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## The Curious Case of Inactive Bankruptcy Practice in China: A Comparative Study of U.S. and Chinese Bankruptcy Law

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# The Curious Case of Inactive Bankruptcy Practice in China: A Comparative Study of U.S. and Chinese Bankruptcy Law

*By Yujia Jiang\**

*Abstract: The current Chinese bankruptcy law has been enacted and effective for seven years, with academic discussions and judicial decisions emerging at a rapid speed. However, reorganization practice in China is considerably less active than that in the United States. This Note provides an overview of the current state of Chinese bankruptcy law from a comparative perspective and tries to discern some possible explanations for China's inactive bankruptcy practice. After introducing the major provisions under Chinese bankruptcy law and comparing them to their U.S. counterparts, this Note identifies several possible factors that could discourage bankruptcy practice in China, all of which relate to the overly broad judicial discretion and government involvement in Chinese bankruptcy practice.*

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TABLE OF CONTENTS

I. Introduction .....	560
II. Initiating Mechanism Under Chinese and U.S. Bankruptcy Laws ..	563
A. The Limited Concept of Debtors in China .....	563
B. Filing a Claim: Chinese Court's Broad Discretion in Deciding Whether to Accept a Case.....	565
1. Debtor's Restricted Access to Reorganization in China ...	566
2. The Chinese Court's Broad Discretion in Deciding Whether to Accept a Case .....	568
C. The Ineffective Automatic Stay Regime in China.....	570
III. During the Reorganization: The Limited Role of a Bankruptcy Administrator in China.....	572
A. The Qualification of Administrators.....	572
B. The Appointment of Administrators.....	573
C. Comparative Perspective: A Debtor's Inability to Control Operations During Reorganizational Proceedings .....	574
IV. Distribution: Priorities, Voting, and Cramdown .....	576
V. After Reorganization: Management's Potential Exposure to Civil Liabilities .....	578
VI. Case Studies: Why Does East Star Airline Have to Liquidate?.....	579
VII. Conclusion .....	582

I. INTRODUCTION

In 2006, China passed a modern Enterprise Bankruptcy Law (2006 EBL), which provides for a reorganization mechanism that allows a company to rearrange its business affairs without liquidation.<sup>1</sup> With the recent global economic slowdown, reorganization cases have become a focus of legal studies in China.<sup>2</sup> However, the reorganization practice in

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<sup>1</sup> Zhonghua Renmin Gongheguo Qiye Pochan Fa (中华人民共和国企业破产法) [Enterprise Bankruptcy Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 27, 2006, effective June 1, 2007), Lawinfochina (北大法律英文网), ch. 8 [hereinafter 2006 EBL].

<sup>2</sup> For general discussion of reorganization in China by Chinese scholars after the passage of the new bankruptcy law, see Qi Ming (齐明), *Lun Pochan Chongzheng Zhong de Gongsì Zhili* (论破产重整中的公司治理) [*Corporate Governance in Insolvency Reorganization*], 23 DANGDAIFAXUE (当代法学) [CONTEMP. L. REV.] 133 (2009); Wang Xinxin (王欣新), *Chongzheng Zhidu Liluny Shiwu Xinlun* (重整制度理论与实务新论) [*Contemporary Analysis of the Reorganization Theory and Practice*], 11 FALÜSHIYONG (法律适用) [J.L. APPLICATION] 10 (2012); Zhang Yanli (张艳丽), *Chongzheng Jihua Bijiao Fenxi* (重整计划比较分析) [*Comparative Analysis about Reorganization Plan*], 4 FaxueZazhi (法学杂志) [L. SCI. MAG.] 80 (2009); Zhao Hongren (赵泓任), *Qiye Pochan Chongzheng Jihua Kexingxing de Falü Fenxi* (企业破产重整计划可行性的法律分析) [*Legal Analysis About the Feasibility for the Reorganization Plan of Corporate Bankruptcy*], 6 FAXUEZAZHI (法学杂志) [L. SCI. MAG.] 137 (2010).

China is much less active than that in the United States. In 2009, bankruptcy filings totaled 1,473,675 in the United States while the number of accepted bankruptcy applications in China reached only 2,434.<sup>3</sup> Ironically, the number of accepted bankruptcy applications declined following the enactment of China's new bankruptcy law.<sup>4</sup> Through an analysis of the statute and various case studies, this Note analyzes reasons for that inactivity.

China only passed its modern Bankruptcy Law seven years ago.<sup>5</sup> Thus, it faces many new challenges and shortcomings as compared to the much more advanced bankruptcy law system in the United States.<sup>6</sup> Various reasons have been proposed for the relatively inactive bankruptcy practice in China,<sup>7</sup> however, the fundamental reason seems to be China's deep-rooted belief in collectivism and its tradition of allocating more active roles to the court and government throughout the dispute resolution process.<sup>8</sup> Although China has made various efforts to move towards a more adversarial system so as to build an impartial judicial organ, it is still facing many difficulties with the prevalent inquisitorial system.<sup>9</sup> The active roles of court and government agencies reflect the view that the dispute resolution system in China is a matter of collective concern rather than a private matter, which is rooted in the Chinese majoritarian preferences for social stability.<sup>10</sup> It also illustrates a tendency in Chinese society to favor the interest of a group over individuals and to deemphasize private rights.<sup>11</sup> This tendency leads to more discretion and power, both in the courts and in the government agencies.<sup>12</sup> In contrast, the U.S.

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<sup>3</sup> Karen Redmond, *Growth in Bankruptcy Filings Slows in Calendar Year 2010*, U.S. COURTS (Feb. 15, 2011), [http://www.uscourts.gov/news/newsview/11-02-15/growth\\_in\\_bankruptcy\\_filings\\_slows\\_in\\_calendar\\_year\\_2010.aspx](http://www.uscourts.gov/news/newsview/11-02-15/growth_in_bankruptcy_filings_slows_in_calendar_year_2010.aspx); Cao Siyuan (曹思源), *Qiyè Pochan An Chuang 14 Nian Zuidi de Fansi* (企业破产案创14年最低的反思) [*Examination of the Lowest Bankruptcy Case Number in 14 Years*], 2 HU-GANG JING JI (沪港经济) [SHANGHAI & H.K. ECO.] 20 (2010).

<sup>4</sup> See Cao, *supra* note 3; see also Anna Ansari, *The 2006 Enterprise Bankruptcy Law of the People's Republic of China: A Further Step Toward the Creation of a Modern Insolvency Framework*, 20 J. BANKR. L. & PRAC. 5, art. 2 (2011) (stating that in 2008, 3,139 cases were accepted, while in 2006, 4,300 cases were accepted).

<sup>5</sup> 2006 EBL, *supra* note 1.

<sup>6</sup> Zhen Li, *Zhongmei Pochan Chongzheng Zhidu Bijiao Yanjiu* (中美破产重整制度比较研究) [Comparative Analysis of Chinese and U.S. Restructuring Systems] (Mar. 15, 2011) (unpublished master dissertation, Shandong University), available at <http://www.doc88.com/p-187718730156.html>.

<sup>7</sup> See Emily Lee, *The Restructuring Process Under China's Corporate Bankruptcy System*, 45 INT'L LAW. 939, 973 (2011) ("Attributive to this are a number of factors such as local protectionism, lack of qualified bankruptcy professionals in China, and certain judges' inclination to apply the more familiar old bankruptcy law over the 2006 EBL.").

<sup>8</sup> Ansari, *supra* note 4.

<sup>9</sup> See Randall Peerenboom, *What Have We Learned About Law and Development? Describing, Predicting, and Assessing Legal Reforms in China*, 27 MICH. J. INT'L L. 823, 844 (2006).

<sup>10</sup> *Id.* at 846.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

adversarial system prefers an impartial role of the court or government agencies.<sup>13</sup> Disputing parties, acting primarily through their lawyers, dominate the litigation process rather than judges or government officials.<sup>14</sup> Specifically, the U.S. Bankruptcy Code, which was adopted in 1978, has transformed the bankruptcy court “from active participant to passive arbiter.”<sup>15</sup>

This Note focuses on the possible negative impact of the court’s active role and government agencies’ excessive involvement in reorganization practice in China. The discussion proceeds as follows: Part II compares the initiating mechanism under the 2006 EBL and U.S. Bankruptcy Code, including who can file for a bankruptcy claim, what constitutes the necessary standards of bankruptcy, and how the automatic stay regime works. This part notes that Chinese courts have broad discretionary power because only limited debtors can file for reorganization under the 2006 EBL. Filing standards for bankruptcy are also vague, which leaves much room for maneuvering. More importantly, the automatic stay regime has serious limitations in China and thus is ineffective in practice. Part III introduces one of the most important players during the reorganization process in China, the administrator. After an overview of the administrator’s qualification and appointment process in China, Part III then compares its U.S. counterpart. Part IV discusses the distribution plan under both the 2006 EBL and U.S. Bankruptcy Code, highlighting that the 2006 EBL provides only limited distribution priorities arrangements to a debtor while the U.S. Bankruptcy Code provides a broad range of possibilities.<sup>16</sup> This reduces a debtor’s chance of getting financing necessary for rehabilitation in China.<sup>17</sup> Furthermore, flexible standards applicable to the confirmation of a reorganization plan reaffirm the court’s discretionary power.<sup>18</sup> Part V continues with a brief overview of the possible exposure of a debtor’s management to civil liabilities in China, while Part VI studies the famous East Star Airline (ESA) case, which raised concerns about the court’s overly broad power and the government agency’s excessive involvement in bankruptcy cases.<sup>19</sup> Finally, Part VII concludes with the general

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<sup>13</sup> *Id.* at 844.

<sup>14</sup> Robert A. Kagan, *Adversarial Legalism: Tamed or Still Wild?*, 2 N.Y.U. J. LEGIS. & PUB. POL’Y 217, 220 (1998).

<sup>15</sup> Walter W. Miller, Jr., *Bankruptcy Code Cramdown Under Chapter 11: New Threat to Shareholder Interests*, 62 B.U. L. REV. 1059, 1066 (1982).

<sup>16</sup> Yongqing Ren, *A Comparative Study of the Corporate Bankruptcy Reorganization Law of the U.S. and China* 181 (July 14, 2011) (unpublished Ph.D. dissertation, University of Groningen), available at <http://irs.ub.rug.nl/ppn/334565847>.

<sup>17</sup> *Id.*

<sup>18</sup> Wang Xinxin & Xu Yanguang (王新欣 & 徐阳光), *Pochan Chongzheng Lifa Ruogan Wenti Yanjiu* (破产重整立法若干问题研究) [*Research on Issues on Bankruptcy Reorganization Legislation*], 1 ZHENGZHI YU FALV (政治与法律) [POL. SCI. & L.] 89, 93 (2007).

<sup>19</sup> See Gao Zhihong (高志宏), *Kunjingyu Chulu: Woguo Pochan Guanliren Zhidu de Xianshi Kaocha* (困境与出路：我国破产管理人制度的现实考察) [*Problems and Solutions: A Practical*

observation that, from a comparative perspective, the broad power of Chinese courts and the excessive involvement of government agencies might be the explanation for inactivity, although more needs to be seen given the limited passage of time since the 2006 EBL enactment.

## II. INITIATING MECHANISM UNDER CHINESE AND U.S. BANKRUPTCY LAWS

China introduced the concept of reorganization in its 1986 Enterprise Bankruptcy Law (Trial Implementation or 1986 EBL).<sup>20</sup> However, under the 1986 EBL, the reorganization practice is only available to state-owned enterprises (SOEs).<sup>21</sup> Also, there were only six provisions dealing with the reorganization process, with no detailed techniques and protective measures.<sup>22</sup> In response to the growing demand of private entity bankruptcies, China has enacted the 2006 EBL that became effective in 2007.<sup>23</sup> The current Chinese bankruptcy regime consists of the 2006 EBL, various administrative regulations, and judicial interpretations promulgated by the Supreme People's Court of the People's Republic of China (SPC).<sup>24</sup>

The following subsections provide an overview of the current Chinese bankruptcy and reorganization regime as compared to U.S. laws. Specifically, Chinese courts have overly broad power because (1) only limited debtors can file for reorganization, (2) the standards of accepting a case are vague under the 2006 EBL, and (3) the automatic stay regime does not work as well in China given the fifteen-day window between a filing and the court's final acceptance of a case.

### A. The Limited Concept of Debtors in China

The 2006 EBL applies to corporate entities, financial institutions, or other organizations.<sup>25</sup> One important difference between the 2006 EBL and the 1986 EBL is that the 2006 EBL applies not only to SOEs, but also to

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*Examination of China's Bankruptcy Administrator System*], 8 FAZHI YANJIU (法治研究) [RES. ON RULE OF L.] 60, 62 (2010).

<sup>20</sup> Zhonghua Renmin Gongheguo Qiye Pochan Fa (Shixing) (中华人民共和国企业破产法(试行)) [Enterprise Bankruptcy Law (Trial Implementation)] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 2, 1986, effective Mar. 2, 1987), Lawinfochina (北大法律英文网) [hereinafter 1986 EBL].

<sup>21</sup> *Id.* art. 2; see also Wang Weidong (王卫东), *Pochan Fa Shiyong Fanweizai Woguo de Bainian Licheng* (破产法适用范围在我国的百年历程) [Research on the History of the Applicability of Bankruptcy Laws in China], 4 SHANGYESHIDAI (商业时代) [COMMERCIAL TIMES] 59, 60 (2008).

<sup>22</sup> 1986 EBL, *supra* note 20, art. 2; see also Lijie Qi, *The Corporate Reorganization Regime Under China's New Enterprise Bankruptcy Law*, 17 INT'L INSOLVENCY REV. 13, 15 (2008).

<sup>23</sup> 2006 EBL, *supra* note 1; see also Xinlin Sun, Zhong Mei Ri Pochan Chongzheng Zhidu Zhi Bijiao Yanjiu (中美日破产重整制度之比较研究) [Comparative Research on Bankruptcy Restructuring System of China, America and Japan] (2006) (unpublished Master's dissertation, Qingdao University).

<sup>24</sup> Lee, *supra* note 7, at 940.

<sup>25</sup> 2006 EBL, *supra* note 1, arts. 2, 134.

private corporate entities.<sup>26</sup> However, as the 2006 EBL only applies to organizations,<sup>27</sup> natural persons who do not qualify for organization status cannot avail themselves of bankruptcy law's protections.<sup>28</sup>

Another breakthrough of the 2006 EBL is that it provided, for the first time, bankruptcy procedures for financial institutions.<sup>29</sup> According to Article 134, financial institutions include, but are not limited to, commercial banks, securities companies, and insurance companies.<sup>30</sup> However, only the State Council's financial supervisory and regulatory institution may file for bankruptcy on behalf of financial institutions for either liquidation or reorganization.<sup>31</sup> Thus, some scholars are skeptical about how useful the newly enacted financial institution bankruptcy proceedings will be in practice.<sup>32</sup>

The U.S. Bankruptcy Code is embodied in Title 11 of the United States Code.<sup>33</sup> It is divided into chapters: Chapters 1, 3, and 5 contain provisions that generally apply to all bankruptcy cases, and the remaining chapters set forth different procedures for distinct kinds of bankruptcy cases.<sup>34</sup> Chapter 11 is designed to straighten out the affairs of corporations in financial distress and will be the focus of this Note.<sup>35</sup> It provides a mechanism for shutting down distressed corporations and sorting out their financial difficulties in a coherent way.<sup>36</sup>

According to the U.S. Bankruptcy Code, only a person who resides in, or has a domicile, a place of business, or property in the United States may file for bankruptcy.<sup>37</sup> Such "persons" include individuals, partnerships, and corporations, but not a government unit.<sup>38</sup> Thus, although there are still concerns over the effectiveness of the U.S. Bankruptcy Code in resolving

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<sup>26</sup> *Id.* art. 2.

<sup>27</sup> *Id.*

<sup>28</sup> See Rakhi I. Patel, *A Practical Evaluation of the People's Republic of China's 2007 Enterprise Bankruptcy Law*, 10 U.C. DAVIS BUS. L.J., 109, 112 (2010); Liu Dingfa & Wu Lei, *Bad News for Debtors*, 27 INT'L FIN. L. REV. 70 (2008); Zhu Shaoping (朱少平), *Qiye Pochan Fa de Tiaozheng Fanwei* (企业破产法的调整范围) [*The Scope of Application of Enterprise Bankruptcy Law*], WUHAN LIGONG DAXUE XUEBAO (武汉理工大学学报) [J. WUHAN U. TECH.] 4, 6 (2007).

<sup>29</sup> 2006 EBL, *supra* note 1, art. 134. For discussions urging the Chinese legislature to enact bankruptcy mechanisms for natural persons, see Qi Ming (齐明), *Lun Woguo Goujian Ziranren Pochan Zhidu de Biyao Xing* (论我国构建自然人破产制度的必要性) [*The Necessity of Introducing Bankruptcy Mechanism for Natural Persons in China*], 21 DANGDAIFAXUE (当代法学) [CONTEMPORARY L. REV.] 94 (2007).

<sup>30</sup> 2006 EBL, *supra* note 1, art. 134.

<sup>31</sup> *Id.*

<sup>32</sup> See Patel, *supra* note 28, at 114–15 (“[I]t is unlikely that we will see any of these institutions actually face bankruptcy in the near future.”).

<sup>33</sup> DOUGLAS G. BAIRD, *ELEMENTS OF BANKRUPTCY* 4 (5th ed. 2010).

<sup>34</sup> *Id.* at 6.

<sup>35</sup> *Id.* at 18.

<sup>36</sup> *Id.*

<sup>37</sup> 11 U.S.C. § 109(a) (2011).

<sup>38</sup> 11 U.S.C. § 101(41) (2010).

failed complex financial institutions,<sup>39</sup> no supervisory authority needs to file for bankruptcy on behalf of financial institutions.<sup>40</sup> Unless a special regime is in place, such as those for banks or insurance companies, Chapter 11 of the Bankruptcy Code remains the primary instrument for resolving bankruptcy of financial institutions.<sup>41</sup> Furthermore, a natural person can also invoke bankruptcy law in the United States under Chapter 7 or Chapter 13 of the Bankruptcy Code.<sup>42</sup> The decision to separate the treatment of corporate and individual bankruptcy in the United States, however, does not imply that one is more important than the other.<sup>43</sup> Rather, the division is in response to different policies and practices in these two categories.<sup>44</sup> Because human beings cannot be terminated the way corporate entities can, individual bankruptcy cases are oriented more towards the economic rehabilitation of the debtor than that of their corporate counterparts.<sup>45</sup>

In this sense, the U.S. Bankruptcy Code applies to a broader group of people, with fewer restrictions, than the 2006 EBL in China. This affords courts with less power to filter out reorganization cases at its discretion.<sup>46</sup>

#### B. Filing a Claim: Chinese Court's Broad Discretion in Deciding Whether to Accept a Case

In addition to the fact that only a selective group of people can file for bankruptcy, Chinese courts also have more power because debtors are given less opportunity to reorganize through the court system. This is due to the fact that conversion from complete liquidation to reorganization is more difficult in China once a creditor files for liquidation.<sup>47</sup> Furthermore, given the ambiguous standards that govern whether a court will “accept” a case under the 2006 EBL, a Chinese court has much more discretion than a U.S. court.<sup>48</sup>

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<sup>39</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-707, *BANKRUPTCY: COMPLEX FINANCIAL INSTITUTIONS AND INTERNATIONAL COORDINATION POSE CHALLENGES* (2011).

<sup>40</sup> See 11 U.S.C. § 109 (2011).

<sup>41</sup> Stephen J. Lubben, *Financial Institutions in Bankruptcy*, 34 SEATTLE U. L. REV. 1259, 1264 (2011).

<sup>42</sup> In contrast, an ordinary corporation can file either a Chapter 7 or a Chapter 11 petition. However, a corporation usually finds itself in Chapter 7 only after first having tried unsuccessfully to reorganize under Chapter 11. BAIRD, *supra* note 33, at 17–18.

<sup>43</sup> ELIZABETH WARREN, *CHAPTER 11: REORGANIZING AMERICAN BUSINESSES* 3 (2008).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> Li Dongfang & Zhang Lisha (李东方 & 张丽莎), *Zhongwai Pochan Lifa Ruogan Zhongda Wenti de Bijiao* (中外破产立法若干重大问题的比较) [*Comparison of the Key Issues in Chinese and Foreign Bankruptcy Legislations*], 10 CAIKUAI XUEXI (财会学习) [STUD. OF FINANCING & ACCT.] 19, 19 (2006).

<sup>47</sup> Once a creditor has filed for liquidation in China, the debtor or its major capital contributor may not freely pursue reorganization, but must apply to the court to convert the ongoing liquidation proceeding to reorganization. See 2006 EBL, *supra* note 1, art. 70.

<sup>48</sup> In China the bankruptcy test under the 2006 EBL is still ambiguous, while in the United States

1. *Debtor's Restricted Access to Reorganization in China*

According to Article 7 of the 2006 EBL, both debtor and creditor may file for complete liquidation.<sup>49</sup> A debtor may file for liquidation in two situations: (1) when the debtor cannot pay off the current debts due, and the assets are unavailable to pay off all of the debts, taking into account both the debts currently due and those that will become due in the future,<sup>50</sup> and (2) when the debtor apparently lacks the ability to pay off his or her debts now or in the future, regardless of the debtor's actual ability to pay.<sup>51</sup> It is difficult to tell the difference between the two situations, though the second is easily met once a creditor has evidence to support a reasonable belief that the debtor cannot pay off his or her debts, even if the debtor is still generating income.<sup>52</sup> The two tests for liquidation filings appear to be very vague, and the 2006 EBL provides no guidance on how to differentiate them.<sup>53</sup> This could be one aspect of the 2006 EBL where "further legislation or interpretation from the People's Supreme Court of China" is needed.<sup>54</sup>

A creditor may also file for involuntary liquidation against the debtor if the debtor fails to file for bankruptcy.<sup>55</sup> A creditor may file these involuntary bankruptcy applications if the debtor cannot pay off his or her debts when they become due.<sup>56</sup> Thus, unlike in the United States, there is no requirement that liabilities actually exceed assets in order to file for bankruptcy in China.<sup>57</sup> However, when the creditor submits an involuntary application, the court must inform the debtor within five days of the filing date.<sup>58</sup>

Similar to the U.S. mechanism, applications for liquidation and reorganization are closely related in China. A debtor who meets either of the two tests for bankruptcy application may freely file for reorganization, unless the creditor has made an involuntary liquidation filing.<sup>59</sup> Article 2 also allows reorganization if the debtor has apparently forfeited the ability

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the courts have developed a clear financial distress standard. See discussion *infra* Part II.B.2.

<sup>49</sup> 2006 EBL, *supra* note 1, art. 7.

<sup>50</sup> Qi, *supra* note 22, at 17; Roger Frankel & Debra I. Felder, *Close, But No Cigar*, 26 INT'L FIN. L. REV. 48 (2007).

<sup>51</sup> 2006 EBL, *supra* note 1, arts. 2, 7.

<sup>52</sup> 2006 EBL, *supra* note 1, arts. 2, 7.

<sup>53</sup> Patel, *supra* note 28, at 112.

<sup>54</sup> See David L. Eaton et al., *China's New Enterprise Bankruptcy Law*, 2 PRATT'S J. BANKR. L. 543, 545 (2007).

<sup>55</sup> 2006 EBL, *supra* note 1, art. 7.

<sup>56</sup> *Id.*

<sup>57</sup> Patel, *supra* note 28, at 113.

<sup>58</sup> 2006 EBL, *supra* note 1, art. 10.

<sup>59</sup> *Id.* art. 2.

to pay off its debts.<sup>60</sup> The application for reorganization can be filed either independently or during the liquidation proceeding.<sup>61</sup> However, unlike its U.S. counterpart, the 2006 EBL does not allow flexible conversion from liquidation to reorganization. Once the liquidation proceeding has been initiated by the creditor pursuant to Article 70 of the 2006 EBL, the debtor or its major capital contributor must apply to the court to convert the ongoing liquidation proceeding to reorganization to prevent the enterprise from being wound up.<sup>62</sup> Thus, the court has the discretion to either convert the case or to continue the liquidation.<sup>63</sup> It is not clear whether, or even how, the creditor may convert the case from liquidation into reorganization; the issue is not addressed by the 2006 EBL and case law is not a binding authority in China.<sup>64</sup>

In the United States, both voluntary and involuntary filings are possible.<sup>65</sup> A voluntary case is commenced when a debtor files for bankruptcy.<sup>66</sup> This commencement also serves as an “order for relief,” which means that a proper voluntary filing alone satisfies the conditions necessary for the automatic stay regime to apply and for a court to administer the case.<sup>67</sup> In contrast, more conditions need to be met for involuntary filings,<sup>68</sup> which require three or more creditors who hold non-contingent claims against the debtor adding up to at least \$14,425 of unsecured or under-secured debt.<sup>69</sup> Furthermore, an involuntary filing does not constitute an order for relief.<sup>70</sup> Rather, the bankruptcy court will only issue an order for relief if the petition is not “controverted” by the debtor.<sup>71</sup> If the petition is controverted, the court will order relief only if the debtor is “generally not paying” debts as such debts become due.<sup>72</sup>

In addition to providing detailed guidance for involuntary filings, the U.S. Bankruptcy Code provides more opportunities for reorganization by allowing liquidation cases to be easily converted into reorganizations.<sup>73</sup>

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<sup>60</sup> *Id.*

<sup>61</sup> *Id.* art. 70.

<sup>62</sup> *Id.*; see also Chen Bao, *Comparative Studies of China's Enterprise Bankruptcy Law and the U.S. Bankruptcy Law*, 19 J. BANKR. L. & PRAC. 599, 605 (2010); Ren, *supra* note 16, at 189.

<sup>63</sup> 2006 EBL, *supra* note 1, art. 70.

<sup>64</sup> John J. Rapisardi & Binghao Zhao, *A Legal Analysis and Practical Application of the PRC Enterprise Bankruptcy Law*, 11 BUS. L. INT'L 49, 50 (2010).

<sup>65</sup> 11 U.S.C. §§ 301, 303 (2010).

<sup>66</sup> *Id.* § 301.

<sup>67</sup> *Id.*; see also BARRY E. ADLER ET AL., *BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS* 66 (4th ed. 2007).

<sup>68</sup> 11 U.S.C. § 303.

<sup>69</sup> *Id.* § 301.

<sup>70</sup> ADLER ET AL., *supra* note 67, at 68.

<sup>71</sup> 11 U.S.C. § 303(h).

<sup>72</sup> *Id.* § 303(h)(1).

<sup>73</sup> See *In re Mead*, 28 B.R. 1000, 1002 n.3 (E.D. Pa. 1983) (arguing that the policy goal of the case conversion sections in the Bankruptcy Code is to give the debtor the right and opportunity to conduct a

Debtors subject to an involuntary Chapter 7 liquidation filing enjoy an absolute right to convert that liquidation proceeding into a voluntary reorganization case, provided that they are otherwise eligible for relief under Chapter 11.<sup>74</sup> By stipulating that any waiver of the right to convert a case is unenforceable, the U.S. Bankruptcy Code provides the debtor with more opportunities to reorganize.<sup>75</sup> Such a conversion may be accomplished either before or after an order for relief has been entered in the involuntary case.<sup>76</sup> Furthermore, unlike the 2006 EBL, under which a creditor may not convert a liquidation case into reorganization, the U.S. Bankruptcy Code allows any “party in interest” (including creditors and the U.S. Trustee) to request the court to convert voluntary or involuntary Chapter 7 proceedings into Chapter 11 proceedings at any time.<sup>77</sup> Consequently, in the United States, debtors are given more opportunities to pursue reorganizations and the court has only limited power to prevent them from doing so.

## 2. *The Chinese Court’s Broad Discretion in Deciding Whether to Accept a Case*

Another important difference between the U.S. and Chinese bankruptcy law is that, following a bankruptcy filing, a Chinese court has fifteen days to consider whether to accept the application and a bankruptcy case does not begin until it is accepted.<sup>78</sup> This deadline can be extended to another fifteen days under special circumstances.<sup>79</sup> In contrast, a reorganization case formally begins in the United States when the debtor or a creditor files for bankruptcy.<sup>80</sup> Thus, in the United States, the debtor may use voluntary filing strategically.<sup>81</sup> Under the 2006 EBL, the debtor *applies* for bankruptcy, and the court has discretion whether to *accept* the application or not.<sup>82</sup> Such a decision may not occur within fifteen days of the application, and the ambiguous rule regarding the two bankruptcy tests discussed in Part II.B.1 allows the Chinese court to have broad discretion over what criteria to use.<sup>83</sup>

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reorganization for the purpose of repaying debts).

<sup>74</sup> See generally W. HOMER DRAKE, JR. & KAREN D. VISSER, *BANKRUPTCY PRACTICE FOR GENERAL PRACTITIONER* §§ 6:7, 11:10 (3d ed. 2011); PATRICK A. MURPHY & ERIC SAGERMAN, *CREDITORS’ RIGHTS IN BANKRUPTCY* §§ 6:7, 4:8 (2d ed. 2012).

<sup>75</sup> 11 U.S.C. § 706(a) (2010).

<sup>76</sup> See 11 U.S.C. § 1112(a)(2) (2010); 11 U.S.C. § 706(a).

<sup>77</sup> 11 U.S.C. § 706(b).

<sup>78</sup> 2006 EBL, *supra* note 1, art. 10.

<sup>79</sup> *Id.*

<sup>80</sup> 11 U.S.C. § 301(a) (2005) (“A voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition . . . by an entity that may be a debtor . . .”).

<sup>81</sup> See William J. Woodward, Jr., “Control” in *Reorganization Law and Practice in China and the United States: An Essay on the Study of Contrast*, 22 TEMP. INT’L & COMP. L.J. 141, 157 (2008).

<sup>82</sup> 2006 EBL, *supra* note 1, art. 2 (emphasis added).

<sup>83</sup> 2006 EBL, *supra* note 1, art. 2, 10 (“The people’s court shall decide whether or not to accept an

Given that a Chinese court is the ultimate arbiter of whether a case can proceed under the 2006 EBL, there is a compelling need for complementary rules to clarify what constitutes “apparently lacks the ability to pay off his debts” or “forfeited the ability to pay off his debts,” and what pleading burdens must be met.<sup>84</sup> Before the necessary clarifications are made by the SPC, the court still had broad discretion in deciding when and whether to accept bankruptcy cases.<sup>85</sup> In contrast, in the United States, the standards are clear and rather easy to meet. A filing must be made in good faith, or otherwise face dismissal.<sup>86</sup> U.S. courts have developed a distinction between financial distress and economic distress, which provides a relatively clear guideline for determining whether a filing is made in good faith.<sup>87</sup> “Financial distress” occurs when the firm does not have enough income to cover what it has borrowed, but the firm itself is working well in other aspects.<sup>88</sup> In other words, financial distress means that the firm is suffering from a cash flow problem but maintains a successful business model.<sup>89</sup> “Economic distress” occurs when a firm cannot generate sufficient revenue to pay its debts regardless of its capital structure.<sup>90</sup> In other words, economic distress means that the firm has failed as a business or has a failing business model.<sup>91</sup> A filing for reorganization in good faith is usually made when a firm is in financial distress rather than economic distress, because a failing business has nothing of value to save.<sup>92</sup> Chinese bankruptcy law does not seem to address this issue in detail, though the requirements for filing to some extent illustrate the concept of economic distress.<sup>93</sup> These vague standards therefore discourage bankruptcy filings, especially voluntary filings, which is a very important initiating mechanism for bankruptcy.<sup>94</sup> In this way, the power of Chinese courts again negatively impacts bankruptcy practices in China.

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application for bankruptcy within 15 days from the date it receives the application.”).

<sup>84</sup> Qi, *supra* note 22, at 17.

<sup>85</sup> See Steven Arsenault, *The Westernization of Chinese Bankruptcy: An Examination of China’s New Corporate Bankruptcy Law Through the Lens of the UNCITRAL Legislative Guide to Insolvency Law*, 27 PENN ST. INT’L L. REV. 45, 84–85 (2008).

<sup>86</sup> *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 112 (3d Cir. 2004).

<sup>87</sup> *Id.* at 108.

<sup>88</sup> Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573, 580–81 (1998); see also Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J.L. & ECON. 381, 382–83 (2007).

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> See 2006 EBL, *supra* note 1, art. 2.

<sup>94</sup> See Woodward, Jr., *supra* note 81, at 157 (“Nearly all reorganization filings are voluntary.”).

C. The Ineffective Automatic Stay Regime in China

One of the most important goals of the bankruptcy law is to prevent a creditor's race.<sup>95</sup> Outside of bankruptcy law, the operative paradigm is "first in time is first in right."<sup>96</sup> Thus, whoever levies on a debtor's assets first wins and gets paid before other creditors.<sup>97</sup> This preference arrangement, together with the fact that an insolvent firm usually does not have enough assets to meet its debt, creates an incentive for the creditors to race against each other to be the first to collect from the firm.<sup>98</sup> This is the classic example of a "creditor's race." A creditor's race is itself destructive to the "going concern" value of the company because the creditors are likely to pursue the debtor's assets at the same time, forcing piecemeal sales that may destroy whatever synergy existed between the assets.<sup>99</sup> The U.S. Bankruptcy Code deals with this problem by implementing the automatic stay regime, which stays all efforts to sue on or collect from a debtor's prepetition debt, or to put a lien on the debtor's property.<sup>100</sup>

In the United States, an automatic stay arises by operation of law the moment a debtor files a petition in a U.S. bankruptcy court.<sup>101</sup> The automatic stay under Section 362 is drafted in the broadest terms possible, including "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title."<sup>102</sup> Furthermore, the stay operates as a prohibition against "all entities," including sheriffs, U.S. marshals, collection agencies, and creditors who are owed the money.<sup>103</sup>

The 2006 EBL has a similar framework for automatic stay, though only in limited circumstances and lacking detailed rules.<sup>104</sup> Article 19, Article 20, Article 75, and Article 92 of the 2006 EBL set forth the

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<sup>95</sup> ADLER ET AL., *supra* note 67, at 29. A creditor's race exists because of the collective action problem of the creditors, where they are trying "to get all of one's own debt repaid, and let the devil take the hindmost," which could destroy any going-concern value created by a firm. *In re Milwaukee Cheese Wis., Inc.*, 112 F.3d 845, 847 (7th Cir. 1997). For arguments against justifying reorganizations with creditors' collective action problem, see Nicholas L. Georgakopoulos, *Bankruptcy Law For Productivity*, 37 WAKE FOREST L. REV. 51, 69 (2002).

<sup>96</sup> Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 988 (1992).

<sup>97</sup> *Id.*

<sup>98</sup> *See id.*

<sup>99</sup> *See* David Gray Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CIN. L. REV. 453, 464 (1992); Thomas H. Jackson, *Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules*, 60 AM. BANKR. L.J. 399, 399 (1986) (stating that the recognized goal of bankruptcy law is ensuring that creditors do not make a bad situation worse by engaging in a destructive race to the debtor's assets).

<sup>100</sup> 11 U.S.C. § 362 (2006); *See also* ADLER ET AL., *supra* note 67, at 104.

<sup>101</sup> 11 U.S.C. § 362.

<sup>102</sup> *Id.* § 362(a)(6); *see also* WARREN, *supra* note 43, at 27.

<sup>103</sup> WARREN, *supra* note 43, at 27.

<sup>104</sup> *See* Eaton et al., *supra* note 54, 545-46.

automatic stay regime in China.<sup>105</sup> After a Chinese court accepts an application for bankruptcy, measures for preserving the debtor's property should be stayed and procedures for judicial execution should also be suspended.<sup>106</sup> Similarly, any existing civil action or arbitration involving the debtor that has not yet concluded will be suspended.<sup>107</sup> However, the action or arbitration may resume after an administrator takes over the debtor's property.<sup>108</sup>

During the process of reorganization, efforts to foreclose on security interests over specific property of a debtor are not allowed under the 2006 EBL.<sup>109</sup> However, in the case where possible damage or depreciation to the value of the collateral may impair the secured creditor's rights, an application may be made to a court to preserve the secured property.<sup>110</sup> Where a creditor fails to claim his or her rights according to the provisions of the 2006 EBL, he or she may not exercise these rights when the reorganization is still ongoing.<sup>111</sup>

Compared to the U.S. Bankruptcy Code, the 2006 EBL is limited in the sense that it only covers judicial proceedings or arbitrations, not administrative proceedings or other non-adjudicative proceedings such as mediations.<sup>112</sup> Those other proceedings are covered under the U.S. Bankruptcy Code.<sup>113</sup> Thus, the U.S. Bankruptcy Code provides broader automatic stay protection.

A more severe problem with the 2006 EBL automatic stay regime is that its application is seriously limited by the court's discretionary power given the fifteen-day window.<sup>114</sup> As discussed above, the court has fifteen days to rule on whether a bankruptcy application is accepted.<sup>115</sup> The decision of accepting a case will not relate back to the date of filing.<sup>116</sup> The automatic stay, however, does not arise until the court accepts the

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<sup>105</sup> 2006 EBL, *supra* note 1, arts. 19, 20, 75, 92.

<sup>106</sup> *Id.* art. 19.

<sup>107</sup> *Id.* art. 20.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* arts. 72, 75.

<sup>110</sup> 2006 EBL, *supra* note 1, art. 75.

<sup>111</sup> *Id.* art. 92.

<sup>112</sup> Fu Cuiying (付翠英), *Pochan Baoquan Zhidu Bijiao* (破产保全制度比较) [*Comparison of Bankruptcy Property Preservation Systems*], 3 BILIAOFA YANJIU (比较法研究) [J. COMP. L.] 25, 38–39 (2008) (China).

<sup>113</sup> See 11 U.S.C. § 362 (2006).

<sup>114</sup> 2006 EBL, *supra* note 1, art. 10 (“Except for the circumstances as specified in the preceding paragraph, the people's court shall decide whether or not to accept an application for bankruptcy within 15 days from the date it receives the application.”).

<sup>115</sup> *Id.*

<sup>116</sup> Han Changying & Li Ling (韩长印&李玲), *Jianlun Meiguo Pochan Fa Shang de Zidong Dongjie Zhidu* (简论美国破产法上的自动冻结制度) [*Introduction of Automatic Stay in the United States*], 41 HENAN DAXUE XUEBAO (河南大学学报) [J. HENAN UNIV.] 37, 39 (2001) (China).

application.<sup>117</sup> This fifteen-day window creates a gap between the filing and acceptance of the application in which other creditors can continue to pursue collection efforts.<sup>118</sup> In this sense, a bankruptcy filing essentially operates like a public announcement that invites all creditors to collect on their debts.<sup>119</sup> Given the financial difficulties of a debtor in bankruptcy, creditors with early access to the filing will race to get their portion, which may result in piecemeal sales that destroy the synergy of the debtor's business.<sup>120</sup>

Consequently, debtors lose another important bargaining tool that they could use in negotiating with creditors.<sup>121</sup> By deferring the application of an automatic stay, the court's discretionary power may again discourage bankruptcy filings in China.<sup>122</sup>

### III. DURING THE REORGANIZATION: THE LIMITED ROLE OF A BANKRUPTCY ADMINISTRATOR IN CHINA

After a bankruptcy case is initiated, a Chinese court will appoint an "administrator"—similar to a trustee in the United States.<sup>123</sup> An administrator cannot resign without justifiable reasons and the resignation of an administrator is subject to approval by the Chinese court.<sup>124</sup>

#### A. The Qualification of Administrators

The SPC has promulgated several guidelines and regulations relating to the qualification, management, and appointment of administrators.<sup>125</sup> Every qualified administrator is registered in the administrator list, updated by relevant courts in China.<sup>126</sup> A qualified administrator can be either an organization (i.e., a law firm, accounting firm, or bankruptcy-liquidation

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<sup>117</sup> See, e.g., 2006 EBL, *supra* note 1, art. 19 ("After the people's court *accepts an application* for bankruptcy, the measures for preserving the property of the debtor shall be lifted and the procedure for execution shall be suspended.") (emphasis added); see also Cuiying, *supra* note 112, at 38.

<sup>118</sup> Patel, *supra* note 28, at 117.

<sup>119</sup> Changying & Ling, *supra* note 116, at 39.

<sup>120</sup> *Id.*

<sup>121</sup> See Woodward, Jr., *supra* note 81, at 157 (arguing that because debtors' exercise of automatic stay powers convert creditors' sunk costs on collection efforts into wasted expenses, it has the effect of encouraging negotiations between debtors and creditors).

<sup>122</sup> Zhang Yanli (张艳丽), *Pochan Baoquan Zhidu de Heli Shezhi* (破产保全制度的合理设置) [*Restructuring of Bankruptcy Property Preservation System*], 26 ZHENGFAJUNYAN (政法论坛) [TRIB. POL. SCI. & L.] 42, 48 (2008) (China).

<sup>123</sup> 2006 EBL, *supra* note 1, art. 13.

<sup>124</sup> *Id.* art. 29.

<sup>125</sup> See Lawrence (Lixin) Yang, *Administrator in China's New Enterprise Bankruptcy Law: Objective Standards to Limit Discretion and Expand Market Controls*, 82 AM. BANKR. L.J. 533, 534 (2008).

<sup>126</sup> 2006 EBL, *supra* note 1, art. 2.

firm),<sup>127</sup> or an individual with relevant knowledge and license.<sup>128</sup> A special committee, which must consist of at least seven members from a court, will decide the list of administrators.<sup>129</sup> The result will then be published through influential local media for ten days.<sup>130</sup>

## B. The Appointment of Administrators

Given the administrator's substantial involvement and influence in the liquidation and reorganization process, there are detailed rules on the appointment of administrators in China.<sup>131</sup> On one hand, the administrators appointed by the court are often local persons or entities tasked with ensuring that they are familiar with the local situation.<sup>132</sup> They are also expected to have close ties to the company to render effective management.<sup>133</sup> On the other hand, if the debtor is a commercial bank, securities company, or insurance company, the administrators will often be a non-local entity in order to ensure fairness.<sup>134</sup> This also applies to cases with complicated legal issues or nationwide impact.<sup>135</sup>

The administrator is appointed through a random drawing to avoid manipulation of the appointment or a potential conflict of interest.<sup>136</sup> Once appointed, the administrator cannot refuse the appointment without a justifiable reason, which is intended to further ensure that the appointment is free from manipulation.<sup>137</sup> Another way to maintain the administrator's impartiality is to grant the court the power to set the administrator's compensation. As illustrated by the East Start Airline case, court controls the appointment process and the ultimately appointed administrators often

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<sup>127</sup> See Yang, *supra* note 125, at 535; see also Charlie Xiao-Chuan Weng, *To Be, Rather than to Seem: Analysis of Trustee Fiduciary Duty in Reorganization and Its Implications on the New Chinese Bankruptcy Law*, 45 INT'L L. 647, 651 (2011) ("Most trustees are professionals from law firms and accounting firms.")

<sup>128</sup> See Yang, *supra* note 125, at 535.

<sup>129</sup> Zuigao Renmin Fayuan Guanyu Shenli Qiye Pochan Anjian Zhiding Guanlirende Guiding (最高人民法院关于审理企业破产案件指定管理人的规定) [The SPC's Regulations on Appointment of Administrators in Enterprise Bankruptcy Cases] (promulgated by the SPC, effective June 1, 2007), 11, arts. 10–11 [hereinafter SPC Regulation on Appointment].

<sup>130</sup> *Id.*

<sup>131</sup> See, e.g., 2006 EBL, *supra* note 1, arts. 22–29.

<sup>132</sup> SPC Regulation on Appointment, *supra* note 129, art. 15.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* art. 28. See Yang, *supra* note 125, at 542 ("[C]ourts that hear bankruptcy cases are required to appoint administrators randomly in one of three ways: waiting turns, drawing lots, and machine-controlled lottery.")

<sup>137</sup> SPC Regulation on Appointment, *supra* note 129, art. 28.

are closely related to the local government to add another level of control.<sup>138</sup>

### C. Comparative Perspective: A Debtor's Inability to Control Operations During Reorganizational Proceedings

The active role of the Chinese court and government is clearly reflected in their control over a debtor's operation during its reorganization process.<sup>139</sup> The administrator, rather than the debtor, dominates 2006 EBL proceedings. During the reorganization process, the debtor may, through his application and upon court approval, manage his property and business operations on his own under the supervision of an administrator.<sup>140</sup> However, the debtor's power is still limited in three ways<sup>141</sup>: (1) when the court accepts the reorganization application, it will also appoint an administrator; (2) even if the court decides to grant the debtor control over operations, such a decision usually takes time and the administrator retains the power to run the business during the interim; and (3) the debtor in control is still subject to the administrator's supervision.<sup>142</sup> Given that 2006 EBL proceedings are administrator-oriented and the court has the exclusive power to appoint administrators, approve its resignation, and determine their fees, the court more or less controls the operation of the debtors throughout the process.<sup>143</sup> Under the 2006 EBL, an administrator must manage the operations of the debtor and perform his duties according to the provisions of the law, report his work to the court, and is subject to supervision by the creditors' meeting and the creditors' committee.<sup>144</sup> In contrast, the U.S. Bankruptcy Code provides the debtor a debtor-in-

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<sup>138</sup> Zuigao Renmin Fayuan Guanyu Shenli Qiye Pochan Anjian Queding Guanliren Baochou de Guiding (最高人民法院关于审理企业破产案件确定管理人报酬的规定) [The SPC's Regulations on the Compensation of Administrators in Enterprise Bankruptcy Cases] (promulgated by the SPC, Apr. 4, 2007, effective June 1, 2007), Lawinfochina (北大法律英文网) (China).

<sup>139</sup> See Deng Yanjun (邓艳君), *Lun Woguo Xin Pochan Fa Zhong Renmin Fayuan Dingwei de Queshiji Wanshan* (论我国新破产法中人民法院定位的缺失及完善) [Discussion on the Lack of Neutral Position of People's Court in 2006 EBL and Suggested Improvements], 3 JISHOU DAXUE XUEBAO (吉首大学学报) [J. JISHOU U.] 59, 60 (2010) (China); Qi Ming (齐明), *Chongzheng Qijian Gongsigongzhi Quan Eryuan Moshi Tanjiu* (重整期间公司控制权二元模式探究) [The Dual Control Model in Corporate Governance During Reorganization], 37 QIUSHI (求是) [SEEKING TRUTH] 95, 99 (2010) (China).

<sup>140</sup> 2006 EBL, *supra* note 1, art. 73.

<sup>141</sup> See Jin Chun (金春) et al., *Pochan Chongzheng Chengxu Zhong de Guanliren Zhidu* (破产重整程序中的管理人制度) [The Administrator System in Reorganization], 28 ZHENGFA LUNTAN (政法论坛) [TRIB. POL. SCI. & L.] 52, 55 (2010).

<sup>142</sup> *Id.*

<sup>143</sup> 2006 EBL, *supra* note 1, arts. 13, 22; see also Qi, *supra* note 22, at 17; Zou Linhai (邹林海), *Xin Qiye Pochan Fayuan Guanliren Zhongxin Zhuyi* (新企业破产法与管理人中心主义) [The New Bankruptcy Law and the Administrator Oriented Approach], 49 HUADONG ZHENG FA XUEYUAN XUEBAO (华东政法学院学报) [J. E. CHINA U. POL. SCI. & L.] 121, 122 (2010).

<sup>144</sup> 2006 EBL, *supra* note 1, arts. 23, 25, 29.

possession (DIP) status with the powers of a bankruptcy trustee.<sup>145</sup> In most cases, a DIP may run the business in the “ordinary course” as it sees fit.<sup>146</sup> Congress argued that in many cases creditors would benefit from the DIP legislation in both saved expenses and business continuity, which results from precluding a change in management and avoiding the substantial learning curve of new management.<sup>147</sup> In contrast, the Chinese system prevents both the creditors and debtors from enjoying those benefits.<sup>148</sup>

Some scholars call the Chinese Bankruptcy Administrator model a “modified debtor-in-possession approach.”<sup>149</sup> However, such a name is misleading in that it conceals the fact that the debtor does not have a favorable position in proposing a reorganization plan.<sup>150</sup> In the United States, the DIP has exclusive rights within 120 days to propose a reorganization plan and the court usually extends that time.<sup>151</sup> In China, however, most of the time the administrator will propose the reorganization plan notwithstanding a lack of familiarity with the debtor’s operation in the past or the industry in general.<sup>152</sup>

Furthermore, the crux of the problem is the absence of judicial autonomy and independence, which is an overriding concern in enforcing the 2006 EBL.<sup>153</sup> In one of the SPC’s opinions, the court was encouraged to cooperate with local government authorities in order to resolve the challenging issues that arise in the context of bankruptcy proceedings.<sup>154</sup> However, local government interference is one of the fundamental obstacles to the enforcement of the 2006 EBL.<sup>155</sup> In China, a debtor must usually seek the approval of a local government before it files for

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<sup>145</sup> Woodward, Jr., *supra* note 81, at 147.

<sup>146</sup> *Id.*

<sup>147</sup> H.R. REP. NO. 95-595, at 233 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963.

<sup>148</sup> See Qi Ming & Qiu Xiaoguang (齐明 & 仇晓光), *Woguo Pochan Fa Zhong Ziyuan Pochan Yuanze de Fansi yu Chonggou* (我国破产法中自愿破产原则的反思与重构) [*The Reflection and Reconstruction of the Voluntary Bankruptcy Principles under the EBL*], 246 DONGBEI SHIDA XUEBAO (东北师大学报) [J. NE. NORMAL U. (PHIL. & SOC. SCI.)] 29 (2010).

<sup>149</sup> Charles D. Booth, *Bankruptcy Laws in Socialist Market Economies*, 18 COLUM. J. ASIAN L. 93, 129 (2004).

<sup>150</sup> Zhang, *supra* note 2, at 81 (stating that both the creditor and administrator may propose a reorganization plan).

<sup>151</sup> Theodore Eisenberg & Stefan Sundgren, *Is Chapter 11 Too Favorable to Debtors? Evidence from Abroad*, 82 CORNELL L. REV. 1532, 1549 (1997).

<sup>152</sup> Li, *supra* note 6.

<sup>153</sup> Rapisardi & Zhao, *supra* note 64, at 57.

<sup>154</sup> Zuigao Renmin Fayuan Guanyu Zhengque Shenli Qiye Pochan Anjian Wei Weihu Shichang Jingji Zhixu Tigong Sifa Baozhang Ruogan Wenti de Yijian (最高人民法院关于正确审理企业破产案件为维护市场经济秩序提供司法保障若干问题的意见) [*The SPC’s Opinion on Correctly Hearing Enterprise Bankruptcy Cases and Preserving the Order of the Market Economy by Offering Judicial Guarantee*] (promulgated by the SPC, June 12, 2009, effective June 12, 2009), *available at* [http://www.court.gov.cn/qwfb/sfwj/yj/201002/t20100224\\_1927.htm](http://www.court.gov.cn/qwfb/sfwj/yj/201002/t20100224_1927.htm); *see also* Rapisardi & Zhao, *supra* note 64, at 57.

<sup>155</sup> Rapisardi & Zhao, *supra* note 64, at 57.

reorganization.<sup>156</sup> Furthermore, a court must ask for help from the local government to coordinate with creditors, especially banks, to facilitate the reorganization process.<sup>157</sup> Support from the local government is therefore a key factor in achieving success in a reorganization case.<sup>158</sup> Thus, Chinese courts must accommodate two seemingly conflicting values: cooperating with local governments and maintaining judicial independence.<sup>159</sup>

Additionally, some scholars point out that under the 2006 EBL's ambiguous threshold for accepting bankruptcy applications, outside forces and political parties continue to put pressure on the courts.<sup>160</sup> For example, sometimes even the SPC issues opinions that explicitly require courts to cooperate with administrative agencies to resolve challenging issues in the context of bankruptcy.<sup>161</sup> It is also worth noting that the government has easier ways to participate in the bankruptcy proceeding. For example, according to Article 24 of the 2006 EBL, the administrator can be a liquidation team composed of persons from relevant departments, including a certified public accountant firm, a bankruptcy liquidation firm, or any other public agency.<sup>162</sup> Thus, the court may directly designate persons from the relevant departments of the government, which allows a more direct and active role for the government.<sup>163</sup>

#### IV. DISTRIBUTION: PRIORITIES, VOTING, AND CRAMDOWN

Under the previous Chinese bankruptcy regime, employees were paid first using the proceeds from the sale of assets and given priority over secured creditors.<sup>164</sup> The court would often waive the secured creditors' claims in the bankruptcy proceedings to guarantee the priority given to employees' claims.<sup>165</sup> Thus, protection of the priority of the secured creditors over employees' claims is one important improvement to creditors' rights under the 2006 EBL.<sup>166</sup> The 2006 EBL explicitly provides that "[a] creditor secured by the specific property of the bankrupt shall enjoy the priority in being repaid with the specific property."<sup>167</sup> After the

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<sup>156</sup> Wang Jianping & Zhang Dajun (王建平 & 张达君), *Pochan Chongzheng Jihua Pizhun Zhidui Fansi* (破产重整计划批准制度及反思) [*Reflection on Reorganization Plan Confirmation System*], 23 RENMIN SIFA (人民司法) [PEOPLE'S JUDICATURE] 52, 53 (2010).

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> Rapisardi & Zhao, *supra* note 64, at 57.

<sup>160</sup> *See, e.g.*, Ansari, *supra* note 4.

<sup>161</sup> Rapisardi & Zhao, *supra* note 64, at 57.

<sup>162</sup> 2006 EBL, *supra* note 1, art. 24.

<sup>163</sup> Yongqing Ren, *The "Control Model" in Chinese Bankruptcy Reorganization Law and Practice*, 85 AM. BANKR. L.J. 177, 182 (2011).

<sup>164</sup> Liu & Wu, *supra* note 28, at 70.

<sup>165</sup> Rapisardi & Zhao, *supra* note 64, at 50.

<sup>166</sup> *See* Liu & Wu, *supra* note 28, at 70; Patel, *supra* note 28, at 113.

<sup>167</sup> 2006 EBL, *supra* note 1, art. 109.

secured creditors have been paid and after deductions of bankruptcy expenses and debts of common benefits from the bankruptcy property, repayment shall be made in the following order: (1) employees' claims; (2) social security expenses and insurance claims; and (3) unsecured claims.<sup>168</sup>

However, the employees' claims remain a high priority even though they are now subordinated to secured claims.<sup>169</sup> Article 6 sets out the policy that the court shall, in accordance with law, guarantee the legitimate rights and interests of the employees.<sup>170</sup> Moreover, as a compromise, the 2006 EBL provides that employees' claims incurred before August 27, 2006 shall still enjoy priority over secured creditors if they cannot be satisfied out of the debtor's assets.<sup>171</sup>

As for the voting regime, creditors who declare claims are members of the creditors' meeting and may exercise voting rights.<sup>172</sup> A simple majority of the creditors whose claims represent more than two-thirds of the debt amount may approve the draft plan.<sup>173</sup>

Cramdown, or a nonconsensual plan confirmation, happens when one or more groups of creditors vote against the confirmation of a plan, but the plan may nonetheless be approved when other conditions are met.<sup>174</sup> Under the 2006 EBL, where a draft plan is not approved, a second voting may be convened after negotiation.<sup>175</sup> If a plan still fails the second voting, a Chinese court may approve the plan over the objections of the dissenting classes, provided that the following six criteria are met<sup>176</sup>: (1) the secured creditors will be paid in full or be compensated in a fair manner, without substantial impairment to the security interests,<sup>177</sup> or are in such a class as has consented to the plan; (2) the employees' claims and tax claims will be paid in full or are in such a class as has consented to the plan; (3) the unsecured creditors will get at least the same amount as under the

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<sup>168</sup> 2006 EBL, *supra* note 1, art. 113; *see also* Qi, *supra* note 22, at 23.

<sup>169</sup> Roman A. Tomasic, *The Conceptual Structure of China's New Corporate Bankruptcy Law*, in CHINA'S NEW ENTERPRISE BANKRUPTCY LAW: CONTEXT, INTERPRETATION, AND APPLICATION 30 (Rebecca Parry ed., 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1546556](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1546556) ("This employee protection principle [in Article 6 gives] employee claims a higher priority than normal unsecured claims, such as those of trade creditors.").

<sup>170</sup> 2006 EBL, *supra* note 1, art. 6.

<sup>171</sup> 2006 EBL, *supra* note 1, art. 132; *see also* Liu & Wu, *supra* note 28, at 72.

<sup>172</sup> 2006 EBL, *supra* note 1, art. 59; *see also* Qi, *supra* note 22, at 21.

<sup>173</sup> 2006 EBL, *supra* note 1, art. 84; *see also* Qi, *supra* note 22, at 21.

<sup>174</sup> *See* Isaac M. Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C. L. REV. 925, 925 (1979-80); WARREN, *supra* note 43, at 155. For the conditions that must be satisfied in the United States to proceed with a cramdown, *see* Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441 (1984).

<sup>175</sup> 2006 EBL, *supra* note 1, art. 87.

<sup>176</sup> *Id.*

<sup>177</sup> This seems to be the functional parallel of the U.S. "fair and equitable test," which means that a court can confirm a plan only if the plan is fair and equitable and does not discriminate unfairly. *See* 11 U.S.C. § 1129(b)(2) (2010).

liquidation regime,<sup>178</sup> or are in such a class as has consented to the plan; (4) the adjustment made to the rights and interests of investors is fair and just or are in such a class as has consented to the plan; (5) members of the same voting group are treated fairly; and (6) the reorganizational plan is feasible.<sup>179</sup>

The 2006 EBL voting requirements and conditions of a cramdown case closely resemble the standards in the United States.<sup>180</sup> Because of Chinese courts' tradition of closely monitoring a case, the discretionary criteria under the cramdown regime may offer another possibility for the court to use its power.<sup>181</sup> Furthermore, in the United States, assets are distributed first to secured creditors and then to unsecured creditors.<sup>182</sup> However, unsecured claims in the United States cover a broader group of claims as compared to the 2006 EBL, including administrative expenses incurred to help administer the case and new financing acquired after bankruptcy filings to facilitate reorganization.<sup>183</sup> Both the administrative expenses and newly acquired financing take priority to pre-filing unsecured claims.<sup>184</sup> These additional priority options are powerful tools for a debtor in the United States to bargain for better post-filing financing terms, as lenders are more likely to provide loans that have priority over pre-filing unsecured claims.<sup>185</sup> As a result, the failure of the 2006 EBL to provide special priority to post-filing financing limits the administrator's ability to get better financing that is critical for the debtor's rehabilitation.<sup>186</sup>

#### V. AFTER REORGANIZATION: MANAGEMENT'S POTENTIAL EXPOSURE TO CIVIL LIABILITIES

Another discouraging factor for filing bankruptcy petitions under the 2006 EBL is its treatment of the debtor's management members. The 2006 EBL does not grant much power to the debtor's management during the

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<sup>178</sup> This is similar to the U.S. "best interests test," which states that an individual dissenter can get at least the same amount he would have received under liquidation. *See id.* § 1129 (a)(7)(A); ADLER ET AL., *supra* note 67, at 675.

<sup>179</sup> This is similar to the "feasibility test" in the United States, meaning that a court may not confirm a plan unless the court is satisfied that confirmation is not likely to be followed by the liquidation or further reorganization of the debtor. *See* 11 U.S.C. § 1129 (a)(11); ADLER ET AL., *supra* note 67, at 683.

<sup>180</sup> *See* 11 U.S.C. § 1126(c), 1129 (2010).

<sup>181</sup> Wang & Xu, *supra* note 18, at 93.

<sup>182</sup> 11 U.S.C. §§ 725, 726 (2010).

<sup>183</sup> *Id.* §§ 507, 726, 364(c).

<sup>184</sup> *Id.* §§ 507, 726, 364(c).

<sup>185</sup> Studies have found that there is a direct relation between DIP financing and the success of reorganization under Chapter 11. *See* Fayez A. Elayan & Thomas O. Meyer, *The Impact of Receiving Debtor-in-Possession Financing on the Probability of Successful Emergence and Time Spent Under Chapter 11 Bankruptcy*, 28 J. BUS. FIN. & ACCOUNT. 905, 934 (2001), available at <http://homes.chass.utoronto.ca/~szhou/print/DIPjournalBusFinAcc.pdf>.

<sup>186</sup> *Id.*

reorganization process.<sup>187</sup> Instead, it prescribes possible civil penalties of the debtor's management members together with their duty to answer questions in creditors' meetings and to remain in the same domicile throughout the reorganization process.<sup>188</sup> The penal system reflects a strong monitoring by the court and the government.<sup>189</sup> Thus, management in China appears to "lack[] incentives to either acknowledge financial problems prior to bankruptcy" or to remain in position to help administrators operate the debtor after filing.<sup>190</sup> This again harms the bankruptcy practice in China because the managers are usually the best source of information about the company's operations and most likely to file for bankruptcy, though they may have caused the problems that ultimately led to the financial difficulty.<sup>191</sup>

#### VI. CASE STUDIES: WHY DOES EAST STAR AIRLINE HAVE TO LIQUIDATE?

The discussions above illustrate how Chinese courts and government agencies have broad discretionary powers in the reorganization proceeding. Sometimes, however, the expected practice and the actual practice that emerges can diverge.<sup>192</sup> Thus, a close examination of actual cases may shed light on how the 2006 EBL works in practice.

As for the Chinese government agencies' involvement in the bankruptcy proceedings, the Qinling reorganization case serves as a prominent example.<sup>193</sup> The liquidation panel as appointed by the court only consisted of two professionals, namely one lawyer and one financial consultant.<sup>194</sup> Other members of the panel consisted of 22 government officials from different bureaus and departments.<sup>195</sup> These officials included deputy mayors, a dean, a deputy dean of the state-owned assets supervision and administration commission, and deputy directors of the environment bureau.<sup>196</sup> This shows how active a role the Chinese government plays in bankruptcy proceedings.<sup>197</sup> Similarly, in another recent reorganization case involving Jinxing Real Estate Corporation in Zhejiang Province, the district government—rather than the debtor itself—

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<sup>187</sup> See 2006 EBL, *supra* note 1.

<sup>188</sup> *Id.* arts. 15, 23, 125.

<sup>189</sup> Li, *supra* note 6.

<sup>190</sup> Patel, *supra* note 28, at 120.

<sup>191</sup> *Id.*

<sup>192</sup> Woodward, Jr., *supra* note 81, at 150.

<sup>193</sup> SHANGHAI SEC. EXCH., PUBLIC NOTICE ON MATTERS CONCERNING REORGANIZATION ISSUED BY SHAANXI QINLING CEMENT (GROUP) CORP. LTD. (2009) (on file with author).

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*; see also Ren, *supra* note 16, at 65.

<sup>197</sup> Ren, *supra* note 16, at 65.

made an announcement to creditors and led negotiations between the creditors and the debtor, reflecting the government's involvement in that case.<sup>198</sup> These practices, together with the court's broad power in deciding whether to accept a case and monitoring administrators, place the debtor in an extremely uncertain situation where the debtor may not want to risk filing for reorganization because he may lose control of his business, which is what exactly happened in the Eastern Star Airline (ESA) case.

The ESA case serves as one of the best illustrations of how the Chinese court and government both exercise control over a debtor. ESA is a privately owned airline in China that became financially distressed in 2008 and was forced to cease operations in March 2009.<sup>199</sup> The court accepted the involuntary bankruptcy application filed by ESA's creditors, including General Motors, on March 27, 2009.<sup>200</sup>

The court-appointed administrator consisted of various governmental authorities, including the Wuhan Transportation Commission, the Legislative Affairs Bureau, the Wuhan Labor Union, and the Public Safety Bureau.<sup>201</sup> The debtor and the administrator had very different views about the economic conditions of ESA.<sup>202</sup> The debtor had been aggressively seeking reorganization by proposing two plans with the help of main creditors and strategic investors.<sup>203</sup> The first reorganization plan was proposed in July 2007, with the consent of ten main creditors led by China Aviation Oil Group and joined by a main investor, Wuhan Hongxing International Travel Company. The first plan proposed conversion of debt to equities and loan extensions, together with new investments, but was soon replaced by the second plan.<sup>204</sup> The second reorganization plan was proposed in August 2009, with financing of RMB200 million to RMB300 million provided by a main investor, China Equity Group.<sup>205</sup> This plan

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<sup>198</sup> *Yuhang Jinxing Fangchan Shenqing Pochan Qingsuan* (余杭金星房产申请破产清算) [Yuhang Jinxing Real Estate Corp. Has Applied for Bankruptcy], SOHU (Apr. 10, 2012), <http://roll.sohu.com/20120410/n340141005.shtml>.

<sup>199</sup> Ren, *supra* note 16, at 186; Xiong Jinchao (熊金超), *Dongxing Hangkong Gongsì Yin Wuli Huanzhai Bei Zanting Yunying* (东星航空公司因无力还债被暂停运营) [*ESA is Forced to Stop Operation Because of Lack of Ability to Pay for the Debts Due*], SINA (Mar. 15, 2009), <http://finance.sina.com.cn/chanjing/b/20090315/08115977604.shtml>.

<sup>200</sup> Xiong, *supra* note 199.

<sup>201</sup> Ren, *supra* note 16, at 186–87; Gao, *supra* note 19, at 62.

<sup>202</sup> The debtor claimed that with the cooperation of main debtors and injection of new financing, ESA will be able to survive the current difficulties. The administrator insisted that reorganization was not viable as ESA had huge amount of debts and had lost its airplanes and routes. See Liu Weixun (刘伟勋), *Dongxing Hangkong Shengsi 150 Ri* (东星航空生死 150 日) [*The Life or Death of ESA in 150 Days*], SINA (Aug. 28, 2009), <http://finance.sina.com.cn/chanjing/sdbd/20090828/23096680123.shtml>.

<sup>203</sup> See Li Fengtao (李凤桃), *Zhaiquan Ren Bianshen Zhanlue Touzi Zhe Zhong Hang You "Yingjiu" Dongxing Hangkong* (债权人变身战略投资者中航油"营救"东星航空) [*From Debtor to Strategic Investor, China Aviation Oil's Effort to Save ESA*], SOHU (July 20, 2009), <http://business.sohu.com/20090720/n265329694.shtml>.

<sup>204</sup> *Id.*

<sup>205</sup> See Gao, *supra* note 19, at 61; Zhang Da (张达), *Dongxing Hangkong Xin Chongzu Fang*

proposed to use these funds to lease three airplanes in order to solve the current financial difficulties.<sup>206</sup> After ESA recovered, the management would introduce international airlines as strategic investors and diversify ESA's shareholders by going public within the next three to five years.<sup>207</sup> The second plan was later amended on August 25, 2009 as a final effort to persuade the court.<sup>208</sup> In the amended second plan, China Equity Group would receive 70%–80% of the equity shares of ESA while ESA's creditors would convert their debt into 20%–30% of ESA's equity shares, and the original shares of ESA would be converted into debt.<sup>209</sup>

While ESA and its creditors were making efforts to save the corporation, the administrator repeatedly announced that there was no hope of reorganizing.<sup>210</sup> Despite the debtor's efforts and desire to secure a reorganization plan, the court ordered the liquidation rather than reorganization of ESA in August 2009, only five months after its bankruptcy filing.<sup>211</sup> After this case, some critics argued that this was a forced liquidation and that there should be more limits on the power of the Chinese administrator.<sup>212</sup>

The practical examples above illustrate how Chinese courts and government officials play an active role in bankruptcy proceedings, discouraging debtors from initiating or entering into the reorganization proceedings. Though some scholars argue that the differences between the U.S. and Chinese models are not very large,<sup>213</sup> the above case studies seem to suggest otherwise. Indeed, one can still feel the pronounced negative impact of the current EBL model on the initiation and administration of bankruptcy proceedings in China.<sup>214</sup>

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*Xinzhongli Jituan Xianshen* (东星航空新重组方信利集团现身) [*Dongxing's New Reorganization Participant—China Equity Group*], SINA (Aug. 18, 2009), <http://finance.sina.com.cn/chanjing/gsnews/20090818/06566629278.shtml>.

<sup>206</sup> Zhang Jie (张杰), *Dongxing Hangkong Pochan An Falü Wenti Yanjiu* (东星航空破产案法律问题研究) [*Legal Analysis of ESA Bankruptcy Case*], 4 ZHENGQUAN FAYUAN (证券法苑) [SEC. L. REV.] 384, 386 (2011); Liu, *supra* note 202.

<sup>207</sup> Liu, *supra* note 202.

<sup>208</sup> *Id.*

<sup>209</sup> *Id.*

<sup>210</sup> Cui Xiaohong (崔晓红), *Shuizai Daoyang Dongxing Pochan* (谁在导演东星破产) [*Who is Directing ESA to Bankruptcy*], SINA (Aug. 11, 2009), <http://finance.sina.com.cn/review/observe/20090811/14516601190.shtml>.

<sup>211</sup> *Wuhan Zhongyuan Caiding Dongxing Hangkong Pochan Qingsuan* (武汉中院裁定东星航空破产清算) [*The Intermediary Court of Wuhan Ordered Liquidation of ESA*], SINA (Aug. 27, 2009), <http://finance.sina.com.cn/chanjing/gsnews/20090827/10146671931.shtml>.

<sup>212</sup> Gao, *supra* note 19, at 65.

<sup>213</sup> *E.g.*, Ren, *supra* note 16, at 179–81 (arguing (1) that the U.S. DIP is subject to challenge and may be replaced by a trustee, and thus a Chinese debtor does not necessarily enjoy fewer opportunities with respect to becoming a DIP; and (2) that the Chinese DIP system is “basically a modified DIP approach”).

<sup>214</sup> *See* Gao, *supra* note 19, at 65.

## VII. CONCLUSION

Based on both statutory analysis and case studies, this Note identifies the excessive involvement of Chinese courts and government agencies in bankruptcy proceedings. This overly broad power is often felt throughout a reorganization case. When initiating these cases, the court has broad power to decide whether to accept a case within fifteen days. The vague filing standards under the 2006 EBL leave the court with broad discretion. Furthermore, this fifteen-day window prevents effective implementation of the automatic stay regime under the 2006 EBL.

After a case has been initiated, the court then has exclusive power to appoint and remove the administrator who will manage a debtor's business throughout the reorganization proceedings. Furthermore, the administrators often are government agencies. By closely monitoring activities of the administrator, Chinese courts and government agencies in fact control a debtor's management during the reorganization process. In addition, the distribution plan and voting requirements under the 2006 EBL also give limited options to debtors to acquire post-filing financing and provide broad power for a court to confirm a plan over dissenting creditors. Finally, after reorganization in China, the debtor's management members may face possible civil liabilities, further dissuading them from filing for reorganization.

All of these factors show tremendous discretionary power of the court and government agencies during reorganization proceedings, which may explain the inactive bankruptcy practice in China. It is worth noting, however, that reorganization practice in China is still a developing concept and much of the above analysis is largely theoretical. Explanations offered here may prove incomplete or inaccurate with emerging practices. Still, understanding the 2006 EBL from a comparative perspective is of great importance to China, both today and in the future.