the court within three months after the creditors' petition for bankruptcy was filed with the court.<sup>133</sup> There is no doubt that access to the rescue regime was completely under the control of government authorities. It should be noted that once the petition for rescue of the higher-level department was accepted by the court, there would be an automatic stay on debt enforcement by individual creditors and the reorganization period would not last more than two years. In the meantime, the debtor enterprise was required to present a draft of a conciliation agreement to the creditors' meeting for negotiation and this conciliation agreement should clearly stipulate the terms about the amount and date of debt repayment.<sup>134</sup>

Once the conciliation agreement was approved by the creditors' meeting and confirmed by the court, the bankruptcy proceedings would be suspended and the court-approved agreement would bind all the stakeholders.<sup>135</sup> In the reorganization period, the superior government department would be in charge of making the reorganization plan and this plan would need to be discussed by the worker's

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<sup>132</sup> Bankruptcy Law 1986, article 3.

<sup>133</sup> Bankruptcy Law 1986, article 17. If the debtor does not have upper-level department, the shareholders' meeting will decide to petition or not. This point is supplemented by Article 28 of the Judicial Interpretation 2002 issued by the Supreme People's Court. See C Boyle (ed), *The Asia-Pacific Restructuring & Insolvency Guide 2006*, p47 (on-line edition, available at <http://www.adb.org/Documents/Guidelines/restructuring-insolvency/restructuring-insolvency.pdf>); C Ding "The New Development of Chinese Law on Corporate Rescue" [2003] *Insolv. L.* 197.

<sup>134</sup> Bankruptcy Law 1986, article 18.

<sup>135</sup> Bankruptcy Law 1986, article 19.

congress. It may be noted that the labour class enjoyed an advantageous position in SOEs. The comprehensive hearing of opinions and suggestions from employees reflected the democracy, collectivity and accountability in these bankruptcy and rescue proceedings. The implementation of the reorganization plan would take place under the supervision of the worker's congress and creditors' meeting.<sup>136</sup>

It can be concluded that this joint conciliation and reorganization approach could not represent a true corporate rescue culture. Firstly, the debtor and its creditors could not easily and efficiently invoke the rescue proceedings because a series of awkward conditions were set on the threshold which was too high to reach in most instances. Secondly, the access to the reorganization was controlled by government authorities which to some degree had no incentive to bear such a "costly, troublesome and sometimes risky mission".<sup>137</sup> Thirdly, this rescue approach did not show sufficient respect to creditors who were placed in a passive and fragile position. No further rights were granted to creditors in the scheme of rejuvenation except that they are entitled to vote for the conciliation agreement and to supervise the implementation of the reorganization plan. Fourthly, the reorganization was supposed to be carried out on a commercial basis under which either the independent insolvency professionals would take over the enterprise's assets and business affairs, and draft the reorganization plan, or the debtor would remain in control and formulate the reorganization plan under the assistance of independent insolvency professionals. The undue interference of government might cause unfair competition and break the market rules. Moreover, it tended to decrease the efficiency of reorganization because the officials were not bankruptcy law experts. They had to hire professional lawyers or accountants who provided necessary knowledge and analysis for their decision-making. Undoubtedly, this involvement would increase the cost. Therefore, the reported cases which applied to this joint rescue regime were rare.<sup>138</sup>

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<sup>136</sup> Bankruptcy Law 1986, article 20.

<sup>137</sup> W Wang, "Adopting Corporate Rescue Regimes in China: A Comparative Survey" (1998) 9 AJCL 234, section 3.1

<sup>138</sup> This information is available at <http://www.asianrestructuring.com/> (last visit 31 May



### **3.2.2.3 Bankruptcy legal framework prior to the enactment of China's new bankruptcy law**

#### ***3.2.2.3.1 Scrappy status of China's bankruptcy laws and regulations***

It is noteworthy that there was no unified bankruptcy law dealing with the insolvencies of all types of enterprises prior to the promulgation and implementation of the new Enterprise Bankruptcy Law 2006. The bankruptcy legal structure at that time was comprised by a series of scrappy legislation which was embraced by several national laws, judicial interpretation issued by Supreme People's Court (SPC) and regional insolvency regimes. With the deepening of the economic reforms and the emerging establishment of a market economy, the amount of national legislation caused the bankruptcy legal framework to be very complicated and cumbersome.<sup>139</sup> First of all, the 1986 bankruptcy law applied exclusively to SOEs, and the Chapter XIX of the Civil Procedure Law 1991 regulated the reconciliation and liquidation of non-SOEs with legal person status. Disparate insolvency provisions could be found in the relevant national laws and regulations which specifically dealt with the bankruptcy of various types of foreign investment enterprises.<sup>140</sup> In addition, it is important to note that the SPC promulgated two judicial interpretations, respectively in 1991 and 2002, both of which were of far-reaching influence on the hearing of bankruptcy cases.<sup>141</sup> The 1991 Interpretation aimed to overcome the loopholes and imprecision of the 1986 bankruptcy law, and the 2002 Interpretation clarified the ambiguities of insolvency provisions in various national laws and attempted to avoid the potential conflicts of bankruptcy procedures.<sup>142</sup> Furthermore, some national laws

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2008)

<sup>139</sup> Metaphorically, China's old bankruptcy legal system was described as "an onion" with different layers of laws and regulatory rules which applied to different types of enterprises and in specific situations. Undoubtedly, it is impossible to avoid the ambiguities and conflicts of laws. See R Tomasic and M Wang "The Long March Towards China's New Bankruptcy Law", in R Tomasic (ed), *Insolvency Law in East Asia* (Ashgate, 2006), p95.

<sup>140</sup> For more details, see Ibid at 97.

<sup>141</sup> Although in China's legal structure, judicial interpretations issued by the SPC are placed at a lower level than the national laws enacted by the NPC, in practice, judicial interpretations almost have the same legal effect as the national laws.

<sup>142</sup> The Opinion of the Supreme People's Court on Several Issues in the Implementation of

also involved bankruptcy provisions. For example, the Company Law stipulates the dissolution and liquidation of companies including limited liability companies and joint stock companies, both of which have separate corporate personality,<sup>143</sup> and the Commercial Bank Law also articulated particular rules regulating the winding up of commercial banks and the distribution of bankruptcy estates.<sup>144</sup> Finally, what cannot be ignored are the bankruptcy regulatory rules which were enacted by the local legislatures of “special economic zones”.<sup>145</sup> The most typical case is the Shenzhen Enterprise Bankruptcy Regulations enacted by the local congress on November 10, 1993 under the delegated power of the Standing Committee of NPC. The local bankruptcy regulations comprise an important component of the Chinese bankruptcy legal framework, and they shall be applied in local areas as long as they do not conflict with the principles of the national laws.<sup>146</sup>

### ***3.2.2.3.2 Planned bankruptcy (policy-oriented bankruptcy) of SOEs***

It is noteworthy that the large amount of non-performing loans in the state-owned banks and labour-related issues have always been the major obstacles to the implementation of bankruptcy proceedings. Compared with the effectiveness and efficiency of the implementation of bankruptcy laws, the government has been more concerned with the potential social unrest which would inevitably be caused by the possible collapse of a financial institution and the protest of laid-off workers as a

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PRC Enterprise Bankruptcy Law (Trial Implementation), (the 1991 Opinion); The Rules on Several Issues About the Hearing of Enterprise Bankruptcy Cases, (the 2002 Rules); Tang, above n.17, at paras.5.26, 5.27 and 5.29; J Lam and J Wong “FIE Bankruptcy Legal Framework Clarified by the New Judicial Rules in the People’s Republic of China” (2003) 18 J.I.B.L.R. 82.

<sup>143</sup> PRC Company Law 2005, articles 188 and 191.

<sup>144</sup> PRC Commercial Bank Law 2003, article 71.

<sup>145</sup> These special areas include Shenzhen, Zhuhai, Shantou, Xiamen and Hainan which are the earliest cities that engaged in the market-oriented economic practice ahead of other areas of mainland China and are deemed as the “windows” of the reform and opening up policy. The foreign investors could enjoy special economic and tax policies and the local governments to some degree have autonomy.

<sup>146</sup> Harmer, above n.128, at 2571; X Zhang and C Booth “Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience” (2001) 15 *Columbia Journal of Asian Law* 1.

result from the bankruptcy of SOEs.<sup>147</sup> Huge efforts have been made by the State to secure social stability which has been the main priority of the CCP at all times.

In 1994, the central government launched a Capital Structure Optimization Programme (CSOP) in 16 pilot cities which aimed to support the financially ailing but still viable enterprises, to close down the completely failed enterprises by administrative directives rather than bankruptcy laws and market rules, and to cope with the arrangement of the unemployed workers appropriately.<sup>148</sup> This programme restricted bankruptcy and encouraged mergers of loss-making SOEs with profitable SOEs.<sup>149</sup> The bankruptcy of SOEs in the 16 test-point cities was followed by a series of administrative decrees out of the proceedings of existing bankruptcy laws. It was why this approach was called “planned bankruptcy” or “administrative closure”, in which special policies were adopted in relation to employees, who enjoyed the main priority in the distribution order.<sup>150</sup> In other words, all the proceeds of the bankruptcy estates were employed to realize the claims of employees, whether or not the assets were subject to a security. Obviously, this rule contradicted the distributional principle which had been established by the 1986 law, and partially pursued social stability at the expense of the interests of banks and secured financiers.

It was noteworthy that the applicable scope of the policy bankruptcy was enlarged to 56 cities in 1996 and 111 in 1997, and eventually to the national level under a directive issued by the National Bankruptcy Liaison Group (NBLG), which stipulated that, as long as the SOEs were listed in the programme sanctioned by the

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<sup>147</sup> This section only discusses the special benefit to the laid-off workers in the planned bankruptcy programme. The issues about NPLs and banking community reforms will be developed in s 3.2.2.4.2.

<sup>148</sup> Tang, above n.17, at para.5.79.

<sup>149</sup> Harmer, above n.128, at 2571.

<sup>150</sup> The article 1 of the 1994 Pronouncement clearly stipulates that “in any implementation of SOE bankruptcies, it is the responsibility of the relevant local government to ensure that all steps and all measures are to be taken, practically at all costs, to firstly settle properly workers of the bankrupt enterprise, and to preserve social stability.” See Tang, above n.17, at para.5.80.

State Council, the bankruptcy or merger of such SOEs should comply with the special policies rather than the existing bankruptcy laws.<sup>151</sup> In the process of economic transition, the planned bankruptcy did play a significant role in the adjustment of capital structure, the large-scale closure of debt-laden SOEs and the arrangement of laid-off workers in order to realize the optimization of resources and avoid social unrest. It can be seen that the closure of 3,377 economically distressed SOEs were implemented under the special policies and the central government properly resolved the arrangement of about 6.2 million unemployed workers and wrote off the NPLs of state banks and the losses of Assets Management Companies (AMCs) to a total amount of RMB 223.8 billion yuan (US\$ 28 billion).<sup>152</sup>

However, upon closer inspection it may be seen that planned bankruptcy under special policies caused a number of severe problems which may be considered to have undermined the achievements of the economic reform. First of all, the implementation of planned bankruptcy blocked the application of the bankruptcy law proceedings which were supposed to apply to all types of enterprises with legal person status. In other words, it led to unfair competition between the SOEs and non-SOEs. In addition, the banking community was hostile to the planned bankruptcy programme because, in the zero-sum situation, the secured claims of state banks were ranked behind the employees' claims in the distribution order, which explicitly violated the principle established by the 1986 law.<sup>153</sup> The special policies conducive to the arrangement of workforce resulted in a huge increase in the NPLs of state banks, which gave rise to the potential risks of financial collapse.<sup>154</sup> It should be noted that the policy bankruptcy was the outcome of a specific historic

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<sup>151</sup> Y Sun, *Bankruptcy Law: Legal Theory and Practical Analysis* (People's Court Press, Beijing, 2003), p19-21.(in Chinese)

<sup>152</sup> Y Xu, *The Speech on Enterprise Bankruptcy Law* (Law Press-China, 2006), p397-412 (in Chinese). For more recent statistics about planned bankruptcy, see M Simmons and J Jiang, "A New Insolvency Law in China" (2007) 4 *International Corporate Rescue* 10, 11; *People's Daily*, 28 August 2006.

<sup>153</sup> Bankruptcy Law 1986, article 28.

<sup>154</sup> It should be noted that some SOEs wrongfully made use of these special policies to evade their debts owed to banks, which was called "false bankruptcy, real escape". See Tang, above n.17, at para.5.81.

stage and was an expedient in the process of economic transition. The State-owned Assets Supervision and Administration Commission has officially declared that the planned bankruptcy programme will end its mission at the end of 2008 and the newly enacted bankruptcy law will apply to all types of enterprises.<sup>155</sup> The termination of the planned bankruptcy system symbolizes the gradual establishment of the market economy status of China.<sup>156</sup>

### ***3.2.2.3.3 Informal rescue arrangements in relation to SOEs: the “Changchun Approach”***

In the 1990s, along with the constant development of the market-oriented reforms, the distressed SOEs which carried heavy debts had become a major factor that might have largely impeded the growth of the national economy and created a potential risk to the financial market. It is of significance that the Chinese government was looking for new thoughts, flexible approaches and effective methods to rehabilitate such ailing enterprises and rescue the profitable state-owned assets by means of out-of-court restructuring. The Changchun Approach, which was applauded as a remarkable breakthrough in the debt-restructuring of the SOEs, was produced in this context.

Changchun city is the capital of Jilin Province, which is situated in the Northeast of China. It is an old industrial city where a lot of significant SOEs are located.<sup>157</sup> With the deep-going economic reform, the local SOEs suffered hard times in competition with private enterprises. These debt-laden enterprises faced serious obstacles to profitability, such as outdated equipment, surplus workers, inefficient management and so on. In 1995, the local government started to seek a new and appropriate

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<sup>155</sup> Article 133 of the Enterprise Bankruptcy Law 2006 merely reserves planned bankruptcy for the SOEs which have been granted by the State Council before this new law came into force. There will be about 2,000 out of 100,000 SOEs which are allowed to continue to benefit from the special policies during the period from 2005 to 2008.

<sup>156</sup> This view is expressed by Professor Dr Li Shuguang who is the chief drafter of the new Enterprise Bankruptcy Law 2006. See: <http://www.gog.com.cn/gzrb/g0403/ca632689.htm>

<sup>157</sup> Tomasic and Wang, above n.139, p122-123.

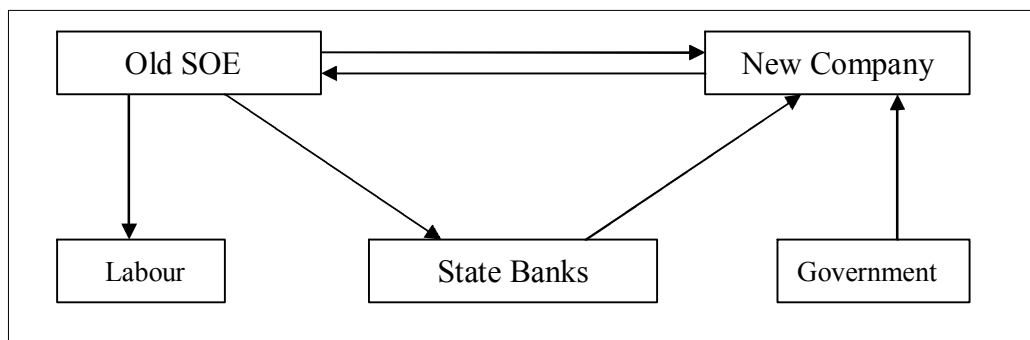
solution to rescue the profitable assets of such economically distressed enterprises. In 1996, a new approach of “Purchasing-Sale Restructuring” (PSR) was created. With the successful practice and experience in Changchun, this approach has been introduced in other parts of China.<sup>158</sup>

The Changchun Approach, as an informal rescue arrangement, aims to rescue the profitable assets of an insolvent SOE which cannot avoid liquidation. As long as the assets are still able to produce product efficiently and this product is promising to be sold well, these assets can be deemed as profitable and are applicable to this approach. According to this PSR theory, the local government injected legal registered capital and leased land to set up a new company, and then transferred the profitable assets from the old distressed enterprise to the new one. The process of transfer was according to the market-oriented method, and professional public agencies like accounting firms and asset valuation firms were involved to ensure that this process was fair and transparent. It should be noted that this transaction cannot proceed without the involvement and support of the major creditors, which were usually the “big four” state-owned commercial banks and whose claims should account for at least two-thirds of the total debts. The banks would make loans to the newly established company which was able to purchase the assets. When the old insolvent enterprise received the payment, it would be used to resolve labour claims and repay the debts of the major creditors, often the same banks. (See Figure 3.1)

**Figure 3.1: Transfer of funds under the “Changchun Approach”**

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<sup>158</sup> By the end of 2001, 35 SOEs were successfully restructured and rehabilitated under the PSR approach in Changchun city. See W Wang, “Changchun Approach: A New Scheme for Debt Restructuring in China”, a conference paper which is available at [http://www.usc.cuhk.edu.hk/webmanager/wkfiles/1474\\_1\\_paper.doc](http://www.usc.cuhk.edu.hk/webmanager/wkfiles/1474_1_paper.doc) (last visit 31 July 2008)



It is clear that the state banks were the biggest beneficiaries of this debt-restructuring approach. They advanced healthy loans to the new company which had a good prospect of repayment. In addition, they might obtain some repayment from the old enterprise, which would enhance their recovery rate and get rid of some NPLs. It is therefore observed that the money under this approach went around in a circle and finally back into the banks.<sup>159</sup> In contrast to the financial creditors, other preexisting creditors, like small trade creditors and suppliers, would not benefit from this rescue arrangement, even though they could not get anything if this approach was not adopted. In other words, they are the forgotten classes in this PSR style. It was indicated that the government would rather enable someone to get something than everyone to get nothing.

From the perspective of a western insolvency professional, the Changchun approach is a typical “hive down” arrangement, but it is considered to be spectacular in China. It may be noted that the Chinese government is willing to accept western advanced thoughts and measures to restructure the ailing enterprises out of court. Prior to the creation of the Changchun approach, the government had tried two methods to rescue insolvent SOEs, but both methods were either contradicting the market rules or illegal. For instance, in order to salvage a debt-laden enterprise, the government once forced an efficient and productive enterprise which did the same or similar business to merge with an insolvent one, regardless of whether the former was willing or not.

<sup>159</sup> C Booth, “Corporate/Debt Restructuring: Japan, the Hong Kong SAR & the People’s Republic of China: A Roundtable Discussion” (2002) 10 *American Bankruptcy Institute Law Review* 1, 23.

As a consequence, the business of the insolvent one would not be turned around and the competitive and productive one might be badly influenced by the administrative merger, which violated market-oriented mechanisms. In addition, under another method the government tried to transfer the valuable assets from a distressed SOE to a connected enterprise and then the former was put into winding up proceedings. It was the case however that payment for the transaction would never come back to the insolvent one. This practice of “cutting the new enterprise off from the old one” caused the huge amount of NPLs, and damage to the trade creditors and suppliers. Fundamentally, it was illegal and called as “false bankruptcy, real escape” by the banking community.<sup>160</sup>

Generally, it can be observed that this PSR approach had three features. First of all, the government was involved in the whole process. Although the government did not play the leading role, without its mediation and facilitation the rescue attempt would be unlikely to succeed. Secondly, the power of labour was material. With the transfer of the profitable assets, the majority of workers will also transfer to the new company with the production line and equipment by new contracts of employment, but the redundant workers may lose their jobs. The old ailing enterprise had to satisfy their claims and rearrange their lives from the proceeds of the transaction, because of the inadequate social security system. If the worker’s congress failed to pass the proposal of the assets transaction, the restructuring would not be carried out. Thirdly, the small trade creditors and suppliers may be expected to be involved in the negotiation and to fight for their own interests, but due to their weak bargaining position, their opinions may be subject to cramdown by the major financial creditors. According to the analysis of Prof. Wang, the Changchun Approach was legal because all the interested parties had the opportunity to negotiate.<sup>161</sup> It is however arguable that since all the creditors would vote in a single class and normally the value of the claims of

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<sup>160</sup> Tang, above n.17, at para.3.71.

<sup>161</sup> W Wang, “The Bad Assets of Banks & Corporate Rescue in China” (Dec 2002), a paper presented on the Second Forum for Asian Insolvency Reform (FAIR) in Thailand.



ordinary unsecured creditors was small, the creditors' meeting and the result of vote were at the mercy of financial creditors. It can be concluded that the small trade creditors and suppliers became the real victims in this approach.

### **3.2.2.4 Market-oriented reform and legal construction push forward the bankruptcy and corporate rescue law reforms**

#### ***3.2.2.4.1 Economic transition and state-owned enterprises reform***

China has undergone massive changes since the central government launched its economic reform and opening up policy in 1978.<sup>162</sup> At the initial stage of the reform, the CCP ingeniously resolved the ideological debate between capitalism and socialism by putting forward the “bird in the cage” theory and “cat” theory, both of which paved the way for the market-oriented reform and the introduction of western advanced legal institutions.<sup>163</sup> In contrast to the “big bang” approach which was taken by the reformers of the former Soviet Union and Eastern European countries, China adopted a mild way to push forward the transformation from a planned command economy to a market economy by a gradual reform process under the guidance of a philosophy that was metaphorically termed “crossing the river by feeling the stones under the feet.”<sup>164</sup> In other words, China's economic transition was carried out on the basis of experiment and incremental progress, which was conducive to generalizing the experience and modifying the policy timely. In order to avoid or mitigate the detriments in consequence of the shift in economic structure between the two economic systems, the CCP made use of intermediate mechanisms, such as the adoption of a dual-track pricing system with a view to improving the

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<sup>162</sup> For the background of the economic reform, see Lubman, above n.19, p103; Tang, above n.17, at para.3.05.

<sup>163</sup> The “cat” theory represented the dominant viewpoint of pragmatism in the Chinese Communist Party at the early stage of the economic reform. It can be described that “it does not matter whether the cat is black or white; it is a good cat if it catches mice”. Some institutions like the market, private ownership, corporate legal personality and bankruptcy originated in Western countries. So long as they could serve for the Chinese economy and legal construction, the Chinese government should bravely borrow these institutions, combine them with China's unique institutions, and put the ideological debate aside. See Wong, above n.22, at 156.

<sup>164</sup> Bell, Khor and Kochhar, above n.24, p2.

reallocation of resource and gradual decontrol of price, and the establishment of special economic zones for the import of foreign capital and high technology under priority of special economic and taxation policy.<sup>165</sup> The most important feature of the economic reform was the decentralization of authority from the State Council to local governments and SOEs, which to some degree were conferred decision-making power on some issues. The ongoing marketization reform resulted in the establishment of competitive mechanisms and the privatization of the state-owned assets, but the state-owned sector still play the dominant role in the national economy. After three decades of efforts, China has eventually formulated an emerging socialist market economy which is based on a mixed ownership and marked by unique Chinese characteristics.

It is noteworthy that SOE reform is the most crucial component of China's market reforms.<sup>166</sup> Under the passive impact of the old economic system, SOEs failed to compete with private and foreign-invested enterprises in the competitive industries because of their lack of operational autonomy and appropriate incentives. With the further decentralization of management and decision-making power, SOEs could self-arrange production and sale according to the supply-and-demand rule on a commercial basis. The "big pot", a legacy of the former planned economy, was abandoned by the reform which purported to get rid of the equalitarianism and restore the incentives and creativity of workers and the vigour of enterprises.<sup>167</sup> The eventual aims of the SOE reform are to build an efficient corporate governance structure and formulate a modern enterprise system by means of clear corporate property rights and ownership structure, manifest autonomy of operation and relevant responsibility, separation between SOEs and government agencies, and scientific

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<sup>165</sup> Ibid.

<sup>166</sup> For an overview of SOE reform, see R Garnaut, L Song, S Tenev and Y Yao *China's Ownership Transformation: Process, Outcomes, Prospects* (World Bank and the International Finance Corporation, 2005), p2-11; CA Holz *China's Industrial State-owned Enterprises: Between Profitability and Bankruptcy* (World Scientific, 2003).

<sup>167</sup> X Deng, *Selected Works of Deng Xiaoping 1982-1992*, Vol.3 (Renmin Press Beijing, 1993), p155.

management.<sup>168</sup>

#### ***3.2.2.4.2 Reforms of state-owned banks and disposal of non-performing loans by assets management companies***

The bank community reforms commenced with the spin-off of the “big four” state banks from the People’s Bank of China (the central bank) in the initial stage of the economic reform and then the “big four” were reorganized into wholly state-owned commercial banks which were operated on a profit and loss basis.<sup>169</sup> These state-owned banks had previously been subject to the government-dictated lending, which meant that the banks had to advance loans to the SOEs directly under administrative order rather than commercial principles on the basis of market forces, in order to keep the loss-making SOEs away from the brink of insolvency and maintain existing employment for the avoidance of social unrest.<sup>170</sup> Although the government clearly understood that it was just an expedient, the government still directed its solely owned banks to lend for the short-term value of social stability at the price of the accumulation of non-performing loans (NPLs). In addition, the enforcement of debts owed to state banks was very weak and vulnerable. Since both the SOEs and banks were owned and operated by the state, metaphorically the debt-enforcement of banks seemed like taking money out from the left pocket and putting it into the right one. This was why the state banks normally did not have any incentive to claim.<sup>171</sup> Moreover, in order to ensure social stability, the government’s attitude was rather to sacrifice the interests of state banks for the priority of the social security obligations to the employees in the planned bankruptcy programme.

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<sup>168</sup> Tenev and Zhang, above n.36; RD Ewing, “Chinese Corporate Governance and Prospects for Reform” (2005) 14 *Journal of Contemporary China* 317.

<sup>169</sup> S Thomas and C Ji, “Banking on Reform” (2006) 33 *China Business Review* 20, 22. The “big four” state-owned banks are respectively Bank of China (BOC), China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC).

<sup>170</sup> N Lardy, *China’s Unfinished Economic Revolution* (Brookings Washington, D.C. 1998), p83.

<sup>171</sup> R Parry and H Zhang, “China’s New Corporate Rescue Laws: Perspectives and Principles” (2008) 8 *JCLS* 113.

Because of the weakness left by the old economic structure, the state-owned banks suffered from serious issues, notably the high level of NPLs, surplus and untrained staff, and an inefficient corporate governance structure. Due to the lack of effective internal control and adequate supervision, the amount of NPLs in the “big four” commercial banks had already reached RMB 1 trillion (equivalent to £ 66 billion) by 1997.<sup>172</sup> Although China survived the Asian Financial Crisis, the NPLs ratio of the “big four” was still as high as 40 percent in 1998.<sup>173</sup> Obviously, there existed potential risks of financial collapse in the state banks, which had drawn the attention of the central government. In order to eliminate the financial risks and enhance the competitiveness of the “big four”, the State Council respectively set up four asset management companies (AMCs) in 1999 which were mainly used to acquire and transfer the NPLs from the “big four” by reference to the experience of the US and some Asian countries. This approach was intended to mitigate financial risks, reduce the NPLs of banks and enable the balance sheets of the state banks to be improved. In addition, it was conducive to realizing debt-equity swap and restructuring the capital and debts of the financially distressed SOEs. The establishment of AMCs could help the “big four” commercial banks to improve their position strategically by eliminating their bad and doubtful loans in order to improve their financial state and strengthen their ability to compete with foreign banks. In addition, AMCs, as specialized financial institutions, have advantages of collection, management and sale of assets over banks. Professional skills are required to realize a high rate of recovery and cash return by the sale of the portfolio or repackaging the non-performing assets for sale to domestic or international investors.

When dealing with the non-performing loans, the AMCs will assess their potential value from two aspects. One is immediate disposal for a quick cash return. Normally, this “sale” method includes the re-packaging of non-performing loans in order to

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<sup>172</sup> Tang, above n.17, at para.3.66.

<sup>173</sup> Thomas and Ji, above n.169, at 21.

cater to the special needs or preferences of the external purchasers. The other is to invest extra funds in the non-performing loans if there are some reasonable prospects that the value of them is likely to go up, in order to realize a higher rate of recovery. Undoubtedly, this approach will entail more risks.<sup>174</sup> In addition, another main function of AMCs is to help the debtor company restructure through its financial difficulty in order to avoid eventual failure, especially in the case of state-owned enterprises. One strategy of debt restructuring is debt-equity swap. According to s 43 of PRC Commercial Bank Law 2003, commercial banks are not allowed to invest in enterprises and to be shareholders of enterprises. Therefore, the conversion of debt to equity in respect of non-performing loans could not be carried out in banking community. It is submitted that this is another reason why it was necessary to set up AMCs, where the debt-equity swap and debt restructuring could be implemented by AMCs in order to avoid violating the rules of the Commercial Bank Law. It should be noted that by the end of March 2004, the four AMCs had already dealt with bad loans of RMB 528.68 billion and realized RMB 105.47 billion in cash recovery, which accounts for 19.95 % of NPLs.<sup>175</sup>

The successful reduction of the NPLs had made a good preparation for transformation and listing of the “big four”. In 2004, the State Council had injected US \$ 45 billion from the state’s foreign exchange reserve into two state-owned banks, respectively Bank of China (BOC) and China Construction Bank (CCB), each of which was allocated US \$ 22.5 billion. Undoubtedly, the injection of capital could further improve the position of state banks and paved the way for the reform of commercialization.<sup>176</sup> By the end of 2006, it was praiseworthy that the NPLs ratio of the “big four” had decreased into one digit (9.5%) and the banks’ capital adequacy had met the international standard.<sup>177</sup> Such developments indicate that the state

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<sup>174</sup> See Tang, above n.17, at para.3.63.

<sup>175</sup> Statistics are available at the official websites of China Securities Regulatory Commission and AMCs. Tang, above n.17, at para.3.65.

<sup>176</sup> Tang, above n.17, at para.3.66.

<sup>177</sup> *People’s Daily*, 22 August 2006.

banks have reached a healthy and stable status unlike several years ago when the state banks were technically insolvent under the high NPLs ratio. In addition, three of the “big four” have successfully transformed into joint stock companies and listed in China and overseas, and the last one has also finished its transformation and is attempting to be listed in the near future. During the process of transformation, all of them have built a modern corporate governance structure according to the current company law and cut off redundant and incompetent staff. All of these measures have made the “big four” more competitive and efficient, and they are gradually to realize the transition from a government structure to a market-oriented operation.<sup>178</sup> According to its WTO commitments, China should have fully opened the banking sector to foreign banks at the end of 2006. There has been some limited opening up of the market and undoubtedly, the “big four” have faced drastic competition and new challenges which may continue to increase the concerns of government. It should be noted, however, that the Chinese market in the banking sector is still not completely open to foreign bankers on account of the unforeseeable competition and the vulnerability of domestic banks. In this regard, the State Council issued a regulation just prior to the deadline of opening up which to some extent was intended to restrict the commercial activities of foreign banks.<sup>179</sup> However, it is undeniable that the bank reforms have scored some remarkable achievements which pave the way for the promulgation and implementation of the new bankruptcy and corporate rescue law and are in favour of building a good connection with their customers.

#### ***3.2.2.4.3 Ongoing improvement of the social security system***

With the socio-economic transition, the government was fully aware that the original social welfare system had become a big hurdle to the economic structure reform. The introduction of market-oriented competitive mechanisms was unquestionably a threat to the operation of the SOEs, which tended to bear a heavy burden of social security

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<sup>178</sup> S Lubman, “Looking for Law in China” (2006) 20 *Columbia Journal of Asian Law* 1, 26.

<sup>179</sup> United States Trade Representative, *Report to Congress on China’s WTO Compliance*, p82-83 (2006).

provision.<sup>180</sup> From the perspective of the implementation of bankruptcy proceedings, winding up a SOE meant terminating the provision of social welfare to its employees, who would lose their “life money” under the old enterprise-sponsored system.<sup>181</sup> In terms of corporate rescue, a reorganization attempt would normally be accompanied by the hive-off of unprofitable assets and the redundancies of surplus workers. The greater the level of retention of workers, the greater the strain on the resources of the financially ailing enterprise, which may not be able to afford such cost.<sup>182</sup> It should be noted that the increase in the enforcement of bankruptcy and rescue laws will also expose serious unemployment issues which may shake social stability.

The economic transition pushed forward the reforms to the social security system which entailed two fundamental steps. The first one aimed at transforming the enterprise-financed labour insurance model to a unified social protection scheme, the funding of which is shared by the government, enterprises and individual employees and is operated by government agencies.<sup>183</sup> The second one was to enlarge the basic “social safety net” to cover all the residents in urban areas. The peasants in the rural areas were relatively neglected because they were regarded as being self-sufficient.<sup>184</sup> The deeply-rooted notion of the “iron rice bowl”, which was signaled as the legacy of the planned economy, was broken by the reforms, which built the employment relationship between enterprise and its employees by contract. That meant the institution of life-long employment was to be eliminated. In the meantime, a series of programmes were launched to ensure that the laid off workers were retrained and rearranged in new workplaces. During the social security transition, the state became the main actor with the assistance of the market,

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<sup>180</sup> Leung, above n.40, at 73.

<sup>181</sup> For example, under the pre-reform system, the SOEs were responsible for the pension of its employees until their death. The social welfare relationship was built directly between the enterprise and individual workers. See Tang, above n.17, at para.3.29.

<sup>182</sup> Parry and Zhang, above n.171, at 113.

<sup>183</sup> Y Zhu, “Recent developments in China’s social security system” (2002) 55 *International Social Security Review* 39, 40.

<sup>184</sup> S Cook, “From Rice Bowl to Safety Net: Insecurity and Social Protection during China’s Transition” (2002) 20 *Development Policy Review* 615, 620-631.

non-governmental organizations and informal networks.<sup>185</sup> It was noteworthy that a remarkable measure was taken by the State Council, which initiated the establishment of the “National Social Security Fund” to resolve the long term ageing problem and increasing demand for the pension payments in 2000 by means of a fund from the proceeds of disposal of the assets from the SOEs.<sup>186</sup> As a whole, the achievements obtained in the social security transition are encouraging economic growth and the deepening of SOEs reforms, which are conducive to the establishment of a new bankruptcy and rescue legal framework. Although reforms to the social security system have obtained remarkable achievements which are conducive to promoting the innovation of the bankruptcy and corporate rescue laws, it is undeniable that there is still a long way to go before a social security system as adequate and efficient as those of the Western Europe will be attained.

#### ***3.2.2.4.4 The achievements and shortcomings in the gradual legal construction toward a “rule of law”***

It is self-evident that the development of an economy requires a well-functioning and complete legal system, and the sustained economic development forces the judiciary to be more efficient and powerful. A World Bank report claimed that “countries with stable government, predictable methods of changing laws, secure property rights, and a strong judiciary saw higher investment and growth than countries lacking these institutions.”<sup>187</sup> The more economic growth that a government pursues, the more attention needs to be paid to the perfection of domestic legal construction. From the perspective of the Chinese economic structure reforms, it can be found that the amount of foreign investment was fairly small in the first stage from 1978 to 1992, in which the legal system was weak and incomplete, while it has been increasing since 1992 concomitantly with a series of legal reforms to the judiciary and the

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<sup>185</sup> For more details, see K Lin and O Kangas, “Social policymaking and its institutional basis: Transition of the Chinese social security system” (2006) 59 *International Social Security Review* 61.

<sup>186</sup> Tang, above n.17, at para.3.34.

<sup>187</sup> The World Bank (1999: 23), citing the *World Development Report 1997: The State in a Changing world*.



promulgation of a pack of market-based commercial laws. Particularly in 1999, the principles of “rule of law” were eventually established by the Constitution, and the construction of a socialist rule-of-law China became the tenet and target of the Chinese Communist Party.<sup>188</sup>

According to the theory of Randall Peerenboom, rule of law is composed of an independent judiciary, competent and adequate judges with requisite knowledge and skills, and sufficient powers to decide cases impartially.<sup>189</sup> Although the progress in judicial reforms and legal construction is remarkable, the above three requirements are still the key challenges to China’s judiciary. It has been observed that:

“The Chinese legal system is steadily improving but remains tainted by political influence, lack of transparency and corruption, according to lawyers both foreign and local. ... The quality of judgments in China has improved but when the cases involved sensitive issues or people, you can predict the result.”<sup>190</sup>

Even if the principle of judicial independence has been established by the Constitution and Judges Law,<sup>191</sup> illegal interference from government authorities still cannot be completely eradicated because of the political structure.<sup>192</sup> In addition, a series of scandals and corruptions may result in the people’s mistrust and resentment of the authority of the judiciary.<sup>193</sup> Local protectionism is another big issue which will frustrate the adjudicating principles of fairness and justice and undermine the final goal of rule of law.<sup>194</sup> Particularly in bankruptcy cases, the creditors in respect of the debtor may be located in a number of provinces and they cannot easily realize their claims, because the budget of the local court is determined and allocated by the local government and this may lead to protection of local interests by local court.<sup>195</sup>

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<sup>188</sup> Chinese Constitution Amendment 1999, article 13.

<sup>189</sup> R Peerenboom, *China’s Long March Toward Rule of Law* (CUP, Cambridge, 2002), p280.

<sup>190</sup> *South China Morning Post*, 27 March 2004.

<sup>191</sup> Constitution 1982, article 126; Judges Law 1995, article 8.

<sup>192</sup> Peerenboom, above n.189, p280-282.

<sup>193</sup> Tang, above n.17, at para.5.10.

<sup>194</sup> S Li “Bankruptcy Law in China: Lessons of the Past Twelve Years” (Winter 2001) *Harvard Asia Quarterly*, Volume V, No.1

<<http://www.asiaquarterly.com/content/view/95/40/>>

<sup>195</sup> See the comments of Mr Cao Siyuan, “the father of bankruptcy law in China”, in the

Nevertheless, what can be praiseworthy is that China has been unshakably on its way to challenge and eradicate the traditional deeply-rooted mindset of rule by men and to build a regime of rule of law on the basis of the emerging socialist market economy. In addition, judicial practice of the old bankruptcy laws in the past two decades has to some degree accumulated relevant knowledge, skills and experience for the judges who were well-trained and competent at hearing bankruptcy-related cases. However, it is indicated from the small number of the reported bankruptcy cases that the judges who actually have judicial experience of hearing bankruptcy cases merely account for a small proportion, and pursuant to the current organization of the court system there is no special court for the trial of bankruptcy cases, which are normally under the charge of the second branch of the civil division of a court at any level, except in some cities like Shenzhen.<sup>196</sup> That is to say that there is a big shortage of professional judges with expertise and skills of insolvency law and the lack of resources including the competent staff and facilities has become a big challenge to the judiciary with the implementation of the new bankruptcy law.<sup>197</sup> It can be therefore concluded that the emerging rule of law, the deepening of the judiciary reforms and the enhancement of the judges' ability and quality in the bankruptcy law area will promote and strengthen the bankruptcy legal framework and pave the way for the reforms of corporate rescue laws, but one thing that should be borne in mind is that there is still much effort and progress to be made by the Chinese government in order to be a real rule-of-law country.

#### ***3.2.2.4.5 External pressure***

The exterior pressure from the international economic environment is also a significant impetus which might be lobbying for the change of China's bankruptcy

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*South China Morning Post*, 19 April 2000; Q Zhang, "The people's court in transition: the prospects of the Chinese judicial reform" (2003) *Journal of Contemporary China* 69, 89.

<sup>196</sup> Zhang and Booth, above n.146, at 1.

<sup>197</sup> X Lan "Outdated Bankruptcy Law Updated" available at [http://www.bjreview.com.cn/200430/Business-200430\(B\).htm](http://www.bjreview.com.cn/200430/Business-200430(B).htm). (last visit 31 July 2008)

legal framework. Although China has made great achievements on its economic transition to becoming a market economy, China's full market economy status is still not recognized by the US and EU, both of which are the two largest trade partners of China.<sup>198</sup> The inefficiency and ineffectiveness of China's old bankruptcy law constitutes one of the reasons upon which the EU has refused to recognize China as having a full market economy.<sup>199</sup> Undoubtedly, this non-recognition may have a bad impact on China's export interests, put China in a disadvantageous position in trade disputes and erode its international image and reputation.<sup>200</sup> To some degree, the non-recognition urged the Chinese legislature to push forward the bankruptcy law reform and accelerated the legislative process, particularly after EU first refused China's petition for full market economy status in 2003. In addition, a modernized bankruptcy law which is in line with international standards and principles may assist China to build an appealing investment environment, which could eliminate the concerns of investors and ensure the increase in the flow of foreign capital into the Chinese market.

### **3.2.2.5 Corporate rescue culture in the long-awaited new Enterprise Bankruptcy Law 2006**

As early as 1994, the central government organized an insolvency law review committee to overhaul the 1986 law and enact a revamped enterprise bankruptcy and reorganization law by referring to the achievements of insolvency law reforms of the Western industrialized nations.<sup>201</sup> A praiseworthy draft was formulated in 1995, but

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<sup>198</sup> See EU-China News: Market Economy Status Report Encourages Further Progress, No.4, 2004, available at <http://www.delchn.cec.eu.int/newsletters/200404/018.htm> (last visit 31 May 2007)

<sup>199</sup> On the 9<sup>th</sup> Annual EU-China Business Summit held in September 2006 in Helsinki, EU Commission once again rejected the China's petition for a full market economy status by four reasons, one of which was the ineffectiveness and inconsistency of China's bankruptcy law. More information is available at <http://business.sohu.com/20060911/n245265614.shtml> (last visit 31 May 2008)

<sup>200</sup> J Shi, "Twelve Years to Sharper One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy" (2007) 16 *Norton Journal of Bankruptcy Law and Practice* 645, 653.

<sup>201</sup> The Bankruptcy Law and Restructuring Center of China University of Political Science

it failed to pass because of the major concerns about inadequate social security system and the huge NPLs in state banks which might cause financial collapse and social unrest.<sup>202</sup> Subsequently, the drafting group resumed its mission respectively in 1998 and 2000, where again the draft was suspended by the legislature due to the potential danger of social instability. With the deepening of economic reform and the emerging establishment of a market economy, the achievements in the banking reforms and social security transformation paved the way for the promulgation of an entirely new bankruptcy law which was desperately needed. In August 2003, the Financial and Economic Commission of the NPC restarted the drafting process and comprehensively collected suggestions from government agencies, courts and insolvency professionals in order to reach further consensus.<sup>203</sup> The improved draft was heard twice in June and October 2004 and was eventually promulgated on 27 August 2006.<sup>204</sup> The merits of the new bankruptcy law are self-evident. It borrows a brand-new legal institution, “administrator” and formulates an advanced formal corporate rescue legal framework, which is the so-called “reorganization” regime.<sup>205</sup> When the petition for the reorganization procedure is accepted by the court, the court is empowered to appoint an administrator to take over all of the company’s affairs. There will be an automatic stay on the debt enforcement of individual creditors, and in this period of protection the administrator is required to draft a reorganization plan and negotiate with creditors. The plan which has been approved by the creditors’ meeting and granted by the court has a binding effect on the enterprise and its creditors. In addition, the debtor is allowed to apply for continuing control in the reorganization. If the application is sanctioned by the court, the directors of the

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and Law presented a translation of China’s new bankruptcy law, which is available at (2008) 17 *International Insolvency Review* 33-55.

<sup>202</sup> Wang, above n.116, at 234.

<sup>203</sup> Xu, above n.152, p43-44.

<sup>204</sup> For more knowledge about the latest draft, see C Booth, “Drafting Bankruptcy Laws in Socialist Market Economy: Recent Development in China and Vietnam” (2005) 18 *Columbia Journal of Asian Law* 93; EJ Chua, “China’s Central Government Sets Short Timetable for Bankruptcy Law Reform” (2005) 20 *J.I.B.L.R.* 610; M Barker and R Purser, “Moving China’s Goalposts” (2005) 2 *International Corporate Rescue* 328.

<sup>205</sup> For a brief introduction, see M Simmons and J Jiang, “A New Insolvency Law in China” (2007) 4 *International Corporate Rescue* 10.

enterprise remain in full control of the affairs under the supervision of an administrator. This mechanism comes close to the notion of the transpacific debtor-in-possession model under the US Chapter 11.<sup>206</sup> This is a general picture of China's newly established formal corporate rescue legal framework, of which the detailed substantive rights, procedures and assessment of efficiency and effectiveness will be fully developed in the following chapters.<sup>207</sup>

## Concluding remarks

The unique culture and ideology of the UK and China forms a vivid comparison that reveals people's distinct attitudes and patterns of thought towards the role of law. Owing to the deep-rooted impact of the traditional mindsets under the Confucian and Maoist theory, it is very difficult for Chinese people to understand and accept the notion of bankruptcy which has been well developed in England for several hundred of years. Even nowadays, the legal institution of bankruptcy law is still not popular and fully recognized among the ordinary people in China. That is mainly because bankruptcy law is a completely new outcome of China's market-oriented reform which people cannot understand under the old mindsets. Another reason is that the people are in fear of bankruptcy because of the poor social security system. Different legal cultures and entrepreneurial cultures have led the UK and China to adopt different approaches to the development of their bankruptcy laws. It is praiseworthy that England has established an efficient and well-functioning corporate rescue structure after experiencing two waves of reforms to its insolvency proceedings in

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<sup>206</sup> Parry and Zhang, above n.171, at 113.

<sup>207</sup> It should be noted that the new bankruptcy law also provides a "reconciliation" procedure which aims to reach a compromise on debt reduction between the debtor and its creditors under the supervision of court. Reconciliation has the rescue-oriented mechanism if the debtor and its creditors could reach a composition and it could avoid liquidating the debtor. Compared with reorganization regime, the rescue-oriented mechanism of reconciliation is very weak and the procedure is very simple. There is no moratorium available to restrain the claims of individual creditors. Thus, it is nearly unlikely to realize the rehabilitation of debtor. Instead, it just provides another alternative for the creditors to obtain a better recovery than insolvent liquidation. Therefore, reconciliation procedure is out of the discussion of this thesis. For some knowledge of it, see W Wang, *The Interpretation and Substance of Bankruptcy Law* (Law Press-China, 2007), P278-304.(in Chinese)

the mid 1980s and the beginning of the new millennium. Comparatively, in China the emerging rescue culture has been formulated recently in the new bankruptcy law which for the first time introduces the legal institutions of “administrator” and “reorganization” by referring to the experience of Western world.

The reforms in China, including the reforms of SOEs, banking sector, social security and legal construction in the past three decades prompted for the bankruptcy law reforms, and lobbied for a new bankruptcy and corporate rescue legal framework which is conducive to China’s emerging market economy and rehabilitation of financially distressed but economically viable enterprises. The tortoise has eventually crossed the winning line after 12 year long-awaited drafting process that reflects the government’s hesitation and concern over social stability. In the legislative process, some barriers, such as the huge amount of NPLs in state banks and the inadequate social welfare system, prevented the enactment of the new bankruptcy law. Although some problems have been ameliorated, they have not gone away and still remain threat to the implementation of the new law. The social impact of the new law is potentially great because there is a prospect of large-scale redundancies through bankruptcy proceedings and possible accumulation of NPLs which may invoke negative social consequences. Therefore, the impact of the new law is likely to be limited by the judiciary and the enforcement might be subject to government influence under the current political structure.

## **Chapter IV : A critical assessment of the Chinese corporate rescue laws and policies on the basis of the English model**

### **Introduction**

The company voluntary arrangements (CVAs) and administration procedures, which were first introduced by the Insolvency Act 1986 on the recommendation of the Cork Report, formulated the UK corporate rescue laws and since then the UK corporate insolvency has entered a new era of rescue culture.<sup>1</sup> However, both rescue regimes failed to perform their functions as they were initially expected from a statistical perspective. A series of factors led to the failure of the original CVAs and administration procedures which suffered serious deficiencies and were under-used in practice. In order to improve the efficiency and effectiveness of the rescue laws, reforms were encouraged with a view to providing a better alternative to companies in financial trouble and seeking rehabilitation. The first major reform since the 1986 Act was brought by the Insolvency Act 2000 which enhanced the attractiveness of the CVA regime and was seen as having an eye-catching influence on the reorganization and business turnaround of small companies.<sup>2</sup> Subsequently, the Enterprise Act 2002 was enacted and it aimed to revamp the old administration proceedings and assist ailing firms by enhancing the effectiveness of the rescue-oriented insolvency regime. The 2002 reforms brought dramatic changes to the UK formal rescue legal framework which abolished the administrative receivership regime in all but a small range of situations and streamlined the administration procedure.<sup>3</sup> There is no doubt that the new format administration

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<sup>1</sup> J Tribe, "Company Voluntary Arrangements and Rescue: A New Hope and a Tudor Orthodoxy" [2008] J.B.L. (forthcoming)

<sup>2</sup> K Gromek Broc "England and Wales: The Impact of the Revised Company Voluntary Arrangement Procedure" in K Gromek Broc and R Parry *Corporate Rescue: An Overview of Recent Developments from Selected Countries* (2<sup>nd</sup> edn, Kluwer Law International, 2006), p99.

<sup>3</sup> R Goode, "The Case for the Abolition of the Floating Charge", in J Getzler and J Payne (eds), *Companies Charges---Spectrum and Beyond* (OUP, Oxford, 2006), P11.

procedure will have a far-reaching impact on the consequences of corporate insolvency. In China, a modified, rescue-oriented and court-centralized reorganization procedure was established by the new bankruptcy law and this reorganization regime is applicable to all types of enterprises with legal person status. China's reorganization procedure was formulated by borrowing ideas from the achievement and experience of advanced jurisdictions with developed insolvency and corporate rescue laws and considering China's unique situations. The legal institution of corporate rescue was easily recognized and accepted by the Chinese government which has long been concerned with the issues of unemployment, weak social security and a vulnerable financial system that may be incurred by mass insolvent liquidations. Thus, the reorganization regime was expected to foster a rescue culture which could be helpful for social stability.<sup>4</sup> This chapter aims to examine the main features and detailed rules of the modern corporate rescue laws of both the UK and China, and to understand the different approaches which both governments adopted when they faced the common question of how to rescue financially distressed companies. It will also find out the similarities and differences of the legal rules, principles and policies. Most importantly, it will identify the weaknesses and deficiencies of the new Chinese rescue laws in light of the contextual factors discussed in the previous chapter by referring to the English CVA and administration regimes as a comparator.

## **4.1 England: company voluntary arrangements (CVAs)**

### **4.1.1 Initiation of the CVA regime and moratorium**

A CVA commences with a proposal which is issued by the directors of a company in the circumstance where the company is not subject to administration or liquidation with an initiative to propose a voluntary arrangement for a scheme in satisfaction of

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<sup>4</sup> J Shi, "Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy" (2007) 16 *Norton Journal of Bankruptcy law and Practice* 645, 666.



debt repayment or a reorganization of the company's affairs.<sup>5</sup> The major reform brought by the Insolvency Act 2000 was the introduction of a moratorium which may enable the small and "eligible" company to take a breath, negotiate with creditors, attempt to obtain support from creditors and conclude a composition binding the company and its creditors.<sup>6</sup> During this temporary prescribed period, the debt enforcement by individual creditors is strictly restricted.<sup>7</sup> In addition, the moratorium could also shield the company from other legal actions, like the repossession of property, which cannot be enforced without the permission of the court.<sup>8</sup>

In order to benefit from the moratorium, the directors must obtain a positive report from an insolvency practitioner who supports the proposed arrangement and consents to act as a nominee. In judicial practice, directors may tend to consult the intended nominee in advance and obtain advice which could assist the directors to draw up a proposal in line with the opinion of the insolvency practitioner.<sup>9</sup> In addition, the directors shall file five compulsory documents in the prescribed form with court.<sup>10</sup> These documents include the proposed voluntary arrangement setting out terms, a statement of the company's affairs articulating the company's assets, liabilities and business affairs, a statement from the proposed nominee which confirms his consent to act, and a report from the proposed nominee which in his opinion supports the proposed arrangement as a reasonable prospect.<sup>11</sup> In addition, the directors must

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<sup>5</sup> If the company is in administration or liquidation, the proposal may be made by administrator or liquidator. IA 1986, s 1(1)(3).

<sup>6</sup> It has been emphasized that a successful CVA attempt needs to satisfy two conditions, respectively a realistic proposal and creditors' support for that proposal. See S Frisby, *Report on Insolvency Outcomes*, presented to the Insolvency Service on 26 June 2006, p63.

<sup>7</sup> IA 1986, Sch A1, para.12; J Tribe, "Company Voluntary Arrangements and Rescue: A New Hope and a Tudor Orthodoxy" [2008] J.B.L. (forthcoming)

<sup>8</sup> C Dunn and S Brooker "Effect of the Insolvency Act 2000 on Landlord and Tenant Law" (2001) 5 *Landlord & Tenant Review* 25.

<sup>9</sup> L Sealy and D Milman, *Annotated Guide to the Insolvency Legislation 2006/2007* (9<sup>th</sup> edn, Sweet & Maxwell London, 2006) Vol 1, p21.

<sup>10</sup> For more details, see E Bailey, *Voluntary Arrangements* (2<sup>nd</sup> edn, LexisNexis Butterworths, 2006), para.6.3.

<sup>11</sup> IA 1986, Sch A1, para.7(1)(a)(b)(d)(e).

submit a statement of evidence which could prove that the company meets the criteria of eligibility for a moratorium.<sup>12</sup> A company is eligible if it meets two or more conditions out of three: respectively turnover (not more than 2.8 million), balance sheet total (not more than 1.4 million) and the number of employees (up to 50).<sup>13</sup> The moratorium commences with the prescribed documents being filed with the court, and lasts for a 28 day period that may be extended.<sup>14</sup>

#### 4.1.2 The nominee's role in CVAs

It should be noted that the nominee's role is more extensive and onerous than under the original CVA.<sup>15</sup> The nominee is required to form a statement of opinion on the basis of the information submitted by the directors on the inception of the procedure which determines the commencement of the proposed CVA and statutory moratorium.<sup>16</sup> The nominee must address the following three issues in the statement, whether:

- (1) there is reasonable prospect of the proposed CVA being approved and implemented;
- (2) it is likely that the company will have sufficient funds available during the proposed moratorium to enable the company to continue its trading;
- (3) meetings of the company and its creditors should be summoned to consider the voluntary arrangement.<sup>17</sup>

Prior to making the statement, the nominee must ensure that the proposal is realistic and promising. The formulation of such opinion relies for example on evidence that new financial supporters are willing to advance sufficient funds for the company to carry on its business, or that the existing suppliers will continue to supply goods for the company during the proposed moratorium.<sup>18</sup> Undoubtedly, such requirements impose a heavy burden on the nominee, who has a difficult task in carrying out his

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<sup>12</sup> IA 1986, Sch A1, para.7(1)(c).

<sup>13</sup> CA 2006, s 382 (3).

<sup>14</sup> IA 1986, Sch A1, paras.8, 32 and 35.

<sup>15</sup> A Smith and M Neill, "The Insolvency Act 2000" (2001) 17 *Insolvency Law & Practice* 84, 85.

<sup>16</sup> IA 1986, s 2(3). The nominee is also entitled to doubt the accuracy of information of company affairs by reasonable cause which he is responsible to satisfy. For a discussion of the nominee's position, see *Re a Debtor (No.140 IO of 1995)* [1996] 2 BCLC 429.

<sup>17</sup> IA 1986, Sch A1, para.7(1)(e).

<sup>18</sup> Smith and Neill, above n.15, at 85.

work. It is noteworthy, however, that these requirements are employed to ensure the viability of the proposal, prevent the abuse of the moratorium and prohibit an illicit connection between the director and the nominee.<sup>19</sup> In addition to making this statement, the nominee is obliged to, with twenty-eight days of the notice of the proposal being given to him, submit a report to the court, in which the nominee shall express his view as to whether or not the proposal has a reasonable prospect of success, and whether or not the meetings of the company and its creditors should be summoned. If so, he must specify the date, time and place in the report.<sup>20</sup> It is noteworthy that the last big function which the nominee shall perform in the CVA process is to supervise the implementation of the proposed voluntary arrangement if it is approved by the meetings of the company and its creditors. In this circumstance, the nominee becomes the supervisor who must discharge his duty of supervision independently.<sup>21</sup> The supervisor is entitled to apply to the court for directions when some particular issue arises in the course of implementation. The conduct and decisions of the supervisor are under the supervision of the company's creditors and other interested parties, any of whom is allowed to petition to the court for rectifying any act or decision of the supervisor.<sup>22</sup>

#### 4.1.3 Vote and approval of a CVA

The nominee is responsible to summon separate meetings of the company and its creditors in order to approve the proposed voluntary arrangement with or without modifications as he thinks fit.<sup>23</sup> All the creditors of whom the nominee is aware in respect of the debtor shall vote in a single class of meeting. The voting structure is not as complex as schemes of arrangement, where all the creditors will be categorized into different voting classes.<sup>24</sup> In a CVA, the approval of the proposed

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<sup>19</sup> Ibid; see also Frisby, above n.6, at 63.

<sup>20</sup> IA 1986, s 2(2); Sealy and Milman, above n.9, p24-25.

<sup>21</sup> IA 1986, s 7(2); Gromek Broc, above n.2, p97.

<sup>22</sup> IA 1986, s 7(3); Sch A1 para.26(1).

<sup>23</sup> IA 1986, s 3(1); Sch A1, para.29.

<sup>24</sup> R Parry, *Corporate Rescue* (Sweet & Maxwell, London, 2008), para.17-01.

voluntary arrangement needs the consent of 75 percent of creditors who vote in person or by proxy by reference to the value of their claims, and also requires the support of at least 50 percent of shareholders in value of their shares.<sup>25</sup> The voluntary arrangement will take effect if it is approved by both meetings. However, the meetings of creditors' and company may have divergent decisions. If the proposal is approved by the creditors' meeting but rejected by the company meeting, the decision of the former overrides that of the latter, and the proposal is approved. However, there is a remedy for the dissenting member of the company who is entitled to apply to the court.<sup>26</sup>

An application can also be made to the court by a dissenting creditor, member or contributory of the company to challenge the voluntary arrangement on the grounds that it has unfairly prejudiced the interests of the applicant, or there has been some material irregularity at or in relation to either of meetings. The entitled applicants include the person who is entitled to vote at either of the meetings; the person who would have been entitled to vote at the meeting of creditors if he had had the notice of it; and the nominee.<sup>27</sup> If the court is satisfied by the application, it may revoke or suspend the effect of the approved proposal, and give directions for the calling of further meetings to reconsider the original proposal or approve a revised proposal.<sup>28</sup>

It is important to note that the court is not positively involved in approving the proposed voluntary arrangement, and the proposal will take effect after it is approved at the creditors' meeting. The approved proposal has a binding effect on the company and every person who was entitled to vote at the meeting, including the dissentients and those who had received the notice but did not vote.<sup>29</sup> The arrangement does not

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<sup>25</sup> IR 1986, r 1.19-1.20.

<sup>26</sup> IA 1986, s 4A(3); Sch A1, 36(3); E Bailey, *Voluntary Arrangements* (2<sup>nd</sup> edn, LexisNexis Butterworths, 2006), para.7.13.

<sup>27</sup> IA 1986, s 6(1); Sch A1, para.38(1). *Sisu Capital Fund Ltd and others v Tucker* [2005] All ER (D) 202.

<sup>28</sup> IA 1986, s 6(4); Sch A1, para.38 (4).

<sup>29</sup> IA 1986, s 5 (2).

bind preferential creditors and secured creditors without their consent.<sup>30</sup> The arrangement does not have binding effect on the persons, who cannot take advantage of the arrangement.<sup>31</sup> The arrangement does not prevent a person, whose claim was not brought within the arrangement, from initiating legal action against the company for the pursuit of his claim.<sup>32</sup> In short, the persons, who do not have the voting entitlement, are not to be bound by the voluntary arrangement.<sup>33</sup>

#### 4.1.4 Court's involvement

The establishment of CVAs purported to create a simple, quick and cheap corporate rescue regime which could facilitate an agreement of composition with creditors, and it will have a binding effect on the company and creditors who are entitled to vote without obligation to go to the court.<sup>34</sup> It can be observed that in respect of the CVAs, the court plays the role of a guardian who maintains order, removes difficulties and resolves disputes of substantive rights and procedural issues among the interested parties. With regard to the court, the judges are experts in the interpretation of bankruptcy and corporate rescue laws, rather than the experts in the accounting, restructuring and business turnaround areas. Undue involvement of the court in the investigation and technical issues of reorganization may cause delay to the rescue process and increase costs. Although the court is not actively engaged in the CVAs, it is still involved on some occasions which are very significant. If the directors of a company intend to obtain a moratorium for the proposed voluntary arrangement, they must file the appropriate documents in the prescribed form with court.<sup>35</sup> The court in the process of application for a moratorium could prevent the abuse of the protection provided by the moratorium which may cause delayed entry of the nonviable

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<sup>30</sup> J Tribe, "Company Voluntary Arrangements and Rescue: A New Hope and a Tudor Orthodoxy" [2008] J.B.L. (forthcoming)

<sup>31</sup> *R A Securities Ltd v Mercantile Credit Co Ltd* [1994] BCC 598.

<sup>32</sup> *Alman v Approach Housing Ltd* [2001] 1 BCLC 530.

<sup>33</sup> Sealy and Milman, above n.9, p29; S Hermer, "CVAs: how binding they are?" (1995) 16 Comp. Law. 276.

<sup>34</sup> *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) ("Cork Report"), para.102.

<sup>35</sup> IA 1986, Sch A1, para.7(1).

company into liquidation proceedings and lead to deterioration of the creditors' prospects of recovery.<sup>36</sup> One important function which the court plays in the CVA process is to resolve uncertainty or difficulties that arise during the proposed voluntary arrangement. The supervisor is entitled to apply to the court for directions regarding a particular matter which arises where the company undergoes the CVA procedure.<sup>37</sup> Another function of court in the CVA regime is to resolve litigation which is triggered by an interested party who is dissatisfied with the act or decision of the supervisor. The court may confirm, reverse or modify any act or decision of the supervisor under the application.<sup>38</sup> In addition, the court may appoint a substitute for the supervisor to carry out the supervisor's functions if this is expedient.<sup>39</sup>

#### 4.1.5 The impact of the CVA regime and comments

The CVA procedure emphasizes voluntariness, which could encourage directors of a small eligible company to initiate the rescue procedure at an early stage when the company is facing financial difficulty. Compared with the administration procedure, the CVA regime provides a company rescue vehicle which is similar to the US 'debtor-in-possession' model. In contrast to schemes of arrangement, the CVA regime offers a quick and cost-effective way of rehabilitating companies in financial trouble.<sup>40</sup> However, statistics indicate that the number of CVAs has been small.

***Figure 4.1: The Incidence of CVAs from 1987 to 2007***<sup>41</sup>

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<sup>36</sup> Gromek Broc, above n.2, p99.

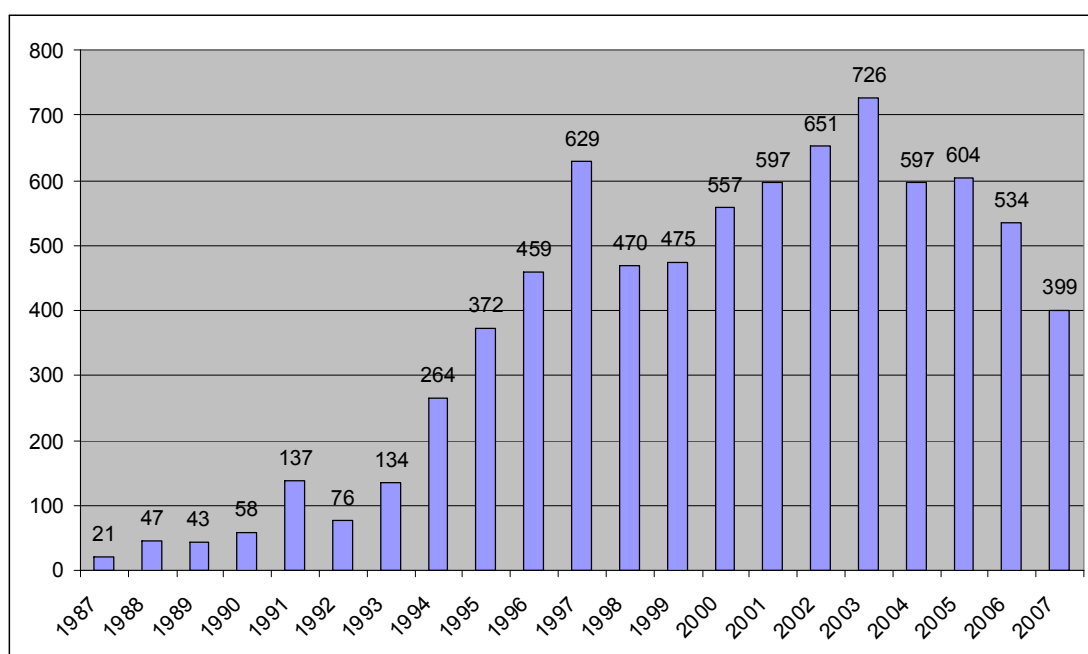
<sup>37</sup> IA 1986, s 7(4).

<sup>38</sup> IA 1986, s 7(3).

<sup>39</sup> IA 1986, s 7(5).

<sup>40</sup> IF Fletcher "UK Corporate Rescue: Recent Developments—Changes to Administrative Receiverships, Administration, and Company Voluntary Arrangements—The Insolvency Act 2000, The White Paper 2001, and the Enterprise Act 2002" (2004) 5 EBOR 119, 133.

<sup>41</sup> Statistics are available at <http://www.insolvency.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm> (last visit on 31 May 2008)



Particularly compared with the figures of corporate liquidation, it could clearly be demonstrated that CVA regime has been underused.

<b>Year</b>	<b>CVAs</b>	<b>Administration</b>	<b>Administration (EA2002)</b>	<b>Administrative Receivership</b>	<b>Liquidation</b>
1999	475	440	-	1,618	14,280
2000	557	438	-	1,595	14,317
2001	597	698	-	1,914	14,972
2002	651	643	-	1,541	16,305
2003	726	497	247	1,261	14,184
2004	597	1	1,601	864	12,192
2005	604	4	2,257	590	12,893
2006	534	0	3,560	588	13,137
2007	399	2	2,327	477	12,427

The operation of the CVA regime experienced a slow beginning in the early years on account of several reasons like the block of administrative receivership, the unavailability of a moratorium and lack of knowledge and understanding as to the newly established rescue procedure. Even though the Insolvency Act 2000 effected

<sup>42</sup> Statistics are available at <http://www.insolvency.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm> (last visit on 31 May 2008)

dramatic changes to the CVAs and the number reached the highest level in 2003 when the new Act came into force, the number fell in the following years. The impact of the reforms is limited from the perspective of statistics, but it does not necessarily mean that the reforms have not been successful. It must be evaluated over a longer period of time. It should be noted that the moratorium introduced by the Insolvency Act 2000 is only available to small eligible firms. This restriction may probably become a deficiency because large companies cannot obtain benefit from the moratorium in the CVAs. Thus, the combination of a CVA and administration becomes an attractive and popular way to pursue the attempted rescue.<sup>43</sup>

## **4.2 England: the revamped administration proceedings**

### **4.2.1 Access to the administration procedure**

An effective corporate rescue regime which is in line with international principles and standards should provide easy, cheap and quick access to the rescue procedure for the financially distressed companies which are desperately seeking assistance for turnaround.<sup>44</sup> Any delay in the opening stage may cause detriment to the initiation of rescue proceedings and accordingly the financially troubled firms may lose their optimal opportunities of being rehabilitated by the waste of time. According to the old style administration procedure, applicants who intended to trigger this rescue-oriented procedure had to present a petition for a court order.<sup>45</sup> In other words, every administration order and appointment of administrator was made on the basis of a court hearing. Therefore, the old legislation was designed as a court-driven regime and undoubtedly it had two major disadvantages. Firstly, this court-based administration increased the workload of the judiciary, which could result in delay in the commencement of the proceedings and an increase in the costs. Secondly, the administration application could be easily blocked by a floating charge holder who

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<sup>43</sup> Frisby, above n.6, at 62-63.

<sup>44</sup> The World Bank, *Principles for Effective Insolvency and Creditor Rights Systems* (Revised Draft, 2005), para.C14.1.

<sup>45</sup> IA 1986, s 9 (1).



was entitled to appoint an administrative receiver before the court made an administration order. It should be noted that one remarkable innovation of the reforms made by the Enterprise Act 2002 is the introduction of an out of court appointment mechanism under the streamlined administration. The qualifying floating charge holder, the company or its directors are entitled to appoint an insolvency practitioner as the administrator without the involvement of the court.<sup>46</sup> The extra-judicial appointment provides the distressed debtor with quick and flexible access to rescue proceedings without a court hearing, eases the concerns of the judiciary regarding a heavy work load and may accordingly avert unnecessary delay and cost.<sup>47</sup>

The Enterprise Act 2002 inserted a new section into the Insolvency Act 1986 which severely restricts the use of administrative receivership, which was highly and comfortably employed by banks and other financiers with a floating charge to take control of the assets and business affairs of their ailing customer, and enforce the loan contract by means of appointing an administrative receiver.<sup>48</sup> As a compromise, the floating charge holders are vested with the power to appoint an administrator out of court who should act for the interests of all the stakeholders. This mechanism of the extra-judicial appointment of an administrator seems to balance the interests of the floating charge holders, whose power to appoint an administrative receiver has been virtually abolished in respect of debentures created after 15 September 2003, and it is expected that this out-of-court route into administration may be the usual

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<sup>46</sup> IA 1986, Sch B1, paras.14 and 22. "The essential characteristics of a qualifying floating charge are: (a) that the charge must by its terms give the holder power to appoint an administrator (or an administrative receiver); and (b) the charge (or that and other charges taken together) must relate to the whole or substantially the whole of the company's property." "The company may take this step by resolution of the shareholders passed at a general meeting." See Sealy and Milman, above n.9, p511 and 516.

<sup>47</sup> R Goode, *Principles of Corporate Insolvency Law* (3<sup>rd</sup> edn, Sweet & Maxwell, London, 2005), para.10-13.

<sup>48</sup> S 72 of IA 1986 was inserted by the s 250 of EA 2002 which generally abolishes administrative receivership. However, there are still six exceptions which do not prevent the appointment of an administrative receiver according to s 72B to s 72G of IA 1986. See S Davies QC (ed), *Insolvency and the Enterprise Act 2002* (Jordans, Bristol, 2003), p45-47.

mode.<sup>49</sup> It should be noted that the floating charge holder is not allowed to appoint an administrator where the company is already in administration, or a provisional liquidator of the company or an administrative receiver has been in office.<sup>50</sup> In addition, the floating charge should be “enforceable” which means that “the floating charge holder is entitled to call in their security”.<sup>51</sup>

The company or directors are also empowered to appoint an administrator out of court.<sup>52</sup> Such mechanisms may give the directors the right incentive to seek advice from outside insolvency specialists at an early stage in the cycle of decline and to pursue a successful rescue outcome, rather than gambling on over-risky commercial activities.<sup>53</sup> The out-of-court route for the company or its directors is a radical innovation of the new administration regime which breaks the monopoly of floating charge holders over the power of the extra-judicial appointment of an administrator.<sup>54</sup> It should be noted, however, that the legislation imposes a series of restrictions upon the company and its directors in order to prevent the abuse of the out-of-court appointment. First of all, the company or its directors may only appoint an administrator when the company is insolvent or is likely to be insolvent.<sup>55</sup> Such an appointment is prohibited from prejudicing the interests of the holder of a floating charge. Prior to making an appointment, a written notice should be given to the holder of a floating charge who is allowed four choices:

- (1) simply consenting to the appointment;
- (2) making his own appointment of administrator if he so decides;
- (3) blocking this appointment by appointing an administrative receiver if it is allowed;

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<sup>49</sup> Goode, above n.47, at para.10-13.

<sup>50</sup> IA 1986, Sch B1, paras.7 and 17.

<sup>51</sup> Paragraph 658 of the Explanatory Notes to EA 2002.

<sup>52</sup> IA 1986, Sch B1, para.22.

<sup>53</sup> V Finch, “Re-invigorating Corporate Rescue” [2003] J.B.L. 527, 552.

<sup>54</sup> Davies, above n.48, p110.

<sup>55</sup> IA 1986, Sch B1, para.27 (2) (a).

(4) applying to the court for a court-based administration.<sup>56</sup>

In addition, the anti-abuse provisions include prohibition of out of court appointments where the company has been in liquidation or a winding up petition has been presented or the company has been in an administrative receivership. This route is not available for a company which is intending to enter into a second administration less than 12 months after a first or which has entered an earlier CVA with the benefit of a moratorium within the previous 12 months, but the legislation does not prevent the company and its directors from applying for an administration by court order in these circumstances.<sup>57</sup>

The revamped administration procedure retains the court-based appointment for which the company or its directors, or one or more creditors in respect of the company, are entitled to apply.<sup>58</sup> The court can make the order under its wide discretion, if two conditions, respectively “the insolvency condition” and “the purpose condition”, are satisfied.<sup>59</sup> This route under court order offers creditors without a qualifying floating charge their only access to the administration procedure. In terms of a qualifying floating charge holder who is able to adduce evidence that the charge is enforceable, he may apply to the court without the need to prove that the company satisfies “the insolvency condition”.<sup>60</sup> An important feature of the new procedure is that a company which has already been in liquidation can enter into administration by court order. This flexibility is reflected in the following two circumstances, where a qualifying floating charge holder is entitled to apply for an administration order in a compulsory liquidation; and a liquidator may apply whether the company is in a voluntary or compulsory liquidation.<sup>61</sup> In addition to granting an

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<sup>56</sup> S Foster, “Enterprise Act 2002: Changes to Corporate Insolvency” [2003] *Insol. L.* 174.

<sup>57</sup> Sealy and Milman, above n.9, p516-519.

<sup>58</sup> IA 1986, Sch B1, para.12(1).

<sup>59</sup> IA 1986, Sch B1, para.11; see Davies, above n.48, p87. “The court may make an administration order in relation to a company only if satisfied—(a) that the company is or is likely to become unable to pay its debts, and (b) that the administration order is reasonably likely to achieve the purpose of administration.”

<sup>60</sup> IA 1986, Sch B1, para.35.

<sup>61</sup> IA 1986, Sch B1, paras.37 and 38; Goode, above n.47, at para.10-16.

order, the court has the power to dismiss the application, make an interim order or treat it as a winding up application.<sup>62</sup>

In terms of theoretical reflection, it was expected that the administration appointment made by a qualifying floating charge holder outside court would become the most common mode and the floating charge holders could use administration as an alternative to the administrative receivership, which has been severely restricted since the EA 2002 came into force. However, from the perspective of judicial practice, it is indicated that the most predominant method of entry into administration now is an out of court appointment of administrator by the company or its directors under paragraph 22.<sup>63</sup> Two factors may explain this finding. First, there might be no qualifying floating charge holders in the cases where the company or its directors make the administration appointment. In the survey led by Dr Sandra Frisby, it was observed that “in 30 % of cases where a paragraph 22 appointment was made there was no qualifying floating charge holder who could have appointed.”<sup>64</sup> Second, banks may not prefer to appoint administrators on account of reputational concerns. Banks neither want to be the appointers of administrators in dealing with their bad loans, nor do they want to make hostile appointments which may incur the blame of other creditors.<sup>65</sup> However, it does not necessarily indicate that the banks as secured creditors with floating charges do not play any role in administration appointments made under paragraph 22. Banks tend to encourage directors of their distressed clients to make appointments instead of appointing directly, and accordingly the directors are willing to make the administration appointments because they can potentially avoid personal liabilities like wrongful trading.<sup>66</sup> In addition, in the cases where the company or its directors appoint administrators, banks may have a strong

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<sup>62</sup> Foster, above n.56, at 174.

<sup>63</sup> A Katz and M Mumford, *Study of Administration Cases*, Report to the Insolvency Service in October 2006, p33.

<sup>64</sup> Frisby, above n.6, at 12.

<sup>65</sup> J Armour, A Hsu and A Walters, *The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings*, A Report Prepared for the Insolvency Service in December 2006, p17-18.

<sup>66</sup> Ibid.

influence on the decision to appoint and the identity of the insolvency practitioners.<sup>67</sup> Before deciding to make an appointment, the directors may consult with banks and banks may introduce the insolvency practitioners or their firms. It can be found that although the administration appointments made by floating charge holders may be of a relatively low proportion, the significance and role of secured creditors cannot be ignored.

#### 4.2.2 Moratorium

It is noteworthy that there is an automatic stay as the company is in administration. This moratorium is very protective and watertight in relation to the assets of the company, towards which any debt enforcement and legal action is restricted unless it is permitted by the consent of the administrator or a court order.<sup>68</sup> This statutory moratorium covers two distinct stages. An interim moratorium is available for a company which is intentionally being put into administration.<sup>69</sup> This provisional protection enables the troubled company to avoid drastic action by creditors and other interested parties in the period where the application for administration has been presented but not yet granted by the court, or an administrator has been appointed by a qualifying floating charge holder or the company or its directors out of court but the appointment has not yet taken effect due to the relevant requirements.<sup>70</sup> The second stage of the moratorium commences from the time that the administration comes into effect and extends throughout the whole process of administration. It should be noted that there is an automatic end to the appointment of an administrator, which must cease to have effect at the end of one year period, and there is no possibility of a retrospective extension after this one year period expires. An extension may only be obtained prospectively during the time when the

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<sup>67</sup> Frisby, above n.6, at 13; Katz and Mumford, above n.63, at 34.

<sup>68</sup> IA 1986, Sch B1, paras.42 and 43. For more discussion, see Goode, above n.47, at paras.10-49—10-70.

<sup>69</sup> IA 1986, Sch B1, para.44.

<sup>70</sup> IA 1986, Sch B1, paras.18 and 29; Davies, above n.48, p120.

appointment of an administrator remains in force.<sup>71</sup> The automatic ending of administration after one year is a new feature which was introduced by the 2002 reforms. Since the moratorium could shield the distressed debtor from debt enforcement and the repossession of goods, this time limit indicates the legislature's concerns regarding possible detriment to the interests of creditors that might be caused if the debtor was provided with indefinite protection.<sup>72</sup> The one year period can be extended by the consent of creditors for up to six months or by court order for a specified period.<sup>73</sup> It is important to note that the insolvency practitioners could present a proposal to creditors for a voluntary arrangement when the company is already in administration. This combination of a CVA and administration creates an effective rescue mechanism under which the financially troubled company can obtain the advantages of the CVA procedure and attempt to reorganize the company within the protection of the moratorium under administration. From the perspectives of insolvency practitioners, the CVA under the shield of administration represents a genuine corporate rescue mechanism and such a strategy could make the company rescue more promising.<sup>74</sup>

#### 4.2.3 The hierarchy of statutory objectives

One major change introduced by the new administration legislation is the establishment of a single hierarchy of objectives, which replace the original four alternatives that were of equal weight and not mutually excluded.<sup>75</sup> Three statutory purposes are placed in a hierarchy and the company is sent into administration according to one single purpose whether the administration appointment is made in or out of court. The administrator is required to undertake his functions with the objective of:

- “(a) rescuing the company as a going concern, or
- (b) achieving a better result for the company's creditors as a whole than would be likely if the

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<sup>71</sup> IA 1986, Sch B1, para.76. See the relevant case *Re TT Industries Ltd* [2006] BCC 372.

<sup>72</sup> Sealy and Milman, above n.9, p547.

<sup>73</sup> IA 1986, Sch B1, paras.76-78.

<sup>74</sup> Frisby, above n.6, at 62-63.

<sup>75</sup> Sealy and Milman, above n.9, p504.

company were wound up (without first being in administration), or  
(c) realizing property in order to make a distribution to one or more secured or preferential creditors.”<sup>76</sup>

The emphasis of the new administration is to rescue the company as a going concern, which is the primary purpose in the statutory hierarchy that the administrator has to pursue. The true meaning of ‘rescuing the company as a going concern’ is the preservation of the company as a legal entity, with as much of its business or undertakings intact as possible.<sup>77</sup> If a proposal involves a sale of the whole business of the company and leaves the company as a shell to be liquidated, this proposal cannot be said to be in line with the wording of “rescuing the company as a going concern”.<sup>78</sup> Thus, it is necessary to distinguish between rescuing the business as a going concern and rescuing the company as a going concern, and the former cannot be brought within the primary statutory purpose. The wording of “rescuing the company as going concern” can be interpreted as indicating that “the company will emerge from administration with its solvency restored, or safeguarded at least for the short term, and with its existing business or some part thereof remaining intact and capable of being carried on outside a formal insolvency”.<sup>79</sup> Whether rescuing the company as a going concern is reasonably practicable or not depends on the subjective analysis and judgment of the administrator.<sup>80</sup> If a company is facing a short-term cash flow problem and the major creditors in respect of the company, or any third party, is willing to inject funds for continued trading, it may make the administrator conclude that achieving the primary purpose is reasonably practicable.<sup>81</sup> The IPs tend to consider reorganizing a financially distressed company by way of a combination of administration with a company voluntary arrangement in order to rescue the company as a going concern.<sup>82</sup>

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<sup>76</sup> IA 1986, Sch B1, para.3(1).

<sup>77</sup> Davies, above n.48, p80.

<sup>78</sup> *Re Rowbotham Baxter Ltd* [1990] BCC 113 at 115.

<sup>79</sup> I Fletcher, J Higham and W Trower, *The Law and Practice of Corporate Administrations* (Butterworths, 1994), para.1.11.

<sup>80</sup> Fletcher, above n.40, at 136.

<sup>81</sup> Davies, above n.48, p82.

<sup>82</sup> Katz and Mumford, above n.63, at 62-65.

The administrator cannot move on to pursuing the secondary purpose, which aims to achieve a better result for the company's creditors as a whole than would be effected in an immediate winding up, unless the primary purpose cannot reasonably be achieved.<sup>83</sup> If there is no prospect of new financing becoming available for the company to continue trading during the moratorium, the company will not be able to carry on its existing production programme and pay the wages and social insurance for the employees. In this circumstance, the administrator may think that the creditors will benefit more from a sale of the company's assets as a going concern than from a piecemeal sale of the assets in the liquidation proceedings. If the first two statutory objectives are reasonably excluded, the administrator will have to go for the last objective which enables the administrator to dispose of the company's assets with intent to make a distribution to one or more secured or preferential creditors. The process of the last objective is quite similar to the abolished administrative receivership which intends to dispose of the property of the company by a quick sale and realize the claims of a secured lender who appointed the administrative receiver. However, the underlying policy aim between them is different because the new administration regime encourages collectivity and the administrator, whether appointed in or out of court, owes duties to the creditors as a whole. In short, the hierarchy of statutory objectives in the new administration procedure aims to promote more cases where the companies are rescued as a going concern, but insolvency outcomes may not be in line with this initial expectation. Some surveys argue that the case of company rescue according to the primary purpose is rare.<sup>84</sup>

#### 4.2.4 Administrator's roles in the rescue proceedings

The administrator, who is either appointed by a qualifying floating charge holder or the company or its directors out of court, or appointed under a court order, is an officer of the court, and accordingly the administrator is subject to the directions of

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<sup>83</sup> *Re British American Racing (Holdings) Ltd* [2005] BCC 110.

<sup>84</sup> Armour, Hsu, and Walters, above n.65, at 22.



the court.<sup>85</sup> Once an administrator is appointed, he will take over the control and management of the company's property and business affairs from the board of the company, and will owe fiduciary duties and a duty of care and skill to the company and its creditors.<sup>86</sup> The administrator must exercise his broad powers in accordance with the decisions made by the creditors' meeting and subject to the directions given by the court.<sup>87</sup> The administrator is required to act in the best interests of the company and perform his duties for the creditors of the company as a whole rather than some specific interested party.<sup>88</sup> In other words, the administrator shall pursue the maximum realizations of the creditors' claims and try to preserve both shareholder value and employment as much as possible. Acting for the creditors as a whole represents the underlying policy of collectivity, which is opposed to individual enforcement in pursuit of realizing the claim of a certain interested party at the expense of other stakeholders.<sup>89</sup> In order to make the administration procedure quick and cost-effective, the administrator is subject to a general duty to "perform his functions as quickly and efficiently as is reasonably practicable".<sup>90</sup>

Under the old administration regime, the administrator was required to produce a report to explain the financial status and business affairs of the company, and to support the view that the appointment of an administrator is appropriate.<sup>91</sup> The new administration legislation abolishes the requirement of an independent report with a view to reducing the costs of entry. However, in practice, insolvency practitioners tend to conduct a complete investigation of the company's property and business and understand the background of the company at a similar level to the old rule 2.2 report

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<sup>85</sup> IA 1986, Sch B1, para.5. The new style out-of-court administrator is an officer of the court so as to obtain the recognition in EU under the EC Regulation on Insolvency. See Davies, above n.48, p109 and 133.

<sup>86</sup> IA 1986, Sch B1, paras.67 and 68; J Armour and R Mokal "Reforming the governance of corporate rescue: the Enterprise Act 2002" [2005] LMCLQ 28, 41; R Mokal, *Corporate Insolvency Law: Theory and Application* (OUP, Oxford, 2005), p235.

<sup>87</sup> Ibid.

<sup>88</sup> IA 1986, Sch B1, para.3 (2); *Kyrris v Oldham* [2004] 1 BCLC 305, 331.

<sup>89</sup> Fletcher, above n.40, at 137.

<sup>90</sup> IA 1986, Sch B1, para.4; Sealy and Milman, above n.9, p505.

<sup>91</sup> IR 1986, r 2.2.

prior to the appointment, even if it is not officially required.<sup>92</sup> The administrator shall submit a statement of proposals for pursuing the statutory purpose of administration as soon as is reasonably practicable after the administration takes effect, or in any event within eight weeks after the company enters administration.<sup>93</sup> The eight-week period can be further extended for no more than 28 days with the consent of all the secured creditors and a majority of unsecured creditors, and it can only be extended once.<sup>94</sup> It can be observed that the usual eight-week time is shorter than the original three-month period which was enacted by the 1986 Act, and this reduction of time limit purports to prevent the procedures being protracted and costly for small firms and is in line with the general requirement under para.4 for the administrator to perform his duties as quickly and efficiently as is reasonably practicable.<sup>95</sup>

#### 4.2.5 Creditors' meeting and creditors' committee

The creditors' meeting has a significant authority and is entitled to approve or refuse the proposals produced by the administrator and challenge the administrator's conduct for the sake of collectivity and transparency. An initial meeting of creditors must be called as soon as reasonably practicable after the administration takes effect, or in any event within a period of ten weeks after the company enters administration.<sup>96</sup> The initial meeting should consider the proposals presented by the administrator and approve them without modifications, or with modifications to which the administrator consents.<sup>97</sup> The court can direct, or the company's creditors whose claims account for at least 10 percent of the total amount of the company's

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<sup>92</sup> Armour, Hsu and Walters, above n.65, at 25.

<sup>93</sup> IA 1986, Sch B1, para.49(5).

<sup>94</sup> IA 1986, Sch B1, para.108(5).

<sup>95</sup> HL Deb., 29 July 2002, Col.782.

<sup>96</sup> IA 1986, Sch B1, para.51(2). It should be noted that the initial meeting of creditors may not be summoned in three prescribed manners which are addressed in para.52(1), unless it is requested by creditors whose claims amount to at least 10 % of the total debts of the company.

<sup>97</sup> IA 1986, Sch B1, para.53(1).

debts can request, a further meeting to consider a revised proposal.<sup>98</sup> The court may make an order to cease the effect of the administration if the initial meeting of creditors fails to approve the proposals or the further creditors' meeting refuses to accept the revised proposals.<sup>99</sup> Although the creditors' committee is not compulsorily required, it is important and reliable from the perspective of insolvency practitioners.<sup>100</sup> The administrator could perform his duties by taking account of the advice and soundings provided by the creditors' committee, whose members may normally be the key creditors, in order to justify his actions and avoid potential litigation.<sup>101</sup>

#### 4.2.6 Ending administration

Since the administration procedure provides a moratorium which aims to shield the financially troubled company from debt enforcement and repossession of property, there should be a time limit to the period of protection. Infinitely protracting administration may do harm to the interests of creditors, and make the procedure time-consuming and expensive. Accordingly, there is an automatic end to the effect of the appointment of the administrator after a period of one year, even though this period can be extended under certain conditions.<sup>102</sup> In addition, the court may terminate the effect of administration under the application of the administrator.<sup>103</sup>

It was argued that, at a practical level, one shortcoming of the old administration legislation was that it failed to provide a flexible route for coming out of administration.<sup>104</sup> In the old administration regime, there was no link between the exits of administration and winding up proceedings or dissolution. Thus, the administration had to be terminated under a court order and then the company was

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<sup>98</sup> IA 1986, Sch B1, para.56; Parry, above n.2, p69.

<sup>99</sup> IA 1986, Sch B1, para.55(2)(a).

<sup>100</sup> Armour, Hsu and Walters, above n.65, at 23.

<sup>101</sup> Ibid.

<sup>102</sup> IA 1986, Sch B1, para.76.

<sup>103</sup> IA 1986, Sch B1, para.79.

<sup>104</sup> Davies, above n.48, p171.

placed into liquidation. Undoubtedly, this process was a waste of time and money at the expense of creditors.<sup>105</sup> It should be noted that the new administration regime establishes two main features to address the failure of exits of the previous administration. First, it provides the administrator with the power to make a distribution to a secured or preferential creditor of the company, or to a creditor who is neither secured nor preferential under the permission of court.<sup>106</sup> Second, the new legislation builds a bridge to connect administration with creditors' voluntary liquidation and dissolution. Administration can be converted to voluntary winding up proceedings in the circumstances where the administrator thinks "(a) that the total amount which each secured creditor of the company is likely to receive has been paid to him or set aside for him, and (b) that a distribution will be made to unsecured creditors of the company (if there are any)."<sup>107</sup> In addition, the company can be placed directly into dissolution if the administrator thinks that the company has no property available for distribution to its creditors. The company will be dissolved at the end of three months following a notice of dissolution being sent to the registrar of companies by the administrator.<sup>108</sup> It should be noted that the conversion to creditors' voluntary liquidation or dissolution is subject to the decision of the administrator, and no separate order of ending the effect of administration and discharging administrator is required.<sup>109</sup> During the process of conversion, no court order is necessary.<sup>110</sup>

#### 4.2.7 Pre-packaged administration

A pre-pack sale in administration has become a popular approach to dealing with corporate difficulties.<sup>111</sup> A pre-packaged administration is basically a process where

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<sup>105</sup> Ibid at 172.

<sup>106</sup> IA 1986, Sch B1, para.65; *Re GHE Realisations Ltd* [2006] 1 WLR 287; *Re HPJ UK Ltd (In Administration)* [2007] BCC 284; for more details, see R Parry, *Corporate Rescue* (Sweet & Maxwell, London, 2008), para.8-08.

<sup>107</sup> IA 1986, Sch B1, para.83.

<sup>108</sup> IA 1986, Sch B1, para.84.

<sup>109</sup> Parry, above n.2, p83.

<sup>110</sup> *Re Ballast plc* [2005] BCC 96; Sealy and Milman, above n.9, p553.

<sup>111</sup> V Finch, "Pre-packaged administrations: bargains in the shadow of insolvency or

the business of a financially distressed company is sold commonly to its incumbent management team, as soon as the company enters administration. The pre-pack deal has been agreed prior to the company being placed into administration under the assistance of insolvency practitioners and with the support of the company's bankers.<sup>112</sup> In a pre-pack structure, the insolvency practitioner/administrator is allowed to sell the business to the company's management team without the consultation and approval of unsecured creditors and the leave of court, whether in the pre-EA 2002 or post-EA2002.<sup>113</sup> Although the company's business may be saved intact and employees may preserve their jobs in a pre-pack arrangement, the interests of ordinary unsecured creditors will be jettisoned because the key point of a successful pre-pack is to buy business free of some or all of the unsecured debts. This is to say that the intended inside buyers, secured creditors and insolvency professionals will benefit from a pre-pack administration at the expense of the interests of unsecured creditors. Normally, a pre-pack sale will be completed immediately after the appointment of an administrator. The functions of the creditors' meeting may be undermined because the sale has been finished before the creditors' meeting would be convened. The pre-pack sale might be denied if a creditors' meeting was called to consider it.<sup>114</sup> In addition, it should be noted that a pre-packaged administration is not in accordance with the primary purpose in the statutory hierarchy, which is to rescue the company as a going concern. A pre-packaged administration pursues a sale of business as a going concern which could achieve a better result than would be achieved in an immediate liquidation. In a pre-pack, an insolvency practitioner to be appointed as administrator may not consider the possibility of rescuing the financially distressed company prior to selling the business to the directors of the company.<sup>115</sup> The administrator has the statutory

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shadowy bargains" [2006] J.B.L. 568.

<sup>112</sup> P Walton, "Pre-packaged administrations—trick or treat?" (2006) 19 *Insol. Int.* 113.

<sup>113</sup> *Re T&D Industries Plc* [2000] 1 BCLC 471; *Re Transbus International Ltd (In Liquidation)* [2004] BCC 401.

<sup>114</sup> *DKLL Solicitors v Revenue and Customs Commissioners* [2007] BCC 908.

<sup>115</sup> L Qi, "The rise of pre-packaged corporate rescue on both sides of the Atlantic" (2007) 20 *Insol. Int.* 129, 134-135.

power to sell the company's asset without the requirement of convening a creditors' meeting or applying for the court's sanction if he thinks that the unsecured creditors will be paid in full or no payment will be made to unsecured creditors.<sup>116</sup> If an insolvency practitioner has prepared or made a pre-pack deal, and has not evaluated other options, the administrator will be in breach of his statutory duty.<sup>117</sup> In short, a pre-packaged administration is often, in essence, a management buy out rather than a reorganization of a company's debt structure and business affairs. The whole process of a pre-pack may be under the control of secured creditors and it will not happen without the support of banks.<sup>118</sup>

#### 4.2.8 The impact of the 2002 reforms on the insolvency outcomes

The revamped administration regime has had a considerable influence on corporate insolvency outcomes, especially on the choice of insolvency proceedings. It is demonstrated by Figure 4.2 that the number of administrative receiverships declined from 2001 to 2007 and the number of administrations, including both court-appointed and out of court administrations, showed a sharp increase from 2003 after the Enterprise Act 2002 came into force on 15 September 2003. Clearly, the trend which is illustrated by the Figure is in accordance with the original expectation and the underlying policy aims which purported to boost the corporate rescue culture by virtually abolishing the floating charge holder-friendly administrative receiverships. Such receiverships remain in some exceptional cases and in the circumstances where the floating charge was created prior to 15 September 2003. At the practical level, the receiverships in such cases may still be used as a quick and efficient way to realize debts in the case where the secured lender is under-secured

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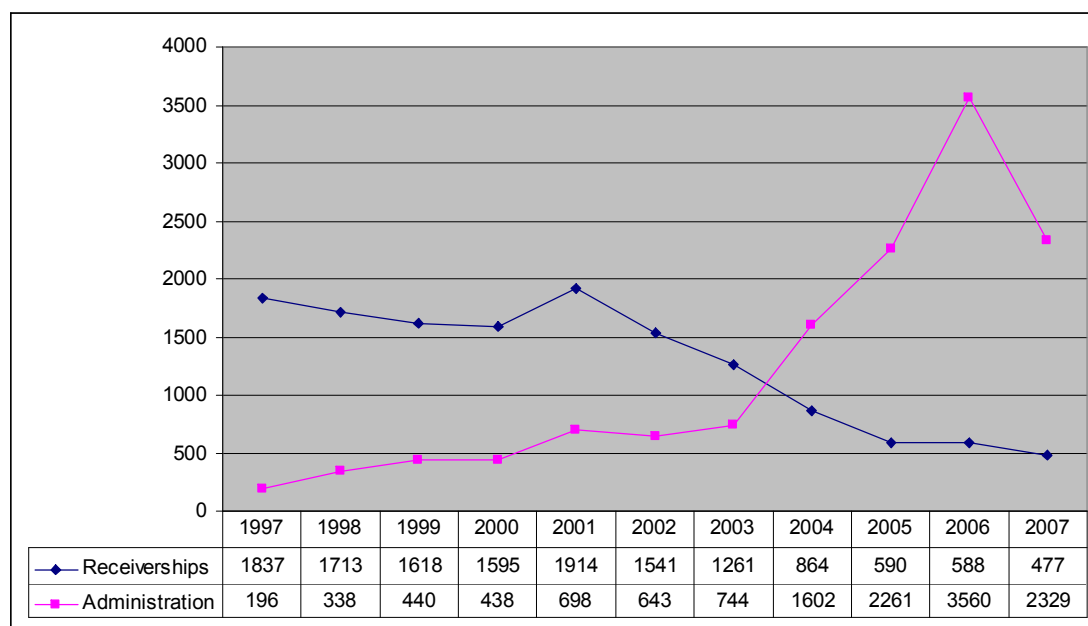
<sup>116</sup> IA 1986, Sch B1, para.52.

<sup>117</sup> Walton, above n.112, at 116.

<sup>118</sup> This paragraph only briefly introduces the nature and process of pre-packaged administration and makes an emphasis on the role of secured creditors in a pre-pack structure. For the full discussion of pre-packaged administration, see V Finch, "Pre-packaged administrations: bargains in the shadow of insolvency or shadowy bargains" [2006] J.B.L. 568; S Frisby, *A Preliminary Analysis of Pre-packaged Administrations*, Report to The Association of Business Recovery Professionals in August 2007; R Parry, *Corporate Rescue* (Sweet & Maxwell, London, 2008), para.3-04.

and there is no property available for a distribution among the other creditors.<sup>119</sup>

**Figure 4.2: The Incidence of Administration and Administrative Receivership from 1997 to 2007<sup>120</sup>**



The trend of more administration appointments and less administrative receiverships is in line with the original expectation, but a trend of administration being used as a substitute for liquidation is a new finding which has been investigated by some scholars.<sup>121</sup> Several reasons may explain this effect. First, the decision of House of Lords in *Re Leyland DAF* overrode the ruling which was originally established in *Re Barleycorn Enterprises Ltd*,<sup>122</sup> and held that the expenses of liquidation, which used to be paid in priority to floating charge claims, are not payable out of the proceeds of the assets subject to a floating charge.<sup>123</sup> The reversal of this ruling may motivate insolvency practitioners to choose administration rather than liquidation because the

<sup>119</sup> Armour, Hsu and Walters, above n.64, at 18-19. This report also addresses another reason which could motivate IPs to choose administration from the perspectives of the self-interests of the IPs. It is observed from a series of interviews with IPs that the appointment of the IPs in the new administration is more secured than in creditors' voluntary liquidation.

<sup>120</sup> The statistics are available at <http://www.insolvency.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm> (last visit 31 July 2008)

<sup>121</sup> Katz and Mumford, above n.63, at 18.

<sup>122</sup> *Re Barleycorn Enterprises Ltd* [1970] Ch.465.

<sup>123</sup> *Re Leyland DAF, Buchler v Talbot* [2004] 2 AC 298.

administrator's expenses and remuneration are payable in priority to any security.<sup>124</sup> It should be noted that this motivation is likely to be temporary since the Companies Act 2006 reestablishes that liquidation expenses are payable out of the assets subject to a floating charge.<sup>125</sup> The second reason which makes the insolvency practitioners favour administration over liquidation is that a company without assets available for a distribution among creditors can be sent straight into dissolution under the new legislation. In addition, the new administration procedures enable the administrator to dispose of the company's assets and make a distribution. Therefore, administration could be the best alternative for creditors especially for secured and preferential creditors in the circumstances where the administrator could make a quick sale of the company's assets to realize their claims before the initial creditors' meeting is summoned.<sup>126</sup>

## **4.3 China: the modified reorganization procedure**

### **4.3.1 Initiation of the proceedings**

In contrast to the old corporate rescue regime in the 1986 law, the new reorganization procedure broadens the scope of applicants. Either the debtor or a creditor is entitled to petition to the court for commencing the rescue proceedings.<sup>127</sup> In addition, the application for reorganization of SOEs does not require the permission of the relevant government department any more. The abolition of the government's dominant role in the restructuring of SOEs could avoid undue administrative intervention and make the rescue laws readily available for financially distressed SOEs, in order to enhance the possibility of rehabilitation. Compared with the British CVAs and administration procedures, China's new rescue law is very strict on the

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<sup>124</sup> IA 1986, Sch B1, para.99.

<sup>125</sup> CA 2006, s 1282.

<sup>126</sup> Armour, Hsu and Walters, above n.65, at 18-19; A Keay, "What future for liquidation in light of the Enterprise Act reforms" [2005] J.B.L. 143; L Linklater, "New style administration: a substitute for liquidation?" (2005) 26 Comp. Law. 129.

<sup>127</sup> H Bufford, "The New Chinese Bankruptcy Law: Text and Limited Comparative Analysis" (2007) 16 *Norton Journal of Bankruptcy Law and Practice* 697.



conditions of entry into the reorganization procedure. Since out-of-court appointment is not available, the entitled applicants have to apply to the court for a reorganization order. The court has the discretion to file for reorganization as long as the applicant is able to adduce evidence to satisfy one of the following three circumstances:

- (1) the company is unable to repay its due debts and the value of the company's assets is less than the amount of the liabilities;
- (2) the company is unable to repay its due debts and the company obviously lacks the ability to pay off all of its debts; or
- (3) the company is likely to be unable to repay its debts.<sup>128</sup>

Clearly, the first one is a combination of cash flow test and balance sheet test. The second one requires cash flow insolvency and also needs to prove that the company is apparently on the slide into balance sheet insolvency. If an applicant presents an application for liquidation and the financial state of the company meets one of the first two conditions, the court can declare bankruptcy of the company.<sup>129</sup> The third circumstance means that a reorganization procedure can be triggered if a company is likely to become insolvent. The court may accept the reorganization application if the company is encountering the possibility of losing the ability to pay off its debts.

If the company is already in winding up proceedings, the company or the shareholders whose contributions amount to more than 10% of the registered capital of the company could petition for reorganization before the court declares bankruptcy.<sup>130</sup> It is not clear whether the court will remove the previous administrator from the office and then appoint a new one, or whether the previous administrator will continue to perform his functions when the petition for reorganization by the company or the eligible shareholders in liquidation is accepted

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<sup>128</sup> Bankruptcy Law 2006, article 2; R Parry and H Zhang "China's Corporate Rescue Laws: Perspectives and Principles" (2008) 8 JCLS 113, 127; Shi, above n.4, at 661.

<sup>129</sup> L Qi, "The Corporate Reorganization Regime under China's New Enterprise Bankruptcy Law" (2008) 17 *International Insolvency Review* 13, 17.

<sup>130</sup> Bankruptcy Law 2006, article 70; M Simmons and J Jiang, "A New Insolvency Law in China" (2007) 4 *International Corporate Rescue* 10, 13.

by the court.<sup>131</sup> As a whole, the gateway to the reorganization proceedings is completely under the control of the courts, which have to carefully scrutinize the application materials before they make an order. The onerous workload may cause undue delay and an increase in expense.<sup>132</sup>

#### 4.3.2 Moratorium

In relation to the relevant rules regarding the moratorium in China's reorganization procedure, the legislation on this issue is ambiguous and insufficient. Although there is no article which prescribes the specific period of protection, it is inferred that the period of the moratorium is identical to the period of the reorganization process, which commences from the application for reorganization being accepted by the court until the termination of reorganization under the court order.<sup>133</sup> One scholar argued that the reorganization proceedings are limited to a period of nine months.<sup>134</sup> Apparently, this is a complete misunderstanding because the time limit of nine months is imposed upon the administrator or the directors of the company under a debtor-in-possession (DIP) process, who are required to produce a proposal of the reorganization within six months from the application of reorganization being filed with the court and it can be further extended up to three months by court order under reasonable cause.<sup>135</sup> Unlike the English administration procedure, there is no automatic termination of China's reorganization and accordingly no specific period of moratorium.<sup>136</sup>

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<sup>131</sup> According to the China's new bankruptcy law, the insolvency professionals appointed in charge of the "liquidation", "reorganization", and "reconciliation" are all called as "administrator".

<sup>132</sup> This point will be further developed in s 4.3.9.1.1

<sup>133</sup> Bankruptcy Law 2006, article 72; W Wang, *The Interpretation and Substance of Bankruptcy Law* (Law Press-China, 2007), p208-210.(in Chinese)

<sup>134</sup> M Falke, "China's New Law on Enterprise Bankruptcy: A Story with a Happy End" (2007) 16 *International Insolvency Review* 63, 71.

<sup>135</sup> Bankruptcy Law 2006, article 79.

<sup>136</sup> For a detailed discussion of the reorganization period, see L Qi, "The Corporate Reorganization Regime under China's New Enterprise Bankruptcy Law" (2008) 17 *International Insolvency Review* 13, 19-20.

In principle, during this period, the creditors with property security are not allowed to enforce their claims. If they could adduce evidence to prove that there is any reasonable prospect that the assets subject to the security may be damaged or the value of such assets decreased, secured creditors are entitled to petition to the court to resume their right to enforce.<sup>137</sup> In addition, the moratorium in China's modified reorganization regime is fragile because there are no restrictions on the property right holders, such as a lessor under a lease agreement or a landlord, who may repossess their property under the terms of their contract.<sup>138</sup> Furthermore, there is no interim moratorium available for the company in the period that the application materials for reorganization have been submitted to the court by the entitled applicants but the order has not been made by court. This period of vulnerability is of uncertain duration because the period within which the court must make an order is not prescribed. This legislative lacuna provides an opportunity for creditors to grab the property of the company, whether the period is long or short. In summary, the moratorium in China's rescue laws is not effective and watertight. The failure of it may undermine the attractiveness of the rescue-oriented procedure for the company or the creditors who might attempt to rehabilitate the distressed company by the reorganization regime.

#### 4.3.3 Administrator's roles in reorganization

In addition to the reorganization procedure, another remarkable feature of China's new bankruptcy law is the establishment of the legal institution of administrator, which primarily replaces the outdated liquidation group, which was normally constituted by officials from different government departments. Those officials who were provisionally organized to act in the liquidation group normally did not have expertise in accounting and insolvency laws. That meant that they had to employ qualified accountants and lawyers to deal with technical issues and provide legal advice to the liquidation group. There is no doubt that this process caused extra

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<sup>137</sup> Bankruptcy Law 2006, article 75.

<sup>138</sup> Bankruptcy Law 2006, article 76.

expense and delay.<sup>139</sup> In addition, since these officials were nominated by government, administrative intervention was unavoidable.

Pursuant to the new bankruptcy law, the administrator will be nominated when the application for reorganization is accepted by the court, and the court monopolizes the power to appoint an administrator.<sup>140</sup> In some jurisdictions like the UK and Germany, only an individual natural person can serve as an administrator,<sup>141</sup> but in China, the administrator may be either an intermediary agency, which embraces law firms, accounting firms or bankruptcy & liquidation firms, or a natural person who is professionally qualified to act.<sup>142</sup> It is important to note that the new law remains unclear as to whether or not an international insolvency professional who is quite familiar with China's bankruptcy legal framework can be designated as an administrator.<sup>143</sup> It is submitted that, since the law fails to exclude this situation specifically, this possibility at least exists. Especially at present, in view of the insufficiency of insolvency experts who have been professionally licensed in China, the participation of foreign professionals with advanced skills and experience will enable China's judiciary to fill a huge gap.

Once the court accepts the petition for reorganization proceedings, it will designate an administrator, who is required to take over the assets and the business affairs of the enterprise. The administrator must discharge his duty loyally and diligently, otherwise he may be punished with a fine upon the court order. If the interests of the debtor, its creditors, or a third party are damaged, owing to a breach of this general

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<sup>139</sup> Y Xu, *The Speech on Enterprise Bankruptcy Law* (Law Press-China, 2006), p181-182.(in Chinese)

<sup>140</sup> Bankruptcy Law 2006, articles 13 and 22.

<sup>141</sup> In the UK, the insolvency practitioners, as individual professionals, can be appointed to be administrator. In Germany, the trustee must be an individual rather than a legal entity. In addition, this trustee must be suitable to the case and independent from the debtor and all the creditors. See German Insolvency Code (InsO), section 56 (1); C Paulus, "The New German Insolvency Code" (1998) 33 Tex. Int'l L. J. 141, 146.

<sup>142</sup> Bankruptcy Law 2006, article 24; Simmons and Jiang, above n.130, at 11. It is submitted that the law retains the institution of liquidation group which may act as an administrator merely in the circumstances where SOEs are put into bankruptcy proceedings.

<sup>143</sup> Falke, above n.134, at 70.

duty, a personal liability to compensate will be imposed.<sup>144</sup> The administrator has the obligation to report to the creditors' committee, if the administrator performs functions involving a transfer or disposal of property and property-related rights. If there is no creditors' committee, the administrator shall report to the court.<sup>145</sup> In addition, the administrator shall submit a reorganization proposal to the creditors' meeting and court within six months of the application for reorganization being accepted by the court, and this period can be further extended by three months under a court order if a justifiable ground is demonstrated.<sup>146</sup> Apparently, this period is much longer than the prescribed time in respect of the CVAs and administration procedures. It is prescribed that the proposal of reorganization should contain the following issues:

- (1) operational and business strategy;
- (2) categorization of creditors;
- (3) adjustment of claims;
- (4) proposal for satisfaction of debts;
- (5) implementation period of the proposed reorganization plan;
- (6) supervisory period of the implementation of the proposed reorganization plan;
- (7) other arrangements in favour of the reorganization of debtor.<sup>147</sup>

It should be noted that if the administrator fails to produce a reorganization proposal in the prescribed period, the court can terminate the reorganization procedure and declare bankruptcy of the debtor, and accordingly the debtor will be automatically put into liquidation proceedings.<sup>148</sup>

Unlike the CVA and administration procedures, the administrator in China's rescue laws is not liable to summon the first creditors' meeting, which should instead be

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<sup>144</sup> Bankruptcy Law 2006, article 130. For a full understanding of the specific duties of an administrator, see article 25; Simmons and Jiang, above n.130, at 12.

<sup>145</sup> Bankruptcy Law 2006, article 61.

<sup>146</sup> Bankruptcy Law 2006, article 79 (1) (2).

<sup>147</sup> Bankruptcy Law 2006, article 81.

<sup>148</sup> Bankruptcy Law 2006, article 79 (3).

convened by the court.<sup>149</sup> When the proposal of reorganization is approved by the meetings of creditors and sanctioned by the court, the administrator will perform the function of supervision in the supervisory period which has been stipulated in the proposal. After the supervisory period expires, the administrator is required to submit a report to the court which elaborates the implementation of the rescue scheme. This supervisory period can be extended under the court order upon an application of the administrator, and the appointment of the administrator ceases to have effect as the supervisory report is submitted.<sup>150</sup> In the event that the debtor fails to implement the reorganization proposal or implements the reorganization proposal by default or fraud, the rescue laws provide grounds for ending the implementation of the proposal and putting the debtor into liquidation under the court order on the basis of the supervisory report.<sup>151</sup>

#### 4.3.4 Creditors' meeting and creditors' committee

In China's new bankruptcy legal framework, the creditors' meeting is a significant organization which plays a crucial role in a bankruptcy or reorganization case. The initial creditors' meeting is to be called in the prescribed period by the court which shall give notice of a specific time and venue to the creditors of the company if the court is aware of the claims and addresses of the creditors.<sup>152</sup> In addition, the matters or proposals which will be discussed or voted on the meeting shall be notified to the creditors in advance of 15 days as well. The creditors' meeting is not a standing

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<sup>149</sup> Ibid, article 84. It is noteworthy that the Chinese reorganization procedure introduces similar features to the US debtor-in-possession (DIP) model. During the reorganization period, the debtor is entitled to petition to the court for retaining the full control over the company's property and business under the supervision of the administrator. If the court grants the petition, the debtor is obliged to produce the reorganization proposal and report to the creditors' meeting and court in accordance with the rules which apply to the administrator. See article 80 of the new law. For the discussion of Chinese modified DIP, see s 4.3.6 and s 4.3.9.1.4.

<sup>150</sup> Bankruptcy Law 2006, article 91.

<sup>151</sup> Bankruptcy Law 2006, article 93.

<sup>152</sup> Further creditors' meeting can be convened by the court if the court thinks it is necessary. It can also be convened by the chairman of the creditors' meeting under a proposal of administrator, creditors' committee or any creditor or creditors whose claims amount to more than one fourth of the total claims. Bankruptcy Law, article 62.

organization because such a structure would be time-consuming and expensive. The expenses of the creditors' meeting should be treated as a part of liquidation expenses which will be payable out of the bankruptcy property under priority in the distributional order, and accordingly the property for the recovery of creditors will be diminished. As far as time and cost is concerned, it is not appropriate and practicable to convene a creditors' meeting very often.

It should be noted that the creditors' meeting will perform a series of important functions in insolvency proceedings. First, with regard to the administrator that is appointed by the court, the creditors' meeting is entitled to apply to the court for removal of the administrator and replacement with a new one if the creditors' meeting thinks that the court-appointed administrator has failed to perform his functions legally and fairly or the administrator is not competent. However, the court holds the final say.<sup>153</sup> Second, the creditors' meeting shall review the schemes of liquidation or reorganization and remuneration of the administrator. If it has objection to the schemes, it can apply for court's adjudication.<sup>154</sup> Third, the creditors' meeting shall perform a function of supervising the actions of the administrator and this general power of supervision includes two aspects. The creditors' meeting is entitled to ask the administrator to explain his actions and decisions, and to provide relevant documents and information about the exercise of his functions. If the creditors' meeting is not satisfied with the administrator's interpretation, the creditors' meeting could apply to the court.<sup>155</sup> Fourth, the creditors' meeting will decide whether to continue trading or not. It may be argued that the administrator should hold the power of determining which business affairs should be continued or not on the basis of the company's financial state and prospect of reorganization. However, in China's insolvency proceedings this power is conferred upon the creditors' meeting and as a supplement the administrator could

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<sup>153</sup> Shi, above n.4, at 663.

<sup>154</sup> Bankruptcy Law 2006, article 61 (2).

<sup>155</sup> Bankruptcy Law 2006, article 61 (3); Wang, above n.133, p175.

exercise this power before the initial creditors' meeting is convened.<sup>156</sup>

The creditors' committee is not a compulsory organization and may not be required in all bankruptcy cases. A creditors' committee may be appropriate to be established where there are a large number of creditors whose claims are dispersed, and the creditors' committee should perform their functions as representatives of creditors.<sup>157</sup> According to China's new bankruptcy law, the creditors' meeting may decide to establish a creditors' committee which is given various powers, similar to its counterpart in British insolvency laws. It should be noted that there is a primary difference in relation to the creditors' committee between Chinese and British insolvency laws. In terms of the formation of a creditors' committee, it is stipulated in China's new bankruptcy law that the number of committee members should be no more than nine and there should be one representative of employees or the labour union of the company on the committee. In addition, the workers' representative and the members elected by creditors require the confirmation of the court by written form.<sup>158</sup> These requirements represent the philosophy and policy underlying China's new law which on the one hand provides a ground for labour to be involved in the decision of important matters during the liquidation or reorganization proceedings and emphasizes the protection of the interests of employees; on the other hand reflects that Chinese bankruptcy law procedures are court-driven and the court is involved in every step. Comparatively, there are no equivalent requirements in British insolvency laws.

#### 4.3.5 Reorganization proposal: voting, approval and implementation

In China's reorganization regime, the procedure for approving the proposal of a

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<sup>156</sup> Bankruptcy Law 2006, article 61 (5); Wang, above n.133, p176.

<sup>157</sup> United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law*, 2004, p197.

<sup>158</sup> Bankruptcy Law 2006, article 67; L Qi, "The Corporate Reorganization Regime under China's New Enterprise Bankruptcy Law" (2008) 17 *International Insolvency Review* 13, 18.



rescue attempt which is produced by the administrator or the company itself is quite complicated. Fundamentally, the proposal of reorganization will come into effect if it is approved by the creditors' meeting and sanctioned by the court. First, the court is responsible for convening the creditors to vote in distinct classes within a month of receiving the proposal. In view of different natures and characteristics of claims, the creditors will be divided into four groups, respectively:

- (1) secured creditors;
- (2) employees with unpaid wages and social insurance;
- (3) creditors with tax claims;
- (4) ordinary unsecured creditors.

It should be noted that the court has the discretion in due course to organize a separate group of creditors from the group of ordinary unsecured creditors who hold a relatively small amount of claims in order to protect the interests of small creditors.<sup>159</sup> If the reorganization proposal involves the interests of shareholders of the company, a voting group of shareholders should be summoned.<sup>160</sup> The acceptance of the proposal needs the approval of all the voting groups, and the approval of each group requires the consent of a majority of creditors with more than two thirds in value of their claims.<sup>161</sup> The administrator should present an application for the court's sanction once the proposal is approved by the meetings of creditors (and the meeting of shareholders in some certain circumstances), and then the court will decide whether to grant the proposal or not.<sup>162</sup>

Because of the inadequacy of the legislative skills and judicial experience, the law is not clear about what the court will consider. That means that the court may be involved in the investigation of the substantive contents of the proposal, which cannot treat any creditor unreasonably. In addition, the procedural issues, presented

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<sup>159</sup> Bankruptcy Law 2006, article 82.

<sup>160</sup> Bankruptcy Law 2006, article 85. For a comprehensive discussion about the protection of shareholders in reorganization procedure, see s 4.3.7 of the thesis.

<sup>161</sup> Bankruptcy Law 2006, article 84.

<sup>162</sup> Bankruptcy Law 2006, article 86.

by a dissenting creditor who argues that he has been unfairly prejudiced in the process of the vote, will be heard as well. Even though the proposal has been approved by the meetings of creditors and the company, the court still has a wide discretion to reject it as long as the court can confirm the illegitimacy of the substantive rights or procedures. The sanction of court will lead to two legal effects, respectively the termination of the reorganization procedure and the immediate coming into force of the reorganization proposal. It is important to note that there is a remedy in the circumstances where one or more classes of creditors fail to approve the proposal.<sup>163</sup> The administrator may negotiate with the creditors of this class and make some modifications for further voting, but the modification is not allowed to damage the interests of the creditors in the other classes and the shareholders of the company as well.<sup>164</sup> Provided that the creditors of this class refuse to vote or fail to give approval again at the further meeting, the administrator is still entitled to apply to the court for sanction and the court has discretion to override the objection of those creditors and make the order upon the satisfaction of three conditions, respectively according to the reorganization plan: that the claims of creditors in this class can be well satisfied; all the creditors and shareholders in each voting class are treated fairly and reasonably; and the reorganization strategy in the draft is feasible. This is the so-called “cramdown” rule. It is indicated that the judiciary holds the final say on the rescue scheme and the power of the court is supreme to the authority of the creditors’ meeting.<sup>165</sup> Once the reorganization proposal is granted by the court, it will have a binding effect on the company and all the creditors. The proposal should be implemented in compliance with the terms under the supervision of the administrator.<sup>166</sup> If the debtor fails to perform its obligations under the reorganization proposal, the court shall terminate the implementation of the proposal and adjudicate bankruptcy upon the application of administrator or any interested

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<sup>163</sup> Bankruptcy Law 2006, article 87.

<sup>164</sup> L Qi, “The Corporate Reorganization Regime under China’s New Enterprise Bankruptcy Law” (2008) 17 *International Insolvency Review* 13, 21.

<sup>165</sup> J Shi, above n.4, at 668.

<sup>166</sup> Bankruptcy Law 2006, article 90.

party.<sup>167</sup>

#### 4.3.6 Corporate control and management in reorganization: PIP or DIP?

A crucial question, which may largely determine the destiny of a corporate rescue attempt, is who is entitled to take control over the management of a troubled company, the independent insolvency professionals or the debtor during the reorganization? From the perspectives of international standards, it is interesting to note that

“[t]here are three typical approaches in reorganization proceedings: (i) exclusive control of the proceeding is entrusted to an independent insolvency representative; or (ii) governance responsibilities remain invested in management; or (iii) supervision of management is undertaken by an impartial and independent insolvency representative or supervisor. Under the second and third approaches, complete administration power should be shifted to the insolvency representative if management proves incompetent, negligent or has engaged in fraud or other misbehavior.”<sup>168</sup>

It is well known that in the United States debtor-in-possession (DIP) model, the existing management of the financially ailing company retains the full control of the assets and business during the reorganizing process. As a supplement to address the problems of mismanagement, fraud, incompetence of the debtor, or for other causes, a trustee may be appointed to displace the existing management and take over the debtor by the court’s order.<sup>169</sup> On the contrary, the UK adopted a different approach to design the rescue-oriented administration procedure on the other extreme in which the existing management of the debtor company will be displaced by an independent insolvency practitioner. This is the so-called practitioner-in-possession (PIP) model.<sup>170</sup> It can be seen that both the DIP and PIP model have provided good examples and a useful experience for the countries which intend to reform their bankruptcy and rescue laws. However, when the legal reformers consider borrowing

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<sup>167</sup> Bankruptcy Law 2006, article 93.

<sup>168</sup> The World Bank, *Principles for Effective Insolvency and Creditor Rights Systems* (Revised Draft, 2005), para.C6.2.

<sup>169</sup> US Bankruptcy Code 1978, Chapter 11 Reorganization, § 1101 and 1107.

<sup>170</sup> For the relative merits of the US DIP model and the British PIP model, see D Hahn, “Concentrated Ownership and Control of Corporate Reorganizations” (2004) 4 JCLS 117; V Finch, “Control and co-ordination in corporate rescue” (2005) 25 *Legal Studies* 374.

the US or the UK model, one thing which should be borne in mind is to pay attention to domestically peculiar background issues, like the causes of corporate failure and commercial morality of the market.

A long debate among the drafting committee of China's new bankruptcy law was whether to import the same DIP style procedures from the US Reorganization regime. It would be impossible and unwise for a country, which shares different ideologies and attitudes towards bankruptcy law, to transplant or embrace the same DIP from the US instantly without any change. It has been observed that "[i]t is not easy for China to accept the DIP model since China has long viewed bankruptcy as a disgrace due to the failure and incompetence of the debtor."<sup>171</sup> In view of the economic and legal reality, which indicated that inefficient corporate governance, mismanagement and incompetence of directors are the main causes of corporate decline, especially the massive failure of state-owned enterprises, the majority of the drafters eventually decided to introduce the PIP model as the main format, and incorporate the similar DIP model as a supplement.<sup>172</sup> It is stipulated that the court-appointed administrator takes over the assets and business affairs of the debtor.<sup>173</sup> However, during the reorganization period, the debtor is entitled to apply to the court for the sanction of DIP proceedings.<sup>174</sup> This DIP is different from the US model, because although the debtor will retain control over the business and be in charge of the reorganization, this will be done under the supervision of the court-appointed administrator. Apparently, the modified DIP to some degree limits the existing management, and the directors under the DIP are subject to the monitoring of an independent insolvency practitioner.<sup>175</sup> It is quite similar to the English CVA regime.

#### 4.3.7 A notable feature of China's reorganization: shareholders'

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<sup>171</sup> Shi, above n.4, at 669.

<sup>172</sup> Ibid.

<sup>173</sup> Bankruptcy Law 2006, article 74.

<sup>174</sup> Bankruptcy Law 2006, article 73.

<sup>175</sup> L Qi, "The Corporate Reorganization Regime under China's New Enterprise Bankruptcy Law" (2008) 17 *International Insolvency Review* 13, 18.

## rights of involvement in the rescue process.

Broadly speaking, the new bankruptcy law is conducive to the protection of rights and interests of the shareholders from three aspects. First, the new reorganization procedure provides the shareholders with easy access to the rescue regime. It is stipulated that the financially distressed debtor under the majority decision of the shareholders' meeting is entitled to apply to the court for reorganization.<sup>176</sup> In order to prevent the major shareholders from manipulating the shareholders' meeting and to protect the interests of the medium and small shareholders, the new law allows the shareholders, who contribute to more than 10 per cent of the debtor's registered capital, to trigger the rescue proceedings.<sup>177</sup> Second, although shareholders' controlling power is largely stripped in reorganization, they still have rights to be involved in the process of producing a restructuring proposal. It should be noted that shareholders are encouraged to engage in the negotiation and express their own opinion on the rescue scheme freely. Shareholders' rights of involvement can be realized through a shareholders' committee, the members of which are either major shareholders or elected, and are entitled to exercise such right on behalf of all the shareholders. It is noteworthy that China's rescue law has shed light on the right of involvement of shareholders in reorganization, whose representatives are allowed to attend the creditors' meeting which specially negotiates over the reorganization proposal.<sup>178</sup> Third, since shareholders have a right to be involved, logically they should have the right to vote for the reorganization proposal. It is provided that a group of shareholders should be established to vote if the reorganization proposal involves the adjustment of the capital structure and existing shareholders' interests.<sup>179</sup> However, the veto of the shareholders' group cannot absolutely impede the approval of the rescue arrangement, because the court could cramdown the objection of the

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<sup>176</sup> Bankruptcy Law 2006, article 70 (1).

<sup>177</sup> Bankruptcy Law 2006, article 70 (2); Parry and Zhang, above n.128, at 127.

<sup>178</sup> Bankruptcy Law 2006, article 85 (1).

<sup>179</sup> Bankruptcy Law 2006, article 85 (2); see the reorganization case of *Canghua Chemical Industry Joint Stock Company* in 2007, relevant information is available at <http://news2.eastmoney.com/071129,731487.html> (last visit on 31 May 2008)

voting group of shareholders if certain conditions are satisfied.<sup>180</sup> In the reorganization of *Zhengzhou Baiwen*, the majority of pre-bankruptcy shareholders were not happy with the arrangement for changing the capital structure and dissented against the transfer of their half of the share capital to the intended investor Sanlian Group.<sup>181</sup> Zhengzhou Municipal Intermediate Court established a principle that the pre-insolvency shareholders have no right to stop the approval and implementation of the rescue scheme during the course of reorganization.<sup>182</sup> This principle has been further developed by the new bankruptcy law, which stipulates that the court is entitled to sanction a reorganization proposal even though this proposal has been rejected by the equity investors' group, as long as no one is unfairly and unreasonably treated.<sup>183</sup> In short, China's reorganization procedure favours the shareholders' rights and interests, and to some degree enables existing shareholders to generate right incentives and actively engage in a rescue attempt.

#### 4.3.8 Court's involvement

Compared with the British rescue laws, the new Chinese rescue regime is a court-centralized procedure, in which the court is involved in almost every major step. Fundamentally, China follows a civil law tradition under which the bankruptcy law proceedings are court-driven.<sup>184</sup> First of all, the access to the rescue proceedings is completely under the control of the judiciary. Since the out-of-court appointment mechanism is not available in this law, the door to the reorganization regime cannot be opened to the applicants without the court's order.

Secondly, the new rescue procedure fails to stipulate the period within which the

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<sup>180</sup> X Song, "The Court's Role in the Proceedings of Enterprise Bankruptcy and Restructuring and Problems that Needs to be Solved", a paper presented at the Forum on Asian Insolvency Reform, April 2006 in Beijing.

<sup>181</sup> For the details, see X Wei, "People's Republic of China: the Legal Features of Chinese Capital Markets in the Light of the Zhengzhou Baiwen Case" (2002) 23 Comp. Law. 100.

<sup>182</sup> Y Zhang, "The urgency of legalizing corporate reorganization—from the perspective of Zheng Baiwen case", *China Securities*, 24 July 2002.

<sup>183</sup> Bankruptcy Law 2006, article 85 (2) and article 87.

<sup>184</sup> Shi, above n.4, at 665.

court shall decide whether or not to make the order after it receives the application for reorganization.<sup>185</sup> It can be speculated that this legislative omission may provide an excuse for the court which may postpone the period of examining the application materials and making the judgment. Unquestionably, the unexpected delay to access to the reorganization procedure may diminish the successful rate of turnaround. Particularly according to the new law, there is no interim moratorium available to cover this uncertain period, in which the individual creditor is allowed to trigger the liquidation proceedings or other legal action.

Thirdly, in relation to the new law, the court is liable to carry out some duties, which are performed by other authorities rather than the court in the rescue networks of other countries. One obvious example is that the court which accepts the reorganization is required to summon the meeting of creditors in distinct classes to vote within a month after it receives the reorganization proposal. Undoubtedly, the administrator shall be responsible for convening the creditors' meeting rather than the court under the British rescue laws.<sup>186</sup> In addition, the establishment of a creditors' committee needs the written confirmation of the court even though members of the committee have been selected by the creditors' meeting.<sup>187</sup> Comparatively, in the British Administration regime, the creditors' committee is merely established by the creditors' meeting without the need of court's confirmation.<sup>188</sup> It can be observed that the reorganization regime imposes extra work on the courts which may result in the unlimited expansion of judicial power; and may also cause delay to the rescue process and a resultant increase in the relevant cost.

Fourthly, the judiciary holds the final say on all the administrator-related issues including the administrator's qualification, appointment, replacement and

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<sup>185</sup> This point will be further developed in s 4.3.9.1.1.

<sup>186</sup> IA 1986, Sch B1, para.56(1).

<sup>187</sup> Bufford, above n.127, at 697.

<sup>188</sup> IA 1986, Sch B1, para.57(1).

remuneration. Since China has no judicial experience of the newly established institution of “administrator”, the Supreme People’s Court is conferred an authority of stipulating relevant criteria to qualify and make a roster of the eligible law firms, accounting firms, bankruptcy and liquidation firms and individual practitioners for selection.<sup>189</sup> Under the authorization, the Supreme People’s Court issued a judicial interpretation, which specifies the comprehensive rules of how to qualify and appoint an administrator in a bankruptcy or reorganization case.<sup>190</sup> Obviously, the judiciary takes complete control over the access to this market. It may be argued that the relevant administrative department (PRC Ministry of Justice) or an independent autonomous organization should discharge the function of qualifying the competent public agencies and insolvency professionals, rather than the judiciary. The judiciary is unsuitable to take charge of qualifying competent intermediary agencies and insolvency professionals because in this circumstance the judiciary is not only a rule-maker, but also a gatekeeper. In addition, the court holds the power to appoint an administrator in a bankruptcy or reorganization case and determine the remuneration of the administrator. All the significant powers relating to administrator issues have been concentrated on the judiciary. Therefore, it might be very difficult to ensure that the judiciary is impartial. Even though currently it is immature to establish an autonomous body to qualify, manage and supervise the insolvency professionals, it is foreseeable that it must be established once all the conditions are satisfied. The major concern is that, provided the crucial powers, such as qualifying the eligible candidates, appointing an administrator and determining the remuneration of the administrator in a detailed case, are held by courts, it is quite difficult to ensure transparency and fairness, and to prevent the abuse of powers because of a lack of effective supervision.<sup>191</sup> In addition, the courts have a monopoly over the power of

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<sup>189</sup> Bankruptcy Law 2006, article 22 (3).

<sup>190</sup> “Provisions on Appointment of Administrator in Hearing Bankruptcy Cases”, issued by Supreme People’s Court on 4 April 2007 and valid since 1 June 2007. For more information, see A Tang and P Au, “China’s enterprise bankruptcy law: The central government’s new regulations on bankruptcy administrators”, HKICPA (November 2007) <[http://www.hkicpa.org.hk/APLUS/0711/p48\\_50.pdf](http://www.hkicpa.org.hk/APLUS/0711/p48_50.pdf)> (last visit on 31 August 2008)

<sup>191</sup> R Parry and H Zhang, “China’s New Bankruptcy Law: Notable Features and Key



designating administrators in bankruptcy and reorganization regimes.<sup>192</sup> It should be noted that there was a fierce debate about who should be entitled to appoint an administrator, the creditors' meeting or the court; and this debate to some extent delayed the final deliberation of the new bankruptcy law in the drafting process.<sup>193</sup> Moreover, the court is involved in the decision of the administrator's remuneration. Although the creditors' meeting is entitled to petition to the court and oppose the remuneration scheme, the court will eventually determine it.<sup>194</sup>

In short, it is submitted that the Chinese court-centralized bankruptcy and reorganization proceedings have imposed a heavy workload on the judicial system which is in pressing need of sufficient and well-trained judges with professional expertise in insolvency law and relevant subjects. At present, the severe lack of competent judges will inevitably have a bad impact on the capacity of the courts to handle bankruptcy cases and will hamper the efficiency of the judiciary. Clearly, this is currently a major concern over the implementation of the new law.

#### 4.3.9 Potential problems, solutions and prospects

It was expected that the reorganization procedure would largely be used in China's bankruptcy practice with the implementation of the new law. However, initial judicial practice indicates that the Chinese corporate rescue law is not yet as efficient and effective as its counterpart of the UK, because reorganization cases filed in court have proved rare at the national level during the first year of enforcement.

##### 4.3.9.1 Key problems in relation to the implementation

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Problems of Enforcement" (forthcoming).

<sup>192</sup> Falke, above n.134, 69.

<sup>193</sup> C Booth, "The 2006 PRC Enterprise Bankruptcy Law: The Wait Is Finally Over" (2008) 20 SAclJ 275, at 299; Shi, above n.4, at 663. This issue will be developed in s 4.3.9.1.2.

<sup>194</sup> Bankruptcy Law 2006, article 28 (2). Under the authorization of the new law, the Supreme People's Court issued a judicial interpretation (Provisions on the Determination of Administrator's Remuneration in Hearing Bankruptcy Cases) in April 2007 which specifically stipulates the rules regarding administrator's remuneration and court's role. See Shi, above n.4, at 665.

#### ***4.3.9.1.1 Is the access to the reorganization procedure quick and efficient?***

It has been previously mentioned that, since there is no mechanism of out of court appointment in the Chinese reorganization procedure, the entitled parties, including the debtor company, creditors, and shareholders who contribute more than 10 per cent of the registered capital, have to petition to the court when the company is insolvent or likely to be insolvent.<sup>195</sup> There are several potentially significant issues that may affect the opening stage of a corporate rescue case in judicial reality. First, the law is unclear about what the application materials should include. There is an article regulating the application materials for bankruptcy rather than reorganization, and it is stipulated that the applicant should submit an application form and relevant evidence.<sup>196</sup> The legislative lacuna in this respect may lead to at least two problems. Firstly, the applicant may wonder what materials and evidence could convince the judges to accept the reorganization application. If the applicant is a creditor, it could be easy for the creditor to prove that the debtor is unable to pay due debts because the failure of debtor to perform according to contract terms is enough. However, it would be extremely difficult for a creditor to adduce evidence that the value of the debtor's liabilities exceeds the value of its assets, since the creditor has no access to the debtor's financial and accounting information. The evidence of debtor's failure to pay due debts can prove that the company is facing financial trouble and in need of immediate reorganization to avoid insolvent liquidation.<sup>197</sup> If the applicant is the debtor company, the applicant should arguably be required to submit relevant materials regarding the company's assets, financial and accounting information, unpaid wages and social insurance of employees. In addition, the debtor should provide an initial proposal for the reorganization which may include whether there is

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<sup>195</sup> Bankruptcy Law 2006, article 70 (2); Simmons and Jiang, above n.130, at 13. It should be noted that when determining the application of bankruptcy procedures, the UK requires either the cash flow or balance sheet insolvency, while China needs both. Apparently, the double requirements of cash flow and balance sheet test may cause an additional hurdle and extra delay in triggering bankruptcy or reorganization proceedings. See Falke, above n.134, at 66.

<sup>196</sup> Bankruptcy Law 2006, article 8.

<sup>197</sup> R Parry and H Zhang, "China's New Bankruptcy Law: Notable Features and key problems of Enforcement" (forthcoming).

a potential investor who intends to inject fresh funding, and whether the company could obtain sufficient funds for continued trading during the reorganization period. This information could convince the judges that there is a reasonable prospect that the company could be rehabilitated and that the applicant is not attempting to abuse the reorganization procedure to avoid debt enforcement. Secondly, the uncertainty of law in this aspect may provide a wide discretion to the court because there is no specific criterion to accept or refuse an application. For instance, pursuant to the current rescue law, theoretically any creditor is entitled to trigger the reorganization procedure, but in a particular case the court may assess the percentage of the value of this claim in the value of the total debts. In other words, to what extent will a court be satisfied with a claim of a creditor to decide the debtor's inability to pay debts? Apparently, this is a legislative lacuna which may present difficulties for the judges. It may be argued that, if the value of the creditor's claim is very small, the court may dismiss the application and suggest that the creditor petitions to the court by other civil procedures.<sup>198</sup> It should be noted that in this respect the English insolvency law has provided a good example, which addresses the tests of a company's inability to pay debts. It is stipulated that if "(a) [the company] neglects to pay, secure or compound to the reasonable satisfaction of the creditor a debt exceeding £750 within three weeks of a written demand in the prescribed form; or (b) execution or other process on a judgment against the company is returned unsatisfied, wholly or in part;" the court may adjudicate the company's inability to pay debts.<sup>199</sup> It is submitted that the Chinese legislature or Supreme People's Court could follow this thread, and design its own rules and standards on the basis of economic and legal reality.

The second big problem is that there is no clear time limit for the court to make the decision as to whether or not to accept a reorganization application. It is an omission

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<sup>198</sup> This point has been explained by Prof. Shuguang Li, a drafter of the new bankruptcy law, at a conference which was organized by the Research Center of Bankruptcy Law and Restructuring of Renmin University and Beijing Weiheng Law Firm on 27 August 2007.

<sup>199</sup> IA 1986, s 123 (1); Goode, above n.47, at para.4.08.

that may evidently cause an indefinite delay by the court. The more time wasted in the application stage, the less chance there is to rehabilitate the ailing company, especially since there is no interim moratorium to cover this period. Some scholars think that this time limit should be in line with the rule which regulates bankruptcy.<sup>200</sup> In other words, they argue that the court should make the decision within 15 days of receiving the reorganization application and this period can be extended by a further 15 days by the approval of the upper-level court.<sup>201</sup> However, it can be observed that the judiciary has apparently not so far followed the limit of a 30-day period as evidenced by the case of *Canghua Chemical Industry Joint Stock Company* in which the court considered the reorganization application for more than two months before it eventually accepted it.<sup>202</sup> It is submitted that it is necessary to impose a clear time limit upon the court and the period should be at least one month for the court to assess the reorganization application. In some circumstances, professional accountants and auditors may be involved in the investigation and report to the court whether the company is in financial distress and whether it is feasible to rehabilitate it. If the case is extremely complicated, like the reorganization of a listed company, this time limit may be extended for another month under the approval of the upper-level court. In short, the opening stage of the Chinese rescue law, which is completely under the control of the court, is not efficient, and the distressed company cannot easily get access to the reorganization procedure due to the legislative uncertainty.

#### ***4.3.9.1.2 Appointment of administrator***

The question of who should have the power to appoint an administrator in a company reorganization case was one of the most contentious issues during the drafting process.<sup>203</sup> The appointment of an administrator reflects a balance between the

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<sup>200</sup> Wang, above n.133, p206; L Qi, "The Corporate Reorganization Regime under China's New Enterprise Bankruptcy Law" (2008) 17 *International Insolvency Review* 13, 19.

<sup>201</sup> Bankruptcy Law 2006, article 10.

<sup>202</sup> <http://business.sohu.com/20070615/n250585971.shtml> and <http://stock1.jrj.com.cn/news/2007-12-13/000003049626.html> (last visit on 31 May 2008)

<sup>203</sup> Shi, above n.4, at 663.

court-guided procedure and creditor-oriented procedure. Basically, it was a complex issue during the formulation of the new bankruptcy law, as the drafting committee grappled with the question as to who shall be conferred the authority to appoint an administrator: the court, the creditors, or other authorities? It was argued that the creditors' meeting should be entitled to make the appointment because the bankruptcy legal procedure fundamentally aims to protect the interests of creditors.<sup>204</sup> However, the majority of the drafters held that the administrator in a bankruptcy or reorganization case should remain independent and neutral, and act for the interests of all the stakeholders.<sup>205</sup> The mechanism of appointment made by the majority decision of creditors' meeting seems perhaps to be a suitable alternative, but it may be manipulated by major creditors. Comparatively, the appointment by a court might be more efficient and could avoid the unfair control of major creditors. Eventually, the new bankruptcy law vested such power in the court, which has a monopoly over the appointment of an administrator whether in a bankruptcy or reorganization case.<sup>206</sup> As a compromise, the law allows the creditors' meeting to petition to the court for removal of the administrator if it thinks that the administrator fails to perform his duties lawfully and justifiably, or the administrator is incompetent to hold this position. However, the creditors' meeting cannot appoint a new administrator without the court's order.<sup>207</sup> This arrangement shows that the court is dominant over the creditors' meeting on this issue. This rule indicates that Chinese courts are empowered in the bankruptcy or corporate rescue procedure in a similar manner to their counterparts in other civil law countries, more than their counterparts in the common law system. However, even though the Chinese legal reformers referred to the German system and borrowed the court-appointed mechanism from German Insolvency Law, they are different in essence because,

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<sup>204</sup> Wang, above n.133, p36.

<sup>205</sup> W Wang, "Administrator in the New Bankruptcy Law of China", a paper presented at the Forum on Asian Insolvency Reform 2004: Insolvency Systems and Risk Management in Asia, New Delhi, India, on 3-5 November 2004. It is available at [http://www.iiiglobal.org/country/china/Administrator\\_in\\_new\\_BL.pdf](http://www.iiiglobal.org/country/china/Administrator_in_new_BL.pdf) (last visit on 31 May 2008)

<sup>206</sup> Bankruptcy Law 2006, article 13.

<sup>207</sup> Bankruptcy Law 2006, article 22 (2); Simmons and Jiang, above n.130, at 12.

according to the German law, the creditors' meeting is entitled to remove the administrator who has already been appointed by the court, and nominate a new one.<sup>208</sup> In other words, the Chinese courts have the final say on the appointment of an administrator and creditors' objection cannot override the court's decision. The court must decide how to appoint an administrator from those qualified intermediary agencies or individual insolvency professionals from a local roster.<sup>209</sup> In order to satisfy the principles of fairness, justice and transparency, the court may take the form of a random allocation, such as rotation and a blind draw.<sup>210</sup> In relation to complicated and influential cases, like the bankruptcy or reorganization of a listed company, the court may adopt a competitive method of bidding and tendering, to choose the most competent and cost-effective intermediary agencies or an insolvency professional as an administrator.<sup>211</sup> As for the bankruptcy or reorganization of a financial institution like a commercial bank or an insurance company, the court will consider and follow the recommendation of the relevant government bodies, like the China Banking Regulatory Commission (CBRC) and China Insurance Regulatory Commission (CIRC).<sup>212</sup> However, it is important to know that the court has the discretion to appoint more than one administrator in a bankruptcy related case. In the first bankruptcy case in Beijing since the new bankruptcy law was implemented, the *Bankruptcy of Beijing Danyao Real Estate Ltd*, the court appointed two administrators: Beijing Weiheng Law Firm and Beijing Enterprise Liquidation Firm.<sup>213</sup> This was mainly because currently there is no uniform body of insolvency practitioners who are able to deal with the bankruptcy-related legal, financial and accounting issues. The court, which simultaneously appointed a law firm and a liquidation firm in this case, expressed its concerns with the shortage and inadequacy of knowledge and skills offered by a single administrator. It indicates that China is in

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<sup>208</sup> German Insolvency Code (InsO), sections 27 and 57; Paulus, above n.141, at 146.

<sup>209</sup> Bankruptcy Law 2006, article 22 (3).

<sup>210</sup> Provisions on the Appointment of Administrators in Hearing Bankruptcy Cases, article 15 (2).

<sup>211</sup> Shi, above n.4, at 663.

<sup>212</sup> Ibid.

<sup>213</sup> See the comments at <http://hyzc.net/ytsh/2007-9/10/20070910268373.html> (last visit 31 July 2008)

need of a new system to qualify the competent insolvency professionals who should possess insolvency law related skills and expertise.<sup>214</sup>

#### ***4.3.9.1.3 The feature of the out of court appointment in English Administration: borrowing or refusing?***

It should be noted that the English insolvency law reforms have provided a very good example of an out of court appointment mechanism to the Chinese legal reformers who may consider whether or not it is likely and practicable to borrow this feature and fit it into the current bankruptcy legal framework. This is a very tricky question but worth considering, because an extra-judicial appointment could enable a financially distressed firm to enter into rescue proceedings more quickly and efficiently. In addition, the appointment of an administrator made outside court could bring about an interim moratorium which could protect the debtor company from individual claims. However, in the lengthy legislative process, the mechanism of an out of court appointment, as in English Administration, never became a subject in the drafting committee, the members of which argued that historically China never had experience of any extra-judicial procedure in bankruptcy laws. In addition, the bankruptcy legal framework was not mature and developed because of the limited and inconsistent practice of the judiciary in bankruptcy and reorganization cases.<sup>215</sup> Moreover, China constantly referred to and followed the rules of traditional civil law countries which preferred court-driven bankruptcy proceedings. Finally, from the perspective of the economic and legal reforms of past 30 years, it can be found that Chinese reformers preferred to adopt progressive steps to push forward reforms gradually. In other words, they refused to accept over-risky and drastic measures and innovations which might incur an unpredictable result. Therefore, it has been argued that there is no reasonable prospect for China to borrow the mechanism of out of

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<sup>214</sup> R Parry and H Zhang, "China's New Bankruptcy Law: Notable Features and Key Problems of Enforcement" (forthcoming).

<sup>215</sup> S Li, "Bankruptcy Law in China: Lessons of the Past Twelve Years" (Winter 2001) *Harvard Asia Quarterly*, Volume V, No.1  
<<http://www.asiaquarterly.com/content/view/95/40/>>. (last visit on 31 May 2008)

court appointment in the near future.

Whether or not the new bankruptcy and rescue law could operate well needs the real test of judicial practice. The legislature will not consider the reform of introducing the British extra-judicial appointment feature in the short term. However, that does not necessarily mean that the Chinese legal reformers would ignore the English style in the long run.<sup>216</sup> When the new bankruptcy and corporate rescue legal framework becomes mature through the judiciary accumulating adequate experience and lessons by hearing bankruptcy-related cases consistently and the judges and insolvency professionals fully developing their skills and expertise, China certainly could refer to the English Administration and try to build an extra-judicial appointment system on the basis of existing reorganization practice which may enable a distressed company to get access to the reorganization procedure more efficiently. In this regard, the problem is who might be entitled to nominate an administrator out of court? According to the counterparts of the English Administration, the qualifying floating charge holder, the company and its directors have been conferred the authority to appoint an administrator out of court. The security device of floating charge has been well developed in the UK since it was first established in *Re Panama, New Zealand and Australian Royal Mail Company*.<sup>217</sup> It is treated as a crucial tool for the British financial market. Under administrative receivership which was built upon the floating charge, the floating charge holder could appoint an administrative receiver to take over the assets and business affairs of the debtor. When the administrative receivership procedure was virtually abolished in order to promote the usage of the rescue-oriented administration in the reform, the floating charge holder was given power to appoint an administrator outside court as a compromise. It can be observed

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<sup>216</sup> The legislative history of the UK provides a good example. The administration procedure as a corporate rescue regime was first introduced in the Insolvency Act 1986, but it was underused and failed to play the function in judicial practice as reformers expected. After 16 years, the Enterprise Act 2002 fully revamped the administration and one of the most remarkable innovations was the establishment of the mechanism of out of court appointment in paras.14 and 22 of Sch B1 which was inserted in the Insolvency Act 1986.

<sup>217</sup> (1870) 5 Ch App 318.



that the floating charge as a financial tool has been used for more than a century and accordingly the operation of the extra-judicial appointment mechanism is very mature. Comparatively, in China the legislation recently introduced the institution of the floating charge in its new Property Rights Law which is conceptually similar to the English floating charge.<sup>218</sup> However, it should be noted that the holder of a floating charge according to the Chinese law cannot enjoy as strong power in bankruptcy proceedings as the English floating charge holders in the administrative receivership or administration procedures. Although the Chinese legal framework has recognized the legal concept of floating charge, in a manner common in Chinese legislation the recognition is tentative and not well integrated with relevant legislation, such as the new bankruptcy law.<sup>219</sup> In addition, in the UK, the floating charge holders are normally the banks and financial institutions which are owned by private investors. But, the situation in China is different because nine out of the top ten domestic banks are completely owned or controlled by the state. If the floating charge holders were given the power to nominate an administrator out of court, it would be likely to be subject to government intervention. Therefore, the floating charge holders should not be conferred such power in the foreseeable future. However, the legal reformers may consider empowering the debtor or its board to make the appointment of an administrator outside court. First, the directors are in the best position to sense the impending financial difficulty of the company. Second, some intermediary agency or individual insolvency professional may work in a company as a financial or legal consultant. They are very close to and familiar with the financial status and business affairs of their client. It would be easy and quick for this intermediary agency or insolvency professional to produce a reorganization proposal if the debtor or its board was entitled to appoint this intermediary agency or individual professional as an administrator out of court. Third, in the light of the judicial practice of the bankruptcy legal framework, it can be found that in 2006,

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<sup>218</sup> PRC Property Rights Law 2007, article 181.

<sup>219</sup> For more comments on the Chinese floating charge provisions, see J Chung and O Cox, "Tentative Steps" (2007) 26 *International Financial Law Review* 45.

there were 2,857 bankruptcy-related cases filed in court, but 2,712 of them, which accounted for nearly 95 per cent, were triggered by the debtor.<sup>220</sup> These statistics could demonstrate that the majority of bankruptcy or reorganization cases were invoked by the debtor, who is in the better position to understand the financial information and sense financial trouble than creditors. Thus, it is submitted that if the reformers refer to the English mechanism of out of court appointment in the future, they should consider conferring such power upon the debtor or its directors in the first place. Logically, there should be one remedy available for the creditors to keep balance between the debtor and its creditors. Provided that the majority of the creditors' meeting is not satisfied with the appointment made by the debtor, the creditors' meeting should be entitled to petition to the court for removal. It should be borne in mind that all the above analysis is developed on the basis of the hypothesis that the Chinese legislature will consider borrowing the extra-judicial appointment feature from England in the long term. Although it is undeniable that this mechanism may conflict with the traditional court-driven procedure of China's bankruptcy law, it is worth considering.

#### ***4.3.9.1.4 Potential weaknesses in the Chinese modified DIP model?***

It is submitted that there are several problems which may impede the implementation and effectiveness of the Chinese modified DIP. First, the new law provides the debtor with access to the DIP procedure by applying to the court for retention of control during the reorganization, but the law is not clear about who is entitled to make such an application, the general meeting of shareholders or the board of directors? According to the Chinese company law, the management power of the board of directors is limited and normally the general meeting of shareholders makes the final decision regarding big business events such as a merger with another company, or an increase in registered capital.<sup>221</sup> To apply for the DIP is a crucial issue for the

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<sup>220</sup> Data are provided by Beijing Siyuan Merger and Bankruptcy Consultancy Firm, available at <http://www.caosy.com/> (last visit on 31 May, 2008)

<sup>221</sup> PRC Company Law 2005, articles 47 and 109.

corporate administration of the distressed company in reorganization. Thus, on this logic, the board of directors should not be allowed to petition without the authority of the shareholders' meeting. This logic holds that if the board intends to apply for DIP, it has to convene an interim meeting of shareholders for authority prior to filing the application in court. It can be imagined that this process will cost time and money. Therefore, it is submitted that the board of directors should be authorized to make an application for DIP proceedings directly for efficiency and cost-effectiveness, but this needs to be made explicit in the legislation. Second, what factors should the court take into account before granting a DIP application? This is a legislative lacuna which may provide the court with a wide discretion. It has been suggested that the court should fully investigate what caused the corporate distress: unpredictable market reasons or the incompetence of management? If the insolvency mainly resulted from poor management and decision-making, the court would unquestionably dismiss the DIP application. In addition, the judges need to assess whether or not the existing directors are able to manage the ailing company in continued trading during the reorganizing process. In other words, the court will evaluate the directors' experience and ability to deal with the balance of risk and return, to negotiate and produce a reasonable and practicable rescue proposal during the reorganization.<sup>222</sup> In this sense, the debtor must submit the management record and board minutes along with the DIP application for the consideration of the court in order to prove the competence of directors. Moreover, the court will listen to the suggestions of the representatives of the labour union who are familiar with the management. The opinions of creditors are also very significant. After all, the creditors bear the risk and cost of a rescue attempt. They will lose more if the reorganization fails. Thus, it can be supposed that the court will not grant a DIP if the creditors' meeting strongly opposes it.<sup>223</sup> The third problem is how long the court shall be permitted to make the decision. There is supposed to be a clear time limit

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<sup>222</sup> Wang, above n.133, p211-216.

<sup>223</sup> This viewpoint was supported by Prof Jingxia Shi, the drafter of the new bankruptcy law, in an interview on 11 July 2007.

under which the court must finish the investigation of a DIP application and decide whether to grant it or not, but the new law fails to do so. In view of the above analysis, it can be assumed that it will take some time for the judges to complete their investigative work to reach a good decision. It should be noted that all the matters discussed here have not been codified yet and it is expected that these shortcomings and ambiguity may be clarified by further legislation or judicial interpretation on the basis of practice.

#### ***4.3.9.1.5 New funds for reorganization***

It has been analyzed that the availability of new financing is of crucial significance for a rescue attempt. Financially distressed companies, which are encountering cash flow problems, are urgently in need of fresh funds to continue trading out of their financial difficulties.<sup>224</sup> The additional finance post-petition could enable the ailing firms to pay for necessary expenses and maintain the ongoing business operation. The question is where the new finance may come from? In the ordinary course of business, there are normally three ways available for a company to raise funds, respectively self-raising funds from the stock and bond exchange market, new investment from the existing shareholders or new investors, and borrowing money from banks and potential lenders. However, when a company is close to insolvency, obtaining finance is understandably difficult. First, in relation to the self-raising method in the Chinese capital market, there are stringent restrictions on issuing stocks and bonds for a company in order to protect the interests of public investors, especially as the company is insolvent or likely to be insolvent.<sup>225</sup>

Second, seeking a strategic investor is a significant route to obtain fresh funds, particularly when a financially troubled firm cannot borrow money from banks and financial institutions. From the limited judicial practice and experience, it is demonstrated in this style of reorganization that a certain proportion of shares will be

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<sup>224</sup> G McCormack, “Super-priority new financing and corporate rescue” [2007] J.B.L. 702.

<sup>225</sup> PRC Securities Law 2005, articles 13 and 16.

transferred from the existing shareholders to the strategic investor, and in return the investor will inject funds or introduce a project which can bring a benefit for the company monetarily. Provided that the company is successfully rehabilitated, the new investor will become the controlling shareholder.<sup>226</sup>

Third, as previously noted, the Chinese reorganization procedure borrows the US DIP model, and accordingly introduces DIP financing which could enable the debtor to borrow money for continued trading by means of providing a security on the debtor's property which has not been pledged as collateral.<sup>227</sup> Although this provision is in line with the international standard, the problem is when a company is in the slide into insolvency, there are normally no adequate assets available for a new security to guarantee a new loan. In other words, this stipulation lacks operational specifics in Chinese reality.<sup>228</sup> In addition, a notable legislative lacuna of the Chinese reorganization regime is super-priority financing which is conducive to the generation of post-petition funds. It should be noted that such financing could encourage lenders to extend credit to the debtor for restructuring without concerns because the position of the post-petition lenders is to jump over the existing creditors including the secured creditors in the distributional queue.<sup>229</sup> In China's new bankruptcy law, there is one section which indirectly mentions the priority of the new financing in the post-petition bankruptcy or reorganization.<sup>230</sup> It can be deduced from this section that the lenders could enjoy priority only in the circumstances where the money is borrowed for the wages and social security expenses of the employees in the continued trading. Moreover, the lenders cannot leapfrog over the

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<sup>226</sup> Please see the first reorganization case in Beijing, the comments about *Reorganization of Beijing Xianju Reproductive Health Hospital Limited Liability Company* are available at <http://www.pcfil.cn/news/20070820/85.html> (last visit December 3, 2007)

<sup>227</sup> Bankruptcy Law 2006, article 75 (2); L Qi, "The Corporate Reorganization Regime under China's New Enterprise Bankruptcy Law" (2008) 17 *International Insolvency Review* 13, 22.

<sup>228</sup> Shi, above n.4, at 669.

<sup>229</sup> H. Jason Gold, Valerie P. Morrison and Alexander M. Laughlin, "Superpriority Financing: Last in Time First in Line" (26 April, 2002)

[http://www.wileyrein.com/publication.cfm?publication\\_id=11386](http://www.wileyrein.com/publication.cfm?publication_id=11386)

<sup>230</sup> Bankruptcy Law 2006, article 42 (2).

existing secured creditors. Therefore, it can be said that this priority is limited, and different from the internationally recognized concept of super-priority. It can be concluded that the Chinese reorganization procedure fails to give the banks and potential lenders sufficient incentives to advance a loan in order to reconstruct a troubled firm. This explains why the Chinese banks are unwilling to lend to an enterprise which is in financial difficulty. In addition, although the Chinese banking sector has obtained great achievements in dealing with non-performing loans during the past decade, the current amount of non-performing loans of state banks is still RMB 1251,78 billion which accounts for 6.17% of the total commercial loans.<sup>231</sup> Thus, the banks are very prudent in lending, and the loan policy is very tight. One survey indicates that nearly 90% of medium and small sized enterprises are encountering difficulties in raising funds from banks in China.<sup>232</sup> Apparently, at present the banks' attitudes and incentives are not conducive to reorganizing a company in financial distress.

Finally, it is important to note that state banks are reluctant to extend credit to private enterprise for two primary reasons. One is political, and the other is the state banking system's lack of institutional experience in and incentives for advancing loans to private businesses.<sup>233</sup> First, the SOEs can raise funds from state banks more easily than the enterprises in the private sector, and continue to obtain the preponderance of bank financing resulting from the government's direction. In order to develop some specific industries, the State Council or local governments may instruct the state banks to lend money to some enterprises which are owned by the state. This is the so-called policy loan which is in essence extended on the basis of administrative order. The policy loan as a strategic tool could play an important function in

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<sup>231</sup> Statistics are available at <http://www.cbrc.gov.cn/chinese/home/jsp/index.jsp> (last visit 30 November 2007)

<sup>232</sup> This survey was conducted by Standard Chartered and Chinese Academy of Social Science in 2007 under the support of Chinese National Development and Reform Commission, and the involvement of more than 400 medium and small sized enterprises.

<sup>233</sup> K Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Cornell University Press, 2002), p33.

promoting some specific industries like ship-building or steel production.<sup>234</sup> In addition to the policy loans, the local governments tend to exert pressure on state banks to finance the economically struggling SOEs in localities with the intention to keeping these debt-laden SOEs away from insolvency. That is mainly because the liquidation of SOEs especially large SOEs may result in massive unemployment and social instability. It can be observed that although in some localities SOEs are not as efficient and productive as their private counterparts, they can still obtain financial aid.<sup>235</sup> Second, apart from the exertion of political pressure on the state banking system to extend loans to the SOEs, the state banks institutionally lack experience in and incentives to finance private enterprises. Under the previous planned economy, all the bank loans were advanced to the public sector based on the government's instruction, and there were no commercial bankers. With the development of economic transition and market-oriented reform, the increasingly growing private sector is in need of more and more funds from state banks which should extend credit on a profit-oriented rather than political basis.<sup>236</sup> Undoubtedly, this requires the bank staff to change their outdated mindsets and learn new skills and techniques, such as assessing the risks and evaluating the creditworthiness of their new clients, rather than the state units. In addition, it is observed that "the banking system itself remains institutionally biased toward lending to state units. Loan officers may expect forgiveness for making bad loans to state entities because, after all, they are essentially different parts of the same 'state'---a rationalization that could not be used for bad loans to private businesses."<sup>237</sup> This fundamentally represents the indifferent and negative attitude of state banks towards their potential clients in the private sector. Although the state banks could profit by an increase in the loan interest rate, they are still unwilling to extend credit to these clients who may bring high risks. Therefore, it would be more difficult for private-owned enterprises to borrow from

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<sup>234</sup> Policy loans have ever occurred in Japan and South Korea. Ibid at 34.

<sup>235</sup> N Lardy, *China's Unfinished Economic Reform* (Brookings Washington, D.C. 1998), p21-58.

<sup>236</sup> Tsai, above n.233, p35.

<sup>237</sup> Ibid.

state banks than SOEs.

#### **4.3.9.2 Relevant issues related to and influential over the reorganization regime**

It should be noted that some issues, which are outside bankruptcy law but quite related to its implementation by the judiciary, cannot be ignored. These issues to some extent may have a bad impact on the operation and consistency of the bankruptcy and reorganization proceedings. For instance, the late response of the judiciary may have caused a delay in implementation. The new law has been promulgated since 27 August 2006, and has authorized the Supreme People's Court to make rules as to how to qualify the competent intermediary agencies and individual professionals, make a roster of the administrators in provincial level, and appoint an administrator in a bankruptcy or reorganization case.<sup>238</sup> However, the Supreme People's Court did not immediately make a response to the requirement of the new law. It produced a judicial interpretation, named "Provisions on the Appointment of Administrators in Hearing Bankruptcy Cases", and released it on April 16, 2007 which was quite near to the implementation date on June 1, 2007. It has been mentioned that when a court decides to accept a bankruptcy or reorganization case, the court shall appoint an administrator at same time. The problem is that in some provinces when the new law was implemented, the roster of qualified administrators was not available.<sup>239</sup> Undoubtedly, the delay by the judiciary may severely hamper the effectiveness of the new law. This section cannot list all the relevant problems here but merely focuses on two significant issues: respectively undue administrative interference and the immature legal and accounting frameworks.

##### **4.3.9.2.1 Administrative intervention**

Given the fact that the Chinese judiciary is completely under the control of the

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<sup>238</sup> Bankruptcy Law 2006, article 22 (3).

<sup>239</sup> This point was presented by Prof. Shuguang Li, the drafter of the new bankruptcy law, on a forum which was hosted by the Bankruptcy Law Research Centre of China Renmin University and Beijing Weiheng Law Firm on August 27, 2007.



Chinese Communist Party, judicial autonomy will still be a big concern which may to some extent influence the implementation of new bankruptcy and rescue law.<sup>240</sup> Administrative intervention was a severe problem which had a bad impact on judicial independence under the old bankruptcy regime. According to the policy-oriented bankruptcy which has been mentioned above, 3,658 SOEs were liquidated and closed administratively from 1994 to 2005 based on the policies and directions of government and a huge amount of money, mainly from two resources, respectively the distribution of the bankrupt estate by “super-priority” and state aid, had been set aside to satisfy labour claims and to attempt to avoid social unrest, even at the expense of other interested parties. It is important to note that in the short history of bankruptcy legislation and limited bankruptcy cases under the previous bankruptcy legal framework, the Chinese government, whether the central or local government tended to be deeply involved in bankruptcy cases, especially the bankruptcy or reorganization of a SOE.<sup>241</sup> Administrative intervention is a political issue more than a legal issue. This could explain why the judicial power is inevitably restricted in hearing bankruptcy cases by administrative authority, because the bankruptcy-related issues like the unpaid wages of the employees and weak social security system are very sensitive and crucial to social stability.<sup>242</sup>

It can be observed that administrative intervention has brought about some problems. First, it caused unfair competition and treatment among the enterprises owned by the state and enterprises held privately or invested by foreign investors. Second, it aimed at avoiding a potential financial and social crisis at the expense of creditors in the private sector. Third, excessive administrative interference may conflict with market discipline, on the basis of which a bankruptcy law is designed and operated normally. Under the influence of strong administrative authority, the judges would hesitate

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<sup>240</sup> Shi, above n.4, at 679-680.

<sup>241</sup> A typical case which suffered from administrative interference was the *bankruptcy of Shanxi Yuncheng Detergent Factory* in 1994. For the details of the case, see A Tang, *Insolvency in China and Hong Kong: A Practitioner's Perspective* (Sweet & Maxwell Asia, 2005), paras.5.88-5.91.

<sup>242</sup> Ibid at para.5.10.

when they hear a bankruptcy or reorganization. At present, the budget of local court is allocated from the revenue of local government, and the finance and appointments of judges rely on the local administrative authority.<sup>243</sup> In other words, both the judges and the courts are closely associated with the local administrative agencies politically and economically. All the facts indicate that the courts are not completely independent from the government.<sup>244</sup> The lack of judicial independence may incur local protectionism, to which bankruptcy and reorganization cases cannot be an exception.<sup>245</sup> Under the old bankruptcy law, a liquidation group was organized by the representatives of relevant government sectors and the court worked closely with this liquidation group. The judges carried out the proceedings on the basis of the schedule which had been arranged by the local government. Therefore, it can be observed that “in essence, judges regard their function in bankruptcy as a coordinator of interests, rather than a final arbiter of disputes”.<sup>246</sup> It can be anticipated that under administrative involvement and in light of the court’s limited experience of hearing bankruptcy cases, the judges cannot develop their knowledge and skills as competently and independently as their peers in the developed bankruptcy regimes like the UK and US.<sup>247</sup>

With the establishment of an emerging market economy, the bankruptcy and rescue laws must be operated based on market discipline, which in essence excludes improper involvement by government. Although the new bankruptcy law retains the concept of a liquidation group, which can be appointed to be an administrator, it is strictly restricted.<sup>248</sup> This may indicate a trend that the government authorities are gradually shifting out of bankruptcy regimes, except in the bankruptcy or reorganization of financial institutions and some SOEs which have been listed in a

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<sup>243</sup> Q Zhang, “The People’s Court in Transition: The Prospects of the Chinese Judicial Reform” (2003) 12 *Journal of Contemporary China* 69, 71.

<sup>244</sup> X Zhang and C Booth, “Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience” (2001) 15 *Columbia Journal of Asian Law* 1.

<sup>245</sup> Zhang, above n.243, at 89.

<sup>246</sup> Shi, above n.4, at 680.

<sup>247</sup> Ibid.

<sup>248</sup> Bankruptcy Law 2006, article 24 and 133.

roster by the State Council.<sup>249</sup> It is noteworthy that the ongoing development of an effective social security network could lessen the government's concerns with the negative effects of bankrupting an enterprise, and accordingly judicial autonomy can be realized even though administrative intervention cannot be eradicated thoroughly.

#### **4.3.9.2.2 Weak infrastructure**

The effective implementation of the new bankruptcy and rescue law needs adequate judges who are competent at hearing bankruptcy-related cases. It is evident from the short history of bankruptcy legislation and inconsistent judicial practice that there are not enough judges in the Chinese judiciary with relevant skills, expertise and experience of bankruptcy law and bankruptcy-related knowledge like finance and accounting.<sup>250</sup> Undoubtedly, this poor situation will influence not only the efficiency of the new law, but also the effectiveness and quality of a detailed case.<sup>251</sup> It should be noted that a series of training programmes which intend to develop the expertise and enhance the ability and competence of the judges have been taken by the Supreme People's Court since the new bankruptcy law was enacted.<sup>252</sup> Objectively, these programmes have scored a great achievement in the development of knowledge and skills for the special judges who have been equipped with as much expertise as their peers in the western mature bankruptcy regimes. Nevertheless, whether or not the judges are able to well use their knowledge and skills in a bankruptcy-related case needs the test of judicial practice.

In order to carry out the new law efficiently and effectively, China is in need of legal professionals who are experts in the field of bankruptcy and rescue law. It has been

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<sup>249</sup> Shi, above n.4, at 680.

<sup>250</sup> See the relevant comments on [http://english.peopledaily.com.cn/200406/28/eng20040628\\_147731.html](http://english.peopledaily.com.cn/200406/28/eng20040628_147731.html) (last visit 13 November 2007)

<sup>251</sup> [http://www.lunwenwang.com/Freepaper/Legalpaper/economicrules/200608/Freepaper\\_20990.html](http://www.lunwenwang.com/Freepaper/Legalpaper/economicrules/200608/Freepaper_20990.html) (last visit 14 November 2007)

<sup>252</sup> [http://news.xinhuanet.com/legal/2006-12/31/content\\_5552327.htm](http://news.xinhuanet.com/legal/2006-12/31/content_5552327.htm) (last visit 31 May 2008)

stated by the Ministry of Justice that there were approximately 118,000 lawyers and 11,691 law firms by the end of 2007 in China, but only a small fraction of the lawyers have the experience of dealing with bankruptcy or reorganization cases.<sup>253</sup> In addition, it is noteworthy that there are currently only 733 lawyers who are specially working for companies as legal advisors. It is evidenced that only 4% of about 5 million business enterprises have regular legal advisors.<sup>254</sup> Needless to say, it will take a long time for China to form a strong team of insolvency law specialists, and apparently the new bankruptcy law could bring a potentially big market for foreign insolvency professionals to fill the gap. Another weakness of the Chinese infrastructure is the inadequate accounting system, which is one of the four reasons why the EU has refused to recognize the full market economy status of China.<sup>255</sup> Fundamentally, the current status of China's accounting system can be generalized as having two problems. One is inadequacy and inconsistency; the other is not following the track of internationally accepted accounting standards. The lack of a coherent and consistent system of producing, recording, collating and reporting financial information has led to unreliability and uncertainty regarding the financial status of a company. On the one hand, China's market-oriented accounting system has only experienced 16 years since the first regulation about accounting procedures and reporting systems for enterprises was issued in 1992.<sup>256</sup> An adequate system which is in line with the international standards has not been established yet during the economic transition. On the other hand, China's accounting system lacks professional accountants and independent auditors, similar to the situation with

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<sup>253</sup> [http://www.legalinfo.gov.cn/moj/lsgzgzzds/2005-06/14/content\\_154886.htm](http://www.legalinfo.gov.cn/moj/lsgzgzzds/2005-06/14/content_154886.htm) (last visit 14 November 2007)

<sup>254</sup> F Allen, J Qian and M Qian, "Law, finance and economic growth in China" (2005) 77 *Journal of Financial Economics* 57, 67.

<sup>255</sup> The other three reasons are respectively the state influence, bankruptcy law and reforms of financial sectors. It should be noted that in the Ninth China-EU Summit, China's request for the recognition of a full market economy status was once again refused by European Commission because of the dissatisfaction at the above four criteria.

<http://english.cri.cn/2946/2006/09/10/53@137367.htm> (last visit 13 November 2007)

<sup>256</sup> This regulation titled "General Financial and Accounting Principles for All Enterprises in the PRC" was issued by the Ministry of Finance in November 1992.

competent judges and lawyers.<sup>257</sup> All these reasons lead to unreliable financial information and fraud, which can be evidenced by the fact that 40 listed companies had been penalized by the reason of inappropriate accounting practice from 1998 to 2005.<sup>258</sup> It was observed and stated by the State Audit Bureau that “68 per cent of SOEs had fundamental systemic shortcomings that led to misleading or inaccurate financial statements being reported.”<sup>259</sup> Needless to say, China needs a long time to develop an adequate and internationally recognized accounting system which could efficiently and effectively support judicial practice on bankruptcy and corporate rescue cases.

## Concluding remarks

In the UK, the reforms brought by the Insolvency Act 2000 and Enterprise Act 2002 have remarkably developed the rescue culture, established new rescue-oriented mechanisms and improved the existing deficiencies. Although the incidence of CVAs still remains small in contrast to liquidation and administration, the reforms make the procedure more effective and its impact may be verified by statistics in the long term. The achievement of the 2002 reforms can be demonstrated by the numbers of administrations from 2003 to 2006 which rose sharply. The revamped administration procedure emphasizes rescuing the financially distressed company as a going concern. Although this trend of increase may be influenced by reasons, such as the abolition of administrative receivership and the IPs favouring administration over liquidation, the notable impact is that the new legislation promotes collectivity and accountability which is in accordance with the policy aims of corporate rescue and caters to all the stakeholders.

In China, the introduction of the reorganization procedure effects dramatic changes in the new bankruptcy law which represent significant progress in modernizing this

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<sup>257</sup> Allen, Qian and Qian, above n.254, at 70.

<sup>258</sup> Tang, above n.241, para.5.15.

<sup>259</sup> Ibid. Also see: *Hong Kong Economic Journal* on 31 March 2004.

law as part of the economic transition. Compared with the British CVAs and administration procedures, there are some similar features in the Chinese modified reorganization regime which are obvious and need not be addressed here. What should be noted are the major differences which may be caused by China's unique situations or legislative deficiencies. First, in terms of the opening process, the initiation of China's reorganization proceedings is completely under the control of the court whether the debtor or a creditor makes the application. Second, the moratorium under China's rescue laws is not watertight and there is no interim moratorium available to protect the debtor, in contrast to similar rules in administration and the CVA with moratorium regime. Undoubtedly, the English rescue laws provide a good example for Chinese policy-makers to consider improving their weak and ineffective moratorium in the similar way. Third, the creditors' committee in the Chinese liquidation or reorganization process is very strong. The representative of employees is involved in this committee and accordingly he will have a voice for the interests of employees. In addition, the creditors' committee holds strong substantive rights to make crucial decisions like the disposal of property which are supposed to be decided by IPs from the eyes of British insolvency professionals. Fourth, the process of vote and approval to the reorganization proposal is complex in the reorganization regime, and is similar to the Schemes of Arrangement under the Part 26 of Companies Act 2006. All the creditors will be divided into different voting groups according to the nature of their claims, and the proposal needs the approval of all the voting groups and sanction of the court as well. Fifth, China's reorganization procedure is a court-driven regime which follows the tradition of civil law countries. In other words, the court is involved in every big step of a rescue attempt. It is submitted that the Chinese court is a decider of major issues, a controller of the rescue process, a coordinator of all the stakeholders, and a dispute-resolver of legal challenges to the administrator.

It was expected that the emerging Chinese rescue culture would be effective to rehabilitate the troubled enterprises and increase the use of the rescue regime. From

the perspective of judicial practice, the operation of new rescue laws was slow and inefficient in the first year since the new bankruptcy law was implemented in June 2007. It can be perceived that the impact of the modified reorganization procedure was limited. The slow operation of the new corporate rescue system is in line with the predictions of some drafters who argued that the implementation of the new law might not bring about dramatic change and remarkable effect immediately on account of complicated economic, political, legal and cultural factors.<sup>260</sup>

Potential problems which may influence the enforcement of the new corporate rescue law were explored. First, the opening of the reorganization proceedings is under the control of the court, which may cost time and money. Due to the legislative lacuna and inadequacies, access to the rescue procedure in China's reorganization regime is not as quick and efficient as its counterpart in the British corporate rescue laws. In addition, in the process of the qualification and appointment of an administrator, the court plays a central role. The court is involved in all the administrator-related issues and has a final say. This approach was adopted despite the concerns of people regarding the court's lack of independence and transparency. When taking into account the question regarding whether the British out of court appointment mechanism can be borrowed or not, it can be concluded that this issue may not be considered by the reformers in the near future since the relevant infrastructure is not established. However, it does not necessarily mean that this presumption is off the table for ever. It is worth considering. It should be noted that the Chinese corporate rescue law borrowed the US DIP model, but legislative shortcomings still remain and may weaken the operation of the Chinese modified DIP. These potential problems need to be resolved by future legislation or judicial interpretation. In relation to new financing in the process of reorganization, since the new bankruptcy law did not introduce the super-priority financing mechanism, it is difficult for the troubled firms to obtain new funds from banks for continued trading. In addition, the lack of enough

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<sup>260</sup> Shi, above n.4, at 649.

competent judges with relevant skills and expertise of bankruptcy law, undue administrative intervention and the huge dearth of insolvency professionals may lead to the limited effect of the new bankruptcy and corporate rescue law. In the context of China, the new corporate rescue law cannot be well used and fully effective without relevant legislation and judicial interpretation in the near future.

An effective corporate rescue procedure also needs to reshape the bargaining power of each interested group and bring them to the negotiation table to reach a rescue scheme binding all the interested parties. This will be developed in the following chapter.



## **Chapter V: Balance of power and control of each interested group in the network of rescuing companies**

### **Introduction**

The key goal of a rescue culture is to rehabilitate the financially distressed but still economically viable company and give the honest but unfortunate entrepreneur a chance in order to avert insolvent liquidation of the company and unnecessary loss to society.<sup>1</sup> A successful corporate reorganization requires well-designed and efficient legal rules which could effectively organize every interested group to participate in a rescue attempt, enable all the interested parties to sit around the negotiation table for a practicable rescue scheme, and reshape their bargaining powers based on their property rights and claims towards the assets of the troubled company.<sup>2</sup> Various parties have different control powers and their own plans when they are involved in the reorganization of the troubled company. The crucial point is how to break the imbalance of power between the strong and weak interested parties, enable them to form the right incentives to reorganization and co-ordinate all the players to push forward.<sup>3</sup> In order to reach an effective balance and co-ordination of every interested party in a robust rescue regime, legal reformers need to take into account a series of issues like entry into a rescue regime at an early stage, the provision of a moratorium, and encouragement of new finance.<sup>4</sup> They may consider how to weaken the strong bargaining power of the banks and restrict their unilateral debt enforcement in order to preserve the remaining assets of the ailing debtor for continued trading? How to improve the weak position of the ordinary unsecured creditors for the policy aims of

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<sup>1</sup> A Belcher, *Corporate Rescue: A Conceptual Approach to Insolvency Law* (Sweet & Maxwell, London, 1997), p12.

<sup>2</sup> United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law*, 2004, p28.

<sup>3</sup> V Finch, "Control and Co-ordination in Corporate Rescue" (2005) 25 *Legal Studies* 374.

<sup>4</sup> For a comprehensive discussion of the theoretical issues of moratorium and new financing, see D Milman, "Moratoria on enforcement rights: revisiting corporate rescue" [2004] *Conveyancer and Property Law* 89; G McCormack, "Super-priority new financing and corporate rescue" [2007] *J.B.L.* 702.

a collective approach? How to protect the class of labour in rescue laws in line with the political and social aims?

The 2002 reforms in the UK, which aim to foster a rescue culture and to emphasize the preservation of enterprises, have brought about dramatic changes in the balance of control of different interested groups. The recasting of the bargaining power and control has had a significant impact on the attitudes and incentives of different actors and influenced the operation of the new insolvency proceedings. In contrast, although the reforms in China have rearranged the power of control a bit in the new bankruptcy legal framework and brought some entitlements to different interested groups, the reforms need to move forward. One thing should be borne in mind that deep reforms in China largely depend on the state's unwillingness to become less involved and more relaxed about the consequences for workers. They also rely on a developed social security system which is able to provide a sufficient safety net. These issues are outside bankruptcy law but influence the effectiveness and outcomes of the implementation of China's new bankruptcy law.

This chapter aims to address the central issues of balance of power and co-ordination from five aspects, respectively banks, ordinary unsecured creditors, directors, employees and the state. It examines the way in which players bargain in the corporate rescue laws of the two nations, analyzes the balance of power reallocation and differing treatment of each interested group, and explores the differences of the government policies and attitudes in relation to the balance of control and co-ordination in corporate rescue.

## **5.1 Banks and secured financiers**

Banks and financial institutions are always conferred significant political and economic power, because they make great contributions to economic development, the prosperity of the corporate sector and the stability of the financial market. It can

be observed that the business of an enterprise is composed of hundreds of debtor-creditor relations, in which the relations between banks and the enterprise prevail against the others. By means of the advantage of enormous financial resources, banks and finance companies may exert influence on setting property rights as they make a loan and attempt to take priority over other interested parties when their business customers fall into reorganization or liquidation. “The object of the creditor who takes security for the debt due to him is to obtain priority over other creditors in the event of the debtor’s insolvency.”<sup>5</sup> Security which usually collateralizes the debtor’s assets is deemed as the easiest and most reliable way for the lenders to reduce financial risk.<sup>6</sup> When the debtor defaults, secured creditors are able to possess the collateral and recover their loans by sale or auction. It is therefore observed that security not only defends the privilege of banks in the lender-borrower relations, but also enables the security holder to take advantage in the competition with other creditors in the clash of claims. Particularly when a debt-laden company is declared bankrupt, the assets are insufficient for distribution among all the claimants. The conflict of creditors’ interests demonstrates that the greater the proportion of the debtor’s assets that go into the pockets of the banks or finance companies, the less that is left for distribution to unsecured creditors. Banks are the most sophisticated organizations which hold strong property rights in the enforcement of their claims. In addition, banks can exert influence on the scheme of bankruptcy or reorganization proposal because normally banks, as financial creditors, dominate the creditors’ committee.<sup>7</sup> A corporate rescue attempt would be unlikely to succeed without the support of banks. Undoubtedly, banks are the strongest interested group in corporate insolvency proceedings.

### 5.1.1 Banks and secured lenders in England—weakening the

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<sup>5</sup> *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) (‘Cork Report’), para.1491.

<sup>6</sup> BG Carruthers and TC Halliday, *Rescuing Business: The Making of Corporate bankruptcy Law in England and the United States* (Clarendon Press Oxford 1998), p159.

<sup>7</sup> *Ibid.*

## strong power

The legal institution of a floating charge, which was created by the British Court of Equity in the latter part of the 19<sup>th</sup> century, has provided entrepreneurs with an attractive way to raise finance, which enables them to use collateral with flexibility in the ordinary course of business.<sup>8</sup> The legal efficacy of a floating charge was accepted by both commercial practitioners and the judiciary, which recognized the floating charge as an effective and flexible approach to security based on a contractual agreement between the lender and the borrower.<sup>9</sup> It has ever since then been deemed as the fundamental part of the British financial structure.<sup>10</sup> It was indicated in a study that more than 80 per cent of firms which were involved in this study used the floating charge for financing.<sup>11</sup> If the borrower breaches the terms of the security contract, the holder of a floating charge, usually the bank, is entitled to appoint an administrative receiver to take over the assets and business affairs of the debtor company, enforce the debts owed to the bank and act merely for the interests of his appointer in administrative receivership.<sup>12</sup> However, this procedure has long been criticized by the ordinary creditors who are normally left little or nothing in the pool of assets for distribution, and accordingly argue that the strong position of a floating charge holder in insolvency proceedings should be weakened. The administrative receivers tended to pursue a quick sale of assets subject to a floating charge for the recovery of his appointer.<sup>13</sup> No mechanisms in the administrative receivership encouraged the administrative receivers to go for the maximum economic value and rescue the troubled company as a going concern.<sup>14</sup> During the

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<sup>8</sup> For the knowledge of the early history of floating charge, see J Armour, "Should We Redistribute in Insolvency", in J Getzler and J Payne (eds), *Companies Charges---Spectrum and Beyond* (OUP, Oxford, 2006), P191.

<sup>9</sup> IF Fletcher "UK Corporate Rescue: Recent Developments—Changes to Administrative Receiverships, Administration, and Company Voluntary Arrangements—The Insolvency Act 2000, The White Paper 2001, and the Enterprise Act 2002" (2004) 5 EBOR 119, 122.

<sup>10</sup> Carruthers and Halliday, above n.6, p199.

<sup>11</sup> F Franks and O Sussman, *The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies*, IFA Working Paper 306 (2000), 3.

<sup>12</sup> Fletcher, above n.9, at 123-124.

<sup>13</sup> J Armour and S Frisby, "Rethinking Receivership" (2001) 21 OJLS 73, 87.

<sup>14</sup> For the inadequacies of administrative receivership, see S Davies QC (ed), *Insolvency and*

insolvency law reforms in the 1980s, it was proposed that receivership should be abolished; nevertheless this strong opposition to floating charges was not accepted by the Cork Committee.<sup>15</sup> Nearly two decades since then in the legislative reforms brought about by the EA 2002, two major changes will be of significant impact on the incentives and lending policy of banks, respectively the virtual abolition of administrative receivership and the introduction of top-slicing provisions. It should be noted that the new legislation has abolished the preference of Crown debts, and it seems to have improved the position of a floating charge holder in the distributional order. But, the policy aim underlying this reform is to enhance the recovery to ordinary unsecured creditors at the bottom of the queue rather than banks.<sup>16</sup>

It is important to note that the 2002 reforms reduce the attractiveness of the floating charge for banks and financiers.<sup>17</sup> It will cause a shift from providing finance by a concentrated creditor using the floating charge to more asset-based financing security like the fixed charge.<sup>18</sup> It will lead to a general trend towards fragmentation in businesses' borrowing. More asset-based finance, which is built upon the value of specific asset classes rather than the evaluation of the debtor's entire business undertakings and prospects, will reduce the reliance on a single bank and accordingly reduce the influence of the bank's control in administration.<sup>19</sup> In addition, it is noteworthy that the government rejected an amendment which proposed to establish a statutory framework for super-priority financing.<sup>20</sup> Super-priority financing is a significant tool for the financially distressed firms to raise funds for reorganization which could provide a statutory guarantee to repay the lenders in advance of existing creditors, whether secured or unsecured creditors. During the Parliamentary debate, it

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*the Enterprise Act 2002* (Jordans, Bristol, 2003), p38-39.

<sup>15</sup> Carruthers and Halliday, above n.6, p200; Cork Report, chap 36.

<sup>16</sup> Armour, above n.8, p201; Insolvency Service, *Insolvency—A Second Chance*, Cm 5234 (2001), p12.

<sup>17</sup> Armour, above n.8, p202-203.

<sup>18</sup> D Prentice, "Bargaining in the Shadow of the Enterprise Act 2002" (2004) 5 EBOR 153.

<sup>19</sup> J Armour, A Hsu and A Walters, *The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings*, A Report Prepared for the Insolvency Service in December 2006, p24.

<sup>20</sup> McCormack, above n.4, 702.

was proposed that the court should have the power to grant an application for super-priority financing as long as it is satisfied that:

- “(a) the moneys to be provided will be used for expenditure necessary to (i) continue the operation of business of the company in order to meet the administrator’s objectives; or (ii) otherwise to protect and preserve the business and assets of the company during the administration; and
- (b) the secured creditors are not prejudiced by the provision of super-priority financing; and
- (c) it is appropriate to make the order in the overall interests of the administration.”<sup>21</sup>

However, the government was eventually unwilling to introduce super-priority financing. The failure to create super-priority financing may to some extent influence the banks’ incentives to advance funds to the ailing firms and undermine the outcome of the new rescue-oriented administration.<sup>22</sup>

The effects of the legal reforms may lead to another shift of the bank’s approach from debt enforcement towards risk management.<sup>23</sup> The bank would have more incentives to monitor the financial status and gather information on the management and business of the borrowers at a far earlier stage than was the situation under the pre-EA 2002 arrangements.<sup>24</sup> The bank is able to employ the means of loan agreements to restrict what kind of behaviour can be undertaken, and to require the borrower to supply the information which the conditions of the covenants need. This proactive approach which is adopted by the bank highlights three aspects: early warning signs of a firm which is facing financial difficulty; the capacity of the company’s management to overcome the impending troubles and risks; and managing the performance of the company’s management in dealing with the risk and return.<sup>25</sup> When financial trouble is signaled, the bank might be involved in the appointment of an outside accountant to conduct an independent review of the ailing company’s business,<sup>26</sup> or refer the company to consult a relevant professional body

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<sup>21</sup> Davies, above n.14, p21.

<sup>22</sup> McCormack, above n.4, 713.

<sup>23</sup> V Finch, “The Recasting of Insolvency Law” (2005) 68 MLR 713, 725.

<sup>24</sup> S Frisby, *Report on Insolvency Outcomes*, presented to the Insolvency Service in August 2006, p21.

<sup>25</sup> Finch, above n.23, at 723.

<sup>26</sup> British Bankers’ Association (BBA), *Banks and Businesses: Working Together When You*

like a “Business Support Team”.<sup>27</sup> The bank’s incentive to lend or not, and the company’s business strategy towards the financial difficulty will largely depend on the review and recommendations of the independent professionals. Through this activity, the bank is involved in the management and decision-making, and the debtor company depends on the financial support of the bank for rehabilitation.

Subsequently, an assessment will be issued by the Business Support Team to consider the quality and competence of the management and evaluate whether the directors and managers in the management team are able to deal with the difficulties and challenges which they will face or have already faced. The incompetent performer will be squeezed out, and a specialist will be recommended to fill the vacancy.<sup>28</sup> It is therefore observed that “the earlier that a bank intervenes in the decline of a company’s fortunes, the greater will be the bank’s incentive to pursue rescue, rather than debt recovery, objectives. This is because the earlier the intervention, the smaller will be the risk of non-repayment to the bank and the greater the prospect of successful turnaround.”<sup>29</sup>

### 5.1.2 The Chinese banking sector in bankruptcy legal framework—improving a weak position<sup>30</sup>

In the economic transition, the enforcement of security of state banks was weak and the incentives to enforce were limited. They made loans to the state-owned enterprises (SOEs) under the administrative order of the state, rather than the commercial principles of the market. Because of the policy loans under government intervention, banks’ own mismanagement and some other reasons, the

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*Borrow—A statement of principles* (1997)

<sup>27</sup> L Otty, “Banking on the Managers” (Winter 2002) *Recovery* 12.

<sup>28</sup> For more details, see Finch, above n.23, at 723-726; V Finch, “Doctoring in the shadows of insolvency” [2005] J.B.L. 690.

<sup>29</sup> Ibid.

<sup>30</sup> For a brief introduction of China’s banking structure, see J Teo and BS Suresh, “WTO: Wanting Time’s Over—China Opens Its Domestic Banking Market to Banks after Recent Changes to Its Banking Law and Regulations Makes Them WTO Compliant” (2007) 22 J.I.B.L.R. 333.

non-performing loans of state banks had accumulated to an incredible level which could endanger the stability of the entire financial market.<sup>31</sup> Under a series of reforms which have been discussed in Chapters III and IV, the situations of the banking sector, especially the state-owned commercial banks, have largely improved. This section only highlights whether or not the position of banks has improved in the new bankruptcy law regime. In addition, do the banks have the right incentives to lend to the distressed firms in the reorganization procedure?

In the old bankruptcy legal framework, especially in the “policy bankruptcy” structure for SOEs, the state banks usually as secured creditors made concessions to labour claims in the distribution of the insolvent estate, primarily because of the inadequate social security system.<sup>32</sup> However, in the new law the banks become the winner. The banks, as creditors with security, are entitled to realize their debts from the proceeds of the collateral in the liquidation process outside the distribution of the insolvent estate among bankruptcy expenses, labour claims, tax authorities, social security deductions and unsecured creditors.<sup>33</sup> This is to say that the liquidation expenses and the claims of creditors with preferential status are not payable out of the property subject to a security. This priority may ease the bank’s fear of the super-priority of the employees in the old regime and encourage banks to make loans to enterprises, whether SOEs or private enterprises, as long as they can provide sufficient security.

In addition, it should be noted that the new reorganization regime may to some extent promote the banks’ willingness to lend to troubled firms which are still economically viable. Post-reorganization financing can be attracted by providing collateral as security or in some circumstances giving priority over existing creditors.<sup>34</sup> In order

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<sup>31</sup> J Leng, “China’s Banking Reform in the Context of Globalization and Transition” [2006] EBLR 1271.

<sup>32</sup> R Parry and H Zhang, “China’s New Corporate Rescue Laws: Perspectives and Principles” (2008) 8 JCLS 113, 117.

<sup>33</sup> Bankruptcy Law 2006, articles 109 and 113.

<sup>34</sup> UNCITRAL, above n.2, p115-117.



to obtain new financing for continuing trading, the debtor or administrator is entitled to borrow from banks by means of security over the remaining assets which have not been covered by other securities.<sup>35</sup> In addition, in order to pay the wages and social insurance of workers who continue to work under a rescue attempt, the debtor or administrator could readily get a loan from a bank because such lending has been conferred super-priority.<sup>36</sup> It is noteworthy, however, that this super-priority financing is limited to the scope of raising funds for wages and social security during a corporate reorganization process, and the banks which provide such financing cannot enjoy priority over the existing secured creditors. Therefore, it is submitted that such financing which is stipulated by the new reorganization procedure is not in line with the principles of world-recognized super-priority financing. The inadequate post-reorganization financing legislation may limit the banks' incentives to support a rescue attempt. Whether providing a new security or the limited super-priority for the new funding, it will undoubtedly diminish the pool of the insolvent estate and reduce the recovery rate of unsecured creditors, and accordingly lead to the conflict between banks and weak creditors.<sup>37</sup> A strong power of supervision is vested in the creditors' meeting which should discharge the duty of monitoring whether or not the debtor or administrator has employed the new financing for the specific purposes according to the loan agreement.<sup>38</sup> If the debtor or administrator failed to do so, any interested party like unsecured creditors would apply to the court.<sup>39</sup> It is submitted that the new law could have some influence over the lending policy and rescue incentives of the banks. The banks won the battle against the labour unions in the Parliamentary debate on the issue of priority of repayment which was one of the most contentious issues during the lengthy legislative process.<sup>40</sup> The limited super-priority financing

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<sup>35</sup> Bankruptcy Law 2006, article 75(2).

<sup>36</sup> Article 42(4).

<sup>37</sup> W Wang, *The Interpretation and Substance of Bankruptcy Law* (Law Press-China, 2007), p224-225.(in Chinese)

<sup>38</sup> Bankruptcy Law 2006, article 61(3).

<sup>39</sup> Bankruptcy Law 2006, article 78.

<sup>40</sup> J Shi, "Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy" (2007) 16 *Norton Journal of Bankruptcy Law and Practice* 645, 671.

stipulation could encourage banks to advance funds to a financially distressed firm, but is unlikely to promote banks to provide sufficient financing to support a rescue attempt.

In the reorganization procedure, what really bothers the banks is the automatic stay which will be imposed on debt enforcement in the reorganization period.<sup>41</sup> The policy aim of an automatic stay is to weaken the enforcement power of creditors and ensure that the remaining assets are used for continued trading.<sup>42</sup> The moratorium may cause the hostility and impatience of the banks. “If the moratorium is too long it could encourage banks to opt for direct enforcement of debts rather than rescue. If the duration of the moratorium is too short then there may not be enough time to negotiate a solution and rescuing option.”<sup>43</sup> During this enforcement-freezing period, the collateral is under the control of the debtor whether the possession has passed to the secured creditor or not, and this collateral is crucial for corporate rehabilitation. However, there is a remedy for the secured creditor to keep the balance between the automatic stay and the protection of creditors’ rights. It is stipulated that a secured creditor is allowed to apply to the court for resuming his right to enforce security if he could attest that there is obvious probability that the collateral may be damaged or devalued, and it is enough to harm the rights and interests of the secured creditor.<sup>44</sup>

## **5.2 Creditors in the weak bargaining position**

In contrast to the powerful creditors like the state and banks, the unsecured creditors, who hold weak bargaining power in the marketplace, are usually neglected in the corporate insolvency and reorganization arena. It is common from the perspectives of insolvency laws around the world that the unsecured creditors are arranged at the bottom of the distributional queue (just ahead of shareholders), and get little recovery,

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<sup>41</sup> Bankruptcy Law 2006, article 72.

<sup>42</sup> R Haselmann, K Pistor and V Vig, “How Law Affects Lending”, Columbia Law and Economic Working Paper No.285, September 2006.

<sup>43</sup> V Finch, “Re-invigorating Corporate Rescue” [2003] J.B.L. 527, 538.

<sup>44</sup> Bankruptcy Law 2006, article 75 (1).

or nothing, from corporate bankruptcy property. It is important to note that unsecured creditors cover a wide range of players in the business transaction, from a bank to an individual customer. A bank may become an unsecured creditor for the remaining part of the loan, if its loan is not fully collateralized or the value of the collateral has reduced. Two common sets of unsecured creditors are respectively the individual consumers and trade suppliers, who comprise the major part. Consumers effectively make great contributions to the property exchange and trade transactions, and they extend credit to a firm for goods, electronic products or services by prepayment, and then suffer loss if the firm is put into bankruptcy proceedings.<sup>45</sup> Trade suppliers, commonly the small firms or sole traders who supply goods first and expect to get payment later, are in the same situation as consumers. Although all the unsecured creditors are weak, the meaning of weakness is different in specific circumstances where a creditor may have weak bargaining power in the market, or weak capacity to mobilize when the debtor enterprise is insolvent. This section merely highlights the positions of ordinary unsecured creditors, who are vulnerable and nearly ignored in corporate bankruptcy proceedings.

Fundamentally, the vulnerability and weakness of individual customers and trade suppliers can be interpreted from the following four aspects. First, these two interested groups extend credit to a firm without taking security on its assets, and they cannot bargain for security, because the negotiation can increase the transaction costs and lead to infrequency of the transaction and immobilization of the market.<sup>46</sup> Particularly for the individual consumers, there is nearly no way to get collateral since their transactions are too small. In contrast to large creditors, trade suppliers and consumers are undoubtedly at a disadvantageous situation when they have to

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<sup>45</sup> In England, the institution of trust could provide a special protection to individual customers who have either paid the full price for the goods or paid a deposit. A separate bank account, "Customers' Trust Deposit Account", can be created for the money paid by customers in advance. Such money will not fall into the general assets of the company for distribution to all the creditors, and instead it can be refunded to the customers. See *Re Kayford Ltd (In Liquidation)* [1975] 1 WLR 279; also see *Re Farepak Food and Gifts Ltd (In Administration)* [2007] 2 BCLC 1.

<sup>46</sup> Carruthers and Halliday, above n.6, p304-305.

negotiate with large creditors at the creditors' meeting in a bankruptcy or reorganization procedure. Second, consumer creditors and trade suppliers suffer from a shortage of expertise. As an example from China's new bankruptcy law, one recent survey shows that 62% of the interviewees who are either professional accountants or senior management staff have never heard of this law.<sup>47</sup> Therefore, ordinary citizens are unlikely to have done so. Third, it is extremely difficult for weak creditors to get access to the financial status and management reports of the debtor firm. In contrast to the state and financial creditors, they have less information and fewer recourses to judge whether the fortunes of the debtor are rising, keeping even or declining. In China, weak creditors only have ready access to the financial reports of joint stock companies which publicly raise funds from the Shanghai or Shenzhen Stock Exchanges. This type of company is compulsorily required to release financial information and an auditing report in every accounting year.<sup>48</sup> Apart from that, they have no way to approach the financial information of other companies. Although the trade suppliers have a closer relationship with the buyer and can obtain more information about the buyer's financial situation, the information will change and multiply fast. It has been observed that sometimes "the information will be more reputational than technical".<sup>49</sup> Fourth, the consumers and trade suppliers may suffer from severe problems of collectivity.<sup>50</sup> There are many disparate parties in a typical bankruptcy or corporate rescue case, where they do various types of business; their amounts of transactions with debtor are different and they may be located in different places. All these differences surely will cause divergence when they negotiate and vote for a reorganization plan. In addition, another unfavourable factor in relation to weak creditors is time. They cannot wait for payment, even though they may be able to get a higher recovery after a longtime bankruptcy case or corporate turnaround. In the *Bankruptcy of Beijing Xiangjugong Cake Factory*, it can be observed that there

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<sup>47</sup> This data was collected from a "Seminar on New PRC Enterprise Bankruptcy Law" which was held by Deloitte in Beijing on 13 July 2007.

<sup>48</sup> PRC Company Law 2005, article 166. Y Zhou, *New Survey on Corporation Law* (Law Press China, 2006), p451.(in Chinese)

<sup>49</sup> Carruthers and Halliday, above n.6, p304.

<sup>50</sup> Belcher, above n.1, p116.

were 83 trade suppliers and consumer creditors in respect of this small-sized enterprise and these creditors were situated in many provinces of China. It was difficult for them to organize together to sit in the creditors' meeting, and they failed to pass the bankruptcy proposal on many occasions because the amounts of their credit were small and average. In the end, this small case lasted for five years from September 2001 to July 2006 and the weak creditors got a penny in a pound.<sup>51</sup> This indicates that there is little hope to form a common alliance for consumers and trade suppliers in the bankruptcy or reorganization of a small firm, let alone a large corporation.

### 5.2.1 The unsecured creditors in English corporate insolvency law

In so far as the legislative reforms brought by the EA 2002 are concerned, the imbalance between the strong and weak creditors in the insolvency regime has been reshaped and the trade suppliers and consumer creditors at the bottom of the repayment queue are able to obtain more returns from the pool of the bankrupt estate than in the old insolvency legal framework. The withdrawal of the preferential status of Crown debts, the innovation of top-slicing provisions and the abolition of administrative receivership have improved the poor situation of the unsecured creditors in the scheme of asset distribution and encouraged them to participate in a rescue attempt and to continue to supply goods or extend credit to the ailing company for continued trading. It has been observed that "the space has been created for use to be made of the talents and commercial acumen and demands of unsecured creditors... This can bring much-needed commitment and goodwill to the rescue process which, in turn, can provide a much-needed dynamism and confidence which arguably the older, more static approach lacked."<sup>52</sup>

First, the abolition of the Crown preference enables a greater proportion of proceeds

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<sup>51</sup> The author obtained the unreported case materials and statistics from the local court of Chaoyang District, Beijing in September 2006.

<sup>52</sup> H Rajak, "The Enterprise Act and Insolvency Law Reform" (2003) 24 Comp. Law. 3.

of bankrupt property to be shared with weak creditors. It is estimated that the Government used to receive approximately £90 million of preferential debts per year from all insolvencies, and after the reform about £70 million would be sliced away for the repayment of unsecured creditors.<sup>53</sup> This measure could create two positive effects. One is immediate higher recoveries for weak creditors; the other is to encourage the revenue departments to have positive attitudes and the right incentives to face the troubled firms and to consider the corporate rescue alternatives.<sup>54</sup>

Second, the reforms have introduced the top-slicing provisions which aim to set aside a percentage of the net proceeds of the assets subject to a floating charge and distribute them among the unsecured creditors.<sup>55</sup> This certain proportion of floating charge assets are called as the “prescribed part” which purports to ameliorate the poor recoveries of ordinary unsecured creditors in the old insolvency regime. This conception is not new since the Cork Committee had proposed a “Ten Percent Fund” which the government ultimately failed to accept.<sup>56</sup> It can be found that the top-slicing provisions did not adopt the 10 percent proportion of floating charge assets which were originally proposed by the Cork Committee.<sup>57</sup> It is stipulated that the prescribed part shall be calculated:

- (a) where the company’s net property does not exceed £10,000; 50 % of the net property in value;
- (b) where the company’s net property exceeds £10,000, 50% of the first £10,000 in value, 20% of the company’s net property over £10,000 in value, but the maximum amount of the prescribed part to be made available for the satisfaction of unsecured creditors is £600,000.<sup>58</sup>

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<sup>53</sup> Davies, above n.14, p30. More details about the abolition of Crown preference will be discussed later in s 5.5.1.

<sup>54</sup> The Association of Business Recovery Professionals (R3), *11<sup>th</sup> Survey of Company Insolvency* (2003), p11.

<sup>55</sup> Some scholars call them ‘ring fence funds’. See V Finch, “Re-invigorating Corporate Rescue” [2003] J.B.L. 527.

<sup>56</sup> Cork Report, para.1538.

<sup>57</sup> Carruthers and Halliday, above n.7, p339.

<sup>58</sup> Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097). For more knowledge

A certain amount of realizations of assets subject to a floating charge which is created after the commencement of the EA 2002 will therefore flow into the pool for distribution to unsecured creditors, who may feel safer and be more encouraged to engage in rescuing the troubled firm.<sup>59</sup> It should be noted, however, that in the post-EA 2002 insolvency regime, the secured creditors have simply adjusted their lending policy to rely less on floating charges. The general shift from financing by floating charges towards asset-based financing securities will cause a fragmentation in lending which will not be concentrated by a single bank.<sup>60</sup> The original purpose of top-slicing is undermined because the banks could avoid the top-slicing provisions by less reliance on the security of the floating charge.

Third, with abolition of administrative receivership and the revamped statement of the administrator's objectives, the rescue culture is boosted. The administrator is required to take into account the interests of all the creditors, primarily from the perspective of how to turn the troubled firm around according to the statutory hierarchy of revised objectives. This mechanism encourages collectivity, which provides the opportunities for unsecured creditors to be involved in the rescue process and enables unsecured creditors to continue their support to the ailing firm.<sup>61</sup>

### 5.2.2 Inadequate protection to the weak interested groups in China

It was indicated in a survey that the recovery rate of debts in corporate insolvency was approximately 8 per cent under the old bankruptcy law regime, and a more significant point to note is that this low percentage covered not only the realization of secured debts and preferential debts, but also the recovery of debts owed to the ordinary unsecured creditors.<sup>62</sup> In other words, weak creditors like trade suppliers

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about the "net property", see S Davies QC, *Insolvency and the Enterprise Act 2002* (Jordan Publishing Limited, Bristol, 2003), p59-60.

<sup>59</sup> V Finch, "Re-invigorating Corporate Rescue" [2003] J.B.L. 527.

<sup>60</sup> Armour, above n.8, p223.

<sup>61</sup> Finch, above n.59, at 543.

<sup>62</sup> This data was from a report which was issued by Guangdong Provincial High Court. It is available at [http://www.hicourt.gov.cn/News/news\\_detail.asp?newsid=2003-3-4-9-22-46](http://www.hicourt.gov.cn/News/news_detail.asp?newsid=2003-3-4-9-22-46)

and consumers who are usually ranked at the bottom of queue might get zero or little under that rate. The new bankruptcy law has addressed the weak position of ordinary unsecured creditors, especially in the reorganization where the class of ordinary unsecured creditors should be organized to negotiate and vote for the reorganization proposal.<sup>63</sup> The refusal of the class of ordinary unsecured creditors could impede the approval of the rescue proposal.<sup>64</sup> Thus, such substantive and procedural rights ensure better treatment of these weak interested parties, and further avoid the reorganization procedure being at the mercy of major creditors. However, there are no provisions like the British abolition of Crown debts and top-slicing funds which could immediately and effectively enhance the debt recovery of the weak creditors. It is submitted that the weak position of ordinary unsecured creditors has not been fundamentally changed yet.

The trade suppliers may feel unfairly treated because they extend credit to a company but have to share the value of the goods or service which they have provided with other unsecured creditors if the company becomes insolvent. In legal and commercial practice, there are three alternatives to protect the interests of trade suppliers outside the bankruptcy law field. First, a trade supplier could ask the buyer to pay a deposit prior to the delivery of goods. The deposit, which should not exceed 20 per cent of the value of the debts, would not be returned to the buyer if he failed to pay in full.<sup>65</sup> Nevertheless, the protection of deposit is limited, since the major amount of debt is exposed to danger. Second, a trade supplier may force the buyer to find a third party who is willing to guarantee the realization of the debt. The guarantor would be liable to repay the due debt to the trade supplier provided that the buyer was in breach of the duty of payment.<sup>66</sup> However, in the ordinary course of transaction, it is difficult for the buyer to seek such a guarantor, mainly because the guarantor must have some

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(last visit on 31 May 2008)

<sup>63</sup> Bankruptcy Law 2006, article 82.

<sup>64</sup> However, the objection of class of unsecured creditors is subject to the cramdown rules. See Bankruptcy Law 2006, article 87.

<sup>65</sup> PRC Security Law 1995, article 91.

<sup>66</sup> PRC Security Law 1995, chap 2.



special relationship with the buyer and the guarantor must be willing to be involved in this transaction and assume the uncertainties.<sup>67</sup>

Third, retention of title provides an effective weapon for the protection of trade suppliers, who remain title of the goods, even though the goods have been possessed by the buyer. The seller is entitled to repossess his goods if the buyer fails to make payment under a reservation of title clause in a sale contract. It has been in widespread use in Germany where the trade suppliers could get back approximately 64 per cent of the value of their debts in contrast to the 14 per cent recovery rate of ordinary unsecured creditors.<sup>68</sup> In England, reservation of title is limited to cases where a contract of sale reserves title to the seller with an intention to obtain full payment. It could secure the price of goods and the obligations of the buyer prior to subsequent contracts. The seller has had difficulties in asserting claim against proceeds of sub-sales or against new products made by using retention of title goods. Attempts to extend reservation of title to cover the proceeds of sub-sales or products made out of materials have been unsuccessful.<sup>69</sup> According to Chinese laws, retention of title is a significant contractual principle, which is not precluded by bankruptcy law. It is noteworthy that the property right holders are allowed to repossess their property which is under control of a troubled firm in the reorganization procedure.<sup>70</sup> From the perspective of trade suppliers, retention of title could enable them to jump from the bottom of the distributional order to the top even ahead of secured creditors. However, in so far as the administrator is concerned, retention of title may do harm to a rescue attempt. On the one hand, the banks may be reluctant to finance the troubled firm because of the uncertainty caused by retention of title; and on the other hand, by means of retention of title, the trade supplier could claim back the property which may be crucial for reorganization. In a

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<sup>67</sup> For more discussion about personal guarantee, see P Jiang, *Civil Law* (China University of Political Science and Law Press, 2007), p490-501.(in Chinese)

<sup>68</sup> This information is from Carruthers and Halliday, above n.7, p356.

<sup>69</sup> R Goode, *Principles of Corporate Insolvency Law* (3<sup>rd</sup> edn, Sweet & Maxwell, London, 2005), para.6-39.

<sup>70</sup> Bankruptcy Law 2006, article 76.

business transaction, if the bargaining power of a buyer is very strong and that of the trade supplier is very weak, the trade supplier may find it difficult to argue for retention of title in negotiation since the buyer could look for another supplier. In addition, the goods delivered by a trade supplier, like bricks, wood and cement will be incorporated into a new product from which the supplier cannot identify the original materials. In this circumstance, a retention of title clause in the contract will not work against the buyer, because the buyer will have the ownership of the new product.

### **5.3 Directors**

As the financial status of company is going from bad to worse, who is usually in the best position to sense the impending disaster? The answer is undoubtedly the directors, who are in charge of the company's business affairs and property under the principle of managerial autonomy. Since they will lose their post, get a bad reputation and have to restart again, there is little incentive for directors to split the company by commencing winding up proceedings, unless the rehabilitation of the company is hopeless. In order to encourage reorganization and enhance a successful rate of rehabilitation, the legal reformers should consider how to incentivise directors to put the ailing company into a rescue procedure at an early stage. Clearly in this regard, timing is critical. The greater the delay in access to corporate rescue proceedings, the greater the loss of hope for the rehabilitation of a financially distressed firm. It should be noted that the redistribution of controlling power in the rescue regime will have an influence over the directors' managerial incentives. For instance, the pre-bankruptcy directors in some circumstances where the directors and shareholders are the same persons tend to continue trading for the hope of a return to solvency if they know that they will lose control over the company. Such over-risky commercial activities will expose the creditors' interests to danger and undermine the rationale of limited liability. Therefore, generating the right incentives and reshaping directors' powers in the structure of the rescue regime become the core issues.

Insolvency law reforms may consider providing a “sticks and carrots” approach.<sup>71</sup> The “sticks” intend to prevent directors from taking opportunistic commercial activities by imposing civil liability and disqualification, even criminal liability. The “carrots” give the directors some hope of regaining control over the company during corporate rescue proceedings and ensure that directors take appropriate action in a timely manner. This approach could effectively incentivise directors when they sense impending financial trouble.<sup>72</sup>

### 5.3.1 Regulating directors by “sticks and carrots” approach in England

Directors of an English company may envy the chief executives and managers who work for an American company when the company is facing financial difficulty. They face a dilemma when the company is in financial trouble. If it is hopeless for the ailing company to avoid insolvent liquidation, the directors will incur personal liabilities by continued trading. However, if directors initiate the procedure of administration, their controlling power over the company will be handed over to an outside insolvency practitioner.<sup>73</sup> In order to provide more protection to the interests of creditors of the financially distressed company and rehabilitate the commercial morality of the market, under the recommendation of the Cork Report the Insolvency Act 1986 for the first time introduced a “wrongful trading” provision which is also called as “irresponsible trading” by some scholar.<sup>74</sup> If directors know or ought to conclude that there is no reasonable prospect for the company of avoiding insolvent liquidation, they should take every step with a view to mitigating potential losses of the company’s creditors, rather than take risky activities.<sup>75</sup> Otherwise, the directors

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<sup>71</sup> R Mokal, “Administrative Receivership and Administration---An Analysis” (2004) 57 *Current Legal Problems* 355, 362.

<sup>72</sup> Ibid.

<sup>73</sup> McCormack, above n.4, at 515.

<sup>74</sup> A Keay, “Wrongful trading and the liability of company directors: the theoretical perspective” (2005) 25 *Legal Studies* 431, 432.

<sup>75</sup> IA 1986, s 214; A Keay, “Wrongful trading and the point of liability” (2006) 19 *Insolv. Int.* 132.

may incur wrongful trading liability and will be ordered to make a contribution to the company's assets.<sup>76</sup> The court also has a wide discretion to disqualify the irresponsible directors for a period of 2 to 15 years.<sup>77</sup> The wrongful trading provision was called a "welcome additional weapon in the fight against abuse of the privilege of limited liability", and the potential for it to play a deterrent role was noted.<sup>78</sup> It may urge directors to discharge their duties positively, including keeping alert to the company's financial status and filing the financial and management accounts on time.

The legal practice in the past twenty years indicated that the innovation of wrongful trading did not work as well as Parliament expected. Many hurdles might impede its application. For instance, selecting a date on which directors knew or ought to have realized that there was no reasonable prospect of the company avoiding insolvent liquidation is extremely difficult.<sup>79</sup> In addition, "no reasonable prospect" is a very elusive phrase, which literally means precluding every possibility of survival of the company.<sup>80</sup> From the perspective of directors, there are some uncertain factors in practice which are almost impossible to anticipate. First of all, as long as the financial support of banks or other financiers exists and continues, directors will definitely believe that there is a reasonable prospect that the company could continue trading. However, no reasonably diligent directors are able to predict when withdrawal of the support by the banks or financiers would happen, because they are entitled to do so without giving any warning sign.<sup>81</sup> In addition, when a company runs into a financial predicament, the directors may attempt to turn the business

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<sup>76</sup> The first wrongful trading decision subject to s 214 was made by Knox J in *Re Produce Marketing Consortium Ltd (No.2)* which was of great importance.

<sup>77</sup> CDDA 1986, s 10; *Official Receiver v Doshi* [2001] 2 BCLC 235.

<sup>78</sup> F Oditah, "Wrongful Trading" [1990] LMCLQ 205, 222. It should be noted that both fraudulent trading and wrongful trading provisions could remove the directors' shield for the protection of limited liability and impose personal liability on them. However, in practice fraudulent trading did not work well, primarily because the standard of proof of the incentive to defraud is much higher than that of wrongful trading. This section merely focuses on wrongful trading.

<sup>79</sup> A Hicks, "Advising on wrongful trading: part 1" (1993) 14 Comp. Law. 16, 17.

<sup>80</sup> *Re Hawkes Hill Publishing Co Ltd (In Liquidation)* [2007] BCC 937, at para.41.

<sup>81</sup> M Simmons, "Wrongful Trading" (2001) 14 *Insolvency Intelligence* 13.

around by looking for new investors. Some investors may promise to invest and their promise may make the directors strongly believe that there is a reasonable prospect of survival for the company. If these investors fail to inject funds which they have promised, it would undoubtedly fall outside the scope that directors could reasonably anticipate.<sup>82</sup>

The wrongful trading provision is described as a “stick” which deters directors from taking opportunistic activity at the price of creditors’ interests.<sup>83</sup> By fear of personal liabilities, directors might be willing to place the financially distressed company into a rescue regime. The revamped administration provides out-of-court appointment mechanisms under which the rescue-oriented administration can be initiated by the directors of an ailing company.<sup>84</sup> This expedited out-of-court appointment could be a “carrot” that reduces time and costs, and eliminates the directors’ concerns.<sup>85</sup> Fears are likely to be alleviated more by the CVA regime, within which the directors could remain in control over the company. In addition, the board could exert some influence over the insolvency proceedings by the appointment of an administrator.<sup>86</sup> Many surveys have indicated that the management-related causes, including irrationality, incompetence of the management team and wrong decisions of strategy and the like, are the main causes of corporate failure.<sup>87</sup> It is clear that the administrator appointed by the company or its directors may probably be replaced by an appointment initiated by a qualified floating charge holder or other creditors who are entitled to apply to the court for an order of administration appointment. It is therefore observed that the company or its directors’ appointment mechanism cannot

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<sup>82</sup> *Rubin v Gunner* [2004] BCC 684

<sup>83</sup> A Campbell, “Wrongful Trading and Company Rescue” (1994) 25 *Cambrian L. Rev.* 69.

<sup>84</sup> IA 1986, Sch.B1, para.22.

<sup>85</sup> In the case *Re Chancery plc*, the directors intended to apply for an administration in order to avoid incurring wrongful trading liability. See *Re Chancery plc* [1991] BCC 171 at 172; and the comments on A Keay, “Wrongful trading and the liability of company directors: the theoretical perspective” (2005) 25 *Legal Studies* 431.

<sup>86</sup> J Armour and R Mokal, “Reforming the governance of corporate rescue: the Enterprise Act 2002” [2005] *LMCLQ* 28, 32.

<sup>87</sup> V Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP, Cambridge, 2002), p126.

be expected to be the main access to administration.<sup>88</sup> In administration, the existing board is subject to the administrator and the powers of directors are suspended.

Although the board can exert influence on the selection of IPs, the board cannot regain control during the administration procedure. The new administration regime provides the company or its directors with the out of court appointment mechanism as a “carrot”, but the “carrot” seems less juicy.<sup>89</sup> Moreover, it is worth noting that in closely held companies, directors are commonly the major shareholders who have sunk almost all their savings into the company. They tend to explore every possibility to turn their troubled company around. Provided that they avoided over-risky activity and put their company into rescue proceedings earlier, greater rehabilitation should take place.

### 5.3.2 Directors in China’s two-tier board system: how to generate the right incentives?

The corporate governance structure of Chinese companies borrows features of the Anglo-American and German systems. All types of companies, including the limited liability company, joint-stock company and listed company, adopt a two-tier board structure, consisting of a board of directors and a supervisory board. The basic structure of governance can be illustrated in the following figure.<sup>90</sup>

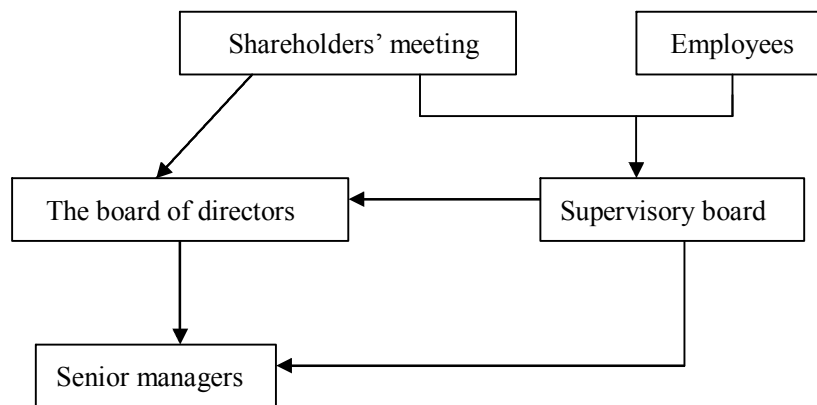
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<sup>88</sup> Armour and Mokal, above n.86, at 33.

<sup>89</sup> Ibid.

<sup>90</sup> For a comprehensive discussion of China’s corporate governance from a comparative perspective, see J Yang “The anatomy of boards of directors: an empirical comparison of UK and Chinese corporate governance practices” (2007) 28 Comp. Law. 24; C Law and P Wong, “Corporate governance: a comparative analysis between the UK and China” (2005) 16 I.C.C.L.R. 350.

**Figure 5.1: The structure of corporate governance of a Chinese company**



The two boards are set at the same level, and discharge different functions. The board of directors is appointed by the shareholders' meeting. Company law has vested a wide range of powers over management and business decision-making upon directors and has also laid down some duties which they have to perform faithfully and diligently. The supervisory board is comprised of representatives of shareholders and employees according to the law and the company's constitution. The supervisory board plays a significant role in supervising the financial status of the company, monitoring the behaviour of directors and senior managers in the ordinary course of business and rectifying their misconduct which may harm the interests of the company. However, the Chinese supervisory board does not enjoy the power of removing the dishonest or irresponsible director and nominating a new one.<sup>91</sup> This is the fundamental difference from the German supervisory board, which is in a superior position over the board of directors.<sup>92</sup>

### *Board of directors*

It is clear that the board of directors has been placed at the heart of corporate governance. The powers and functions of board are normally stipulated in the company's constitution, which is surely under the influence of the shareholders'

<sup>91</sup> J Yang, "Comparative corporate governance: reforming Chinese corporate governance" (2005) 16 I.C.C.L.R. 8, 11.

<sup>92</sup> J Dahya, Y Karbhari and J Xiao, "The Supervisory Board in Chinese Listed Companies: Problems, Causes, Consequences and Remedies" (2002) 9 *Asia Pacific Business Review* 118; M Andenas and F Wooldridge, *European Comparative Company Law* (CUP, Cambridge, 2008), p297.(forthcoming)

meeting. The board of directors plays a crucial role in managing the property and business affairs of the company in the ordinary course of business. The directors need to perform fiduciary duties and act for the interests of the company. It should be noted that, provided the directors are in breach of the fiduciary duty or the duty of care and diligence, and they cause the bankruptcy of the company, they will incur personal liability. In addition, such directors will be disqualified for three years from the termination of the bankruptcy proceedings.<sup>93</sup> It can be seen that “sticks” have been provided by the new bankruptcy law to ensure that directors appropriately perform their duties, otherwise civil liabilities and disqualification will be imposed. More seriously, if the directors hide the company’s assets, repay debts which are fabricated or by other means transfer the assets at an unreasonably low value with the intent to avoid debts, and the behaviours of such directors have seriously done harm to the interests of creditors in respect of the company, then such directors will be imprisoned and fined.<sup>94</sup> These “sticks” could effectively urge directors to consider a probable reorganization attempt and take action at the time of financial difficulty in order to avoid eventual failure. In the corporate insolvency regime, when the directors sense the impending financial difficulties of the company, they could convene a shareholders’ meeting, report the financial status and suggest that a reorganization procedure should be initiated immediately. After the shareholders’ meeting agrees the suggestion of triggering a rescue procedure, the directors are entitled to petition to the court. The directors cannot initiate the rescue proceedings directly, unlike the English directors who are allowed to appoint an administrator out of court according to the new administration regime.<sup>95</sup> Of course, this process will take time and costs, and the directors’ rescue attempt may be blocked by the decision of the shareholders’ meeting.

Since the Chinese reorganization procedure incorporates the US DIP model and the

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<sup>93</sup> Bankruptcy Law 2006, article 125.

<sup>94</sup> PRC Criminal Law Amendment 6, 2006, article 6.

<sup>95</sup> Bankruptcy Law 2006, article 70.



English PIP model, the directors could regain control over the management of the ailing company during the reorganization period by applying to the court for the DIP. As long as the application is granted, the board of directors is entitled to take over the assets and business affairs of the company from the administrator and carry on the reorganization, but still under the supervision of the administrator.<sup>96</sup> The Chinese modified DIP model to some degree provides a “carrot” to the directors of the ailing company and gives the directors some hope of regaining control during reorganization, but this control is subject to the monitoring of the administrator.

### *Supervisory board*

In China’s two-tier board structure, the supervisory board plays the main role of supervising the finance of the company and the behaviour of directors. The supervisors in this board are entitled to convene an interim general meeting and propose to remove reckless and irresponsible directors. But they cannot dismiss such directors directly, since the board of directors is not subject to the supervisory board at the parallel level. Clearly, the role of the supervisory board is limited and particularly in some companies which are incorporated by former SOEs, the supervisory board is regarded as only a nominal unit.<sup>97</sup> Although the supervisory board is bestowed the power to rectify the misconduct of directors, in practice this power is very weak, since the directors are not accountable to the supervisory board. Provided that the directors fail to correct their illicit behaviour, the supervisors have to resort to a decision of the interim general meeting or take legal action against the irresponsible directors on behalf of the company. However, if the major shareholders support the directors and reject the proposal of the supervisory board, the supervisors have nothing to do and they will not have incentives to challenge again because two thirds of members of the supervisory board are representatives of shareholders. This is why the supervisory board can be described as a tiger without teeth.<sup>98</sup> The

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<sup>96</sup> Bankruptcy Law 2006, article 73.

<sup>97</sup> Dahya, Karbhari and Xiao, above n.92, at 124.

<sup>98</sup> L Miles and Z Zhang, “Improving Corporate Governance in State-Owned Corporations in China: Which Way Forward?” (2006) 6 JCLS 213, 227.

rationale of setting a supervisory board in the corporate governance aims at resolving the agency problem between shareholders and the board of directors.<sup>99</sup> If the supervisors in this board fail to perform their duties responsibly, the agency costs cannot be reduced. For instance, in a company where the state is the sole shareholder or controlling shareholder, both the directors and supervisors are appointed by the government and they might be friends or have some connections each other. In this circumstance, the supervisors are unwilling to expose the relevant directors to trouble.<sup>100</sup> Therefore, it can be concluded that three major problems, respectively lack of legal power, independence and competence, lead to the unsuccessful operation of supervisory board in the corporate governance.<sup>101</sup>

## 5.4 Labour

Workers who build a fixed connection with a firm and obtain wages, pensions and the like through their employment contracts are the real profit-producers.<sup>102</sup> When the firm which is in the slide into insolvency fails to pay remuneration and social insurance of employees in due course, the workers become creditors in respect of their unpaid wages, and moreover they are unsecured creditors towards the bankrupt firm with preferential treatment in the British and Chinese insolvency proceedings. It should be noted that workers often enjoy some advantages over the consumers and trade suppliers. First of all, it is common in the distribution of bankrupt property that the labour claims are conferred statutory priority over the unsecured creditors, even though the degree and scope of the preferential status may be limited.<sup>103</sup> In addition, the workers who work in a firm are likely to have better information about the situation of the firm's business. Even though they do not have access to the financial and accounting records in the ordinary business, they can sense the profitability or

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<sup>99</sup> Zhou, above n.48, p348.

<sup>100</sup> Ibid.

<sup>101</sup> Dahya, Karbhari and Xiao, above n.92, at 124-131.

<sup>102</sup> For more understanding of the relation between the employee and the firm, see S Wheeler, "Labour and the Corporation" (2006) 6 JCLS 361.

<sup>103</sup> A Keay and P Walton, "The Preferential Debts Regime in Liquidation Law: In the Public Interests?" [1999] *Company Financial and Insolvency Law Review* 84.

downturn of the firm.

In some countries, the workers are fully recognized as participants in a company. The representatives of the workers are involved in corporate governance and decision-making. They have rights to be informed and consulted. When the company is in the vicinity of insolvency, they are entitled to engage in the negotiation of a rescue scheme and to exert influence on the approval of the rescue scheme. It should be noted that France follows this model and the workers are able to raise the alarm under the alert system. In addition, in China, the worker representatives can participate in the corporate governance and have a voice and power of action. At least one representative of the work force which is elected through the workers' congress should be appointed to be a director in the board of a company which is completely owned by the state.<sup>104</sup> Moreover, the representatives of the workforce can also be elected to be members of the supervisory board. The proportion of workers' representatives in the supervisory board should be not less than one third. The workers' representatives, who become the members of the supervisory board through election, are vested the power to monitor financial reports and state of the company, and supervise the behaviour of directors in the ordinary course of business.<sup>105</sup>

In contrast to the powerful secured creditors like banks and large financiers, it is clear that labour creditors are the weak and vulnerable group in the bankruptcy legal framework. First, the workers may lose their jobs as a result of corporate failure. Since they have made years of effort in the firm, specialized their skills in one particular area and got used to the old working environment, they may have to be trained for a new position and to adjust themselves to the new team. Undoubtedly, this process will cause time and costs of both the workers and the government. It can

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<sup>104</sup> PRC Company Law 2005, article 68.

<sup>105</sup> The detailed number can be set in the company's constitution. See PRC Company Law 2005, articles 52 and 118; Zhou, above n.48, p350.

be seen that in the collapse of MG Rover, about 5,000 workers were made redundant. The Blair government made £50 million available to fund the retraining and re-skilling of those being made redundant and another £ 40 million to make the statutory redundancy payment.<sup>106</sup> Second, the workers' ability to enforce their claims is weak unless they are unionized or well organized. Individual workers are unlikely to be able to resist a pay cut. Third, provided that the workers are not unionized or organized, their access to legal and accounting expertise is limited, because no individual worker is willing to hire a professional for their claims. On the one hand, they may not be able to afford the expense; and on the other hand, "there will be a tendency for workers to want to 'free ride' on another worker's attempt to get his or her share of the assets".<sup>107</sup>

Since a series of negative consequences for workers may be triggered by the eventual corporate failure, the workers may be more enthusiastic about rescuing the ailing firm. It is well known that a successful reorganization normally embraces changes in business strategy, reconstructing the capital structure, part unemployment of the workers and reduction of total debts. The workers as a whole absolutely have to sacrifice some of their interests for the final victory. For instance, some workers may lose their jobs and as for the remaining workers, their wages and social welfare may be cut during the process of reorganization. The more protection to the workers' interests, the much harder for a successful reorganization. Clearly, when the legal reformers design the rules of rescue law and consider redistributing the power of the workers' class in the rescue network, they will largely depend on the bankruptcy law, laws about labour's rights and employment contracts, and their current social security system.

#### 5.4.1 Protections to the employees of a distressed firm in England

When a company is insolvent, the employees are able to claim for their back wages

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<sup>106</sup> <http://news.bbc.co.uk/1/hi/business/4447323.stm> (last visit 6 March 2008)

<sup>107</sup> Carruthers and Halliday, above n.6, p308.

and benefits through a series of routes. The insolvency legislation has conferred preferential status upon labour claims ahead of unsecured creditors in the distribution of the bankruptcy estate.<sup>108</sup> The employees used to share the distributional priority with the Inland Revenue and HM Customs & Excise, but now have become the principal preferential creditors since the preference of Crown debts was abolished by the 2002 reforms.<sup>109</sup> It is noteworthy that the employees' claim for remuneration with preferential status is limited to £800 and the amounts beyond this limit are dealt with as an ordinary unsecured debt.<sup>110</sup> In addition, this preferential claim may be influenced and reduced by a claim with security like the fixed charge. However, this disadvantage may not bother the employees too much, since they are entitled to claim their unpaid wages and pensions and the like from the social security system. The labour-related laws enable employees of an insolvent company to claim for a wide range of entitlements against the state National Insurance Fund (NIF).<sup>111</sup> This is a more secure and productive way for employees to benefit, and it is therefore commented that "the advantages of the NIF route are that NIF entitlements are guaranteed as opposed to preferred."<sup>112</sup> In addition, the English employment laws are very conducive to the continuation of employment contracts when a transfer of business is incurred, according to the Transfer of Undertakings (Protection of Employment) TUPE Regulations 2006 which intends to protect employees from unfair dismissal.<sup>113</sup> The purchaser of the sale of an insolvent business is liable to inherit the acquired right of the affected employees. In other words, when the business of a company is sold, the affected employees will be transferred to the transferee who shall accept the existing terms in connection with the employment

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<sup>108</sup> IA 1986, s 175.

<sup>109</sup> Davies, above n.14, p30.

<sup>110</sup> IA 1986, Sch 6, paras.9 and 12; Insolvency Proceedings (Monetary Limits) Order 1986 (SI 1986/1996), art.4.

<sup>111</sup> Employment Rights Act 1996, ss 166-170 and ss 182-190. S Frisby, "TUPE or not TUPE? Employee Protection, Corporate Rescue and 'One Unholy Mess'" (2000) 3 CFILR 249; R Eldridge, "TUPE Operates to Damage Rescue Culture" (September 2001) *Recovery* 21.

<sup>112</sup> Finch, above n.86, p555.

<sup>113</sup> For more discussion about the new TUPE Regulations, see R Upex and M Ryley, *TUPE: Law and Practice* (Jordans, Bristol, 2006); J McMullen, "An Analysis of the Transfer of Undertakings (Protection of Employment) Regulations 2006" (2006) 35 *Industrial Law Journal* 113.

contracts. Any dismissal, because of the transfer or a reason connected with it, is regarded as unfair dismissal and the employee is accordingly entitled to compensation, unless the dismissal is for or principally for an economic, technical or organizational reason.<sup>114</sup>

It is common that a reorganization proposal may include the selling of an unprofitable unit or a hive down of the insolvent part for a going concern sale. The transferee may be reluctant to be responsible for the acquired rights of the employees or the transferee may intend to cut down the size of the transferred business and dismiss the redundant workers. This will largely depend on the extent to which the terms of the employment contract can be modified.<sup>115</sup> In addition, in a rescue procedure the employees hope that their continued work can be paid with a guarantee which could encourage them to stay in the distressed firm. The establishment of super-priority in the insolvency system, rules of employment contract adoption and protection of employees may eliminate the employees' fear of losing jobs and entitlements to wages and pensions.<sup>116</sup> Under the new administration, the administrator is entitled to make distributions to employees so as to assist the purpose of administration.<sup>117</sup> It is observed that "the first step to assist a corporate rescue is to induce the retained workforce to continue to work. Employees will be reluctant to help, however, unless they receive a better assurance that they will receive their wages than a promise from an insolvent company"<sup>118</sup> In addition, the TUPE 2006 may to some extent assist corporate rescue and survival of the business or undertaking which is subject to the transfer.<sup>119</sup> Special treatments are given under TUPE to the relevant insolvency proceedings in which some liabilities of payment to

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<sup>114</sup> Directive 2001/23/EC, Art 4 (1); TUPE 2006, Reg. 7 (1)(2).

<sup>115</sup> For the effect of TUPE on corporate rescue, see Frisby, above n.111, at 249; Eldridge, above n.111, at 21.

<sup>116</sup> Finch, above n.87, p560.

<sup>117</sup> IA 1986, Sch B1, para.66; *Re MG Rover Espana SA* [2006] BCC 599.

<sup>118</sup> H Collins, K Ewing and A McColgan, *Labour Law Text and Materials* (Hart, Oxford, 2001), p1034.

<sup>119</sup> TUPE 2006, Reg. 8; R Parry, *Corporate Rescue* (Sweet & Maxwell, London, 2008), para.3-06.

employees will be met by the National Insurance Fund. This could ease the concerns of the transferee and promote the transfer of the entire or part of undertakings as a going concern.<sup>120</sup> The 2006 Regulations do not list what types of insolvency proceedings are covered, but they exclude proceedings commenced with the objective of liquidation, according to Articles 8 and 9. The relevant insolvency proceedings include the proceedings under a collective approach and under supervision of an insolvency practitioner who owes duties to all the creditors.<sup>121</sup> In this sense, the CVA and administration procedures are covered by the Regulations. The 2006 Regulations may also to some degree encourage the transfer of undertakings from insolvent entities by allowing the transferor, the transferee and the insolvency practitioner to vary the terms and conditions in the contracts of employment. In order to protect the interests of the affected employees in the context of transfer, the 2006 Regulations impose restrictions and requirements on the variation of contracts.<sup>122</sup>

#### 5.4.2 The labour's position in China's bankruptcy legal framework

Historically, Chinese labour has been a strong and active actor in the political stage and the worker class is conferred a superior position according to both the Constitution of the Chinese Communist Party and the Preface of China's Constitution. When the legal reformers enact or revise bankruptcy laws, they tend to take account of the workers' interests in the first place primarily because of the political factor, the underdeveloped social security system and inadequate employment laws. Under the old economic structure, the workers were closely attached to their employing enterprise.<sup>123</sup> Where the enterprise fell into insolvent liquidation, the workers not only lost their jobs, but also their entitlements to social welfare benefits, which were

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<sup>120</sup> R Upex and M Ryley, *TUPE: Law and Practice* (Jordans, Bristol, 2006), p103.

<sup>121</sup> *A guide to the 2006 TUPE Regulations for employees, employers and representatives* (March 2007), p28. Available at <http://www.berr.gov.uk/files/file20761.pdf> (last visit 31 May 2008)

<sup>122</sup> TUPE 2006, Reg. 9.

<sup>123</sup> J Leung, "Social security reforms in China: issues and prospects" (2003) 12 Int J soc welfare 73.

normally provided by the enterprise itself rather than the government. The bankruptcy of a large SOE would lead to the unemployment of thousands of workers and the concomitant social unrest. This was one reason why people always avoided talking about bankruptcy, a very politicized and sensitive topic, at the beginning of the economic reform.<sup>124</sup> In view of these negative effects, the government came up with an expedient, “policy bankruptcy”, in order to avoid the application of 1986 law to the SOEs. In short, the proceeds of collateral and the bankruptcy estate were to be used to pay the back wages and benefits first. The policy bankruptcy regime enabled the workers to enjoy superior priority in the distribution of assets which largely violated the principles established by the 1986 law and infringed the interests of secured creditors like the banks.<sup>125</sup> When the emerging market economy was established at the beginning of this century, the Chinese government launched a legislative programme which aimed at enacting a new bankruptcy law. In June 2004, the Standing Committee of NPC deliberated on the first draft in which labour claims ranked ahead of unsecured creditors but below the secured creditors.<sup>126</sup> There was an intense debate during the first reading and representatives of labour unions at national level and officials of the Ministry of Labour and Social Security proposed to rank the status of labour claims prior to those of the secured creditors. Subsequently, during the second reading, the distributional order was turned over and the workforce was conferred priority over secured creditors.<sup>127</sup> The debate then lasted for nearly two years and to a large extent impeded the drafting process and deliberation.<sup>128</sup> Finally, the 3<sup>rd</sup> draft passed the final reading in August 2006 and established that the secured creditors could realize their debts from the collateral, while the remaining assets would comprise the bankruptcy property which is used for liquidation

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<sup>124</sup> J Xie, *Theory of Chinese Bankruptcy Legal System* (People Court Press, Beijing, 2005), p79-84.(in Chinese)

<sup>125</sup> Parry and Zhang, above n.32, at 117.

<sup>126</sup> 1<sup>st</sup> draft of PRC Enterprise Bankruptcy Law (June 2004), article 80.

<sup>127</sup> 2<sup>nd</sup> draft of PRC Enterprise Bankruptcy Law (October 2004), articles 113 and 127; for the English version of the 2<sup>nd</sup> draft, see A Tang, *Insolvency in China and Hong Kong: A Practitioner's Perspective* (Sweet & Maxwell Asia 2005), paras5.31-5.46.

<sup>128</sup> This information was collected from an interview on 11 July 2007 with Prof. Jingxia Shi who was involved in the drafting process of the new bankruptcy law.



expenses and distribution to other creditors. Although labour claims have been ranked below those of the secured creditors, they have priority over the government tax liabilities and claims of ordinary unsecured creditors.<sup>129</sup>

It has been aforementioned that the Chinese Company Law enables the worker representatives to be involved in corporate governance, especially in SOEs and large public companies, and to exert influence over the management. In addition, one of the worker representatives is entitled to be a member of the creditors' committee which has the power of supervising the management and disposal of the bankruptcy property, distribution of the bankruptcy property and convening a creditors' meeting.<sup>130</sup> In the process of reorganization, the class of workers is entitled to negotiate over the terms of the reorganization proposal, and to veto the reorganization proposal if they are unsatisfied.<sup>131</sup> In order to encourage the employees to keep working in the troubled firm and promote the firm to continue trading, the employees have been conferred priority which could ensure the employees are paid ahead of other unsecured claimants.<sup>132</sup> From the perspective of the newly enacted Employment Contract Law, it is clear to note that it is not easy to dismiss redundant workers in a corporate reorganization. If the employing firm intends to cut more than twenty employees, or less than twenty but the number which is cut accounts for 10 % of the total employees, this firm needs to notify the labour union or provide an explanation for all the employees thirty days in advance. Meanwhile, this firm is required to report the plan of dismissal to the bureau of labour and social security in the local government for approval.<sup>133</sup> Apparently, this rule will cause an increase in time and costs, and government agencies are entitled to be involved in the dismissals and redundancies prior to a rescue attempt. However, from the contrary perspective, it is indicated that the bargaining power of the

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<sup>129</sup> Bankruptcy Law 2006, article 113.

<sup>130</sup> Bankruptcy Law 2006, articles 67 and 68.

<sup>131</sup> Bankruptcy Law 2006, article 82.

<sup>132</sup> Bankruptcy Law 2006, article 42.

<sup>133</sup> PRC Employment Contract law 2007, article 41.

employees in the rescue network is very strong.

## **5.5 State**

The state is entitled to participate in the bankruptcy or reorganization as a singular creditor that is normally owed a substantial amount of unpaid taxes by a troubled firm. In addition, the troubled firm may have used up the social security deductions which will have been collected by the firm itself on behalf of the state and which it is supposed to pay the relevant government agencies on time. If the claims of the state cannot be fully recovered, the loss to the state will fall ultimately on the tax payers and public service cuts. It can be observed that the state enjoys a strong position in bankruptcy and corporate rescue regimes even though the debts owed to it by the struggling firm are normally not secured with assets. The state is potentially able to exploit other resources to enforce its claim and obtain advantages in the insolvency proceedings on the basis of the state's superior authority and coercion. It has strong incentives to realize the back taxes and social security deductions on the basis of its strong power of enforcement and advantageous position in the ranking of distribution. The powerful status of the state as a player in the bankruptcy or corporate rescue legal framework may have a significant impact on the interests of the other interested parties. On the one hand, the more the state grabs from the pool of the bankrupt estate, the less there is left for the other creditors; and on the other hand, the state's immediate and strong enforcement of the repayment could lead to the reduction of the remaining assets which will surely destroy the probability of rehabilitation of the ailing firm and ruin the rescue culture.<sup>134</sup> To some extent, the attitudes, incentives and efforts of the state may determine the difference between success and failure of a rescue attempt.

### **5.5.1 Abolition of Crown preference and restriction on state aid in the UK**

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<sup>134</sup> Carruthers and Halliday, above n.6, p212.

Traditionally, the Crown debts enjoyed preferential status in the queue of distribution even though these debts were unsecured. In the insolvency law regime before the EA 2002 came into force, the Crown debts ranked after the expenses of liquidation and fixed charge holders, but before the other unsecured debts. If the assets of a company available for the distribution of general unsecured creditors are insufficient to meet Crown debts, the Crown debts should be paid out of the assets subject to a floating charge.<sup>135</sup> The preferential status of the Crown can be explained by the following two justifications: “(a) unpaid tax is owed to the community at large and, therefore, the preference benefits the community as a whole; and (b) unlike those who engage in business on a day-to-day basis, the Crown is an involuntary creditor.”<sup>136</sup> However, the existence of Crown preference caused considerable criticism and dissatisfaction of the public that argued for a reduction of the categories of preferential claims, and even a complete abolition. It was argued that the preferential claims in an insolvency may be against the *pari passu* principle and do harm to the interests of ordinary unsecured creditors. For these reasons, as early as the English insolvency law reforms in the 1980s, the Cork Committee had recommended that the preference of Crown debts be eliminated.<sup>137</sup>

The 2002 reforms abolished the preferential status of Crown debts and this measure could result in three major effects.<sup>138</sup> First, the ordinary unsecured creditors will benefit from the abolition of Crown preference. It is estimated that approximately £70 million per annum becomes available for distribution to unsecured creditors.<sup>139</sup> Second, the abolition of Crown preference will consolidate the claims of employees with priority.<sup>140</sup> Small residual categories of claims retain preferential status since the Crown lost preference, and these categories include: (a) contributions to occupational pension schemes; (b) remuneration of employees for the relevant period;

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<sup>135</sup> IA 1986, s 175.

<sup>136</sup> The Cork Report, para.1409.

<sup>137</sup> The Cork Report, para.1398.

<sup>138</sup> EA 2002, s 251.

<sup>139</sup> V Finch, “Re-invigorating corporate rescue” [2003] J.B.L. 527, 533.

<sup>140</sup> Davies, above n.14, p31.

and (c) levies on coal and steel production according to the European Coal and Steel Community (ECSC) Treaty.<sup>141</sup> Third, the abolition of preference may encourage the Crown departments to be actively involved in corporate rescue proceedings. In the post-EA insolvency regime, the Crown becomes an ordinary unsecured creditor without priority and ranks at the bottom of queue. The Crown debts can obtain more recovery from a successful reorganization.<sup>142</sup> However, there might be one concern that the Crown departments would be likely to take earlier enforcement towards financially troubled firms. Clearly, this measure may be detrimental to a rescue attempt.

One fundamental difference of the state's roles in bankruptcy and corporate rescue regimes between the UK and China is whether or not the state is able to provide aid to bail out insolvent businesses without restriction. The Chinese government has strong incentives to be involved in the reorganization of financially troubled SOEs and provide financial assistance because of complicated political and economic reasons. However, in the UK the provision of subsidies and other forms of aid by state is subject to the EC state aid law which restricts state intervention in order to maintain fair competition of member states in the free market. State aid law is unique to the European context and purports to regulate the conduct of EU member states which cannot simply grant aid with intention to favour certain undertakings or inject funds to rescue the insolvent companies unless specific procedures are followed. However, there is no state aid law in the US and China.<sup>143</sup>

### 5.5.2 Strong position of the state in China's bankruptcy legal framework

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<sup>141</sup> EA 2002, s 251; IA 1986, Sch 6; L Sealy and D Milman, *Annotated Guide to the Insolvency Legislation 2006/2007* (9<sup>th</sup> edn, Sweet & Maxwell London, 2006) Vol 1, p585.

<sup>142</sup> Davies, above n.14, p33.

<sup>143</sup> For more knowledge about state aid law, see L Hancher et al, *EC State Aids* (3<sup>rd</sup> edn, Sweet & Maxwell, London, 2006). For relevant legislation, see <[http://ec.europa.eu/comm/competition/state\\_aid/legislation/provisions.html](http://ec.europa.eu/comm/competition/state_aid/legislation/provisions.html)> (last visit on 31 August 2008)

A unique strength of state is that it could design bankruptcy rules which confer priority upon government agencies, and subsequently seize assets in priority to other creditors. It is therefore observed that the state is not only a rule-maker but a significant player as well in bankruptcy law.<sup>144</sup> Under China's new bankruptcy law, the claims of the state, including unpaid tax and social insurance deductions, rank behind secured debts, expenses of liquidation and labour claims, but before ordinary unsecured creditors.<sup>145</sup> Apart from the roles of a law-maker and an interested party in the bankruptcy legal framework, the state could also play a role of providing finance to troubled firms. In the previous centralized planned economy and at the beginning of the economic reform, the Chinese central government used to set aside a large amount of funds from the annual budget to assist distressed state-owned enterprises and rearrange the laid-off workers, but now this situation is changing very fast along with the establishment of the emerging socialist market economy and entry into the WTO. Only 10% of state-owned enterprises' total funding is derived from the state budget.<sup>146</sup> This trend is in line with the principles of competition laws which strongly restrict the government from stepping in, in order to maintain fair competition among economic entities in the free market.<sup>147</sup> Although the situation that the state tended to bail out distressed state-owned enterprises has changed so far, the state may still be likely to provide financial aids to salvage some ailing SOEs, in particular the large and influential enterprises, the life or death of which will have a significant impact on the stability of the local region.<sup>148</sup> Last but not least, the state can act as a coordinator in reorganization cases regarding SOEs. When the rescue process or negotiation falls into difficulty or deadlock, the local government and relevant agencies may assist in providing solutions to the disagreements, offering special policies to the troubled firms and mitigating the dissatisfaction and concerns

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<sup>144</sup> Ibid.

<sup>145</sup> Bankruptcy Law, article 113.

<sup>146</sup> F Allen, J Qian and M Qian, "Law, finance, and economic growth in China" (2005) 77 *Journal of Financial Economics* 57, 80.

<sup>147</sup> For the relevant provisions of state aid in the EU, see Articles 87-92 EC Treaty; Hancher et al, above n.143.

<sup>148</sup> Parry and Zhang, above n.32, at 140.

of the affected employees. The administrator and court will to some extent rely on the local government in relation to labour-related issues, because at present a developed social security system has not been established in China. In the near future, the state involvement in the bankruptcy and corporate rescue cases of SOEs is likely.

## Concluding remarks

In the UK, the 2002 reforms have to some extent weakened the strong power of banks in the pre-EA 2002 legal framework with the abolition of administrative receivership and introduction of top-slicing provisions. Banks are not as reliant on the security of floating charges as they used to be. A shift from the security of a floating charge over the entire business and undertakings of the debtor towards more asset-based finance has formed. This general trend may result in the reduction of their control power in the new administration regime on account of less reliance upon a single bank and the fragmentation of lending.<sup>149</sup> Even though the banks as qualifying floating charge holders are entitled to appoint an administrator out of court, they are unwilling to do so. The banks are inclined to participate in the restructuring of an ailing firm by sharing the fees and risks of a reorganization attempt.<sup>150</sup> Broadly speaking, the banks may be very conservative in lending to their clients which are in financial trouble, and may have more incentive to monitor the financial status of their customers in order to prevent eventual failure of their customers. In China, the banks have experienced a series of problems which were caused in the nearly thirty-year economic transition, notably poor corporate governance, state manipulation and non-performing loans. With the development of the economy and ongoing reforms in the banking sector, the state banks have become increasingly strong and competitive in the financial market. The new bankruptcy law has largely improved the weak position of banks in the existing bankruptcy legal framework, and encouraged banks, whether state banks and private banks, to make loans to financially troubled firms for

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<sup>149</sup> J Armour, A Hsu and A Walters, *The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings*, A Report Prepared for the Insolvency Service in December 2006, p24.

<sup>150</sup> Ibid.

reorganization by the introduction of limited super-priority provision and other security measures in line with international standards.

The abolition of Crown debts and the top-slicing provisions in the English insolvency legal reforms could effectively increase the pool of the insolvent estate for distribution among ordinary unsecured creditors and enhance their recovery rates. The reforms enable weak creditors to participate in the collective approach of corporate rescue even though they “are perceived as being acrimonious and unsophisticated” and “tend to be heterogeneous” when they negotiate for a rescue arrangement in the creditors’ meeting.<sup>151</sup> In addition, the reforms may encourage trade suppliers to continue supplying goods or services to their financially troubled customers during reorganization, since the trade creditors are able to obtain a better result than under the old regime. It is important to note that under the new legislation of administration, an administrator is allowed to make a payment to an unsecured creditor for the statutory purpose of administration.<sup>152</sup> The payment can be made, without reference to the court, to a trade supplier who provides raw materials or other essential products which are crucial for continued trading.<sup>153</sup> As a whole, the innovations brought about by the EA 2002 could balance the weak power of the ordinary unsecured creditors, enhance the probability of a successful reorganization and boost the collectivity of the rescue culture. Comparatively, China’s new bankruptcy law has arguably not paid too much attention to changing the vulnerability of the weak creditors. Hence, they are inclined to protect their own interests by means of legal devices out of the bankruptcy law field like retention of title clauses which enable the weak creditors to rank ahead of other creditors. However, these legal forms of security may have a bad impact on rescuing a troubled firm.

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<sup>151</sup> Belcher, above n.1, p116.

<sup>152</sup> IA 1986, Sch B1, para.66.

<sup>153</sup> L Sealy and D Milman, *Annotated Guide to the Insolvency Legislation 2006/2007* (9<sup>th</sup> edn, Sweet & Maxwell, London, 2006), Vol 1, p541.

In relation to the board of directors, traditional English culture views it as absurd that the directors, whose actions led to the insolvency of the company, continue to retain control in the rescue proceedings. An independent professional acts as a trustee in charge of the reorganization and the original directors are ousted. A successful reorganization needs well designed rescue laws which can effectively encourage the directors to put the company into a rescue regime and in this regard the CVA regime may be attractive. The English wrongful trading and disqualification provisions play the role of impetus, as “sticks”, which could urge directors to trigger rescue procedures in order to avoid severe personal liabilities. The newly streamlined administration provides the directors with easy access to rescue by the out of court appointment mechanism as a “carrot”, but this “carrot” may not be attractive to directors because the administration procedure is under the control of an IP rather than directors. Notably, China introduced a modified DIP model and it may encourage directors to initiate reorganization proceedings when they sense impending financial crisis, because the DIP model provides directors with some hope of regaining control. However, this repossession of the debtor is subject to the supervision of the administrator. Although, provisions in some Chinese laws establish “sticks” to prevent directors from doing irrationalities and to force them to take appropriate measures to avoid insolvent liquidation, these “sticks” are not as strict and extensive as those in English laws. In addition, in China’s two-tier board structure, the supervisory board should perform function of supervision as holding a “stick”, but it fails to do so because the supervisory board is not powerful in the corporate governance. Future legislation may consider strengthening the position of the supervisory board and confer real powers upon the members of the supervisory board.

In the UK, the claims of employees are conferred preferential status in the queue of distribution when their employer is in insolvent liquidation. Their unpaid wages and social insurance can be met by the National Insurance Fund in the context of insolvency. The TUPE Regulations 2006 provide the affected employees in a transfer



of insolvent businesses with sufficient protection. In contrast to the British counterpart, Chinese bankruptcy laws have assumed too many social responsibilities for workers which are supposed to be shared by the government agencies that are in charge of social welfare. This explains why workers are always a strong interested group in corporate bankruptcy and rescue regimes. The new bankruptcy law brings more entitlements to employees who could have a voice regarding the rescue arrangement and vote for the approval of a reorganization proposal. The basic aim of Chinese political policy is to maintain social stability. Instability may be invoked by the large-scale bankruptcy of enterprises, especially state-owned enterprises.<sup>154</sup> The protest of thousands of laid-off workers regarding their claims to unpaid wages, social insurance and their requests for a new job may escalate the conflict between labour and government, and lead to social unrest. In so far as the Chinese legal reformers are concerned, they attempt to design rules to weaken the labour's strong position and prevent the government from stepping in under the bankruptcy and rescue legal framework. The key issue is to build a developed social security system as sufficient and effective as the British counterpart to release the fear of bankruptcy of both the workers and government. Although the reform to social security is on-going, it will take time to form a system as adequate as that of England.

Traditionally, the Crown debts in both England and China enjoyed preferential status in the insolvency regime. This situation has changed in England since the Crown preference was abolished under the reforms of the Enterprise Act 2002. However, in China, the preference of state claims remains unchanged, and the state plays multiple roles under the current bankruptcy law framework. The government agencies are likely to assist ailing SOEs with financial aids even though China has entered WTO. The Chinese government tends to bail out large SOEs when they are financially distressed under political, economic and social reasons. In England, the government cannot step in and simply provide economic aids to an ailing firm because the EU

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<sup>154</sup> There were some cases of labour unrest in A Tang *Insolvency in China and Hong Kong: A Practitioner's Perspective* (Sweet & Maxwell Asia, 2005), para.3.24.

state aid laws regulate the state behaviour. This is the fundamental difference between England and China in relation to corporate rescue.

## Chapter VI: Conclusion

Corporate rescue laws, which aim to reorganize and preserve viable businesses, give honest but unfortunate entrepreneurs a second chance, and concomitantly benefit creditors as a whole, are necessary to boost the economy and avoid the domino effect of corporate failure. Corporate rescue procedures provide an alternative to liquidation when a company is near insolvency. Normally, there will be an automatic stay during rescue proceedings on debt enforcement by individual creditors and repossession of property of relevant property right holders. This moratorium allows the distressed company to negotiate with creditors under the assistance of insolvency professionals to seek a practical reorganization proposal which needs to be approved by the majority of creditors, and the sanction of court as well in some jurisdictions. New financing is desperately needed for the ailing company to keep the business continuing.<sup>1</sup>

The corporate rescue culture of the UK was established by the IA 1986 which introduced two remarkable rescue-oriented regimes, respectively the CVAs and administration under the recommendation of the Cork Committee. CVAs were intended to provide a cheap, quick and effective ground for small ailing firms as a means of reaching a composition or reorganization agreement with binding effect on the company and its creditors. Administration was perceived as a “hybrid procedure combining the exceptional powers of floating charge receivership with an altered set of objectives, based on collectivity of approach and a rescue-oriented mission”<sup>2</sup> It should be noted that a series of reforms were brought by the IA 2000 and the EA 2002 with a view to improving the old legislations concerning CVAs and administration which were underused and ineffective. In China, the new bankruptcy

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<sup>1</sup> G McCormack, “Control and corporate rescue – an Anglo-American evaluation” (2007) 56 I.C.L.Q. 515; G McCormack, “Super-priority new financing and corporate rescue” [2007] J.B.L. 701.

<sup>2</sup> IF Fletcher “UK Corporate Rescue: Recent Developments—Changes to Administrative Receiverships, Administration, and Company Voluntary Arrangements—The Insolvency Act 2000, The White Paper 2001, and the Enterprise Act 2002” (2004) 5 EBOR 119, 125.

law, which came into force in June 2007, is an important development for the Chinese economy, since it provides for the first time a legislative mechanism for the restructuring of both private companies and SOEs.<sup>3</sup> The Chinese reorganization procedure was designed by referring to the US Chapter 11, but it was not a direct transplant. It is the most eye-catching feature of the new bankruptcy law and represents the new Chinese rescue culture.

Undoubtedly, there are fundamental differences between British and Chinese corporate rescue laws. The first difference is institutional divergence which in essence explains two different institutional arrangements governing bankruptcy proceedings in the two countries.<sup>4</sup> In the UK, the insolvency practitioners play dominant roles and enjoy wide powers in the administration regime. The rescue proceedings are driven by the IPs rather than court, which is not involved in the rescue process except making directions to the IPs or resolving litigation. In contrast, China's new bankruptcy law is a court-centralised framework in which the court dominates the liquidation and corporate rescue procedures rather than IPs and creditors.<sup>5</sup> Every major step of corporate insolvency proceedings is under the control and close supervision of the court from the initiation of the bankruptcy or reorganization procedure to the end of a case. The Chinese court plays a crucial role in deciding all the administrator-related issues, including the qualification, appointment, removal and remuneration of the administrator.<sup>6</sup> The Chinese IPs may envy their British counterparts who enjoy strong power in the revamped administration regime. For instance, the British administrator under the new legislation of administration is entitled to dispose of assets and make a payment to

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<sup>3</sup> R Parry and H Zhang, "China's New Corporate Rescue Law: Perspectives and Principles" (2008) 8 JCLS 113.

<sup>4</sup> L Qi, "The rise of the pre-packaged corporate rescue on both sides of the Atlantic" (2007) 20 *Insolv. Int.* 129, 130.

<sup>5</sup> R Parry and H Zhang, "China's New Bankruptcy Law: Notable Features and Key Problems of Enforcement" (forthcoming)

<sup>6</sup> J Shi, "Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy" (2007) 16 *Norton Journal of Bankruptcy law and Practice* 645.

creditors or make distributions to employees with the intention of achieving the purpose of administration. However, when the Chinese IPs dispose of the debtor's assets, they have to report to the creditors' committee or the court (if the creditors' committee is not established) immediately.<sup>7</sup> It can be deduced that if the administrator fails to make the report in time, or if this report of assets disposal is objected by the creditors' committee or the court, the administrator cannot carry out such a scheme. Otherwise, the administrator will face legal challenge.<sup>8</sup> However, concerns may be raised regarding the court-driven model in the Chinese context. Undoubtedly, the overarching functions of the court will impose a heavy workload on the judiciary, which will increase the expense and time consuming nature of proceedings. As far as IPs are concerned, accountants dominate the British insolvency business market, and lawyers primarily act as assistants and advisers to the accountants who are normally appointed to be the office-holders, such as administrator or liquidator.<sup>9</sup> In China, lawyers dominate the market. It can be evidenced by the roster of administrators in Beijing. There are 100 intermediary agencies which have been qualified by the Beijing Provincial High Court in 2007, including 65 law firms, only 33 accounting firms and 2 bankruptcy & liquidation firms.<sup>10</sup>

In addition, it should be noted that the British and Chinese corporate insolvency laws are built on the basis of different value-oriented policy aims. The British corporate insolvency law is a typical pro-creditor regime. To be more exact, it is a secured creditor-friendly framework. Historically, the secured creditors in the UK, normally the banks, enjoyed a very secured and comfortable position by means of administrative receiverships which provided them with a quick and effective

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<sup>7</sup> Bankruptcy Law 2006, article 69.

<sup>8</sup> Bankruptcy Law 2006, article 130.

<sup>9</sup> J Flood and E Skordaki, "Normative Bricolage: Informal Rule-making by Accountants and Lawyers in Mega-insolvencies" in G Teubner (ed), *Global Law Without A State* (Aldershot: Dartmouth, 1997), p112.

<sup>10</sup> Information is available at [http://www.unilawyers.com/news/2008/0104/article\\_2938.html](http://www.unilawyers.com/news/2008/0104/article_2938.html) (last visit 31 July 2008)

enforcement approach without accountability to ordinary unsecured creditors. The following is a vivid description of the British banks from the perspective of an American.

“...if an American Banker is very, very good, when he dies he will go to the United Kingdom. British Banks have far more control than an American secured lender could ever hope to have. Receiverships on the British model are unknown and almost unthinkable in the US. A US Banker could barely imagine a banker’s Valhalla in which a bank could veto a reorganization as a UK bank may effectively veto an administration by appointing an administrative receiver.”<sup>11</sup>

Although administrative receivership has been virtually abolished and replaced by the new style administration, the secured creditors still hold strong power in the new corporate rescue-oriented administration. For instance, the bank as a qualifying floating charge holder is entitled to appoint an administrator out of court.<sup>12</sup> The new administration regime arguably provides sufficient protection to the interests of secured creditors. It is stipulated that the administrator’s statement of proposals shall not include terms which may affect the right of a secured creditor of the company to enforce his security.<sup>13</sup> In addition, it should be noted that there is no ‘cramdown’ provision in the British administration procedure.<sup>14</sup> In other words, the objection of secured creditors to the statement of proposals cannot be overridden by the court.<sup>15</sup> However, in China’s reorganization regime, the class of secured creditors can be crammed down if certain conditions are satisfied.<sup>16</sup>

Compared with the British pro-creditor model, the Chinese enterprise bankruptcy legal framework can be treated as a pro-employee model on account of complicated

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<sup>11</sup> J Westbrook, “A Comparison of Bankruptcy Reorganization in the US with Administration Procedure in the UK” (1990) 6 *Insolvency law & Practice* 86, 87.

<sup>12</sup> Although some reports indicate that the banks do not prefer to make appointment and instead encourage the directors of the financially troubled firms to appoint administrator out of court, the banks may still exert influence on the identity and selection of IPs. A Katz and M Mumford, *Study of Administration Cases*, Report to the Insolvency Service in October 2006, p33; J Armour, A Hsu and A Walters, *The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings*, A Report Prepared for the Insolvency Service in December 2006, p17-18.

<sup>13</sup> IA 1986, Sch B1, para.73(1)(a).

<sup>14</sup> V Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP Cambridge 2002), p196.

<sup>15</sup> McCormack, above n.1, at 515.

<sup>16</sup> Bankruptcy Law 2006, article 87.

historical, economic and political factors. During the economic transition, the poor social security system made legal reformers pay more attention to the protection of labour interests. A past example in the short history of China's bankruptcy law practice was "planned bankruptcy" which was initiated by the State Council in the mid-1990s on the basis of regulations and policies in respect of the insolvency of state-owned enterprises; and primarily aimed to resolve labour claims at the expense of the interests of secured creditors. China's new bankruptcy law also emphasizes the protection of the workers of insolvent firms. First, the new legislation has conferred preferential status on labour claims which have priority over claims of state and unsecured creditors.<sup>17</sup> In addition, the labour claims are not confined to unpaid wages and social insurance. They also include compensation fees which should be paid according to relevant laws and administrative regulations.<sup>18</sup> More importantly, there is no limit to the amounts of the labour claims with preference. Second, there is a compulsory requirement that there should be one representative of employees in the creditors' committee.<sup>19</sup> Therefore, this employees' representative could play the function of supervising the administrator's conduct during the bankruptcy or reorganization proceedings on behalf of all the employees. In this sense, it is submitted that the employees may be informed and consulted by their representative, and accordingly exert influence over the action of administrator and scheme of reorganization through their representative. Third, in the process of voting on a reorganization proposal, there should be a voting group of employees who can approve or reject the rescue proposal.<sup>20</sup> Obviously, the super preference of employees' claims in the distribution of the insolvent estate and their entitlements to be involved in the bankruptcy and reorganization proceedings reflect the government's policy aims of protecting employees which surely justify the view that China's bankruptcy law is a pro-employee model. It should be added that from the perspectives of the British revamped administration regime and the Chinese modified

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<sup>17</sup> Bankruptcy Law 2006, article 113.

<sup>18</sup> Bankruptcy Law 2006, article 82.

<sup>19</sup> Bankruptcy Law 2006, article 67.

<sup>20</sup> Bankruptcy Law 2006, article 82.

reorganization procedure, the insolvency law reforms of both countries indicate a functional convergence towards a rescue culture which seeks to preserve the financially distressed but economically viable firms. In essence, corporate rescue laws are an effective debtor-friendly legal framework to the rehabilitation of troubled firms which the legal reformers of both governments are seeking.

The third major difference of the British and Chinese corporate rescue laws is who is entitled to take control over the governance of the reorganization procedure. In the UK, the corporate reorganization proceedings opt for the manager-displacing model in which the process of a rescue attempt is under the complete control of an outside IP. Although the existing directors remain in office, their powers are handed over to an external administrator who may be appointed by a qualifying floating charge holder, the company or its directors, or the court in administration. This manager-displacing model was built upon the mindset of management-blaming which was deeply rooted in the UK, and made the attitude towards corporate failure and the pre-petition management of a distressed firm different from the culture and situation of the US. It was observed that

“[i]n England insolvency, including corporate insolvency, is regarded as a disgrace. The stigma has to some extent worn off but it is nevertheless still there as a reality. In the United States business failure is very often thought of as a misfortune rather than wrongdoing. In England the judicial bias towards creditors reflects a general social attitude which is inclined to punish risk takers when the risks go wrong and side with creditors who lose out. The United States is still in spirit a pioneering country where the taking of risks is thought to be a good thing and creditors are perceived as being greedy.”<sup>21</sup>

Comparatively, the control and management structure of China’s new rescue law borrowed the feature of the US debtor-in-possession model and established a modified reorganization procedure. Once an application for reorganization is accepted by a court, the court shall appoint an administrator who will take control of the debtor’s property and business affairs from the hands of the existing management. This arrangement resembles the British practitioner-in-possession model. However, the debtor could apply to the court for a sanction of DIP. If the application is granted,

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<sup>21</sup> G Moss, “Chapter 11: An English Lawyer’s Critique” (1998) 11 *Insolv. Int.* 17, 18.



the existing directors and managers of the debtor will regain control over the governance of the reorganization. This control is not exclusive since the conduct of the directors and managers is subject to the supervision of the administrator, who could initiate a legal challenge to their negligence and misbehaviour. It can be perceived that the corporate control and governance of China's reorganization regime is different from the UK administration model because the existing directors and managers do not lose their management functions to an external and impartial IP. The outside IP will play a supervisory function in China's modified DIP which constitutes the fundamental difference from the US approach. In essence, the Chinese DIP model combines the main features of the US and the UK corporate rescue laws, and this model appears in line with the guidelines regarding international insolvency legislation.<sup>22</sup>

Fourth, there is an obvious difference in the prevention of eventual corporate failure between the British and Chinese corporate insolvency laws. The UK insolvency law reforms established the "sticks and carrots" approach and the out of court appointment mechanisms which purport to place the troubled firms in the rescue-oriented administration procedure at an early stage. The "sticks", such as wrongful trading liability and directors disqualification provisions, could encourage directors to invoke rescue proceedings promptly when the company approaches insolvency. If the directors continue trading in the circumstances where there is no reasonable prospect that the company could avoid insolvent liquidation, such directors may incur severe personal liabilities. The "sticks" may deter directors of ailing firms from taking over-risky activity, thus the introduction of wrongful trading could effectively prevent the abuse of limited liability at the expense of creditors, avoid corporate failure, encourage early filing of a reorganization case and concomitantly boost the rescue culture. However, the wrongful trading provision is not sufficient in itself to ensure that a troubled firm can be put into rescue

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<sup>22</sup> The World Bank, *Principles for Effective Insolvency and Creditor Rights Systems* (Revised Draft, 2005), para.C6.2.

proceedings at an early stage. Efficient and quick access to administration is also required. The 2002 reforms established the out of court appointment approach which enables the directors of a distressed company to initiate administration as soon as possible when needed.<sup>23</sup> The British corporate insolvency proceedings have therefore established an effective system to ensure the early entry of an ailing firm into administration, but there are no equivalent counterparts in China's bankruptcy legal framework. No relevant provisions similar to the UK wrongful trading can be found in either the Company Law 2005 or the Enterprise Bankruptcy Law 2006. The "sticks" in Chinese law are not strict and extensive. The Chinese reorganization procedure establishes a DIP model which provides existing board of directors with some hope of regaining control of the company in the rescue process. In short, the UK is more inclined to use "sticks" to ensure that directors behave properly and put the ailing company into rescue proceedings in a timely manner. However, the Chinese bankruptcy law may enable the directors to have the right incentives by using the DIP as a "carrot".

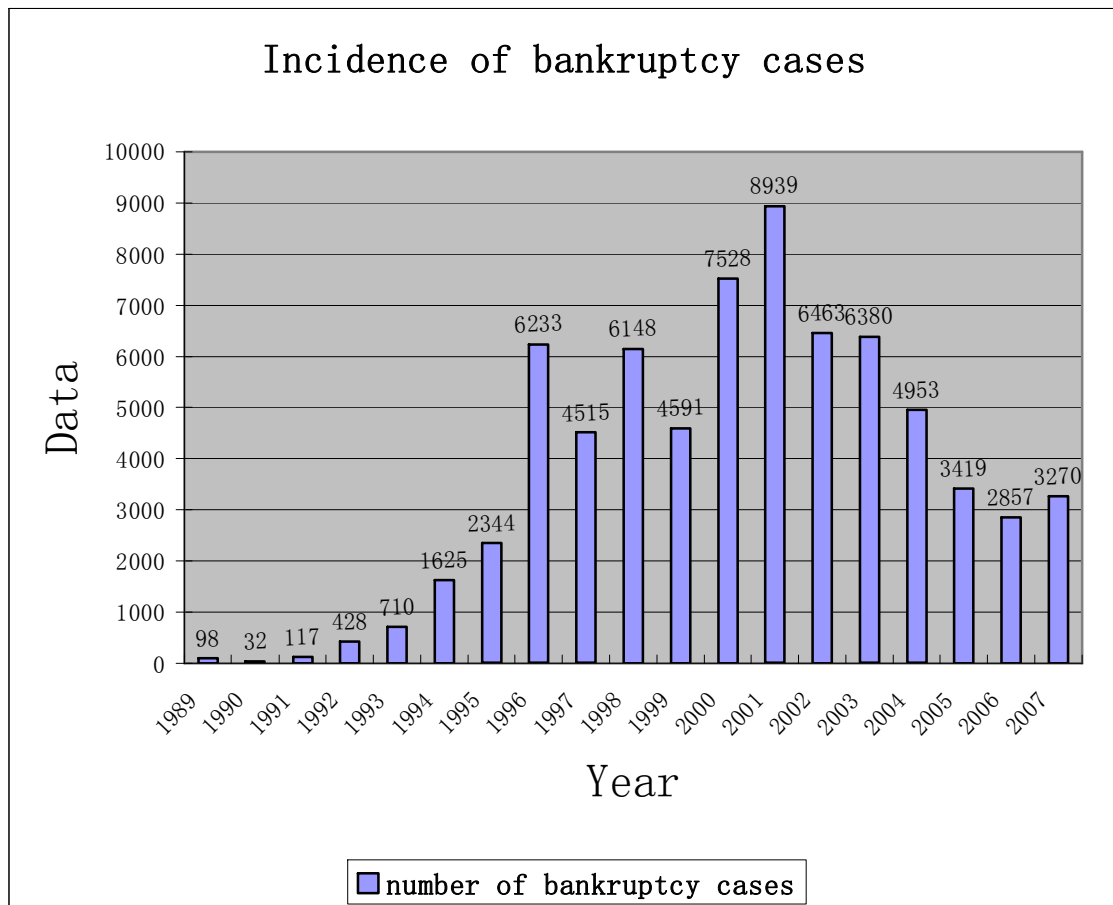
From the perspective of the implementation of China's new corporate rescue laws, it can be perceived that the reorganization procedure is so far underused and inefficient. The weak enforcement can be explained by a series of reasons including ineffective access to the reorganization proceedings, court's undue involvement in the procedure and administrator-related issues, loose drafting of the Chinese DIP model and lack of new financing. In addition to the legal reasons, there are some other factors like the administrative intervention, the skill gap of insolvency professionals, the lack of competent and experienced judges and insolvency practitioners and the weak social security system. The thesis has come up with some suggestions and solutions to some of the above problems. In the long run, all these problems can be resolved with the development of Chinese bankruptcy law reforms. The Supreme People's Court has organized a bankruptcy law expert committee including judges, insolvency

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<sup>23</sup> IA 1986, Sch B1, para.22.

practitioners and academic staff since the new bankruptcy law was implemented in June 2007, and the mission of this committee is to produce a judicial interpretation addressing the problems which have occurred in judicial practice. Hopefully, this thesis could provide some new thought and insight for the consideration of Chinese legal reformers.

## Appendix I: The Statistics of Enterprise Bankruptcy Cases in China (1989-2007)



Statistics are available at <http://www.caosy.com/view.asp?id=71> (last visit on 31 July 2008)

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