Corporate Reorganization under the Enterprise Bankruptcy law of the People's Republic of China - the Relevance of Anglo-American Models for China

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Zinian Zhang

Abstract

In 2006, in an effort to nurture its corporate rescue culture, the People's Republic of China (PRC) enacted a rescue-oriented bankruptcy law, the Enterprise Bankruptcy Law 2006 (the EBL 2006). However, it remains unknown as to how effective the implementation of this new corporate rescue regime will be. This thesis aims to address this uncertainty by drawing upon data from an empirical study, which covers a period of nearly five years of enforcement, investigating how this law has been translated from the law in the books into the law in action.

This thesis has four research questions. The first question examines the extent to which China's new corporate rescue law is used to rehabilitate troubled companies. The second seeks to identify which party dominates the existing corporate rescue processes. The third explores how economic value is preserved and distributed in corporate rescues. The final question assesses whether court confirmation of reorganization plans is adequate in fulfilling the goals of the corporate reorganization regime in China.

By reviewing and analysing the collected data, this thesis has found that the PRC Bankruptcy Law has been mainly used to reorganize large companies in China. As for the nature of control over the legal process in rescues, this thesis has found that most PRC rescues use an administrator-in-possession model. The data suggest that China's new rescue law has been effective in preserving going concern value as it has increased the average unsecured creditor recovery rate from less than ten per cent in liquidations to thirty-four per cent in reorganizations.

But, great challenges arise in distributing value, especially in listed company reorganizations, as this thesis finds that two fundamental distribution principles – the absolute priority and *pari passu* principles - are often breached in China's corporate rescue cases. Finally, the data demonstrate that China's courts are currently unable to fulfil the legal policy goals of the PRC's corporate rescue regime when confirming corporate reorganization plans; this failure can largely be attributed to the lack of judicial independence.

Corporate Reorganization under the Enterprise Bankruptcy Law of the People's Republic of China – The Relevance of Anglo-American Models for China

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Dedicated to My Dear Parents

STATEMENT OF COPYRIGHT

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Any mistakes and defects in this thesis remain my own responsibilities.

LIST OF ABBREVIATION

ADB	Asian Development Bank
APEC	Asia-Pacific Economic Co-operation Forum
CEO	Chief Executive Officer
CVA	Company Voluntary Arrangement
DIP	Debtor in Possession
EBL	Enterprise Bankruptcy Law
FAIR	Forum on Asian Insolvency Reform
GDP	Gross Domestic Products
GTZ (GIZ)	Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ)
IMF	International Monetary Fund
INSOL	International Association of Restructuring, Insolvency & Bankruptcy Professionals
IP	Insolvency Practitioner
M&A	Merger and Acquisition
SME	Small and Medium enterprise
SOE	State Owned Enterprise
OECD	Organization for Economic Co-operation and Development
PIP	Practitioner in Possession
UK	United Kingdom
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
US	United States
WTO	World Trade Organization

CHAPTER 1

INTRODUCTION

1. INTRODUCTION

The prevailing corporate reorganization regime has been developing in the US since the late nineteenth century,[1] but still remains relatively new for many countries, even in most western countries.[2] In the UK, for example, it was the Cork Report of the early 1980s which marked the official starting point of corporate reorganization awareness.[3]

In China, it was as late as 1995 when the corporate rescue regime was formally acknowledged by its lawmakers shortly after its new round of bankruptcy law amendments began to be made.[4] Bearing in mind the merits of the corporate reorganization regime in preserving the going-concern value of troubled companies and, more importantly, in saving jobs, China eventually embraced the corporate rescue culture. This was reflected in the passage of the Enterprise Bankruptcy Law of 2006 (the EBL 2006) which placed the corporate reorganization procedure at the top of China's all three bankruptcy procedures.[5] The EBL 2006 came into force on 1 June 2007.[6]

After nearly five years of implementation, an empirical study of China's corporate rescue law in action was needed to examine how this new rescue law operated in reality in China. This thesis aims to undertake such a task.

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[1] See Charles J Tabb, 'The Future of Chapter 11' (1992-1993) 44 *South Carolina Law Review* 791. See also Charles Warren, *Bankruptcy in United States History* (DA Capo Press 1972).

[2] It may be part of the globalization of commercial law, as corporate reorganization has been transplanted into many jurisdictions in the late 20th century, see further at Jay Lawrence Westbrook, 'The Globalisation of Insolvency Reform' (1999) *New Zealand Law Review* 401, 402.

[3] Department of Trade, *Insolvency Law and Practice: Report of the Review Committee: Presented to Parliament by the Secretary of State for Trade by Command of Her Majesty* (Cmnd 8558, 1982). See also Muir Hunter, 'The Nature and Functions of a Rescue (1999) 104 *Commercial Law Journal* 426, 434.

[4] See generally at Weiguo Wang, 'Adoption of Corporate Reorganization Regime in China – a Comparative Study' in Weiguo Wang and Roman Tomasic (eds), *Reforms of PRC Securities and Insolvency Laws* (Press of China's University of Political and Legal Science, Beijing, China 1999, in Chinese).

[5] The making of China's Enterprise Bankruptcy Law 2006 has been reviewed by Charles D Booth, 'The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over' (2008) 20 *Singapore Academy of Law Journal* 275. See also Roman Tomasic (ed), *Insolvency Law in East Asia* (Ashgate 2006).

[6] The preface of China's Enterprise Bankruptcy Law 2006 states that it took effect on 1 June 2007.

In this thesis, the terms corporate reorganization and corporate rescue are used interchangeably. In general, corporate rescue includes formal and informal rescue processes: an informal rescue takes place outside the court, which is largely driven by commercial forces; whilst a formal rescue is a judicial bankruptcy procedure that aims to rehabilitate a bankrupt company and is strictly subject to procedural and substantive bankruptcy rules.[7] In this thesis, corporate rescue only refers to formal rescue under the bankruptcy law, unless stated otherwise.

Furthermore, in China, the EBL 2006 has two procedures both of which can be used to rescue a troubled company: the reorganization and the compromise procedures.[8] Given that the corporate reorganization procedure in the EBL 2006 is the main rescue process, this thesis only focuses on the rescue procedure known as corporate reorganization. This means that the corporate compromise procedure in the EBL 2006 is excluded from this thesis, although it should be kept in mind that this procedure can also be invoked to reorganize a bankrupt company.

By the same token, in this thesis, corporate rescue in the US concerns the formal corporate reorganization procedure under Chapter 11 of the US Bankruptcy Code 1978. In the UK, the formal rescue focuses on administration, the main rescue procedure, under the UK Insolvency Act 1986.

2. NECESSITIES OF THIS THESIS

As for the research on China's new corporate rescue law, in China there are several active Chinese bankruptcy scholars[9] writing widely in this area. Unfortunately, most of them

[7] See generally Vanessa Finch, 'Corporate Rescue: a Game of Three Halves' (2012) 32 *Legal Studies* 302 (noting the distinction between formal and informal rescues). See also Michelle J White, 'Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-of-Court Debt Restructuring' (1994) 10 *Journal of Law, Economics, & Organization 268*.

[8] See Hailin Zou, 'China's Corporate Rehabilitation System – Theories and Application' (2007) 25 *Journal of China University of Political Science and Law* (in Chinese) 48.

[9] There are several leading Chinese scholars worth mentioning here: Professors Wang Weiguo, Li Yongjun and Li Shuguang from China University of Political and Legal Science, Professor Wang Xingxing from Renmin University of China, Professor Han Changyin from Shanghai Jiaotong University, Professor Wang Shihu from Southwest University of Political and Legal Science and Professor Zou Hailin from China Academy of Social Science Institute of Law. Professor Shi Jingxia also has some research interests in China's corporate bankruptcy law research.

share one weakness: they lack a broad-ranging understanding, in both theory and practice, of corporate rescue law outside China.[10]

In the western world, some bankruptcy scholars have shown great interest in China's bankruptcy law, but, partly because of linguistic barriers, little research into the details of China's bankruptcy laws has been done.[11] Although there have been some international comparative studies by western scholars,[12] few of these shed much light on China's bankruptcy laws.

We have recently seen the publication of two China-related comparative bankruptcy law studies. In 2009, Palmer and Rapisardi published a study of China's new Enterprise Bankruptcy Law which was written from an American comparative perspective.[13] Around the same time, Dr Haizheng Zhang completed a PhD thesis in England that compared China's corporate rescue regime with that of the UK.[14] Without doubt, these works have contributed considerably to the English-language literature on China's corporate rescue law research.

Palmer and Rapisardi's book, however, largely focused on practical issues, as they are practising lawyers, and paid little attention to theoretical analyses. More importantly, in their book, only a small section was dedicated to discussing corporate reorganizations in China. With regard to Dr Haizheng Zhang's PhD thesis, this, in contrast, would be the first comparative corporate rescue study between China and the UK written in English. But Zhang's thesis concentrates on comparing the statutory rules of China's new bankruptcy law

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[10] See Bruce G Carruthers and Terence C Halliday, 'Negotiating Globalization: Global Scripts and Intermediation in the Construction of Asian Insolvency Regimes' (2006) 31 *Law & Social Inquiry* 521, 561.

[11] Some western scholars should be noted as they contribute a great deal to China's bankruptcy law research: Professor Roman Tomasic from University of South Australia, Professor Charles D Booth from University of Hawai'i at Mānoa, Professor Rebecca Parry from Nottingham Trent University. Professors Bruce G Carruthers and Terence C Halliday are also interested in China's bankruptcy law research, although they analyse it from the sociological perspective. A recent China bankruptcy law study in English was that of Rebecca Parry and others (eds) *China's New Enterprise Bankruptcy Law: Context, Interpretation and Application* (Ashgate 2010).

[12] For example, a comparative study of corporate rescue in the US and the UK was undertaken by Professor Gerard McCormack in his book, *Corporate Rescue Law – An Anglo-American Perspective* (Edward Elgar, 2008). Meanwhile, other much-quoted comparative studies can, selectively, be found in Theodore Eisenberg and Shoichi Tagashira, 'Should We Abolish Chapter 11? The Evidence from Japan' (1994) 23 *The Journal of Legal Studies* 111, and, Timothy C G Fisher and Jocelyn Martel, 'Should We Abolish Chapter 11: Evidence from Canada' (1999) 28 *Journal of Legal Studies* 233.

[13] See Deryck A Palmer and John J Rapisardi, *The PRC Enterprise Bankruptcy Law, The People's Work in Progress* (Beard Books 2009).

[14] See Haizheng Zhang, 'Making an Efficient and Well-Functioning Corporate Rescue System in Chinese Bankruptcy Laws: From the Perspective of a Comparative Study between England and China' (PhD thesis, University of Leicester 2008).

with those of the UK and has not shed much light on other advanced jurisdictions, especially the US which is probably the most developed country in corporate rescue research.

Moreover, one common characteristic of these two valuable studies is that they did not draw upon empirical evidence, especially from China, to build their arguments. They knew what had been written on statutory books, but learned little on what was happening in reality. Time may have not permitted them to do so, as it was only on 1 June 2007 that the EBL 2006 formally took effect. Given the less-developed legal infrastructure in China, there probably were no available judicial statistics for them to review how this law had been translated through the statute books into actual practice.

This thesis attempts to address two gaps. The first and foremost is the gap between China's corporate rescue regime as seen from the statute books and that which operates in practice. It is an empirical study. Admittedly, such a gap exists in all jurisdictions; however, due to a lack of a well-developed rule of law,[15] it can be argued that this gap could be considerably greater in China. This further merits an empirical study. The second gap is the gap in the corporate rescue research involving China and its western counterparts.[16] In particular, lessons learned from the US and the UK, if applicable, will be referred in this study in order to enhance the understanding of China's new corporate rescue regime.

3. RESEARCH QUESTIONS

In designing research questions, this thesis takes into account the international debate on corporate rescue law as well as the challenges flowing from corporate rescue law practice in China. Specifically, this thesis seeks to answer four questions:

The first is whether China's new corporate reorganization law is frequently used, and if not, what are the main obstacles hindering its application.

The second asks who is primarily in control in China's corporate reorganizations. This is because control is always at the heart of a corporate reorganization process and has a

[15] See generally Stanley Lubman, 'Bird in a Cage: Chinese Law Reform after Twenty Years' (2000) 20 *Northwestern Journal of International Law & Business* 383.

[16] See generally Charles C Ragin, *The Comparative Method – Moving beyond Qualitative and Quantitative Strategies* (University of California Press 1987).

considerable effect on both the incentives of relevant parties to use this procedure and the outcomes of value distribution.

The third is examining how value preserved through corporate rescues is distributed between interested parties in China's corporate reorganizations. In particular, this question will focus on investigating the application of the *pari passu* and the absolute priority principles.

The fourth and final question asks whether the courts' confirmation of corporate reorganization plans is adequate to fulfil the policy goals of the corporate reorganization regime. Under the EBL 2006[17] a reorganization plan, which has been voted by all classes of impaired parties, must be ultimately confirmed by the court.

4. STRUCTURE OF THIS THESIS

After the introduction in chapter 1, chapter 2 is devoted to a literature review, as existing studies are critical to an understanding of the fundamental principles of corporate rescue. In chapter 3, a contextual background discussion of the making of China's corporate rescue law will be undertaken. Chapter 4 describes the methodology, explaining how the data were collected from China. The thesis used a combination of qualitative and quantitative research approaches to investigate the implementation of China's new corporate rescue law. Chapters 5 and 6 report the empirical findings. In particular, chapter 5 reports the corporate rescue law implementation in China as a whole, based on the collected data, which are mainly quantitative, at the national level; chapter 6 reports the fieldwork interview results conducted in one Chinese province, Zhejiang, as this province produced a large proportion of China's corporate rescue cases and was for this reason selected for a case study. Chapters 7 and 8 discuss the findings reported in the two preceding chapters, and some international experience or lessons will be referred to. Chapter 9 – conclusions – examines the extent to which the above four research questions have been answered, and the potential for reform in this area of Chinese law will be raised, and some future areas of research will be suggested.

[17] Articles 86 and 87 of the EBL 2006.

CHAPTER 2

LITERATURE REVIEW

1. INTRODUCTION

Corporate reorganization, as a broadly defined concept,[1] emerged from the US railway bankruptcy receiverships over one hundred years ago; eventually, it evolved into Chapter 11 of the US Bankruptcy Code of 1978, which is widely regarded as the benchmark for the modern corporate rescue regime across the world.[2] In fact, since the 1970s, there seems to have been a global wave of bankruptcy law reform and one of its significant features was to establish a rescue-friendly bankruptcy system.[3] In the UK, for example, its insolvency law was substantially updated in 1986 so as to embrace the corporate rescue culture. Germany amended its bankruptcy statute in 1994 in favour of a new bankruptcy rescue regime.[4] China saw its rescue-oriented bankruptcy law, the EBL 2006, passed by its People's Congress in 2006.[5]

Partly because corporate reorganization has long been developing in the US and is nascent in many other countries, most academic literature on this issue emanates from the US. In recent decades, some UK scholars joined the debate because of the emergence of corporate rescue in Britain after the 1980s. In China, because of the novelty of the new corporate rescue

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[1] See Gabriel Moss, 'Chapter 11 – an English Lawyers Critique' (1998) 11 *Insolvency Intelligence* 17, 18 (noting that rescue largely means preserving the company's business in England; whereas in the US, it is mainly directed to saving the entity of the company).

[2] The corporate reorganization was gradually shaped from the railway receiverships from the late 1800s. See further Charles Jordan Tabb, 'The History of the Bankruptcy Laws in the United States' (1995) 3 *American Bankruptcy Institute Law Review* 5, 21.

[3] See generally Jay Lawrence Westbrook, 'The Globalisation of Insolvency Reform' (1999) *New Zealand Law Review* 401, 403.

[4] See Ian F Fletcher, 'UK Corporate Rescue: Recent Developments – Changes to Administrative Receivership, Administration, and Company Voluntary Arrangement – The Insolvency Act 2000, The White Paper 2001, and the Enterprise Act 2002' (2004) 5 *European Business Organization Law Review* 119 (overhauling all rescue instruments in the UK law). See also Klaus Kamlah, 'The New German Insolvency Act: Insolvenzordnung' (1996) 70 *American Bankruptcy Law Journal* 417.

[5] See generally Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113.

regime and its education system,[6] there were not many valuable academic articles written on this subject. Therefore, the literature reviewed in this chapter is mostly from the US and the UK and is written in English.

To explore the relevant literature, this chapter, in response to the four research questions set out in chapter 1, focuses on four areas: the commencement, the control, value distribution, and the courts' confirmation of reorganization plans of the corporate reorganization system. The remainder of this chapter is accordingly arranged into five Parts: (i) Part 2 discusses issues concerning the commencement of a corporate rescue procedure; it also contains arguments regarding the goals of the corporate rescue regime and instruments to induce an early rescue. (ii) Part 3 sheds light on control in corporate rescue processes. (iii) Part 4 is devoted to analysing the value distributional norms, and (iv) Part 5 centres on criteria used by courts to confirm reorganization plans. (v) Part 6 concludes and reviews the foregoing arguments.

2. COMMENCEMENT OF CORPORATE RESCUE

Prior to a formal corporate reorganization procedure, the first question which must be asked would be what goals this regime is designed to accomplish. Answering this question is vital, since it has significant effects on a series of issues flowing from rescue processes. In general, as to the goals of a corporate reorganization regime, there were two mainstream views.

2.1. Maximisation of Creditors' Returns

In 1982, an article written by Thomas H Jackson was published in the Yale Law Journal; this might mark the starting point of the debate as to what goals the corporate rescue regime should pursue.[7] Jackson upheld that the bankruptcy reorganization regime should operate in

[6] See Bruce G Carruthers and Terence C Halliday, 'Negotiating Globalization: Global Scripts and Intermediation in the Construction of Asian Insolvency Regimes' (2006) 31 *Law & Social Inquiry* 521, 561.

[7] Thomas H Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 *The Yale Law Journal* 857.

the best interests of creditors; in particular, he argued that maximising creditor recovery should be the exclusive goal of the corporate reorganization regime.

Some years later, in 1989, Jackson reinforced his view in a co-authored article,[8] where he and Robert E Scott argued that bankruptcy might have other goals, such as value redistribution, but maximising creditor recovery prevails if there is a conflict between these objectives.[9]

From the economic perspective, Thomas H Jackson's view would be understandable and even justifiable. A company is widely seen to be owned by shareholders when it is solvent; accordingly, when the company becomes insolvent, its ownership is seen to transfer to creditors. Given that creditors have become the company's new owner, the company in bankruptcy (the estate) should undoubtedly operate in the best interests of creditors. Jackson's viewpoint seems to be consistent with the conventional theory of shareholder primacy in company law,[10] where it is thought that a company is, in the absence of insolvency, owned by shareholders whose benefit is seen as being at the centre of the company's objectives.

In the legal sense, however, the story may be totally different. A company is an independent legal entity - the company is a subject, not an object. The company belongs to itself; shareholders are not the owners of the company. In strict legal terms, shareholders only invest for control and dividends, and unable to acquire or claim the company's ownership.

In the meantime, as argued by Margaret M Blair and Lynn A Stout in 1999, a company, especially a public company, serves the interests of a wide range of interested parties, including shareholders, employees, creditors and local communities etc. The company rather acts as a connection between these parties.[11] Shareholders are only part of a group whom the company should serve.

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[8] Thomas H Jackson and Robert E Scott, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75 *Virginia Law Review* 155.

[9] Ibid 204.

[10] See generally Lynn A Stout, 'Bad and Not-so-bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189. See also generally John Armour, Simon Deakin and Suzanne J Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41 *British Journal of Industrial Relations* 531.

[11] Margaret M Blair and Lynn A Stout 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 249.

Thus, in the legal sense, one the one hand, shareholders are not the owners of the company, and on the other, they are also not the exclusive party that the company is serving.[12] Creditors, thus, could not inherit the ownership status that even shareholders do not have. At least in theory, thus, placing creditor interests absolutely at the centre of corporate reorganization reflected in Jackson's creditor recovery maximisation theory seems to be untenable.

But, Jackson's theory still had a huge impact. In 2002, partly relying on Jackson's creditor interests' maximization theory, Douglas G Baird and Robert K Rasmussen argued that corporate reorganization should be abolished on the grounds that corporate reorganization could be replaced by effective asset or going concern sales. From the viewpoint of Baird and Rasmussen, the company's control must be transferred to creditors immediately at the time when the company gets bankrupt, and it is up to creditors to decide whether to sell the assets piecemeal or as a going concern, and the debtor should be excluded because it has no economic interests in the company any more. This was mainly because Baird and Rasmussen contended that the reorganization system might have been misused by debtors at the expense of creditors.[13]

Baird and Rasmussen's argument should be appreciated in its context. In US corporate reorganization, it is the norm rather than the exception for a debtor to stay in control when a corporate reorganization procedure is entered. So, the thrust of Baird and Rasmussen's corporate reorganization abolition proposal is to exclude debtors from formal corporate rescue procedures in the belief that only creditors have direct interests in the company after insolvency.

The problem of Baird and Rasmussen's argument is that the means proposed by them are not fit for accomplishing their goal. They advocated that corporate reorganization had the sole goal of maximising creditor recovery but suggested a less optimal, and even counterproductive, means to pursue the aim. In particular, neither transferring the control of

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[12] See Lynn M LoPucki, 'A Team Production Theory of Bankruptcy Reorganization' (2004) 57 *Vanderbilt Law Review* 741, 750.

[13] Douglas G Baird and Robert K Rasmussen, 'The End of Bankruptcy' (2002) 55 *Stanford Law Review* 751. See also Douglas G. Baird and Robert K. Rasmussen 'Chapter 11 at twilight' (2003) 56 *Stanford Law Review* 673.

the company to creditors nor encouraging the company's asset sale would contribute to the maximisation of creditors' returns in bankruptcy.

This is because, in the first place, protecting creditors in corporate reorganization is unlikely to be achieved by giving them the control of the company. Allocating control to creditors must take into account whether the latter are capable and competent to conduct the debtor's bankruptcy process. In general, it is the debtor, in particular its old managers, who have the information and knowledge to turn the company around, especially when it is deeply in distress. By and large, creditors are not able to run the company in bankruptcy because they are not familiar with the debtor's business operation. In the second place, excluding the debtor, particularly its old management, will inevitably cause loss of the company's going concern value, as a result of which creditors' returns will be accordingly reduced.[14] In addition, allowing creditors to sell the company is also not an optimal way to maximising creditors' returns, because the sale of the company has to face the illiquidity of the market for troubled companies; in other words, the company sale price will be severely depressed by market illiquidity. Thus, the sale of the company (piecemeal or going concern sale) will reduce recovery for creditors rather than increase it.[15]

In short, it may be counterproductive to set up creditor interests' maximisation as a sole goal of the corporate reorganization regime. To tackle the deficiency of this theory, value redistribution as a goal of corporate reorganization emerged shortly after Jackson's 1982 article.

2.2. Value Redistribution

In 1987, Robert E Scott argued that corporate reorganizations should have multiple goals, rather than have the exclusive goal of maximising creditor returns.[16] He agreed that creditors must be well protected but analysed that other parties, in particular debtors, should also be looked after in corporate reorganizations; value redistribution should be one of the goals of

[14] See Vanessa Finch, 'Control and Co-ordination in Corporate Rescue' (2005) 25 *Legal Studies* 374, 385.

[15] See Lynn M LoPucki and Joseph W Doherty, 'Bankruptcy Fire Sales' (2007) 106 *Michigan Law Review* 1, 4. See also Jagdeep S. Bhandari and Lawrence A. Weiss 'The Untenable Case for Chapter 11: A Review of the Evidence' (1993) 67 *American Bankruptcy Law Journal* 131.

[16] Robert E Scott, 'Through Bankruptcy with the Creditors' Bargain Heuristic' (1986) 53 *The University of Chicago Law Review* 690, 707.

the corporate reorganization regime, which means that risks should be shared by all relevant parties.

In the same year, Elizabeth Warren also expressed her sharply defined view that corporate reorganization is designed to redistribute value between the interested parties rather than to exclusively concentrate on maximising creditor returns.[17]

The theoretical underpinning for Scott and Warren's arguments is that business failure is more 'an unanticipated common disaster … much like a hurricane or an earthquake' than a consequence of the debtor's incompetence or mismanagement.[18] Business failures, as a result, are worthy of sympathy, and risks should be shared; it is unfair for innocent debtors to bear risks in their entirety.

Indeed, value redistribution as the goal of corporate reorganization may be used to justify a debtor-in-possession as well as departure from absolute priority in US corporate reorganizations.[19] It should, however, be made clear that value redistribution must be premised upon the condition that the business failure is exogenous or at least is because of honest mistakes; otherwise it may create moral hazard. At the same time, concerns arise as to where to draw the line in sharing risks between parties, in particular, between creditors and shareholders. The fundamental principle of distributing value between shareholders and creditors is the absolute priority principle according to which shareholders can receive nothing unless and until creditors are paid in full. To strike a fair balance between creditor and shareholder, it is worth noting that the deviation from absolute priority in corporate reorganization must be undertaken with the consent of disadvantaged parties; otherwise, value redistribution will undermine market efficiency, because creditors' certainty and predictability in the wider market will be compromised or even jeopardized.

In 2000, Brian A Blum echoed Scott and argued that the continued popularity of corporate reorganization in the US had suggested that corporate rescue should have a two-tier goal, namely both creditor recovery maximisation and value redistribution should be the

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[17] Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *The University of Chicago Law Review* 775.
[18] Scott (n 16) 699.
[19] See Alan Schwartz, 'A Normative Theory of Business Bankruptcy' (2005) 91 *Virginia Law Review* 1199, 1203.

goals of a corporate reorganization regime.[20] Blum argued that the social goals of businesses should be borne in mind when deciding whether to rescue a troubled company, and that exclusively focusing on the maximisation of creditor interests may put the social value of businesses at jeopardy.[21]

Blum's view is likely to be compatible with the pro-rescue mechanisms in the US as Chapter 11 of the US Bankruptcy Code of 1978 allows a debtor to keep on running the company after it enters the corporate reorganization procedure, and even the absolute priority rule can be relaxed in favour of the debtor in an effort to deliver a more feasible rescue. Value redistribution may also be in harmony with the maximisation of creditor interests, as inviting debtors to join rescues will usually give a better return to creditors. Corporate reorganization is therefore not a zero-sum game between creditors and the debtor, and it could be carried out in the interests of both creditors and the debtor.

Whether creditor interest maximisation or value redistribution is adopted, a rescue would be more likely to be achievable if it can be filed as early as possible. In the next section, we review mechanisms to encourage early rescues.

2.3. Encouraging Early Rescues

In 2008, Gerard McCormack discussed mechanisms in the US and the UK designed to encourage an early rescue; this occurred in his far-reaching comparative study, 'Corporate Rescue Law – an Anglo-American Perspective'.[22] McCormack argued that, in the US, debtors are incentivized to file for reorganization in a timely manner because they are allowed to stay in control under a debtor-in-possession approach; more importantly, the debtor-in-possession aims to take advantage the debtor's experience and information so as to make the rescue more achievable. A debtor-in-possession was dubbed as a 'carrot' policy which gives an incentive to the debtor in exchange for its voluntary and timely rescue filing. By contrast to the US, the UK has no debtor-in-possession policy; rather than a 'carrot', there

[20] Brian A Blum, 'The Goals and Process of Reorganizing Small Business in Bankruptcy' (2000) 4 *The Journal of Small & Emerging Business Law* 181, 226.
[21] Ibid 235.
[22] Gerard McCormack, *Corporate Rescue Law – An Anglo-American Perspective* (Edward Elgar Publishing 2008) 132.

is the 'stick' or the use of wrongful trading; this provides a warning that forces the debtor to take early rescue actions; otherwise, the debtor company directors will be personally liable for creditors' losses.[23]

In order to encourage early rescue filings, however, both the debtor-in-possession and the wrongful trading approach seem not to be enough. Under the debtor-in-possession approach, a debtor might be induced to file a voluntary rescue petition, but its prospect is likely to be slim because of the absolute priority principle in distributing the company's value in insolvency. The absolute priority principle means that shareholders will receive nothing unless creditors are fully paid. Given the insolvency of the company, filing for reorganization in court will largely lead to cancellation of shareholders' interests; as a result, the debtor, in particular its equity managers, will definitely try to avoid filing for a formal rescue in spite of the debtor-in-possession, because their own or their principal's equity may be wiped out in the coming bankruptcy rescue process.[24] This fear has been corroborated by an empirical study from the US which showed that the majority of voluntary reorganization filings essentially occurred because of imminent liquidation threats from creditors;[25] in other words, filing for reorganization was mainly used by debtors to keep creditors at bay. It is more a strategy of the debtor to seek to stay in business longer. Thus, the debtor-in-possession approach is necessary but not sufficient to persuade debtors to take early formal rescue action. Its effectiveness also depends on whether the absolute priority principle could be applied with certain flexibility.

As for the use of the wrongful trading procedure to warn or force debtors to take early rescue action, their efficacy is considerably undermined by the difficulties that arise in its enforcement. Andrew Keay argued that the main problem in the use of the wrongful trading was that it was difficult to identify the point at which directors knew or should have known that the company could not avoid liquidation. Moreover, fearful of its chilling effect upon entrepreneurship, British authorities are unlikely to penalize directors by using the wrongful

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[23] Ibid 132-5.

[24] Douglas G Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108 *The Yale Law Journal* 573, 952 (stating 'the manager, for their parts, have no reasons to restructure the firm if a restructuring leaves them with nothing').

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

trading approach.[26] So, this mechanism is not frequently applied in practice to force early rescues in the UK.

Until recently, Vanessa Finch was sceptical of the use of the wrongful trading approach to facilitate early rescues. She contended that "the current law under-deters directors from excessively sustained trading in spite of an array of constraints including the potential for wrongful trading and misfeasance actions".[27]

Meanwhile, in comparing the British rescue regime with the US Chapter 11, Lijie Qi argued that, for the sake of an early rescue, it is more desirable for policymakers to reward rather than threaten debtors to take early actions, because the debtor-in-possession seems to have a better effect than the wrongful trading approach has.[28] Rebecca Parry also raised concerns that the UK might lack "an effective debtor in possession procedure (especially) for medium and large companies" so as to promote the corporate rescue culture.[29]

Transplanting the debtor-in-possession into the UK's insolvency law might, however, not be an easy task on the grounds that it will encounter a series of obstacles ranging from the different social attitudes towards business failures to the judicial path dependency.[30]

In sum, in pursuit of an early rescue, a host of tools should be available, including a debtor-in-possession, the flexibility of absolute priority and, more importantly, a stringent individual debt enforcement system.

3. THE CONTROL OF CORPORATE RESCUE

In regard to the control in corporate rescue, there are two leading models worldwide: namely the debtor-in-possession model found in the US and the practitioner-in-possession model found in the UK.[31]

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[26] See generally Andrew Keay, 'Wrongful Trading and the Point of Liability' (2006) 19 *Insolvency Intelligence* 132.

[27] Vanessa Finch, 'Corporate Rescue: A Game of Three Halves' (2012) 32 *Legal Studies* 302, 320.

[28] Lijie Qi, 'Managerial Models during the Corporate Reorganization Period and Their Governance Effects: the UK and US Perspective' (2008) 29 *Company Lawyer* 131, 140.

[29] Rebecca Parry 'Is UK Insolvency Law Failing Struggling Companies?' (2009) 18 *Nottingham Law* Journal 42, 50,

[30] See McCormack (n 22) 127.

As noted above, a debtor-in-possession model assumes that, in principle, the debtor will remain in control after the formal corporate rescue process begins, although during the rescue procedure the management are imposed with fiduciary duties to act in the best interests of a wide range of stakeholders.[32] By way of contrast, in British corporate rescue proceedings, mainly administration procedures, the management will be automatically replaced by an outside administrator, usually an insolvency practitioner, when the formal rescue procedure starts; thus, it is a practitioner-in-possession model that is found in the major British corporate rescue procedures.[33]

In addition, Rebecca Parry has argued that there is a modified debtor-in-possession approach enshrined in both the German and Chinese bankruptcy rescue laws, where a debtor can be authorized to regain control of the company from the administrator after the rescue procedure has been entered, but is subject the latter's supervision afterwards.[34]

3.1. The Debtor-in-Possession Model

Through examining the history of the debtor-in-possession model used in the US's bankruptcy law, Harvey R Miller noted that the fundamental underpinning of a debtor-in-possession model is that "the entity best suited to administer and effect a rehabilitation and reorganization of a financially and operationally distressed debtor would, in most circumstances, be the debtor". [35] The debtor, in particular its managers, has specific information and experience on the company's position; therefore, a practical rescue has to rely on the involvement of the debtor. But the danger here is that the debtor is not an impartial or disinterested party in the rescue process and may unfairly exploit control at the expense of other parties, especially the creditors.

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[31] See Finch (n 14) 375.

[32] See generally John T Roache, 'The Fiduciary Obligations of a Debtor in Possession' (1993) *University of Illinois Law Review* 133.

[33] See Gerard McCormack, 'Apples and Oranges? Corporate Rescue and Functional Convergence in the US and UK' (2009) 18 *International Insolvency Review* 109, 116.

[34] Parry (n 29) 50.

[35] Harvey R Miller, 'The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judges as Producer, Director, and Sometimes Star of the Reorganization Passion Play' (1995) 69 *American Bankruptcy Law Journal* 431, 432.

The concern of debtors' biased control is not unnecessary. Lynn M LoPucki once reported, in one of his empirical studies, that the debtor-in-possession was really abused by some debtors in the US, since he found that most debtors filed for Chapter 11 bankruptcy only to remain in business longer or to avoid immediate liquidation by creditors. In particular, he revealed that, in his studied cases, only twenty-six per cent of debtors using Chapter 11 survived rescue procedures; put differently, the majority of debtors were not really suitable for the rescue procedure and they misused Chapter 11 in order to postpone the business closure. LoPucki, thus, contended that there was a systemic failure in the debtor-in-possession model and proposed that there should be more creditor control in Chapter 11 procedures in the US.[36]

The high failure rate of Chapter 11s, which is used to attest the misuse of the debtor-in-possession procedure, as demonstrated by LoPucki, may, however, be interpreted differently. A later empirical study conducted by Elizabeth Warren and Jay Lawrence Westbrook found that, in the US, some debtors might seek to file under Chapter 11 to unfairly exploit the debtor-in-possession procedures, but these inappropriate filings would be quickly jettisoned by bankruptcy judges. More specifically, as revealed by Warren and Westbrook, nearly half of the Chapter 11 cases were dismissed by judges within six months of filings, because these debtors were indeed not suitable candidates for rescue, i.e., the high failure rate under Chapter 11 reflects the efficiency of the US bankruptcy system in curbing the abuse of the debtor in possession procedure.[37]

It should also be noted that the use of the US debtor-in-possession procedure does not mean that debtors can conduct rescue processes entirely at their own discretion. Instead, there is a series of supervision and counter-abuse mechanisms. Harvey Miller argued that there are several approaches available to minimise, if not eliminate, the negative effects of the debtor-in-possession model. at first, a debtor would be replaced by a trustee if its business failure can be ascribed to fraud or dishonesty; this means that a potential debtor-in-possession must first satisfy the pre-failure intention test; the availability of the debtor in possession is not guaranteed. Furthermore, the debtor-in-possession can only manage the company in the ordinary course of business, and any substantial business activities should be undertaken with

[36] LoPucki (n 25) 99.

[37] Elizabeth Warren and Jay Lawrence Westbrook, 'The Success of Chapter 11: A Challenge of the Critics' (2009) 107 *Michigan Law Review* 603, 621.

the court's permission. More importantly, the debtor is subject to the fiduciary duty to serve all interested parties rather than to continue its role as the agent of the shareholders. In addition, the debtor should be subject to the scrutiny of the mandatorily organized creditors' committee, amongst other things.[38]

It is noteworthy that a debtor-in-possession model does not mean that the debtor's managing team can be kept intact during the rescue process. On the contrary, an empirical study by Stuart C Gilson in 1990 reveals that approximately half of company directors, in the cases studies, lost their jobs after the companies' financial crisis.[39] In other words, on the face of it, the old management team as a whole was retained; however, its composition would often be substantially changed. But Gilson's aforementioned data should be read carefully. His sampled cases included Chapter 11 cases and other non-bankruptcy debt restructurings, and there was no exact figure to describe directors' removal exclusively during Chapter 11s. It, therefore, is not quite accurate to reach the conclusion that half of the directors would be sacked after the Chapter 11 process begins.[40] But one point is certain: many senior managers of debtors would be ousted, although a debtor-in-possession was used in these rescue processes.

3.2. The Practitioner-in-Possession Model

Unlike the dominant debtor-in-possession model as found in the US's Chapter 11, under the UK's corporate rescue procedures, mainly administration,[41] a company's directors will be entirely replaced by an administrator, who will be a qualified insolvency practitioner (IP). This situation may thus be called a practitioner-in-possession model.[42] Strictly speaking, however, a practitioner-in-possession is also available in the US under Chapter 11 where a debtor could also be replaced by a trustee if the court believes that the company's failure

[38] Miller (n 35) 435-49.

[39] Stuart C Gilson, 'Bankruptcy, Boards, Banks and Blockholders' (1990) 27 *Journal of Financial Economics* 355.

[40] See Finch (n 27) 306. See also Gerard McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation' (2007) 56 *International and Comparative Law Quarterly* 515.

[41] In the UK, there are several legal procedures for corporate rescue, but the main one is the administration. See further Finch (n 27) 302.

[42] Finch (n 14) 375.

could be attributed to fraud or dishonesty.[43] So, the practitioner-in-possession model is not unique to UK insolvency administration.

As for the justification for the practitioner-in-possession model in the UK, Gerard McCormack has maintained that British social attitudes towards business risk-taking and failures do not favour a debtor-in-possession approach.[44] In the UK, business risk-taking is, in general, not widely preferred by society at large. Failed businessmen are, as a result, more likely to be blamed rather than to be sympathized with. And it seems to be socially unacceptable for businessmen who are responsible for failures to be entrusted to continue their positions during formal rescue processes.[45]

Using the UK's general social attitudes towards business failure to warrant a practitioner-in-possession model, may however create controversy. This is because social attitudes are too broad and elusive in character. In the corporate bankruptcy context, it can largely be interpreted as attitudes of creditors, since it is creditors who are directly affected by corporate bankruptcy. Primarily, frustration or anger would be the immediate reaction of creditors when they are informed of bankruptcy, as their financial interests will inevitably be harmed. Thus, the so-called British social attitudes towards business failures can be understood as the frustration of creditors towards a debtor's failure. The key concern here, however, is that creditors' frustration does not justify removing the debtor from the corporate rescue process, because such an instinctive response to punish the debtor or demand a scapegoat fails to appreciate the diverse causes of business failures.

As for causes of business failures, Harvey Miller argued that they may be identified at two levels.[46] At the first level, a business failure could be occasioned by either endogenous or exogenous factors. regarding exogenous factors, there may be a sudden economic recession or even a substantial default of a creditor that brings down the company; therefore, in the case of exogenous reasons for a failure, it is unfair to punish the debtor who is not culpable for the business distress. At the second level, even where a business failure is endogenous, as

[43] It was found by LoPucki and Whitford that trustees were appointed only in a small number of Chapter 11s in the US, but the practitioner in possession was still used if certain conditions were met. See Lynn M LoPucki and William C Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141 *University of Pennsylvania Law Review* 669, 700.

[44] McCormack (n 40) 521-4.

[45] Ibid.

[46] Miller (n 35) 445.

examined by Bruce G Carruthers and Terrence C Halliday, it may be related with totally different intention of the debtor: an honest mistake, reckless business speculation, or fraud.[47] Accordingly, if it is the debtor's honest mistake which results in the bankruptcy, removing the debtor from the rescue process seems to be disproportional. Hence, it seems to be irrational to scapegoat the debtor and sack it immediately, no matter whether the failure is exogenous and whether it is an honest mistake causing the distress.

In short, using general social attitudes to justify the debtor-displacement in rescues might be untenable, since it fails to take into account the diverse causes of business failures.

Furthermore, John Armour and his co-authors have argued that the UK practitioner-in-possession model might have been shaped by the concentrate ownership structure as well as the concentrate debts of most UK companies. On the one hand, corporate ownership concentration means that these companies are largely owner-managed. When a corporate bankruptcy reorganization process begins, in order to prevent biased control of the debtor, it is essential that the debtor be replaced by an independent IP. On the other hand, given that most UK companies rely heavily on bank finance, banks as the main creditors could more effectively manage a debtor-displacing rescue procedure because of the convenient coordination between them and the administrator. In other words, the potential friction or coordination challenges between creditors could be minimised. Armour and his co-authors argued that, because of these two factors, debtor-displacement would be suitable for British corporate rescues.[48]

Some key factors might, however, have been overlooked by Armour and his co-authors. With regard to concentrated ownership, it is true that most UK companies are closely held,[49] as is widely the case elsewhere where the majority of businesses are SMEs.[50] This means that these companies are not only closely owned but also shareholder managed; in other words,

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[47] Bruce G Carruthers and Terence C Halliday, *Rescue Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford University Press 1998) 269.

[48] John Armour, Brian R Cheffins and David A Skeel Jr, 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 *Vanderbilt Law Review* 1699, 1702.

[49] See generally Julian Franks and Colin Mayer, 'Corporate Ownership and Control in the UK, Germany and France' (1997) 9 *Journal of Applied Corporate Finance* 30.

[50] See Meghana Ayyagari, Thorsten Beck and Asli Demirguc-Kunt, 'Small and Medium Enterprises across the Globe: A New Database' World Bank Policy Research Paper 3127, August 2003 <http://elibrary.worldbank.org/docserver/download/3127.pdf?expires=1375023624&id=id&accname=guest&checksum=D3B00168C66CF4BEEC748D773C2AB7A4> accessed 28 July 2013.

they are directly controlled by shareholders. In theory, it seems desirable that shareholder managers be replaced when a bankruptcy reorganization procedure is entered, because of the worry that they may misuse their control to the detriment of creditors. But, one difficulty arises immediately; the alleged biased control would be eliminated by replacing shareholder managers with an IP; however the feasibility of rescue will be materially undermined, because an IP is often technically unable to effectively rescue a troubled company due to his lack of information and specific understandings of the company's affairs.[51] Therefore, rescuing a closely held company will be adversely affected by replacing the shareholder managers with an outside, independent IP.

Meanwhile, as for striking a balance between the feasibility of rescue and the prevention of biased control of debtors, it is worth remembering the historic development of the debtor-in-possession model in the US. It was reported by Charles Jordan Tabb that, when the debtor-in-possession model was officially recognized and inserted into Chapter XI of the Chandler Act in the US in 1938, it was exclusively designed for small and medium enterprises, or closely held companies, on the grounds that it was unrealistic to rescue these companies without the involvement and continued service of shareholder-managers.[52] To a certain extent, US lawmakers have tried to weigh creditor protection against the feasibility of corporate rescues, especially when troubled companies are closely held. There is a real concern here about the potential biased control of the debtor-in-possession, but this could be minimised by a range of supervision measures, as argued before. Thus, the US such experience suggests that concentrated corporate ownership needs more a debtor-in-possession than a practitioner-in-possession approach.

As for concentrated debts of most UK companies, admittedly, from the point of view of financial creditors, namely banks, with a practitioner-in-possession available, it would be quite efficient and effective for them to appoint an administrator to take control of the company and pursue their own agenda in a timely fashion. But this brings a danger here that a new type of biased control emerges – the biased control exercised by banks. As argued by

[51] See generally Olof Brunninge, Mattias Nordqvist and Johan Wiklund, 'Corporate Governance and Strategic Change in SMEs: The Effects of Ownership, Board Composition and Top Management Teams (2007) 29 *Small Business Economics* 295.

[52] Tabb (n 2) 30.

Vanessa Finch,[53] a bank-appointed administrator would prioritise banks' interests at the expense of other creditors, in particular unsecured trade creditors. Interestingly, in the UK, it was mainly the biased control of banks in corporate rescues which led to the radical amendment of the UK insolvency law in 2002, as a result of which the former system of administrative receivership was virtually abolished.[54] In other words, lawmakers in the UK have recognised that concentrated debts had negatively affected the practitioner-in-possession approach, and that the biased control wielded by concentrated debts should be prevented. Concentrated debt is a problem for a practitioner-in-possession model. Thus, it seems inappropriate to use concentrated debts to justify a practitioner-in-possession model in the UK's rescue regime.

Nevertheless, Gerard McCormack concluded that although the UK is different from the US in regard to prevailing social attitudes to entrepreneurship and different types of debt markets, 'there is no single knockout or standout reason' that could explain why the UK has a debtor-displacement rescue regime that is distinctive from the US debtor-in-possession.[55] It is noteworthy that Vanessa Finch recently remained sceptical of the efficacy of a practitioner-in-possession in the UK administration procedure and argued that UK rescues might have been considerably undermined by the automatic removal of debtors.[56]

Probably, in the near future, British policy-makers may rethink the *pros and cons* of its practitioner-in-possession model and revise it to enhance the UK's corporate rescue regime.

4. VALUE DISTRIBUTION

By and large, value distribution in corporate reorganization is bound by two fundamental norms: the absolute priority and the *pari passu* principles. The absolute priority principle deals with value distribution between shareholders and creditors in corporate bankruptcy; in particular, this principle means that shareholders will receive nothing unless creditors are

[53] See Finch (n 14) 381.
[54] See generally Sandra Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67 *The Modern Law Review* 247.
[55] McCormack (n 40) 550-1.
[56] Finch (n 27) 319-20.

paid in full, and it asserts that "debt should be paid before equity".[57] Unlike the absolute priority principle, the *pari passu* principle governs value distribution between creditors similarly situated; specifically, the principle requires that "creditors holding formally similar claims under non-insolvency law are to be paid back the same proportion of their debt in their debtor's insolvency".[58] Since there are few controversies about the *pari passu* principle in corporate rescue, this Part of the literature review focuses on the absolute priority principle and its deviation.

4.1. The Absolute Priority Principle

In English literature, it is widely known that the absolute priority principle was originally formulated in the case of *Northern Pacific Railway Company and Northern Pacific Railroad Company v. Joseph H. Boyd* (hereinafter the *Boyd* case) adjudicated by the US Supreme Court in 1913[59] wherein the Court upheld that shareholders could not retain an interest, in the form of either equity or control or both, in the reorganized company until and unless creditors have been paid in full.

In substance, the absolute priority principle was not 'created' or 'established' by the *Boyd* case; instead, this case simply formalised this rule because it was derived from principles of equity. To some extent, this principle is also compatible with the limited liability principle: shareholders are shielded with limited liabilities,[60] and the price paid for this is that they consent to subordinate their claims to creditors in the event of insolvency. But the *Boyd* case gave rise to a concern: the absolute priority principle seems to be quite harsh to shareholders, especially to shareholder-managers, because they are not allowed to hold an interest of any form, either in equity or in control, in the reorganized company.

In reality, it can be argued that shareholders, especially shareholder-managers, in the reorganized company should be treated differently. If a shareholder-manager is, due to his or

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[57] Douglas G Baird and Robert K Rasmussen, 'Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations' (2001) 87 *Virginia Law Review* 921, 937.

[58] Rizwaan Jameel Mokal, 'Priority as Pathology: The *pari passu* Myth' (2001) 60 *Cambridge Law Journal* 579, 583.

[59] 228 U.S. 482, 33 S. Ct. 554.

[60] See generally E Merrick Dodd, 'The Evolution of Limited Liability in American Industry: Massachusetts' (1948) 61 *Harvard Law Review* 1351.

her expertise and experience in running the business, invited by the new owner to join the company in the wake of the corporate reorganization process, and even is given some equity, it may not raise concerns of violation of the absolute priority principle. The issue may, however, be changed dramatically in nature; it is a breach of absolute priority if such an offer is agreed to by the end of the reorganization process; it may even amount to a kind of collusion. This problem may become very subtle or tricky, so that whether it is a breach of absolute priority will depend on *when* a shareholder-manager enters an agreement with the company's new owner to sell his or her experience and knowledge in exchange for an interest in the new company.

It was mentioned by Elizabeth Warren that, after the *Boyd* case, the absolute priority principle remained as a common law rule until the enactment of the US Bankruptcy Code of 1978; this was partly because law-makers in the US were fully aware of the dilemma regarding this principle's application in corporate rescues.[61] In 1978, this principle was eventually codified, but certain flexibility was also provided for.

It should be noted that, before 1978, the absolute priority principle, as a common law rule, was exclusively applicable in in US Chapter X reorganization involving large companies; by contrast, in the then Chapter XI reorganization procedure (which was essentially a compromise process), this principle was not mandatory. In the Bankruptcy Code of 1978, a new Chapter 11 was created by merging the previous Chapters X and XI, and, more importantly, the absolute priority principle became a default rule in the new law.

With regard to the rationale of the absolute priority principle, it was argued by Barry E Adler that the absolute priority principle may, by implication, reflect bargains between creditors and shareholders by which 'equity investors purchase residual claims subordinate to those of creditors, in return, these equity investors gain both control of the firm and the right to any value in excess of the amount the firm owes creditors'.[62] Undoubtedly, absolute priority was intended to protect creditors and to prevent shareholders and their agents from unfairly taking advantage of their position as insiders.[63] Absolute priority might result from

[61] Elizabeth Warren, 'A Theory of Absolute Priority' (1991) *Annual Survey of American Law* 9, 38.
[62] Barry E Adler, 'Bankruptcy and Risk Allocation' (1992) 77 *Cornell Law Review* 439, 441.
[63] Warren (n 61) 37.

implied bargains between creditor and shareholder; however, in a strictly legal sense, it is a statutory obligation for shareholders to prioritize creditors' claims.

The absolute priority principle is necessary to protect creditors, but is not enough. In theory, in the event of insolvency, shareholders will get nothing unless and until creditors' claims are met in full. The worry here, however, is that shareholders may have obtained what they have expected long before the company's insolvency through their own or their agents' control, and the company may have become an empty shell at the time of insolvency, which makes creditors' priority meaningless. Thus, the goals that the absolute priority principle aims to accomplish will rather depend on a full investigation of the company's business when the company is insolvent. Shareholders and their agents should be held accountable if they misuse their control for illegal pre-insolvency gains. Investigating the company's business, however, raises the concern of costs, especially when there are few assets left in the bankrupt company.

As far as the application of the absolute priority principle is concerned, it was noted by Elizabeth Warren that 'the application of the absolute priority rule produces little controversy' in a corporate liquidation, though it becomes complicated in a corporate reorganization.[64] In fact, even in a liquidation, on the face of it, the absolute priority rule seems to be stringently followed: however, deviation from it is, in real terms, still often seen.

For example, B Espen Eckbo and Karin S Thorburn reported that, in Sweden, there is a strict bankruptcy liquidation system whereby a bankrupt company will be automatically auctioned and a corporate reorganization regime does not exist; but the deviation from the absolute priority rule usually occurs when a sale-back is concluded.[65] In a sale-back, the company's business or its assets are, partly because of market illiquidity for troubled companies, sold back to the former managers some of whom are equity-holders. More importantly, Eckbo and Thorburn noted that the average price of a sale-back is always lower than that of sales to outsiders.[66] Obviously, the difference in the company's' value goes to the equity-managers, although creditors are not fully paid. This means the deviation from

[64] Ibid 9.
[65] B Espen Eckbo and Karin S Thorburn, 'Automatic Bankruptcy Auctions and Fire-Sales' (2008) 89 *Journal of Financial Economics* 404, 405.
[66] Ibid.

absolute priority can still happen, although against the backdrop of a stringent liquidation system.

In the UK's formal bankruptcy procedures, it was mentioned by Julian R Franks and his co-authors that the absolute priority rule is rigorously applied.[67] However, it was also mentioned by Vanessa Finch that at least in some UK pre-packaged administrations departures from this rule can still be observed when businesses are sold to management-connected parties at undervalued prices.

Thus, in company liquidations, the absolute priority rule is formally complied with; however, in real terms, deviations from the rule can still happen but in a subtle way. In corporate reorganizations, by way of contrast, this rule does give rise to many controversies, and these will be reviewed in this next section.

4.2. Deviations from the Absolute Priority Principle

Different in liquidation, the deviation from the absolute priority principle takes place more visibly in corporate reorganization, partly because its rigorous application may be unproductive.

Walter J Blum and Stanley A Kaplan have argued that sometimes serious concerns arise when absolute priority is considered and applied in corporate reorganization. First, inaccurate asset evaluations will undermine the objectives of absolute priority. Unlike in a liquidation where the company's sale is real, the company sale in a reorganization is hypothetical, and the company's price is determined by an asset valuation result. The difficulty here, however, is that asset valuation always involves uncertainties and inaccuracies. More specifically, Blum and Kaplan stated that:

The valuation procedure always produces a dollars and cents figure; although that figure looks mathematically exact, it actually reflects in a single number a whole series of highly

[67] Julian R Franks, Kjell G Nyborg and Walter N Torous, 'A Comparison of US, UK, and German Insolvency Codes' (1996) 25 *Financial Management* 86, 91.

conjectural and even speculative judgements concerning long-range business expectations and hazards as well as future social and general economic conditions.[68]

Therefore, considering inaccurate valuations, if a company's assets are undervalued, it may be quite unfair to extinguish the interests of junior investors, especially shareholders and unsecured creditors, simply by mechanically applying the absolute priority rule. The contrary is equally true: if a company's assets are overestimated, senior investors have to concede part of the company's value to junior ones, which means that junior parties may unfairly take advantage of the overvaluation. Thus, applying absolute priority has to face the problems occasioned by inaccurate asset valuation.

Second, Blum and Kaplan contended that that applying absolute priority would undermine the feasibility of rescue, because the equity-managers who have the information and experiences to run the company will be driven away. At the same time, the disappearance of these equity-managers would also lead to the loss of the company's going concern value, since their expertise and experience are a significant part of the company's know-how.[69]

In addition, Blum and Kaplan argued that it seems to be justifiable under the absolute priority doctrine for a company's liquidation value to entirely go to creditors; however, the company's going concern value generated from the continued service of old equity-managers should be treated in a different way. In other words, these equity-managers should be allowed to share the value created by their continued service in the new company; otherwise, they have no reasons to remain and provide their expertise.[70]

Perhaps, for these reasons, Douglas G Baird and Donald S Bernstein mentioned that the departure from absolute priority is commonplace in US corporate reorganization, though it is fiercely debated.[71] In the UK, as reported by Julian R Franks and his co-authors,[72] it is rare to

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[68] Walter J Blum and Stanley A Kaplan, 'The Absolute Priority Doctrine in Corporate Reorganizations' (1974) 41 *The University of Chicago Law Review* 651, 656.

[69] Ibid 657.

[70] Ibid 660.

[71] Douglas G Baird and Donald S Bernstein, 'Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain' (2006) 115 *Yale Law Journal* 1930, 1932.

[72] Franks, Nyborg and Torous (n 67) 91.

see the deviation from absolute priority in formal rescue procedures; however, in informal rescues, such deviation is not uncommon.[73]

The deviation from absolute priority may, however, only be suitable and justifiable in the reorganizations of SMEs.[74] Most SMEs are personally owned and managed. Given that SMEs are personally managed, a going concern sale rescue is highly unlikely because it would be quite difficult and even unrealistic in some instances for an outside buyer to step in and turn the company around. Meanwhile, without the involvement of old equity-managers, the going-concern value of these SMEs will be materially reduced; in turn, creditor interests will also be jeopardised. Perhaps, because of these concerns, prior to the US's Bankruptcy Code of 1978, absolute priority was not mandatory in reorganizations of SMEs.[75] Interestingly, this may echo corporate rescues in Japan where, according to Theodore Eisenberg and Shoichi Tagashira,[76] absolute priority can be legally put aside in bankruptcy rescues of SMEs.

But, the deviation from absolute priority is also hotly disputed, because it raises serious concerns about its negative effects on market efficiency. First and foremost, Douglas G Baird argued that deviating from absolute priority in pursuit of a pragmatic rescue may compromise the legal certainty and predictability of creditors in the market.[77] Without deviating from absolute priority, creditors would be more confident in extending credit, since they are aware that the absolute priority rule provides them the protection in case of the debtor's insolvency. In anticipation of potential deviation from absolute priority, however, creditors would be either more hesitant to extend credit or charge higher interest rates to cover potential and extra losses. Stanley D Longhofer noted that creditors are 'unwilling to provide any funding to these borrowers at any rate of interest' if they are aware that the absolute priority rule will be breached in the event of bankruptcy.[78]

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[73] For example, in the informal rescue case of British Energy, the absolute priority rule was relaxed to facilitate the rescue. See Committee of Public Accounts, The Restructuring of British Energy (HC 2006-07, 892).

[74] Baird and Rasmussen (n 57) 947-8.

[75] John D Ayer, 'Rethinking Absolute Priority after *Ahlers*' (1989) 87 *Michigan Law Review* 963, 977.

[76] Theodore Eisenberg and Shoichi Tagashira, 'Should We Abolish Chapter 11? The Evidence from Japan' (1994) 23 *The Journal of Legal Studies* 111, 150.

[77] Baird (n 24) 590-2.

[78] Stanley D Longhofer, 'Absolute Priority Rule Violations, Credit Rationing, and Efficiency' (1997) 6 *Journal of Financial Intermediation* 249, 259.

As a consequence, if creditors are unwilling to provide credit or charge higher interest rates because of the deviation from absolute priority in corporate rescues, market efficiency will inevitably be harmed.

Second, Lucian A Bebchuk suggested that deviation from the absolute priority rule may also give rise to moral hazard, since rewarding equity managers by relaxing absolute priority may send the wrong message to the market - managers will not be responsible for their own mistakes that have caused company failures.[79] Business ethics could thus be at stake.

Bebchuk continued to argue that[80] moral hazard may also be caused by reckless business ventures by managers when they anticipate deviating from absolute priority in incipient formal rescues. Because of the potential deviation from absolute priority, the company's managers may be emboldened to engage in high-risk-and-high-reward ventures. They know that if the venture succeeds, they will be rewarded because of deviating from absolute priority in future formal rescues, but they have nothing to lose if the venture fails, as it is creditors who have to bear the full costs. This creates moral hazard. Thus, deviating from absolute priority may raise business ethical concerns and place creditor interests in greater jeopardy.

These worries, however, may be superfluous, because they fail to consider the preconditions for deviating from the absolute priority rule in corporate reorganization. First, it is worth noting that deviating from absolute priority is not unconditional; instead, it must be strictly premised upon the consent of disadvantaged parties in corporate rescues, whether it is a formal or informal rescue.[81] This suggests that creditors' legal certainty and predictability about absolute priority will not be sacrificed or undermined. Instead, creditors are given more options. They can choose to be paid out of the company's entire liquidation value without the continued service of old equity-managers. Alternatively, they can invite the equity-managers to rebuild the company together and share the going concern value in excess of liquidation value contributed by the latter. So, in real terms, market efficiency will not be compromised.

Second, it is true that business ethnics would be threatened if managers are not responsible for their own mistakes or misconduct that lead to the company bankruptcy. It

[79] Lucian Arye Bebchuk, 'Ex Ante Costs of Violating Absolute Priority in Bankruptcy' (2002) 57 *The Journal of Finance* 445, 448.

[80] Ibid 446.

[81] In the US, Japan and the UK, deviation from absolute priority must be based on the consent of creditors; otherwise, the rescue proposal will fail.

should, however, be remembered that the corporate rescue regime is only designed and is open to companies whose failures are not due to dishonesty or fraud; in other words, a company will be excluded from the corporate rescue procedure if there is evidence that its failure involves morally unacceptable conduct.[82] So, the concern about moral hazard will, in theory, at least, be ruled out because dishonest companies and their managers will not be allowed to enter formal rescue processes at the first stage. Of course, in practice, a screening test[83] of rescue eligibility should be stringently enforced so as to prevent moral hazard from arising.

In sum, deviating from absolute priority is aimed to facilitate a viable and pragmatic rescue, and, at the same time, market efficiency will be enhanced rather than undermined if the deviation can be processed under the established rules.

5. COURT CONFIRMATION OF REORGANIZATION PLANS

The reorganization plan is at the heart of a corporate reorganization procedure. After the reorganization plan is voted on by all classes of impaired parties, it may be subject to court confirmation, although this varies from jurisdiction to jurisdiction. In the US, for example, under its bankruptcy law, a reorganization plan must be confirmed by the court.[84] By contrast, in the UK, a reorganization plan (a proposal) will take effect immediately after being voted on by creditors without the need to be confirmed by the court.[85] China seems to have followed the US practice, since a reorganization plan in China's corporate reorganization must be eventually confirmed by the court.[86]

If a reorganization plan has been accepted by the majority of all classes of voters, it may be subject to a normal court confirmation procedure. In some instances, however, if a reorganization plan has failed to win support from all classes of voters, its proponent can still

[82] Robert J Berdan and Bruce G Arnold, 'Displacing the Debtor in Possession: The Requests for and Advantages of the Appointment of a Trustee in Chapter 11 Proceedings' (1984) 67 *Marquette Law Review* 457, 460.

[83] See generally Wai Chee Robinson, 'Entry Requirements: A Comparative Analysis of the Corporate Rescue Regimes in Australia, the United Kingdom and the United States of America' (1995) 8 *Corporate and Business Law Journal* 129. See also Warren and Westbrook (n 37) 632 (arguing that the US bankruptcy judges fare well in culling unsuitable companies in rescue proceedings).

[84] 11 USC Sec. 1129.

[85] Insolvency Act 1986 s 24.

[86] Article 86 of the EBL 2006.

ask for court confirmation if certain requirements are met by the plan; this kind of strong judicial intervention is dubbed as a cram-down[87] in the US corporate reorganization regime. China has also transplanted cram-downs into its bankruptcy law.

This part of the literature review focuses on the criteria used by courts to assess reorganization plans in both normal and cram-down confirmation processes.

5.1. General Requirements

To be confirmed by the court, a reorganization plan must, in general, pass the following tests. First, Kenneth N Klee argued that a reorganization plan cannot be confirmed unless and until it has been accepted by at least one class of impaired parties that are not insiders.[88] Such a requirement might provide quite a low threshold, especially under Chapter 11 in the US where creditors are often divided into many classes to reflect their distinctive claims.[89] The more such these classes are created, the more easily this test is passed. It can be argued that the US has a pro-rescue regime, so that policymakers tend to see more rescue plans confirmed by reducing the hurdles of approval.

Second, as discussed by H Miles Cohn, a reorganization plan should be made in good faith if it seeks confirmation.[90] Put simply, a reorganization plan should be made with honesty and with real intention to implement it. The good faith test, however, appears to be very subjective and elusive. Interestingly, the US Bankruptcy Code does not give the exact definition as to what constitutes good faith.[91] In practice, judges in the US are given a great deal of leeway to interpret good faith. It is suggested that this test concentrates on assessing whether the proponent of the plan has fully disclosed information to objecting parties.

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[87] See generally Richard F Broude, 'Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative' (1984) 39 *The Business Lawyer* 441.

[88] Kenneth N Klee, 'All You Ever Wanted to Know About Cram Down under the New Bankruptcy Code' (1979) 53 *American Bankruptcy Law Journal* 133,137.

[89] See generally William Blair, 'Classification of Unsecured Claims in Chapter 11 Reorganization' (1984) 58 *American Bankruptcy Law Journal* 197.

[90] See generally H Miles Cohn, 'Good Faith and the Single-Asset Debtor' (1988) 62 *American Bankruptcy Law Journal* 131.

[91] Ibid 134. See also Walter J Blum, 'The "Fair and Equitable" Standard for Confirming Reorganizations under the New Bankruptcy Code' (1980) 54 *American Bankruptcy Law Journal* 165.

Third, Kenneth N Klee has argued that a reorganization plan must also pass the creditor-best-interest test: creditors must be paid no less than they would be in liquidation.[92] The underlying rationale here is that a rescue task cannot be pursued to the detriment of creditors. More specifically, the test makes clear that the company's liquidation value must be entirely used to meet creditors' claims. But, as for the company's going concern value in excess of its liquidation value, this test is silent and does not specify who should be the statutory recipients. John D Ayer has argued that the US lawmakers initially intended that a company's total going concern value should go to creditors,[93] but this test seems to somehow deviate from this intention. Probably, the distribution of the company's going concern value in excess of its liquidation value is left to renegotiations between creditors and shareholders, so that this test is aimed to give more flexibility to interested parties.

In practice, this test faces difficulties caused by inaccuracies inherent in making asset valuations.[94] As discussed before, asset valuations are always subjective and inaccurate. This test, as a result, will be more easily met if the company's assets are undervalued; also, this test may put higher pressure on related parties in the event of overestimation. It was argued by Water W Miller Jr[95] that the main danger here is in making under-valuations. Given that a company is deeply distressed, the relevant parties' expectations to the company's future will be supressed, and this may naturally lead to low valuations of assets. In the case of under-valuations, junior parties, in particular unsecured creditors and shareholders will be harmed, although the creditor-best-test is superficially passed.

Fourth, Kenneth N Klee argued that[96] a reorganization plan must comply with the absolute priority principle, unless the disadvantaged parties have agreed with its deviation. This requirement is critical for protecting creditors; in turn, it may minimise the negative effects in the wider market caused by deviating from absolute priority. It is worth noting here that the absolute priority principle is a default rather than mandatory rule in corporate rescues; the flexibility of absolute priority can be used only at the option of creditors. This

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[92] Klee (n 88) 137.
[93] Ayer (n 75) 1011.
[94] See generally Chaim J Fortgang and Thomas Moers Mayer, 'Valuation in Bankruptcy' (1985) 32 *UCLA Law Review* 1061.
[95] Walter W Miller Jr, 'Bankruptcy Code Cramdown under Chapter 11: New Threat to Shareholder Interests' (1982) 62 *Boston University Law Review* 1059, 1087.
[96] Klee (n 88) 137. See also James C Bonbright and Milton M Bergerman, 'Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization' (1928) 28 *Columbia Law Review* 127.

requirement is also consistent with the creditor-best-interest test, which paves the way for shareholders (mainly shareholder managers) to share the going concern value in excess of the company's liquidation value. It is rather for mutual benefits if creditors decide to invite equity-managers to join the rescue by relaxing the absolute priority doctrine, because the continued service of the latter will certainly increase the company's going concern value.

Apart from these general tests, a reorganization plan must pass another important test, the feasibility test, which will be reviewed separately in the next section because of its significance.

5.2. The Feasibility Test

Nancy Rhein Baldiga argued that, in the US, in order to get a reorganization plan to be confirmed by the court, the proponent must first convince judges that the plan is feasible; namely, that it is most likely for the debtor to survive if the plan is confirmed.[97] Baldiga pointed out that, although the feasibility test is rather subjective, at its heart is it likely to require cash injection, because the provision of cash is crucial for both the company's ongoing business operation and paying creditors as promised in the plan.[98] In reality, however, Baldiga argued that judges in the US seemed not to be very competent in assessing the feasibility of reorganization plans on the grounds that there were still many reorganization plans that passed judges' feasibility tests but eventually failed.[99] Such facts suggested that judges might not be highly competent in assessing the feasibility of reorganization plans, but these can also be understood as they promoted rescue outcomes by being lenient to rescue plans.

In general, a reorganization plan may be comprised of two basic sub-plans: the first is to restructure the company's business, and the second is to distribute the company's value among interested parties. Thus, the feasibility test should concentrate on examining the sub-plan on business restructuring. Given that the business restructuring plan is rather a commercial judgement, it requires the judge assessing the plan to have relevant knowledge of

[97] Nancy Rhein Baldiga, 'Is This Plan Feasible: An Empirical Legal Analysis of Plan Feasibility' (1996) 101 *Commercial Law Journal* 115, 116.
[98] Ibid 122.
[99] Ibid 129.

both the company's own business model and market conditions. Judges, however, are legal experts, so assessing a corporate business restructuring plan, which is replete of commercial decisions, may be far beyond the capacity of judges. Not surprisingly, as observed by Harvey R Miller that, in the US, bankruptcy judges have 'only limited authority, ability, resources, and expertise' to evaluate a plan's feasibility.[100]

Baldiga continued to argue that in practice judges tend to rely on ammunition provided by rejecting parties to assess whether the plan is feasible, since these parties have incentives to challenge the restructuring plan with their own insight and understanding.[101] Listening to opposing views would be quite useful for a judge in helping her to reach a proper feasibility judgement. In particular, it seems to be advisable for judges to consider dissenting views presented by the company's banks and main suppliers, because the latter usually possess a depth of understanding of the company's business through their close monitoring and long-term business relationships.

Furthermore, to reach a sound feasibility judgement, in some instances, judges may hire business management experts to give professional evidence, but this raises the problem of increasing costs.

Interestingly, bearing in mind that the feasibility test is largely a commercial judgement, Klaus Kamlah reported [102] that, in Germany, judges are not required to assess a reorganization plan's feasibility, and this is left for creditors to decide whether a reorganization plan should be allowed to go. But German practice should be understood in its own historic context of the bankruptcy system. Germany did not have a formal corporate rescue regime until 1994, which means that there would be few experienced judges to fulfil the role in assessing a reorganization plan's feasibility. Meanwhile, there is no separated bankruptcy court system in Germany; perhaps, as a result, there might not be many judges specialising in corporate bankruptcy. It is realistic not to require judges to do such highly technical jobs.[103] By contrast, in the US, the corporate reorganization regime has been

[100] Harvey R Miller, 'Chapter 11 Reorganization Cases and the Delaware Myth' (2002) 55 *Vanderbilt Law Review* 1987, 2006.
[101] Baldiga (n 97) 116.
[102] Kamlah (n 4) 432.
[103] Ibid 417-8.

developing for over a hundred years, and there is a relatively mature bankruptcy judicial system with trained and experienced bankruptcy judges in office.[104]

In a nutshell, the feasibility test gives objecting parties a chance to challenge the seriousness of a rescue plan and opens the door to necessary state intervention. With regard to the scope of state intervention, it is recommended that judges conservatively play their judicial roles in assessing the feasibility of a reorganization plan; in particular, a plan will be deemed to be feasible if it has been supported by the majority of impaired parties or if there are no substantial feasibility challenges raised by objecting parties.[105]

5.3. The Use of Cram-downs

Ideally, prior to seeking confirmation, a reorganization plan has been accepted by all classes of impaired parties, and is therefore subject to a normal confirmation process. For various reasons, however, a plan may have failed to win sufficient votes in some classes; such a plan may still be confirmed by the court if certain criteria are met: this arises in a cram-down.[106]

Perhaps because of concerns that cram-downs may undermine freedom of contract,[107] this mechanism is not available in the UK and many European continental countries,[108] nor is it available in Canada [109] and Australia. [110] For the sake of efficiency of corporate reorganization procedures, China borrowed this procedure from the US, transplanting it into its new EBL 2006.[111]

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[104] See generally Tabb (n 2) 5.

[105] Baldiga (n 97) 118.

[106] 11 USC Sec. 1129. See also Lynn M LoPucki and William C Whitford, 'Preemptive Cram Down' (1991) 65 *American Bankruptcy Law Journal* 625.

[107] See generally G H L Fridman, 'Freedom of Contract' (1967) 2 *Ottawa Law Review* 1.

[108] Andrew Wilkinson, Tony Horspool and Ian McKim, 'The Case for Unifying the EU's Insolvency Laws' (2005) 24 *International Financial Law Review* 49, 50 (noting that cram down is absent in many European countries including the UK).

[109] Yaad Rotem, 'Contemplating a Corporate Governance Model for Bankruptcy Reorganizations: Lessons from Canada' (2008) 3 *Virginia Law & Business Review* 125, 130 (mentioning that cram down is not available in Canadian corporate rescue law).

[110] Colin Anderson, 'The Australian Corporate Rescue Regime: Bold Experiment or Sensible Policy?' (2001) 10 *International Insolvency Review* 81, 107 (noting that a rescue procedure in Australia may end in liquidation if creditors vote against the proposed reorganization plan).

[111] Article 87 of the EBL 2006.

Kenneth N Klee argued that, although cram-downs have been included in Chapter 11 of the US Bankruptcy Code, policy makers did not expect it to be used frequently, and it was rather intended to facilitate negotiations between interested parties.[112] More specifically, it was emphasized by Jack Friedman that cram-downs were actually designed to improve the efficiency of rescue processes and to prevent unnecessary delays.[113] So, a cram-down is rather a rule that is intended to be a last resort; it provides a chance for a fair and equitable reorganization plan to be confirmed in an efficient way. Given that a cram-down reflects strong state intervention, certain conditions must be met if a cram-down is imposed.

Jack Friedman found that, in general, there are two extra tests which must be passed if a cram-down is issued. First, objecting parties cannot be discriminated against in the plan; second, the plan should be fair and equitable.[114] Friedman noted that the first test is, in essence, to ensure that the *pari passu* principle is complied with and the second test is used to determine whether the absolute priority principle has been applied.[115]

Obviously, these two tests are used to ensure fairness and equity between creditors as well as between creditors and shareholders. Within creditors, the fundamental principle of collectivity requires that they share the company's value commensurate with each claim; namely, they recoup *pro rata* where their claims cannot be fully met out of the company's value. Meanwhile, as to relationships between shareholder and creditor, the absolute priority principle sets out the boundaries regarding how the company's value can be distributed between these two groups.

Given that these two tests are compulsory in the cram-down confirmation procedures, the contrary should also be well understood: if it is a normal confirmation procedure, the *pari passu* and absolute priority rules can be relaxed with the consent of disadvantaged parties, and this may, as argued before, give considerable flexibility to relevant parties to pursue a rescue outcome.

In sum, a series of tests are designed for courts to assess whether a reorganization plan can be confirmed. A court confirmation procedure might be essential in order to ensure that

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[112] Klee (n 88) 171.
[113] Jack Friedman, 'What Courts Do To Secured Creditors in Chapter 11 Cram Down' (1993) 14 *Cardozo Law Review* 1495, 1497.
[114] Ibid 1501.
[115] Ibid 1503.

some basic corporate bankruptcy principles are complied with and that impaired parties are treated with fairness and equity.

6. CONCLUSIONS

In reviewing the above literature, several issues about the corporate reorganization regime have been addressed.

First, in regard to entry into a corporate reorganization procedure, a review of literature indicates that consideration must be given to encouraging early rescue petitions. For the sake of an early rescue, the US resorts to a debtor-in-possession approach so as to induce debtors to file for reorganization, and the UK seeks to rely on a wrongful trading mechanism to warn debtors to take early rescue actions. In practice, a debtor-in-possession system seems to be more effective than wrongful trading in producing more early rescues. But, it can be argued that a debtor-in-possession is necessary for an early rescue but it is not sufficient. Attention should also be paid to empowering creditors to use liquidation to collect outstanding debts. A debtor-in-possession is not enough to instigate an early rescue unless there is powerful liquidation pressure from creditors.

With regard to control in corporate reorganization, different countries have their own different models. In the US, debtors are generally allowed to remain in charge but have to bear fiduciary duties to serve all impaired parties in rescue processes. In the UK, debtors will be automatically replaced by IPs in rescues, because UK business culture does not have confidence in the ability of debtors who have brought companies into troubles to be able to turn them around. Given that debtors possess the information and knowledge of troubled companies, the involvement of debtors in rescues seem to be more effective to accomplish rescue goals. Of course, to prevent abuse, debtors running rescues should be under intense scrutiny by courts, creditors or by both of them.

Concerning value distribution in corporate reorganization, through this review of the literature, it was found that absolute priority is strictly applied in UK corporate rescues, but in US Chapter 11 proceedings, deviations from it are possible but are subject to certain conditions. Absolute priority is one of the most fundamental principles in bankruptcy law, and the worry here is that deviation from it in corporate rescues may negatively affect the legal certainty and predictability of creditors in the wide market which in turn may undermine

market efficiency. But the existing studies show that the potential drawbacks of deviating from absolute priority in reorganization have been addressed and taken into account. In particular, it has been learned from the existing literature that deviations should first occur with the consent of disadvantaged parties and, second, deviations should be aimed at preserving and increasing company going concern values. Creditors' legal certainty and predictability, as a result, will not be compromised, and more importantly, their interests will be enhanced by the flexibility of absolute priority in reorganization.

Regarding the court confirmation of reorganization plans, it was found that, in US Chapter 11s, a series of tests have been established for courts to ensure fairness and equity in reorganization plans. These tests are of importance in safeguarding some basic bankruptcy principles. Some may view court confirmation as state intervention, but it can also be contended that this is more like state protection.

The corporate reorganization regime is multifaceted and should be understood and implemented by taking into account all its principles and preconditions; otherwise, we may be unable to distinguish the essential from the secondary.

After reviewing the relevant literature, the next chapter will describe the contextual background of China's corporate reorganization law. In particular, it will give a brief history of Chinese bankruptcy law, and the making of the Chinese new corporate rescue system will be discussed.

CHAPTER 3

CONTEXTUAL BACKGROUND

1. INTRODUCTION

The previous chapter reviewed relevant literature on some major principles and practices of the corporate reorganization regime and formed a tentative view that corporate reorganization will create a situation wherein both creditors and debtors would benefit from rescue outcomes. In the meantime, a review of the literature suggested that some concerns on the negative effects of the rescue regime are really exaggerated, as the potential downsides of this regime have already been taken into account and some counter-abuse mechanisms have also been made available.

In the light of the apparent merits of the corporate rescue regime, in recent decades there seemed to have been a global trend for many countries to establish or enhance their own corporate bankruptcy reorganization laws.[1] For example, based on the recommendations of the Cork Report in the UK, the Insolvency Act 1986 was enacted so as to nurture a corporate rescue culture; moreover, for the sake of strengthening the rescue regime, the UK administrative receivership was virtually abolished by the Enterprise Act 2002 so as to give way to the new administration procedure, thereby creating a purer rescue process.[2] Similar rescue-friendly insolvency law reforms have also been undertaken in the US[3] and in more recent times in Germany,[4] Canada,[5] Australia,[6] as well as in other European countries.[7]

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[1] See generally Jay Lawrence Westbrook, 'The Globalisation of Insolvency Reform' (1999) *New Zealand Law Review* 401, 404.

[2] See a brief discussion of corporate rescue development in the UK at Pontian Okoli, 'Rescue Culture in the United Kingdom: Realities and the Need for a Delicate Balancing Act' (2012) 23 *International Company and Commercial Law Review* 61.

[3] See Charles Jordan Tabb, 'The History of the Bankruptcy Laws in the United States' (1995) 3 *American Bankruptcy Institution Law Review* 5.

[4] See Klaus Kamlah, 'The New German Insolvency Act: *Insolvenzordnung*' (1996) 70 *American Bankruptcy Law Journal* 417.

[5] See Lynn M LoPucki and George G Triantis, 'A Systems Approach to Comparing US and Canadian Reorganization of Financially Distressed Companies' (1994) 35 *Harvard International Law Journal* 267, 277.

[6] See Andrew Keay, 'A Comparative Analysis of Administration Regimes in Australia and the United Kingdom' in Paul J Omar (ed), *International Insolvency Law: Themes and Perspectives* (Ashgate 2008).

Many efforts have also been made by international institutions, as well as some regional ones, to facilitate the spread of the corporate rescue culture. For example, in 2005 a Legislative Guide on Insolvency Law was prepared by the United Nations Commission on International Trade Law (UNCITRAL); this Guide gives support to the idea that a second chance should be given to financially distressed companies for the common good.[8] The World Bank was also involved in promoting the corporate rescue culture worldwide, and this is reflected in the Bank's Insolvency Principles and Guidelines (April 2001), and both formal and informal corporate rescue approaches are highlighted and recommended in the Guidelines.[9]

Apart from the UN and the World Bank, much promotion of the corporate rescue culture has been undertaken by the OECD and the IMF.[10] In particular, in partnership with the Asian Development Bank and others, between 1999 and 2009, the OECD organized a series of bankruptcy law conferences to consult with experts in Asian countries as to updating their national bankruptcy systems.[11] During this period, the merits of corporate reorganization were widely discussed and debated in Asia.[12]

In response to this global move to revamp corporate bankruptcy laws, China, as the second biggest economy in the world,[13] seemed to have been influenced by the changing focus of corporate bankruptcy norms. In 1993, China started to revise its corporate bankruptcy legislation with a view to establishing a rescue-oriented corporate insolvency system.[14] Its progress to a modern rescue-friendly bankruptcy regime took twelve years to achieve, as the new rescue-oriented law, the P. R. China Enterprise Bankruptcy Law 2006

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[7] Rebecca Parry, 'Introduction' in Katarzyna Gromek Broc and Rebecca Parry (eds), *Corporate Rescue: An Overview of Recent Developments from Selected Countries in Europe* (Kluwer Law International 2004) 1-2.

[8] UNCITRAL, *Legislative Guide on Insolvency Law* (United Nations Publication 2005) 27.

[9] The World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (The World Bank, 2001) 45.

[10] See further at Bruce G Carruthers and Terence C Halliday 'Negotiating Globalization: Global Scripts and Intermediation in the Construction of Asian Insolvency Regimes' (2006) 31 *Law & Social Inquiry* 521, 525.

[11] The theme of each conference organized by the OECD can be found on its official website <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/insolvencyinasia-forumonasianinsolvencyreformfair.htm> accessed 20 May 2013. See also Roman Tomasic, 'Insolvency Law Reform in Asia and Emerging Global Insolvency Norms' (2007) 15 *Insolvency Law Journal* 229, 245.

[12] See OECD, *Informal Workouts, Restructuring and the Future of Asian Insolvency Reform* (the OECD 2003) 8.

[13] David Barboza, 'China Passes Japan as Second-Largest Economy' *The New York Times* (New York, 16 August 2010) B1.

[14] Changyin Han, 'The Legislative Evolvement of Bankruptcy Enterprise Law in China and Its Lessons' (2009) 7 *Citizen and Law* (in Chinese) 2, 3.

(the EBL 2006), was not passed by China's People's Congress until 27 August 2006,[15] coming into effect on 1 June 2007.[16]

On the face of it, the EBL 2006 is rescue-friendly and even rescue-centred. The face that its chapter on bankruptcy reorganization comes before chapters on liquidation and compromise suggests that corporate reorganization would be intended to be the first option when corporate bankruptcy procedures are considered.[17]

This chapter explores the contextual background of China's corporate reorganization law. Given that corporate rescue law is part of corporate bankruptcy law, a brief history of China's bankruptcy law will also be investigated. The remainder of this chapter is divided into four parts. (i) Part 2 describes China's successive bankruptcy laws before 1949, and in particular the notion of a second chance or a fresh start in these bankruptcy laws will be examined. (ii) Part 3 analyses the China EBL 1986 that was the first corporate bankruptcy legislation of the Communist Administration after 1949; much attention will be paid to its corporate reorganization procedure and its implementation.[18] (iii) Part 4 concentrates on analysing China's most recent corporate rescue law, the EBL 2006. The legal framework of the new corporate rescue regime will be discussed. Finally, (iv) Part 5 will present some conclusions.

2. CHINA'S BANKRUPTCY LAWS BEFORE 1949

In China's feudal societies before the 20th century, agriculture was at the heart of the national economy; by contrast, commercial activities, such as trade, were largely constrained, because China's authorities traditionally believed that it was agriculture not commerce that was critical to social prosperity.[19] As a consequence, commerce was rather marginalized in

[15] It was predicted that the new law might have been passed by the China People's Congress far earlier than 2006. See generally Roman Tomasic, 'Insolvency Law Principles and the Draft Bankruptcy Law of the People's Republic of China' (1998) 9 *Australian Journal of Corporate Law* 211.

[16] See generally Charles D Booth, 'The 2006 PRC Enterprise Bankruptcy Law: The Wait Is Finally Over' (2008) 20 *Singapore Academy of Law Journal* 275.

[17] Hailin Zou, 'Analysis and Application of Corporate Rescue Law in China (2007) 25 *Journal of China University of Political Science and Law* (in Chinese) 48.

[18] Article 200 of the China Civil Procedure Law 1991 regulated rehabilitation of non-state-owned enterprises.

[19] See generally at Laurence Jacobs, Guopei Gao and Paul Herbig, 'Confucian Roots in China: A Force for Today's Business' (1995) 33 *Management Decision* 29. And an analysis of such a policy in Chinese can be seen at Guihai Li, 'Dissecting the Feudal Policy of Encouraging Agriculture and Restraining Commerce in China' (1981) 4 *Academic Forum* (in Chinese) 68.

China's feudal societies. The lack of commercial activities in ancient China may partly explain the absence of bankruptcy law, because bankruptcy is firmly associated with debts that in turn flow from trading.[20]

In the ancient China, as in most western countries, defaulting in debt payment was deemed to be a criminal offence that would result in penalties being imposed upon the debtor ranging from being flogged to being imprisoned; such an approach remained in force in China until the end of the Qing Dynasty in 1911.[21] In addition, there was a long-standing custom in China for debts to be inherited, which was encapsulated as the saying 'the son pays his father's debts'.[22] Recent research indicated that such a custom is still practiced in some regions in China today.[23]

Thus, given that commerce was constrained, and that there was a harsh debt enforcement system, there appears to be little room for bankruptcy law to develop in the ancient China.

In the middle of the 19th century, however, China's authorities increasingly realised[24] the importance of commerce and industry because they acknowledged that the widening gap between the East and the West at that time was mainly attributed to China's underdeveloped industry and trade systems. As a response, major economic policies started to change. In particular, after the defeats in two Opium Wars in the 1860s, China campaigned to establish its own industries.[25] Although it would be premature to jump to the conclusion that the radically changed economic policies at that time directly resulted in China's first bankruptcy law, at least the proliferation of businesses after that period did pave the way for a bankruptcy law to emerge.

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[20] Siyuan Cao, 'Exploration of Enterprise Bankruptcy' (1985) 5 *Reform of Economic System* (in Chinese) 22. See also Xiahong Chen, 'The Modern China's Bankruptcy Regimes and Their Fates' (2010) 28 *Tribune of Political Science and Law* (in Chinese) 57.

[21] See generally Xuemei Wang, 'The Social and Legal Environment at the End of Qing Dynasty from the Angle of Merchants' Criticism to the Bankruptcy Law 1906' (2006) 143 *Journal of Sichuan University (Social Science Edition)* (in Chinese) 120.

[22] ibid.

[23] Liming Wang, 'Problems in Amending Enterprise Bankruptcy Law' (2005) 3 *Legal Science* (in Chinese) 3, 5.

[24] In the late 19th century there was a national campaign to develop industry and trade in China, see further at Peng-Sheng Chiu, 'Prohibiting Monopoly and Protecting of Patent: On the Soochow Gold Foil Case in the Late Qing Dynasty' (2000) 3 *Peking University Law Journal* (in Chinese) 311.

[25] See generally William C Kirby, 'China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China' (1995) 54 *The Journal of Asian Studies* 43.

Near the end of the Qing Dynasty, partly due to the government's determination to establish a modern commercial law system mainly by borrowing from abroad[26] and partly because of the practical need to handle business crises,[27] China's first bankruptcy law was enacted in 1906.

2.1. The Bankruptcy Law of 1906

In May 1906,[28] the Bankruptcy Law 1906, the first Chinese bankruptcy law, obtained the royal assent and was promulgated.[29] This law had been proposed by the Ministry of Commerce. The 1906 law had nine chapters containing sixty-nine articles.[30]

The 1906 law had a wide scope of application. Specifically, both individuals and companies could file for bankruptcy.[31] Meanwhile, the bankruptcy procedure under the 1906 law was largely a civil society supervised process, i.e., there was little state[32] involvement in bankruptcy procedures.[33] A debtor could file for bankruptcy before a local Chamber of Commerce, the non-governmental organization, which was responsible for appointing a trustee who would take over the debtor's assets and business affairs. Although bankruptcy

[26] Shuguang Li, 'The Introduction of Western Legal Culture and Its Effect on Great China Legal System' (1991) 1 *Democracy & Science* (in Chinese) 42, 43.

[27] Xiahong Chen, 'The Modern China's Bankruptcy Laws and Their Fates' (2010) 28 *Tribune of Political Science and Law* (in Chinese) 57, 60.

[28] The 1906 law might be promulgated in May 1906, as a leading legal historian in the China Social Academy, Professor Lizhi Xu, argued that the law obtained the royal assent in April 1906 under China's lunar calendar; however, under the Gregorian calendar, it should be May 1906. See further at Lizhi Xu, 'Commercial Law Establishment in the Late Qing Dynasty' (in Chinese) <http://www.iolaw.org.cn/shownews.asp?id=2367> accessed 8 July 2012. However, another book indicated that the law might be made in Autumn 1905, since it received the royal assent at that time, see further at Chang Nieh-Yun and J. H. Teesdale, *Translation of the Chinese Bankruptcy Code of 1905* (The American Presbyterian Mission Press, Shanghai 1907). Obviously, the further investigation in this regard is needed.

[29] Xiulan Yao, 'China's Modern Bankruptcy Laws' (2003) 25 *Modern Law Science* (in Chinese) 151, and Ronald Winston Harmer, 'Insolvency Law and Reform in the People's Republic of China' (1996) 64 *Fordham Law Review* 2563, 2567.

[30] Yao ibid.

[31] Articles 1, 7 and 8 of the China Bankruptcy Law 1906. See further at Wang (n 21) 121.

[32] It may be debatable as to whether under the Bankruptcy Law 1906 the bankruptcy procedure was an administrative process. See further Harmer (n 29) 2567.

[33] Yao (n 29) 152.

procedures had to be reported to local government, this was mainly done for the registration purpose.[34]

To seek equality between creditors, the *pari passu* principle was set out in the 1906 law. Including the *pari passu* principle in the bankruptcy law was a significant step towards building a modern bankruptcy law in China, because before the 1906 law, creditors were treated differently according to their different status. In particular, before 1906, in the case of a business bankruptcy, foreign creditors were placed at the top of the payment ranking followed by state creditors, with other domestic creditors ranked at the bottom.[35] Thus, the 1906 law was revolutionary, as this was the first time that all creditors were treated equally in China's bankruptcy proceedings.

More importantly, the 1906 law was intended to provide a fresh start for unfortunate but honest debtors; Article 66 stipulated that unpaid debts could be discharged on condition that the bankruptcy did not involve bad faith.[36] In the event of fraud or dishonesty, defaulted debts could not be discharged; instead, Chapter 6 of the 1906 law set out how to open a criminal investigation and to prosecute unscrupulous debtors.[37]

After the 1906 law came into effect, there was an unexpected backlash from business sectors, especially the banking businesses in Shanghai, Ningbo and Zhenjiang, etc. It was rumoured that banks objected to the *pari passu* principle, among other objections.[38] The banks' voices were so strong that in November 1907[39] a proposal was made by the Ministry of Agriculture, Industry and Commerce (the former Ministry of Commerce)[40] to the Emperor, stating that the 1906 law should be 'deliberated' further because of the resistance it encountered. It was also suggested that the 1906 law should be amended to comply with the

[34] Article 3 of the China Bankruptcy Law 1906. See the nature of Chamber of Commerce in China at Qiusha Ma, *Non-Governmental Organizations in Contemporary China: Paving the Way to Civil Society?* (Routledge 2006) 33-35.

[35] Yao (n 29) 152.

[36] Ibid.

[37] Ibid 151.

[38] Wang (n 21) 121(describing why the 1906 law was complaint by the businesses in China).

[39] Again, under the China's lunar calendar, it is October 1907; however in Gregorian calendar, it is November 1907. See further at Xu (n 28).

[40] In November 1906, the Ministry of Commerce was restructured and renamed as the Ministry of Agriculture, Industry and Commerce, see Kui Wang, 'Reasons of Reforming the Ministry of Commerce in Late Qing Dynasty' (2009) 1 *Jiangxi Social Sciences*(in Chinese) 151.

incipient commercial code. This proposal received the royal approval shortly afterwards.[41] Controversially, this royal assent was widely regarded as a revocation of the Bankruptcy Law 1906, although the proposal did not explicitly state that the law should be nullified.[42]

Perhaps because of the ambiguity inherent in the above proposal, the 1906 law was still used in some regions in China after this time,[43] but was suspended in other regions after 1907.[44] However, this law was entirely abandoned in 1911 when the Qing Dynasty, the last feudal royal family in China, crumbled because of the Republican Revolution.[45]

2.2. The Bankruptcy Bill of 1915

China started a new chapter in the history of its bankruptcy laws after the collapse of the Qing Dynasty.[46]

In 1915, the Republic Warlords Government in Beijing[47] released a Bankruptcy Bill that had three parts containing 337 articles.[48] Unfortunately, the 1915 Bill was never officially passed by the legislature.[49] Interestingly, in 1926, after being shelved for over ten years, the Ministry of Justice of the Warlords Government circulated the 1915 Bill to Chinese law courts, instructing them that the principles embedded in the Bill could be used by judges to try bankruptcy disputes.[50] Despite the ambiguity of its status, some features of the 1915 Bill are still worth mentioning.

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[41] Wang (n 21) 124.
[42] Ibid 125.
[43] Ibid, and see also Xu (n 28).
[44] Motono Eiichi, 'Sino-British Disputes over Collecting Debts in Shanghai before the 1911 Revolution: An Analysis of Several Civil Cases Just After 'The Rubber Stock Financial Crisis'' (2004) 357 *The Waseda Journal of Political Science and Economics* (in Japanese) 55, 56 (noting that the 1906 law was suspended in Shanghai after 1907).
[45] See generally at Peter Zarrow, *China in War and Revolution, 1895-1949* (Routledge 2005) Chapter 2 especially.
[46] See generally George T Yu, 'The 1911 Revolution: Past, Present, and Future' (1991) 31 *Asian Survey* 895.
[47] Actually, the warlords government in Beijing was the first stage of the Republic of China. See further Arthur Waldron, 'The Warlord: Twentieth-Century Chinese Understanding of Violence, Militarism, and Imperialism' (1991) 96 *The American Historical Review* 1073.
[48] Chen (n 27) 63.
[49] Zenping Chen, 'Zhang Jian and His Involvement in Twice Commercial Law Enactment Campaigns in Modern China' (2003) 19 *Journal of Nantong Teachers College (Social Sciences Edition)* (in Chinese) 15, 18.
[50] Yao (n 29) 153.

In order to give a fresh start to debtors, the 1915 Bill stipulated that income earned by a debtor after the bankruptcy declaration was excluded from the estate, which meant that this would enable the debtor to have a more viable recovery after bankruptcy.[51] At the same time, to encourage a potential rescue, the 1915 Bill allowed debtors to initiate reconciliation plans at any time during bankruptcy processes; this suggested that debtors were given the chance to avoid being liquidated.[52]

Unlike the 1906 law that used a Chamber of Commerce to supervise bankruptcy, the 1915 Bill designated law courts to do this job. It was a court that was empowered to appoint a trustee to manage the estate, and even a meeting of creditors should also be convened by the court.[53] One study indicated that the 1915 Bill was applied in some, but not many, bankruptcy cases in China.[54]

Without a valid bankruptcy law, China's courts mainly relied upon local custom[55] and some basic legal principles[56] when adjudicating bankruptcy disputes during this period.

The 1915 Bill did not survive long. The Beijing Warlords Government was defeated in an internal power struggle in 1928, and after that the central Republic Government moved its capital from Beijing to Nanjing.[57] Several years later, the Kuomintang-dominated Nanjing Republic Government officially enacted a new bankruptcy law.

2.3. The Bankruptcy Law of 1935

The Bankruptcy Law 1935 was promulgated by the Legislative Yuan, the parliament of the Kuomintang Nanjing Government, on 1 June 1935, coming into force on 1 October 1935.[58]

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[51] Ibid 152.
[52] Ibid 153.
[53] Ibid.
[54] Chen (n 27) 63.
[55] The custom in dealing with bankruptcy varied from region to region, see further Wang (n 21) 124.
[56] See generally Yao (n 29) 153.
[57] See generally Zarrow (n 45).
[58] Chen (n 27) 66. The Bankruptcy Law 1935 is online available on the present Taiwan Legislative Yuan's website 'http://www.ly.gov.tw/en'.

The 1935 law assimilated many principles derived from UK and French bankruptcy statutes. It had four parts and 159 articles. The four parts were general principles, conciliation, liquidation, and bankruptcy offences, respectively.[59]

The 1935 law was acclaimed by many scholars as a masterpiece of legal transplantation that integrated foreign advanced bankruptcy norms with local conventions.[60] For instance, the 1935 law advocated China's business practice of conciliation by placing the conciliation procedure as the first option in bankruptcy; the law even went a step further: a conciliation agreement supervised either by a law court or by a local Chamber of Commerce could be recognized under the 1935 law.[61]

Although the 1935 law was well regarded, little was known of its implementation. Perhaps this was because after it came into effect, China was mired in civil war for decades,[62] and it may largely have remained a dead letter in the statute books.

Unfortunately, the 1935 law also had a premature death; in 1949, when the Communist Party won the civil war and founded a new government, all statutes enacted by the former Kuomintang Government were revoked. The 1935 law was also revoked.[63] This law remained in force only in Taiwan after 1949, and remains so today.[64]

Overall, between 1906 and 1949, there were three bankruptcy statutes in China that were mainly designed to provide an orderly debt collection procedure for creditors and to relieve honest but unfortunate debtors.

With regard to the bankruptcy rescue culture that may have developed, it is fair to say that there were almost no explicit concepts of rescue found in these statutes. But, it is noteworthy that some implied rescue principles can still be seen in these laws. For instance, it was evident from all these bankruptcy laws that bankruptcy relief, in the form of discharging

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[59] Yao (n 29) 153.
[60] Ibid.
[61] Ibid.
[62] See generally at Suzanne Pepper, *Civil War in China: The Political Struggle, 1945-1949* (2nd edn, Rowman & Littlefield 1999).
[63] The China Communist Party Central Committee, 'The Decree of Abolishing All Legislation Enacted by Kuomintang Administration and Emphasizing the Continuity of Communists Judicial Principles' (in Chinese) <http://cpc.people.com.cn/GB/64184/64186/66650/4491574.html> accessed 11 July 2012.
[64] The Bankruptcy Law 1935 could be accessed at Taiwan Legislative Yuan's website on <http://lis.ly.gov.tw/lgcgi/lglaw?@5:1804289383:f:NO%3DC704522*%20OR%20NO%3DC004522%20OR%20NO%3DC104522$$4$$$NO> accessed 28 July 2012.

debts, could be given to honest debtors. Furthermore, an honest but unfortunate debtor could even be allowed to retain some assets on humanitarian grounds. More importantly, a conciliation procedure was highlighted in the successive bankruptcy laws, which suggested that, with debt forgiveness, a debtor might have a better chance to survive in the future.

After 1949, because of the command economy imposed by the new Communist Government, the bankruptcy system was deemed to be unnecessary in China for almost 40 years afterwards.

3. CHINA ENTERPRISE BANKRUPTCY LAW OF 1986

In 1978, after China's Cultural Revolution, the Communist Government in China made efforts to reform its economy so as to bring the country back on track,[65] and its loss-making state-owned enterprises (SOEs) were seen as being in need of special attention.[66] To tackle heavily indebted SOEs, China's policy-makers realised that a bankruptcy law would be a useful tool to cull inefficient SOEs.[67]

Not surprisingly, bankruptcy reorganization was also discussed and deliberated by China's bankruptcy law drafters at this time, although their knowledge and understanding on this subject were quite limited.[68] Some proposals were raised in China, particularly, it was suggested some troubled SOEs could be reorganized rather than liquidated in bankruptcy, because liquidating inefficient SOEs had to be weighed against its social effects.[69] Nevertheless, there was a consensus that China needed a new bankruptcy law to advance its SOE reforms.[70]

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[65] See generally Harry Harding, *China's Second Revolution Reform after Mao* (The Brookings Institution 1987).

[66] See Justin Yifu Lin, Fang Cai, and Zhou Li, 'Competition, Policy Burdens, and State-Owned Enterprise Reform (1998) 88 *The American Economic Review* 422.

[67] Siyuan Cao, 'An Analysis of Bankrupting the Long Term Money-losing SOEs' (1984) 9 *Outlook Weekly* (in Chinese) 18.

[68] Guofen Ying, 'Establishing a Bankruptcy Regime with China's Characters' (1985) 5 *Tribune of Political Science and Law* (in Chinese) 53, 55.

[69] Siyuan Cao, 'A Proposal of Making a Bankruptcy Law' (1984) 11 *Social Science* (in Chinese) 42.

[70] Siyuan Cao, 'A Brief Analysis of Enterprise Amalgamation and Bankruptcy Law' (1988) 20 *Journal of Economy* (in Chinese) 26, 27.

After a fierce debate[71] as to whether it was politically sensible to have an enterprise bankruptcy law within a socialist regime, the reformers won the battle; the Enterprise Bankruptcy Law 1986 (For Trial Implementation) (the EBL1986) was eventually passed by China's People's Congress on 2 December 1986, coming into force on 1 November 1988.[72]

3.1. The Main Features of the EBL 1986

The EBL 1986 had a limited scope of application: it only applied to SOEs.[73] This meant that individuals and non-state-owned enterprises could not seek bankruptcy relief under the EBL 1986. Such a limited scope of application was set up because the government only intended to have a bankruptcy law to help reform SOEs; in other words, this law was not aimed at creating a debt collection system for creditors.[74] In particular, this law had two specific goals. The first was to liquidate distressed SOEs if the government thought it was necessary to do so.[75] The second was warning managers of underperforming SOEs that the central government was serious, and that some money-losing SOEs would be liquidated if they could not regain profitability as required by the government.[76] Thus, it is clear that the EBL 1986 was not made for creditors as part of the debt collecting systems.

Meanwhile, the EBL 1986 established strong government control in bankruptcy, although, at first sight, bankruptcy procedures were court-supervised.[77] Firm government control can be seen in many aspects. For example, a bankruptcy procedure could not be entered until and unless government permission was given.[78] When accepting a bankruptcy filing, the court had to appoint a government organized liquidation committee as the trustee

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[71] See further at Ta-Kuang Chang, 'The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process' (1987) 28 *Harvard International Law Journal* 333, 346.

[72] Siyuan Cao, 'The Development of Bankruptcy Law in China' (1996) 4 *Academic Research* (in Chinese) 15, 16.

[73] Article 2 of the EBL 1986.

[74] Booth (n 16) 285.

[75] Siyuan Cao, 'The Second Analysis of Enterprise Bankruptcy' (1985) 46 *Outlook Weekly* (in Chinese) 11, 12.

[76] Cao (n 70) 27.

[77] See further Shuguang Li, 'Bankruptcy Law in China: Lessons of the Past Twelve Years' (2001) 4 *Harvard Asia Quarterly* 1 (the page number is not from the original journal as it is not available online).

[78] Article 8 of the EBL 1986. It is almost impossible for creditors to successfully lodge a bankruptcy liquidation procedure before a court in China to liquidate the defaulting debtor, see further Xianchu Zhang and Charles D Booth, 'Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience' (2001) 15 *Columbia Journal of Asian Law* 1, 11.

managing the estate.[79] The government's dominance in the bankruptcy of SOEs seemed to reflect the socialist ideology whereby a socialist bankruptcy law should, as argued by one legal scholar in China, prioritize state interests,[80] and in order to achieve this goal, it was a necessity to place government at the helm of the SOE bankruptcy procedure.

Furthermore, bankruptcy procedures under the EBL 1986 called for little involvement by professionals, such as lawyers and accountants. As mentioned above, a trustee had to be a government organized liquidation committee that was comprised of senior officials from relevant government agencies;[81] professionals, such as lawyers, did not have the chance to be included on these committees, [82] although China's legal profession had been restored years before the promulgation of the EBL 1986.[83]

Moreover, a glance at the EBL 1986 suggests that this law was pro-rescue or rescue-friendly, as there was one chapter dedicated to bankruptcy reorganization. Even the corporate reorganization procedure seemed to be arranged as the first option in the bankruptcy law as the chapter on reorganization was placed before that on liquidation.[84]

But, the corporate reorganization procedure under the EBL 1986 appeared to be deeply flawed mainly because of its application process. Under Article 17 of the EBL 1986, a reorganization procedure could not be straightforwardly filed in court; instead, it had to be based upon a liquidation procedure that has already been filed by creditors. More contentiously, converting a liquidation into a reorganization procedure had to be requested by a government agency that supervised the debtor SOE - neither creditors nor debtors were allowed to directly petition for reorganization under the EBL 1986.

If the court agreed with the government's reorganization request, a liquidation procedure would change into a reorganization, and the EBL 1986 gave the government up to two years to restructure the debtor.[85] Before the deadline, the debtor that was supervised by the

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[79] Article 24 of the EBL 1986.
[80] Ying (n 68) 54.
[81] Article 24 of the EBL 1986.
[82] Booth (n 16) 292.
[83] See generally Jenkin Chan Shiu-fan, 'The Role of Lawyers in the Chinese Legal System' (1983) 13 *Hong Kong Law Journal* 157, 158.
[84] Chapter 4 is for restructuring and Chapter 5 for liquidation in the EBL 1986.
[85] Article 17 of the EBL 1986.

government was liable to submit a reorganization plan for a vote to a meeting of creditors,[86] and the reorganization process might lead to a successful conclusion if the plan was accepted by the creditors' meeting and was later confirmed by the court.[87]

Although the EBL 1986 was criticized for being too simple and ambiguous, it was the first attempt by the socialist China to develop its legal framework on corporate bankruptcy. Given that the EBL 1986 was only applicable to SOEs, China later enacted a law to regulate the bankruptcy of non-state-owned enterprises.

3.2. Bankruptcy Law for Non-State-Owned Enterprises

To fill the gap left by the EBL 1986, a chapter regulating the bankruptcy of non-state-owned enterprises was inserted into China's Civil Procedure Law 1991.[88] Thereafter, China established a bifurcated bankruptcy law system;[89] the bankruptcy of SOEs was regulated by the EBL 1986 and the bankruptcy of non-state-owned enterprises was subject to the Civil Procedure Law 1991. It is noteworthy that the concept of a non-state-owned enterprise was broadly interpreted in China, as it included collectively-owned, private and foreign-invested enterprises.

Under Article 199 of China's Civil Procedure Law 1991, a bankruptcy liquidation procedure could be petitioned either by a debtor or its creditors in the event of insolvency. A similar corporate reorganization procedure was also made available in this law. Under Article 202, during a liquidation procedure, the debtor could propose a reconciliation plan, and a possible rescue outcome could be reached if the plan was agreed to by the creditors' meeting and was confirmed by the court. Again, the application process of a conciliation procedure had the same drawback as that found in the EBL 1986. A conciliation procedure could not be filed directly; it also had to be based on a liquidation procedure that had already been filed by creditors. More contentiously, only the debtor enterprise was allowed to propose a conciliation plan. Overall, like the EBL 1986, the bankruptcy chapter in China's Civil Procedure Law 1991 was also too simple, lacking details for its effective implementation.

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[86] Article 18 of the EBL 1986.
[87] Article 19 of the EBL 1986.
[88] Chapter 19 of the China Civil Procedure Law 1991.
[89] Booth (n 16) 277.

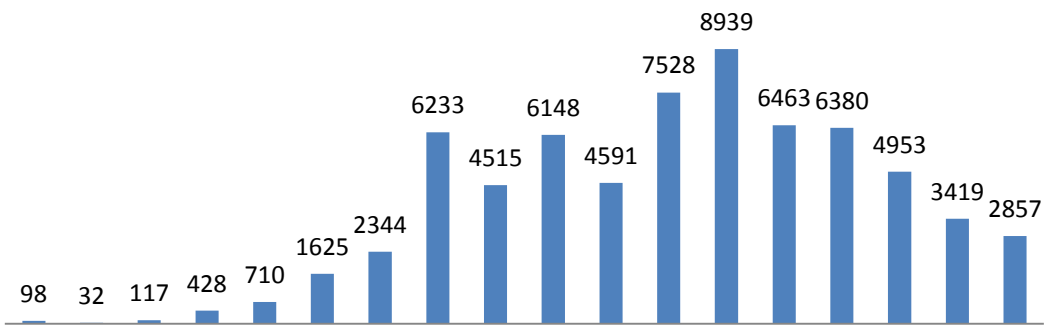
In addition to the EBL 1986 and the Civil Procedure Law 1991, several judicial interpretations were issued by China's Supreme People's Court that sought to clarify bankruptcy issues.[90] The corporate reorganization procedures were also given some further guidelines by the Court in these documents.[91]

3.3. Weak Implementation

From 1989, when the first bankruptcy law, the EBL 1986, came into effect, China's courts began to handle enterprise bankruptcy. In practice, however, there were not many bankruptcy cases. Figure 1 shows that the number of enterprise bankruptcy cases rose from 98 in 1989 to 8939 in 2001, although between these dates there were fluctuations. The number then declined gradually to 2857 in 2006.

It was estimated that about 800,000 enterprises were dissolved each year in China.[92] Therefore, bearing in mind such a number, only a very small proportion of dissolving enterprises used corporate bankruptcy procedures to settle defaulted debts.

Figure 1: The Number of Enterprise Bankruptcy Cases in China Annually. Source: Si Yuan Think Tank, Beijing 2011



[90] For example, in 2002, a comprehensive judicial interpretation on bankruptcy was released by the China Supreme People's Court. See further at the China Supreme People's Court, 'Regulations on Enterprise Bankruptcy Proceedings' (Beijing, 30 July 2002, in Chinese) <http://www.law-lib.com/law/law_view1.asp?id=40889> accessed 15 July 2012.

[91] See Booth (n 16) 301.

[92] Biqiang Wang, 'China's Hidden Bankruptcy' *Economic Observer* (Beijing, China 5 June 2009) <http://www.eeo.com.cn/ens/finance_investment/2009/06/05/139307.shtml> accessed 16 July 2012. See further Roman Tomasic and Zinian Zhang, 'From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergence in Implementation: The Case of Corporate Reorganizations in China' (2012) 12 *Journal of Corporate Law Studies* 259.

With regard to the relatively small number of corporate bankruptcy cases, it can be argued that this was mainly due to the Chinese government not wanting to see many enterprises being liquidated for fear of massive unemployment,[93] because the vast majority of SOEs were technically bankrupt when the EBL 1986 was promulgated. Put differently, if the EBL 1986 had been rigorously implemented in China, nearly all the SOEs should have been liquidated – this was something that the Chinese government could not afford to do politically.

Although the EBL 1986 was the principal bankruptcy law made for SOEs, a large proportion of existing enterprise bankruptcy cases, as shown in Figure 1, were actually used to liquidate collectively-owned enterprises[94] that were also directly managed or controlled by government.[95] For example, it was noted by Prof. Li Shuguang, a leading Chinese bankruptcy scholar, that in 1997 sixty-nine per cent of enterprise bankruptcy cases in China were to liquidate collectively-owned enterprises.[96]

Presumably, the majority of bankrupt SOEs were quietly dissolved by the government through administrative processes, because, by comparison with court-involved bankruptcy procedures, administrative processes might give the government a great deal of leeway in solving troubled SOE problems.

In addition, the small number of enterprise bankruptcy cases would also be attributed to the insurmountable entry into bankruptcy procedures for private enterprises.[97] Under Chapter 19 of the Civil Procedure Law 1991, private companies in China were allowed to file, or to be filed by creditors, for bankruptcy. In reality, however, China's courts virtually denied bankruptcy filing for private enterprises.[98] Without entering bankruptcy procedures, these

[93] See a provincial study which indicated the fragility of the social security in China at the Financial Committee of Liaoning Provincial Congress of China, 'Report of Corporate Bankruptcy in Liaoning Province' (1995) 2 *Review of Economy*（in Chinese）24, 25.

[94] Weidong Wang, 'The Scope of Bankruptcy Law and Its History in China' (2008) 4 *Commercial Times* (in Chinese) 59, 60.

[95] For example, in Shenyan, one of the bankruptcy trial cities in China, there were eleven local government agencies in charge of all collectively-owned enterprises in the city. See further Yongjie Chen and Tao Su, 'An Investigation of Collectively-owned Enterprises Bankruptcy in Shenyan' (1986) 2 *Finance and Economy* (in Chinese) 34, 35.

[96] Li (n 77) 1.

[97] See generally Mike Falke, 'China's New Law on Enterprise Bankruptcy: A Story with a Happy End?' (2007) 16 *International Insolvency Review* 63, 67.

[98] Weijing Wu, 'Commencement of Bankruptcy in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganization Law' (2004) 35 *Victoria University Wellington Law Review* 239, 244.

private company owners often simply chose to walk away from their enterprises,[99] which meant that, on the one hand, they could not access bankruptcy relief, and on the other hand, creditors were deprived of this powerful liquidation means to collect debts.

Overall, China's enterprise bankruptcy regime was not well implemented before 2006.

3.4. Corporate Reorganization after the EBL 1986

As noted above, the EBL 1986 was designed to be a law for liquidation as well as for reorganization of enterprises. The reorganization procedure of the EBL 1986, however, was rarely used in practice;[100] this was mainly because of the flaws in its complicated application process.

In fact, the application process of the reorganization procedure of the EBL 1986 was somewhat contradictory. Under Article 17 of the EBL 1986, a reorganization procedure had to be requested by the government agency that supervised the debtor SOE after a liquidation procedure had been filed by creditors. In practice, however, without government permission, it was impossible for a liquidation procedure to be entered in the first place. It, therefore, seemed to be paradoxical for a government agency to, firstly, agree with a creditor to liquidate the debtor in court and, later, to ask the court to convert liquidation into reorganization. If the government agency intended to restructure the debtor SOE, it did not need to use this superficially complicated route; instead, it could directly restructure the debtor enterprise by itself outside the court. This strange route to a formal reorganization procedure might, as a result, be one of the main factors that stifled the use of the rescue regime under the EBL 1986.

Similar to the reorganization procedure in the EBL 1986, a corporate rehabilitation process for non-state-owned enterprises was made available in Chapter 19 of China's Civil Procedure Law 1991. But, as noted above, it was quite difficult for these enterprise

[99] See Zhang and Booth (n 78) 11.

[100] Weiguo Wang, 'Adopting Corporate Rescue Regimes in China, A Comparative Survey' (1998) 9 *Australian Journal of Corporate Law* 234, 238.

liquidation applications to be accepted by courts at the first stage, let alone to be converted into the bankruptcy reorganization procedure at a later stage.[101]

It is not an exaggeration to say that both reorganization procedures under the EBL 1986 and China's Civil Procedure Law 1991 remained a dead letter on the statute book.

The absence of formal bankruptcy reorganization, however, did not mean that there were no informal ones, especially given a huge number of troubled SOEs in China. In fact, outside courts, Chinese government efforts to restructure and reorganise money-losing SOEs have never stopped after the enactment of the EBL 1986.

In 1996, for example, the Chinese central government campaigned to reorganize some loss-making SOEs by merging them with financially healthy SOEs.[102] Prof. Li said that in 1996 a total of 1,192 troubled SOEs were merged with their healthy fellows in China's fifty-six central-government-designated experimental cities, and in 1997 this number increased to 1509.[103] But such a campaign faced immediate resistance from SOEs.

One study reveals that this campaign was opposed by both the host and the merged, and that it was complaint that government-initiated mergers were like forced marriages, because, on the one hand, the government paid little attention to each side's willingness to join together; on the other hand, the commercial feasibility of mergers was always overridden by the government's own political agenda.[104] In some instances, the merger led to the collapse of two SOEs, because both sides were unhappy with the marriage.[105]

Given this resistance, China's central government stopped the merger campaign after 1997, and soon after the central government's policy changed to 'supporting the large SOEs and letting go the small ones', according to which most of the small and uneconomic SOEs

[101] The lack of government institutions' support makes courts be very cautious in accepting bankruptcy filings in China. See further Zhang and Booth (n 78) 10.

[102] See further the China Economy and Trade Commission and the People's Bank of China, 'Issues of SOEs Merger and Bankruptcy' (Beijing, 25 July 1996, in Chinese), see also Wang (n 100) 240.

[103] Li (n 77) 1.

[104] Sheng Wang, 'Hindrance of Merger and Restructuring of State-owned Enterprises' (2000) 4 *Fujian Theoretical Review* (in Chinese) 10, 11. See also Mei Bai, 'Problems and Solutions in Enterprises' Merger' (1999)1 *Review of Global Economy* (in Chinese) 53.

[105] Wang ibid.

were to be declared bankruptcy, sold, shutdown, or privatized, whilst large and strategic SOEs were further subsidised and became stronger.[106]

As noted above, many troubled SOEs were actually reorganized by the government without using the formal rescue law under the EBL 1986;[107] however, troubled private companies sometimes had to resort to the informal rescue mechanism under the contract law to seek survival,[108] which might be very difficult in practise.

After the EBL 1986, China experienced the dramatic move from centrally-planned to a market-based economy, as well as remarkable economic growth. These changes required the introduction of a modern corporate bankruptcy law. This eventually led to the promulgation of the Enterprise Bankruptcy Law 2006 (the EBL 2006).

4. CHINA'S ENTERPRISE BANKRUPTCY LAW OF 2006

As early as 1993, voices were heard requesting the amendment of the EBL 1986,[109] but the pressure to modernise the bankruptcy law probably emanated mostly from rapid changes of China's economy in recent decades.

4.1. Economic Growth after the EBL 1986

After 1986, China made substantial progress in its economy. Both its economic structure and its status in the global market were reshaped.

First, the state owned sector in China's economy shrank considerably after the EBL 1986. From 1980 to 1996, for example, the share of industrial output from SOEs in China fell from 80.2 to 43.2 per cent, being almost halved.[110] After that, the reduction in the state sector

[106] See generally at Yuanzheng Cao, Yinyi Qian and Barry R Weingast, 'From Federalism, Chinese Style to Privatization, Chinese Style' (1999) 7 *Economics of Transition* 103.

[107] For example, in 2002, Zhenbaiwen, a state-controlled company, was rescued without invoking the rescue law. See Changyin Han and Wei Kang, 'The Restructuring of Zhenbaiwen: From the Perspective of Bankruptcy Law' (2002) 42 *Journal of Henan University (Social Science)* (in Chinese) 76.

[108] The P R China promulgated its first contract law on 15 March 1999.

[109] Cao (n 72) 16.

[110] See Gary H Jefferson and others, 'Ownership, Productivity Change, and Financial Performance in Chinese Industry' (2000) 28 *Journal of Comparative Economics* 786, 788.

continued. According to the OECD, from 1998 to 2003, the registered share of state ownership in China's industrial firms declined from 37.3 to 13.8 per cent.[111] Moreover, nationwide SOE reforms were almost finished by 2000: this was because, as noted above, nearly all unwanted and loss-making SOEs had been closed down or sold.[112] In other words, concerns over potential massive unemployment caused by bankrupting SOEs were no longer relevant.

Second, in recent decades, there was a burgeoning private sector in China. One report has shown that in 2003 the private sector, perhaps for the first time, contributed 52.3 per cent of China's national industrial added value, exceeding the state-owned sector.[113] With the emergence of a strong private sector, China's economy at large grew at a striking speed after 1986. China's annual gross domestic product (GDP) rose to $10,129 billion in 2010 from $4,157 billion in 2003; China maintained its annual economic growth rate at around ten per cent for nearly a decade.[114] As noted above, in 2010, overtaking Japan, China became the second largest economy in the world.[115]

Third, after 1986, China increasingly became a global player in the international business community. This was marked by China's accession to the WTO in 2001.[116] Three years later, China's international trade jumped to $53.51billion a year, emerging as the third biggest trader worldwide.[117] In 2006, there were 450 of the World's Fortune 500 companies which directly invested in China.[118]

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[111] See Sean Dougherty and Richard Herd, 'Fast-Falling Barriers and Growing Concentration: The Emergence of a Private Economy in China' (OECD, Economics Department Working Papers, No. 471. 16 December 2005) 9.

[112] Shuguang Li, 'Several Critical Problems in Amending Enterprise Bankruptcy Law' (2002) 20 *Journal of China University of Political Science and Law* (in Chinese) 7, 8.

[113] Ibid.

[114] The OECD, 'Country Statistical Profile: China 2011-2012' (OECD, 18 January 2012) <http://www.oecd-ilibrary.org/economics/country-statistical-profile-china_csp-chn-table-en> accessed 19 July 2012.

[115] David Barboza, 'China Passes Japan as Second-Largest Economy' *The New York Times* (New York, 16 August 2010) B1.

[116] The World Trade Organization, 'Accession of the People's Republic of China' (WT/L/432, 10 November 2001) 1.

[117] See Dorothy Guerero, 'China, the WTO and Globalization: Looking beyond Growth Figures' *Focus on the Global South* (6 February 2006) <http://yaleglobal.yale.edu/content/china-wto-and-globalization-looking-beyond-growth-figures>accessed 20 July 2012.

[118] The US-China Business Council, 'Foreign Investment in China' (February 2007) <https://www.uschina.org/info/forecast/2007/foreign-investment.html> accessed 20 July 2012.

These economic changes apparently required a revamp of China's bankruptcy laws.[119] During the same period, pressures from outside China also increased, and this might have played an even greater role in persuading China to enact a bankruptcy law that could reflect basic internationally-recognized bankruptcy principles. Partly because China did not have an effective corporate bankruptcy system, the European Union and the US refused to recognise China's market economy status before 2006,[120] which might have substantially disadvantaged China in the global market.

Thus, the combination of domestic needs and external pressures led to the enactment of the EBL 2006.

4.2. Preparing the EBL 2006

On 18 September 1993, a national conference on bankruptcy was held in Beijing, and a proposal to amend the bankruptcy law was raised by Mr Cao Siyuan, the architect of the EBL 1986.[121] Perhaps triggered by Mr Cao's motion, China formally started, through the Financial and Economic Committee of China's People's Congress, to update its bankruptcy law from March 1994.[122]

In March 1995, a meeting of bankruptcy law drafters was held in Chengdu, Sichuan Province, China, and Chapter 11 of the US Bankruptcy Code 1978, the iconic rescue regime, was formally introduced and discussed in the meeting. Bearing in mind the merits of Chapter 11, the drafters added a chapter on corporate reorganization in the bankruptcy law.[123] In fact, back in early 1993, a bespoke article discussing the virtues and vices of the US Chapter 11 appeared in a leading Chinese academic journal that might have influenced the law-makers to develop a rescue-friendly bankruptcy law in China.[124]

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[119] See generally the World Bank, 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems' (April 2001) 25.

[120] See Kimberlya Tracey, 'Non-Market Economy Methodology under US Anti-Dumping Laws: a Protectionists Shield from Chinese Competition' (2006) 15 *Currents: International Trade Law Journal* 81.

[121] Cao (n 72) 16.

[122] Han (n 14) 3. See also Roman Tomasic and Margaret Wang, 'Reforming China's Corporate Bankruptcy Laws' (2005) 18 *Australian Journal of Corporate Law* 220.

[123] Wang (n 100) 240.

[124] Phillip Boer and Yu Tan (tr), '*An Analysis of Chapter 11 of American Bankruptcy Code 1978*' (1993) 30 *Peking University Law Journal* (in Chinese) 59.

The drafting process was progressed as planned. In September 1995, the final version of the draft was submitted for deliberation to China's People's Congress Standing Committee, the top legislative voting vehicle of the Congress.[125] However, this draft was unexpectedly shelved by the Committee without explanation.[126] The Congress was probably concerned about the social consequences of bankrupting SOEs, because, as discussed above, at that time, nearly all SOEs were technically insolvent.[127]

Three years later, in 1998, the bankruptcy law amendment was resumed[128] presumably because, at the time, China was in intense negotiations with other WTO members concerning its potential membership of the Organization; an effective bankruptcy law system was definitely seen as a sign of China's commitment to be a competent contender.[129] On 26 November 1999, a leading Chinese bankruptcy scholar, Prof. Wang Weiguo, who was a key member of China's new bankruptcy law drafting team, was even invited to give a lecture[130] to China's Politburo, the top policy-making body in China's ruling Communist Party. The merits of corporate bankruptcy reorganization regimes abroad were introduced and recommended. The then President Jiang Zeming who chaired the lecture also expressed his interests in having a corporate reorganization law in China.[131] Support for introducing a rescue-oriented bankruptcy law was high; however, this was easier said than done.

The major difficulty in reforming China's bankruptcy law during this period was how to deal with the bankruptcy of troubled SOEs, and the progress on drafting a new bankruptcy law was stalled by disagreements among academics as well as among top political leaders after 1998. Among academics who joined the drafting team, the disagreement focused on whether the SOEs should be subject to the new bankruptcy law or whether there should be a

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[125] Han (n 14) 3.

[126] Ibid.

[127] See Jingxia Shi, 'Bankruptcy Law Reform in China' (The Second Forum for Asian Insolvency Reform, Bangkok, Thailand, 16-17 December 2006) 2, see also Yaobing Yan, 'Incubated for Ten Years, a New Bankruptcy Will be Passed in the Congress Soon' (2004) 42 *China Economy Weekly* (in Chinese) <http://www.people.com.cn/GB/paper1631/13317/1193978.html> accessed 20 July 2012.

[128] Shi ibid.

[129] Haiyun Deng, 'For WTO Accession, China Is Expediting the Reform of Commercial Laws' *Guangming Daily* (Beijing, 20 January 2000, in Chinese) <http://news.sina.com.cn/china/2000-1-20/54629.html> accessed 21 July 2012. See also Mathieu Remond, 'The EU's Refusal to Grant China 'Market Economy Status' (MES)' (2007) 5 *Asian Europe Journal* 345.

[130] The text of the lecture was later circulated nationwide in China. See Weiguo Wang, 'Enhancing the SOEs Reform in a Way of Rule of Law (Beijing, 26 November 1999, in Chinese) <http://www.china-review.com/sao.asp?id=5061> accessed 21 July 2012.

[131] See Weiguo Wang, 'The Objectives of Drafting the New Enterprise Bankruptcy Law' (2002) 20 *Journal of China University of Political Science and Law* (in Chinese) 14, 16.

separate bankruptcy statute exclusively made for SOEs, given some distinct problems faced by most SOEs.[132] Whereas, in political circles, the then Chairman of the People's Congress insisted that employees' claims in SOE bankruptcy should take priority over those of secured creditors; however, the Premier gave more consideration to banks, the principal secured creditors.[133] These elites could not persuade each other; so the standstill arose after 1999.

In January 2001, a draft bankruptcy law entitled 'P. R. China Enterprise Bankruptcy and Reorganization Law' emerged and was submitted for consideration to the People's Congress Financial and Economic Committee.[134] There was no publicly available information as to what has been fiercely debated behind the scenes, but one point was certain - the 2001 reform effort failed once again.

In August 2003, the People's Congress Financial and Economic Committee formed a new bankruptcy law drafting team,[135] and perhaps because of external pressures or lobbying that will be discussed later, the process of updating the bankruptcy law accelerated. On 21 June 2004, a formal draft of the bankruptcy law was finalized by the Congress Financial and Economic Committee and was sent to the Congress Standing Committee for deliberation.[136] Surprisingly, it took over two years for the Standing Committee to examine the draft in three focused meetings.[137] In the interim, a major OECD-State Council co-sponsored insolvency conference was held in Beijing in April 2006 and this might expedite the momentum for reform.[138] The wait was finally over on 17 August 2006 when the bill was passed in the Congress.[139]

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[132] Shi (n 127) 2.
[133] Carruthers and Halliday (n 10) 568.
[134] Wu (n 98) 240.
[135] Zhijie Jia, 'Explanation of the Draft of Enterprise Bankruptcy Law' (2006) 7 *Gazette of China Congress Standing Committee* (in Chinese) 575.
[136] Ibid.
[137] Zhongxi Qi, 'The Draft of Bankruptcy Law Delineates Approaches to Financial Institutions' Failure' *Xinhua News* (Beijing, 22 August 2006, in Chinese) <http://news.sina.com.cn/c/l/2006-08-22/181910797587.shtml> accessed 21 July 2012.
[138] The OECD, '5th Forum for Asian Insolvency Reform (FAIR), Beijing, China, 27-28 April 2006' <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/5thforumforasianinsolvencyreformfairbeijingchina27-28april2006.htm> accessed 6 December 2013.
[139] The preface of the EBL 2006.

In total, it took twelve years to make the EBL 2006.[140] During this long process, pressure or influence from outside China probably played a significant role in urging China to enact a modern bankruptcy law as so to enhance its market economy and protect investors.

4.3. International Influence

As for the international influence on the creation of the EBL 2006, it seems to have been a two-way process; from inside China, its willingness (mainly in the form of academic debate[141]) to assimilate so-called international 'best practice' of corporate insolvency norms was strong; from outside China, many international institutions were proactive in consulting or even pressuring China to advance its bankruptcy law reforms more quickly. This section describes the efforts made by international bodies that helped to enact the EBL 2006.

A. Forum on Asian Insolvency Reform (FAIR)

From 1999, to foster insolvency law reform in Asia, the Organization for Economic Co-operation and Development (OECD) has been organizing a series of international conferences entitled 'Forum on Asian Insolvency Reform (FAIR)' in collaboration with the Asia-Pacific Economic Co-operation Forum (APEC) and the Asian Development Bank (ADB).[142] At the time of writing, seven meetings of the FAIR have taken place (Indonesia in 2001, Thailand in 2002, Korea in 2003, India in 2004, China in 2006, Thailand in 2009; and Manila in 2013) in addition to the initial conference held in Sydney in 1999.[143] FAIR was of importance in introducing some international bankruptcy principles to China's law-makers.[144] A prominent Chinese bankruptcy law expert, Prof. Wang Weiguo, was a frequent meeting participant of FAIR, acting as a bridge between China and the western world.[145]

Under the umbrella of FAIR, the ADB also made efforts to persuade China to embrace a world class and workable bankruptcy regime.[146] In particular, the ADB hired an eminent

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[140] See generally Booth (n 16)
[141] See generally Han (n 14) 6, Wang (n 131) 14 and see also Wang (n 100) 234.
[142] 'Insolvency in Asia - Forum on Asian Insolvency Reform (FAIR)' OECD <http://www.oecd.org/document/34/0,3746,en_2649_34813_2383970_1_1_1_1,00.html> accessed 22 July 2012.
[143] Ibid.
[144] See Tomasic (n 11) 261.
[145] See Carruthers and Halliday (n 10) 546.
[146] Tomasic (n 11) 265.

Australian lawyer, the late Mr Ron Harmer, the architect of Australia Bankruptcy law reforms,[147] and another reputable insolvency expert, Mr John Lees from Hong Kong, to provide China-specific advice.[148]

The impact of FAIR on China's bankruptcy law making, however, could not be overestimated. For instance, the ADB, the major collaborator of FAIR in Asia, liaised with China's National Development and Reform Commission, a ministry of China's central government, which was not exactly the body responsible of drafting the new bankruptcy law.[149] Therefore, it might only have indirect influence on the real law makers.

In addition, it appears that the ADB's enthusiasm to enhance China's bankruptcy law reforms might not have been seriously appreciated by China. Back in 1996, the ADB was requested by China's central government to give advice on its bankruptcy law reform, and as a result, a special report was prepared and was delivered by the ADB to China's side in a timely manner. The report made many recommendations, including, among others, the creation of a corporate rescue regime and the establishment of a body of insolvency practitioners. Five years later, surprisingly, when the ADB reminded China about some advice made in the report, the latter replied that the report had been physically lost, and more embarrassingly that that report had never been circulated to China's bankruptcy law drafters.[150]

Like the ADB, the OECD also had its own Chinese partner, the Development Research Centre of the State Council, when it organized the 5th meeting of FAIR in Beijing in 2006,[151] and again this Centre was not the direct law drafting body. Thus, probably the only effects of FAIR were enriching academic debates in China. By contrast, GTZ, a German aid agency, contracted by the German Federal Government, might have had a more direct influence, as it

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[147] See generally Kent William Yamanaka Anderson, 'Comparative Approaches to Continuing Legislative Reform: Considering Insolvency Law Reform in Japan and Several Common Law Countries' (Law in Asia and the Near Future Conference, Australian National University College of Law, November 2001) 3.

[148] Carruthers and Halliday (n 10) 562.

[149] Ibid 564.

[150] Terence C Halliday and Bruce G Carruthers, 'Foiling the Financial Hegemons: Limits to the Globalization of Corporate Insolvency Regimes in Indonesia, Korea and China' in Christoph Antons and Volkmar Gessner (eds) *Globalisation and Resistance: Law Reform in Asia since the Crisis* (Hart 2007) 282-3.

[151] '5th Forum for Asian Insolvency Reform (FAIR), Beijing, China, 27-28 April 2006' OECD <http://www.oecd.org/document/63/0,3746,en_2649_34813_38141887_1_1_1_1,00.html> accessed 22 July 2012.

established a partnership with China's People's Congress Financial and Economic Committee that was responsible for drafting the new bankruptcy law.[152]

B. German GTZ

Unlike other international institutions, GTZ had a long history of involvement in China, obtaining much insight into China's political system and the subtle cultural differences that could not be learned by others in the short term.[153]

In order to push forward China's bankruptcy law reform, GTZ hosted several *ad hoc* conferences in China before 2006 wherein many internationally-recognized insolvency scholars were invited and exchanged their expertise and understanding with their Chinese counterparts.[154] More importantly, many of the members of China bankruptcy law drafting team were invited to these conferences and were even funded by GTZ to have study tours to Germany and other developed countries where they were shown how the corporate insolvency system operated abroad.[155]

To make the most of these conferences, GTZ collected and edited some useful proposals made by international experts, which might be of practical value and politically appropriate to China's bankruptcy law reform, and submitted them directly to China's People's Congress Financial and Economic Committee which was responsible for drafting the bankruptcy law bill. The responses from China's side were said to be very positive.[156] Not surprisingly, as a result, there was clear evidence of German bankruptcy law principles transplanted into the EBL 2006; for example, the administrator-supervised debtor-in-possession in the EBL 2006 was simply duplicated from German bankruptcy law without any modification.[157]

Apart from the OECD, the ADB and GTZ, other international organizations were also involved in the making of the EBL 2006.

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[152] See further at GTZ, 'GTZ Legal Advisory Service Newsletter' (Edition 1/2006) <http://lawprofessors.typepad.com/china_law_prof_blog/files/newsletter_12006en.pdf> accessed 23 July 2012.

[153] Carruthers and Halliday (n 10) 567.

[154] Ibid 565.

[155] See generally GTZ (n 152).

[156] Carruthers and Halliday (n 10) 566.

[157] See generally Manfred Balz, 'Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law' (1997-1998) 23 *Brooklyn Journal of International Law*167, 175.

C. The World Bank

As early as 2000, the World Bank conducted a national study of SOE bankruptcy in China; this was done to advise China on bankruptcy law reform issues and was published as 'Bankruptcy of State Enterprises in China: A Case and Agenda for Reforming the Insolvency System'.[158] In this report, the World Bank urged China to, *inter alia*, amend its bankruptcy laws, nurture a profession of insolvency practitioners and train judges with bankruptcy knowledge. [159] This report, however, was quietly buried by China and never came to the notice of China's mainstream bankruptcy scholars, let alone the bankruptcy law draftsmen.[160]

Although the Bank was later active in offering prompt feedback concerning a draft of China's bankruptcy law[161] and participating in the FAIR Beijing meeting,[162] it did not have a strong influence on the text of the EBL 2006.[163]

In addition, the contribution from the representatives of the United Nations Commission on International Trade Law (UNCITRAL)[164] and the American Bar Foundation[165] should not be forgotten, as all of them suggested many global insolvency norms for the EBL 2006. Overall, many global bankruptcy principles were adopted in the EBL 2006[166] mainly because of advice from the above international institutions in China.

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[158] An abridged Chinese version of the report was published by a local journal in China, and see further the World Bank, 'An Analysis of China SOEs Bankruptcy: the Necessity and Instruments of Reforming China's Bankruptcy Regime (2001) 2 *Comparative Economic and Social Systems* (in Chinese) 60.

[159] Peter Nolan, *Evaluation of the World Bank's Contribution to Chinese Enterprise Reform* (the World Bank 2005) 4.

[160] After searching Chinese literature concerning the making of the EBL 2006, it was found that the World Bank's 2000 Report had never been mentioned by the leading Chinese bankruptcy scholars. See generally Shuguang Li, 'The Effects of New Enterprise Bankruptcy Law 2006' *Journal of East China University of Political Science and Law* (in Chinese) 110.

[161] Halliday and Carruthers (n 149) 284.

[162] See Vijay Srinivas Tata, 'The Case for a Strong Regulatory Framework: the World Bank Principles in Asia' (Forum on Asian Insolvency Reform V, Beijing China, 27-28 April 2006).

[163] Halliday and Carruthers (n 149) 284.

[164] See United Nations Commission on International Trade Law, 'Legislative Guide on Insolvency Law' <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> accessed 6 December 2013. See also Jenny Clift, 'UNCITRAL Legislative Guide on Insolvency Law' (Forum on Asian Insolvency Reform 2006, Beijing China, 27-8 April 2006).

[165] See Terence Halliday, 'Lawmaking and Institution Building in Asian Insolvency Systems' (Forum on Asian Insolvency Reform 2006, Beijing, China, 27-8 April 2006).

[166] See Falke (n 97).

4.4. Key Features of the Rescue-Oriented EBL 2006

The EBL 2006 has twelve chapters comprising 136 articles. Unlike the EBL 1986, the new law applies to all types of enterprises.[167] It has three main corporate bankruptcy procedures: Chapter 8 deals with bankruptcy reorganization, Chapter 9 covers bankruptcy compromise and Chapter 10 governs bankruptcy liquidation.[168] This sequence might also rather reflect the lawmakers' intention to promote or encourage corporate reorganization.[169]

A. Broad Entry

The most striking characteristic of the EBL 2006 would be that it is rescue-oriented. To make the rescue procedure widely accessible, the EBL 2006 provides a broad entrance route for companies seeking rescue relief.

First, a corporate rescue candidate is broadly defined. Article 2 of the EBL 2006 stipulates that a company may be liquidated if it is bankrupt; however, it can also be reorganized. This suggests that the EBL 2006 does not set up any preconditions for a company to seek reorganization. Perhaps the rescue procedure is intended to be open to all bankrupt companies.

In June 2004, reporting to China's People's Congress Standing Committee, the deputy director of the People's Congress Financial and Economic Committee, Mr Jia Zhijie, stated that the reorganization procedure in the bankruptcy bill was designed for distressed companies that have a reasonable prospect of survival.[170] But his explanation was still somewhat subjective and elusive, because there were not specific benchmarks that could be used to make a judgement regarding suitable candidates for corporate reorganization.

Perhaps, China's People's Congress intentionally left the notion of corporate reorganization candidacy open so as to reduce the threshold and to widen the point of rescue entry.

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[167] Article 2 of the EBL 2006.
[168] The EBL 2006.
[169] Zou (n 17) 51.
[170] Jia (n 135) 576.

Second, to make the corporate rescue regime more accessible, the EBL 2006 encourages a wide range of parties to file for reorganization. Unlike under the EBL 1986, whereby the formal reorganization process could only be requested by the government, the reorganization procedure under the EBL 2006 could be directly filed by both debtor and creditor.[171] Furthermore, to promote the use of rescue, where there is a corporate liquidation procedure already filed by creditors, the EBL 2006 stipulates that the debtor can request the court to convert the liquidation into reorganization procedure, and shareholders holding more than ten per cent of the company's equity are also entitled to make such an application.[172] A reorganization procedure, thus, could be initiated by a wide range of interested parties.

Third, bankruptcy tests can be relaxed if a company voluntarily files for reorganization. The EBL 2006 stipulates that a company that is bankrupt or is likely to be bankrupt could file for reorganization;[173] this suggests that the company does not need to be bankrupt when it files for reorganization.[174] The exemption from bankruptcy might be one of the most striking elements of the EBL 2006, because it may considerably boost the attractiveness of the corporate rescue regime.

As for the first research question in this thesis concerning whether the rescue procedure will be frequently used, this seems to be promising, because the EBL 2006 sends a clear message that the law seeks to promote more corporate rescues.

B. Two Choices of Control

Under the EBL 2006, whether a reorganization, compromise or liquidation is chosen, a debtor will be immediately replaced by a court-appointed administrator at the time when the bankruptcy procedure is entered, and the company will be managed by the administrator thereafter.[175] Therefore, in general, the default control model in China's formal corporate rescue procedure can be described as an 'administrator-in-possession' system.

Bearing in mind that the corporate reorganization procedure aims to rescue companies, an alternative control model is exclusively made available for corporate reorganization.

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[171] Article 7 of the EBL 2006.
[172] Article 70 of the EBL 2006.
[173] Article 2 of the EBL 2006.
[174] See generally Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 113.
[175] Article 13 of the EBL 2006.

Under Article 73 of the EBL 2006, the debtor (the management) can regain control from the administrator if the court agrees with the debtor to such a request. In the event that the debtor retakes the company with the leave of the court, the administrator will withdraw as a monitor overseeing the debtor-in-possession afterwards.

So, for China's corporate reorganization regime, there are two types of control: an administrator-in-possession system as the default control model and a debtor-in-possession system under an administrator's supervision. It should be noted that the latter is premised on two conditions: first, there should be an ad hoc application made by the debtor intending to recoup control, and, second, the application must be approved by the court. If there is no application made by the debtor, or if the application is rejected by the court, the administrator will continue to remain in charge.

Concerns are also raised as to whether a debtor-in-possession can be easily accessed by debtors in practice, because the EBL 2006 does not specify the criteria that courts can apply to assess whether control could be returned. This means that debtors will face uncertainty about whether a debtor-in-possession would be really accessible. Moreover, in the case of a debtor-in-possession, the EBL 2006 does not clarify supervision roles played by administrators; without clear statutory boundaries between the debtor and the administrator, it may cause friction that hampers rescues.

So, as to the second research question of this thesis regarding the control in China's corporate rescue regime, in theory, both the administrator-in-possession and the debtor-in-possession models are available. What this thesis is to explore is the extent to which these two models are used in practice.

C. Professionalism

Before the enactment of the EBL 2006, where there was a corporate bankruptcy, there was always a local government organized liquidation committee that was appointed by the court as the administrator to take over the company's assets and to manage business affairs;[176] it was very rare for professionals, such as lawyers and accountants, to be included

[176] Article 24 of the EBL 1986 and Article 201 of the China Civil Procedure Law 1991.

in these liquidation committees.[177] So, in general, there was no real profession of insolvency practitioners in China before 2006.

The EBL 2006, however, attempts to change the bankruptcy landscape by establishing China's insolvency practitioner profession.[178] A whole chapter of the EBL 2006 is dedicated to qualifying and regulating insolvency practitioners.[179]

But the problem here is that the EBL 2006 still preserves the option of appointing a local government organized liquidation committee as the administrator in a corporate bankruptcy procedure.[180] In other words, courts may not choose qualified insolvency practitioners as administrators, if they want a local government organized liquidation committees to be involved. This may cast a shadow over the future development of insolvency practitioners in China.

Parry and Zhang have argued that appointing a local government organized liquidation committee as the administrator might only be used in the bankruptcy of SOEs, because the bankruptcy of these companies would be more politically complex, and that, ideally, these issues should be left to the government to resolve.[181]

Nevertheless, the EBL 2006 still marks a turning point for China's bankruptcy law and indicates that China intends to establish a market-driven corporate insolvency system whereby insolvency practitioners will play a significant role in improving the efficiency and fairness of corporate bankruptcy.[182]

D. Flexibility in Value Distribution

As is well known, there are two fundamental value distribution rules in corporate bankruptcy: the *pari passu* and the absolute priority principles. These two principles are, under Article 113 of the EBL 2006, clearly laid down in China's corporate liquidation procedure.

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[177] Booth (n 16) 292.
[178] Li (n 112) 10. See also Ravi Bendapudi, 'People's Republic of China Bankruptcy Law' (2008) 6 *Santa Clara Journal of International Law* 205, 214.
[179] Chapter 3 of the EBL 2006.
[180] Article 24 of the EBL 2006.
[181] Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113, 130.
[182] See Booth (n 16) 300.

In corporate reorganization procedures, however, the EBL 2006 gives parties a great deal of latitude as to whether to apply or deviate from these two principles. Under Articles 81 and 87, these two principles are treated as default rules rather than as mandatory principles, i.e., deviation from these two principles is allowed, provided that it occurs with the consent of disadvantaged parties.[183] In particular, deviating from absolute priority may pave the way for inviting debtors to join rescues, and as a result this might make rescues more achievable.[184]

As for the third research question of this thesis concerning value distribution, consideration will be given to the extent to which these two basic distribution rules are applied in China's new corporate rescues.

E. Court Confirmation

Similar to court confirmation in the US Chapter 11, a reorganization plan that has been voted on under the EBL 2006 should also be sent to the court for confirmation. A reorganization plan takes effect only after being confirmed. In general, there are two different court confirmation procedures; these are the normal and cram-down confirmation procedures.

The normal procedure is used to confirm a reorganization plan that has been accepted by all classes of impaired parties. Under Article 86 of the EBL 2006, if the plan has been accepted by all classes of voters, the proponent of the plan can submit it to the court for confirmation within ten days of voting; the court may then confirm the plan if it believes that the plan comports with the EBL 2006.[185] But, the main problem here is that Article 86 of the EBL 2006 is vaguely worded, because it does not specify what requirements a plan must meet to obtain confirmation. In other words, again, courts will find no specific requirements to apply when assessing whether to approve a plan. This may bring uncertainties to both the proponents of the plan as well as the court.

The cram-down confirmation procedure is designed for courts to confirm a reorganization plan that fails to be accepted by one, or more than one, class of voters. Given that cram-downs reflect strong state intervention, a set of clear requirements and tests are enunciated in the EBL 2006 to ensure that they can be used correctly.

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[183] Article 81 of the EBL 2006.
[184] Article 87 of the EBL 2006.
[185] Article 88 of the EBL 2006.

First, a renegotiation with objecting parties is required before a cram-down can be requested. The EBL 2006 stipulates that, in the event that a reorganization plan fails to be accepted by some classes of impaired parties, the proponent of the plan must open a new round of negotiations with the objecting parties. This means that a failed plan cannot be submitted for a cram-down consideration immediately.[186] If the plan is still voted down by even one of the classes of voters in the second round, or the objecting parties refuse to renegotiate and to vote again, then the plan can be sent to the court to consider imposing a cram-down.

Second, under Article 87 of the EBL 2006, the reorganization plan seeking a cram-down must pass the creditor-best-interest test, according to which creditors must be paid no less than they would be paid in a liquidation. But, the EBL 2006 seems to be more permissive, Article 87 adds an exception; this test can be satisfied if creditors agree to be paid less than they would be paid in a liquidation. Put simply, the creditor-best-interest test is used as a default rather than as a compulsory rule in China's new corporate reorganization regime. It appears to be excessively liberal.

Third, under Article 87 of the EBL 2006, the reorganization plan must pass the fair and equitable test. It can be argued that this test means that the *pari passu* and the absolute priority principles should be applied, unless disadvantaged parties agree with a departure from these principles.

Fourth, the reorganization plan must pass the feasibility test. This test requires that a reorganization plan seeking a cram-down should be feasible, i.e., that there is a real prospect for the company to survive if the plan is confirmed.

The reorganization plan will be confirmed under a cram-down if the court believes that all these requirements and tests are met; otherwise, the reorganization plan may be rejected, and the reorganization procedure will be converted into a liquidation procedure – the company will be liquidated. If confirmed, the reorganization plan will then be executed by the debtor and the administrator is liable to monitor its implementation.[187]

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[186] Article 87 of the EBL 2006.
[187] Articles 89 and 90 of the EBL 2006.

Regarding how Chinese courts will confirm reorganization plans, this is what the fourth research question of this thesis aims to investigate.

5. CONCLUSIONS

Although the trajectory of China's bankruptcy law can be traced back to as early as 1906, China's early bankruptcy statutes were not quite consistent mainly because of China's radical social and political changes in the recent centuries.

China's first bankruptcy law of 1906 remained in force for less than two years. The 1935 law was enacted and enforced at a time when China was deeply mired in civil war. The 1986 law was only made for SOEs, and more importantly it was exclusively used by the government to liquidate loss-making SOEs; in other words, as noted, this law was not intended to be a debt collection tool for creditors.

Before 2006, it seemed that the enforcement of China's successive bankruptcy laws remained very weak. It is even no exaggeration to say that, prior to the enactment of the EBL 2006, China did not have a well-functioning corporate bankruptcy system and its relevant bankruptcy institutions were accordingly underdeveloped. Investors, especially creditors, had little confidence in using the bankruptcy law. China, however, attempted to reform its corporate bankruptcy system, and the EBL 2006 was something of a milestone for China towards building a modern corporate bankruptcy regime to strengthen its market economy.

The EBL 2006 is China's first modern bankruptcy law that is applicable to all enterprises, but its main drawback would be that it does not regulate personal bankruptcy.[188] This law also benefited from China's effective interaction with international institutions; as a result, many internationally-recognized 'best practice' bankruptcy principles were absorbed into the EBL 2006. The EBL 2006 was also China's first rescue-oriented bankruptcy law into which many pro-rescue mechanisms abroad were assimilated and in particular it drew upon many pro-rescue mechanisms from Chapter 11 in the US.

[188] See generally Shihu Wang and Gang Li, 'Eligibility of Personal Bankruptcy in China' (1999) 21 *Modern Law Science* (in Chinese) 38 (arguing that China needs a personal bankruptcy law to fill the gap).

With regard to this thesis's first research question concerning the use of the new corporate rescue procedure under the EBL 2006, a glance at the text of the EBL 2006 suggests that that there would be an increase in corporate reorganizations, because the EBL 2006 sets out many pro-rescue provisions to promote the use of the corporate reorganization procedure as analysed above. In view of the weak enforcement of bankruptcy law in China before 2006, however, it should be realistic because a fine formal corporate reorganization regime should be based on an effective bankruptcy liquidation system. It will take time for China to use the EBL 2006 to build a well-functioning liquidation system. So, it would be overly optimistic to predict a proliferation of corporate reorganizations in China after 2006.

For the second research question concerning control in corporate reorganization, what remains uncertain is the extent to which an administrator-in-possession or a debtor-in-possession model will be used. Ideally, if a debtor-in-possession approach is more frequently used, it may enhance the new rescue regime in China, because it will encourage debtors to file an early rescue and will improve the feasibility of rescues.

With respect to the third question over value distribution in reorganization, in principle, the EBL 2006 provides considerable flexibility to parties involved, as both the *pari passu* and the absolute priority principles could be relaxed. In order to protect creditors, however, the EBL 2006 sets up safeguarding limits: deviating from these two principles must be carried out only with the agreement of disadvantaged parties. Moreover, much creditor protection is embodied in reorganization plan confirmation procedures.

As to the last research question - court confirmation of reorganization plans, the normal confirmation procedure of the EBL 2006 gives courts a great deal of leeway in confirming reorganization plans that have been accepted by all classes of impaired parties; this is because there are no specific requirements for courts to be bound when assessing these plans. In contrast, in a cram-down confirmation procedure, a series of tests are made by the EBL 2006, requiring courts to ensure that all these tests are passed before a cram-down is imposed.

In sum, the EBL 2006 has paved the way for a new corporate rescue regime to develop in China. Given that this thesis aims to examine how the new corporate rescue law operates in practice, the thesis will examine a body of data to evaluate its implementation. To better understand the data collected, the next chapter will describe the methodology used in data collection for this thesis.

CHAPTER 4

METHODOLOGY

1. INTRODUCTION

In the previous chapter, the contextual background of China's corporate bankruptcy reorganization law has been investigated. The history suggests that there were many inconsistencies in China's bankruptcy law in the past. Before 2006, although there were three bankruptcy statutes – the 1906, 1935 and 1986 bankruptcy laws, they were generally not well enforced for various reasons. More importantly, the 1986 bankruptcy law - the EBL 1986, was only occasionally used by the government to close down inefficient, bankrupt SOEs. Nevertheless, before 2006, China did not have a well-functioning corporate bankruptcy system, and this may have a negative effect on the implementation of the new corporate bankruptcy rescue regime that is embedded in the EBL 2006.

The most striking piece of China's bankruptcy law, however, would be its newly-enacted EBL 2006 which embodies the contemporary corporate rescue culture, and, in particular, includes many well-known international 'best practices' of the corporate rescue regime, such as a debtor-in-possession system, the flexibility of absolute priority, *inter alia*. The EBL 2006 is rescue-oriented and creates a new legal framework for troubled companies to seek rehabilitation in formal bankruptcy proceedings.

This thesis aims to investigate how China's new corporate rescue law is enforced. In order to answer this thesis's four research questions, the relevant data were collected with a view to painting a comprehensive picture of China's corporate rescue law in action. This chapter describes the methods used to collect these data. Describing these methods can also help demonstrate the strengths and limitation of the data.

In collecting the data, this thesis used both quantitative and qualitative methods.[1] For example, to answer whether China's new corporate rescue procedure is regularly used, the quantitative method was adequate, as mathematically collecting the number of rescue cases is sufficient to answer this question. Equally, to investigate why debtors are hesitant to file for reorganization, a qualitative method (face-to-face interviews) were used so as to investigate debtors' concerns towards rescue procedures. To be sure, some research questions should be answered by using a combination of quantitative and qualitative methods.

Collecting China's corporate bankruptcy data was considerably difficult because of China's less developed statistical infrastructure. In the US and the UK, for example, some basic national bankruptcy statistics are publicly available on relevant authorities' websites;[2] however, in China, there are few such official statistics. Perhaps, bankruptcy information is still regarded as a negative phenomenon in the socialist economy, and therefore China's Communist Authorities have been unwilling to make it publicly known.[3]

For academic researchers, at present the only limited source of China's national bankruptcy statistics is the Siyuan Thinktank,[4] a Beijing-based private consulting firm specialising in bankruptcy, which is led by an eminent bankruptcy expert, Cao Siyuan, who is the architect of China's EBL 1986.[5] But the Siyuan Thinktank can only provide the national numbers on how many corporate bankruptcy cases are accepted in China each year; there are no further detailed statistics, such as the annual national number of corporate reorganizations.

The data in this thesis regarding national corporate reorganizations was able to be collected partly because there were relatively few corporate rescue cases in China that arose after the EBL 2006; otherwise, it would be impracticable for this thesis to collect this data.

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[1] See further at Keith F Punch, *Introduction to Social Research: Quantitative and Qualitative Approaches* (2nd edn, Sage Publications 2005) 1.

[2] In the US, the national statistics of bankruptcy information can be accessed from the Administrative Office of US Courts at www.uscourts.gov, and the national number of firms could be reached at the US Census Bureau at www.census.gov. In the UK, the England and Wales company statistics can be obtained from the Company House at www.companieshouse.gov.uk, and the relevant insolvency figures can be accessed from the Insolvency Service at www.insolvency.gov.uk.

[3] See generally 'Bankruptcy in China, Silent Busts' *Economist* (London, 9 Oct 2008) <http://www.economist.com/node/12380989> accessed 20 October 2011.

[4] The China annual national number of bankruptcy cases can be accessed on its website at http://www.caosy.com/view.asp?id=63 (accessed 20 August 2013).

[5] See further the legacy of Cao Siyuan at Terence Charles Halliday and Bruce G Carruthers, *Bankrupt – Global Lawmaking and Systemic Financial Crisis* (Stanford University Press 2009) 253.

The national number of corporate rescue cases would be closest to the real figure, because the Zhejiang number of rescue cases surveyed in the national data collection in 2010 was later verified as accurate by the Zhejiang case study that was undertaken for this research in 2012.

The data collection for this thesis took place at two stages: first, it surveyed the national data on corporate rescues in China in late 2010, and, second, the data were collected in a province, Zhejiang, in early 2012. The remainder of this chapter is, accordingly, arranged into two parts: (i) Part 2 describes how the national corporate rescue data were collected, and (ii) Part 3 explains the Zhejiang fieldwork which involved interviewing people who took part in corporate reorganizations.

2. THE NATIONAL SURVEY[6]

Advised by my supervisor, Prof. Roman Tomasic,[7] the national corporate rescue data collection began in early December 2010 and was completed by the end of January 2011 at Durham University, England. It took nearly two months to search and identify Chinese corporate rescue cases. The data contained all corporate reorganization cases accepted by Chinese courts between 1 June 2007 and 30 November 2010, or over a total of three-and-a-half years.

It should be noted that this data only included reorganization cases accepted by courts during the selected period. This meant that two other categories of cases were excluded: the first was the cases that were filed but were rejected by courts, and the second were those that were filed before 30 November 2010 but were still not accepted by courts by 30 November 2010, which was the deadline for this thesis's national data collection. Article 10 of the EBL 2006 gives courts fifteen days to decide whether to accept or reject a corporate reorganization

[6] The format of the following two parts is cited from Robert Brewer, *Your PhD Thesis: How to Plan, Draft, Revise and Edit Your Thesis* (Studymates 2007) 143.

[7] The data were used to present a paper examining the implementation of China's corporate rescue regime in INSOL 2011 Singapore Annual Conference. Later some of the data were published in Roman Tomasic and Zinian Zhang, 'From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergence in Implementation' (2012) 12 *Journal of Corporate Law Studies* 295.

filing, so there is a gap between reorganization filing and acceptance.[8] All cases included in this national data collection were filed and accepted during the aforementioned period.

In this part, the first section describes the content of the data. The second section outlines the sources of the data. The third section explains the methods used to access the data. The fourth presents the methods used in analysing the data.

2.1. The Content of the Data

The focus of the data collection was undertaken by reference to the four research questions raised in the first chapter.

A. Corporate Rescue Entry

This section responds to the first research question regarding how frequently the corporate rescue procedure is used in China. In order to build a fairly comprehensive picture of corporate rescue in China, the following nine sub-aspects of the date were surveyed.

First, it was the annual national number of corporate reorganization cases. This number was calculated by including all cases accepted by courts between 1 June 2007 and 30 November 2010. Specifically, the data contained the name of each individual company entering into the formal corporate rescue procedure under the EBL 2006 as well as of the name of each court that handled the rescue case.

To provide a better understanding of whether China's new corporate rescue law was widely used, apart from collecting the annual corporate reorganizations, the data also expanded to cover three related figures: the annual numbers of companies that were on the government company registration record, the annual dissolutions and corporate bankruptcy cases. This was aimed to reach three comparison ratios: the company dissolution rate that was a measure on how many companies were dissolved out of the all companies registered at the beginning of each year, the company bankruptcy rate that was to identify the extent to which dissolved companies used the corporate bankruptcy procedures to exit the market, and the

[8] William J Woodward, Jr, '"Control"' in Reorganization Law and Practice in China and the United States: an Essay on the Study of Contrast' (2008) 22 *Temple International & Comparative Law Journal* 141, 144 (arguing Chinese court acceptance procedure may cause delay and inefficiency in corporate reorganization).

company reorganization rate that was to measure how many companies in the bankruptcy procedure chose the corporate reorganization procedure to seek rehabilitation. These rates were expressed as percentages.

More importantly, to assess the use of corporate bankruptcy and reorganization procedures in China, these three corresponding rates from the US, and England and Wales were also searched and calculated so as to allow an international comparison to be made. Such international comparisons would identify the potential gaps of China's enforcement of both bankruptcy and reorganization laws.

Second, given that the corporate rescue regime was of novelty in China, it would take time for courts and businesses to become familiar with it, so the data examined whether there was a pattern indicating that the new rescue procedure was increasingly being used over each consecutive half year. For this purpose, all rescues cases were rearranged according to the date at which they were formally accepted by courts. As the surveyed period was three-and-a-half years, it was divided into seven half years for analytical convenience.

Third, given that China is a vast country with thirty-one provinces (including cities and autonomous districts at provincial level, not counting Hong Kong and Macau), this thesis surveyed the number of corporate rescue cases taking place in each province in order to identify how well the corporate rescue law was used in different regions. Of course, the regional gaps in economic development should be adequately borne in mind.

Fourth, the data shed light on the different levels of courts handling corporate reorganization. Specifically, all rescue cases were categorized into three groups: cases handled by courts at lower, intermediate and provincial supreme court levels. This was to investigate the level of courts at which corporate reorganizations were more likely to be accepted. China has a four-level court system: at the top is China's Supreme People's Court, and three levels of local courts at province, prefecture and county levels respectively. China's Supreme People's Court does not directly hear corporate bankruptcy cases, so all bankruptcy cases are handled by courts at the three local levels.

Under Article 3 of the EBL 2006, corporate bankruptcy should be filed in the court where the debtor company operates or is registered, but it is silent as to the level of the court to which a bankruptcy petition can be lodged. In a 2002 judicial notice, China's Supreme People's Court required that lower people's courts at country level deal with the bankruptcy

of companies that are registered by company registration authorities at county level, and intermediate people's courts at prefecture level handle those registered at higher levels and provincial supreme people's courts can choose to accept any corporate bankruptcy filings at their own discretion. But in this judicial notice, China's Supreme People's Court also indicated that jurisdiction regarding any individual case could be subject to the discretion of local courts. This means that local courts have wide latitude in deciding which level of the court to try an individual bankruptcy case.[9]

When the EBL 2006 was drafted, some foreign experts suggested that corporate bankruptcy be dealt with by courts at intermediate level so as to avoid local protectionism and to take advantage of the higher quality of judicial personnel available at this level, but China's law makers have not accepted such suggestion.[10] Hence, it is necessary to examine that in practice which level of courts were more likely to hear corporate reorganization.

Fifth, the data were collected regarding which parties filed for corporate reorganization. This was to understand the extent to which the new rescue regime was preferred by, or more accessible to, a certain group of interested parties, i.e., creditors or debtors. Under Article 70 of the EBL 2006, apart from debtors and creditors, shareholders holding more than ten per cent of the company's equity could also request the court to change a creditor-filed liquidation procedure into a corporate reorganization one. So, a corporate rescue procedure could be filed by three types of parties: debtors, creditors and shareholders.

Sixth, the data looked at the governmental connections of companies that entered the rescue procedure. This was to investigate whether a well-connected company had more chance to use the formal rescue procedure for rehabilitation. Similarly, the data also examined whether a company in rescue was a listed company publicly traded on either the Shanghai or Shenzhen Stock Exchanges; this was to find the potential favouritism, because listed companies in China are often either state-owned or state-controlled.

Seventh, the data recorded frequently quoted reasons used by courts in rejecting corporate rescue filings. But it should be noted that not many rejected filings were collected

[9] China's Supreme People's Court, 'Several Issues of Enterprise Bankruptcies' (Beijing China, 18 July 2002, in Chinese) Article 1, 2.

[10] Terence C Halliday, 'Police Brief: The Making of China's Corporate Bankruptcy Law' (2007) *Oxford Series in Law, Justice and Society* 1.

by this thesis. Unlike accepting a corporate reorganization filing, the court is not liable to advertise its decision if it rejects a filing. So, most of rejected filings were likely to be hidden without being known by the public, especially given that this thesis accessed such information mainly from the media reports. The data collection in this regard appeared to be more difficult, because many courts refused to register the corporate reorganization filing in the first place; therefore, it made the official rejection in the second place impossible. Although several rejected filings collected by this thesis were limited in number, they still could paint a picture as to what the court would react before a corporate reorganization filing in the real world. Knowing these reasons could develop an understanding regarding the difficulties faced by companies that sought to use the formal corporate rescue procedure.

Eighth, the data contained the success rate of corporate rescues in China. Admittedly, the concept of 'success' is elusive. But, here it is specifically defined by looking at whether a reorganization plan was confirmed by the court and was fully executed thereafter. The data on this subject were incomplete, because at the time of data collection, some reorganization cases were still in the process of preparing reorganization plans, and in some other rescues the reorganization plans were in the process of execution. So, the data on this subject only covered the cases whose reorganization plans had been executed and whose reorganization attempts had been officially terminated.

Ninth, the data were collected on how many corporate reorganizations were filed too late. This thesis defined a filing as being late if the company had ceased trading when the formal rescue petition was lodged. Ceasing trading appeared in different forms, depending on different industries. In the manufacturing industry, for example, the company ceased trading because its assemble line was switched off and most of workers had to leave the company. For the real estate industry, the company ceased trading if its construction project was suspended because the company was unable to pay construction contractors. This thesis identified ceasing trade by examining whether the media had reported so.

In sum, with regard to entries into the corporate rescue procedure in China, this thesis collected the above data to demonstrate how well the rescue filing was handled by courts.

B. The Control during the Rescue

As for control in the rescue procedure, theoretically, it would be too complicated to define 'control', because control is a multifaceted concept. For the sake of simplification, this

thesis chose the following issues, which are in line with the academic concept of control, to describe control in Chinese corporate rescues.

First, the data contained the administrator appointment in corporate rescues. As noted, where a corporate rescue filing is accepted, the court will simultaneously appoint an administrator to take control of the company's properties and business affairs. It is noteworthy that an administrator in China's corporate bankruptcy law is not an individual, but is an entity. More precisely, an administrator would be either a local government-organized interim liquidation committee, a qualified law firm, a qualified accounting firm, or a professional liquidating firm.[11] Here, the data calculated the extent to which each of these four kinds of candidates was appointed as the administrator in corporate rescues. These data were summarised as percentages.

The administrator-appointment related data were also included. Under Article 22 of the EBL 2006, a meeting of creditors is allowed to challenge the court's appointment of the administrator. Article 22 stipulates that a meeting of creditors can request the court to replace an existing administrator if creditors can prove that the administrator could not discharge its duties competently or even-handedly. Challenging court administrator appointments could be a powerful lever for creditors to influence control in rescues, so the data collection was expanded to investigate whether and how the administrator appointment was challenged by creditors.

Second, under Article 73 of the EBL 2006, in a company reorganization procedure, the debtor could regain control from the administrator if the court approves the debtor's request. This suggests that a debtor-in-possession is also available in China's corporate rescue regime, although it should be subject to the administrator's supervision. In the case where such a request is allowed by the court, in theory, the landscape of control will be radically changed. So, this thesis collected the data on how many reorganization cases used the debtor-in-possession. These data were also calculated as percentages.

Third, at the centre of control would be the right to propose the reorganization plan for vote. So, the data were identifying who proposed the reorganization plan in these rescue cases. Under Article 80 of the EBL 2006, it is the administrator who has the exclusive right to

[11] Article 24 of the EBL 2006.

propose a reorganization plan to a vote; however, in the case where control is returned to the debtor, this right is accordingly transferred to the debtor. But, as is well known, the law as written down does not always reflect the law in action. To examine the real nature of control in rescues, this thesis' data collection went a step further to look at whether there was deviation from Article 80 in practice.

Finally, given that allocating control to a certain party also partly aims to improve the efficiency of the rescue, the related data were also addressed. For the sake of simplification, the efficiency of the reorganization procedure was judged by calculating the average time spend on the rescue cases. The time spent on an individual reorganization case was counted from the date when the court accepts the rescue filing to the date on which the court confirms the reorganization plan. And the time on executing the reorganization plan was excluded.

C. Value Distribution

The data on value distribution specifically cast light on the following three aspects.

First, corporate reorganization is intended to preserve going concern value of a financially-troubled company by avoiding a destructive liquidation. So, in the first place, the relevant data were needed to check whether or to what extent the company's going concern value had been preserved. However, quantifying how much going concern value was preserved was a very difficult task, because it was technically impossible to draw a clear line between an individual company's going concern and liquidation value.

In practice, an asset evaluator would be hired to appraise both going concern and liquidation value of a company in the rescue process in China, but, the valuation was often inaccurate. Especially when there was an auction, a huge difference would emerge between the evaluated going concern value and the final bidding price. So, it would be considerably superficial to use these two sets of figures generated from the valuator report to measure how much going concern value has been preserved.

Instead, this thesis calculated the average creditor recovery rate in rescues, and then compared it with its counterpart in liquidations. From the potential difference of creditor recovery rates between reorganization and liquidation, it could be known whether the corporate reorganization procedure had preserved going concern value of troubled companies.

It is worth noting that, in nearly all existing corporate rescue cases in China, it was the norm rather than the exception for secured and preferential creditors to be fully paid. So the creditor recovery rate was only drawn from the recovery rate for unsecured creditors. When making comparison, this thesis, accordingly, used the average recovery rate for unsecured creditors in liquidations.

Second, the data sought to examine the application of the *pari passu* principle. In particular, the data shed light on whether and to what extent the pari passu principles was applied in distributing value of companies in reorganization. Under Article 87 of the EBL 2006, the *pari passu* principle is a default rather than mandatory rule. This means that whether to apply this rule could be subject to negotiations of affected parties. Of course, in the case where there is no agreement reached, this rule should automatically apply. Moreover, the data also included for what purposes the deviation from the *pari passu* principle was made in the rescue case.

Third, the data collection moved to examine the application of the absolute priority principle in rescues. This principle is also a default rule under Article 87 of the EBL 2006. This thesis investigated the extent to which this principle was applied and relaxed in distributing value of companies in reorganization. But, more attention was paid to the data on deviations from the absolute priority principle. Furthermore, as has investigated deviations from the *pari passu* principle, the data went further and looked into what goals were pursued in the case that deviations from the absolute priority principle took place.

D. Reorganization Plan Confirmation

A corporate reorganization procedure may reach its final stage when the reorganization plan is submitted to the court for confirmation. The data contained how many reorganization plans were confirmed by courts, and equally importantly, how many of them were dismissed. Meanwhile, the efficiency of courts in confirming reorganization plans was also investigated.

Given that a cram-down may be used to confirm a reorganization plan under Article 87 of the EBL 2006, the data identified how many reorganization cases used the cram-down to forcibly confirm the plans. As a corollary, the odds of each class of interest parties to be forced by the cram-down was also examined and computed.

In addition, under the EBL 2006, a cram-down cannot be imposed unless and until the relevant statutory requirements and tests are met or passed. So, the data checked whether and how these requirements and tests were met or passed when cram-downs were used.

2.2. Data Sources

Primarily, for this national survey, the bulk of the data were derived from newspaper reports, and the rest of them were from other institutions which made their relevant information publicly available. The major data sources are listed as follows.

A. Newspapers

Many corporate reorganizations in China were widely reported by Chinese newspapers. These events draw media attention mainly for the following reasons. First, nearly all existing rescue cases were to rehabilitate large companies. Given the social and economic impact of rescuing a large company, it was not surprising that newspapers were interested in reporting such an event. Second, more notably, large company rescues were often regarded as political events, because many government agencies would, in most instances, be involved. Also, it was not unusual for local senior politicians to directly participate in an individual corporate rescue procedure. So, the state-controlled propaganda machine (mainly newspapers) was deployed to publicize government efforts and achievements in managing the economy.[12] Third, the corporate rescue regime was a new legal procedure in China; many news agencies and even the general public were very curious about how this legal mechanism operated; and this might also attract newspapers to report such cases. Perhaps for these three reasons, most China's corporate rescues received a considerable amount of press coverage. This made this thesis' data collection possible.

In general, reorganization of listed and non-listed companies seemed to attract press attention somewhat differently. For listed company reorganization, given its impact upon general public shareholders nationwide, it was mainly national newspapers investigating and reporting these events. Most of these newspapers are Beijing-based and focus on reporting

[12] Generally see Benjamin L Liebman, 'Watchdog or Demagogue? The Media in the Chinese Legal System' (2005) 105 *Columbia Law Review* 1.

commercial and judicial news. They included: *Legal Daily*（fa zhi ri bao）,[13] *China Stock News*（zhong guo zhen quan bao）, *The People's Court Daily*（ren ming fa yuan bao）, *Stock Daily*（zhen quan shi bao）, *Shanghai Securities Daily*（shanghai zhen quan bao）, *21st Century Economy News*（21 shi ji jing ji bao dao）, *Daily Economy News*（mei ri jing ji xin wen）, *Stock Market Weekly*（zhen quan shi chang zhou kan）, *Caijing*（cai jing）and *The First Economy Daily*（di yi cai jing ri bao）.

By contrast, regarding reorganization of non-listed companies, because of their regional economic importance, these cases were largely reported by local newspapers at city or provincial level. For example, the reorganization of *Jiangxi Xingzhen Pharmaceutical Co. Ltd*. was only reported by the local newspaper, *Pingxiang Daily*.[14] Compared with national newspapers, local newspapers appeared to be less critical, and these news reports were also less comprehensive. In particular, many key figures, which were likely to be treated by the local government as politically embarrassing, were missing in the local newspaper reports. For example, in the reorganization of *Zhonghen Steel Co. Ltd. Sichuan,* key figures in the reorganization plan, including the recovery rate for unsecured creditors and whether there was a cram-down, were not available in local newspaper reports.[15] This exerted more challenges to collecting the data.

All these newspapers had their online editions, which made the data collection possible and more convenient. Among all newspapers, the *People's Court Daily* deserves more attention, because it was the main source of corporate reorganization information at national level.

B. *The People's Court Daily*

The People's Court Daily is a newspaper in Chinese that was founded and is managed by China's Supreme People's Court. It publishes seven days a week. According to a decree of China's Supreme People's Court released in 2005, public notices of all Chinese courts must

[13] Some newspapers have their English names; otherwise, their names are translated by the author. Any conflict of translation should be subject to the original Chinese name shown in brackets.

[14] Jie Qian and Cuxuan Xu, 'Jiangxi Xingzhen Pharmaceutical Co. Ltd. Restructured' *Pingxiang Daily* (Pingxiang Jiangxi China, 18 August 2009) (in Chinese) 1.

[15] Youbing Lan and Yuansong Chen, 'The Success of the First Corporate Reorganization Case in Sichuan' *Mianyang Evening News* (Mianyang Sichuan China, 11 January 2010) (in Chinese) A2.

be advertised on *the People's Court Daily*.[16] Considering that the EBL 2006 requires the court to give a public notice when accepting a corporate bankruptcy filing,[17] therefore, the acceptance of all corporate reorganization filings in China can be found in *the People's Court Daily*.

By and large, information on corporate reorganization from *the People's Court Daily* was highly reliable and accurate. However, two main weaknesses here should be noted. The first was that these public notices advertised on *the People's Court Daily* only provided some basic, procedural issues about rescues. Specifically, a public notice included: (1) the name of the company and who files for reorganization; (2) the date when the filing is accepted; (3) which entity is appointed as the administrator; and other information.[18] But, as for substantive information including, among other things, the size of debts involved and the creditor recovery rate, these public notices revealed little. The second weakness was that some historic public notices from the *Daily* had been deleted from its website when this thesis's data collection project started. The archives of these public notices could not be publicly accessed. So, this made the data incomplete. In fact, many public notices originally published on the *Daily* were from other secondary sources.

Apart from the newspapers, much information on listed company reorganization was obtained from two officially designated websites.

C. Listed Company Information Disclosure

Many Chinese corporate rescue cases were reorganising listed companies which were publicly traded on either the Shanghai or Shenzhen Stock Exchanges. As one of the regulating requirements, listed companies are liable to disclose their important business information to the public.[19] Given the importance of entering corporate reorganization procedures, listed companies had to disclose their information on corporate rescues. In China, there are two official websites designated for listed companies to feed transparency to some extent: the website of the Shanghai Stock Exchange at www.sse.com.cn and the Shenzhen

[16] The Notice of Proclamation Compulsorily Published on People's Court Daily issued by China People's Supreme Court on 21 January 2005.
[17] Article 14 of the EBL 2006.
[18] Article 14 of the EBL 2006.
[19] Article 30 of the Listed Company Information Disclosure Regulation issued by China's Securities Regulatory Commission on 30 January 2007.

Stock Exchange at www.szse.cn. Therefore, a great deal of listed company reorganization information was derived from these two websites.

It is also noteworthy that another website, www.cninfo.com.cn, established by one of the Shenzhen Stock Exchange's son companies, the *Shenzhen Securities Information Co. Ltd.*, also offered comprehensive information on Shenzhen listed company reorganizations, because much historical information that have been deleted on the website of www.szse.cn could be found there. These two websites were complementary in providing the rescue information on Shenzhen listed companies.

D. Professional Firms

Some data were obtained from professional firms' websites. In most cases, these firms, which were mainly accounting or law firms, were appointed as administrators to manage rescue processes. In some instances, it was even the case that the professional firm as the administrator officially used its website as a formal channel to disclose rescue-related information probably because of its independence and technical capability. For instance, in the reorganization of *Jiangsu Hongjie Electronics Co. Ltd.* in 2009, the administrator, *Jiangsu Xingrui Accounting Firm*, used its website as the main window to feed the case's transparency: nearly all the critical rescue documents, including the reorganization plan and the sheet of creditors' claims, were made publicly available on its website.[20]

In other instances, the relevant information appeared in the professional firms' news bulletins. These firms had the incentive to advertise their experience to appeal to prospective clients. For example, without the news bulletin publicized on the website of *Zhejiang Xingyun Law Firm*, it was impossible to know about the reorganization of *Zhejiang Xing'an'jiang Steel Co. Ltd.* which was handled in Zhejiang in 2010.[21]

These websites, however, were not the primary data sources, as less than five cases were found in this way. But, undoubtedly, they considerably enriched and enhanced this thesis's data collection.

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[20] The Administrator of *Jiangsu Hongjie Electronics Co. Ltd*, The Report to the Court and the Creditors' Meeting (Changshu Jiangsu China, 8 March 2010) (in Chinese).

[21] Zhejiang Xingyun Law Firm, An Analysis of Practical Issues of the Corporate Reorganization Case (Hangzhou Zhejiang China, 27 September 2011) (in Chinese).

E. China's Insolvency Practitioners Association

Strictly speaking, China's Insolvency Practitioners Association is still not a legally-recognized entity in China as it has not officially registered in the government,[22] but has set up its website, http://www.qshyxh.com, gathering a great deal of court public notices on corporate bankruptcy, including corporate reorganization. In fact, many public notices that were originally advertised on the *People's Court Daily* were derived from this Association's website, because they had been deleted from the *People's Court Daily* website.

F. Individual Practitioners

Inevitably, the data collected through the internet were incomplete in both depth and width, so some insolvency practitioners were then contacted for details. But in most cases they declined to provide information by explaining that it was concerned about commercial confidentiality, although only publicly available information circulated to creditors in creditors' meetings was requested. Fortunately, there were still several public-spirited lawyers who replied quickly and provided the materials requested.

2.3. Ways of Collecting Data

The vast majority of the data were collected via the internet, and the rest was obtained by using the telephone and email.

A. Using the Internet

The data collection for this thesis was made possible mainly because nearly all sources had their online websites; hence, it was not very difficult to access relevant information. To trawl the internet, the web search engine 'Google' was primarily used.[23] At the same time, given that most information appeared in Chinese, the web search engine in China 'Baidu'

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[22] In China, the Communist Party is vigilant regarding the establishment of civil societies, so it is rare for such an association to be legally registered and recognized in China. See generally Peter Ho, 'Greening without Conflict? Environmentalism, NGOs and Civil Society in China (2001) 32 *Development and Change* 893-921.

[23] The function of web search engines can be briefly reviewed at Liwen Vaughan and Yanjun Zhang, 'Equal Representation by Search Engines? A Comparison of Websites across Countries and Domains' (2007) 12 *Journal of Computer-Mediated Communication* 888.

was also used, and even, anecdotally, Baidu would be more effective than Google in searching online materials in Chinese.[24]

In order to gather as much information as possible, the keywords that were used to search varied quite widely. These keywords included but were not limited to: corporate bankruptcy (gong si po chan), corporate reorganization (gong si chong zhen), corporate rescue (gong si zhen jiu), bankruptcy reorganization (po chan chong zhen), judicial reorganization (si fa chong zhen), enterprise reorganization (qi ye chong zhen), and reorganization (chong zhen), etc.

It should be noted that the above keywords were in Chinese not in English, as nearly all information in this respect appeared in Chinese. Interestingly, many corporate reorganization cases handled in Taiwan were also obtained, because Chinese is spoken and used in both countries.[25] Given that this thesis exclusively focused on the mainland China, namely, the People's Republic of China, the rescue cases in Taiwan were used for reference purposes rather than were included in the data collection.

There were two steps taken for each search. The first step was using the aforementioned key words to identify individual companies entering the rescue procedure. The second step of each search was to change the key words to the company's name, including its official, abbreviated and its acronym names if applicable. This led to more detailed company-specific information.

All relevant webpages were recorded and stored in this thesis's electronic portfolio.

B. Telephone

To a large extent, collecting the data by phone was a failure, as nearly all respondents declined to provide information in this way. It was normal, given that there was no trust established before. It is worth noting that some courts in China still could not be contacted by phone, as in some areas phone numbers of law courts (and other governmental institutions)

[24] See generally at Haiquan Long and others, 'Evaluate and Compare Chinese Internet Search Engines Based on Users' Experience' (2007 International Conference on Wireless Communications, Networking and Mobile Computing, Shanghai, September 2007) <http://ieeexplore.ieee.org/xpls/abs_all.jsp?arnumber=4341279&tag=1> accessed 4 June 2012.

[25] See the political relation between China and Taiwan generally at Lijun Shen, *China and Taiwan: Cross-Strait Relations under Chen Shui-Bian* (Institute of Southeast Asian Studies 2002).

were still treated as a kind of state secret, and the general public had no publicly available access to these numbers.

C. Email

There were three cases collected by using email. A lawyer, Mr. Shen Tianfen, from Hangzhou, Zhejiang Province, responded to an email request quickly, and days after all legal documents of the three reorganization cases handled by him were obtained.

2.4. Data Reliability

It can be ensured that the data collected in this thesis were reliable. As noted, the vast majority of the data were obtained from newspaper reports. Given that China's newspapers are state-owned and rigorously regulated, it is highly unlikely for the newspapers to fabricate facts. Furthermore, the news of corporate reorganization was largely commercial in nature; namely, it was not politically sensitive; therefore, it seemed unnecessary for the government to manipulate such information.[26] Moreover, it should be noted that most of the facts were also double-checked through different newspaper sources for the sake of credibility.

Apart from newspaper reports, the majority of the data for listed company reorganizations were obtained from two official information-disclosure websites. They were trustworthy, because these information would have been verified several times by different regulating authorities before being made public.

As for the data from the professional firms' websites and individual practitioners, most of the data appeared in photocopied original files; this produced great confidence.

In sum, there was little doubt about the reliability of the data. The main problem of the data was its incompleteness. For example, perhaps due to local government pressures, in some instances, the key information on the unsecured creditor recovery rate, especially when it was very low, and on whether a cram-down was issued seemed to be intentionally concealed in newspaper reports, since such information might be negative from a local

[26] Generally see Susan L Shirk, 'Changing Media, Changing China' in Susan L Shirk (ed), *Changing Media, Changing China* (Oxford University Press 2011). Shirk found that in China commercial news would be more reliable than political news from the general public point of view.

government point of view. This caused some problems for the data collection, and the comprehensiveness of the data was adversely affected. To address the incompleteness of the data, in later chapters, the limits of the data in each particular aspect will be clarified.

2.5. Data Analysis

The statistical analysis was mainly used in order to generate a summary of corporate rescue law implementation in China. In particular, two types of figures were extracted: probabilities and trends. The probability figures aimed to ascertain the likelihood of certain practices. For example, this thesis calculated the average unsecured creditor recovery rate in rescues through averaging the unsecured creditor recovery rate in all individual rescue cases; the average figure was useful to understand the extent to which unsecured creditors would recover their debts in corporate rescues.

As for the trend, this was mostly used in counting the number of rescues during certain periods; this was to examine the use of the rescue procedure over time. In addition, it was also used to identify geographic differences in using the rescue procedure rehabilitate local troubled companies.

It is worth noting that the average unsecured creditor recovery rate in Chinese corporate rescues calculated by this thesis was slightly lower than the genuine one because of an artificially simplified method of calculation. More specifically, in some rescue cases in China, unsecured creditors were paid *pro rata*, i.e., the *pari passu* principle was applied; however, in other, although not too many, cases, unsecured creditors were paid at different rates, i.e., the *pari passu* principle was relaxed.

For example, in the reorganization of *Guangming Furniture Co. Ltd.* in 2009, under its confirmed reorganization plan, the first ¥30,000 debt of each unsecured creditor was paid one hundred per cent; over ¥30,000, eighteen per cent was paid.[27] Evidently, the deviation from

[27] The Administrator of *Guangming Furniture Co. Ltd*., 'The Reorganization Plan of *Guangming Furniture Co. Ltd.*' (Yichun City, Heilongjiang Province, China, 19 April 2010, in Chinese) <http://stock.quote.stockstar.com/1_000587_000000000000036lux.shtml> accessed 9 June 2012.

the *pari passu* principle was made to attract votes from small creditors.[28] However, in real terms, the amount of unsecured creditor payment at higher rates seemed to be very small in quantity. In the *Guangming* case, the amount of debts which had a one hundred per cent payment was only ¥68,271, and it appeared to be negligible if compared with the ¥381,631,802 unsecured debts paid at the eighteen per cent rate.

Thus, for the sake of simplicity, this thesis chose the unsecured creditor recovery rate that applied for the majority of unsecured debts as the representative recovery rate. By this standard, for example, in the *Guangming* case, the recovery rate of eighteen per cent was selected as the recovery rate for all unsecured creditors. Obviously, the average unsecured creditor recovery rate reported in this thesis would be slightly, but negligibly, lower than the genuine one.

Using this simplified method was also realistic. In theory, a comprehensive recovery rate for unsecured creditors in a rescue case could be precisely calculated by dividing the whole amount of unsecured debt by the actual amount paid to all unsecured creditors, although they were paid at different rates. But, in practice, the problem was that such an ideal approach could not be realised, because usually the different recovery rates were available, whereas the exact amounts of debts paid at different rates were not accessible; hence, this optimal method lacked sufficient data support, and had to be placed aside.

Overall, this national data collection mainly used the quantitative method to paint the picture as to how the new corporate rescue law was enforced in China. At the second stage of the data collection, namely, the Zhejiang case study, the qualitative research method was mainly employed.

3. METHODS FOR THE ZHEJIANG STUDY

Zhejiang is an economically well-developed province located in eastern China, adjacent to Shanghai. Zhejiang province was selected for a case study mainly because this province

[28] The practice of differentiating unsecured creditors repayment rates was also found in Germany where small unsecured creditors could be paid at a higher rate in exchange for their consent to the rescue plan. See Julian R Franks, Kjell G Nyborg and Walter N Torous, 'A Comparison of US, UK and German Insolvency Codes' (1996) 25 *Financial Management* 86, 94.

handled nearly a quarter of China's corporate reorganization cases between June 2007 and November 2010. Therefore, its relatively large number of corporate reorganizations would be helpful in identifying some common problems and patterns.

Moreover, the decision to do the Zhejiang study arose also because of an official corporate rescue report released by Zhejiang's Supreme People's Court in late 2011.[29] In this report, the Court reviewed corporate rescue practice in the province and provided much insight. This report was likely to be the first judicial report on corporate rescue made by a provincial supreme court in China.

During January 2012, twenty people were interviewed; among of them were eight lawyers, two accountants, three judges, five creditors (or their representatives), one debtor and one government senior official.

3.1. Zhejiang Study Preparation

Unlike the preceding national survey which focused on collecting objective figures, the Zhejiang study aimed to investigate the behaviour and incentives of interested parties in the rescue procedures; this meant that subjective opinions and observations were collected.

In late November and December 2011, the interview questions were designed at Durham University, England, under the auspices of Prof. Roman Tomasic. Under Durham University's academic regulations, research proposals involving interviews should be subject to the University's ethics approval. Therefore, after the interview questions were finally drafted, a 'Durham Law School Ethics and Data Protection Monitoring Form' for the Zhejiang study was submitted to the University on 2 December 2011, which outlined the research interview questions, prospective interviewees, the anonymity principle, among other things. On 13 December 2012, Durham University Law School approved the proposal. In the process of the fieldwork, the guidelines demonstrated in the approval form were strictly complied with.

[29] The Zhejiang Supreme People's Court, 'Report of Corporate Reorganization in Zhejiang (2007.6 – 2011.11)' (Hangzhou Zhejiang China, 22 November 2011, in Chinese).

In early January 2012, the candidate travelled to Zhejiang, China to undertake field-work for one month, visiting seven cities: Fuyang, Hangzhou, Jinghua, Quzhou, Shaoxing, Yiwu and Zhoushan for the interviews. The data collected were then processed in February 2012 at Durham University.

It was worth noting that the number of the Zhejiang corporate rescue cases collected in the preceding national 2010 survey was verified as accurate by this Zhejiang fieldwork. All corporate rescue cases taking place in Zhejiang during the chosen period were included in this Zhejiang study.

3.2. Data Content

Covering a longer period than that in the national survey, the Zhejiang study examined rescue cases accepted by courts in Zhejiang between 1 June 2007 and 31 December 2011. The previous national survey counted the cases accepted between 1 June 2007 and 30 November 2010. In total, thirty-five companies entered corporate reorganization procedures in Zhejiang in the aforesaid period. The data focused on the following issues, which in turn responded to the four research questions of this thesis.

A. Entry Difficulties: The Problem of Access

Before asking why it was so difficult for a formal corporate rescue procedure to be entered, the Zhejiang study collected the data on the number of companies on the register, company dissolutions, bankruptcies and reorganizations in Zhejiang during this period in order to paint a full picture regarding bankruptcy law enforcement as a whole.

As for interview questions, the first was to ask why courts were hesitant to accept corporate rescue filings. The second was asking why government support was essential for a court to accept a rescue filing. The third question focused on why many rescue filings were commenced too late.

All replies and comments were summarized into three categories according to the party they were directed to. Specifically, the first category was about courts as to their concerns towards corporate rescue filings. The second was dedicated to debtors, describing why

debtors were rescue-averse in practice. The third category looked at creditors, examining their attitudes and perceptions towards filing for reorganization.

B. The Control in Zhejiang Rescues

Given that the administrator-in-possession was used in most Zhejiang corporate rescues, first, the interviewees were asked why debtors could not be allowed, or be trusted, to run formal rescue processes. This question was to investigate why the expected debtor-in-possession was not widely used or preferred. This question also aimed to find the attitudes of interested parties towards the debtor-in-possession approach.

The second interview question asked what specific roles were played by the administrators in rescues. In particular, interviewees were asked how the administrator prepared the reorganization plan, because in most rescues the reorganization plan was proposed in the name of the administrator. Meanwhile, an explanation was sought for why it was still the administrator who proposed the reorganization plan in the case that there was a debtor-in-possession according to which it was the right of the debtor, not the administrator, to do so.

Finally, interviewees were asked how creditors influenced control in rescues. Although creditors have a powerful lever - voting on a reorganization plan, such a right would be considerably undermined if creditors could not get sufficient information of the company. So, the interviewees were asked whether creditors were allowed to access the company's books in order to make an informed decision prior to voting on the reorganization plan. In practice, an auditor's report would be made in each reorganization case, so the interviewees were asked whether auditor reports could satisfy creditors' information demands and enhance transparency of the procedure.

C. Value Distribution

Similar to the national survey, the Zhejiang study calculated the average unsecured creditor recovery rate in order to test the strength of the corporate rescue regime in preserving going concern value. Regarding the priority principle in value distribution, given that in most Zhejiang corporate rescues this principle was rigidly adhered to, interviewees were asked whether deviating from absolute priority had been, or could be, considered in order to improve the viability of rescues by inviting old equity-managers to contribute their

information and experience to new companies. The application of the *pari passu* principle was also examined.

D. Reorganization Plan Confirmation

The first interview question was to ask what criteria the courts used to confirm reorganization plans in the normal confirmation procedure, because the EBL 2006 does not give clear instructions in this regard. Moreover, the judge interviewees were asked how they assessed the feasibility of reorganization plans. Second, judge interviewees were asked whether and how cram-downs were used by Zhejiang courts. In particular, judges' attitudes towards cram-downs in Zhejiang were sought.

3.3. Data Sources

The vast majority of the data on Zhejiang corporate rescues were generously provided by insolvency practitioners, including lawyers and accountants who were appointed as administrators. Almost all reorganization plans, as either a hardcopy or electronic one, were also directly given by them in person.

There were only two reorganization cases in which the materials were not directly from the practitioners. The first was the rescue of *Zhejiang Jingxing Trust Co. Ltd.* wherein the administrator was a local-government-organized liquidation committee; all the members of the committee[30] were local government officials in Jinghua, Zhejiang; unfortunately, they declined to be interviewed or to give any case materials. In the Zhejiang Provincial Company Registration Office, however, the photocopied reorganization plan and other key documents of *Jingxing* case were unexpectedly found.[31]

The second case was the reorganization of *Huachen Real Estate Co. Ltd.* in Ningbo, Zhejiang. Nearly all the crucial documents of this case had been made publicly available online at the official website of Beilun's Lower People's Court, Ningbo which handled the

[30] Under Article 24 of the EBL 2006, an administrator is not a natural person, instead it is a unit comprised of individuals.

[31] Article 35 of P. R. China's Company Registration Regulation 2005 issued by the State Council (Beijing, 18 December 2005, in Chinese) <http://old.chinacourt.org/flwk/show.php?file_id=106970> accessed 13 June 2012.

rescue. Hence, it was unnecessary to physically travel to Ningbo to get access to the case materials.

This study was originally planned to interview more judges in Zhejiang, but most of them were not easy to approach. The same difficulty was encountered regarding attempts to interview government officials. As to debtor interviewees, it appeared understandable for them to decline to be interviewed as they were, in most cases, actually expelled during or after rescues, and the re-telling of their stories might exacerbate their misery; therefore, after listening to the grievances of several debtors when they were approached by telephone, the plan to interview more debtors was dropped.

It is worth noting that the Zhejiang study interviewed ten insolvency practitioners who were in charge of seventeen out of twenty reorganizations[32] in Zhejiang. So, the mainstream views of administrators on corporate rescues in Zhejiang would have been adequately investigated by this thesis.

3.4. Ways of Collecting Data

Prior to travelling to Zhejiang in January 2012, the author gathered, by using the internet, publicly available data on Zhejiang corporate rescues as comprehensively as possible. At that stage, both the data on rescues themselves and the contact details of prospective interviewees were searched and collected. Collecting the data from the media seemed to be necessary, because, compared to the source of interviewees who had vested interest in these cases, the media information appeared to be more neutral and objective.

The author met all interviewees in person. Most interviews took place in the interviewee's office. Before each interview, the interviewee was informed of the purposes of this study and the principle of anonymity. In order to avoid interruption and for the sake of confidentiality, the interviews were conducted without third parties present. Most interviews took between one and two hours. No electronic recording apparatus was used, because recording was inappropriate in the local custom context. The notes of responses and

[32] As will be demonstrated later, the Zhejiang case study distinguishes a reorganization case from a reorganized company, because, in some instances, a group company reorganization case may deal with several companies within the same group.

comments of the interviewees were taken by the author in Chinese on the scene and then translated into English in England later.

Most of the reorganization plans were electronically transferred to the author's memory stick from interviewees' computers. There were two cases where the hard copies of reorganization plans were provided. There was only one case, *Zhejiang Jingxing Trust Co. Ltd.* reorganization, whose reorganization plan was photocopied from The Zhejiang Province Company Registration House.

3.5. Data Analysis

Statistical analysis was applied to the Zhejiang data as it had been to the national survey. But this method was only used to briefly examine some objective figures, such as the unsecured creditors' recovery rate. Given that the main goal of the Zhejiang study was to investigate subjective issues of interested parties in rescues, the main analytical method here was observation. Observation as an analytical method was critical in the Zhejiang study, because some interviewees' responses could only be properly interpreted and understood in their contest.

3.6. Focusing Attention on the Zhejiang Data

There are two extra issues in the Zhejiang data that should be specially mentioned. The first is the difference between the number of rescue cases calculated in this thesis and that presented by Zhejiang's Supreme People's Court in its 2011 corporate reorganization report.

The report stated that there were thirty-four companies entering the corporate reorganization procedure in Zhejiang between June 2007 and September 2011, but the Court has not disclosed the list of these companies for public inspection.[33] This thesis, however, found that there were only thirty companies in the formal rescue procedures during this period.

[33] The Zhejiang Supreme People's Court (n 29).

After carefully reading of the report, a potential double-counting problem was found: some going concern sale liquidations were also included by Zhejiang's Supreme People's Court as corporate reorganizations. For example, the liquidation of *Ningbo Bailian Industry Technology Co. Ltd.*, which ended up in a going-concern sale, was counted by the Court as a corporate rescue case in its report.

Presumably, the Court's 2011 report included two categories of cases: the first was the cases that were initially accepted by courts as corporate reorganization irrespective of their final destinations, and the second was liquidations which were eventually operated as going-concern sales. Therefore, the number of rescues was artificially inflated in this official report.

But this thesis recognized and calculated a corporate reorganization case only if it had been accepted by the court as a corporate reorganization procedure. A corporate reorganization case might end up in a piecemeal liquidation, as did happen in Zhejiang, but it was still included as a rescue case for this thesis. By contrast, this thesis did not regard a going concern sale liquidation as a reorganization, because such a method would considerably complicate the statistics.

The second issue is about the social attitudes towards business failures as found by this thesis. The social attitudes towards company failure surveyed in this study were actually established from only interviewing a small group of people. Their views to some degree reflected those of the general public, but strictly speaking, they could not comprehensively represent the latter. It was beyond the scope of this thesis to conduct a comprehensive survey as to the general social attitudes towards business failure. This limit should be borne in mind.

Furthermore, social attitudes observed in this thesis were limited to the companies that entered the formal rescue procedure rather than to a broad range of companies that failed in the market. So, the limit in this respect should also be kept in mind, as causes of business failure in the wider market as a whole would be far broader than those seen in the companies in reorganization.

4. CONCLUSIONS

Generally, this thesis used the collected data to describe and understand the implementation of the new corporate rescue law in China. As to the national survey, most of

this data was from the online sources on the internet; by contrast, the Zhejiang case study was predominantly based on fieldwork interviews.

In the national survey, to a large extent, a quantitative method of statistical analysis was applied with the aim of forming a comprehensive view of corporate reorganization practice nationwide in China. In the Zhejiang case study, a qualitative method of observational analysis was used to examine the behaviour and incentives of interested parties in rescues.

In the next chapter, the research findings from the national survey will be reported, followed by a chapter reporting the Zhejiang study findings. These two chapters will give a more comprehensive view as to what has happened after the enactment of the EBL 2006 in China.

CHAPTER 5

CORPORATE REORGANIZATIONS IN CHINA[1]

1. INTRODUCTION

In the previous chapter, the research methods of this thesis were described; in particular, the methods used to collect empirical data at the national level as well as in Zhejiang province were explained. This chapter reports the research findings of the implementation of the company reorganization regime in China as a whole; the regional Zhejiang research findings will be presented in the next chapter.

In this chapter, given that the data are mainly quantitative in nature, a set of figures will be used to demonstrate China's new rescue law in action. The next chapter, by contrast, will largely consist of the qualitative data drawn from the interviews which explore the behaviours and incentives of interested parties in the rescue procedure.

China's Enterprise Bankruptcy Law 2006 (the EBL 2006) was passed in 2006, but it needed the relevant institutions, especially a body of the insolvency practitioners (IPs), to support its full operation. As noted before in chapter 2, one of the most striking characteristics of the EBL 2006 was to establish the profession of insolvency practitioners in China; in particular, under the EBL 2006, qualified insolvency practitioners could be appointed by courts as administrators to manage companies in corporate bankruptcy procedure. Given that, before the EBL 2006, there was no profession of insolvency practitioners, it was essential to establish a group of qualified insolvency practitioners to meet the legal requirements.

Pursuant to Article 22 of the EBL 2006, in April 2007, China's Supreme People's Court released two judicial notices regulating the qualification and remuneration of insolvency

[1] The earliest version of the finding on Chinese corporate rescue implementation was presented in Roman Tomasic and Zinian Zhang, 'From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganization in China' (2012) 12 *Journal of Corporate Law Studies* 295.

practitioners.[2] Authorised by these two notices, local provincial supreme courts started to make their regional lists of insolvency practitioners after April 2007. Considering that it was June 2007 when the EBL 2006 took effect, however, receiving the authorisation in April 2007 meant that most provincial supreme courts were unable to prepare the list of insolvency practitioners by the time when the EBL 2006 came into force; two months was too short a time for these complicated qualification project to be concluded.

In fact, when the EBL 2006 took effect on 1 June 2007, in most provinces, the list of qualified insolvency practitioners was still pending. For example, in Beijing, it was not until September 2007 when its first insolvency practitioner list was made available.[3] This meant that, during the period between June and September 2007, there were no qualified insolvency practitioners available for administrator appointments in Beijing. Nevertheless, after the EBL 2006 took effect, lists of insolvency practitioners were gradually made and released province by province.

Strictly speaking, the availability of the insolvency practitioner list in each province marked the starting point of the full enforcement of the EBL 2006. But the belated lists of insolvency practitioners did not postpone the enforcement of the EBL 2006; this was because under its Article 24 a local government organized liquidation committee could also be appointed as an administrator, which meant that courts did not have to appoint qualified insolvency practitioners to do the job.

Before reporting the national implementation of China's new corporate rescue regime, the four research questions in this thesis are worth repeating here, because the findings reported in this chapter will focus on them. First, is the new corporate rescue regime frequently used in China? And if not, what are the main obstacles to its commencement? Second, who is actually in control of the existing corporate reorganizations in China? Third, how is value preserved in rescues distributed between interested parties? Finally, is the court reorganization plan confirmation adequate to fulfil the policy goals of the new corporate rescue regime?

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[2] They are the Administrator Appointment Regulation and the Administrator Remuneration Regulation issued by China's Supreme People's Court on 4 and 12 April 2007 respectively.

[3] The Beijing Supreme People's Court, 'The Public Notice of the First Bankruptcy Administrator List of Beijing' (Beijing China, 25 September 2007, in Chinese) <http://bjgy.chinacourt.org/public/detail.php?id=56875> accessed 20 September 2012.

In response to these four questions, the reminder of this chapter is arranged into four Parts: (i) Part 2 reports the number of corporate reorganizations in China and the entry-related issues; (ii) Part 3 outlines control in rescues; (iii) Part 4 sheds light on value distribution in rescues, and (iv) Part 5 describes the courts' confirmation of reorganization plans. In the conclusion, some of the key points of the findings will be summarized.

2. COMMENCEMENT OF CORPORATE RESCUE IN CHINA

As discussed in chapter 3, before the EBL 2006, the corporate bankruptcy system in China was not well developed. Although there was optimism about its enforcement when the EBL 2006 was passed,[4] questions still remained regarding the use of the new corporate rescue regime, because its development largely depended on a rigorous corporate liquidation regime, which in turn needed a well-developed judicial infrastructure, including experienced judges, skilled insolvency practitioners and business confidence to use bankruptcy law, *inter alia*.

2.1. A Small Number of Corporate Reorganizations after 2007

Given the huge size of the Chinese economy,[5] there were a relatively small number of corporate reorganizations after the EBL 2006 took effect. Between 1 June 2007 and 30 November 2010, a period of three and a half years, there were, reportedly, only 111 companies that entered the formal corporate reorganization procedure in China as a whole.[6]

Within these 111 companies, there were some companies in a company group that were jointly reorganized; or, in the language of corporate bankruptcy research, they were consolidated. In the consolidated reorganization procedure, all companies in one group were treated as one legal entity, and accordingly the legal personality of the individual company

[4] Shuguang Li, 'Several Critical Problems in Amending Enterprise Bankruptcy Law' (2002) 20 *Journal of China University of Political Science and Law* (in Chinese) 7, 12.

[5] China overtook Japan and became the second largest economy in 2010. See David Barboza, 'China Passes Japan as Second-Largest Economy' *New York Times* (New York, 16 August 2010) B1.

[6] See Appendix 1 where all Chinese companies in rescue are listed for examination.

was revoked.[7] For instance, in the consolidated reorganization of *Zonghen Group Co. Ltd. Zhejiang* in 2008, the legal personality of six companies in the group was annulled; the six companies were consolidated as one legal entity in the reorganization procedure. In this thesis, these are treated as one corporate reorganization case, but in calculating how many companies are reorganized, the thesis will state that there were six companies in the rescue i.e., the numbers of reorganizations and companies in reorganization are differentiated in this thesis.

Sometimes a company group containing several companies entered the corporate rescue procedure, but the companies within the group were not substantively consolidated, i.e., the individual company' legal personality was retained, and putting them together was just for procedural convenience. In such circumstances, they were treated as several independent reorganizations or reorganization cases. For example, in the reorganization of *Yijiaxiang Food Co. Ltd. Zhejiang* 2010, three of its affiliated companies entered the rescue procedure concurrently in the same court, but they were not consolidated; therefore, they were calculated as four corporate reorganizations dealing with four companies.

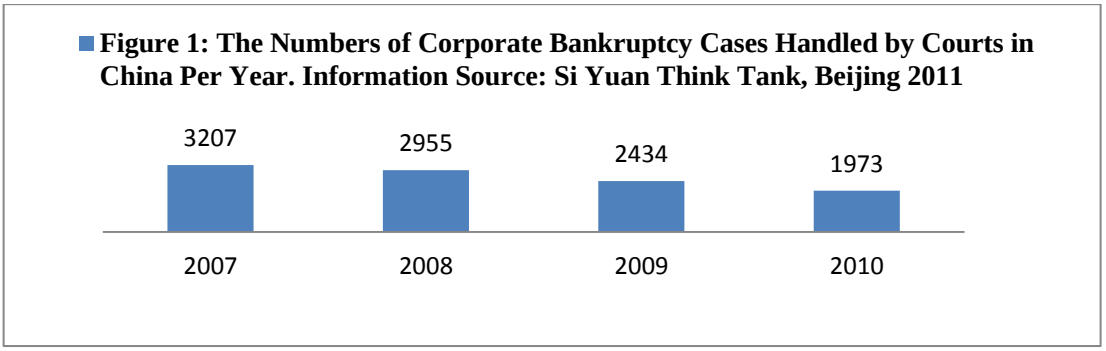
By such standards, this thesis tends to state that there were eighty-seven corporate reorganizations dealing with 111 companies in China between 1 June 2007 and 30 November 2007. On average, there were twenty-five corporate reorganizations handled each year.

Moreover, in order to better understand rescue law implementation in China, this thesis calculated a series of rates, namely the company reorganization, bankruptcy and dissolution rates, each of which will be defined below, and then an international comparison with the US and the UK will be made. As discussed in chapter 4 on methodology, an international analogy would be an optimal way to identify the potential gaps of enforcing the EBL 2006 in China.

First, it is the company reorganization rate, which is calculated from counting the number of corporate reorganization cases out of the number of all corporate bankruptcy cases, including reorganization, liquidation and compromise procedures. From 2007 to 2010 (as Figure 1 shows), Chinese courts as a whole handled 3,207 corporate bankruptcy cases in

[7] See generally Charles M Tatelbaum, 'The Multi-Tiered Corporate Bankruptcy and Substantive Consolidation – Do Creditors Lose Rights and Protection' (1984) 89 *Commercial Law Journal* 285.

2007, 2,955 in 2008, 2,434 in 2009 and 1,973 in 2010. On average, there were 2,642 corporate bankruptcy cases annually. Therefore, twenty-five corporate reorganizations out of 2,642 corporate bankruptcies per year meant that the corporate reorganization rate was 0.95 per cent (twenty-five out of 2,642); put differently, there were 0.95 per cent of corporate bankruptcy procedures that were used to reorganize bankrupt companies.



Second, it is the corporate bankruptcy rate, which was the number of corporate bankruptcies out of that of corporate dissolutions in the given period. The average number of corporate bankruptcies between 2007 and 2010 at 2,646 was already made known above; here, correspondingly, the average number of company dissolutions is needed.

However, accessing China's company dissolution statistics was very difficult, partly because such statistics might still be deemed to be a state secret that the government is unwilling to disclose.[8] So, this thesis had to rely upon other secondary sources to fill the gap.

One recent study conducted by Li and Wang indicates that China's national company dissolutions were 814,600 in 2007, 871,400 in 2008 and 774,700 in 2009; the data for 2010 and onwards were not available; these figures were, according to Li and Wang, obtained from China's Supreme People's Court.[9] On average, there were 820,233 companies that were

[8] For example, in its *Annual Report on Enterprise Registration of 2011*, the China National Company Registration Ministry just gave the number of companies opened in 2011 but kept silent as to the number of companies dissolved in the year. See the China National Company Registration Ministry, 'Annual Report on Enterprise Registration of 2011' (Beijing China, in Chinese) <http://www.saic.gov.cn/zwgk/tjzl/zhtj/bgt/201108/U020110809587501628014.pdf> accessed 27 December 2012.

[9] Shuguang Li and Zuofa Wang, 'Empirical Study of Three Years' Bankruptcy Law Implementation in China' (2011) 2 *Journal of China University of Political and Legal Science* (in Chinese) 58, 60. A 2010 study by Xingxing Wang indicates that China's national numbers of company dissolutions stood at 805,500 in 2005, 672,000 in 2006, 814,600 in 2007, 871,400 in 2008 and 774,700 in 2009, but Prof. Wang did not give the information sources; so this thesis did not used his figures. See further Xingxing Wang, 'Bankruptcy Tests and Enforcement' (2010) 1 *Tianjin Legal Science* (in Chinese) 16, 26.

dissolved annually in China.[10] This figure is consistent with a Beijing-based newspaper' estimate in 2009, which states that there are about 800,000 companies exiting the market each year in China.[11]

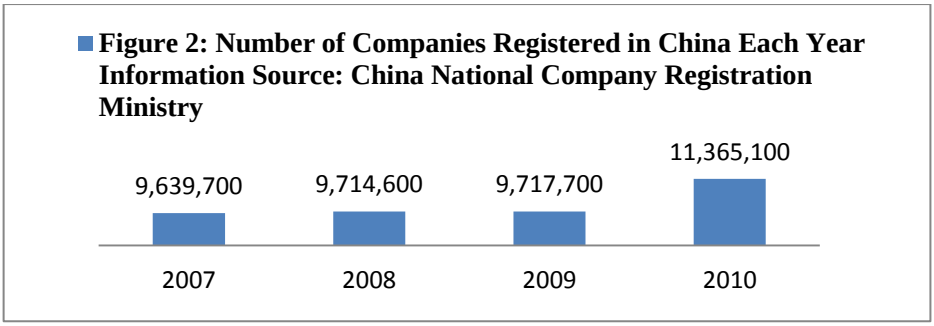
Thus, given the average number of company dissolutions as 820,233, the company bankruptcy rate would stand at 0.32 per cent (2,642 company bankruptcies out of 820,233 company dissolutions); put simply, there were 0.32 per cent of dissolved companies in China that entered into the bankruptcy procedures to solve outstanding debt and to exit the market.

Third, it is the company dissolution rate - the number of companies dissolved out of the number of those on the register at the beginning of each year. As shown in Figure 2, in China, the number of companies[12] registered was 9,639,700 in 2007, 9,714,600 in 2008, 9,717,700 in 2009 and 11,365,100 in 2010 respectively. On average, there were 10,109,275 companies on the register annually in this period. Given the annual figure of company dissolutions at 820,233, China's company dissolution rate was 8.11 per cent (820,233 company dissolutions out of 10,109,275 companies on the register); namely, during the given years, there were annually 8.11 per cent of companies that were closed down and exited the market for various reasons.

[10] It should be remembered that, although Li and Wang's figure was said to be from China's Supreme People's Court, it should still be read with caution, because it was not unusual for China's company registration offices to manipulate these figures in order to maintain the impression of prosperity. For example, fearful the embarrassing increase of company dissolutions on the paper, the company registration office in Yuyao County, Zhejiang Province, postponed in enforcing the company registration law to delist dormant companies with the view to presenting a superficially healthy record in 2009. See the Company Registration Office of Yuyao, 'The Analysis of Enterprise Registration of 2010' (Yuyao Zhejiang China, 8 July 2011, in Chinese)) <http://www.yyaic.gov.cn/art/2011/7/8/art_18458_866708.html > accessed 18 November 2011

[11] Biqiang Wang, 'China's Hidden Bankruptcy' *Economic Observer* (Beijing, China 5 June 2009) (estimating that in China there are approximately 800,000 companies dissolved each year) <http://www.eeo.com.cn/ens/finance_investment/2009/06/05/139307.shtml> accessed 25 October 2011.

[12] It should be noted that the official statistics used the term 'enterprise' rather than 'company' to survey the number of businesses. Given that the most enterprises in China appear in the form of 'company', this thesis regards enterprises as companies. Strictly speaking, there is still a difference; however, for the sake of simplicity, this thesis does not differentiate them; but such a difference should be kept in mind.



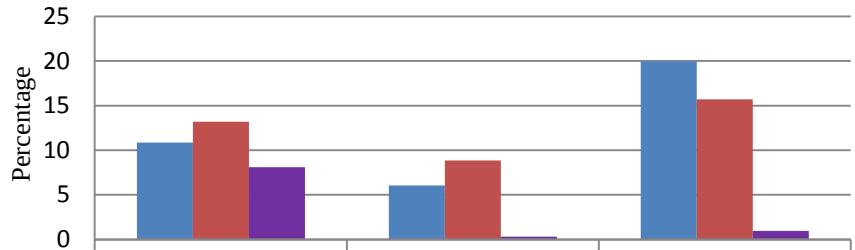
Finally, and more significantly, if a comparison is made of the above figures for China with their counterparts in England and Wales and the US, some striking contrasts will come into light, although it should be noted that such a comparison is useful but superficial, because many differences regarding culture and judicial systems have not been taken into account here.[13]

As has been calculated elsewhere,[14] in England and Wales, from 2007 to 2010, the annual company dissolution rate was 13.20 per cent, the annual company bankruptcy rate stood at 8.55 per cent, and the annual corporate reorganization rate was 15.70 per cent. It should be noted that, in England and Wales, the corporate reorganization procedure includes administration and the company voluntary arrangement (CVA) procedures.

In the US, due to the national census interval, the company dissolutions and bankruptcies in 2009 and 2010 had not been announced at the time of writing, so it has been necessary to turn back to the corresponding statistics from two years earlier (i.e., from 2005 to 2008). Over this period, the annual company dissolution rate of the US was 10.85 per cent, its annual company bankruptcy rate was 6.04 per cent, and the annual corporate reorganization rate stood at 19.98 per cent.[15]

[13] See generally Alan Watson, *Legal Transplants: An Approach to Comparative Law* (2nd edn, University of Georgia Press 1993).
[14] Tomasic and Zhang (n 1) 306.
[15] Ibid 304.

Figure 3: Comparison of Company Dissolution,Bankruptcy and Reorganization Rates in US, England and Wales and China



	Company Dissolution Rate (%)	Company Bankruptcy Rate (%)	Corporate Reorganization Rate (%)
USA	10.85	6.04	19.98
England and Wales	13.2	8.85	15.7
China	8.11	0.32	0.95

All figures of these three jurisdictions are shown in Figure 3. Evidently, there is an apparent similarity of the company dissolution rate between the US, England and Wales and China, which stood at 10.85 per cent, 13.2 per cent and 8.11 per cent respectively. Such a similarity suggests that the market forces in culling inefficient companies in these three countries functioned at similar levels regardless of the differences of judicial infrastructure. China's slightly lower company dissolution rate might be attributed to its relatively higher economic growth rate during that period.[16]

As for the company bankruptcy and reorganization rates, however, a real similarity only exists between the US and England and Wales, while China lagged far behind. In both the US and England and Wales, there were annually six to nine per cent of dissolved companies that used the bankruptcy procedures to solve issues of remaining debts; while in China less than one per cent of dissolved companies chose, or were allowed, to do so.

With regard to the company reorganization rates, in the US and England and Wales, between fifteen and twenty per cent of companies in the bankruptcy procedures chose the reorganization procedure to seek rehabilitation; whilst in China, again, less than one per cent

[16] See the World Bank, 'Data: GDP Growth (Annual %)' <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG> accessed 26 August 2013.

of these companies used the corporate rescue procedure with intention of seeking a rescue outcome.

If the US's figures could be used as the benchmarks, it means that there were 94.7 per cent of dissolved companies in China that should have used the formal bankruptcy procedures to settle defaulted debts but actually did not. By the same token, moreover, there would be up to 95.2 per cent of Chinese companies in bankruptcies that should have filed for reorganization to seek survival but again have not or could not.

If the comparison is made with England and Wales, the similar striking contrasts could be also concluded.

As noted, granted, these comparisons are somewhat superficial, as China's economy and social justice are still at the very lower levels of development.[17] But such contrasting figures do give a pointer to potential improvements that can be made in China. One conclusion is clear: China's corporate bankruptcy law and its bankruptcy reorganization regime were not adequately used as expected.

2.2. Few Signs of Momentum

Given that the corporate rescue law was a new thing in China, it would have taken some time for businesses and practitioners to become familiar with it. An examination was made to identify whether this new law was growingly used after 2007. For this purpose, all companies in rescue were separated into seven consecutive half years according to the date when they were formally accepted by court. The results are shown in Figure 4 below.

Most of the half years saw between ten and twenty companies in reorganization. The number of cases culminated at twenty-five in the half year between June and November of 2009, which might be associated to the then global financial crisis that also hit China hard.[18] After that, however, the number dropped again to eleven during the last half year between June and November of 2010.

[17] See generally Zhiwu Chen, 'Capital Markets and Legal Development: The China Case' (2003) 14 *China Economic Review* 451.

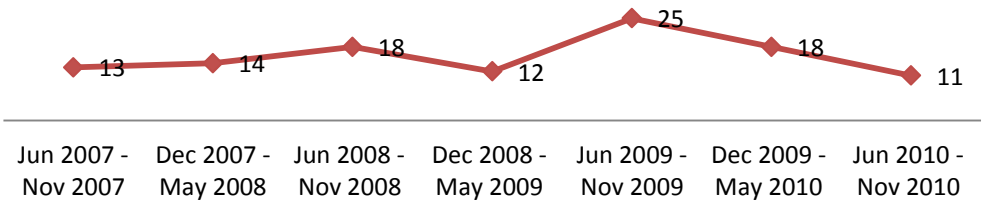
[18] See generally William H Overholt, 'China in the Global Financial Crisis: Rising Influence, Rising Challenges' (2010) 33 *The Washington Quarterly* 21.

So, apparently, there is not a noticeable trend showing that the rescue regime in China has been increasingly used since it was made available from 2007.

Figure 4: The Number of Companies Entering Corporate Reorganization Each Half Year in China

(June 2007 to November 2010)

Information Source: Zinian Zhang's Data Collection, the following figures are from the same source, unless stated elsewhere



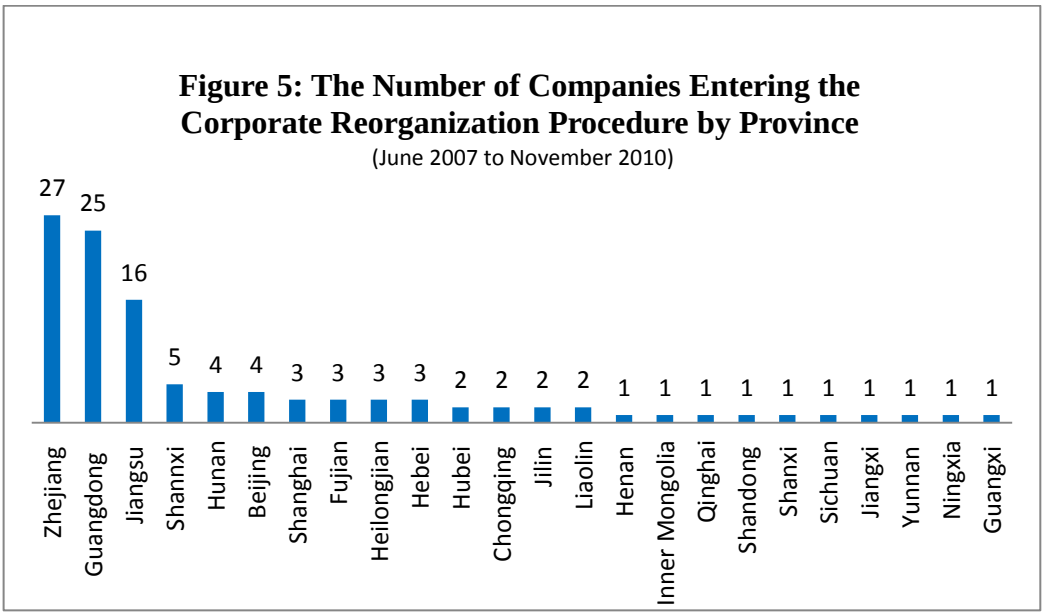
2.3. Regional Differences

Apart from the small number of corporate reorganizations in China as a whole, there was a significant asymmetry between different provinces regarding the use of the corporate rescue procedure.

In Figure 5, all companies in rescue between 2007 and 2010 are grouped according to the province where they entered the rescue procedure. It is clear that the majority of China's corporate reorganization cases took place in three provinces: Zhejiang, Guangdong and Jiangsu. In particular, these three provinces handled 61.26 per cent of these cases (sixty-eight out of 111). In the lead, Zhejiang province dealt with the rescue of 27 companies, almost a quarter of the national number.

Meanwhile, in contrast, there was no reported corporate reorganization case in seven Chinese provinces, although the rescue law had been in force for nearly four years. It is equally striking that although there were reported reorganizations in the remaining twenty four provinces, ten of them had only one company in rescue during the three-and-a-half years after the EBL 2006 came into effect.

Lastly, there were a very small number of companies in rescue in Shanghai and Beijing, though these two cities (at provincial level in both senses of economy and political status);[19] during this period, Shanghai had five companies in rescue, Beijing had only four.



2.4. Court Jurisdictions

With regard to court jurisdictions, it was found that intermediate people's courts dealt with 65.09 per cent of companies in rescue (sixty-nine out of 111), lower people's courts managed 33.96 per cent of them (thirty-six out of 111), and provincial people's supreme courts handled 0.9 per cent (there was, in fact, only one rescue case accepted by Qinghai's Supreme People's Court).

According to a judicial notice issued by China's Supreme People's Court in 2002,[20] as noted before, in principle, a corporate bankruptcy petition should be filed to a lower people's court if the debtor company is registered in a government company registration office at county level; if registered at above county level, the company's bankruptcy should be filed to an intermediate people's court. But a great deal of leeway was also given to local

[19] See generally Tianlun Jian, Jeffrey D Sachs and Andrew M Warner, 'Trends in Regional Inequality in China' (1996) 7 *China Economic Review* 1, 18.

[20] China's Supreme People's Court, 'Several Issues Concerning Enterprise Bankruptcy Cases' (Beijing China, 30 July 2002, in Chinese).

intermediate people's courts, as this notice stipulates that an intermediate court has the final say as to the acceptance of an individual bankruptcy case.[21] Therefore, at the end, it is the local intermediate court that has the discretion regarding whether a reorganization case should be handled by itself or handed down to a lower people's court.

Perhaps because of the mandate from this judicial notice, in some areas the local intermediate court requires that all corporate bankruptcy procedures should be dealt with by itself, i.e., local lower people's courts are deprived of the power to hear corporate bankruptcies. For example, in Guangdong province, Shenzhen's Intermediate People's Court decreed that all bankruptcy procedures in the region must be heard by the intermediate people's court in order to improve efficiency and professionalism.[22] This means that lower people's courts in the Shenzhen prefecture are not allowed to hear corporate bankruptcy, including corporate reorganization.

Exclusively making intermediate people's courts to handle corporate bankruptcies would be desirable: one the one hand, intermediate people's courts often have high-quality personnel; on the other hand, it may rather overcome the problems of local protectionism as well as a lack of judicial independence, both of which have been long undermining the judicial authority in China.[23]

2.5. Applicants

A corporate reorganization procedure could be filed by a debtor, a creditor, or a shareholder; more importantly, the debtor and its shareholders could request the court to change a creditor-filed liquidation into reorganization procedure.

As for the applicants of existing corporate reorganizations, there were eighty-two companies in rescue where such information was publicly available. As shown in Figure 6, fifty out of these eighty-two companies (60.98%) were brought into reorganization by

[21] Ibid Article 3.

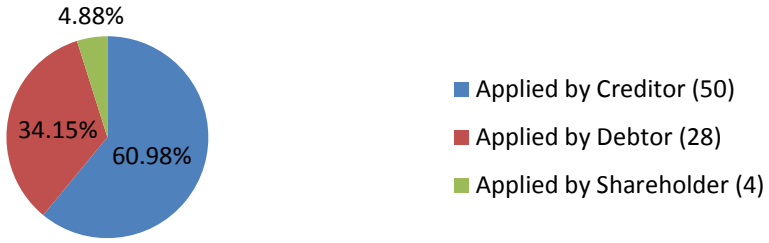
[22] See Shenzhen Intermediate People's Court, 'The White Paper of Corporate Bankruptcy Hearings in Shenzhen Intermediate Court' (Shenzhen Guangdong China, 20 December 2011, in Chinese) <http://www.szcourt.gov.cn/shenwu/view.aspx?id=4207 > accessed 22 September 2012.

[23] See generally at Terence Halliday, 'Policy Brief: The Making of China's Corporate Bankruptcy Law' (2007) *Oxford Series in Law, Justice and Society* 1, 7.

creditors, twenty-eight of them (34.15%) entered reorganization at the application of themselves, and four of them (4.88%) started the formal reorganization procedure at the request of shareholders. So, the majority of the rescues were filed by the creditors in China.

Figure 6: Applicants of Corporate Reorganizations in China

(June 2007 to November 2010)



2.6. Favouritism

Given that there was a strong government presence in existing corporate reorganizations in China, it is necessary to examine whether companies that had state connection had more chances to enter into the formal rescue procedure.

To this end, all debtor companies were classified into three categories: state-connected, private and foreign invested companies. The concepts of the last two categories are easy to understand. The concept 'state-connected' needs to be clarified here.

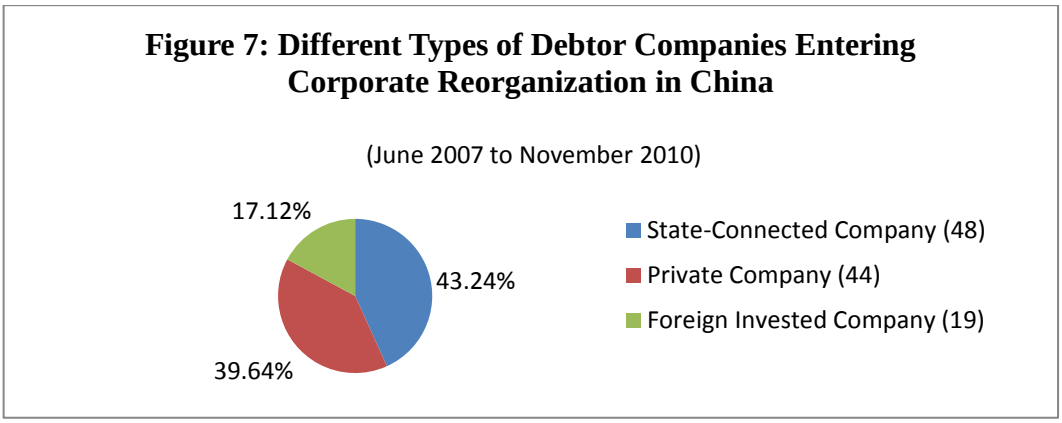
The state-connected companies included these companies that were state-owned, state-controlled, state-participated, and privatized, each of which will be explained as follows.

First, the concept 'state-owned' is common, since it is widely used and recognized as a company with all its equity owned by the state. Second, a state-controlled company is defined as a company that is jointly owned by the state and by private parties, but the state is the major shareholder and controls the company. Third, a state-participated company is a company that is jointly owned, but the state is not the major shareholder, instead it is private parties controlling the company. Lastly, a privatized company is the company which was state-owned before but has been privatized; however, a privatized company in China still has

a strong political connection with the state because of their complex previous relationships, although they are legally separated from the state.[24]

By these standards, as shown in Figure 7 below, forty-eight of these 111 companies (43.24 per cent) were state-connected; forty-one of them (39.64 per cent) were private, and the remaining seventeen companies (17.12 per cent) were foreign invested.

Figure 7: Different Types of Debtor Companies Entering Corporate Reorganization in China



To test whether there was an element of favouritism involved, a set of related figures in 2008 released by China's Company Register Ministry were used to detect the potential bias. According to the Ministry's statistics, in 2008, twenty-six per cent of China's companies (270,540,000 out of a total 971,460,000) were state-connected, sixty-eight per cent (675,420,000 out of a total 971,460,000) were private, and four per cent (43,490,000 out of a total 971,460,000) were foreign invested.[25]

In view of these two sets of figures, it can be found that twenty-six per cent state-connected companies had a forty-eight per cent chance of using the formal rescue procedure, whereas sixty-eight per cent private companies were only given a thirty-nine per cent chance. Apparently, state-connected companies had far more chances to access the formal corporate rescue procedure.

Interestingly, although there were only four per cent of companies in China that were foreign invested, they secured seventeen per cent of the formal bankruptcy rescue

[24] See generally at Hongbin Li and others, 'Political Connections, Financing and Firm Performance, Evidence from Chinese Private Firms' (2008) 87 *Journal of Development Economics* 283.

[25] The State Administration for Industry & Commerce of the P.R.China, 'Report of Business Development of 2008' (Beijing China, 20 March 2009, in Chinese) <www.saic.gov.cn> accessed 6 May 2013.

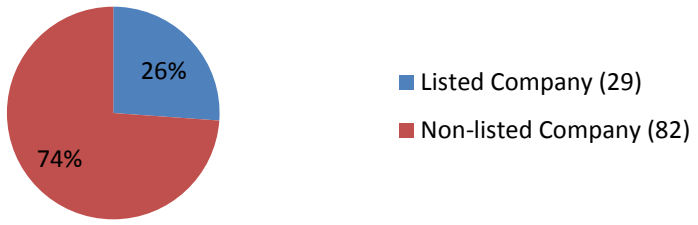
opportunities. A closer examination found that all these foreign companies were Taiwanese invested; these investors were probably more aware of the corporate rescue regime under China's new company bankruptcy law and managed to use this regime for rehabilitation.

Furthermore, apart from the favouritism towards state-connected companies, China's publicly-traded companies seemed to have been given a handsome share of the corporate rescue opportunities. These companies were listed on either the Shanghai or Shenzhen Stock Exchanges. Figure 8 below shows that twenty-nine out of a total 111 companies in rescue were publicly-traded, i.e., 26.13 per cent of the existing rescues were used to reorganize troubled listed companies in China.

As shown in Figure 5 before, many provinces had only one or two companies in rescue during the give period, and it was quite likely for these companies to be the listed ones. For instance, in Hubei Province, there were only two companies brought into reorganization: *Tianfa Oil Co. Ltd*. and *Tianyi Tech. Co. Ltd*., both of them were listed on the Shenzhen Stock Exchange.

Figure 8: Listed and Non-listed Companies in Reorganization in China

(June 2007 to November 2010)



To find out whether listed companies in China had been disproportionally favoured regarding the reorganization opportunity, the comparing statistics were searched and derived. In 2008, according to World Bank,[26] China had 1,604 listed companies (excluding companies listed overseas). Given that, in 2008, as noted before, there were 971,460,000 registered companies in China as a whole, which means that less than 1 per cent listed companies (1,604

[26] The World Bank, 'Listed Domestic Companies, Total, China' <http://data.worldbank.org/indicator/CM.MKT.LDOM.NO> accessed 6 June 2013.

out of 971,460,000) were given twenty-six per cent of the corporate reorganization opportunities. Thus, compared with state-connected companies, listed companies in China had far more chances to use the formal rescue procedure. And it should be noted that many listed companies were also state-connected.

But it should be noted that the above two comparison outcomes are still somewhat superficial, because both state-owned and listed companies were of far more economic significance than the rest of companies, and were large in size regarding annual turnover and employment, etc. In other words, the sheer numbers of them could not tell the whole story. However, at the very least, these contrasting figures suggest that companies which were not well-connected were rather disadvantaged before the opportunities in using the formal corporate reorganization procedure in China.

2.7. Rejections

Given the huge number of dissolved and bankrupt companies in China each year, as shown before, some troubled companies would have desperately sought a breathing space under the new corporate rescue law, but most courts might have turned their backs on these filings. To understand the entry of the new corporate rescue procedure in China, it would be desirable to know how many, or what proportion of, rescue filings were rejected by courts. This, however, was largely impractical, as, on the one hand, there were no relevant official statistics on rejections, and, on the other hand, unlike required to give a public notice when accepting a corporate reorganization filing, courts are not obliged to advertise a rejection; this meant that most objections probably quietly vanished without being publicly noticed.

Four high-profile rejected filings were collected (see Table 1 below), however. Although they do not represent all rejected rescue filings, some understandings in reflection of the difficulties in commencing a formal rescue procedure can still be established.

Table 1: Corporate Reorganization Petitions Rejected in China

(1 June 2007 to 30 November 2010)

	Company	Filing	Court	Rejection	Grounds
1	China Bicycle (深圳中华)	14 Jan 2010	Shenzhen Intermediate Court	28 Dec 2010	A Lack of the Consent of the Revenue Authorities
2	China Kejian (科健股份)	15 Jan 2010	Shenzhen Intermediate Court	20 Sep 2010	A Lack of Sufficient Supporting Documents
3	Hongshen Technology (上海宏盛)	04 Feb 2010	The 2nd Intermediate Court, Shanghai	06 Nov 2010	No Explanation
4	East Star Airlines (东星航空)	08 Apr 2009	Wuhan Intermediate Court	12 Jun 2009	No Explicit Local Government Support and others

The first rejected filing was the attempt to reorganize the company, *China Bicycle Co. Ltd*., which was located in Shenzhen, Guangdong province. The reorganization petition was filed by a creditor that was also the company's largest shareholder to the Shenzhen Intermediate People's Court on 14 January 2010. Under the EBL 2006,[27] the court was required to either accept or reject the filing within fifteen days of receiving the filing. It, however, took almost one year for the court to formally respond to the application; the filing was rejected on 28 December 2010. More surprisingly, to reject the filing, the court explained that it was because that the applicant had not obtained the agreement of the local revenue authorities regarding how to solve the company's outstanding taxes.[28] Such a requirement seemed to have gone beyond either the spirit or the letter of Article 8 of the EBL 2006.

The second rejected filing was to reorganize *China Kejian Co. Ltd*. The company was filed for reorganization by a creditor to the same Shenzhen Intermediate People's Court on 15 January 2010. This time, the court took about eight months to assess the application. On 20 September 2010, the applicant was informed that its filing had been deemed to be withdrawn because of a lack of supporting materials. The court, however, did not specify what these

[27] Article 10 of the EBL 2006.

[28] Pen Wang, '*China Bicycle* Rescue Filing Denied' *Dazhong Stock News* (Nanjing Jiangsu China, 31 October 2011, in Chinese) <http://finance.sina.com.cn/stock/s/20111031/102710723632.shtml> accessed 27 August 2013.

materials were[29] More contentiously, since the reorganization filing was deemed to be withdrawn, it meant that the applicant was also deprived of the opportunity to appeal.

The third rejection happened in Shanghai. On 4 February 2010, *Shanghai Hongshen Technology Co. Ltd*. was filed for reorganization by its creditor to the Shanghai First Intermediate People's Court. Over nine months later, on 6 November 2010, the applicant was told that the filing had been rejected, but no explanations were given.[30] At that time, it was rumoured that the court rejected the rescue filing because the major shareholders of the company could not enter into an agreement on some key restructuring issues.[31] One year later, however, on 27 October 2011, *Hongshen* entered into the formal corporate rescue procedure before Xi'an Intermediate People's Court, Shaanxi Province, after it had relocated its registered office from Shanghai to Shaanxi;[32] perhaps it was the first forum shopping case in China's corporate bankruptcy law history.

The fourth case took place in Wuhan, the capital city of Hubei Province in 2009. *East-Star Airlines Co. Ltd. Hubei,* a private airlines company, was filed for reorganization by its creditor before the Wuhan Intermediate People's Court on 8 April 2009. Over two months later, on 12 June 2009, the court rejected the filing[33] on the grounds that the reorganization proposal prepared by the applicant was not feasible and that the applicant had not shown evidence that the local Wuhan Municipal Government would back the company's reorganization.[34]

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[29] Hongjun Liu, '*Kejian* Rescue Filing Withdrawn' *China Stock News* (Beijing China, 21 September 2010, in Chinese) <http://tech.163.com/10/0921/05/6H365U50000915BE.html> accessed 27 August 2013.

[30] Rui Xu, 'The Court did not Accept the Rescue Filing of *Hongshen*' *Shanghai Stock News* (Shanghai China, 6 November 2010, in Chinese) <http://finance.ifeng.com/stock/ssgs/20101106/2836857.shtml> accessed 27 August 2013.

[31] Jieyun Pen, 'The Court Hasn't Accepted the *Hongshen* Rescue Filing' *First Finance Daily* (Shanghai China, 19 August 2010, in Chinese) <http://www.yicai.com/news/2010/08/393653.html> accessed 27 August 2013.

[32] Xiaoqing Ran, '*Hongshen* Rescue Filing Accepted, but Many Uncertainties Ahead' *Shanghai Stock Daily* (Shanghai China, 29 October 2011, in Chinese) <http://news.xinhuanet.com/fortune/2011-10/29/c_122211993.htm> accessed 27 August 2013.

[33] Tao Li, '*China Aviation Oil* Insists on Rescuing *East-Star Airlines* and Its Three Affiliates Submitted the Application' *China Trade and Industry Daily* (Beijing China, 10 July 2009, in Chinese) <http://www.china.com.cn/economic/txt/2009-07/10/content_18108739.htm> accessed 26 September 2012.

[34] Qianshan Xu and Xingying Wu, '*East Star Airlines* Rescue Attempts Terminated, Questions Remained of its Quick Failure' *Yangtze Daily* (Wuhan Hubei China, 27 August 2009, in Chinese) <http://www.cannews.com.cn/2009/0827/9569.html> accessed 24 November 2012.

These four rejected rescue filings were collected by this thesis mainly because they gained heavy press coverage. The first three companies were publicly-traded and the last one was an airlines company. In other words, these companies' rescue filings mattered public interest, so they attracted much press attention. Conversely, the rejected reorganization filings of other low-profile companies might be just conveniently neglected.

Although these four reorganization attempts were rejected for various reasons, they shared one common feature: all these courts did not meet the statutory deadline to respond to the rescue filings, namely, there was a breach of Article 10 of the EBL 2006 that requires that the court must make the decision within fifteen days of receiving the filing. This lack of timekeeping by the courts also reflects a serious problem on the accountability of the judiciary in China.

Apart from the above individual rejected filings, in fact, some courts have formalized the entry restrictions of the reorganization procedure. For example, in 2011, the Shenzhen Intermediate People's Court, one of the Chinese experimental courts in handling corporate bankruptcy, released a report which stated that 'a filing of corporate bankruptcy (including corporate reorganization) must be assessed considerably carefully and cannot be accepted unless the court believes that both procedural and substantive requirements enshrined in the EBL 2006 have been thoroughly fulfilled'.[35] Its tone of this report was clear: acceptance of corporate reorganization filings must be restricted.

Similarly, in the Hangzhou Intermediate People's Court, Zhejiang Province, another pioneer court in China, one of its reports on bankruptcy (2010) stated that when there is corporate reorganization filing, the applicant will be persuaded by the court not to formally file for reorganization; instead, at the time, the interested parties including major creditors, the debtor, and, more essentially, the potential company buyer, will be summoned by the court to assess the feasibility of the reorganization proposal. If the proposal can be, in principle, agreed by the main parties, the court will allow the formal reorganization procedure to start so as to facilitate the agreed rescue package; otherwise, the court will persuade the

[35] The Shenzhen Intermediate People's Court (n 22).

applicant to drop the filing.[36] In some ways, this is like a pre-packaged reorganization,[37] although the court involves in the pre-filing negotiations.

In sum, the acceptance of corporate reorganization filings were restrictively interpreted by courts in China, thus, making the court accept a corporate rescue filing is considerably difficult.

2.8. A High Success Rate

Perhaps because of excessive entry restrictions of the corporate rescue procedure, the rescue success rate was very high in the existing corporate reorganizations. Here the success of a corporate reorganization case is defined as whether its reorganization plan is confirmed and executed as expected. It was found that there were 103 out of all 111 companies in rescue (92.79%) that survived the rescue processes.[38] Accordingly, there were only eight of these companies (7.21%) which were converted into liquidation. More precisely, within these eight companies, four had no reorganization plan proposed or had the plan voted down by creditors, and the remaining four companies ended in liquidation because their confirmed reorganization plans failed in execution.

2.9. Late Rescue

Generally, most of the reorganizations seemed to have been filed too late. Out of eighty-seven companies in rescue where their information was publicly available, fifty-seven of them (65.52%) ceased trading prior to entering the corporate reorganization procedure.[39] For example, when *Xiamen Xinxin Artefacts Co. Ltd. Fujian* entered the corporate reorganization procedure on 27 February 2009, its business operation had stopped months before on 25 October 2008, and its major shareholder, who was also the chief executive officer, Huang

[36] The Hangzhou Intermediate People's Court, 'The Self-Assessment of Dealing with Corporate Reorganization Cases' (Hangzhou Zhejiang China, 5 January 2010, in Chinese) <www.hzcourt.cn> accessed 26 September 2011.

[37] See generally at Lijie Qi, 'The Rise of Pre-packaged Corporate Rescue on both Sides of the Atlantic' (2007) 20 *Insolvency Intelligence* 129.

[38] See Appendix 1.

[39] See Appendix 4.

Zhongguo, had long been missing. It was the local government that stepped in and handled the company's crisis because of the social unrest concerns over its about 2,000 unpaid and disgruntled workers.[40]

In short, between June 2007 and November 2010, there were not too many corporate reorganizations handled by Chinese courts, and more notably, many of the existing corporate reorganization procedures were used to rehabilitate state-connected and listed companies in China. If a rescue filing was accepted by the court, however, it was high likely for the reorganization plan to be confirmed. And it is noteworthy that most of the existing corporate rescues were filed very late, therefore, much could be done to incentivize relevant parties to take early rescue actions.

3. CONTROL IN RESCUE

Despite the difficulties encountered by troubled companies to enter the corporate reorganization procedure, some companies were still offered a breathing space under the new corporate rescue law. This Part moves to reporting the findings on control in the existing corporate rescues in China.

Under Article 13 of the EBL 2006, whatever the corporate reorganization or liquidation procedure, the court will appoint an administrator to take control of the company at the time when the bankruptcy filing is accepted. But, given that the corporate reorganization procedure aims to continue a company's business, the debtor is allowed to apply to regain control from the administrator. So, this Part reports, first, the findings on administrator appointments and, second, those on the use of the debtor-in-possession model in rescues.

3.1. Administrator Appointments

All administrators in the existing rescues were directly appointed by the courts. As noted before, the power of appointing the administrator is exclusively vested in the hands of courts.

[40] Qirong Kang and Huicong Chen, '*Xinxin Artefacts* is Bankrupt, and its CEO has Absconded' *Haixia Urban News* (Fuzhou Fujian China, 7 January 2009, in Chinese) <http://news.letfind.com.cn/news/2009-1/43821.html> accessed 28 August 2013.

But under Article 22 of the EBL 2006, a meeting of creditors is allowed to challenge the appointment and to request a replacement. In practice, however, such replacement has not been found. But, there are three relevant cases worth mentioning.

The first case was the reorganization of *Xiamen Xinxin Artefacts Co. Ltd. Fujian* in 2009. The previously appointed administrator, a local law firm, was replaced by another law firm; however the replacement was made by the court on its own motion rather than at the request of the meeting of creditors. There was no publicly available information regarding why the court made the replacement.[41]

The second case was the reorganization of *Taizinai Milk Co. Ltd*. *Hunan* in 2010. One of the company's shareholders nominated a Beijing-based law firm as the administrator,[42] but this nomination was simply ignored, probably because the court thought that it had no duty to consider the shareholders' nomination.[43]

The third case was the reorganization of *Haiji Chemical Co. Ltd. Inner Mongolia* in 2009. When the creditors' meeting was held, some angry creditors asked the court to sack the administrator, accusing that the administrator had not discharge its duties adequately in investigating the company's assets, but the creditors' intent was not considered by the court.[44] The failure of this challenge was likely to be caused by two factors. First, the EBL 2006[45] states that the administrator's appointment can only be formally challenged by a meeting of creditors rather than by individual creditors; put differently, there should be a special resolution passed by the creditors' meeting. But the central concern here is that the EBL 2006 is silent on the specific routes whereby individual creditors could use to raise a motion in the creditors' meeting. Without clarification, creditors' voices cannot be adequately heard and counted. Second, in the *Haiji* case, the creditors only met once; the first meeting of creditors

[41] Jingxun Zhen, Haitao An and Jizhou Chen, 'The Corporate Reorganization: A Judicial Effort to Bring the Distressed Firms back on the Rails' *People's Court Daily* (Beijing China, 25 December 2009, in Chinese) <http://oldfyb2009.chinacourt.org/public/detail.php?id=134675> accessed on 27 September 2012.

[42] A recent case study regarding *Taizinai Milk Co. Ltd.* reorganization can been seen at Andrew Godwin, 'Corporate Rescue in Asia – Trends and Challenges' (2012) 34 *Sydney Law Review* 163, 179-186.

[43] Sufan Guo, 'The Doubt of *Taizinai* Reorganization: Questions to the Eligibility of Reorganization Proposal Presented by *Gaoke*' *Legal Daily Weekly* (Beijing China, 6 August 2010, in Chinese) <http://www.legaldaily.com.cn/index/content/2010-08/05/content_2226051.htm> accessed 27 September 2012.

[44] Hua Liu, '*Haiji Chemical Products Co. Ltd.* is being Dismantled by 112 Creditors and Almost RMB 10 Billion Investment of Mingtian is Hindered' *21st Century Economic News* (Beijing China, 14 April 2009, in Chinese) <http://finance.ifeng.com/news/industry/20090414/537494.shtml> accessed 27 September 2012.

[45] Article 22 of the EBL 2006.

was also the last. It seemed too late for creditors to challenge the administrator's appointment. Frustrated by reaction of both the court and the administrator, most of the creditors in the *Haiji* case voted against the administrator's proposed reorganization plan, but days later the court imposed a cram-down confirming the plan.[46]

Except these three cases, there were no other publicly reported cases wherein the administrator's appointment was affected or challenged. Therefore, it is safe to say that the administrators' appointments in China's corporate rescues were completely in the hands of the courts.

It should be noted that, unlike administrators in the UK corporate administration procedures who are exclusively selected from qualified insolvency practitioners (IPs), bankruptcy administrators in China include qualified insolvency practitioners and local government organized liquidation committees. These committees are interim working panels formed by local government agencies. Usually, most of them are local revenue, labour and pension, police, land, company registration and bank regulating authorities. Most of these committees are chaired by local senior politicians, for example a deputy mayor.[47]

Moreover, China's bankruptcy administrators are not individuals but entities, such as law firms, accounting firms, or the aforementioned committees. This would be second key difference from the UK administrators.

As for administrator appointments from these different groups, eighty-three companies in rescue where their information was publicly available were examined. As shown in Figure 9, local government organized liquidation committees were appointed in thirty-nine out of these eighty-three reorganizations (46.99%); law firms were appointed in twenty-six of them (31.33%); accounting firms in thirteen (15.66%) and professional liquidating firms in two cases (2.41%); the remaining three reorganizations (3.61%) had law and accounting firms jointly appointed.

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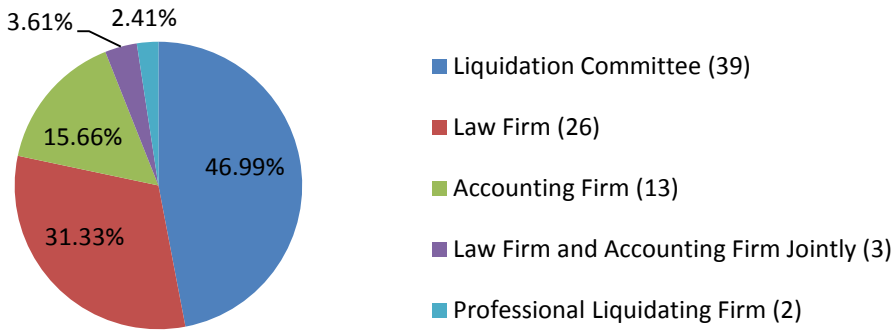
[46] Liu (n 44).

[47] The Administrator of *Beisheng Pharmaceutical Co. Ltd,* 'The Public Notice Concerning Being Filed of Corporate Reorganization' (in this case, the deputy mayor of Beihai City chaired the liquidation committee in *Beisheng* reorganization procedure) <http://app.finance.ifeng.com/data/stock/ggzw.php?id=13456333&symbol=600556> accessed 29 August 2013.

Figure 9: Corporate Reorganization Administrators' Appointments in China

(1 June 2007 to 30 November 2010)



As shown in Figure 9, almost half of the corporate reorganizations used local government organized liquidation committees as administrators to manage the companies in rescue.[48]

On closer examination, it was found that the administrator appointments from local government organized liquidation committees were mainly used in listed company reorganizations. In particular, such an appointment took place in twenty-six out of a total of twenty-nine listed company rescues (89.66%). [49]

Interestingly, if leaving the listed company reorganizations aside, a largely different pattern of administrator appointments emerged. As shown in Figure 10 below, in fifty-four non-listed company reorganizations, local-government-organized liquidation committees were appointed in thirteen reorganizations (24.07%), law firms were appointed in twenty-four reorganizations (44.44%), accounting firms in thirteen (24.07%), professional liquidating firms in one (1.85%), and law and accounting firms were jointly appointed in three cases (5.56%). Law firms took a big share in these appointments.

[48] See Appendix 6.

[49] Liliang Liu, 'Over Thirty Listed Companies Entered Corporate Reorganization Proceedings after the New Enterprise Bankruptcy Law 2006' *Stock Daily* (Beijing China, 6 July 2011, in Chinese) (mentioning that the Supreme Court encouraged courts to appoint liquidation committees as administrators in listed company reorganizations) <http://stock.hexun.com/2011-07-06/131183524.html> accessed 4 October 2012.

Figure 10: Administator Appointments in Non-Listed Company Reorganizations in China
(June 2007 to November 2010)

Although many Chinese corporate reorganizations had administrators appointed from the local government organized liquidation committees, the composition of these committees has rather evolved. Before the EBL 2006, old local government organized liquidation committees were entirely comprised of government officials without the involvement of professionals, such as lawyers;[50] however, the new liquidation committees under the EBL 2006 were to a certain extent different.

Clearly, professionals were more involved in these liquidation committees after the EBL 2006. As noted, there were thirty-nine reorganizations that used the liquidation committee as the administrator; in at least twenty-five of these cases (64.10%), it was found that professionals, especially lawyers, were included in the committee as individual members. In the remaining fourteen cases, notwithstanding that there was no concrete evidence that professionals were officially admitted as committee members, it was often noticed that professionals were hired by these committees as advisors. For instance, in the reorganization of *Jingxing Trust Co. Ltd.* in Zhejiang in 2010, a Beijing-based law firm was contracted by the liquidation committee to advise the process although the lawyers were not officially

[50] See Charles D Booth, 'The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over' (2008) 20 *Singapore Academy of Law Journal* 275, 293-4 (noting that professionals were rarely included in enterprise bankruptcy liquidation committees under the EBL 1986 in China).

included as the committee members.[51] Thus, there was more professionals' involvement in local-government-organized liquidation committees.

Overall, with regard to administrator appointments, this power was completely in the hands of the courts in China, and it has never been effectively challenged by creditors. In the meantime, in listed company reorganizations, China's courts tended to appoint local-government-organized liquidation committees as administrators, whilst in the reorganization of non-listed companies, lawyers had a better chance of appointment.

After an administrator was appointed, as noted, with the leave of the court, the control of the company might be returned to the debtor; in such circumstances, the administrator would retreat and act as a monitor overseeing the debtor-in-possession.

3.2. The Debtor-in-Possession Model

As for the debtor-in-possession, fifty reorganizations were examined, because their information on this was publicly available. It was found that[52] that debtors regained control in thirteen reorganizations (26%), and administrators accordingly continued to control in the remaining thirty-seven reorganizations (74%). Therefore, in most of the rescues, it was the administrator-in-possession rather than the debtor-in-possession model which was used.[53]

Whoever the administrator or the debtor was in control, at the heart of control would be the right to propose a reorganization plan for a vote. This will be reported in the following section.

3.3. Plan Drafters

Under Article 80 of the EBL 2006, a reorganization plan can be proposed by an administrator; but this right will be transferred to the debtor in the event of the debtor-in-

[51] Zhendong Liu, 'Renamed as *Zheshang Jinghui, Jinghua Trust* Survived the Crisis' *Economic Information* (Beijing China, 29 July 2011, in Chinese) <http://news.chinabyte.com/309/12128809.shtml> accessed on 12 Jan 2012.

[52] See Appendix 6.

[53] See generally Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113, 130.

possession; other parties, including creditors and shareholders, are not expressly given the right to do so under the EBL 2006.[54]

As to which parties proposed reorganization plans, there were seventy reorganizations studied.[55] It was found that the reorganization plan was proposed by the administrator in fifty cases (74.29%), which was consistent with the dominance of the administrator-in-possession as noted before; the reorganization plan was proposed by the debtor in twelve reorganizations (17.14%); the administrator and the debtor jointly proposed the reorganization plan in five cases (7.14%), and there was one reorganization case (1.43%) where the reorganization plan was actually proposed by the creditors' committee and the company buyer.

Apparently, administrators played a greater role in proposing reorganization plans. In all cases of the administrator-in-possession, undoubtedly, it was the administrator who prepared the reorganization plan.

In thirteen cases of the debtor-in-possession, however, pursuant to Article 80 of the EBL 2006, the reorganization plan should have been proposed by the debtor. But, within these thirteen cases were two cases where the plan was instead prepared by the administrator, and in another two cases, the reorganization plan was jointly proposed by the administrator and the debtor.[56] It seemed to be deviation from what the debtor-in-possession was intended to do under the EBL 2006.

A reorganization plan might be proposed in the name of an administrator, a debtor, or jointly. The main terms of a reorganization plan, however, would be the results of intense negotiations between the company buyer and other interested parties, because the current corporate reorganization regime in China relied too heavily on the outside buyers to turn troubled companies around.

As to whether a company buyer was successfully solicited in the existing corporate reorganizations, seventy-three reorganizations were examined: sixty-one reorganizations (83.56%) were concluded as going concern sales.

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[54] Article 80 of the EBL 2006.

[55] See Appendix 6.

[56] Rongbin Lou and Ying Chen, 'Face the Facts and Comply with the Law – the Experience in Handling the Reorganization of *Tianting Paper Co. Ltd*.' *China Accountant Daily* (Beijing China, 9 July 2010, in Chinese) 11.

3.4. Efficiency

To examine efficiency of the existing corporate rescues in China, seventy-eight reorganizations whose relevant information was publicly available were studied.[57] On average, it took 198.77 days, i.e., about six-and-a-half months, to complete a corporate reorganization procedure in China.

It is worth noting that the time of a rescue procedure was calculated from the date when the rescue filing was accepted by court to the date on which the reorganization plan was confirmed; the time taken by the court to assess the rescue application prior to accepting the filing and by the debtor to execute the confirmed reorganization plan were excluded.

Furthermore, it was found that the reorganization procedure of listed companies seemed to be conducted more efficiently than that of non-listed companies did. Specifically, if there two groups of companies were separated, it was found that it on average took 120.76 days to complete a listed company reorganization case; whilst, on average, 244.94 days were taken to complete a non-listed company reorganization case. Listed companies spent less than half time non-listed companies did.

The shortest corporate reorganization procedure was found in Sichuan Province where an automotive supplier, *Zhonghen Special Steel Co. Ltd.*, spent only 31 days to go through the rescue process.[58] The longest one occurred in Zhejiang, where it took 536 days for the reorganization of *Huatai Oil Co. Ltd.* to be concluded by the court.

The next Part moves to reporting the findings of value creation and distribution in China's corporate rescues.

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[57] See Appendix 8.

[58] Youbing Lan and Yuansong Chen, 'The Success of the First Corporate Reorganization in the Province' *Mianyang Evening News* (Mianyang Sichuan China, 11 January 2010, in Chinese) A2.

4. VALUE DISTRIBUTION

The corporate reorganization regime would be built on sand if it could not preserve going-concern value. Preserving going-concern value is mainly tested by examining whether rescue procedures have increased creditor recovery rates. So, this Part starts with reporting the value preservation of the corporate rescue regime in China, and then it turns to reporting on value distribution in rescues.

4.1. Preservation of Going-Concern Value

As described in chapter 4, this thesis examined whether corporate reorganization preserved going-concern value by looking at whether creditor recovery rates were increased. Under Article 82 of the EBL 2006, creditors are divided into three classes: secured, preferential (tax and wage) and unsecured creditors. As to recoveries to secured[59] and preferential creditors, it was found that in all existing corporate reorganizations these two classes were paid in full. In other words, the securities were fully honoured, and employees and revenue authorities were well protected, mainly because they ranked above unsecured creditors in the payment hierarchy. So, examining creditor recovery rates only focused on unsecured creditors.

As far as the average unsecured creditor recovery rate is concerned, sixty-nine reorganizations were investigated as their relevant information was publicly available. It was calculated that the average recovery rate for unsecured creditors amounted to 33.67 per cent of their original claims.

The full payment to unsecured creditors was found in several cases, although it was often made in instalments. The lowest payment took place in the reorganization of *Dixian Textile Co. Ltd. Hebei* in which the unsecured creditors were paid at two cents of the dollar.

[59] The major secured creditors in China are banks. Under the banking regulations, bank loans are usually over-secured. For example, it is required by *China Industry and Commerce Bank Group* (ICBC) that the amount of a loan cannot exceed seventy per cent of the value of mortgaged assets. See *the China Industry and Commerce Bank Group*, 'The Rules on Mortgage Loans' (Beijing China, 24 September 1987, in Chinese) <http://www.law-lib.com/law/law_view.asp?id=4560> accessed 28 September 2012.

Zero per cent payment to unsecured creditors did not happen in China's corporate reorganizations.

The 33.67 per cent average unsecured creditor recovery rate in China's corporate reorganizations would be better understood if compared with its counterpart in corporate liquidations.

Until now, there have not been empirical studies calculating the average recovery rate to unsecured creditors in China's corporate liquidations under the EBL 2006. An alternative figure had to be used to fill the gap. One early study indicates that it was not unusual for unsecured creditors to recover nothing in China's corporate liquidation procedures before the EBL 2006, and the average recovery rate for them was always below ten per cent.[60] Therefore, tentatively, if unsecured creditors as a whole could only recover less than ten per cent of their claims in liquidations, China's new corporate reorganization did show its strength in preserving going-concern value, since the recovery rate to unsecured creditors has been increased to 33.67 per cent in reorganizations. It would be a significant achievement.

The above comparisons may only offer a glimpse of the strength of the new corporate rescue regime in preserving going-concern value. But, such comparisons are far from perfection, since a comprehensive, scientific comparison should take into account a wide range of variables of these companies in both liquidation and reorganization procedures, such as the debt/equity ratios, the industry differences etc. Obviously, this is beyond what this thesis could reach.

4.2. The *Pari Passu* Principle

In theory, the *pari passu* principle is not compulsory in China's corporate reorganization procedures. But, given that this principle reflects fundamental equity in distributing value in bankruptcy, it is still regarded as a basic rule to follow in practice.

As noted, in nearly all recues, secured and preferential creditors were paid in full; therefore, the *pari passu* principle only mattered to unsecured creditors.

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[60] Zhang and Booth (n 21) 10.

Regarding application of the *pari passu* principle, sixty-nine corporate reorganization cases where the relevant information was publicly available were examined. It was found[61] that this principle was applied in fifty-one reorganizations (73.91%); accordingly, its departure was found in eighteen cases (26.09%).

Deviating from the *pari passu* principle took place more frequently in reorganization of listed companies. In particular, it happened in twelve out of all twenty-eight listed company reorganizations (42.86%); by contrast, it was only seen in out of all forty-one non-listed company reorganization cases (14.62%). Thus, it was far more likely for this principle to be relaxed in listed company reorganization cases than in non-listed company ones.

The deviation from the *pari passu* principle was used mainly in two forms. The first was to pay small unsecured creditors at a higher recovery rate in exchange for their votes to pass the reorganization plan, because the number of creditors mattered to the plan's passage. As reviewed in chapter 3, a reorganization plan should be accepted by over half in number and over two-thirds in claims of each class of impaired parties. To solicit votes of small creditors, it was common in these cases to design a complex unsecured creditors' repayment scheme whereby smaller creditors were paid at a higher rate or sometimes paid in full.

For example, in the reorganization of *Jiufa Food Co. Ltd. Shandong*, according to its reorganization plan, each unsecured creditor was fully paid on the amount below ¥100,000, and was paid at 20.48 per cent on the amount above ¥100,000.[62] Clearly, a small unsecured creditor would be paid at 100 per cent if his claim was less than ¥100,000; however, to a large unsecured creditor, say, with a debt of ¥ 100,000,000, the full payment on the amount below ¥100,000 was indeed negligible. Thus, the small creditors were the main beneficiaries under such a payment scheme; in turn, they might have no reason to reject the reorganization plan.[63]

The second form of deviation was to pay unsecured creditors who were natural persons at a higher recovery rate in order to maintain social stability in China. Unlike large, corporate

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[61] See Appendix 3.

[62] *Jiufa Food Co. Ltd. Shandong*, 'The Public Notice of Crucial Business' (Shandong China, 15 December 2008, in Chinese) (publicising its reorganization plan and the court's approval).

[63] The reorganization plan should be voted for by over half of creditors in number and over two-thirds of creditors in claims. See Article 84 of the EBL 2006.

creditors, creditors who were natural persons tended to collectively petition before the government if they felt unfairly treated, and this gave rise to concerns of social stability. In response, these individuals were more likely to be paid at a far higher recovery rate so as to avoid mass petitions.

For example, in the reorganization of *Qingtai Trust Co. Ltd. Qinghai* in 2008, all unsecured creditors who were natural persons were paid in full, while other unsecured creditors were paid at ten per cent.[64] In the reorganization of *Zhonggu Sugar Co. Ltd. Guangdong*, the sugar cane farmer creditors were paid at 100 per cent and other creditors were paid at 28.3 per cent only.[65]

In fact, the first form was used more frequently that the second.

The *pari passu* principle deals with payment within the same class of creditors, while the absolute priority principle governs value distribution between creditor and shareholder. As to value distribution in corporate rescues, it is the absolute priority principle rather than the *pari passu* principle that is a source of contention for decades. The following section reports the application of the absolute priority principle in Chinese corporate rescues.

4.3. The Absolute Priority Principle

As to the absolute priority principle, there were sixty-two corporate reorganizations with their relevant information publicly available. It was found[66] that the deviation from this principle occurred in thirty-three out of these sixty-two reorganizations (53.23%).

Most of these deviations took place in listed company reorganizations; in particular, twenty-seven out of all thirty-three deviations happened in the reorganization of listed companies. In fact, the departure from absolute priority in the norm rather than the exception in listed company reorganization. This was because China's Supreme People's Court required

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[64] Ming Sun, 'The Revival of *Qingtai Trust Co. Ltd.*' *21st Century Economic News* (Beijing China, 2 August 2008, in Chinese) <http://www.21cbh.com/HTML/2008-8-1/HTML_AGJWJHDX40FB.html> accessed 30 September 2012.

[65] Fei Feng and others, 'The Reorganization of *Zhonggu Sugar* Has Brought to an End' *Zhanjiang Evening News* (Zhanjiang Guangdong China, 16 September 2010, in Chinese) <http://www.chinainsol.org/show.aspx?id=2053&cid=13> accessed on 1 July 2010.

[66] See Appendix 7.

that shareholders of listed companies should be protected in reorganization regardless of whether the company is insolvent.[67] This is quite contentious.

Compared with listed company rescues, the deviation happened far less frequently in non-listed company reorganizations. In all these sixty-two studied company reorganizations, there were thirty-four non-listed company reorganizations, and the deviation was only found in five of these company reorganizations, i.e., the deviation was used only in 14.71 per cent of non-listed company reorganizations. So, a striking contrast as to applying the absolute priority principle could be found between listed and non-listed company reorganization cases in China.

In most these deviations, it appeared to be a transfer of value from unsecured creditors to shareholders. Secured and preferential creditors were generally not adversely affected, because, as noted before, they were always paid in full.

In listed company reorganizations, the deviation was undertaken mainly in two ways. The first was that all old equity remained intact; accordingly, the reorganization was conducted entirely at the expense of unsecured creditors. For instance, in the reorganization of *Haina Tech Co. Ltd. Zhejiang* in 2007, the unsecured creditors were paid 25.35 per cent of their pre-bankruptcy claims, whereas all equity of the shareholders remained unaffected according to the reorganization plan.[68]

The second, perhaps the most common, was that shareholders joined unsecured creditors to bear the costs of reorganization. In such situation, shareholders were required to give up part of their equity, and the administrator would sell the equity so as to increase recoveries for unsecured creditors. For instance, in the reorganization of *Changling Group Co. Ltd. Shaanxi* in 2008, the general public shareholders were asked to contribute ten per cent of their shares to the administrator who sold them in order to increase the payment rate to unsecured

[67] Xiaoming Song, 'The Court's Role in the Proceedings of Enterprise Bankruptcy and Restructuring and the Problems That Need to be Solved' (The Forum for Asian Insolvency Reform, Beijing China, April 2006) <http://www.oecd.org/china/38184314.pdf> accessed 02 October 2012.

[68] The Administrator of *Haina Tech Co. Ltd*, 'The Reorganization Plan of *Haina Tech Co. Ltd. Zhejiang'* (Hangzhou Zhejiang China, 24 October 2007, in Chinese).

creditors. As a result, the unsecured creditors' recovery rate was increased to eighteen per cent; otherwise, they would have recouped nothing.[69]

It seemed to be quite anomalous that the shares of a listed company in the bankruptcy procedure were still valuable in China. This was mainly because the company's license to be listed at China's stock exchanges, which is strictly controlled by the central government, is high in value. A listed company may be bankrupt, but its license to be quoted in the stock exchange would be worth of between RMB 0.1 to 1 billion, but the key problem is that the license is inalienable and does not belong to the company itself; creditors could not benefit from the license.

In contrast to listed company reorganizations, the deviation from absolute priority in non-listed company rescues, as noted above, was the exception rather than the norm. It happened in only five out of thirty-four non-listed company reorganizations. But, interestingly, the deviation in all these five cases actually went to the extreme: all previous equity remained untouched, i.e., it was entirely the unsecured creditors footing the bill of rescues.

The deviation in these five cases seemed to be attributed to full control by the debtor during the rescue process. For example, in the reorganization of *Dadi Paper Co. Ltd. Zhejiang* in 2010, the debtor regained control from the administrator, and the reorganization plan was also prepared by itself. Therefore, it is not surprising that the debtor used the control to steer the rescue in its own best interests.[70]

At the same time, in these cases, sometimes the circumvention of absolute priority might also be a realistic option for creditors. And by doing so, both unsecured creditors and equity-managers benefited from the circumvention; otherwise, the consequence might be destructive for both sides. For example, in the reorganization of *Xiamen Xinxin Artefacts Co. Ltd.*, as has been mentioned before, the company's controlling shareholder and CEO, Mr Huang Guozhong, absconded to the US shortly before the company collapsed, but was later invited by creditors to come back to turn the company around. In this case, the creditors had to make

[69] *Changling Group Co. Ltd,* 'The Annual Report of *Changling* 2008' (Shaanxi China, 2009, in Chinese).
[70] *Jingding Group Co. Ltd*, 'The Public Notice: Outcomes of Reorganization of *Dadi*' *Stock Daily* (Beijing China, 9 December 2010, in Chinese) D4.

a choice between two options: first, if Mr Huang did not return, the company would be liquidated, since there was no company buyer coming forward, and this could, as estimated, lead to zero repayment for unsecured creditors; second, with Mr Huang's ownership of the company unchanged, the unsecured creditors were promised a ten per cent payment. Without hesitation, creditors decided to choose the second option.[71]

Therefore, the deviation from the absolute priority principle in listed company reorganization was used mainly because of political concerns over maintaining social stability; by contrast, in non-listed company reorganization, it was largely used because of market forces.

In sum, the corporate reorganization regime has been proved to be effective in preserving going concern value of troubled companies in China, as the average recovery rate for unsecured creditors has been increased from less than ten per cent in pre-EBL 2006 corporate liquidations to 33.67 per cent in post-EBL 2006 reorganizations. The current main challenge is how to deal with two fundamental value distribution rules: the *pari passu* and absolute priority principles in reorganizations, because there were widespread deviations from them in the existing corporate reorganizations in China.

In particular, in listed company reorganizations in China, the absolute priority principle was virtually ignored, and the *pari passu* principle was relaxed in nearly half of these cases. By contrast, in non-listed company reorganizations in China, these two principles were largely complied with, and specifically, the deviations from the *pari passu* and absolute priority principles were only seen in 14.62 and 14.71 per cents of these reorganizations respectively.

Strictly speaking, deviations from these two principles are allowed by the EBL 2006, but under Article 87, such deviations must be carried out only if certain statutory conditions are met. To these ends, it is courts which are required to safeguard that the deviation from these two principles are lawfully exercised when confirming reorganization plans. Have courts

[71] Jingxiong Zhen, 'Corporate Reorganization: Judicial Efforts to Revive the Troubled Company' *People's Court Daily (*Beijing China, 25 December 2009, in Chinese) <http://oldfyb2009.chinacourt.org/public/detail.php?id=134675> accessed 27 September 2012.

discharged their duties in making sure that these norms were complied with? These issues will be reported in the next Part.

5. PLAN CONFIRMATION

Under Article 86 of the EBL 2006, a reorganization plan must be submitted to the court for confirmation after it has been voted by all classes of impaired parties. The law allows the court to make a final decision within thirty days of receiving the plan.[72]

5.1. Quick Confirmation

Not surprisingly, all submitted reorganization plans were confirmed by the courts; in other words, there was no one case where the reorganization plan was rejected by the court in China.

In most cases, it appeared to be a formality for the court to confirm a submitted reorganization plan, since it was not unusual for the court to approve a plan on the same day when the plan was submitted,[73] or within two to three days thereof.[74]

In very rare cases, it would take longer. For example, in the reorganization of *Jingwoniu Food Equipment Co. Ltd. Guangdong*, it took over five months for the court to eventually confirm the reorganization plan, though this seemed to be a breach of Article 86 of the EBL 2006. This was an exceptional case, as the quick confirmation was seen in the vast majority of corporate reorganizations in China.

Confirming a reorganization plan that has been voted for by all classes of impaired parties would be easier, perhaps because courts tended to defer to the collective agreement of

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[72] Article 86 of the EBL 2006.

[73] For example, the reorganization plan of *Dandong Chemical Co. Ltd.* was confirmed by the court on the same day when it was voted by the impaired parties. See *Dandong Chemical Co. Ltd*., 'The Report of New Share Offering for Assets Purchase and the Transactions with the Related Parties' (Dandong Heilongjiang China, 22 June 2012, in Chinese).

[74] For example, it took one day for the reorganization plan of *Beisheng Pharmaceuticals Co. Ltd*. to be confirmed by Beihai Intermediate People's Court, Guangxi. See The Administrator of *Beisheng Pharmaceuticals Co. Ltd.*, 'The Public Notice Concerning the Reorganization Plan Voting and Approval' (Beihai Guangxi China, 23 February 2009, in Chinese).

interested parties; however, if a reorganization plan had been voted against by any class of these parties, the court might face a challenge, since the proponent of the plan would request a cram-down.

5.2. Cram-downs

As far as the cram-down is concerned, some seventy-one corporate reorganizations were examined as their relevant information was publicly available; the cram-down was imposed in twenty-nine of these seventy-one reorganizations (40.85%).

A wide range of interest parties was forced to accept reorganization plans by cram-downs.

First, shareholders bore the brunt of these cram-downs. In particular, seventeen out of these twenty-nine cram-downs were issued to override the objection of shareholders. Under Article 85 of the EBL 2006, a reorganization plan that affects old equity must be voted and accepted by shareholders regardless of the company's insolvency. In practice, however, shareholders often refused to attend the meeting to vote on the reorganization plan, because many reorganization plans left nothing to them under the absolute priority principle. For example, in the reorganization of *Jiande Special Steel Co. Ltd. Zhejiang* in 2011, the administrator had to request a cram-down, because the shareholders refused, in anticipation of the application of the absolute priority principle in the plan, the invitation for the meeting that was held to vote on the plan.[75]

In the meantime, a cram-down against shareholders could also be issued at a very late stage. In such situations, usually, the shareholders had voted for a reorganization plan whereby their shares were cancelled due to the company's insolvency. However, later, they declined to cooperate in transferring the company's ownership to the company buyer at the government company registration office, although the transfer was substantially to fulfil formalities. Therefore, to smooth the process, a cram-down had to be requested by either the

[75] The Corporate Bankruptcy Unit of Xinyun Law Firm, Zhejiang, 'Problems of Corporate Reorganizations: A Case Study of *Jiande Special Steel Co. Ltd.*'s Reorganization' (China Insolvency Practitioners Business Conference, Shaoxing Zhejiang China, September 2011, in Chinese).

debtor or the administrator. This was the case in the reorganization of *Zonghen Textile Group Co. Ltd*. *Zhejiang* in 2009.[76]

Second, it was unsecured creditors that were forced by cram-downs to accept reorganization plans. It was found that twelve out of these twenty-nine cram-downs were issued to overrule their objections. Probably, a low recovery rate and a lack of transparency were two main reasons that led unsecured creditors to vote against the plan.

For instance, in the reorganization of *Dixian Textile Group Co. Ltd. Hebei* in 2008, angry of the recovery rate at two cents on the dollar, the unsecured creditors voted against the reorganization plan, but a cram-down was followed to put their objections aside.[77] In 2009, there was another high-profile corporate reorganization case dealing with *Haiji Chemical Co. Ltd. Inner Mongolia*. In *Haiji* case, the unsecured creditors were paid at thirty-six per cent of their claims, but rejected the reorganization plan on the grounds that there were too many questions unanswered, such as how the payment rate was reached and why the administrator did not sue one of the former shareholders who was alleged of unlawfully withdrawing a huge amount of capital before the company's insolvency.[78] Namely, the unsecured creditors used the votes to express their dissatisfaction over the lack of transparency and accountability of the administrator. But their objections were invalidated by a cram-down ruling shortly after the meeting of creditors.

Third, secured creditors were also sometimes forced to accept reorganization plans by cram-downs. In nine out of these twenty-nine cram-downs, it was found that the secured creditors were silenced by cram-downs. For secured creditors, the main dispute arose regarding the level of compensation for the postponed foreclosure of securities. For example, in the reorganization of *Zhonghen Special Steel Co. Ltd*, the secured creditor, a bank, voted against the plan, because it insisted that the interest rate for the extended maturity date should be calculated according to the original loan contract, which was quite high, however, the reorganization plan reduced the punitive interest rate down to the official one-year-loan level.

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[76] Email from Jian Feng, a prominent corporate lawyer in Shaoxing Zhejiang China (16 February 2012).

[77] The Administrator of *Dixian Textile Group Co. Ltd*, 'The Public Notice of Court Approval to the Reorganization Plan' (Chende Hebei China, 31 December 2008, in Chinese).

[78] Hua Liu and Yan Gao, 'An Investigation to the Bankruptcy Oddity of *Haiji Chemical Co. Ltd.*' *Stock Market Weekly* (Beijing China, 27 April 2009 in Chinese) <http://stock.jrj.com.cn/2009/04/2711394859465.shtml> accessed 3 October 2012.

Without an agreement reached by the bank and the administrator, a cram-down was later issued.[79]

In addition, sometimes, revenue authorities were also cram-downed, but this happened only in two of these twenty-nine cases. The first case was the reorganization of *Sanqing Cement Co. Ltd. Shanxi* where the fines claimed by the local tax authority were refused in the reorganization plan, and such a refusal was later supported by the court's cram-down decision.[80] The second case was the reorganization of *Jingwoniu Manufacture Co. Ltd. Guangdong* in which the tax authority voted against the plan, and a cram-down was used, but no explanation was disclosed as to why the tax authority voted down the reorganization plan.[81]

It should be noted that in many cases a cram-down was imposed to force more than one class of impaired parties, namely the above figures rather overlapped. For example, in the case of *Guangxia Industry Co. Ltd. Yinchuan*, the reorganization plan was voted against by both the unsecured creditor and shareholder classes; the cram-down overrode the disagreement of both classes.[82] These overlaps should be noted and kept in mind here.

5.3. The Cram-down Tests

As noted, before a cram-down is issued, a series of tests should be carried out and passed by the court; otherwise, the reorganization plan may be rejected, with reorganization converted into liquidation afterwards.

As noted before, apart from the substantive tests, there is a procedural requirement for a cram-down to meet: the objecting class or classes should be given a second chance to vote on

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[79] Youbing Lan and Zhusheng Liang, 'The Survival of *Zhonghen Special Steel* Partly Because of the Judicial Intervention of Jiangyou Lower Court' (in Chinese) <http://www.jyfans.net/news.php?id=385> accessed 4 October 2012.

[80] The Administrator of *Sanqing Cement Co. Ltd*, 'The Reorganization Plan of *Sanqing Cement Co. Ltd. Shaanxi'* (County Yao Shaanxi China, 28 September 2008, in Chinese).

[81] Beishan Chu, 'The Reorganization of *Jingwoniu* in the Context of the Financial Crisis' *Dongguan Daily* (Dongguan Guangdong China, 22 May 2009, in Chinese) <http://biz.timedg.com/2009-05/22/content_324501.htm> accessed 8 June 2013.

[82] Bing Zhang and Jinting Chao, 'The Difficulties of *Guangxia Industry* Restructuring' *Caixing New Century Magazine* (Beijing China, 20 February 2012, in Chinese) <http://finance.qq.com/a/20120220/000260.htm> accessed 3 October 2012.

the plan before it is submitted to the court for the cram-down consideration, and during this period, the proponent of the plan is liable to renegotiate the terms of the plan with the objecting parties. However, in practice, it seemed that this procedural requirement was not adequately complied with.

It was found that in many cram-downs the objecting parties were in fact not contacted for a second round of voting, let alone for a renegotiation. For example, in the case of *Baoshuo Chemical Co. Ltd. Hebei* in 2008, the reorganization plan was voted against by the class of unsecured creditors; two days later, the administrator straightforwardly submitted the plan to the court without renegotiating and organizing a second round of voting; days later, the cram-down was announced by the court.[83] This was also noticed in the reorganization of *Haiji Lvjian Chemicals Co. Ltd. Inner Mongolia* in 2009.[84]

But the more critical safeguards against the improper use of cram-downs are the three statutory tests.

As to the first creditor-best-interest test, it was found that this test appeared to have been conducted very well, since, at first glance, by simply reading the texts of these reorganization plans, creditors, especially unsecured creditors, were paid not less than they were in liquidation. These seemingly happy ends were likely to be ascribed to the routine use of assets evaluations in most reorganization cases in practice. In nearly all corporate rescue procedures, there was a regular asset evaluation according to which the company's liquidation as well as going concern value would be appraised. It was clear that in all cases creditors were, as stated in the reorganization plans, paid more than the evaluated liquidation value.

For example, in the reorganization of *Dixian Textile Co. Ltd. Hebei* in 2008, according to the assets' evaluation, unsecured creditors would be paid 1.028 per cent of their claims if the

[83] Tong Li, '*Baoshuo*: the Demise of the Large Shareholder and the Birth of the New Shareholder' *Commercial Comments* (Chongqing China, 3 April 2008, in Chinese) <http://finance.sina.com.cn/stock/companyresearch/20080403/17304707726.shtml> accessed 17 December 2012.

[84] Liu and Gao (n 78).

company was liquidated; to pass the creditor-best-interest test, the reorganization plan increased the unsecured creditor recovery rate to two per cent.[85]

Thus, passing this test was largely dependent upon the results of asset evaluations. The worry here is also firmly associated with such asset evaluations. If company assets were undervalued, it would be quite easy to pass this test. Conversely, in the case of inflated valuation outcomes, passing the creditor-best-interest test would not be easy. Although there was no hard evidence that assets of these companies were usually under-valued, it seemed that there was a tendency of undervaluation especially from the view point of administrators and courts both of which stayed in charge and decided which asset evaluators were hired.

In theory, at least, an under-valued result would be favoured or preferred by the administrator and the court. In the case of an under-valued outcome, first, it would be, as said before, easy to pass the creditor-best-interest test through even slightly increasing the unsecured creditor recovery rate above the liquidation value, and, second, a low asset evaluation would be more attractive to potential company bidders since most corporate reorganization cases in China resorted to the business sales. A low asking price which was based on the asset valuations would be far more appealing in inviting more company buyers to bid.

In reality, suspicions over asset undervaluation did cause many disputes. For example, in the reorganization of *Wugu Food Co. Ltd. Beijing* in 2009, many creditors during the creditors' meeting questioned why the company's trademark, a national household name in China, was only appraised at about RMB 1 million, but months ago, a buyer was willing to pay RMB 10 million for it.[86]

Thus, on the face of it, this test was superficially passed in each reorganization case, but the worry was that this test would be essentially destroyed if there was an asset undervaluation. Much should be done to improve the accuracy of asset evaluations.

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[85] The Administrator of *Dixian Textile Co. Ltd,* 'The Reorganization Plan of *Dixian Textile Co. Ltd*.' (Shijiazhuang Hebei China, 15 December 2008, in Chinese).

[86] Yuming Liu and Yihe Ding, 'The Resurrection of *Wugu Food* through Corporate Reorganization' *Democracy and Law Daily* (Beijing China, 29 December 2009, in Chinese) <http://www.mzyfz.com/news/times/g/20091229/151037_2.shtml > accessed 16 May 2010.

The second is the fair and equitable test. This test requires that the *pari passu* and absolute priority principles must apply if the proponent of the reorganization plan seeks a cram-down. But it was found that this test was not well taken by many courts in China.

As noted above, the deviation from the absolute priority principle took place in all listed company reorganizations; therefore, in principle, to pass the fair and equitable test, the courts could not impose the cram-down in listed company reorganizations unless the disadvantaged parties had voted for the reorganization plans. But, in fact, it was found that, in listed company reorganizations, many cram-downs were still issued by the courts in spite of the creditors' objections. For example, in the reorganization of *Guangming Furniture Co. Ltd. Heilongjiang*, a listed company, in 2010, because of the objections of both secured and unsecured creditors, a cram-down was sought and obtained, although evidently there was the deviation from the absolute priority principle in the reorganization plan, because the shareholders retained the majority of their equity in the new company, whilst the unsecured creditors were not paid in full.

In non-listed company reorganizations, the courts' failure to take this test was also visible. For example, in the reorganization of *Fenghua Group Co. Ltd. Guangdong*, a non-listed company, in 2008, the Zhaoqing Intermediate People's Court, Guangdong imposed a cram-down, although the absolute priority principle was relaxed in the reorganization plan.

With regard to the *pari passu* principle, it was treated similarly, i.e., many courts also failed to ensure that this principle was applied when carrying out the fair and equitable test. For example, in the reorganization of *Baoshuo Chemical Co. Ltd. Hebei* in 2008, as noted before, a cram-down was imposed, in spite of the fact that the deviation from the *pari passu* principle appeared in the plan.[87]

The third test is that of feasibility, which means that the court must be convinced that the plan is more likely to be put into effect if confirmed. Given that there is no specific criteria or guidance in the EBL 2006 as to how to assess the feasibility of a reorganization plan, not surprisingly, it was found that there were no clear expression quoted by courts in assessing the feasibility of reorganization plans. In most of the courts' cram-downs, a routine statement

[87] *Baoshuo Chemical Co. Ltd. Hebei*, 'Annual Report of 2008' (Baoding Hebei China, 30 April 2009, in Chinese) 32.

was identified: 'the reorganization plan is believed to be feasible, so the court approves it'. However, no further explanations were given to ascertain how the court reached such a conclusion.

Considering that most of the China's corporate reorganizations were business sale sales, perhaps the buyer's decision to purchase the business might have made the court believe that the plan was feasible, because the reorganization plan was essentially a contract to sell the company.

Overall, concerning these three tests, the first creditor-best-interest test seemed to have been superficially taken well. As for the fair and equitable test, some courts failed to discharge their duties in ensuring the full application of the *pari passu* and absolute priority principles when issuing cram-downs. The third feasibility test was perhaps beyond what courts were technically able to do, and it was largely a formality for courts to state that this test had been passed; in fact, most courts did little to conduct this test.

6. CONCLUSIONS

In general, between June 2007 and November 2010, there were not many corporate reorganization cases in China, but the existing corporate rescue cases may still have profound implications for the future development of the corporate rescue regime, especially given that the intense media coverage over some high-profile corporate reorganization cases had considerably raised the awareness of the new corporate reorganization regime in China nationwide.

As for some key findings in this national data collection, first, compared with the US and the UK, China had a quite low corporate bankruptcy rate as well as a low corporate reorganization rate; this further merits the investigation in the next chapter to examine why China's new corporate rescue law was not used more often.

Second, in nearly half of the existing corporate rescues in China, it was the local-government-organized liquidation committee that was appointed as the administrator. More notably, in the majority of the rescue processes, the expected debtor-in-possession model was not used. Thus, China's corporate rescue procedures were largely controlled by the administrators; this in effect was the administrator-in-possession model. As to whether

China's administrator-in-possession approach may deter debtors from seeking a formal rescue, among other things, the next chapter will shed light on its potential impacts.

Third, as to value distribution, it was found that the deviation from the absolute priority principle was routine in listed company reorganizations in China; meanwhile, the *pari passu* principle was relaxed in about forty per cent of listed company rescues. By contrast, in non-listed company reorganizations, these two fundamental distributional principles were largely followed. The next chapter will go a step further to examine concerns of interest parties towards applying or deviating from these two principles in rescues.

Fourth, China's courts seemed to have been quite lenient to submitted reorganization plans, since all these plans were confirmed by courts; however, serious concerns arose as to the courts' independence especially in conducting the tests for cram-downs, because it was found many cram-downs were issued by courts through bypassing the statutory tests which are mandated by the EBL 2006.

In short, this chapter has painted a comprehensive picture of the new corporate reorganization regime's implementation in China. Behind these statistical figures presented so far, however, there are still many issues that remain unanswered, especially regarding the incentives or intentions of key parties in corporate reorganizations in China. These gaps will be filled in the following chapter, the Zhejiang case study.

CHAPTER 6

A CASE STUDY OF ZHEJIANG

1. INTRODUCTION

In the previous chapter, a review of the implementation of China's corporate rescue law has been made, but there are still many issues in need of further investigations.

As to the first research question, in the last chapter, it was possible to identify a small number of corporate rescues that arose after the EBL 2006 took effect; however, it remains unknown as to what the main factors that hampered the use of the new corporate rescue law were in practice. Concerning the second research question, it has been found that, in the majority of China's existing corporate reorganizations, the administrator-in-possession approach was used, but it remains unknown why the administrator-in-possession approach rather than the expected debtor-in-possession approach was preferred, and equally importantly, questions have also been raised as to what effects the dominant administrator-in-possession approach has had on debtors regarding their willingness to voluntarily enter a formal rescue procedure.

With regard to the third research question on value distribution, in the last chapter, it has been reported that the departures from both the absolute priority and *pari passu* principles were widespread in reorganizations of listed companies in China; in contrast, these were far less likely to happen in non-listed company reorganizations. These raise questions as to what were the main concerns of the parties in charge when deciding to apply or deviate from these two principles.

As for the fourth research question on the court confirmation of reorganization plans, in the last chapter, it has been demonstrated that all reorganization plans were confirmed by the courts; meanwhile it was found that the cram-down was also widely imposed. But it remained largely unknown how courts assessed reorganization plans before confirming them, whether it was a cram-down or a normal confirmation.

The aforesaid questions are what this chapter, the Zhejiang study, attempts to address. In particular, this chapter will use the interview data collected from Zhejiang to review what had happened behind the statistical figures presented in the previous chapter. To be sure, this chapter is intended to reinforce the last chapter, seeking to give a fuller account of China's corporate rescue law implementation.

As mentioned earlier, nearly a quarter of Chinese corporate reorganizations during the studied period took place in Zhejiang province alone, in spite of the fact that Zhejiang is only one of the Chinese thirty-one provinces.[1]

It is worth repeating that the time covered by the Zhejiang study was longer than that of the national study. The Zhejiang study contained corporate reorganization cases accepted by the courts from 1 June 2007 to 31 December 2011; while the national study in the previous chapter surveyed cases accepted by the courts between 1 June 2007 and 31 November 2010. Such a difference should be kept in mind.

Like other provinces, after China's Supreme People's Court released the judicial notice regulating bankruptcy administrator appointments,[2] Zhejiang's Supreme People's Court announced its corporate insolvency practitioner list on 5 September 2007, which selected and listed thirty-four local law firms and fourteen accounting firms as insolvency practitioners.[3] There was an absence of qualified insolvency practitioners in Zhejiang, as the EBL 2006 came into force on 1 June 2007, whilst the first insolvency practitioner list was made available three months later, on 5 September 2007. So, Zhejiang courts were unable to appoint insolvency practitioners as administrators before 5 September 2007. But, as noted above, under Article 24 of the EBL 2006, the court could still appoint a local-government-

[1] This thesis treats Shanghai, Beijing, Tianjin and Chongqing, the four municipals at provincial level in China, as provinces. In the meantime, Taiwan, Hong Kong and Macau are excluded because they are under the totally different jurisdictions.

[2] China's Supreme People's Court, 'Bankruptcy Administrator Appointment Regulation' (Beijing China, 4 April 2007, in Chinese) <http://news.xinhuanet.com/legal/2007-04/17/content_5987397.htm> accessed 15 June 2013.

[3] Zhejiang's Supreme People's Court, 'Zhejiang List of Corporate Bankruptcy Administrators' (Hangzhou Zhejiang China, 5 September 2007, in Chinese) <http://www.zjcourt.cn/content/20061121000001/20070912000006.html> accessed 8 October 2012.

organized liquidation committee as the administrator in a reorganisation. The delayed release of the insolvency practitioner lists also happened in other provinces.[4]

At the time of writing, Zhejiang's Supreme People's Court has updated its corporate insolvency practitioner list since 10 September 2012, and now there are 222 law and accounting firms officially included in this list, over five times the size of the first one.[5] The sharp increase of insolvency practitioners may have significant implications for the future development of corporate bankruptcy law in Zhejiang.

From 1 June 2007 when the EBL 2006 came into effect to 31 December 2011, there were thirty-five companies that entered the corporate reorganization procedure in Zhejiang. In view of some consolidated rescues, as defined before, there were twenty corporate reorganization cases.

In these twenty reorganizations in Zhejiang, there were two reorganizations that have been converted into liquidations and another two cases were still pending; the remaining sixteen cases had been successfully concluded by December 2011 when the data collection in Zhejiang ended. In these sixteen reorganizations, all secured and preferential creditors were paid in full; unsecured creditors recouped on average thirty-six per cent of their pre-bankruptcy claims. Business sale rescues occurred in twelve reorganizations (75%), i.e., it was largely company buyers who turned these troubled companies around.

To report the Zhejiang findings, the remainder of this chapter is arranged into four parts: (i) Part 2 presents the difficulties of relevant parties when a corporate reorganization filing was attempted, (ii) Part 3 describes the factors resulting in the present control models in Zhejiang corporate rescues, (iii) Part 4 explores the justifications of value distribution in rescues, and (iv) Part 5 looks into what courts mainly considered in confirming reorganization plans. The key findings will be summarized in the conclusion.

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[4] The Suzhou Intermediate People's Court, Jiangsu, 'The Implementation of Corporate Reorganization Law – A Case Study of *Yaxing* Rescue' *People Court Daily* (Beijing China, 30 May 2009, in Chinese) (reporting the difficulty of appointing an administrator when the administrator list was still not available in Jiangsu Province) <http://rmfyb.chinacourt.org/public/detail.php?id=128153> accessed 1 April 2011.

[5] Zhejiang's Supreme People's Court (n 3).

2. ENTRY DIFFICULTIES

Under the EBL 2006, in theory, the corporate rescue procedure is open to a broad range of troubled businesses and could be filed by many different parties;[6] in reality, there were, however, too many obstacles impeding entry into the corporate reorganization process.

2.1. Reorganizations in Zhejiang

As noted before, compared with other provinces, Zhejiang did accept more corporate reorganization petitions. In contrast to the number of companies dissolved every year in Zhejiang, however, there were a small proportion of them that used the corporate reorganization procedure in order to survive crises. As shown in Table 1, there were over 50,000 companies that were dissolved in Zhejiang every year between 2006 and 2011; however, less than ten corporate reorganizations per year were handled by all Zhejiang's courts.

Table 1: Company Dissolutions, Bankruptcies and Reorganizations in Zhejiang Province, China[7]

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

Year	Companies on the register	Companies dissolved	Company bankruptcies	Company reorganizations
2006	571,340	63,145	33	0
2007	608,871	58,222	35	1
2008	666,624	62,841	42	2
2009	711,701	57,372	41	7
2010	782,639	52,378	36	7
2011	862,395	53,993	N/A	3

[6] Roman Tomasic and Zinian Zhang, 'China's Enterprise Bankruptcy Law: Implementation of the Corporate Reorganization Provisions' in John Garrick (ed), *Law and Policy for China's Market Socialism* (Routledge, 2012).

[7] The table was once presented in Zinian Zhang, 'Enhancing China's Nascent Corporate Rescue Regime: A Case Study of Zhejiang Province' (the 6th Insolvency Research Conference, London, April 2012).

Why were there so small a number of corporate rescues in Zhejiang? especially given that Zhejiang had an export-based economy, it might have been hit hard by the 2008-9 global financial crisis; presumably, there would have been far more financially distressed businesses that sought a breathing space under the protection of the new corporate rescue law. Difficulties of courts are examined at first.

2.2. Courts' Hesitation

First and foremost, it was the hesitation of courts in accepting corporate reorganization filings that led to the scarcity of formal rescues in Zhejiang. As is known, under Article 10 of the EBL 2006, a formal corporate rescue procedure cannot be commenced unless the court accepts the rescue filing. It was once argued by one leading Chinese bankruptcy scholar shortly before the EBL 2006 took effect that the new corporate rescue law would be stymied if courts turn their backs on bankruptcy filings.[8] Indeed, it would be an exaggeration to say that the courts have totally closed the door; but, at the very least, accepting a corporate rescue filing was an exception rather than the norm for most courts in Zhejiang. The courts' considerable hesitation was likely to be attributed to the following reasons.

A. Manpower

Asked why courts were so wary of accepting corporate reorganization filings, nearly half of the interviewees suggested that the courts had no sufficient judges to handle corporate reorganizations, if the rescue filings were accepted without restrictions.[9] Here, it should be noted that the courts were not particularly hesitant in accepting corporate reorganization petitions, instead, all corporate bankruptcy affairs, including corporate reorganization and liquidation cases, were what the courts did not want to be embroiled with. For the courts, dealing with corporate bankruptcy reorganization cases was as difficult as dealing with corporate bankruptcy liquidation cases. So, in general, the courts tried to avoid accepting all corporate bankruptcy petitions as a whole.

[8] Shuguang Li, 'Reform of the Court' Role in Corporate Bankruptcy' (2007) 6 *Shanghai State Property* (in Chinese) 54, 55.

[9] Appendix 9 Question 3.

The corporate bankruptcy businesses were time-consuming and demanded more judges to handle. Without enough judges, the courts could not afford to fully open the door to accept corporate reorganization filings. Understaffing was one of the main concerns of courts when a petition of corporate reorganization was raised before them.

In Zhejiang, like other provinces, there were no specially-established bankruptcy courts.[10] The corporate bankruptcy businesses including corporate reorganizations were handled by the second civil chamber of all law courts. In most second civil chambers at lower court level, there were usually only four or five judges in service; more notably, these judges were already saddled with too many cases, and it was not unusual for a judge to deal with over 200 litigation cases a year. By China's standards in judicial circles, most judges were overworked. As a result, courts tried not to be bothered with time-consuming corporate bankruptcy cases; there were not enough judges to handle them. It is noteworthy that, after the EBL 2006 took effect, there was no increase of judges in Zhejiang's courts so as to pave the way for the full implementation of the new law, especially at lower court level.

Regarding the existing corporate reorganization cases in Zhejiang, because it was considerably time-consuming to handles them, most judges were reluctant to be designated to deal with them. To encourage judges to handle corporate bankruptcies, many courts in Zhejiang adjusted the judge performance assessment system in favour of these judges. For example, one interviewee said that, in the Fuyang Lower People's Court, one corporate bankruptcy case was calculated as ten normal lawsuits; thus, the judge would be better assessed because one of the main measures to assess the judge performance is based on how many lawsuits he or she handles in a year. Another interviewee said that, in the Shaoxing Intermediate People's Court, one corporate bankruptcy case was counted as at least twenty lawsuits. This was to reward and encourage judges who engaged in bankruptcy issues within the court systems.

The stimulus of multiplying judges' workload assessment, however, seemed not to be enough. One judge interviewee said that nearly one hundred meetings were assembled and chaired by him when he handled one corporate reorganization case, and he felt overwhelmed.

[10] It was advised by foreign experts in the 1990s that China establish a special bankruptcy court system to deal with corporate bankruptcy issues, but this proposal was rejected. See generally Terence C Halliday, 'The Making of China's Corporate Bankruptcy Law' (2007) *Oxford Series in Law, Justice and Society* 2, 7.

Counting one corporate bankruptcy case as ten or twenty lawsuits still could not reflect the workload that he had contributed in the case.

Another judge interviewee suggested that how many lawsuits a corporate bankruptcy case should be counted should consider how many creditors were involved in the case, and that fixing one corporate bankruptcy case as ten or twenty lawsuits still be somewhat mechanical. Furthermore, this judge commented that a corporate reorganization procedure involved almost all areas of law practice ranging from the criminal, civil, administrative, and corporate, and even the intellectual property laws, and that judges in the second civil chamber who focused on practicing business law were not competent to deal with the bankruptcy issues. The corporate bankruptcy affairs required the judges to have comprehensive expertise in many related legal areas.

Thus, on the one hand, because there was no increase of judges, the courts could not afford to accept corporate bankruptcy cases that were time-consuming. On the other hand, inside the courts, individual judges were also unwilling to handle this kind of cases on the grounds that, first, their commitment would not be sufficiently recognised and rewarded, and that, second, they had not professionally prepared to supervise these cases. In other words, there was a shortage of both judges and expertise in the courts to deal with corporate reorganization affairs.

The lack of judges was a real problem that deterred courts from fully accepting corporate bankruptcy filings. But, the lack of bankruptcy law training for judges should also be properly addressed, because they could not gain confidence unless they were educated and trained in the nuances of the bankruptcy law. But, the courts' hesitation to accept corporate bankruptcy cases was more likely to be due to the pressure from outside.

B. Government Support

Most of the interviewees believed that the unwillingness of courts in accepting corporate reorganization filings was also because of the lack of support and cooperation of governmental institutions.

Unlike handling day-to-day lawsuits, when dealing with a corporate reorganization procedure, courts needed administrative services or cooperation from many government institutions. For example, the revenue authorities needed to agree to provide the tax-approved

receipts to the company if its business operation continued during the rescue; the utility authorities could not cut off electricity and water supplies simply on the basis that there were outstanding unpaid bills, etc. In reality, however, the court itself was unable to persuade local government agencies to cooperate and to facilitate the corporate bankruptcy process. Law courts were weak institutions in China's present power systems.

One judge interviewee gave an example to demonstrate the difficulty of the court in dealing with corporate bankruptcy reorganizations.[11] He said that, in the corporate rescue case supervised by him, the local police department played a key role in investigating the company's assets, because the lawyer administrator was not allowed to access the company's records of assets possessed by the banks and the government agencies. Without the involvement of the police, it was impossible to find out the whereabouts of the company's key assets, let alone to restructure the company's business. He, however, emphasized that, in that rescue case, the local police department was actively involved mainly because it was ordered by the local government to support the case; in particular, one of the deputy mayors of the city chaired an *ad hoc* team to direct and facilitate the rescue. If the local government had not intervened, it was highly unlikely for the police department to participate, which meant the rescue process would be far more difficult.

But the key problem was, this judge interviewee continued, that the help, cooperation or coordination provided by the government agencies was the exception rather than the norm; these government agencies, including the police department, were not legally obliged to participate in the corporate bankruptcy process; if these government agencies did not want to give a hand, the court could not force them to do so. The judges felt helpless in proceeding with corporate reorganizations without extra support from local government.

This was echoed by a lawyer interviewee, who said that, in the reorganization case that he was involved, the court asked for a guarantee in writing from the local government that promised to coordinate all government agencies to support if needed; without the guarantee of government, the court was not confident enough to accept the reorganization filing. Moreover, this lawyer interviewee addressed that there had been already several meetings held between the court and the local government before the formal procedure commenced to

[11] Appendix 9 Question 3.

discuss the rescue prospects of the troubled company, and that the formal rescue procedure would have not be allowed to begin until an agreement had been reached between the court and the government. In the agreement, the government consented to share certain responsibilities, and during the subsequent process, the court relied on the government to deploy other government institutions when the administrative services were needed. The need of government support might partly answer the question regarding why courts tended to use the local-government-organized liquidation committee as the administrator in corporate bankruptcy cases.

In real terms, the lack of government support would rather be ascribed to the oversimplification of the EBL 2006 and the less developed rule of law in China.[12] For example, as noted above, the company needed the tax-authority-approved receipts to keep on trading during the formal rescue process; but the revenue authority might refuse to provide these receipts on the basis that the company had unpaid tax generated before the bankruptcy procedure. The tax authority's refusal was lawful. In practice, in the event of such a deadlock, usually it was the judge who had to visit the tax authorities in person and asked for an exemption; or, the judge would ask the government that agreed to support the corporate reorganization procedure to persuade the tax authorities to give leniency.

Thus, at first glance, it was the revenue authority that did not cooperate with the court in facilitating the corporate reorganization case; however, in essence, it was the inconsistence between the tax law and the EBL 2006 causing the stagnation. The EBL 2006 was too simple to envisage and tackle conflicts with other statutes. It was not detailed enough to be conveniently applied in practice.

As to the less developed rule of law in China, this could be epitomized by the difficulties of lawyers in accessing the company's records of assets possessed by the government agencies, such as the company registration and land registration authorities. Under Article 35 of China Lawyer Law 2007, Chinese lawyers did have the rights and privileges to access these records held by government agencies; but in real world, lawyers could not materialise these rights or privileges, because many government agencies tended to deny lawyers' such requests without being held to account. It seemed to be paradoxical. Chinese law said that

[12] See the discussion on the rule of law generally at Antonin Scalia, 'The Rule of Law as a Law of Rules' (1989) 56 *The University of Chicago Law Review* 1175.

lawyers are entitled to access these materials, but remained silent as to whether and how to punish government agencies and their staff if they breach the law by denying lawyers' access to these materials. This seemed to be against the basic principles of the rule of law.

And the things would be changed. If the local government was directly involved in the particular corporate reorganization case or the corporate liquidation case, such an investigation gap would be filled by the local police force.

In reality, if the local government did not give support or was not involved, and if the lawyer administrator was denied the access to the company's records in the government agencies, usually, the judge himself would have to investigate the company's assets by using his own judicial power. But, this was what the judge could not afford the time to do. Thus, the fact that the courts needed the extra support from the government also demonstrated the fact that the rule of law in China was still to some extent weak.

Besides the above concerns, potential mass petitions associated with the corporate bankruptcy affairs would deter courts from accepting corporate reorganization filings.

C. Mass Petitions

The lack of manpower and government support might only make the courts feel unable or reluctant to accept corporate reorganization cases, but the potential corporate bankruptcy related mass petitions would frighten courts away from dealing with corporate bankruptcy affairs.

In recent decades in China, it was a political threat to local authorities, including law courts, if there was a street protest launched by people raising their grievances. The street protest was euphemised as the mass petition, because it was politically sensitive in China.[13] To address and prevent mass petitions, China has established the comprehensive social stability assessment systems, according to which local authorities, especially their senior officials, would be assessed over the number and the scale of mass petitions that occurred in their administrative areas; the officials in charge of a particular government department would be disciplined and even prosecuted if there was a mass petition or a street protest that

[13] See generally Murray Scott Tanner, 'China Rethinks Unrest' (2004) 27 *The Washington Quarterly* 137.

pointed to their department.[14] Beijing central government was seriously concerned about social protests, worrying that this kind of individual event might spread across the whole country and put the ruling Communist Party in trouble.

For law courts, in response to the social stability assessment system, the common strategy was to refuse accepting any lawsuits that involved many individuals, because the large number of individuals was a main cause of mass petitions. To be sure, corporate bankruptcy cases fell into such a business category that courts tried to avoid, since a corporate bankruptcy case always had a large number of either employees or creditors whose existence made courts nervous.

Most interviewees believed[15] that potential mass petitions were the top worry of a court when it decided on whether to accept a corporate reorganization filing. Indeed, the court would steer itself into trouble if it accepted a corporate reorganization petition. The courts' worry seemed not to be superfluous.

Corporate reorganization was really mass petition sensitive; it was found that the mass petition or protest occurred at least in eleven out of twenty reorganizations in Zhejiang (55%); all these mass petitions were made by unpaid employees. But thankfully these mass petitions took place before these formal rescue processes; otherwise, the judges in charge would have faced enormous pressures. Assembling in large number, these unpaid employees laid their grievances before the local government, as under Article 85 of China Employment Law 2005, the local government was liable to enforce the labour law and to ensure that employees were to be paid under their labour contracts. Namely, employees redirected their grievances to government, because they thought that the government had failed to discharge its legal duty in enforcing the employment laws.

One administrator interviewee indicated that, before the court accepted the corporate bankruptcy filing that he was involved, the local government had agreed to tackle and bear the political responsibilities for any possible mass petitions flowing from the corporate

[14] See for example The General Office of China's Communist Party Central Committee and The General Office of China's State Council, 'An Interim Regulation on Holding Party and Government Senior Officials Account' (Beijing China, 12 July 2009, in Chinese) (stating that the local senior officials will be disciplined or even prosecuted in the event of a large scale street protest).

[15] Appendix 9 Question 3.

reorganization process. In other words, for fear of being negatively assessed or accused by the local Communist Party committee, the court needed an advance pardon from the government in case that there was a mass petition in the prospective corporate reorganization process; otherwise, the court was not confident to engage in these issues by accepting the filings.

One phenomenon might reflect the deep anxiety of both courts and local government over the potential protests or social unrests. One lawyer interviewee disclosed that in the reorganization case he was involved in Zhejiang in 2009, to pre-empt the potential protest by creditors, about 800 riot police officers were deployed to monitor the meeting of creditors that was attended only by 600 creditors and their representatives. In another city, a second lawyer interviewee said that, during the meeting of creditors, the police officers seated side by side with creditors; each creditor was flanked with two police officers. In other cities of Zhejiang, other interviewees told that there was a similar heavy riot police presence at creditors' meetings.

This heavy riot police presence at creditor meetings could be interpreted in two ways. At first, the courts were on alert for potential protests; second, without the government support, which could deploy the police force to maintain the security of creditor meetings, the courts even might not be confident enough to hold meetings of creditors.

Thus, from the courts' perspective, it was risky to accept corporate rescue filings. One government official interviewee summarised the situation: courts neither dared to accept corporate reorganization petitions alone nor had any incentive to do so. Keeping their distance from corporate reorganization issues was the strategically correct course to take for courts to remain politically safe.

The courts' hesitation should be partly responsible for the rare use of the new corporate reorganization procedure in Zhejiang, but debtor companies in distress were also rescue averse because they had their own concerns.

2.3. Unwillingness of Debtors

Ideally, corporate reorganization objectives might be more achievable if reorganization proposals could be initiated by debtors themselves, because they have the exact knowledge

and understandings of their own positions. Debtors' experience and information are critical for the success of rescues. In Zhejiang, however, it was rare to see debtors which voluntarily filed for reorganization.

Two practitioner interviewees explained that most debtor companies tried to avoid the corporate reorganization procedure for fear of losing control to third parties, because under Article 13 of the EBL 2006 the entry into the formal bankruptcy reorganization procedure would lead to the automatic resignation of debtors; it was unacceptable to most debtors. Although under Article 73 of the EBL 2006, the debtor might regain control under the court permission at a later stage, these two interviewees emphasized that regaining control was a possibility rather than a certainty; the debtors did not want to gamble; it was too dangerous.

It was, moreover, manifested by some interviewees that at the heart of the debtor' unwillingness to file for reorganization were its fears of exposing the company's books and other financial record to a third party. This was because evading tax was, they said, widespread in business circles, and surrendering the books to a third party largely meant that the debtor disclosed criminal evidence of their own tax fraud. It would, therefore, be fatal for the debtor to file the reorganization petition to the court.

The debtors' worry of losing control was real. As reported in the previous chapter, in fact, it was highly unlikely for the debtor to regain control after the commencement of the rescue, as the debtor-in-possession model was only used in a small percentage of the existing corporate reorganization cases. Put differently, to a large extent, the control lost would be lost for ever.

One critical point, however, was overlooked by these interviewees – the debtor also had no economic incentives to file for reorganization, because the application of the absolute priority principle, which will be described later, meant that nothing would be left for them in rescues.

Overall, from the point of view of debtors, the formal corporate rescue procedure was not as debtor-friendly as expected.

2.4. Creditors' Frustration

China's new corporate rescue regime might not be debtor-friendly. But even in the US where there is a pro-debtor corporate rescue regime as reflected in the debtor-in-possession approach, it was found that most voluntary rescue filings were, in effect, due to imminent liquidation pressures from creditors.[16] So the use of the corporate bankruptcy rescue regime is also dependent on a rigorous debt enforcement system whereby creditors can easily choose either individual debt enforcement or liquidation to collect debts. In Zhejiang, however, in general, creditors had no lever to threaten a liquidation when debtors defaulted. It was even safe to say that a liquidation petition was not a means of collecting debts for creditors. As a result, defaulting debtors did not need to use a corporate reorganization procedure as a bombing haven to keep creditors at bay.

One lawyer interviewee said that, in reality, where a debtor defaulted, creditors could only resort to individual debt enforcement by suing the debtor in court; as to threatening to liquidate the debtor under the EBL 2006, such a course of action would be unrealistic and naïve, because it was insurmountable for the creditor to open a formal bankruptcy procedure in court. In particular, this lawyer interviewee explained that in order to open a bankruptcy process, the creditor had to persuade the local government where the debtor was located to take actions. Without the local government's help, it was a waste of time for the creditor to petition for a liquidation procedure, since such a petition would certainly be refused by the court.

This lawyer interviewee further clarified that if the creditor was from outside the region where the debtor is located, such a possibility would be much simmer, because it was far more unlikely for the local government to support a liquidation petition against a local business in favour of the creditor from outside its administration.

In the existing corporate rescues in Zhejiang, however, it was apparent that some of the rescues were indeed filed by creditors. So, has the assertion of creditors' difficulty in using bankruptcy law been exaggerated? On closer examination, it was found that it has not. In such circumstances, in form, the rescue procedure was filed by creditors; in substance,

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

however, these creditors were actually invited or arranged to submit the application to fulfil the formalities. For example, in the reorganization of *Nanwang Electronic Co. Ltd. Hangzhou* in 2008, the creditor applicant, *Sanhua Group Co. Ltd*., was also one of the company's shareholders, an inside party; after the agreement had been reached between the local government and the court, selecting *Sanhua* to file for reorganization was just a matter of convenience.[17]

Another lawyer interviewee said that it had been repeatedly tested and verified in practice that the corporate bankruptcy procedure, including corporate reorganization, was unavailable to both creditors and debtors unless the local government was involved.

In short, courts had the power to accept a corporate rescue case but hesitated to do so; debtors had the information and knowledge but were unwilling to enter reorganization for fear of the negative consequences; creditors had the intent to recoup their debts through bankruptcy processes but were unable to jump over the hurdle to enter the courthouse. The combination of these factors largely explained why there were few corporate reorganizations in Zhejiang.

3. ADMINISTRATION OF RESCUES IN ZHEJIANG

Although there was a high threshold for companies to enter the formal rescue process, there were still some companies that were brought into the rescue procedure in court. This Part focuses on reporting findings on control in the existing corporate rescues in Zhejiang; in particular, it centres on different roles played by debtors, administrators, and creditors, respectively.

3.1. The Role of Debtors

In theory, as noted, a debtor could regain control from the administrator if the court approves its such a requires; however, in practice, regaining control was not common.

[17] Hejuan Zhao, '*Nanwang* Reorganization Plan Failed' *Caijing* (Beijing China, 29 October 2008, in Chinese) <http://www.caijing.com.cn/2008-10-29/110024211.html> accessed 13 December 2012.

In Zhejiang, it was found that there were only four out of fourteen reorganizations (29%) where the company control was returned to the debtor. More essentially, the returned control appeared to be in name only, as in these four cases the key right to propose the reorganization plan still resided in the hands of the administrator. In particular, in two of these four cases, the reorganization plan was proposed by the administrator, not the debtor;[18] in the third case, the plan was jointly proposed by the debtor and the administrator; [19] there was only the last case where the reorganization plan was really proposed by the debtor.[20] Thus, in real terms, there was just one out of these fourteen cases (7%) where the debtor-in-possession was used.

Why was, in most cases, the debtor excluded from most corporate reorganization cases in Zhejiang? With this question in mind, some explanations were given by the interviewees. By and large, the exclusion of the debtor in Zhejiang corporate rescues was occasioned by the factors as follows.

A. Few Sympathies

The attitudes of the stakeholders towards the business failures might be one of many reasons which led the debtor to be removed before or during the formal rescue process.

In response to the interview question 'what the main cause of the company's failure was', most of the interviewees considered[21] that above all it was the debtor's mismanagement that turned the company from trouble into crisis. In other words, the debtor, and especially its senior managers, was culpable for the company's distress, which meant that most stakeholders had little confidence to allow the debtor to run the company any more in the formal bankruptcy rescue process. Debtors made stakeholders lose confidence.

Apart from the management culpability, many of the interviewees believed that the business crisis was, in most of the rescues, also attributed to the company's over expansion; these companies had borrowed too much to fund their expansion projects, and a sudden squeeze in liquidity brought down the whole company.

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[18] They were *Jinghua Trust Co. Ltd.* and *Tianting Paper Co. Ltd.* in Zhejiang.
[19] The company was *Xiaoshan International Hotel Co. Ltd. Zhejiang*.
[20] It was *Dadi Paper Co. Ltd. Zhejiang* where the reorganization plan was proposed by the debtor itself, and the absolute priority rule was bypassed in that case.
[21] Appendix 9 Question 1.

But, interestingly, the attitudes of the interviewees to the failures of these companies in reorganization seemed to be ambivalent. When the interview question 'to what extent do you think the company's failure was due to the management's dishonesty or fraud' was asked, all interviewees outright replied that they did not think that dishonesty or fraud was involved. They believed that these debtors had done their best to rehabilitate the companies before the formal rescue procedures, but failed to succeed, and that it would be unfair to say that these debtors had intended to defraud creditors, and that these failures were more likely to be mistakes. Put differently, there were still possibilities of conciliation.

B. Disbandment

The absence of the debtor, in most of the rescues, was also because the management had been disbanded prior to the formal rescue procedure. At least, in twelve out of seventeen rescue cases studied here, the company ceased trading prior to entering the formal rescue procedure; it meant, to a large extent, that the management had stopped working or had dissolved. More importantly, it was found that, as the key member of the managing team, the chief executive officer (CEO), absconded or was missing in at least ten out of these twenty reorganizations (50%). It seemed, as a result, to be impossible to rely on the former management, which had disappeared, to run the company during the rescue process.

Partly because of the absence of the old management, one administrator interviewee said that it was even a huge challenge to restore the company's business operation after he was appointed as the administrator, because nearly all key members of the former management had gone, and the chief executive manager was missing.

To be fair, the disappearance of the former management would also be occasioned by the difficulty to enter the formal rescue process at an early stage. As mentioned before, most of the rescues were filed too late. In fact, before the formal rescue, all informal rescue efforts might have been made by the debtors but failed. For instance, on 15 July 2010, *Yijiaxiang Food Co. Ltd. Hangzhou* entered into the formal rescue process; however, its debt crisis erupted as early as in October 2008; during the following period of two years, the debtor made several restructuring attempts, but eventually failed to achieve the ends.[22] The debtor

[22] Yanting Zhang, 'The Stalemate of *Yijiaxiang* Was Broken' *Qianjiang Evening News* (Hangzhou Zhejiang China, 6 September 2011, in Chinese) B3.

had rather exhausted all its rescue efforts before the formal rescue procedure started. Thus, the disappearance of the debtor might be in part because the debtor itself lost confidence in continuing the rescue efforts.

C. Changed Ownership

The overwhelming exclusion of the former management was also because of the widespread going concern sale rescues. In seventy-five per cent of the Zhejiang rescues, the rescue resorted to the going concern sale; it was the new owner who formed a new managing team to run the company; therefore the former management were deemed to be obsolete.

It was even emphasized by one interviewee that the old management would be nuisance in the new company, as many bidders concerned that their future control of the company would be undermined if the former management was still in office, especially in the light of the previous personal connection between employees and these managers; as a result, removing the old managing team was, in practice, usually a precondition for attracting business bidders.

Therefore, in most cases, the debtor was excluded from the process of rescue in Zhejiang; the main party in charge would be the court-appointed administrator.

3.2. Administrators

In thirteen out of seventeen reorganization cases studied, the administrator continued to manage the company during the reorganization procedure, and in the remaining four cases the debtor was authorized to regain control. So, in most cases, it was the administrator-in-possession approach that was in use.

A strong sign of control would be whether the administrator possessed or controlled the company's books; in response to the interview question on whether the company's books were available for the administrator to inspect, all administrator interviewees replied that the company's books and other financial and administrative records were fully under their control; thus, undoubtedly, the administrator was really at the helm.

To make the control complete, many administrator interviewees said that after the rescue filing was formally accepted by the court, the company's general stamp would be

immediately suspended, and a new administrator stamp would be made and used as the company's only official stamp to seal contracts and other legal documents from then on. One administrator interviewee indicated that, after his firm was appointed as the administrator, the company's finance office was required to answer the administrator directly, and all the company's spending had to be authorised by the administrator both in person and in writing.

Furthermore, at the core of the administrator's role in the corporate reorganization procedure might be the right to propose the reorganization plan. It was stated by most of the interviewees that the reorganization plan was mainly drafted by the administrator.[23] Some interviewees added that the main terms of the reorganization plan were in effect shaped by the intense bargaining between the company's buyer, the main creditors and the administrator.

In many of the cases, the local government also had a strong voice in making the reorganization plan, because it could provide some benefits to induce the company's purchaser to turn the company around. For example, to support the reorganization of *Nanwang Group Co. Ltd. Hangzhou* in 2008, the local government promised to buy back the debtor's three pieces of industrial land at the premium prices to improve the company's cash flow; in other words, the relevant parties, including the company buyer, might be more confident to enter into the deal to make the company afloat.[24]

Furthermore, some of the interviewees indicated that, in some cases, it was the company's buyer who determined the main terms of the reorganization plan, since the rescue task had been heavily reliant on the buyer.[25]

As noted before, there were four cases where the company was returned to the debtor, but it was still the administrator who proposed the reorganization plan in three cases. As to this phenomenon, one judge interviewee explained that the debtor in general had exhausted their rescue proposals prior to the formal rescue procedure, so technically they were unable to provide any fresh rescue initiatives to gain the confidence of the creditors; more significantly, returning the company in reorganization to the debtor was largely to invite the debtor to maintain the company's daily business operation rather than to allow them to restructure it;

[23] Appendix 9 Question 10.
[24] Li Ma, '*Jingwoniu* Crumbled and the Uncertainty Encountered by *Nanwang' Faren Magazine* (Beijing China, 23 December 2009, in Chinese).
[25] Appendix 9 Question 10.

therefore, this judge interviewee added, it had to be the administrator proposing the reorganization plan.

Thus, on the face of it, the company was returned to the former management's possession, but the key decision-making power was still in the hands of the administrator; the management was allowed to be back in their office because running the company's business operation needed the old management's experience and information.

Nevertheless, the vast majority of the rescues were firmly controlled by the administrators in Zhejiang.

3.3. Creditors

As noted above, it was predominantly the administrator at the helm of the rescue procedure. Given that creditors did not have a say towards the administrator appointment, it was highly unlikely for them to influence the rescue outcome through the administrator. In practice, the creditors seemed to be considerably passive in the rescue processes.

To assess the degree of creditors' participation in the rescue procedure, the interviewees were asked whether creditors were allowed to access and inspect the company's books in order to let them to make an informed decision when voting on the reorganization plan.

Given that the administrator was in power in nearly all rescues, the administrator interviewees were specifically asked whether they would allow an individual creditor to access or inspect the company's books. Most administrator interviewees replied that the creditors were not allowed to check the company books, let alone other financial documents.[26]

To explain why the creditors were not allowed to inspect the company's books, some of the administrator interviewees said that there had already been an audit report which disclosed and analysed the debtor's financial affairs, so it seemed to be unnecessary for the creditors to re-examine the company's books and to make a second judgement. Other administrator interviewees indicated that an individual creditor's request to verify or confirm

[26] Appendix 9 Question 9.

his own transaction with the company might be satisfied, but the demand to generally inspect all the company's books and other original financial documents would definitely be rejected, because it was a matter of commercial confidentiality.

Ironically, most of the administrator interviewees said that they had not actually received any specific requests from the creditors who had their particular intentions to examine the company books.

The company's books were assumed to one of the main sources to diagnose the company's past business conditions and to estimate whether it has a future; however, some interviewees, including one judge, suggested that it might be a waste of time for the creditors to check the company's books, because most of them were fabricated.[27] They believed that the company's books were unlikely to reflect its real business position, so, a comprehensive understanding of the company's situation could not be reached only by examining those books.

In reality, creditors faced a dilemma on whether to investigate the company by inspecting the company's books. On the one hand, the creditors were generally denied access to the company's books; on the other hand, due to various considerations, they did not take actions to realise their intentions to inspect these books. Furthermore, they would be misled by the company's books, because they were generally not reliable.

So, the only source as well as the only form of information disclosure in the corporate reorganization processes in Zhejiang was the audit report. Several creditor interviewees, however, indicated that, by reading the audit report, they could not form a comprehensive understanding regarding why the company was bankrupt, or whether the company genuinely had a future beyond reorganization, since the audit report was usually excessively skeletal, and lacked details. They very much wanted to know more detailed information about the company, but in view of the potential costs, they could not afford to take actions individually.

[27] See the widespread accounting fraud in Chinese companies generally at Gongmeng Chen and others, 'Ownership Structure, Corporate Governance, and Fraud: Evidence from China' (2006) 12 *Journal of Corporate Finance* 424.

Individual creditors were vulnerable and cost-aware; a creditors' committee was expected to fill the gap and to tackle the collective action problem.[28] It was found, however, that the creditors' committee was established in only four out of a total twenty corporate reorganization cases in Zhejiang (20%), i.e., the creditors' committee was rarely set up to represent creditors in the rescue process. Thus, creditors might be further under-represented in Zhejiang corporate reorganization cases.

In addition to debtors, administrators and creditors, another key player in the rescue process was courts.

3.4. Courts

As to the courts' role in the rescue procedure, different judges made different observations. One judge interviewee said that the corporate reorganization procedure should be, and had to be, controlled by the court, with other interested parties participating, and that the corporate bankruptcy procedure was like a litigation case where judges must control the whole process.[29] The second judge interviewee considered that the rescue case he dealt with was actually controlled by the administrator; he acted just as an adjudicator sitting in the middle. The third judge interviewee gave a moderate answer, stating that the corporate reorganization process was actually operated as a collective forum in which each individual party played its own role under the law, so it was difficult to ascertain who dominated the show.

But, given that the court had the exclusive power in appointing the administrator[30] as well as in determining the administrator's fees,[31] the administrator might show considerable deference to the court in reality. Even one eminent corporate lawyer in Zhejiang once

[28] See generally Dan M Kahan, 'Trust, Collective Action, and Law' (2001) 81 *Boston University Law Review* 333.
[29] Appendix 9 Question 18 Judge 3.
[30] Article 22 of the EBL 2006.
[31] Article 1 of China's Supreme People's Court Judicial Regulation on Administrator Fees 2007.

publicly argued that the administrator should act as an assistant of the judge in corporate bankruptcies.[32]

In a nutshell, the corporate reorganization processes in Zhejiang were mainly controlled by the administrators who in turn answered to the judges.

4. VALUE DISTRIBUTION IN ZHEJIANG RESCUES

In all sixteen successfully completed reorganizations in Zhejiang, secured and preferential creditors were paid in full, and unsecured creditors, as noted earlier, recovered thirty-six per cent of their original claims on average. In two cases, unsecured creditors were paid in full, though the payments were made in instalments. The lowest recovery rates for unsecured creditors happened in the reorganization of *Jiande Special Steel Co. Ltd.* in 2010 where they were only paid at 4.625 per cent.

By and large, the corporate reorganization regime preserved the companies' going-concern value, as it at least prevented these companies from being piecemeal liquidated; the continuity of the company business itself avoided the chain reaction which might put the company's business partners at jeopardy.

The strength of the corporate rescue regime, however, cannot be exaggerated. In the case of too low a recovery rate for unsecured creditors, a chain reaction was still followed. For example, in the reorganization of *Jiande Special Steel Co. Ltd.* as noted above, because of the very low recovery rate at only 4.625 per cent, one of the company's suppliers, *Quhua Logistics Co. Ltd. Zhejiang*, was declared bankrupt shortly afterwards.[33] In other words, the ripple effect still ensued, though a corporate reorganization effort was made.

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[32] See Y Wang, 'Mr Chen Gave a Speech in the Seminar Concerning the Role of Administrators in Shaoxing' (Hangzhou Zhejiang China, 19 September 2011, in Chinese) <http://wqjhlawyer.zfwlxt.com/newlssite/BlogShow.aspx?itemTypeID=53176ddc-94f7-4943-884d-9f0100cbe847&itemID=12563dc3-7d1a-4c9b-a18e-9f62017243e3&user=9898> accessed 16 October 2012.

[33] Zhiling Wang, '*Quhua Group*'s Fiasco in the Reorganization of *Jiande Special Steel' 21st Century Business News* (Beijing China, 4 August 2011, in Chinese) <http://www.21cbh.com/HTML/2011-8-4/2MMDcyXzM1NTE2MQ.html> accessed 18 October 2012.

As a whole, the rescue regime in Zhejiang functioned well in preserving the going-concern value of financially troubled companies. Preserving their value was just the first step; the next step was to distribute it to relevant parties in a fair and equitable way.

4.1. The Absolute Priority Principle

Although China's lawmakers intended to give flexibility to the application of the absolute priority principle in corporate reorganizations,[34] it seemed that there was a lack of understanding among many practitioners on this matter.

In the sixteen completed corporate reorganizations in Zhejiang, it was found there were two cases in which the absolute priority principle was bypassed, and in the remaining fourteen cases this principle was stringently applied. They tended to go to extremes, and the flexibility of this principle embedded in the EBL 2006 appeared not to be fully understood and exploited.

The application of this principle was polarized. In the two deviation cases, the shareholders' equity remained intact, whereas unsecured creditors had to accept a sharp reduction of their debts (in the first case, unsecured debts were cut to 25.35 per cent, and in the second to 15 per cent).[35] In the remaining fourteen cases, by contrast, the absolute priority principle was rigorously adhered to, as all previous shares were cancelled in the reorganization plans. It appeared that there was no middle way or flexibility in applying the absolute priority principle in Zhejiang.

The first deviation case was *Haina Technology Co. Ltd. Zhejiang*, a listed company, in 2007. As noted in the previous chapter, it was the special decree of China's Supreme People's Court to reserve equity for general public shareholders in listed companies'

[34] Article 87 of the EBL 2006.

[35] The unsecured creditors recovered at 25.35 per cent in the reorganization of *Haina Technology Co. Ltd.*, and the unsecured creditors recouped at 15 per cent in the reorganization of *Dadi Paper Co. Ltd*.

reorganizations;[36] therefore, it seemed there was no room left for unsecured creditors to raise objections to the deviation.

The second deviation case took place in Fuyang, Zhejiang in 2009 where the debtor company, *Dadi Paper Co. Ltd*., was managed by the old shareholder-managers; this was the only real debtor-in-possession case, and the reorganization plan was also initiated by the shareholder-managers. The deviation from the absolute priority principle in this case might directly result from the debtor's firm control. Interestingly, in this case, there was no reported objection raised by unsecured creditors to the deviation, although unsecured debts were reduced to fifteen per cent of their pre-bankruptcy claims.

But, one fact should be addressed here. In the reorganization plan of these two deviation cases, although the old shareholders' equity remained untouched, there was no description on how to deal with the company's ownership. Put differently, creditors were not told that the reorganization of the company was made entirely at the expense of them, and that the shareholders survived the crisis without paying any costs. For the sake of transparency, it seemed that the reorganization plan should mention the ownership arrangement in the reorganization plan.

In other cases, it appeared that the sanctity of the absolute priority principle was entirely honoured. Thus, generally speaking, the departure from the absolute priority rule seemed to be the exception rather than the norm in Zhejiang corporate reorganizations, which was different from the national picture presented in the previous chapter.

When asked whether it was appropriate to somehow depart from the absolute priority rule by offering some equity to the shareholder-managers in exchange for the latter's continued service in the new company, the interviewees[37] gave mixed responses.

Some of the administrator interviewees indicated that it seemed unnecessary to deviate from the absolute priority norm on the grounds that, in many of the cases, former equity-managers had left the company prior to the commencement of the corporate reorganization

[36] Xiaoming Song, 'The Court's Role in the Proceedings of Enterprise Bankruptcy and Restructuring and the Problems That Need to be Solved' (The Forum for Asian Insolvency Reform, April 2006 Beijing China) <http://www.oecd.org/china/38184314.pdf> accessed 02 October 2012.

[37] Appendix 9 Question 19.

proceeding; in other words, the possible beneficiaries of the deviation had walked away. This was true. It was widespread for the bosses of bankrupt companies to abscond not only in Zhejiang[38] but also in China nationally[39] before their businesses collapsed.[40]

In the meantime, as was told by other administrator interviewees, because of the prevalence of the going concern sale rescue in Zhejiang, it was highly unlikely for the new owner to retain their predecessors in office. Some interviewees commented that the new owner tended to remove all members of the previous boardroom so as to clear way for full control, let alone give some equity to the former owners.

But, some interviewees suggested that the old equity-managers might be motivated to join the rescue process and to contribute their information and expertise if they could be given some equity in the new company by deviating from the absolute priority rule. One creditor interviewee addressed that it would be desirable to give the old equity-manager some employee shares under a kind of the share-incentive-scheme in the new company; otherwise, the old equity-manager did not have any economic incentive to continue to serve the new company. This interviewee added that deviating from absolute priority would be needed especially in the case where there were no business buyers, and under such circumstances, the involvement of the old equity-manager seemed to be crucial for the company's continued existence.

Inviting the former equity-managers to join the rescue process in some cases seemed to be quite necessary. One judge interviewee gave an example:[41] in the rescue case he handled, the court and the administrator desperately needed the collaboration of the former chief manager of the company, who was also the controlling shareholder, because he was the only person who knew the company's key business information; but that manager was detained by

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[38] See the widespread failed businessmen absconding in Zhejiang at Yu Ran, 'Neither a Borrower nor a Lender Be' *Xinhua Net* (Beijing, China, 17 October 2011) (reporting the pervasive businessmen absconding in Wenzhou Zhejiang China) <http://news.xinhuanet.com/english2010/china/2011-10/17/c_131195527.htm> accessed 18 October 2012.

[39] Chunlai Yu, 'The Steel Businessman, Zhiqiang Chen, Absconded, Causing the Financial Chain Reaction in Tangshan' *Daily Business News* (Beijing China, 14 August 2012, in Chinese) (reporting a multibillionaire who absconded because of his steel company's collapse in Tangshan, Hebei, China) <http://www.nbd.com.cn/articles/2012-08-14/674056.html> accessed 19 October 2012.

[40] In England, it is a criminal offence for the bankrupt including a bankrupt company's director to abscond during or before the bankruptcy process. It seems that China should be advised to criminalize it in the near future. See Insolvency Act 1986 s 158.

[41] Appendix 9 Question 19 Judge 3.

police at that time, and the whole rescue process was made far more complicated due to his absence. But, one critical problem might be overlooked by this judge interviewee. If that manager had been really available before the court and the administrator, in anticipation of the application of the absolute priority principle, which meant that nothing would be left for him, would he have incentives to fully cooperate and disclose all information to them?

In sum, it seemed that most interviewees were not fully aware of the usefulness of the flexibility of absolute priority in rescues. Obviously, the lack of training practitioners, including judges and insolvency practitioners, should be addressed in the foreseeable future.

4.2. The *Pari Passu* Principle

In all sixteen completed corporate reorganizations in Zhejiang, the *pari passu* principle was rigorously applied, which differed from the national practice that was presented in the previous chapter. At the national level, relaxing this principle predominantly occurred in listed company reorganizations; it happened far less frequently in non-listed company rescues.

Given that there was only one listed company reorganization case in Zhejiang, the strict application of the *pari passu* principle seemed to be consistent with the national practice on non-listed company reorganizations.

In a word, the absolute priority and *pari passu* principles were largely conformed to in Zhejiang corporate reorganizations, probably because of Zhejiang's overwhelming market-driven economy.

5. REORGANIZATION PLAN CONFIRMATION IN ZHEJIANG

As has been known, there are two different procedures used by the courts to confirm a reorganization plan: one is the normal confirmation procedure, and the second is the cram-down procedure. This Part reports the findings on these two confirmation procedures.

5.1. Normal Confirmation

In the majority of the corporate reorganizations in Zhejiang, the reorganization plan was accepted by all classes of impaired parties, so it was subject to the normal court confirmation procedure under Article 86 of the EBL 2006. But, the problem is that Article 86 is vague, without specifying what criteria could be used by the court to assess the reorganization plan.

To investigate whether courts have created their own practical criteria in confirming reorganization plans, three judge interviewees were asked whether there were some specific principles that the courts used in confirming the reorganization plans. They gave a quite evasive answer – they only assessed the legality of the reorganization plan. But the concept of legality was still too general to grasp; they were asked to clarify it. It seemed to be embarrassing, as they could not provide the defining answers regarding to how to assess the reorganization plan.

With the first question unsatisfied, the interview question moved to ask them whether the court assessed the feasibility of the reorganization plan.

One judge interviewee gave a straightforward answer: the court was unable to evaluate whether the reorganization plan was feasible because it was a commercial judgement that was beyond judges' capabilities. Other two judge interviewees responded that they did not need to assess the feasibility of the reorganization plan, because this issue had been considered by local government business development department. In particular, these two judge interviewees mentioned that when seeking the company's buyers, the government had considered whether the buyer was financially and technically capable to turn the company around. So, the feasibility of the reorganization plan was already evaluated by the government when selecting the company's buyer. Nevertheless, the courts did not assess the feasibility of the reorganization plans.

Clearly, it could be safe to say that there were no substantial criteria used by the courts to assess the reorganization plans when the plans were confirmed. Confirming the reorganization plans was rather a formality in Zhejiang courts.

5.2. Cram-Down Confirmation

On 15 December 2011, the Zhejiang Corporate Reorganization Report 2011 was released by Zhejiang's Supreme People's Court, which stated that the courts in Zhejiang had ever used the cram-down to force impaired parties to accept the corporate reorganization plans.[42] But, a closer investigation found that this assertion was not entirely true.

It was found that the cram-down had been issued by the court in at least[43] six out of all sixteen corporate reorganizations (37.5%) that had been completed before the deadline of this thesis' data collection in Zhejiang. And, it was shareholders rather than creditors who bore the brunt of the cram-downs in these six reorganizations.

Given that the company in reorganization was already insolvent, arguably, it was equitable to cancel all old shares in the reorganization plan. In response to the cancellation of old shares, however, some shareholders, especially the shareholder-managers, either refused to attend the meeting to vote on the reorganization plan whereby their shares were entirely cancelled,[44] or neglect to cooperate, at the last stage, to convey the company's ownership to the company buyer.[45] To tackle the refusal of the shareholders to corporate, the court had, usually on the request of the administrator, to issue a special ruling, forcibly transferring the company's ownership to the buyer, thus a cram-down was generated.

Zhejiang's Supreme People's Court was quite hesitant about recognising the cram-downs, because it knew that it was not business friendly if the courts frequently used the cram-down to force impaired parties to accept reorganization plans. For some courts, they even tended not to invoke Article 87 of the EBL 2006, the cram-down provision, when there was a real cram-down sanctioned.

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[42] Zhejiang's Supreme People's Court, 'Zhejiang Corporate Reorganization Report 2011' (Hangzhou Zhejiang China, 15 November 2012, in Chinese) <http://www.zjcourt.cn/content/20060320000023/20111115000011.html> accessed 16 October 2012.

[43] In fact, there might be more cram-downs against shareholders in practice. Like Zhejiang's Supreme People's Court, however, many courts tend to hide cram-downs to avoid the embarrassing image that may harm local business investment reputation.

[44] For example, the shareholder-managers of *Jiande Special Steel Co. Ltd.* refused to attend the meeting voting on the reorganization plan. See Xiaoming Chen, 'The Minutes of Xingyun Law Firm Acting as the Administrator in Reorganization of *Jiande Special Steel Co. Ltd*.' (Hangzhou Zhejiang China, 22 June 2011, in Chinese) <http://www.xingyunlawyer.com/showshop.asp?id=195> accessed 14 October 2012.

[45] For example, the court had to issue a special ruling transferring the ownership of the company to the buyer after the former shareholders declined to cooperate in the reorganization of *Zonghen Group Co. Ltd.* Email from Jiang Feng to the author (16 February 2012).

This was the case in the reorganization of *Jinghua Trust Co. Ltd. Zhejiang*. In *Jinhua* case, although the old shareholders were impaired by the reorganization plan wherein all shares were required to be sold to the company buyer at the local government-set price of RMB 1 per share, the old shareholders were not even given the right to vote on the reorganization plan.[46] Strictly speaking, the court's confirmation of the reorganization plan in this case was a cram-down, but the court used Article 86, the normal confirmation provision, rather than Article 87, the cram-down provision, of the EBL 2006 to confirm the reorganization plan; in other words, the genuine cram-down was disguised.

In the reorganization of *Jiande Special Steel Co. Ltd.* where the court, however, specifically applied Article 87 of the EBL 2006, the cram-down provision, to force the shareholders to accept the reorganization plan, because the latter refused to attend the meeting to vote.[47] Obviously, this cram-down was neglected by Zhejiang's Supreme People's Courts in its above report.

Given that most of the *de facto* cram-downs occurred in the wake of the reorganization plan confirmation, it was rare for Zhejiang courts to directly use Article 87 of the EBL 2006, the cram-down provision, to confirm the reorganization plans. For example, in the aforementioned reorganization of *Jinghua Trust Co. Ltd.* where the court confirmed the plan by citing Article 86 of the EBL 2006, a normal approval procedure, in spite of the fact that it was essentially a cram-down.[48]

As for issuing a cram-down, in theory, a set of tests enshrined in the EBL 2006 must be each passed by the court; however, in reality, with a very brief statement that the plan was fair and equitable and feasible, a cram-down was issued by the court, without giving any details as to how and why the court reached this conclusion.

In brief, in the normal reorganization plan confirmation procedure, there were no clear criteria applied by the courts to assess the legality of the reorganization plans. And in the

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[46] Jinghua Intermediate People's Court, 'Civil Procedural Ruling' (Jinghua Zhejiang China, 22 December 2012, in Chinese) (confirming the reorganization plan which adjusted the old shares although there were not shareholders' votes on the plan).

[47] Jiande Lower People's Court, 'The Public Notice of Approving the Reorganization Plan of *Jiande Special Steel Co. Ltd*.' *People's Court Daily* (Beijing China, 31 May 2011, in Chinese) 6.

[48] Jinghua Intermediate People's Court, 'The Public Notice of Approving the Reorganization Plan of *Jinghua Trust Co. Ltd*.' *People's Court Daily* (Beijing China, 5 January 2010, in Chinese) 6.

cram-down confirmation procedure, overwhelmingly, it was shareholders who were forced to accept the reorganization plans, and the courts tended not to give a detailed explanation on how the statutory tests had been passed.

6. CONCLUSIONS

By comparison with most other provinces, Zhejiang did fare better in using the new corporate rescue regime to rehabilitate local troubled companies, but there were still many difficulties and challenges arising in practice. Some key points of the findings are summarised as follows.

As to the relatively small number of corporate rescue cases, the almost insurmountable entry to the rescue procedure might be attributed to many factors. Because of the very weak political status of the judicial sectors, Zhejiang courts were considerably wary of accepting bankruptcy rescue filings, and they treated the corporate bankruptcy case as a quagmire; troubled debtors loathed the formal rescue procedure for fear of losing control; disgruntled creditors were unable to get a hand from the government to trigger a bankruptcy rescue process.

The debtors' fear of losing control was clearly vindicated by the manager-displacement model in most of the corporate rescues in Zhejiang. More importantly, even where the business was formally returned to the debtor, the administrator still retained the crucial powers in rescues, as it was usually the latter who drafted the reorganization plan. Furthermore, the debtor could be totally wiped out in value distribution plans, since in the vast majority of the cases (except the listed company reorganizations), the stringent application of the absolute priority principle meant that nothing would be left for the equity-holders and especially the equity-managers.

With regard to the reorganization plan confirmation, it was found there were not specific criteria used by the courts in Zhejiang to assess the reorganization plans when these plans were submitted for confirmation. Confirming the reorganization plans by the courts was more a waste of time, and caused delays in the corporate reorganization procedures.

So far, both the quantitative and qualitative data on the implementation of China's corporate rescue law has been presented. The next two chapters will discuss these findings and propose some suggestions to improve the new corporate rescue regime in China.

CHAPTER 7

COMMENCEMENT AND CONTROL OF CHINESE CORPORATE REORGANIZATIONS

1. INTRODUCTION

The previous two chapters have presented the data on the implementation of China's new corporate rescue law. Chapter 5 used quantitative research methods to collect a series of figures, providing a review of the rescue law enforcement in China nationally. Chapter 6 applied qualitative research methods by interviewing corporate rescue participants to gain an understanding regarding the behaviours and concerns of interested parties in rescues in Zhejiang, a province of China.

From the findings presented in the two last chapters, as for the first research question regarding the use of the new corporate rescue law in China, it has been found there were a small number of companies that entered the formal rescue process after the EBL 2006 took effect, i.e., the new corporate law was not frequently used. And the Zhejiang study more closely examined the obstacles that impeded the enforcement of the new rescue regime. Several practical obstacles were identified: the courts hesitated to accept corporate rescue filings due to a lack of judicial independence as well as the oversimplification of the EBL 2006; troubled debtors distanced themselves from the formal rescue procedure because of the prevalence of the administrator-in-possession model and the rigorous application of the absolute priority principle (except in listed company rescues); creditors were unable to use the threat of liquidation to pressure debtors to take early rescue actions in court.

With regard to the second research question of this thesis on control in China's formal corporate rescues, it was found that in the majority (74%) of the existing corporate rescues in China the administrator-in-possession approach was used, i.e., debtors were virtually removed from the formal rescue processes. Several factors which led to the wide use of the administrator-in-possession approach were identified by the Zhejiang study. Most of the formal rescues were filed too late, and the troubled company was in fact abandoned by the debtor, especially by the controlling shareholder-manager; as a result, it was impractical to apply the debtor-in-possession approach. Meanwhile, eighty-four per cent of the existing

rescues in China used the going-concern sale to turn troubled companies around; namely, the debtor was not needed because the new company would be entirely operated and managed by the new owner, and even the Zhejiang study indicated that the old management was often deemed to be a nuisance in the eyes of the company buyers, because the former was suspected to be a threat to the latter's prospective full control of the new company.

As for the third research question on value distribution in the rescues, the national findings presented in chapter 5 demonstrated the striking contrast between listed and non-listed company reorganizations. In listed company reorganizations, there was the routine deviation from the absolute priority principle, which was authorized by China's Supreme People's Court before the enactment of the EBL 2006; also, the *pari passu* principle was relaxed in forty-three per cent of listed company reorganizations. By contrast, in non-listed company reorganizations, these two basic value distribution principles were applied in almost ninety per cent of cases.

In the Zhejiang study, it was found that many debtors, especially their controlling equity-managers, had left or absconded before the formal rescues started; thus it was unnecessary for the administrators to consider rewarding them by relaxing the absolute priority principle in exchange for their continued service in the new companies. More importantly, partly because the reorganization process was operated in the shadow of the liquidation process, both the absolute priority and *pari passu* principles were largely applied in non-listed company reorganzations in China, although it should be noted that listed company reorganizations were the exception over value distribution because of excessive government intervention.

As for the final research question regarding the court confirmation of the reorganization plans, in chapter 5, it was found that all reorganization plans were confirmed. Confirmation was likely to be guaranteed. More notably, the courts confirmed the reorganization plans very quickly, and in most cases it took only several days for the reorganization plan to get judicial confirmation. Serious concerns, however, were raised regarding how courts assessed the reorganization plans, especially when a cram-down was considered and issued. It was found that many courts in China failed to apply the fair and equity test when deciding to issue the cram-down, and the Zhejiang study indicated that courts generally did not, and did not have the capacity to, conduct the feasibility test. The less developed rule of law in China made the courts quite vulnerable to governmental intervention; thus confirming a reorganization plan in which the local government was deeply involved was largely a formality for the courts.

With these findings reported in the past two chapters, this chapter will use them to discuss the first two research questions on commencement and control of corporate reorganization procedures in China. Accordingly, the remainder of this chapter is arranged into two parts: (i) Part 2 concentrates on analysing the problems impeding entry into the corporate reorganization procedure, and (ii) Part 3 discusses the current control models in the existing corporate rescues. In the conclusion, some policy reform will be suggested.

2. ENTRY CHALLENGES

Shortly after the promulgation of the EBL 2006, Prof. Li Shuguang, a leading Chinese insolvency scholar, expressed his concern that the EBL 2006 itself may be bankrupt - be shelved - if the courts turn their backs on corporate bankruptcy filings.[1] Given the small number of bankruptcy reorganization and liquidation cases in China, as reported in the previous chapters, it would be an exaggeration to say that the EBL 2006 itself has been totally shelved, but at least the EBL 2006 was not well enforced. This was largely because courts were unwilling to accept corporate reorganization filings. This section begins by analysing the difficulties of courts in handling corporate bankruptcy rescues; this is followed by a discussion of the concerns of debtors and creditors when they seek a corporate rescue solution.

2.1. Establishing Court Confidence

As noted before, there were a small number of corporate reorganization cases after the EBL 2006 took effect, partly because courts had much hesitation in accepting corporate reorganization petitions. Before discussing how to alleviate such hesitation, one fundamental question should be asked: what specific roles should a court plays in a formal corporate bankruptcy procedure? This is because much hesitation of the court appears to be caused by their deep involvement in the corporate bankruptcy procedures.

[1] Shuguang Li, 'Reform of the Court' Role in Corporate Bankruptcy' (2007) 6 *Shanghai State Property* (in Chinese) 54, 55.

Generally speaking, in most jurisdictions, the corporate bankruptcy process is supervised by court. In recent decades, however, it has been increasingly recognized that the role of the court in the corporate bankruptcy procedure should be confined to only adjudicating disputes arising from the bankruptcy procedure, and that the courts should be freed from managing the company in bankruptcy.[2] Judges are arbiters rather than managers in the corporate bankruptcy procedure. The company in bankruptcy should be managed by the trustee or the like, because the danger here is that, if the judges are deeply involved in managing the bankrupt company, their impartiality will be undermined. To this end, for example, in the UK, usually it is an insolvency practitioner who will be appointed as the liquidator or the administrator to manage the company in bankruptcy; in the US, in most bankruptcy procedures, this job is done by a trustee.

As for the role of judges in handling the corporate bankruptcy matters, it seems that experience abroad should be learned by China, since its EBL 2006 established, on the contrary, excessive control of judges over detailed bankruptcy issues. Chinese judges are required to micromanage many administrative affairs in bankruptcy, and apparently many duties and powers of judges are unjustifiable and unnecessary. For example, under Article 62 of the EBL 2006, the first meeting of creditors must be summoned by the court, and Article 84 stipulates that the creditors' meeting to vote on the reorganization plan should also be exclusively convened by the court. In fact, nearly all issues in the corporate bankruptcy procedure should obtain the permission of the judges. Judges are rather overwhelmed, and this is one of the key reasons why Chinese judges are unwilling to accept and to deal with corporate bankruptcy affaires.[3]

Thus, it seems that China's policy-makers need to rethink what roles judges should play in corporate bankruptcy procedures in China. It is essential that there be a fundamental change. Judges are to hear disputes arising from bankruptcy, and all administrative issues should be dealt with and managed by appointed administrators. Without reducing the onerous burden of judges in corporate bankruptcy procedures, it will be considerably difficult to solve

[2] Vanessa Finch, 'Control and Co-ordination in Corporate Rescue' (2005) 25 *Legal Studies* 374, 396. See also Harvey R Miller, 'The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judges as Producer, Director, and Sometimes Star of the Reorganization Passion Play' (1995) 69 *American Bankruptcy Law Journal* 431.

[3] Some judges defended their powers in corporate bankruptcy in China. See Huiyan Bi, 'The Role of Judge in Corporate Reorganization' (2009) 25 *Shandong Justice* 68 (in Chinese) (defending judge dominance in corporate rescue).

the following problems that are currently undercutting courts' willingness to accept corporate rescue petitions.

A. The Lack of Judicial Independence

Corporate bankruptcy issues are commercial in nature rather than politically-sensitive. Chinese courts are assumed to be competent to accept and handle them in the same way as they manage other commercial and civil cases. One character of the corporate bankruptcy case, however, transforms it into a politically-sensitive case: the bankruptcy case always involves a large number of people, who are employees, creditors, shareholders, or a combination of them.[4]

At present, in China, courts and judges are quite wary of a large number of people before them. Quite often, such groups could either gather before the court to protest collectively, or assemble before the local government to voice their grievances if they feel dissatisfied with the court's service. Such protests are euphemised as mass incidents or mass petitions in China. In the current political context in China, both the court and the judges worry about the occurrence of such protests, because the court leaders and the judges in charge would be negatively assessed, disciplined, or even prosecuted by the local government or the local Communist Party committee in the event of such protests happening.[5] Chinese authorities are excessively concerned with the maintenance of social stability for fear of that any small-scale social protests may spread and lead to regional and even national unrest. [6]

Thus, to a large extent, accepting a corporate reorganization filing means that the court is steering itself into trouble because of potential protests. Realistically, to avoid such a trouble,

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[4] See Xingxing Wang and Zhenyou Yi, *China Bankruptcy Forum* vol 3 (Law Press 2009) (in Chinese) 430. See also Susan L Shirk, *China Fragile Superpower* (Oxford University Press 2007). See also Su Yang and Xin He, 'Street as Courtroom: State Accommodation of Labor Protest in South China' (2010) 44 *Law & Society Review* 157.

[5] Carl F Minzner, 'Riots and Cover-ups: Counterproductive Control of Local Agents in China' (2009) 31 *University of Pennsylvania Journal of International Law* 54 (arguing that it is the political responsibility valuation system that hinders the rule of law in China). See also the author's other articles in this area, 'Xinfang: An Alternative to Formal Chinese Legal Institutions' (2006) 42 *Stanford Journal of International Law* 103, and 'China's Turn Against Law' (2011) 59 *The American Journal of Comparative Law* 935. And Thomas Lum, 'Social Unrest in China' (Washington DC: Congressional Research Service, 8 May 2006).

[6] It was reported that after 2010 China spent more on the social stability than on the military service. See Ben Blanchard and John Ruwitch, 'China Hikes Defence Budget, to Spend More on Internal Security' *Reuters* (Beijing China, 5 May 2013) <http://www.reuters.com/article/2013/03/05/us-china-parliament-defence-idUSBRE92403620130305> accessed 20 June 2013.

it seems to be a tactic for most Chinese courts to distance themselves from handling this type of cases that involves a huge number of individuals.

Even this tactic has been formalised in China. In 2004, for example, the vice president of China's Supreme People's Court, Mr Cao Jianming, warned in a national conference attended by all provincial supreme court presidents that law courts had to be very careful when handling legal disputes that involved a huge number of individuals. The tone of Cao's speech was clear: the fewer this type of cases accepted, the safer the courts would be.[7]

The clearer evidence is that in 2004 one provincial court, the Guangxi Supreme People's Court, issued a formal notice according to which the courts in that province were not allowed to accept any cases that would involve a large number of peoples.[8]

Obviously, it is not only corporate reorganization petitions but also a whole category of cases in which Chinese courts try to avoid becoming embroiled. On the face of it, this tactic for courts or judges is a self-protection measure; in essence, it is because of the lack of judicial independence that makes courts quite cautious. An independent judicial system still, however, has a long way to go in China, and it could not be achieved overnight.

B. Government Cooperation

The lack of government support may further undermine courts' willingness to accept corporate reorganization filings.

Under the old corporate bankruptcy regime enshrined in the EBL 1986, court acceptance of a corporate bankruptcy petition was conditional upon the permission of the local government;[9] however, this has radically changed by the EBL 2006. At present, the prior consent of the government is not a prerequisite for a corporate bankruptcy procedure to commence in court, but the court needs the explicit support of the government as a condition

[7] Yu Tian, 'The Supreme Court Requires All Courts to be Prudent in Handling Cases Involving Many Individuals' *Xinhua News* (Beijing China, 20 December 2004, in Chinese) <http://news.xinhuanet.com/zhengfu/2004-12/20/content_2356613.htm> accessed 20 June 2013.

[8] Changping Luo, 'The Guangxi Supreme People's Court Prohibits Courts from Hearing Thirteen Categories of Cases' *The Beijing News* (Beijing China, 12 August 2004, in Chinese) <http://www.china.com.cn/chinese/law/633142.htm> accessed 20 June 2013.

[9] Xianchu Zhang and Charles D Booth, 'Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience' (2001) 15 *Columbia Journal of Asian Law* 1, 8.

to decide whether to accept a corporate bankruptcy petition.[10] Without local governments' promises to support, it is very difficult for the court to progress corporate bankruptcy issues alone.

On closer examination, it has been found that much government support that the court needs is because of the oversimplification of the EBL 2006. On the one hand, the EBL 2006 is still too simple, lacking details for both courts and other interested parties to use to solve practical issues. On the other hand, the EBL 2006 has not been fully aligned with other statutes, and some conflicts between the EBL 2006 and other statutes will lead to the deadlock of the corporate bankruptcy procedure.

For example, as mentioned before, the tax authorities will refuse to provide tax-approved receipts to the debtor company, if there is overdue tax payment; the tax authorities' refusal is right and lawful.[11] Under China's current tax law, without tax-approved receipts, the debtor's continued trading will be disrupted or even be halted, as customers can legally refuse to pay the bills.[12] In spite of the fact that the continuity of trading is of importance in preserving the company's going concern value, the EBL 2006 is too skeletal to provide a solution which could coordinate with tax authorities to tackle this predicament. In reality, when such a deadlock arises, it seems insurmountable for the administrator, usually a lawyer or an accountant, to persuade local tax authorities to give exemption; instead, the court has to use its own political influence to ask for exception.[13] Sometimes, even the court will face the uncertainty regarding whether such exemption is available. In practice, many other similar predicaments trouble both judges and administrators.

Such difficulties would be symptomatic of the lack of government support; however, the real cause is likely to be a lack of specific and precise rules in the bankruptcy law.

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[10] Even sometimes, a court may reject a corporate rescue filing on the basis that there is no government support. For example, it is the case in the reorganization filing of *East Star Airlines Co. Ltd., Hubei.* See Qianshan Xu and Xinyin Wu, 'The Effort to Reorganize *East Star Airlines* is Terminated, and its Sudden Collapse Worries a Lot' *Yangtze Daily* (Wuhan Hubei China, 27 August 2009, in Chinese) <http://www.cannews.com.cn/2009/0827/9569.html> accessed 24 November 2012

[11] The China State Administration of Taxation, 'Unpaid Taxation Regulation' (Beijing China, 7 June 2004, in Chinese) (stating that a company with unpaid tax will be restricted in applying for further tax-approved receipts).

[12] Article 21 of the China Tax Collection Law 2001.

[13] See Pujiang Lower People's Court, Zhejiang, 'The Experience in Hearing Corporate Reorganization of *Tianting Paper Co. Ltd*' (Pujiang Zhejiang China) (the photocopied report was, in January 2012, given to the author by Lou Rongbing, an accountant involved in the reorganization of *Tianting Paper Co. Ltd.*)

C. Manpower of Courts

Many of China's courts are understaffed, especially at local levels, and are unable to cope with corporate reorganization, a kind of new businesses. A typical understaffing example is the Hangzhou Intermediate People's Court, Zhejiang province. According to an official report of the Court in 2009, during the past three decades, the annual number of cases filed in the Court increased eighteen times, whereas the number of judges only doubled.

In addition to understaffing, most courts are also short of judges specialising in corporate bankruptcy.

The lack of experience of judges is quite predictable, because there are no sufficient cases for judges to practise. For example, in Zhejiang although there are 103 courts that are liable to handle corporate reorganizations,[14] twenty corporate reorganization cases during the past five years mean that the vast majority of courts in Zhejiang have never handled corporate reorganizations. To some extent, a vicious circle ensues: the lack of experience makes judges quite cautious to accept corporate reorganization filings, and in turn the shortage of practice further undermines judges' confidence to hear such cases.

To build the court's confidence in accepting corporate reorganization filings, some local experience may be worth introducing. For example, in Hangzhou, the capital city of Zhejiang Province, the local Hangzhou Intermediate People's Court persuaded the city's Communist Party Committee to establish an interim panel at city level. This panel was led by the Party Committee and was comprised of several key government departments, such as the departments of business, tax, police, labour and land, etc. It was this panel that assisted the court to deal with all corporate reorganization cases. It was said that this approach effectively solved two main problems: concerns of judicial independence and the lack of government support.[15] This could be a pragmatic solution in the short term.

As to the lack of manpower and expertise of courts, there might be two ways forward. First, there should be special training courses tailored for judges; confidence comes from

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[14] Zhejiang's Supreme People's Court, 'An Introduction of Zhejiang's Supreme People's Court' (Hangzhou Zhejiang China, in Chinese) (stating that there are 103 courts at all levels in Zhejiang) <http://www.zjcourt.cn/20060320000004/> accessed 24 November 2012.

[15] The Hangzhou Intermediate People's Court, 'Report on Handling Corporate Reorganization Cases' (Hangzhou Zhejiang China, 5 January 2010, in Chinese).

knowledge. Second, and the foremost, judges should be freed from dealing with managerial issues of the corporate bankruptcies, and these issues should be handed over to administrators; this, as discussed above, requires a substantial amendment of the EBL 2006.

2.2. Inducing Debtors

Presumably, entering corporate reorganization would be a powerful lever for a debtor to keep creditors at bay, as the latter's claims will be stayed if a formal court-supervised corporate reorganization procedure begins. This means that any destructive debt enforcement or liquidation initiatives by creditors will be suspended; however, as reported, troubled companies in China try to avoid entering into the formal rescue procedure instead.

A. The Fear for Automatic Resignation

In theory, the debtor can regain control from the administrator under the court permission during the reorganization procedure, but, in practice, it is highly unlikely for this to happen. In particular, at the national level, seventy-four per cent of China's corporate reorganizations were under the control of the administrators. Bearing in mind that the reorganization plan was in fact proposed by the administrator in some cases where the control had been superficially returned, the debtors have been overwhelmingly excluded from the existing corporate rescues in China. In other words, the debtors' fear regarding losing control in the formal rescues almost became a degree of certainty.

With immediate resignation ahead, it seems to be optimal for debtors to postpone formal rescue filings until the company businesses deteriorate beyond the point of no return. The most recent report by Zhejiang's Supreme People's Court on corporate bankruptcy disclosed that many failed companies' CEOs still, in late 2012, chose to abscond rather than to seek bankruptcy protection in court, although the EBL 2006 had been in force for over five years.[16] One key point, however, was missed by this report: the indifference of debtors towards the formal rescue procedure was also attributed to the overwhelming administrator-in-possession in formal rescues, which means filing for reorganization was, from the debtors' perspective, not protection but a suicidal attempt.

[16] Zhejiang's Supreme People's Court, 'Report on Zhejiang Court Corporate Bankruptcy Service 2012' (Hangzhou Zhejiang China, 6 May 2013, in Chinese).

As to whether the debtor should be replaced by an outside administrator in the formal rescue procedure, experiences learned from the US and the UK may be useful for China to enhance the understanding of the value of the debtor-in-possession model.

In the US, prior to the Bankruptcy Code of 1978, there were, under the Chandler Act, two options of control in formal corporate rescue procedures: Chapter X for large companies where the management would be automatically replaced by an outside trustee, and Chapter XI for small and medium companies where the debtor could stay in control without appointing an outside trustee.[17] In reality, however, it was a different story.

To remain in charge, most large companies filed for Chapter XI instead of Chapter X to seek survival, because in Chapter XI they could maintain their own control.[18] In particular, one empirical study revealed that there were less than ten per cent of corporate reorganizations in the US that resorted to Chapter XI for reorganization under the Chandler Act; namely, most debtors tried to avoid automatic resignation in Chapter Xs. Of course, not all large corporations could get the extra blessing of courts to enter Chapter XI in order to use the debtor-in-possession, as a result of which corporate reorganization filings for large corporations dropped sharply after the Chandler Act took effect.

In the light of such hesitation by large companies to use management-displacement Chapter X, the reform was needed, and eventually the Bankruptcy Code of 1978 virtually[19] abolished Chapter X. Under the new Chapter 11 of the Bankruptcy Code of 1978, it is the norm rather than the exception for a debtor to stay in control during the formal reorganization proceedings, whether the debtor is large or small.[20] This is the US popular debtor-in-possession model, which is said to have been immensely encouraged debtors in trouble to use the corporate reorganization law. [21]

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[17] See Miller (n 2) 443.

[18] See Theodore Eisenberg, 'Baseline Problems in Assessing Chapter 11' (1993) 43 *The University of Toronto Law Journal* 633, 644.

[19] An outside trustee can still be appointed if a company's bankruptcy is because of fraud in the US at present.

[20] See William J Woodward, Jr, 'Control in Reorganization Law and Practice in China and the United States: an Essay on the Study of Contract' (2008) 22 *Temple International & Comparative Law Journal* 141, 153.

[21] John Armour, Brian R Cheffins and David A Skeel Jr., 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom (2002) 55 *Vanderbilt Law Review* 1699, 1754-5.

By contrast, the negative lessons could be learnt from the UK where there is a rigorous management-displacement approach in its main formal corporate rescue procedure, administration. In the UK, when a formal rescue procedure is entered, the management will be simultaneously replaced by an administrator, who is an insolvency practitioner, and it is the administrator staying in control during the whole rescue procedure. It was contended that mainly because of strict debtor-displacement, many troubled companies in the UK tend to delay formal rescue proceedings for fear of losing control.[22]

In spite of the fact that there is wrongful trading which is aimed to warn company directors to take early rescue actions in the UK, this mechanism seems, arguably, not to be enough to force directors to file for rescue in a timely manner, because, in practice, wrongful trading encounters a range of barriers in enforcement.[23] Thus, to avoid losing control in formal rescues, many UK troubled companies tend to use informal rescue procedures to weather financial storms, which would be far more difficult than formal processes.[24]

In view of these lessons, it seems that China's bankruptcy law could be somewhat lenient towards troubled companies. Indeed, , the EBL 2006 has paved the way for the use of the debtor-in-possession model, and the present problem is how to remove uncertainties regarding two options between the debtor-in-possession and the administrator-in-possession models. To encourage debtors to seek early and voluntary rescues, it seems to be desirable for China's Supreme People's Court to issue a new judicial notice - if a rescue petition is voluntarily filed by the debtor itself, the debtor-in-possession approach will be automatically available. If so, the uncertainty would be removed; debtors may gain greater confidence to enter a formal rescue procedure.

To be sure, certain requirements should be set up and met if the debtor-in-possession approach is used. First and the foremost, the debtor must be honest. And such honesty should be interpreted in two ways: (a) the business failure must be because of honest mistakes, and (b) the debtor should, during the subsequent rescue process, honestly fulfil his obligations to disclose information to all interested parties. It seems that many of failed debtors in China

[22] Rebecca Parry, *Corporate Rescue* (Sweet & Maxwell 2008) 13.

[23] See Finch (n 2) 390. See also Parry Rebecca, 'Is UK Insolvency Law Failing Struggling Companies' (2009) 18 *Nottingham Law Journal* 42 (arguing British corporate rescue systems may not be inferior to the US Chapter 11).

[24] Armour, Cheffins and Skeel (n 21) 1754-5.

could be granted the debtor-in-possession in rescues. This assertion could be backed by the Zhejiang study of this thesis. In the Zhejiang study, in spite of the fact that most interest parties attributed failures of companies in reorganization to the companies' mismanagement, most of these interest parties were reluctant to accuse the management of them of fraud or dishonesty. Namely, many debtors acted bona fide, trying to avoid bankruptcy but failing to succeed. Therefore, it seems that at least these debtors in Zhejiang could be given a chance of using the debtor-in-possession to seek staying in business.

Second, whether the debtor can continue to stay in control is desirable to be subject to the decision of the creditors as a whole at a later stage, i.e., the creditors should have a say as to whether the debtor is indeed trustworthy.

In some instances, if the creditors have confidence in the debtor, the latter might be rewarded with some equity in the new company for its continued service. This leads to a discussion of the absolute priority principle in rescues.

B. The Rigorous Implementation of Absolute Priority

The disinclination of debtors to use the corporate reorganization regime is also because of the rigorous application of the absolute priority rule in Chinese non-listed corporate rescues - the debtor and especially its equity-holders and equity-managers will get nothing from the rescue process. As a result, they are considerably rescue-averse.

In theory, the application of absolute priority may only deter a debtor company that is equity-managed from voluntarily filing for reorganization; by contrast, a company that has a separation between ownership and control, especially a large public company, may not be affected by this because it is managed by professional managers rather than shareholders. But, in fact, even a professionally-managed large company may also worry about the consequences of applying the absolute priority principle in the formal rescue procedure.

In large professionally-managed companies, some senior managers may not have equity, namely they are not shareholders; however, they have to look after shareholders' interests when making a decision as to whether to file a formal reorganization petition, because it is shareholders who appoint these managers. These managers would be quite hesitant to make a decision to bring the company into a formal rescue process in which all the old equity of the shareholders will be cancelled due to the absolute priority rule.

Under Article 38 of Chinese Company Law 2005, the company's decision to file for reorganization must be made by a meeting of shareholders rather than by the board of directors. Hence, even for a large public company, in view of the consequence of applying absolute priority in the bankruptcy procedure, it is still highly unlikely for the company to voluntarily file for reorganization itself.

Moreover, leaving aside the relationships of appointment between them, these professional managers have to consider negative effects on their reputation if they pursue the company's survival regardless of shareholders' interests. In a word, it will not be an easy decision even for a large professionally-managed company to seek a formal rescue because of the absolute priority rule.

Thus, the potential application of absolute priority[25] will deter all companies from filing for reorganization in China, whether they are equity-managed or not.[26]

C. Absence of the Wrongful Trading Mechanism

Unlike in the US where there are carrot policies, such as the debtor-in-possession approach and the deviation from the absolute priority rule, to incentivise debtors to take voluntary rescue actions, in the UK, there is a stick policy, wrongful trading, which is forcing debtors to take rescue actions earlier.[27] Although there are some difficulties in applying wrongful trading in the UK,[28] it is still to some degree a threat to company directors.[29] But, there is no wrongful trading or the like in Chinese corporate bankruptcy law.[30]

It was once argued by Prof. Wang Weiguo, one of the drafters of the EBL 2006, that when the law drafters consulted businesses as to their expectation towards a new enterprise bankruptcy law, a strong voice from the business cycle was heard and directed to the then

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[25] Xiaoming Song, 'The Court's Role in the Proceedings of Enterprise Bankruptcy and Restructuring and the Problems That Need to be Solved' (The Forum for Asian Insolvency Reform, Beijing China, April 2006) <http://www.oecd.org/china/38184314.pdf> accessed 02 October 2012.

[26] See generally Lijie Qi, 'Managerial Models during the Corporate Reorganization Period and Their Governance Effects: the UK and US Perspective' (2008) 29 *Company Lawyer* 131, 132.

[27] Insolvency Act 1986, s 214.

[28] See Andrew Keay, 'Wrongful Trading and the Point of Liability' (2006) 19 *Insolvency Intelligence* 132.

[29] See Hans C Hirt, 'The Wrongful Trading Remedy in UK Law: Classification, Application and Practical Significance' (2004) 1 *European Company and Financial Law Review* 71, 104-4.

[30] Haizheng Zhang, 'Making an Efficient and Well Functioning Corporate Rescue System in Chinese Bankruptcy Laws: From the Perspective of a Comparative Study between England and China' (PhD Thesis, University of Leicester 2008) 195 (discussing the possible wrongful trading mechanism in Chinese corporate law).

weak investigation and prosecution of unscrupulous managers who steered companies into bankruptcy.[31] Perhaps, bearing in mind that maintaining market morality[32] is also one of the core principles of the corporate bankruptcy law,[33] the EBL 2006 did include a director liability provision. Article 125 stipulates that directors should be held to account if the company's bankruptcy is caused by their breach of duties. However, Article 125 does not go any further to clarify it, namely, holding rogue directors to account is only a general principle in the EBL 2006. The oversimplification of this provision makes it impossible to be enforced in practice.[34] Thus, it can be argued that there is no wrongful trading in China's bankruptcy law.

Given the fact that, as noted before, ninety seven per cent of dissolved companies in China, which are supposed to use the bankruptcy procedures to settle unpaid debts, just walk away without using bankruptcy proceedings, it seems highly unlikely for unscrupulous directors to be held accountable for their wrongdoings.

Shortly after the EBL 2006 took effect, the similar serious concerns were also raised by a famous Chinese judge who argued that the EBL 2006 has a fundamental flaw because it stipulates that filing for bankruptcy is a debtor's right rather than its obligation.[35] This means that there is no legal means to force the debtor that is already bankrupt to file for bankruptcy.

Similar to the UK wrongful trading mechanism, many Eastern European countries have legislated that directors must file for bankruptcy in the event that their companies have defaulted on their debt for a certain period of time.[36] For example, in Hungary, directors are obliged to file for bankruptcy if the company is unable to pay debts for over 90 days;

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[31] Weiguo Wang, 'The Draft of New Enterprise Bankruptcy Law and Corporate Governance' (2005) 2 *Legal Scientists* (in Chinese) 5, 8.

[32] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, Cambridge University Press 2009) 27.

[33] Shuguang Li, 'The Effects of New Enterprise Bankruptcy Law 2006' (2006) 6 *Journal of East China University of Political Science and Law (*in Chinese) 110, 112 (arguing that market morality requires that delinquent directors should be held to account if they are culpable for the bankruptcy).

[34] See Wang (n 31) 9.

[35] Wang and Yi (n 4) 21.

[36] Jens Lowitzsch, *The Insolvency Law of Central and Easter Europe* (INSOL Europe, 2007) 49. See also Maria Brouwer, 'Reorganization in US and European Bankruptcy Law' (2006) 22 *European Journal of Law and Economics* 5.

otherwise, it constitutes an offence, and the directors are personally liable for the creditors' loss afterwards.[37]

Given the deficiency of the EBL 2006 on this matter, it seems quite necessary for China to establish a similar wrongful trading mechanism to prevent directors from abusing the limited liability of companies. If so, an early bankruptcy rescue filing by debtors seems to be more likely.

In sum, debtors are quite reluctant to file for reorganization duo to both management-displacement and the rigid application of absolute priority in China. In the meantime, without pressure of wrongful trading in China, directors may continue to trade to the detriment of creditors until the company passes the point of no return.

2.3. Helpless Creditors

As demonstrated in chapter 5, there were, between June 2007 and November 2010, sixty one per cent of the existing Chinese corporate rescues were filed by creditors. This gives an impression that the formal rescue regime is more accessible for creditors. This conclusion, however, is wrong. In practice, choosing a party to file for reorganization was only a formality, because a formal rescue process could not be entered unless there is a prior agreement between the court and the local government. In other words, creditors alone were unable, or did not have the real power, to open a bankruptcy reorganization procedure in court.

Apart from being unable to gain access to the corporate reorganization procedure in court, individual creditors may also lack incentive to seek a bankruptcy solution in court on the grounds that they will usually recover nothing through a formal bankruptcy process. As a consequence, they tend to avoid going to court to liquidate a defaulting debtor; individual debt enforcement would be a priority for them.[38]

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[37] Ibid 50-1.

[38] See the Shenzhen Intermediate People's Court, 'The White Paper of Corporate Bankruptcy Dealt with by The Shenzhen Intermediate People's Court' (Shenzhen Guangdong China, 20 December 2011, in Chinese) <http://www.szcourt.gov.cn/shenwu/view.aspx?id=4207 > accessed 22 September 2012.

Besides the lack of incentives to bring a debtor into bankruptcy reorganization, creditors also do not possess sufficient information to do that. In the real world, most creditors cannot access financial information of debtors; it is quite difficult for creditors to propose a viable rescue plan to rehabilitate a troubled company; so, granting creditors the right to file for reorganization is largely unsound.[39] Some creditors, however, may be relied on to make a rescue effort – they are banks and main suppliers.

Unlike general trade creditors, banks are usually better positioned to monitor a debtor, because it is common for the debtor's business to be continuously inspected by its major bank under a loan contract.[40] The bank is able to access the debtor's business information, especially its financial documents, and even the debtor's business strategies. Well informed of the debtor businesses, the bank may initiate a feasible rescue plan to rescue the distressed debtor.

Concerns, however, are raised here as to whether banks have economic incentives to do so. In China, most bank loans are secured against debtors' assets.[41] Therefore it would be unnecessary for a bank to rescue a troubled debtor if the loan is secured on the assets. If the debtor is in trouble, the bank may simply foreclose its security. It is the encumbered assets rather than the rehabilitation of the debtor about which the bank is more concerned.

Under narrowly-defined circumstances, banks may be quite keen to rescue troubled debtors. Where a bank loan is under-secured or entirely unsecured,[42] the bank may use its gathered information and understandings to pursue a rescue outcome, such as a going concern sale, in order to recover its own debts. It, however, raises further concerns. If the company has only one under-secured or unsecured bank creditor, this bank may be motivated to rescue the company for a higher debt recovery rate, but if there is more than one such bank involved,

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[39] See Elizabeth Warren and Jay Lawrence Westbrook, *The Law of Debtors and Creditors: Texts, Cases, and Problems* (6th edn, Wolters Kluwer 2009) 423.

[40] See Parry (n 22) 14. See also Finch (n 32) 267.

[41] See The China People's Bank, 'Bank Loan Regulation' (Beijing China, 28 June 1996, in Chinese) (its Article 10 requires that bank loans, in principle, must be secured on assets). See also Meghana Ayyagari, Asli Demirguc-Kunt and Vojislav Maksimovic, 'Formal versus Informal Finance; Evidence from China' (2010) 23 *The Review of Financial Studies* 3048, 3052.

[42] A study shows that in China there are about 44.6% of bank loans which are secured on assets. See Jun Qian and Philip E Strahan, 'How Laws and Institutions Shape Financial Contracts: The Case of Bank Loans' (2007) 62 *The Journal of Finance* 2803, 2815.

coordination between banks may remain a great challenge for the rescue effort.[43] Under latter circumstances, it seems that China's central bank, the China People's Bank, could learn something from the Bank of England, which initiated the London Approach whereby banks can be coordinated for the common good when the same borrowing company is financially embarrassed.[44]

Like banks, a main supplier may also have gained a deeper understanding of the company's business operation and even its future viability. Unlike other small trade creditors, the main supplier may be more familiar to the debtor's business operation through long-term contractual relationships. More importantly, sometimes the debtor is also the strategic customer of the main supplier; therefore, to a certain degree, the main supplier may be unable to afford to liquidate the debtor because of concerns of its own business sustainability. In such a situation, the supplier would be quite willing to raise a rescue motion in an attempt to save the debtor as well as itself.[45]

Except banks and main suppliers, it can be argued that it is unrealistic to expect other creditors to file for reorganization because of their lack of information of debtor companies. Instead, the real problem in China is that creditors should be given the right to use liquidation either as a means to collect debts or as a threat to warn a defaulting debtor to take voluntary rescue actions earlier.

In short, the small number of corporate rescues after the EBL 2006 took effect can be attributed to a set of factors. Because of the lack of judicial independence, Chinese courts are considerable hesitant about accepting corporate rescue filings. In anticipation of being sacked immediately, debtors try to avoid formal rescues. Some creditors may have incentives to rescue a troubled company but are deterred by the insurmountable threshold into the formal rescue procedure.

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[43] See Reinier Kraakman and others, *The Anatomy of Corporate Law a Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 121 (analysing coordination difficulties between creditors).

[44] See Pen Kent, 'Corporate Workouts – A UK Perspective' (2007) 6 *International Insolvency Review* 165 (examining the London Approach in coordinating banks to collectively handle a borrower's financial crisis)

[45] Recently, there was a fresh rescue case in the UK where *Clinton Cards plc* was essentially brought into administration and salvaged by its main supplier, *American Greetings Corporation*, in 2012. See Jennifer Thompson, '*American Greetings* Buys *Clinton* Stores' *Financial Times* (London, 7 June 2012) <http://www.ft.com/cms/s/0/f553f01c-b0c5-11e1-a2a6-00144feabdc0.html#axzz2DRtUBOqX> accessed 27 November 2012.

To improve the use of corporate bankruptcy law, it seems that China may learn something from Russia; there are many similarities between China and Russia regarding their legal and social development. Before 1992, Russia did not have a corporate bankruptcy law. Although Russian first bankruptcy law was enacted in 1992, it was rarely used, which was similar to China's situation. In 1998, Russia had to amend this law and significantly eased the entry into the bankruptcy procedure. It seemed to be a success, as the Russian bankruptcy law of 1998 radically changed the landscape of corporate bankruptcies: there was a proliferation of bankruptcy cases after 1998.[46] Considering the similar bankruptcy law histories and political systems, it seems that Russia may offer some useful experiences in this respect. But, due to the scope of this thesis, it is not possible to go further and make a comparative study, but in the future such a study seems to be fruitful.

3. CONTROL IN CHINESE CORPORATE REORGANIZATIONS

Generally, it is possible to use the debtor-in-possession model and a practitioner-in-possession model to describe control in the formal rescue proceedings. These two concepts, however, are actually polarised, because in practice, the control is far more complex than what these two concepts could explain. Meanwhile, the notion 'control' itself is also rather elusive. To simplify the arguments on control of this thesis, discussion will focus on several key players and their roles in the rescue procedure. In particular, there will be a focus on administrators, debtors and the creditors in China's corporate rescues, respectively.

3.1. Administrators

Under the EBL 2006, an administrator will be appointed to take control of the company when a reorganization petition is accepted.[47] As noted before, control can be regained by the

[46] See generally Ariane Lambert–Mogiliansky, Konstantin Sonin and Ekaterina Zhuravskaya, 'Are Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant' (2007) 35 *Journal of Comparative Economics* 254.

[47] Article 13 of the EBL 2006.

debtor on condition that the court agrees with the debtor's request.[48] In practice, however, the administrator continued to control the rescue process in most of the cases.

A. The Administrator in Full Control

As reported in previous chapters, in the majority of the existing rescue cases, it was the administrator in charge. In particular, the administrator continued to stay in control in seventy-four per cent of the corporate reorganizations in China. Put differently, the probability of the debtor to regain control is quite low.

Moreover, the administrator's control in Chinese corporate rescues may have extended beyond what the above figures demonstrate, because it was still the administrator who proposed the reorganization plan in some cases where the debtor had ostensibly regained control under the permission of the court.[49] Under Article 80 of the EBL 2006, if a debtor is allowed to recoup control from the administrator, the exclusive right of proposing the reorganization plan will also be returned to the debtor. Under such circumstances, however, when the reorganization plan was still proposed by the administrator, this means that it was the administrator rather than the debtor who was really in charge, because at the heart of control is the right to prepare the reorganization plan for vote. Thus, given that the debtor did not propose the reorganization plan in the case that it was entitled to do, debtors as a whole were further marginalised in formal rescues in China.

It should be remembered that Chinese bankruptcy administrators are not always qualified insolvency practitioners, as a local-government-organized liquidation committee can also be appointed as the administrator to control and manage a company in a bankruptcy procedure.[50] This happens frequently in China: such committees have been 'appointed' by courts in forty-six per cent of corporate reorganizations nationally.[51]

It seems to be a surprise, because it may have considerably undermined China's initial commitment to establish and develop a body of insolvency practitioners. Some improvement,

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[48] Article 73 of the EBL 2006.

[49] In principle, under Article 80 of the EBL 2006, the plan can only be proposed by the debtor when control had been returned with the permission of the court.

[50] Article 24 of the EBL 2006.

[51] In effect, a court would be ordered by the local government organized liquidation committee to appoint itself as the administrator. See generally at Xinye Jiang, 'The Role of Administrator in Corporate Bankruptcy' (the 2nd Bankruptcy Forum, Beijing China, 25 June 2009, in Chinese).

however, has been made, as the composition of such committees has been moderately updated. Under the old EBL 1986, these committees were predominantly comprised of government officials.[52] After the EBL 2006, there was apparently more involvement of professionals in these committees, since it has been found that, in at least sixty-four per cent of these committees, lawyers were hired and included as committee members. This is the key difference between liquidation committees before and after 2006.

Appointing a local government organized liquidation committee seemed to be concessions made by courts in order to obtain support and cooperation from local government, because such a committee was usually chaired by local senior officials who were able to mobilize public resources to facilitate rescue issues.[53] But appointing a local-government-organised liquidation committee as the administrator is not free of controversy.

Many[54] have argued that although Article 24 of the EBL 2006 allows courts to appoint the administrator from a local-government-organised liquidation committee, the real intent of the law-maker, China's People's Congress, was to confine the use of local-government-organised liquidation committees in SOE bankruptcies. Put differently, appointing local-government-organised liquidation committees as administrators could only be used in bankruptcy of SOEs; it is equally important to address that such committees should not be appointed as administrators in bankruptcy of companies other than SOEs. But the trouble here is that the Congress did not clarify such boundaries in Article 24 of the EBL 2006. In other words, the floodgates were left open by the Congress probably unintentionally.

Appointing local-government-organised liquidation committees as administrators also raises concerns on the rights of creditors to request an administrator replacement. Under Article 22 of the EBL 2006, a meeting of creditors can ask the court to replace the administrator if they can prove that the incumbent administrator is unable to discharge duties adequately. However, the problem is that if the administrator is a local-government-organised liquidation committee chaired by a local senior official who is even politically superior to the president of the court, would it be realistic for the court to back the replacement request of

[52] Charles D Booth, 'The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over' (2008) 20 *Singapore Academy of Law Journal* 275, 293-4.

[53] Roman Tomasic and Zinian Zhang, 'From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergence in Implementation' (2012) 12 *Journal of Corporate Law Studies* 295, 316.

[54] Guoguang Li, 'The Administrator is the Legal Representative of Estate' (2007) 6 *Shanghai State Capital* (in Chinese) 52, 54.

creditors to order the liquidation committee to leave? There is no doubt that this may place the court in a very difficult position, especially in the context of the current China's political and judicial systems. Even it may be safe to say most Chinese courts have not confidence to say no to local government.

After appointed, the administrator's first priority would be to resume the company's business operation, since there were sixty-six per cent of companies in reorganization which had ceased trading before entering the rescue process. Resuming or continuing the company's trading seemed to be vital for the success of the rescues, because this is of significance to re-establish the confidence of both suppliers and employees.[55] In fact, the main function of the administrator seemed to be to investigate the company's assets and liabilities as well as to join litigations on behalf of the debtor.

The role of the administrator may culminate in proposing the reorganization plan. Under the EBL 2006, the administrator is empowered to propose the reorganization plan where the company's control has not been returned to the debtor.[56] Given that the going concern sale took place in eighty-four per cent of Chinese corporate reorganizations, the main terms of these plans would be how to distribute company value rather than how to restructure company businesses, because the business restructuring issues might be entirely left for the company buyer to solve afterwards.

B. Advantages of the Administrator-in-Possession Approach

Impartiality would be the first and foremost advantage of the administrator-in-possession model in China's corporate rescues,[57] because the procedure of appointing the administrator has ensured the administrator's neutrality.

As has been reported in the previous chapters, the administrators in all reorganizations were directly appointed by courts.[58] Although a creditors' meeting was empowered to

[55] For example, in the reorganization of *Zonghen Textile Group Co. Ltd., Zhejiang*, it is a crucial step for the administrator and other related parties to maintain the company's business operation in order to preserve the company's going-concern value and to retain confidence of suppliers and employees. See Huapin Ru and Jian Qu, 'Wisdom of Notaries Conduces to the Rehabilitation of *Zonghen Group'* (2006) 5 *Dongfang Legal Review* (in Chinese) 37.

[56] Article 80 of the EBL 2006.

[57] See generally John Gerdes, 'Corporate Reorganization: Changes Effected by Chapter X of the Bankruptcy Act' (1938) 52 *Harvard Law Review* 1, 9-12 (describing that a trustee is a disinterested person in bankruptcy).

challenge the appointment,[59] in practice, however, such a challenge has never effectively raised. In a sense, it seems to be pointless for a creditors' meeting to question the appointment, because the successor administrator will still be selected by the court rather than by the creditors' meeting. Namely, creditors could not select the administrator on their own initiative; any challenge would not be fit for purpose. .

Except creditors, other parties, including the debtor, is not allowed to challenge the court's administrator appointment. So, the administrator is virtually immune to the influence of all parties but the court.

The worry here, however, is that if there is heavy local government presence in the rescue the administrator's impartiality would be undermined. In particular, where it is a local government organized liquidation committee appointed as the administrator, such impartiality would be rather diminished, because local government tends to put the local economy and local employment before protecting creditors.[60] And this might be further aggravated if the main creditors are central-government-owned banks or trade creditors from outside the region.

Thus, the administrator's impartiality in Chinese corporate rescues should be understood in its backdrop of the identity of the administrator. Without the intervention of local government, the administrator can be expected to be fully impartial to strike a fair balance between creditor and debtor; however, when local government joins the game, striking the right balance might be not easy.

Moreover, in general, the administrators are competent to process the existing corporate rescues in China most of which are essentially court-supervised merger and acquisitions (M&A). As noted above, the going concern sale was used in eighty-four per cent of the existing corporate reorganizations. In the light of the composition of the administrators, where lawyers were mainly involved, it seemed that they would be quite capable to conduct these rescues, since advising M&As was likely to be the day-to-day business of most corporate lawyers in China.[61] The worry here, however, is that the competence of the

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[58] Article 22 of the EBL 2006.

[59] Ibid.

[60] Ibid. See also Sandra Poncet, 'A Fragmented China: Measure and Determinants of Chinese Domestic Market Disintegration' (2005) 13 *Review of International Economics* 409.

[61] See generally Sida Liu, 'Client Influence and the Contingency of Professionalism: The Work of Elite Corporate Lawyers in China' (2006) 40 *Law & Society Review* 751.

administrator can be doubted if there is a traditional corporate reorganization rescue, not a going concern sale rescue, because the former requires the administrator to have more firm-specific knowledge and information regarding restructuring the troubled company's business operations.

C. Downsides of the Administrator-in-Possession Model

First, administrators, in general, have no knowledge and experience to manage companies in rescues, let alone turn troubled businesses around.[62] The comments of one of the director interviewees in the Zhejiang study are worth mentioning here. He said that the administrator, a group of lawyers in that case, would be capable of safeguarding the company's assets and ensuring the company's financial resources to be properly used; but rehabilitating the company's business largely fell outside the administrator's knowledge and expertise, since it was the debtor itself instead of the administrator who knew the company, its business operation and even the relevant market.

It was also found that many administrators, in particular lawyers, did not have basic accounting knowledge; hence it was quite difficult for them to establish an understanding of the company's business operation during the rescue processes. Perhaps, because of the lack of expertise, knowledge and information, selling these companies might be an optimal choice, since substantial restructuring jobs would pass over to the company buyers. This might partly explain the prevalence of the going concern sale rescues in China.

The administrator's weakness in this regard might be attributed to two factors. The first is that given that most of the administrators were local government organized liquidation committees, undoubtedly, the composition of such committees have suggested its degree of expertise. Most of them were government officials. Running a business would be far different from operating a government department. So in such circumstances, lacking expertise seemed to be certain. The second factor is that insolvency practitioners in China were not trained and examined before being qualified. Different from most other countries,[63] insolvency practitioner lists in China are largely superficially made, because there are no qualification

[62] It is the same in the UK. See Gerard McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation' (2007) 56 *International and Comparative Law Quarterly* 515, 529.

[63] Anneli Loubser, 'An International Perspective on the Regulation of Insolvency Practitioners' (2007) 19 *South African Mercantile Law Journal* 123, 127-136.

training programmes and examinations before naming these professionals as insolvency practitioners.

Second, the administrators' difficulty to get cooperation from the old management should also be borne in mind. The EBL 2006 stipulates that, in order to continue the company's trading, the administrator can hire the old management, or part of them, to run the company in reorganization.[64] This may open the door for the administrator to solicit the expertise and information possessed by the old management with a view of making a feasible rescue.[65]

In practice, however, cooperation from old management is highly unlikely. This is because, in over half of existing corporate reorganizations in China, the company has ceased trading before entering into the rescue proceeding, and in most of these cases, the company's old management have left. Most of these companies were *de facto* abandoned by the debtors. It meant that the information or expertise sources had disappeared, which made the administrators unable to seek cooperation. The Zhejiang interviews revealed that inviting some previous managers to resume company's operation was even a challenge for many administrators, let alone to ask them to give managing advice.

In the meantime, the key business information is probably in the hands of companies' former CEOs, but in most rescues, the CEO has been driven away by the automatic dismissal at the time of the administrator's appointment. In some cases, the CEO would be available to answer the administrator, but it should not be forgotten that most of the CEOs are also shareholders, and even the main shareholders, and that, given the strict application of the absolute priority principle, they may have no economic incentives to fully collaborate with the administrator and disclose the company's information.

Third, the administrator-in-possession model deters debtors from filing for reorganization in a timely manner[66] in China. Under the administrator-in-possession approach, filing for the formal rescue amounts to the automatic resignation for company directors; as a result, the debtors will try to avoid formal rescues. It would be premature to jump to the

[64] Article 74 of the EBL 2006.
[65] See Gerdes (n 57) 10.
[66] See generally Lynn M LoPucki and William C Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141 *University of Pennsylvania Law Review* 669, 757.

conclusion that the small number of formal corporate rescues in China was due to the widely-used administrator-in-possession approach, but it is certain that such a control model substantially undermines debtors' willingness to voluntarily enter into the formal rescue procedure.

In a word, Chinese current corporate rescues largely used the administrator-in-possession approach but such a control model could be only function reasonably when there is a business sale rescue, and when there is no local government intervention. Except in these situations, the administrator-in-possession approach seems to do more harm than good in China's corporate rescues.

3.2. Debtors in Rescues

As noted, the debtor, especially its old management, was largely excluded from most of China's existing formal rescue processes. In theory, the debtor can ask for the court's blessing to regain control; however, this only happened in twenty six per cent of corporate reorganizations in China.

Occasionally, the company's control was superficially returned to the debtor, but it was the administrator instead of the debtor who proposed the reorganization plan. It means that the returned control was largely in name only. As discussed before, this further marginalized debtors in rescue processes.

It can be argued excluding the debtor, in particular its old management, may not severely jeopardise the rescue if it is undertaken as a going concern sale rescue; however, the rescue could be definitely adversely affected if there are no company buyers coming in business auctions, as has frequently happened in China. In other words, retaining the debtor in office would be critical for the future of the troubled company, if the traditional reorganization is the only option.

A. Benefits of Retaining Debtors

First and foremost, allowing the debtor to remain in control will induce it to voluntarily file for reorganization in a timely manner.[67] When the company is in trouble, if the debtor, mainly its directors, is sure that the debtor-in-possession approach is available, the company may be more confident to file for reorganization in court; otherwise, a voluntary rescue filing would be deterred, because it seems to be suicidal for the debtor to file a reorganization petition.

The increased confidence of the debtors to voluntarily file for reorganization was vividly demonstrated by a recent corporate rescue law reform in South Korea. In 2006, South Korea amended its bankruptcy rescue law, introducing the debtor-in-possession approach as the new rescue control model. Not surprisingly, the number of rescue filings, as a result, soared from seventy-six in 2006 to 670 in 2009, almost a ten times increase in only four years.[68]

The experiences of South Korea may be useful for China's bankruptcy law reform. Currently, the main concern is how to remove the uncertainty regarding the availability of the debtor-in-possession model in the EBL 2006, because under Article 73 the debtor-in-possession model is only one possibility and must be conditional upon the court's permission. Ideally, the company could be automatically managed and controlled by the debtor itself if the rescue is voluntarily filed, as argued before. If so, China's corporate rescue landscape might be significantly revamped, although it is only a slight modification of the EBL 2006.

Second, under the debtor-in-possession approach, the rescue would be more feasible because a viable rescue needs the information and experience of the debtor.[69] As discussed before, an outside administrator would be impartial, but the key weakness of the administrator is that it lacks the firm-specific experience and knowledge to restructure an individual company's business. Put differently, restructuring a company's business, which is

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[67] Woodward (n 20) 153.

[68] After transplanting the debtor-in-possession, South Korean corporate reorganization filings increased sharply from 76 cases in 2006 to 670 in 2009. See The International Bank for Reconstruction and Development/The World Bank, *Doing Business 2011 China: Making a Difference for Entrepreneurs* (The World Bank and the International Finance Corporation, 2010) 75.

[69] Warren and Westbrook (n 39) 387.

at the heart of a corporate rescue process, has to depend on the information and experience of the debtor itself.[70]

Retaining the debtor in control does not mean that the entire managing team should be kept intact.[71] Instead, there must be a change regarding the key decision makers, in particular the CEO, of the company. Restructuring a troubled company would not be complete if there is no restructuring or refreshing of its managing team. Even in the US, where there is a default debtor-in-possession approach in the formal rescue, one empirical study revealed that over half of the debtors' chief managers were removed before or during the formal rescue process.[72] So it is desirable for the debtor's managing team to have a reshuffle although under a debtor-in-possession approach.

Third, the debtor-in-possession approach may substantially encourage the spirit of entrepreneurship in society.[73] To a large extent, doing business means risk taking.[74] Giving a second chance to failing but honest entrepreneurs may considerably inspire business ventures. More importantly, lessons learned from the first time failure would be vital to the future success; otherwise, such valuable lessons will be simply wasted.[75]

It, however, is worth addressing that a second chance, in the form of the debtor-in-possession approach, can only be granted to a debtor who has made honest mistakes.[76] If the business failure is because of fraud or dishonesty, the debtor should be held to account rather than be rewarded with a second chance. Granted, in some instances, the business failure might be caused by fraud, but if fraudulent individuals have been removed, the old

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[70] Miller (n 2) 432.

[71] Finch (n 32) 317 (arguing the management change should be a significant part of an effective rescue).

[72] See Gerard McCormack, *Corporate Rescue Law – An Anglo-American Perspective* (Edward Elgar 2008) 150. See also Stuart C Gilson, 'Management Turnover and Financial Distress' (1989) 25 *Journal of Financial Economics* 241, 261.

[73] See generally Seung-Hyun Lee, Mike W Peng and Jay B Barney, 'Bankruptcy Law and Entrepreneurship Development: A Real Options Perspective' (2007) 32 *Academy of Management Review* 257 (analysing the relationship between bankruptcy law and entrepreneurship).

[74] Robert E Scott, 'Through Bankruptcy with the Creditors' Bargain Heuristic' (1986) 53 *The University of Chicago Law Review* 690, 699.

[75] See Muir Hunter, 'The Nature and Function of a Rescue Culture' (1999) 104 *Commercial Law Journal* 426, 462.

[76] Ibid 437.

management as a team can still be retained in office; fraudulent managers should be penalised, but their honest and innocent colleagues should not be scapegoated.[77]

Notwithstanding that the debtor-in-possession approach has these merits, some effective measures should be taken to prevent or counteract potential abuse.

B. Dangers of the Debtor-in-Possession Approach

First of all, the debtor-in-possession approach raises concerns as to whether it may create a moral hazard.[78] If the debtor who has brought the company into trouble is allowed to continue managing the company in the formal rescue procedure, it means that the debtor will not be held to account for its own failure. This may send a wrong message in business circles, since it give the impression that business failures are rewarded rather than punished. Partly because of such attitudes, in the UK, a much-quoted response to the debtor-in-possession approach is that allowing a debtor in control in the formal rescue procedure is likened to allowing an alcoholic to run a pub.[79] And the similar sentiment is also commonplace in most European continental countries[80] where the general public seem not to be sympathetic to failed businessmen.

In China, as reported before, most of the interviewees believed that company failures were somewhat caused by mismanagement - debtors received little sympathy and it seemed to be unacceptable to retain them in rescues.

It, however, appears premature to conclude that moral hazards will be created by the debtor-in-possession approach, since such a view has failed to appreciate that business failure is usually contributed by a mixture of causes.[81]

Generally speaking, causes of business failure can be observed and understood at two distinct levels, as has been argued in chapter 2. At the first level, reasons for business failure can be endogenous or exogenous;[82] as a result, if business failure is attributed to exogenous factors, it would be unfair to blame and punish the innocent management by banning and

[77] Miller (n 2) 445.
[78] McCormack (n 62) 524.
[79] See McCormack (n 72) 127.
[80] See Parry (n 23) 52.
[81] See Bruce G Carruthers and Terence C Halliday, *Rescue Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford University Press 1998) 71.
[82] See Miller (n 2) 445.

excluding them from a formal rescue procedure. For example, a global financial crisis may have led to massive closure of businesses,[83] and undoubtedly some failed businesses in the economic crisis should be treated in a different way. At the second level, even when causes of business failure are endogenous, it may have been occasioned by an honest mistake, business speculation, recklessness or fraudulence.[84] Obviously, under such circumstances, debtors should be judged and dealt with differently according to their different intent in mind. The debtor must be penalized and expelled from the rescue process if its business failure is due to fraudulence; but where it is honest mistakes which lead to the business failure, it would be disproportional to punish and remove the debtor during a rescue process.

Hence, it can be contended that it appears to be a one-size-fits-all judgement that the debtor-in-possession approach always generates moral hazards. In fact, moral hazards can only be caused in the situation where a company's failure is endogenous and involves fraudulent or reckless business conducts, but the debtor is still permitted to stay in control. But the key point here is that the debtor-in-possession has never been intended to be used in such circumstances.

The second worry over the debtor-in-possession approach is that the debtor may, during the rescue process, abuse the control by engaging in high-risk-and-high-reward ventures at the expense of creditors.[85] The debtor, in particular the equity-managers, will obtain something if the venture succeeds; on the contrary, it is the creditors who have to bear the full costs if it fails, because the company's business risks have shifted from shareholders to creditors since the company became insolvent.[86] It would be another form of moral hazard involved.

Such concerns, however, may be natural but miss the points. It seems to be too early to label or categorise the shareholders, especially shareholder-managers, as the party that has no interests in the company when a formal reorganization process starts. It is worth recalling that a plausible candidate for reorganization is a financially distressed company, which means that the company suffers an illiquidity crisis. That is to say, by the bankruptcy cash flow test, the

[83] Tomasic and Zhang (n 53) 306.
[84] See Carruthers and Halliday (n 81) 269.
[85] Carruthers and Halliday (n 81) 71.
[86] Thomas H Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 *The Yale Law Journal* 857.

company is bankrupt because it is unable pay debts that become due; however, by the bankruptcy balance sheet test, the company may still be solvent, since its assets may still exceed its liabilities in real terms.

Even the balance sheet test is also controversial. The balance sheet test itself sounds robust, because it examines and assesses whether the company's assets can meet its liabilities;[87] however, the key weakness here is that the value of assets is predominantly gauged on a hypothetical basis, instead of being derived from a real market sale.[88] In other words, the balance sheet test is dependent on the accurate asset valuations. But as is widely witnessed, asset valuations are always subjective and speculative in nature. Hence, using highly subjective valuations to exclude the debtor and especially shareholders before the end of the bankruptcy game seems to be unjustifiable.

In addition, it should not be forgotten that to encourage debtors to use the corporate reorganization procedure, the EBL 2006 allows a debtor which in not bankrupt to enter this procedure with the view of promoting early, feasible rescues. In other words, some companies in reorganization are not bankrupt in both legal and economic senses. This further suggests that automatically excluding the debtor before or during the reorganization procedure seems to be inappropriate and unfair.

In short, it is too early to conclude that the debtor has no interests in the company when a formal bankruptcy rescue procedure is entered.

Meanwhile, the debtor-in-possession model does not mean that the debtor can run the company's business entirely on its own discretion. Instead, the debtor-in-possession approach is designed to be under strict supervision by the court and creditors when the rescue process is ongoing. There are already monitoring mechanisms available to prevent its abuse. In the US, for example, to supervise debtors, before 1978, it was mainly the court monitoring the debtor - the debtor could only carry on normal businesses in the rescue process, and any substantial asset disposals or entering large contracts have to be subject to the court's permission; after 1978 it was largely the United States Trustee, a public body, which is

[87] See Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 113.

[88] See generally Keith Sharfman, 'Judicial Valuation Behaviour: Some Evidence from Bankruptcy' (2004-2005) 32 *Florida State University Law Review* 387. See also Chaim J Fortgang and Thomas Moers Mayer, 'Valuation in Bankruptcy' (1984-1985) 32 *UCLA Law Review* 1061, and Warren Elizabeth, 'A Theory of Absolute Priority' (1991) *Annual Survey of American Law* 9, 14.

responsible of overseeing the whole debtor-in-possession regime.[89] In China, under the EBL 2006, a debtor-in-possession should also be intensely supervised by a court-appointed administrator.[90] Apart from courts or administrators, creditors via creditor committees will also monitor the debtor-in-possession to avert it from being abused. [91]

Therefore, the concerns about possible abuse by debtors engaging in risky business ventures are necessary, but have been considered and taken into account when designing the debtor-in-possession regime; so these concerns could not be used to deny the use of the debtor-in-possession.

In brief, for the sake of a viable rescue, debtors, in particular their old management, should be allowed, and even motivated, to join the rescue processes. In view of its demerits and merits, apparently many criticisms against the debtor-in-possession approach have been either accommodated or are untenable.

Granted, the debtor-in-possession model seems not to be needed if the rescue is conducted as a going concern sale. Difficulties of going concern sales, however, should not be forgotten: on the one hand, a business sale rescue has to face market illiquidity for troubled companies at first, i.e., there may be no buyers emerging, as has also frequently happened in China's corporate rescue practice; on the other hand, removing the old management will lead to the loss of the company's going-concern value, which in turn will undermine the fundamental justification of the rescue regime in preserving going concern value of troubled companies. And as a result of reduction of the company's going-concern value, creditors will correspondingly be further disadvantage.

Arguably, the debtor-in-possession model seems to be universally useful and should be one of foundations of a contemporary corporate rescue system.

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[89] Robert L Eisen and David K Smrtnik, 'The Bankruptcy Reform Act of 1978 – An Elevated Judiciary (1979) 28 *DePaul Law Review* 1007, 1020.

[90] Article 73 of the EBL 2006.

[91] See Miller (n 2) 431.

3.3. Creditors in Rescues

Whatever the creditors' bargaining or risk sharing theories, increasing creditor recovery rates is always at the top of the corporate rescue objectives.[92] But maximising creditor recoveries does not mean that creditors should be invited to control and manage the company during the rescue processes, because allocating control must take into account the ability and competence of the chosen parties in conducting rescues.[93] In general, creditors are unable to manage a debtor company in the rescue process because they are short of understandings and experiences to the debtor's business. Instead, creditors are protected by the corporate reorganization regime in a different way.

Creditors are given a powerful lever to make their voice heard and counted - the reorganization plan must be voted by the creditors' meetings. And before voting on the reorganization plan, creditors could also organize a creditors' committee – an executive body - to scrutinize the rescue process on the periodical basis. In practice, however, this is easier said than done.

A. Creditors' Positions

The main chance for creditors to make a collective decision in Chinese corporate rescues is at the meeting of creditors.[94] The key weakness of this meeting, however, is that it is limited in times. Even it is not unusual for the creditors' meeting to be held only once in the existing corporate rescues in China.[95]

Meanwhile, it is too late for the first creditors' meeting to be held. Under Articles 45 and 62 of the EBL 2006, the first meeting of creditors will be held at least one month later after the formal rescue process begins. In other words, before the first creditors' meeting, there is a supervision vacuum of creditors.

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[92] See generally Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *The University of Chicago Law Review* 775.

[93] Finch (n 2) 377.

[94] Chapter 7 of the EBL 2006 (focusing on creditors' meetings in corporate bankruptcy).

[95] For example, in the reorganization of *Haiji Lvjian Chemical Products Co. Ltd., Inner Mongolia* in 2009, the creditors' meeting was held only once. See Yie Liu and Yan Gao, 'Facts Shrouded behind the Reorganization of *Haiji Lvjian' Stock Market Weekly* (Beijing China, 25 April 2009, in Chinese) <http://www.p5w.net/stock/news/gsxw/200904/t2313173.htm> accessed 10 December 2012.

More importantly, for creditors, obtaining sufficient information about the company would be crucial for them to make an informed judgement during creditors' meetings; however, as reported in the previous chapters, generally, creditors were not allowed to access the company's books and other financial documents. Without knowing what has exactly happened before and after the company is bankruptcy, creditors would be unable to make a sound decision when attending creditors' meetings. It should also be noted that in general creditors are not familiar with each other. Therefore the lack of coordination between creditors may further undermine the ability or capacity of creditors as a whole to reach a rational collective decision.

Bearing in mind that creditors' meetings cannot conduct day-to-day supervision of the company, the EBL 2006 stipulates[96] that a creditors' committee can be established by the creditors' meeting. The creditors' committee is expected to represent creditors as an executive body. But, such committees are not widely used in practice.

Meanwhile, like creditors' meetings, such a committee is also formed at a very late stage. Under Article 67 of the EBL 2006, a committee of creditors has to be proposed by the creditors' meeting; this means that it is always formed after the first meeting of creditors is held. So, the creditors' supervision vacuum before the first creditors' meeting still remains unfilled. More significantly, it is optional rather than compulsory to establish a creditors' committee in Chinese corporate bankruptcy processes; therefore, it remains uncertain whether such a committee will be formed to supervise the daily operation of the company in rescue.

In reality, as has been seen in Zhejiang, the creditors' committee was only reportedly found in twenty per cent of the rescue cases. Therefore, generally, the committee is not widely used. More importantly, even if there is a creditors' committee, all members are unpaid, and they serve all the other creditors on a volunteer basis. The problem arises as to whether such a committee can operate as effectively as expected.

By and large, creditors in China's corporate reorganizations appear to be considerably vulnerable.

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[96] Article 67 of the EBL 2006.

B. Enhancing Creditors' Participation

Primarily, the creditors' meeting and committee are two main platforms through which creditors can monitor and influence the rescue procedure. In order to improve creditors' participation in rescues, in response, consideration must be given to both the creditors' meeting and committee.

At present, although the EBL 2006 does not make clear that it is mandatory to form a creditors' committee, it seems to be necessary for China's Supreme People's Court to interpret that it is the norm rather than the exception to have such a creditors' committee in corporate reorganization procedures,[97] because it is desirable to have this committee so as to make creditors better represented in rescue processes. To be sure, in Chinese corporate rescues, establishing a creditor committee seems to be more than needed, because nearly all companies in reorganization are large, involving a large number of creditors. For example, in the reorganization of *Dadi Paper Co. Ltd. Zhejiang*, the company had 427 creditors.

Hence, it can be argued that there should be a guidance according to which it is compulsory to form a creditor committee if creditors are over a certain number in the case, e.g., when there is over fifty creditors in a case, there must be a creditor committee; below this figure, whether to form such a committee is subject to creditors themselves.

With regard to supervision vacuum as noted, ideally, a provisional creditors' committee can be appointed by the court or the administrator in advance of the first meeting of creditors.[98] More importantly, the committee should be allowed, and be encouraged, to hire professionals paid out of the company.[99] Without hiring professionals such as lawyers, accountants or business consultants, forming a creditors' committee is only a halfway measure to increase the effective participation of creditors. This is because, on the one hand, the committee members are not sufficiently motivated to represent creditors as a whole due to the collective action problem and, on the other hand, these members are not professionally capable to investigate and analyse the company's businesses and make a sound judgement.

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[97] 'Disclosure of Adequate Information in a Chapter 11 Reorganization' (19810 94 *Harvard Law Review* 1808, 1818.

[98] The German experience can be learned, since a provisional creditors' committee will be formed by the court. See Germany Insolvency Statute 2011 s 22a.

[99] See 'Disclosure of Adequate Information in a Chapter 11 Reorganization' (n 97) 1818. See also Dennis S Meir and Theodore Brown, Jr., 'Representing Creditors' Committees under Chapter 11 of the Bankruptcy Code' (1982) 56 *American Bankruptcy Law Journal* 217.

Many other problems could also be solved if professionals could be hired by the creditors' committee. For example, these professionals could investigate causes of the company's bankruptcy. This is what many creditors in Chinese corporate rescues are keen to know but cannot afford to investigate individually. Meanwhile, it could also overcome the deficient supervision of creditors against the administrator. Most administrators are lawyers or accountants; they are qualified and have special expertise and knowledge. Compared with lawyer and accountant administrators who are repeat players, the creditors in the creditors' committee lack knowledge and experience in corporate bankruptcy; therefore, it make their supervision on the administrator very weak and inadequate. However, the supervision may be considerably improved if the creditors' committee has its own lawyer or accountant advisors. The knowledge asymmetry will be materially rectified, and insiders' supervision could be a more effective way to serve and protect creditors.

With regard to creditors' meetings, it should be admitted that it is costly and time-consuming to hold them on a regular basis. But the problem here is not how frequently such a meeting is held. It is not a matter of quantity. Instead, the current challenge is how to ensure that individual creditors are properly informed of the company's position before they attend the creditors' meeting. At present, the two main problems arise regarding creditors' information rights in China's corporate rescues.

The first is that creditors, in most cases, are only provided with a very general audit report without any detailed description of the company's assets and liabilities. Reading an audit report that contains skeletal financial data and few or no explanations, according to many disgruntled creditors, cannot provide a full account of the company's situation. Secondly, creditors are usually given the audit report as well as a proposed reorganization plan at the time when they attend the creditors' meeting. It is too late. It is not a good practice to provide creditors these documents one or two hours before they are required to cast their votes on the reorganization plan. It is highly unlikely for them to assimilate these materials within such a time limit. To address these problems, at least the administrator should provide relevant documents to creditors in advance of creditors' meetings, allowing the latter to study and fully appreciate them before attending creditors' meetings.

In sum, among most of the existing China's corporate rescues, the administrator-in-possession model was used. The only advantage of the administrator-in-possession model is that, without the involvement of local government organized liquidation committees

appointed as administrators, administrators can be neutral before debtors and creditors. But the major disadvantage of installing an administrator in control is that the administrator is not professionally capable to restructure troubled companies, because they do not have a specific stock of information about troubled companies, and because they are not knowledgeable in business management.

A fine corporate rescue regime in China has to give more consideration to allowing and incentivising debtors to contribute their information and understandings to the rescue. Currently, most debtors are either removed or sidelined in the rescue procedure, and much reform in this regard seems to be needed.

4. CONCLUSIONS

This chapter has examined and discussed issues and problems regarding the first two research questions, i.e., entry and control of corporate rescue procedures under China's new corporate rescue law.

Concerning the start of a formal rescue procedure, it is largely the inaction of Chinese courts which almost stifles entry into formal rescue processes.[100] At the heart of courts' hesitation is the lack of judicial independence as well as the oversimplification of the EBL 2006. This is further exacerbated by the indifference or hostility of debtors to the formal rescue regime due to the prevalence of the administrator-in-possession approach and the rigid application of absolute priority in rescues. Moreover, without effective liquidation pressures from creditors, it is not surprising that debtors delay the commencement of the formal rescue as long as possible, thereby placing creditors' interests in jeopardy.

With regard to control in China's rescues, a set of factors lead to the widespread administrator-in-possession approach in rescues. Notwithstanding that administrators might be impartial in striking a balance between various parties, they could do little to substantially rehabilitate troubled companies, because they are technically incapable of doing so. An effective rescue has to rely on debtors themselves. More importantly, it can be contended that

[100] Xin He, 'The Recent Decline in Economic Caseloads in Chinese Courts: Exploration of a Surprising Puzzle' (2007) 190 *The China Quarterly* 352, 371 (reporting that a Chinese court may reject a litigation petition if it thinks it cannot, economically and politically, benefit from handling such a case).

the debtor-in-possession approach could be universally applicable, since many of the concerns regarding its demerits have been properly addressed and accommodated. China's corporate rescue landscape will be immensely updated and refreshed if the debtor-in-possession approach can be established as the default control model in the rescue processes.

The following chapter will discuss the next two research questions: value distribution and the court confirmation of reorganization plans in China.

CHAPTER 8

MAKING FAIR AND FEASIBLE REORGANIZATION PLANS

1. INTRODUCTION

The last chapter discussed the difficulties of launching a corporate rescue procedure in Chinese courts as well as the practice of control in China's corporate rescue procedure. Obviously, more can be done to clear the hurdles hindering the commencement of the rescue procedures. Moreover, debtors can be encouraged to play a greater role in corporate rescues; otherwise the rescue regime could be negatively affected. In this chapter, the discussion will turn to analysing value distribution that occurs in rescues and the court confirmation of reorganization plans in China.

At the heart of a corporate reorganization plan is the issues on how to distribute the company's value as well as how to restructure the company's business.[1] Given the prevalence of the going-concern sale rescue in China, it seems that restructuring the company's business operations has been largely left to the company's buyer, i.e., most of reorganization plans may mainly deal with value distribution issues.

Whether it is a business sale rescue or a traditional rescue, the reorganization plan should be ultimately subject to the court's confirmation at the final stage. A cram-down might even be imposed if the court believes that the plan could pass the statutory tests enshrined in the EBL 2006.

To discuss these two issues, the remainder of this chapter is divided into three Parts: (i) Part 2 analyses the present value distribution practice in China's corporate rescues. In particular, it centres on two basic value distribution rules: the *pari passu* and absolute priority rules. The discussion of going concern value preservation will also be included in this Part, and the strengths and weaknesses of the current rescue practice in preserving going concern value will be re-evaluated. (ii) Part 3 critiques court confirmation of reorganization plans; it

[1] Lynn M LoPucki and William C Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141 *University of Pennsylvania Law Review* 669, 679.

will highlight the use of the cram-down in forcibly confirming reorganization plans. (iii) Part 4 concludes.

2. VALUE DISTRIBUTION IN CHINA'S CORPORATE RESCUES

Prior to discussing value distribution in rescues, it is useful to analyse the importance of China's corporate reorganization regime in preserving going concern value, since going-concern value preservation lies at the core of the rescue regime. Without preserving going-concern value of companies, the rescue regime as a whole would be built on sand.

2.1. Going-Concern Value Preservation

A company's going-concern value can be preserved by means of preventing the company, its business or its assets, from being dismembered; in other words, the going-concern value that is generated between diverse relationships, internal and external, will not be lost. Ideally, the company as an entity can be preserved, because retaining the integration between human resources and assets will maximise going-concern value preservation. If unachievable, a going concern sale would be the second best choice, although it will rather undermine going-concern value preservation.

A. Increased Recovery Rates

As reported, the national average recovery rate for unsecured creditors in China's existing corporate rescues, between June 2007 and November 2010, stood at thirty-three per cent; in Zhejiang, it was slightly higher, at thirty-six per cent. It is worth noting that, in these rescues, secured and preferential debts were paid in full.[2]

Such debt recovery rates in corporate reorganizations are quite promising, especially when compared with their counterparts in corporate liquidations. As mentioned in chapter 5, according to the studies by Zhang and Booth,[3] and Li,[4] unsecured creditors in China's

[2] Article 113 of the EBL 2006.

[3] Xianchu Zhang and Charles D Booth, 'Chinese bankruptcy law in an emerging market economy: the Shenzhen experience' (2001) 15 *Columbia Journal of Asian Law* 1, 10.

corporate liquidations recovered on average less than ten per cent of their pre-bankruptcy claims, and even it was not uncommon for them to recover nothing in most individual liquidation cases. A recent study by Wang and Yi[5] further confirms that it is not exceptional for unsecured creditors to have zero recovery in China's corporate liquidations.

Apparently, China's new rescue regime has shown its strength in preserving going-concern value, since it substantially increased the unsecured creditor recovery rate from less than ten per cent in liquidations to thirty-three per cent in reorganizations. It is also worth noting that until now there has never been zero recovery to unsecured creditors in the existing corporate rescues in China. These figures send a clear message: corporate reorganizations serve creditors' interests better than liquidations do.

In addition, the social effects of saving these troubled companies should not be forgotten, since, by turning troubled companies around, external or social going-concern value of these companies is also preserved.[6] The company's continued existence and trading have prevented a chain reaction that is detrimental to its suppliers and other business partners. Local communities and even local revenue authorities also benefit much from this.[7] Therefore, taking into account both increasing recovery rates for creditors and avoiding the ripple effects that would harm the community interests, China's new corporate rescue regime is a success.

Concerns, however, are also raised as to how to better preserve going-concern value of troubled companies in China's corporate rescue processes.

B. Challenges

Among all other challenges, the widespread going concern sale rescue is probably the foremost concern, because it is definitely not the most optimal instrument for preserving going-concern value in a modern corporate rescue regime. As reported, between June 2007

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[4] Shuguang Li, 'Bankruptcy Law in China: Lessons of the Past Twelve Years' (2001) 4 *Harvard Asia Quarterly* 2.

[5] Xingxing Wang and Zhenyou Yi, *China Bankruptcy Forum* vol 3 (Law Press 2009, in Chinese) 324.

[6] Richard V Butler and Scott M Gilpatric, 'A Re-examination of the Purposes and Goals of Bankruptcy' (1994) 2 *American Bankruptcy Institution Law Review* 269, 283. See also Lynn M LoPucki, 'The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy' (2003)56 *Stanford Law Review* 645.

[7] See Brian A Blum, 'The Goals and Process of Reorganizing Small Business in Bankruptcy' (2000) 4 *The Journal of Small & Emerging Business Law* 181, 233-4.

and November 2010, eighty-four per cent of existing corporate rescues in China were conducted as the going concern sale.

A going concern sale is one of the ways to preserving going concern value but is not the most ideal. Arguably, there seems to be a ranking of methods to preserve going-concern value. At the top is it to save a company as an entity; in the middle is it a going concern sale; and at the bottom is it to sell assets that are combined as a unit.[8] As previously discussed, a company's going concern value is generated among various relationships, such as business connection between the company and its customers, the relationship among managers and employees, etc. Saving a company through maintaining a bundle of relationships would be the most desirable way to preserve its going concern value. Selling the company's business or assets, by contrast, may inevitably lead to breaking some of these relationships, as a result of which the going concern value of the company will have some degree of loss.

Two factors of the going concern sale rescue may considerably detract from going concern preservation. First, the going concern value generated from the relationship between management and companies' assets[9] will be lost in the going concern sales. In nearly all China's going concern sale rescues, the management were entirely removed before or during the rescue processes, as a result of which so much of these companies' going concern value evaporated. At the same time, along with the removal of old management, these companies' external business connections were also adversely affected, because these connections were firmly related with individual managers.[10] So, further loss of going concern value was made.

Second, the going concern sale rescue has to face market illiquidity for troubled companies. In general, there is not a well-functioning market to sell troubled companies in China. This is partly because buying troubled companies is complex in nature and involves considerations regarding ownership, control and even the possible legal disputes flowing from a purchase. Sometimes there might be hidden liabilities which cause more uncertainties. These considerations and uncertainties may deter many potential buyers from coming forward. For example, during the reorganization of *Yijiaxiang Food Co. Ltd. Zhejiang* in

[8] See generally Gabriel Moss, 'Chapter 11 – an English Lawyers Critique' (1998) 11 *Insolvency Intelligence* 17. See also Lynn M LoPucki and Joseph W Doherty, 'Bankruptcy Fire Sales' (2007) 106 *Michigan Law Review* 1, 5.

[9] LoPucki (n 1) 655.

[10] See generally Seung Ho Park and Yadong Luo, 'Guanxi and Organizational Dynamics: Organizational Networking in Chinese Firms' (2001) 22 *Strategic Management Journal* 455.

2010, several potential buyers contacted the administrator, but eventually all of them left, largely because they could not gain confidence to solve the complex web of the company's debts.[11]

Admittedly, in some cases, an auction can be held if there are over three serious buyers. For example, in the reorganization of *Zhonggu Sugar Co. Ltd. Guangdong* in 2009, there were five serious bidders; the possible highest price of the going concern sale was achieved through the auction.[12] But, in most of the going concern sales, an auction was impossible because there was usually only one buyer.[13] Under China's auction regulations, an auction cannot be held if there are less than three bidders. This means that most business sale rescues cannot achieve the highest price through an auction process. Instead, most of the sales were privately negotiated.

Even in extreme cases, a buyer would intentionally exploit market illiquidity and the company's dire state by offering so low a price. For example, in the reorganization of *Changhong Special Steel Co. Ltd. Jiangsu* in 2010, an offer made by the only buyer was even lower than the company liquidation value appraised by the evaluator; there was no doubt that this offer was outright refused by creditors.[14]

Thus, when a going concern sale is considered and pursued, it has to bear in mind that it will cause loss in the company's going concern value because of the departure of the old management and because of market illiquidity.

In the US, an empirical study reveals that a going concern sale rescue could only, on average, preserve thirty-five per cent of the company's book value, the net asset value in British sense, and that, by contrast, a traditional reorganization, namely saving a company as

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[11] Yanting Zhang, 'Solutions to the Stalemate of *Yijiaxiang* Reorganization' *Qianjiang Evening News* (Hangzhou Zhejiang China, 6 September 2011, in Chinese) B3.

[12] Fei Feng and others, 'The Reorganization of *Zhonggu Sugar* Has Terminated' *Zhanjiang Evening News* (Zhanjiang Guangdong China, 16 September 2011, in Chinese) <http://www.chinainsol.org/show.aspx?id=2053&cid=13> accessed on 1 July 2010.

[13] It is still being debated that whether an auction is valid if there is just one bidder emerging. See generally Nenbao Zhang, 'Effects of Only One Bidder in the Auction' *People's Court Daily* (Beijing China, 4 July 2012, in Chinese) <http://www.zwmscp.com/a/minshangfazonglun/minshangfazonglun/2012/0704/10907.html> accessed 3 July 2013.

[14] The Creditors' Meeting of *Changhong Special Steel Co. Ltd. Jiangsu*, 'The Resolution of the First Creditors' Meeting' (Suzhou Jiangsu China, 11 June 2010, in Chinese).

an entity, could retain eighty per cent of the book value.[15] Such a gap is likely to be caused by the two problems analysed above.

In brief, to preserve going concern value of troubled companies, more consideration should be given to pursuing the traditional reorganization rather than the going concern sale rescue. Preserving going concern value of a troubled company is only the first step to serve creditors and debtors, the next step regarding how to distribute it among interested parties would be more challenging.

2.2. The Absolute Priority Principle

The absolute priority principle is the default norm in distributing value in corporate reorganizations but is mandatory in corporate liquidations. In most jurisdictions, the absolute priority rule is taken for granted, partly because it is deemed to be the fundamental equity norm in distributing residual assets of a company when it is bankrupt.[16] For example, in the UK, a well-developed jurisdiction in bankruptcy law, there are few academic debates as to controversies of applying the absolute priority principle, largely because the UK bankruptcy law virtually rules out deviating from this principle in corporate bankruptcies. [17]

Deviations from absolute priority, however, always exist in one way or another in both liquidation and reorganization processes. This is a fact. For example, in Sweden where there is no corporate reorganization procedure, when a company is bankrupt, an automatic and compulsory auction will be held. A deviation from absolute priority, however, was often found when assets were sold back to old equity managers.[18] In the UK, a deviation can also be frequently identified in some pre-packaged administration procedures[19] and in informal rescues.[20] Thus, the absolute priority principle is not as absolute as its name indicates.

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[15] LoPucki and Doherty (n 8) 3.
[16] Ibid 37.
[17] See Julian R Franks, Kjell G Nyborg and Walter N Torous, 'A Comparison of US, UK, and German Insolvency Codes' (1996) 25 *Financial Management* 86, 91.
[18] Per Stromberg, 'Conflicts of Interest and Market Illiquidity in Bankruptcy Auction: Theory and Tests' (2000) 55 *The Journal of Finance* 2641, 2645.
[19] In some pre-packaged administrations, businesses may be sold to companies' connected parties, so the *de facto* deviation from absolute priority still occurs. See Vanessa Finch, 'Corporate Rescue: a Game of Three Halves' (2012) 32 *Legal Studies* 302, 317.
[20] Franks, Nyborg and Torous (n 17) 98.

Under the EBL 2006 in China, it is also clear that the absolute priority norm is treated as the default rule in corporate reorganizations, and a deviation is possible but should be with the consent of the disadvantaged parties.[21] Given the less-developed rule of law in China,[22] however, in practice, this principle was not rigorously complied with in some company reorganizations.

A. Applications

As reported, the deviation from absolute priority was found in fifty-three per cent of China's corporate reorganizations studied. This is rather unsettling. Closer inspection, however, reveals that most of these deviations took place in listed company rescues. In particular, a deviation was the norm rather than the exception in listed company reorganizations. By contrast, in non-listed company rescues, such a deviation was rarely used, as it was only found in about fifteen per cent of non-listed company reorganizations.

As for listed company reorganizations, it seems that China's central government intends to prioritise the maintenance of social stability at any costs,[23] and this is reflected in China's Supreme People's Court's decree according to which equity of general public investors (shareholders) must be given special protection in corporate reorganizations regardless of whether listed companies in reorganization are insolvent or not. This is mainly because shareholders of listed companies are large in number. If they are unsatisfied with the cancellation of their equity, namely the rigid application of the absolute priority principle, in reorganizations, they may launch mass petitions or street protests to express their grievances. Mass petitions are what China's government are trying to avoid. For the sake of maintaining the social stability, thus, the absolute priority principle is formally relaxed in listed company reorganizations. But such an exemption decree has brought at least two main worries.

The first is a clash of legal rules. The Automatic deviation from absolute priority in listed company reorganizations was authorised in a conference speech given by a senior judge of China's Supreme People's Court, Mr Song Xiaoming, in April 2006. Although it is not a formal decree, it is clear that Mr Song gave this policy instruction on behalf of the

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[21] Article 87 of the EBL 2006.

[22] See generally Eric W Orts, 'The Rule of Law in China' (2001) 34 *Vanderbilt Journal of Transnational Law* 43.

[23] See generally Murray Scott Tanner, 'China Rethinks Unrest' (2004) 27 *The Washington Quarterly* 137.

Court. So, this guidance can be interpreted a decree or a judicial notice issued by the Supreme Court of China.[24]

But, both the letter and the spirit of this decree are not consistent with the EBL 2006 that was promulgated four months later. Song gave the speech in April 2006, and the EBL 2006 was enacted in August 2006. Under 87 of the EBL 2006, a deviation from absolute priority is allowed but must be conditional upon the consent of disadvantaged parties. In other words, the EBL 2006 requires that a deviation must be based on consent in all company reorganizations. The decree, however, removes the condition of the consent set up by the EBL 2006 in listed company reorganizations. In principle, this decree has already been invalidated by the EBL 2006, because the law enacted by China's People's Congress prevails in the event of a clash with any decrees issued by China's Supreme People's Court, and because the EBL 2006 was promulgated later than this decree. In reality, however, this decree is still in force at the time of writing.

The second worry is that this decree is somewhat abused in practice. In his speech, Mr Song made it clear that it was small-and-medium shareholders in listed company reorganizations who can retain some of their equity.[25] It could be literally understood that controlling and institutional shareholders are not included on this special protection list. In spite of the fact that small-and-medium shareholders can be subject to broad interpretation, given that this decree was aimed to maintain social stability, presumably, Mr Song's real intent was defining small-and-medium shareholders as general public shareholders. In other words, Song's speech must be interpreted in the context. In reality, however, all shareholders of listed companies in reorganization were allowed to retain certain percentage of their equity, although all these companies were bankrupt and unable to pay creditors in full.

Leaving listed company reorganizations aside, the deviation from absolute priority in non-listed company reorganizations was exceptional, since it only, as noted above, took place in fifteen per cent of these rescues. Under such circumstances, the deviation was carried out mainly for two purposes. First, a deviation took place because the rescue process was firmly controlled by the debtor. Debtors, especially their equity-managers, have an incentive to use

[24] Xiaoming Song, 'The Court's Role in the Proceedings of Enterprise Bankruptcy and Restructuring and the Problems That Need to be Solved' (The Forum for Asian Insolvency Reform, April 2006 Beijing China) <http://www.oecd.org/china/38184314.pdf> accessed 02 October 2012.

[25] Ibid.

their control, if they can regain it, in rescue processes to maximize shareholders' interests by pursuing deviations from absolute priority. For example, in the reorganization of *Dadi Paper Co. Ltd., Zhejiang*, the company was returned to the debtor in the rescue process, and the reorganization plan was also proposed by the debtor itself, so it was not surprising that the absolute priority principle was put aside in that case. [26]

Second, it is market illiquidity for trouble companies which leads to deviations. As noted before, although most of China's corporate rescues rely on the going concern sales, it is not always easy to find buyers. When there are not company buyers, a deviation seems to be a necessity, because it is the only way to increase the creditor recovery rate by inviting and rewarding equity-managers to turn troubled companies around. For example, in the above *Dadi* case, the attempt to find a company buyer failed, and the only realistic option for creditors was to allow the debtor to continue to run the company, since the latter promised to pay creditors more than they could have in liquidation. In the reorganization of *Xingxing Artefacts Co. Ltd., Fujian*, the equity-manager was also, in fact, invited by the creditors to restructure the company; in this case, although creditors took a significant haircut, with the company's ownership untouched, they were better off than in a piecemeal liquidation.[27]

However the absolute priority principle is applied or relaxed, the primary aim should be to improve the feasibility of corporate reorganization, and this must be the bottom line. In some situations, however, the application of absolute priority seems to be counterproductive.

B. Controversies

At first glance, as discussed, the absolute priority norm must be applied rigorously, because it is a matter of investors' certainty and predictability in the wider market. Without strictly applying this rule, market efficiency will be undermined, because creditors would hesitate to extend credit, and debtors are unable to borrow. In practice, however, its stringent

[26] *Dadi Paper Co. Ltd. Zhejiang*, 'The Reorganization Plan of *Dadi*' (Hangzhou Zhejiang China, 28 December 2009, in Chinese).

[27] Jinxiong Zhen, Haitao An and Jizhou Chen, 'Corporate Reorganization Helps Company to Revive' *People's Court Daily* (Beijing China, 25 December 2009, in Chinese) <http://oldfyb2009.chinacourt.org/public/detail.php?id=134675> accessed 27 September 2012

application may produce unfairness because of the flaws of the supporting mechanisms. Inaccurate asset evaluations can be the first of these concerns.[28]

In corporate liquidations, a company's assets or business will be sold in the open market, so almost no doubt can be cast upon the value of the assets, because it is simply determined by a real sale. In corporate reorganizations, especially traditional corporate reorganizations, by contrast, there is no real sale; instead the sale is hypothetical. The company's price is set according to the valuation of its tangible and intangible assets.[29] If the appraised value exceeds the company's liabilities, there would be a happy end, because after creditors are paid in full, there is still something left for shareholders, but this is a highly unlikely event. In most corporate reorganizations, however, the appraised value of the company's assets is lower than its liabilities. Shareholders will, thus, be deemed to be the parties who have lost all their interests in the company due to the absoluter priority norm.

So, asset valuations are critical in applying absolute priority in corporate reorganization. But the danger is, as noted before, that asset valuations are always inaccurate, because they are largely based on subjective estimates. One study in the US shows that, when a bankrupt company is appraised, sometimes its 'estimated value to market value varies from less than twenty per cent to greater than two hundred fifty per cent'.[30]

In China's corporate reorganizations, company valuation inaccuracies could also be easily identified. There are two extreme cases worth noting. In 2008, there was a high-profile reorganization case in Jiangsu province where *Yaxing Electronic Co. Ltd. Suzhou* entered the corporate reorganization procedure. The company's assets were initially evaluated at RMB 0.4 billion. The subsequent auction, however, ended at the final price of RMB 2 billion, five times the evaluated one.[31] In the same province in 2009, the assets of *Chang Hong Special Steel Co. Ltd. Jiangsu* were appraised at RMB 88 million; however, a serious buyer was only

[28] Douglas G Baird and Donald S Bernstein, 'Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain' (2006) 115 *Yale Law Journal* 1930, 1935.

[29] Douglas G Baird, 'Revisiting Auctions in Chapter 11' (1993) 36 *Journal of Law and Economics* 633, 638

[30] Stuart C Gilson, Edith S Hotchkiss and Richard S Ruback, 'Valuation of Bankruptcy Firms' (2000) 13 *The Review of Financial Studies* 43, 44.

[31] Jing Wu, 'The First Case of Reviving Bankrupt Enterprise' *People's Daily* (Beijing China, 11 February 2009, in Chinese) 15.

willing to pay up to RMB 50 million for the company, i.e., the real value of the assets seemed to have been considerably inflated by the evaluator.[32]

Now, it seems clear. Asset valuations are largely tentative in character. The danger here is that if we use such tentative valuations to apply absolute priority in reorganization, in most cases, at least shareholders will be excluded prematurely at a very early stage. Shareholders, thus, are unfairly treated and are even victimised by inaccurate valuations. Absolute priority was made to pursue fairness and equity, but applying it by using inaccurate valuations will backfire at least from some junior parties' perspective.

One may ask whether China's corporate rescues were not adversely affected by inaccurate valuations, because most of them used the going concern sale rather than the traditional rescue approach. In theory, the going concern sale could minimise, if not eliminate, price inaccuracies associated with valuations, because the market is thought to be best place to set a fair price for assets. But as noted, there is no well-functioning market for troubled companies. And the only effective way to achieve the market value of the company assets is to hold an auction.[33] In other words, if an auction had been held in all going-concern sales in China's corporate reorganizations, applying absolute priority would have not been negatively affected by asset valuation inaccuracies. But it is not the case.

As noted before, most of China's going concern sales were, in fact, negotiated between the company buyer, the administrator and other main parties. An auction was only used in exceptional cases, because there were not enough buyers or bidders to hold an auction. There was no regular market for troubled companies in China. Without an auction, it means that it was still the outcomes of asset valuations which determined the price of the going concern sale. So the potential unfairness was still followed.

The very subjective nature of valuations can be further aggravated by conflicts of interest in China's corporate reorganization. In theory, secured creditors tend to underestimate assets so as to exclude unsecured creditors and shareholders from sharing the value of the company, whereas the latter often overestimate them in order to get something in

[32] Changshu Lower People's Court, 'Ruling to Terminate Reorganization of *Chang Hong'* (Changshu Suzhou Jiangsu China, 24 June 2010, in Chinese) <http://www.chtzg.com/tczm_22.htm> accessed on 30 August 2010.

[33] See generally Paul Klemperer, 'What Really Matters in Auction Design' (2002) 16 *The Journal of Economic Perspectives* 169.

the rescue process.[34] In China's corporate reorganizations, however, such a bias seems to be eliminated, because it is always a court-appointed administrator who hires a licensed auditor to evaluate company assets. The independence of both the administrator and the evaluator could ensure the impartiality of valuations. In practice, however, the story is different.

In practice, asset undervaluations have been long contested by creditors in Chinese corporate reorganizations, and this has also been noticed by China's Supreme People's Court in 2009 that required that judges be serious to creditors' complaints on this.[35] Notwithstanding there is no concrete evidence that administrators would manipulate asset valuations through evaluators, it seems that administrators tend to see as low valuations as possible. This is because, on the one hand, with a low asset evaluation, the administrator will find that it is far easier to pass the creditor-best-interest test when the reorganization plan is submitted to the court for confirmation, and on the other hand, accordingly, the low asking price in selling the company will be more attractive for potential buyers. If these doubts are true, inevitably, undervaluations of assets will undermine what the absolute priority principle is aimed to pursue.

Moreover, the rigid application of the absolute priority rule would create a dilemma. Fairness and equity may be achieved by preventing shareholders, in particular shareholder-managers, from sharing the company's value, because there are even no sufficient assets to meet all claims of creditors. But the feasibility of the rescue is sacrificed, because shareholder-managers whose experience and information are critical to the ongoing operation of the company's business will leave due to the cancellation of their equity under the absolute priority rule. In corporate reorganizations of SMEs,[36] this dilemma becomes more acute. This can be exemplified by the predicament encountered in a recent reorganization case in China.

In the reorganization of *Nanwang Group Co. Ltd., Zhejiang* in 2008, the shareholder-manager, Zhang Jiang, who was also the company's CEO, was removed, because the absolute priority rule required that all his equity had to be cancelled. Some creditors, however, immediately realised that, without his continued service, the reorganized new company

[34] Baird and Bernstein (n 28) 1941.

[35] The asset undervaluations in rescues also came known by China's Supreme People's Court. See 'Solving Debt Risks and Rescuing Troubled Companies' *People's Court Daily* (Beijing China, 22 June 2009, in Chinese) <http://jjzy.chinacourt.org/public/detail.php?id=11436> accessed 4 July 2013.

[36] Douglas G Baird and Robert K Rasmussen, 'Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations' (2001) 87 *Virginia Law Review* 921, 947-8.

would become an empty shell, since the company's business was heavily dependent on his personal relationships with several key customers.[37] The most valuable asset of the company is its equity-manager's customer connection. Excluding this equity-manager meant the considerable loss of the company's value.

The *Nanwang* case demonstrated that the rigid application of the absolute priority principle is, sometimes, a double-edged sword. On the one hand, it is a breach of absolute priority to give something to old shareholder-managers if creditors are not paid in full; on the other hand, the company's future will become precarious because absolute priority forces shareholder-managers, who may be the most capable people knowing how to run the business, to leave the company.[38] Indeed, this dilemma has long been debated in the US. Should the former equity-manager be given some equity in the new company in exchange for his or her continued service?[39] The US case law, however, made it clear that the equity-manager's continued service does not constitute a new value, so he or she is not eligible to share equity in the new company.[40]

This judgement might be right, as the going concern value flowing from equity-managers' involvement in the company has already existed before the reorganization procedure starts, i.e., such value is not newly created. But this judgement does not solve the problem. Admittedly, such value is not freshly created but will be definitely lost if equity-managers leave the company. Both policy-makers and practitioners have to strike a balance when faced with this dilemma.

In brief, applying absolute priority in corporate reorganizations raises serious concerns regarding fairness for junior parties, especially shareholders, as well as feasibility of rescues. Some reforms seem to be needed, or the new understandings should to be established.

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[37] Hejuan Chao, '*Nanwang* Reorganization Plan Rejected by the Creditors' Meeting' *Caijing* (Beijing China, 29 October 2008, in Chinese) <http://www.caijing.com.cn/2008-10-29/110024211.html> accessed 13 December 2012.

[38] See Lucian Arye Bebchuk, '*Ex Ante* Costs of Violating Absolute Priority in Bankruptcy' (2002) 57 *The Journal of Finance* 445, 446.

[39] Bruce A Markell, 'Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations' (1991) 44 *Stanford Law Review* 69, 123.

[40] Ibid.

C. Ways Forward

The absolute priority rule is one of the most fundamental principles in distributing company value. Where a company is closed either through bankruptcy or outside bankruptcy, creditors must be paid before shareholders. But the key point, it can be argued, is that the absolute priority principle is designed and applied upon the assumption that the company is to be dissolved. Rather than dissolving a company, however, corporate reorganization is intended to revive and continue the company's business. In other words, in corporate reorganization, the assumed precondition of applying absolute priority has been changed. In theory, this rule should, accordingly, be modified to accommodate such a change.

As for the future of this rule in China's corporate rescues, some suggestions may be given for listed and non-listed company reorganizations separately, because this rule has been applied differently between them.

With regard to listed company rescues, the routine deviation from absolute priority makes rescues unfair, because the automatic deviation means that reorganizations of listed companies are conducted entirely at the expense of creditors, especially unsecured creditors. More importantly, as discussed before, one principle should be made clear. A deviation from absolute priority must only be used to support the preservation of going concern value and to improve the viability of rescues. By such benchmarks, apparently, retaining all previous shares intact in listed companies' rescues appears to be unjustifiable.

Moreover, the main objective of China's such policy was to highlight the maintenance of social stability, but it seems to be inappropriate to force creditors to bear the cost for the government's intent. In addition, given that this policy violates the EBL 2006, in the near future, this is expected to be seriously reviewed.

Regarding non-listed company rescues, as noted, the application of absolute priority seems to be polarized; most of them rigorously complied with this rule, whereas a small percentage of them entirely ignored it. In general, the rigid application of the absolute priority rule seems to be a direct result of the going concern sale rescues. It can, however, be argued that the going concern sale is not the most plausible approach for reorganization, as it has to encounter the market illiquidity for troubled companies and the loss of company going concern value by virtue of the departure of the old management. The circumvention of

absolute priority, by contrast, also appears to be inappropriate, because at least there should be a risk-sharing mechanism between creditors and shareholders.

To tackle this dilemma, it seems to be desirable for administrators to explain the vices and virtues of absolute priority for creditors at first, and then it is at the option of the latter to decide whether to invite equity-managers to join the rescue and share the losses. This is because, up to the present, in almost all non-listed company deviation cases in China, the reorganization plan has, deliberately or inadvertently, avoided explaining how to deal with the company's ownership after rescue. In other words, creditors were not explicitly informed that it is them who bear the full costs of the rescue, and that shareholders have not shouldered any cost. Perhaps, because of the lack of legal expertise, creditors were unknowingly harmed.

2.3. The *pari passu* Principle

By comparison with the absolute priority principle, the *pari passu* principle appears to be less problematic. In general, this principle is treated in two different ways in many jurisdictions. In the UK corporate reorganizations, the *pari passu* rule is deemed to be a public policy, and interested parties are not allowed to contract out;[41] put another way, it is mandatory in UK corporate reorganization procedures. In other countries, by contrast, such as the US,[42] Germany[43] and China,[44] this principle is treated as a default rule, namely, the *pari passu* can be contracted out.

Under Article 81 of the EBL 2006, there are not specific rules regulating value distribution in corporate reorganizations - it is surprising, and it is at the option of impaired parties to vote on whether the *pari passu* principle[45] should be applied or not. But there is one restriction. Under Article 87 of the EBL 2006, when a cram-down is sought, the *pari passu*

[41] *Belmont Park Investments PTY Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc.* [2011] 38 UKSC 2.

[42] 11 USC Sec. 1129.

[43] Franks, Nyborg and Torous (n 17) 94.

[44] Article 87 of the EBL 2006.

[45] See generally Andrew Keay, Andre Boraine and David Burdette, 'Preferential Debts in Corporate Insolvency: a Comparative Study' (2001) 10 *International Insolvency Review* 167.

principle must be applied;[46] otherwise the plan will be rejected by the court because it cannot pass the fair and equitable test.

As reported, the deviation from the *pari passu* principle took place in twenty-six per cent of the existing corporate reorganizations in China. In particular, the deviation was used in forty-three per cent of listed and fifteen per cent of non-listed company reorganizations.

By and large, deviating from the *pari passu* principle was used for two purposes. The first was to canvass small unsecured creditors to accept reorganization plans. Small creditors might be insignificant in claims but are definitely matter in number. This is because, under Article 84 of the EBL 2006, the reorganization plan will not be passed unless it is accepted by a majority (two-thirds in claims and one-half in number) of each class of impaired parties. Therefore, it is not surprising that reorganization plan proponents bent the *pari passu* principle in favour of small creditors in exchange for their votes.

The second purpose seemed to be controversial. It was made in order to maintain social stability by paying a higher percentage to creditors who were individuals. Maintaining social stability *per se* was understandable and even justifiable, but it seemed inappropriate to let creditors to bear the costs of maintaining social stability, because creditors have no obligation to tackle and pay for the problem of social stability and because the potential social stability troubles were not caused by them.

Whatever soliciting the votes of small creditors or maintaining social stability, the bottom line is that deviating from the *pari passu* principle must be under the consent of disadvantaged parties, and this requires courts to ensure that this principle is adequately followed when the reorganization plan is submitted for confirmation. This will be further discusses in the following Part on court confirmation of reorganization plans.

Finally, at present, a serious concern is raised when applying the *pari passu* principle in China's corporate reorganizations: there is no equitable subordination mechanism in the EBL 2006. This means that all unsecured creditors are paid *pro rata*, regardless of whether some of them may be insiders or connected parties. Without equitable subordination, superficially, fairness seems to have been achieved by paying all unsecured creditors in the same

[46] See Jack Friedman, 'What Courts Do to Secured Creditors in Chapter 11 Cram Down' (1993) 14 *Cardozo Law Review* 1495, 1543.

proportion; however, substantially, great unfairness may have been produced.[47] This is, in effect, a breach of the spirit of the *pari passu* principle. Given there is not an equitable subordination mechanism in statute in China, it is essential that some academic research be conducted at first in the foreseeable future.

To sum up, China's corporate reorganization regime has materially preserved going concern value of troubled companies, since it prevented troubled but viable companies from being piecemeal liquidated. The main challenge to preserving going concern value, however, is that most of China's corporate rescues resorted to the going concern sale rescue, which seems not to be the ideal way to preserve such value. To establish an effective corporate culture, consideration should be given to promoting more traditional corporate reorganizations in China.

To value distribution in China's corporate reorganizations, in the first place, the automatic deviation from absolute priority in listed company reorganizations gave rise to unfairness and also undermined the rule of law in China; in the second place, concerning the *pari passu* principle, it is recommended that an equitable subordination mechanism be installed in statute with a view to filling the gap left by the *pari passu* principle.

3. COURT CONFIRMATION OF REORGANIZATION PLANS

Under Articles 86 and 87 of the EBL 2006, there are two different reorganization plan confirmation procedures: the normal, consensual procedure to confirm a plan which has been voted for by all classes of impaired parties, and the cram-down, non-consensual procedure for a plan which has been rejected by one or more classes of impaired parties.[48]

Before discussing concerns raised from court reorganization plan confirmation in China's corporate reorganization, it seems to be necessary to examine why a reorganization plan should be subject to court confirmation.

[47] See generally Daniel C Cohn, 'Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code' (1982) 56 *American Bankruptcy Law Journal* 293.

[48] These two procedures are governed by Articles 86 and 87 of the EBL 2006 respectively.

Why a reorganization plan should be confirmed by the court? To this question, there are different approaches in the US and the UK. Under Chapter 11 in the US, a plan must be confirmed ultimately by the court.[49] In UK administrations, the main corporate rescue procedures, an administrator's proposal, which is equivalent to a reorganization plan under Chapter 11 in the US, take effects immediately after being approved by a meeting of creditors, i.e., there is not a court confirmation procedure in the UK corporate reorganizations.[50]

Given the prevalent debtor-in-possession system in the US (under Chapter 11), it appears warranted for courts to supervise debtors by scrutinizing reorganization plans and to ensure that fairness and equity are not breached. In the UK, by contrast, with a professional and unbiased insolvency practitioner in charge acting as the administrator, it seems to be unnecessary for judges to make a second assessment by confirming reorganization plans.[51]

In the light of these different approaches, the question must be asked as to why reorganization plans under the EBL 2006 should be approved by courts, especially given that there is already an independent, professional, court-appointed administrator who either supervises a debtor-in-possession or directly manages rescue issues.[52] In fact, asking this question is to examine how far the court intervention in corporate reorganization can go. This is a more fundamental and profound question. Due to the scope of this thesis, more detailed debate cannot be expanded here. But this question deserves more researches in the future.

3.1. Normal Confirmation Procedures

In China's corporate rescues, as noted, where the reorganization plan has been accepted by a majority (one half in number and two-thirds in claims) of each class of impaired parties, it has to be confirmed by the court. Article 86 of the EBL 2006 stipulates that the court will confirm the plan if it is in line with the EBL 2006, however, the key uncertainty here is that Article 86 does not specify the requirements whereby the court could rely to assess a

[49] 11 USC Sec. 1128.
[50] Insolvency Act 1986 s 25.
[51] Vanessa Finch, 'Control and Co-ordination in Corporate Rescue' (2005) 25 *Legal Studies* 374, 397.
[52] See generally Bruce G Carruthers and Terence C Halliday, *Rescue Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford University Press 1998) 379.

reorganization plan. It can be argued that courts might have a great deal of leeway to decide whether a reorganization plan could be confirmed or rejected.[53]

In reality, the reorganization plan in all China's existing corporate rescues has been confirmed by the court. It, thus, seems that Chinese courts were considerable lenient towards submitted reorganization plans. This can be juxtaposed to the low confirmation rate in the US. In the US Chapter 11s, it might not be easy to get courts' blessings, as one empirical study reveals that the confirmation rate was usually lower than fifty per cent, i.e., over half of reorganization plans were eventually rejected by courts in the US.[54]

The 100 per cent court confirmation rate in China might be ascribed to the following reasons.

First, there were a very small number of troubled companies in China that could enter the corporate reorganization procedure under the EBL 2006. Because of the excessively narrowly-interpreted requirements for entry into the formal rescue procedure, the vast majority of troubled companies that could seek a formal rescue solution were in fact excluded from the formal rescue regime.[55] It is, as a result, not surprising that the success of a small number of companies in the rescue process seemed to be guaranteed.

Second, many corporate reorganizations in China were essentially pre-packs. In other words, the formal procedure was largely used to execute pre-packaged rescue agreements. It is noteworthy that, unlike pre-packaged rescues in the UK and the US,[56] China's pre-packs were court-involved, that is to say, courts joined pre-trial rescue negotiations. As noted before, for example, in Hangzhou's Intermediate People's Court, Zhejiang, during an *ad hoc* period before accepting a rescue filing, the court would summon main interest parties to discuss a potential reorganization proposal and would not formally accept the rescue filing unless a blueprint reorganization plan had been agreed.[57] In the light of frequently used pre-packs in

[53] Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Law: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113, 129.

[54] Elizabeth Warren and Jay Lawrence Westbrook, 'The Success of Chapter 11: A Challenge to the Critics (2009) 107 *Michigan Law Review* 603, 614-5.

[55] See ibid 626.

[56] See Lijie Qi, 'The Rise of Pre-packaged Corporate Rescue on both Sides of the Atlantic' (2007) 20 *Insolvency Intelligence* 129.

[57] Hangzhou Intermediate People's Court, 'The Self-Assessment of Dealing with Corporate Reorganization Cases' (Hangzhou Zhejiang China, 5 January 2010, in Chinese) <www.hzcourt.cn> accessed 26 September 2011.

which courts were also involved, it seemed to be attendant for courts to give the green light to these plans at the final stage.

Third, almost automatic confirmation might also be because courts were deeply involved in rescue processes, including formulating reorganization plans. As reported in chapter 6, it was not uncommon that courts in China even participated in reorganization plan negotiations between major parties. So, to a large extent, courts' objecting views would have been considered and absorbed in proposed reorganization plans at earlier stages. Courts, as a result, had no reason to reject a reorganization plan in which the judicial opinions had already been included.

Although all reorganization plans were confirmed by courts in China, there are still some issues that need to be addressed.

The first is that there is, during a confirmation process, no hearing in court where dissenting or objecting parties could raise their voices which may be critical for the court to make a sound judgment. Under Article 86 of the EBL 2006, after receiving a voted reorganization plan, the court will assess it behind closed doors, without listening to any objecting parties.

Strictly speaking, under Article 64 of the EBL 2006, an individual creditor can request the court to revoke a reorganization plan on the grounds that it violates the law, but in reality such a motion has not, reportedly, filed by creditors. This might be partly because of the dilemma of collective action, and partly because of that creditors had no confidence of courts' impartiality, given that the latter had been deeply involved in formulating reorganization plans.

The second issue is that the court's plan confirmation cannot be challenged before a higher court, i.e., there is no appeal procedure. The EBL 2006 is silent on whether an individual party has the right of appeal against a confirmation ruling. Under Article 147 of the China Civil Procedure Law 1991, however, in principle, any decisions made by a court

are subject to appeals. In reality, an appeal is not allowed in China's corporate reorganizations.[58]

Without an appeal procedure, the reorganization procedure might operate more efficiently, but efficiency must always be weighed against fairness. In view of local protectionism and the less-developed judicial independence in China, an appeal dealt with by a higher court seems to be quite necessary. To strike a fair balance, it can be contended that a compromise could be made. A court's confirmation ruling will take effect immediately, but objecting parties can still have the right to appeal. The court's confirmation ruling stands if the appeal is rejected, and equally the confirmation should be revoked if the appeal is allowed by the high court.

3.2. Cram-Downs

Sometimes a reorganization plan fails to be accepted by a majority of voters, so, the plan's proponent may file a motion with the court requesting a cram-down.

The first question that needs to be asked is whether a cram-down can be requested if the plan has been rejected by all classes of impaired parties in China's corporate reorganizations. Article 87 of the EBL 2006 states that a cram-down may be requested in the case that the reorganization plan has been voted against by 'some' classes of impaired parties. Literally, this can be interpreted that a cram-down cannot be requested if the reorganization plan has been rejected by 'all' classes of impaired parties. It was argued by a Chinese judge that Article 87 should be interpreted as that a reorganization plan must be accepted by at least one class of impaired parties before it can be submitted for the cram-down consideration, and if the plan is rejected by all classes of voters, its proponent is not allowed to ask for a cram-down.[59] A recent reorganization case, however, gave an opposite interpretation.

In November 2011, the Yinchuan Intermediate People's Court, Ningxia, issued a cram-down confirming the reorganization plan of *Yin'guang'xia Co. Ltd*., although the plan had been rejected by all classes of voters, including both creditors and shareholders. This cram-

[58] See Xing Xing, 'An Analysis of Cram Down Approval in Corporate Reorganization' (2011) 302 *Journal of Law Application* (in Chinese) 57, 118.
[59] Ibid 58.

down ruling sent a very confusing message as to how to interpret Article 87. Unless there is a new judicial interpretation made by China's Supreme People's Court, such an ambiguity will remain.

In China's corporate reorganizations, under Article 85 of the EBL 2006, regardless of insolvency, a reorganization plan should also be voted by a class of shareholders if their equity is impaired by the plan.[60] Allowing shareholders to vote on the reorganization plan may at least ensure their rights to participate in the rescue process; in practice, however, it produces many controversies which will be discussed later.[61]

Unlike a normal and consensual confirmation procedure whereby there are no specific requirements for courts to confirm reorganization plans, a cram-down procedure has a set of tests to pass. In particular, there are three tests: the creditor-best-interest, fair and equitable, and feasibility test.[62]

A. Cram-downs in Practice

As chapter 5 reported, the cram-down was issued by courts in forty-one per cent of the corporate reorganizations in China at national level. A closer examination revealed that it was shareholders who bore the brunt. More precisely, fifty-nine per cent of the cram-downs were to override shareholder objections; forty-one per cent of them were to silence unsecured creditors; and thirty-one per cent were to overrule dissenting secured creditors. It should be noted that these figures overlapped, as in some cases more than one class of impaired parties were forced to accept the reorganization plans.

As noted shortly before, in most cases of using the cram-down, the main difficulty is how to deal with shareholder rights to vote on the reorganization plan, particularly in the context of the company's insolvency. To many judges and insolvency practitioners, it is a thorny issue. The insolvency status of the company means that the shareholders' equity in the company is worthless or has lost its real value; however the EBL 2006[63] requires that

[60] Article 84 of the EBL 2006.

[61] Bob Wessels and others, *International Cooperation in Bankruptcy and Insolvency Matters* (Oxford University Press 2009) 34 (noting that in most jurisdictions shareholders are not allowed to vote on reorganization plans because of the insolvency of companies).

[62] Article 87 of the EBL 2006.

[63] Article 85 of the EBL 2006.

cancellation and even a reduction of the equity should be agreed by shareholders and is subject to a vote of them.[64]

In the early drafts of the EBL 2006, there were no provisions giving shareholders the right to vote on the reorganization plan, probably because of the consideration that the company in reorganization has already been insolvent. Shortly before the bill was passed by China's People's Congress in 2006, however, there was a motion raised by China's Supreme People's Court stating that shareholders should be allowed to vote on reorganization plans if their equity is impaired by the plan. This motion was accepted by the Congress and was included in the EBL 2006, but both the Congress and the Supreme Court did not explain the justification of this provision.[65]

A year earlier, in 2005, Prof. Wang Liming, a leading Chinese scholar, argued that the reorganization plan must be voted by shareholders irrespective of the company's insolvency, because they have a stake in the company.[66] It is unknown whether China's Supreme People's Court's such motion was influenced by Wang's view. But Wang's stance on this issue seems to be controversial.

Undoubtedly, shareholders have a stake in the company, but their stake, in the form of equity, has no value at the time when the company becomes bankrupt. Where the company is in a bankruptcy reorganization procedure, it appears to be unjustifiable for shareholders, whose interests have been substantially extinguished due to the company's insolvency and under the absolute priority rule, to join the decision making process which will reshape the company's future.

Admittedly, if the 'stake' is broadly defined, shareholders do have stake in the company: their names are still listed as company shareholders in the government company registration office, and they can even receive the residual value if creditors are paid in full by the end of the bankruptcy process. But, such a possibility will not realise in practice due to the company's insolvency. Even, this broad definition gives rise to a further question on whether other stakeholders, such as employees, should also be allowed to vote on the reorganization

[64] Liming Wang, 'Problems in Amending Enterprise Bankruptcy Law (2005) 3 *Legal Science* (in Chinese) 3, 11 (arguing that shareholders still have a stake in the company, although it is bankrupt).

[65] Qiangui Jiang, 'Report on the Revision of Enterprise Bankruptcy Draft' (2006) 7 *Gazette of the Standing Committee of the National People's Congress of the People's Republic of China* (in Chinese) 579, 584.

[66] Wang (n 64) 11.

plan, because they also have a stake in the company. Obviously, this assertion has gone too far. Therefore, the notion of a 'stake' cannot be too broadly interpreted.

The intention of China's Supreme People's Court to allow shareholders to vote on the reorganization plan appears to be understandable, since it aims to protect shareholders in bankruptcy reorganization processes. The Court, however, might not have chosen a proper means to accomplish this goal. Giving them a right to vote on the reorganization plan, as a result, seems to be excessively generous. But, the problem here is that it causes unnecessary delay.

In practice, as reported, in anticipation of the application of the absolute priority rule, most shareholders in China neglected the notices which invited them to vote on the reorganization plans. This has undermined the efficiency of existing rescues. Apart from the delay caused by shareholders in the voting process, further delays were caused because shareholders refused, in many rescues cases, to cooperate in conveying the company's ownership to the company's buyer before government company registration agencies. Ideally, when a reorganization plan is being voted by creditors, shareholders should be informed and allowed to attend the meeting, but they could not be allowed to vote on the plan unless they can prove that the company is still solvent, or creditors have been substantially paid more than they claimed.

B. The Cram-Down Tests

As noted, there are three main tests for the court to assess a reorganization plan when a cram-down is requested. For the first creditor-best-interest test, it appears to be very easy. In China's corporate rescues, it is normal practice for the administrator to hire a licensed auditor to prepare an auditor report in which both the liquidation and reorganization value of the company will be appraised. And in nearly all cases, creditors, in particular unsecured creditors, have been paid more than they were in hypothetical liquidation. But the liquidation value was based on a valuation rather than a genuine market sale, and this gave rise to a great deal of contention in practice.

Like controversies of asset valuations when applying the absolute priority principle, there are similar problems caused by valuation inaccuracies when conducting the creditor-best-interest test for the cram-downs. And the problems here may even be worsened because of conflicts of interest.

The first, and foremost, concern is the potential devaluation of companies' assets. In theory, any bias of valuation could be minimized, if not eliminated, on the grounds that an auditor, usually an accounting firm, is hired by the independent administrator. As analysed before, the appointing process could enable the administrator to be free from the influence or manipulation of either creditors or shareholders. Thus, in principle, a valuation could be objective and trustworthy.

As discussed earlier, however, administrators, who commission evaluators, may have a tendency to give as low a valuation as possible because of several reasons. First, the lower a valuation is, the easier the creditor-best-interest test is passed. Second, with a lower valuation, more buyers could be solicited because of the more attractive asking price. Although, as noted, there is no strong evidence that there is any collusion between the administrator and the evaluator, the alleged devaluation has indeed caused many disputes.[67] In the reorganization of *Wugu Daochang Food Co. Ltd. Beijing* in 2008, for example, the administrator was questioned by many creditors on asset valuations. In particular, they contended why the company's trademark '*Wugu Daochang*', a national household name, was only assessed at the price of RMB 1 million,[68] however, months ago, a buyer was willing to buy it for RMB 10 million, ten times the evaluated price.[69] The devaluation was also frequently disputed by creditors in other corporate rescue cases.

On the face of it, thus, creditors seem to be better paid because the creditor-best-interest test is passed; however, in substance, they may be harmed. In other words, the creditor-best-interest test fails to accomplish its goal to defend creditors' interests in reorganizations.

The second is the fair and equitable test. Presumably, this test centres on the *pari passu* and absolute priority principles, as the US Chapter 11 does;[70] however, it may be premature to jump to the conclusion that these two principles are what the fair and equitable test is concerned with in China's corporate reorganizations. Serious concerns are raised regarding whether these two principles are really included in this test.

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[67] See 'Solving Debt Risks and Rescuing Troubled Companies' (n 35).

[68] Yuming Liu and Yihe Ding, 'The Survival of *Wugu Daochang*' *Democracy and Law* (Beijing China, 29 December 2009, in Chinese) <http://www.mzyfz.com/news/times/g/20091229/151037_2.shtml> accessed on May 16 2010.

[69] Menbing Li, '*Baijia Noodle* Willing to Pay 10 Million for the Trademark of *Wugu Daochang*' *Western China Urban News* (Chengdu Sichuan China, 27 February 2008, in Chinese) <http://www.022net.com/2008/2-27/465533372319577.html> accessed 17 December 2012.

[70] Friedman (n 46) 1543.

One can argue that the *pari passu* principle is included in the fair and equitable test in the EBL 2006, because its Article 87 stipulates that voters, mainly creditors, within the same class must be treated *fairly* if a cram-down is sought, but no further clarification is given to specify what constitutes 'fairly' under such circumstances. This contrasts with the plain description of value distribution in liquidations wherein Article 113 of the EBL 2006 clearly demonstrates that creditors in the same class must be paid *pari passu*. If it is believed that equality is at the heart of fairness, the *pari passu* principle must be included in the fair and equitable test. But, the implementation of the rescue law in China does not seem to support this assertion.

In 2007, there was, for example, a high-profile case in China, the reorganization of *Chuangzhou Chemical Products Co. Ltd. Hebei*. In this case, a cram-down was imposed by the Chuangzhou Intermediate People's Court, Hebei Province, overriding the unsecured creditors' objection to the reorganization plan, although the *pari passu* principle was breached in this plan.[71] The most striking point of this case is that the cram-down was, according to Prof. Li Shuguang, agreed in advance by China's Supreme People's Court.[72] In other words, the *pari passu* principle is probably not recognised and included in the fair and equitable test, because China's Supreme People's Court has answered this question.

After the *Chuangzhou* case, such an opposite understanding was enhanced by other cases. In 2009, for example, in the reorganization of *Guangming Furniture Co. Ltd. Heilongjiang*, a cram-down was also used, although the *pari passu* principle was breached in its reorganization plan.[73]

Thus, in view of both the statutory definition and the practice, there are two contradictory explanations. The first is that the *pari passu* principle is included in the fair and equitable test, and the problem is that Chinese law courts breached the law when imposing

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[71] The Administrator of *Chuangzhou Chemical Products Co. Ltd*., 'The Reorganization Plan of *Chuangzhou Chemical Products Co. Ltd*.' (Chuangzhou Hebei China, 19 December 2007, in Chinese).

[72] Ye Liu and Yan Gao, 'Investigating Bankruptcy Reorganization of *Haiji*' *Stock Market Weekly* (Beijing China, 25 April 2009, in Chinese) (Professor Li Shuguang said, when interviewed by journalists, that the cram-down of *Chuangzhou Chemical Products Co. Ltd.* was actually agreed by China's Supreme People's Court, because it was the first cram-down after the EBL 2006 took effect in China) <http://www.p5w.net/stock/news/gsxw/200904/t2313173.htm> accessed 10 December 2012.

[73] Shupeng Ji, Caishan Zhang and Zehan Zhang, '*Guangming Furniture*: Reorganization or Execution' *Stock Market Weekly* (Beijing China, 7 June 2010, in Chinese) <http://news.hexun.com/2010-06-07/123910667.html> accessed 17 December 2012.

cram-downs. The second explanation is that it is not, this thesis' understanding of Article 87 of the EBL 2006 is wrong. Nevertheless, many uncertainties remain.

As far as the absolute priority principle is concerned, under Article 87 of the EBL 2006, literally, the absolute priority principle is included in the fair and equitable test, because Article 87 states that the payment ranking, namely the absolute priority principle, articulated in Article 113 (for liquidations) should be complied with in a reorganization plan if the plan seeks for a cram-down.[74] Unfortunately, in reality, the absolute priority norm is neglected by many courts when issuing the cram-downs.

In listed company reorganizations, as mentioned before, because China's Supreme People's Court's decree[75] has 'overruled' the absolute priority norm enshrined in the EBL 2006, the cram-down was frequently used by the courts, although the absolute priority principle was relaxed. For instance, in the reorganization of *Baoshuo Co. Ltd., Hebei,* a listed company, in 2007, the deviation from the absolute priority principle in the reorganization plan did not prevent the court from issuing a cram-down that overrode the unsecured creditors' objection.[76] It seems that this cram-down is a breach of Article 87 of the EBL 2006.

In non-listed company reorganizations, although a cram-down was occasionally used, the fair and equitable test was still not adequately conducted by courts. For example, in the reorganization of *Fenghua Group Co. Ltd. Guangdong,* a non-listed company, in 2007, a cram-down was sanctioned by the court, although unsecured creditors received twenty-two per cent of their claims, and all previous equity was kept intact.[77]

Therefore, according to Article 87 of the EBL 2006, the absolute priority doctrine is included in the fair and equitable test, but in practice many courts failed to follow such rules. It is largely a matter of the less-developed rule of law in China, which is beyond the scope of this thesis.

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[74] Article 87 of the EBL 2006.

[75] Song (n 24).

[76] Tong Li, '*Baoshuo*: the Death of Control Shareholders and the Rebirth of the New Shareholders' *Business Society Review* (Chongqing China, 3 April 2008, in Chinese) <http://finance.sina.com.cn/stock/companyresearch/20080403/17304707726.shtml> accessed 17 December 2012.

[77] Jianpin Wang, 'Conversion from Liquidation to Reorganization: *Fenghua Group* Survived the Crisis' *Legal Information* (Beijing China, 30 May 2009, in Chinese) <http://www.legaldaily.com.cn/zbzk/2009-05/30/content_1104139.htm> accessed 17 December 2012.

The third is the feasibility test.[78] This means that a reorganization plan should be feasible or have a high probability to be successfully executed, if it needs a cram-down to survive. The feasibility test is elaborated in Article 87 of the EBL 2006, under which a company's business restructuring plan must be feasible if the reorganization plan's proponent requests a cram-down.[79]

In testing the feasibility of a reorganization plan, it seems that China's courts do lack the proper guidance and experience to fulfil this task.[80] As chapter 6 reported, in fact, courts did not conduct the feasibility test, since, as noted in Zhejiang, the feasibility test was largely dependent upon the involvement of local government business development departments. The inability of judges to undertake the feasibility test would be because of two reasons as follows.

The first reason is that there is no specific guidance in the EBL 2006 that judges can use to apply the feasibility test. Article 87 of the EBL 2006 simply states that a plan must be feasible, but there is no detailed instruction.

The second reason is that judges are professionally unable to test a reorganization plan's feasibility, because it is a commercial judgement in nature. Judges are legal experts, and it is beyond their expertise to make a commercial judgement regarding whether a business restructuring project is likely to succeed. Even in the US where there is a relatively mature bankruptcy court system, regarding the feasibility of a reorganization plan, judges predominantly defer to the debtors' own commercial judgements.[81] In other words, professional bankruptcy judges in the US are also unable to undertake the feasibility test of reorganization plans. This is not what judges are capable to do.

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[78] See generally Elizabeth Warren and Jay Lawrence Westbrook, *The Law of Debtors and Creditors: Texts, Cases, and Problems* (6th edn, Wolters Kluwer 2009) 616.

[79] Article 87 of the EBL 2006.

[80] See Ming Liu and Weihong Chi, 'Court Approval of Reorganization Plan in China' (2011) 10 *Law Application Review* (in Chinese) 81 (analysing how courts in China conduct the tests to confirm reorganization plans).

[81] See George W Kuney, 'Hijacking Chapter 11' (2004) 21 *Emory Bankruptcy Development Journal* 19, 79.

In Germany, perhaps, because of a lack of expertise of judges in this respect, its corporate rescue law does not require judges to assess a reorganization plan's feasibility, and this issue is left to debtors and creditors themselves to decide.[82]

Although the feasibility test is mainly a technical issue, some common sense can still be applied. For example, as analysed in chapter 2 (literature review), a cash injection is likely to be at the heart of a viable reorganization plan. The credibility of obtaining further financing would be one of the main criteria which could be used by the court to assess whether a plan is feasible.[83] At the same time, creditors, especially banks or main suppliers, may have the knowledge about the feasibility of a reorganization plan, because they have gained much insight into the company's sustainability over long-term business relationships. Courts, thus, could ask them for some valuable suggestions.[84]

The cram-downs reflect strong state intervention in corporate rescues; therefore, certain remedies should be available for overruled parties to seek fairness and equity.

C. Remedies

Under Article 87 of the EBL 2006, it seems that a cram-down is final, as it does not state that an overridden party can appeal to a higher court, but equally it does state that an appeal is not allowed. However, Article 4 of the EBL 2006 stipulates that China's civil procedural law is applicable in the case where there are not specific provisions regulating bankruptcy issues. Thus, given there is no specific rule in the EBL 2006, in theory, an overruled party can appeal against a cram-down by relying on Article 147 of China's Civil Procedures Law 1991.

Allowing objecting parties to appeal the cram-down may also be consistent with the international practice. In the US, for example, its bankruptcy law makes it clear that if a cram-down is imposed it may be still be revoked by the court if objecting parties can prove

[82] Klaus Kamlah, 'The New German Insolvency Act: *Insolvenzordnung*' (1996) 70 *American Bankruptcy Law Journal* 417, 432.

[83] Nancy Rhein Baldiga, 'Is This Plan Feasible: An Empirical Legal Analysis of Plan Feasibility' (1996) 101 *Commercial Law Journal* 115.

[84] Ibid 116.

that the reorganization plan involves fraud or dishonesty.[85] In other words, there is a similar appeals procedure for disgruntled parties to seek remedies in the US.

In the UK, technically, there is no cram-down confirmation mechanism. An administrator-proposed reorganization plan will take effect immediately after it has been accepted by a majority of creditors. Dissenting parties, however, can still file a motion requesting a court to revoke a reorganization plan if they believe they have been unfairly prejudiced in the plan.[86]

In Germany, a *de facto* cram-down is also possible,[87] and under such circumstances, an aggrieved party is also given a right of appeal to a higher court.[88]

The specific approaches for remedies may vary in these three jurisdictions, but one point is common: there is always a procedure for dissenting parties to seek relief.

Although it is also believed by some Chinese scholars[89] that there should be a procedural remedy for dissenting parties to appeal to a high court under China's Civil Procedures Law 1991 against a cram-down. In reality, up to the time of writing, there have not been any such reported appeals in China. In practice, this right to appeal is virtually denied by courts.

In sum, in confirming reorganization plans, China's courts seemed to discharge their duties very efficiently, as it is not uncommon for a plan to be confirmed within days of being submitted. To confirm reorganization plans, courts frequently impose cram-downs. But, the main worry is that three basic tests were not well conducted by many Chinese courts.

As for the creditor-best-interest test, it was seemingly applied in all reorganizations, but great unfairness might have arisen because of undervaluations of company assets. With regard to the fair and equitable test, the *pari passu* and absolute priority principles were often neglected by courts when deciding to impose cram-downs. Concerning the feasibility test, Chinese courts were actually unable to apply this test because of a lack of knowledge and

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[85] 11 USC Sec. 1144. See also Glenn W Merrick, 'The Chapter 11 Disclosure Statement in a Strategic Environment' (1988) 44 *The Business Lawyer* 103.

[86] Insolvency Act 1986, s 27.

[87] Kamlah (n 83) 431.

[88] Germany Insolvency Statute 2011, s 248a (4).

[89] See Ming Liu and Weihong Chi, 'Court's Approval of Corporate Reorganization Plans' (2011) 10 *Journal of Law Application* (in Chinese) 81, 89 (arguing that the forced parties by cram-downs should be given the right to appeal).

experience. One serious concern arises as to whether dissenting parties in cram-downs should be given a right to appeal in China's corporate reorganizations.

4. CONCLUSIONS

Although not widely used, China's newly-established corporate reorganization regime has demonstrated its strength in preserving going concern value of troubled companies. In most cases, the going concern value has been preserved by preventing troubled companies from being piecemeal liquidated. Whether there is a going concern sale rescue or a traditional rescue, the integration of troubled companies' hard assets, human resources and business networks have largely remained unbroken. This is exactly what a corporate reorganization regime aims to accomplish. The main challenge, however, is that there are too many going concern sale rescues, and ideally, attention should be redirected to promoting more traditional rescues in China.

As for the third research question of this thesis concerning value distribution in China's corporate rescues, generally, the main problems here are raised over listed company rescues. In listed company rescues, the absolute priority principle has been routinely put aside, and the *pari passu* principle has also been largely sidelined.

In spite of controversies arising when applying absolute priority in corporate rescues, arguably, any deviation from this principle should, first, be based on the consent of disadvantaged parties and, second, aim to enhance the viability of rescues. For these ends, it seemed that the deviation from absolute priority in China's listed company reorganizations was questionable, because it was mainly made for political reasons, i.e., the government sought to prioritise the maintenance of social stability rather than to increase the feasibility of rescues.

Adjusting the *pari passu* principle in most listed company reorganizations occurred for two purposes. One was to give a higher recovery rate to creditors who were individuals because of the policy objective of maintaining social stability in China. The second was to offer a higher return to small creditors in exchange for their votes. This might effectively solve potential holdout problems caused by smaller creditors and make rescues more efficient. But the bottom line is that in making adjustments to the *pari passu* principle, this should also

be agreed by disadvantaged parties; this begs the question regarding how courts will safeguard the basic rules when confirming reorganization plans.

Concerning the fourth research question of this thesis on court confirmation of reorganization plans, to a large extent, many courts were unable to fulfil their roles to ensure that the basic bankruptcy principles are applied in reorganization plans. In all existing reorganizations, there was no reorganization plan which has been rejected by the courts. But this did not mean that all reorganization plans were fairly and equitably made; instead, this might rather reflect the weaknesses of courts in playing their roles in assessing reorganization plans.

For the normal confirmation process, it seems that the use of court confirmation has largely been to satisfy a formality, since courts were often very quick to approve a plan of reorganisation. But the key concern was raised when the cram-down was issued. The cram-down was frequently imposed, but many Chinese courts have not fared well in applying three tests when assessing whether a cram-down can be lawfully delivered. In particular, as for the first of these, the creditor-best-interest test, because of widely alleged under-valuation of assets, this test might only be superficially passed in the reorganization plan, but creditors might, in substance, be victimised. Regarding the second fair and equitable test, the absolute priority and *pari passu* principles have usually been neglected by many courts, and this might have very negative effects on creditors' certainty and confidence. In relation to the third of feasibility test, it virtually remains a dead letter in the statute, because China's courts were technically unable to conduct this test.

In short, most China's courts have not fulfilled their roles in enhancing the goals of the corporate reorganization regime when confirming the plans of reorganization. Many problems were actually caused by the less developed rule of law in China.

Up until now, all four research questions have been discussed. The next chapter will review these four research questions and examine the extent to which these questions have been adequately answered. Finally, some policy suggestions regarding this area of law will also be made in the next chapter.

CHAPTER 9

CONCLUSION

1. INTRODUCTION

After coming into force in 2007, China's new corporate rescue regime enshrined in the EBL 2006 has in general not been widely used; however, in spite of the small number of corporate reorganizations, many lessons have been learned from the first five years' implementation with potential implications for the future.

Three difficulties materially hamper the application of China's new corporate rescue law. The first difficulty arises from the fact that the rule of law in China is still very weak.[1] The new corporate rescue law was frequently either neglected or breached by state agencies; as a result, companies could not build confidence in using this new law. The second difficulty is that Chinese courts were not prepared to handle corporate rescues. Judges were not adequately trained, and more importantly, judicial powers in China have been too weak to manage corporate rescues. The third difficulty is that the rescue law itself has undermined the inclinations of relevant parties to use it, especially in the case of debtors. Without the active involvement of debtors, the rescue law is considerably undermined.

Nevertheless, although it has not been frequently used, the new rescue regime has shown its strength in preserving the going concern value of troubled companies, as reflected in substantially increased creditor recovery rates in existing corporate reorganizations in China.

To conclude this thesis, the remainder of this chapter is divided into 4 Parts. (i) Part 2 recalls the research questions raised in the first chapter, assessing the extent to which these questions have been answered. (ii) Part 3 highlights main, significant findings of this thesis. (iii) Part 4 suggests the potential for further reforms. (iv) Part 5 concludes the analysis.

[1] See generally Randall Peerenboom, *China's Long March toward Rule of Law* (Cambridge University Press 2002).

2. ANSWERING RESEARCH QUESTIONS IN THE THESIS

The four research questions raised in chapter 1 are summarized below. In fact, some answers are more like comments, given the complicated practice of the law in this area. Rather than being seen as 'scientific proof' of propositions in the thesis, the materials presented here provide strong evidence in support of arguments presented.

2.1. Is China's New Corporate Reorganization Procedure Frequently Used?

In view of the small number of corporate rescue cases reported in this thesis, the answer is simple: the new corporate rescue procedure was not frequently used. In particular, it was only occasionally used to rehabilitate large troubled companies. Even the vast majority of China's courts have never accepted corporate reorganization filings in the first five-year period after the EBL 2006 took effect. That is to say, most troubled companies were denied the chance to use this new law to seek relief.

The current situation could be ascribed to several factors: first, it is because of the unwillingness of China's courts to handle corporate rescue cases. In practice, courts were quite cautious about accepting corporate rescue filings.[2] China's judiciary has been too weak to manage corporate rescues by itself. [3] Meanwhile, the less-developed condition of the rule of law in China has further dampened the inclination of courts to engage with corporate rescue issues.[4] In addition, the oversimplified and vaguely-worded EBL 2006 could not hold courts accountable if they refused to comply with the new rescue law, especially regarding accepting corporate rescue filings.

Second, apart from courts, debtors have been deterred from voluntarily filing for reorganization in China; this is because the commencement of a rescue procedure means that the old management would be automatically replaced by an administrator, and that all the

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[2] China's Supreme People's Court, 'Minutes of the Conference on Listed Company Reorganizations' (Beijing China, 29 October 2012, in Chinese) (directing law courts in China to obtain the explicit support of local government before accepting a listed company reorganization petition).

[3] See generally Margaret Y K Woo, 'Adjudication Supervision and Judicial Independence in the P.R.C.' (1991) 39 *The American Journal of Comparative Law* 95.

[4] See generally Benjamin L Liebman, 'China's Courts: Restricted Reform' (2007) 191 *The China Quarterly* 620.

interests of debtors would be cancelled according to the absolute priority rule. As discussed in earlier chapters, one of the key concerns of debtors is that they are afraid of exposing company books to outsiders. More importantly, in the absence of a wrongful trading mechanism in China, debtors are emboldened to continue trading until it is too late to bring troubled companies back from the brink.

Third, creditors in China have lacked both the ability and the willingness to file for a debtors' reorganization in court. In general, creditors do not have access to debtors' information so that a feasible rescue proposal is unlikely to be made by them. Meanwhile, creditors generally prefer an individual debt enforcement system to a collective bankruptcy process.

Consequently, deadlock has usually ensued; on the one hand, courts have turned their backs on corporate reorganization filings; on the other hand, both debtors and creditors have been unwilling and unable to file for reorganization in court.

2.2. Who is Primarily in Control of China's Corporate Reorganizations?

When drafting the new law, China's lawmakers probably sought to include a modified debtor-in-possession system in the new corporate reorganization regime;[5] however, in most of the existing corporate rescue cases, it was the administrator-in-possession approach that was used.

As argued before, the administrator-in-possession system may do more harm than good in a corporate reorganization regime, since it not only leads to the reluctance of debtors to file for early and voluntary rescues, it also causes the loss of going concern value of troubled companies because of the removal of the old management.

Although, in most of China's corporate rescues, it was the administrator-in-possession system that has been used, interference of government cannot be underestimated, especially when the administrator was a local-government-organized liquidation committee. Some scholars have argued that the new corporate rescue regime has been politicized by local

[5] Charles D Booth, 'The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over' (2008) 20 *Singapore Academy of Law Journal* 275, 303.

government so as to serve the local economy and to maintain local social stability in China.[6] This might have further exacerbated the downside of the administrator-in-possession approach in China's corporate rescues.

2.3. How is Preserved Value in Corporate Rescues Distributed?

One of the many advantages of enforcing China's new corporate rescue regime is that it has considerably preserved going concern value of financially troubled companies. Although not widely used, the new corporate rescue law has shown such strength. The average unsecured creditor recovery rate in rescues amounts to thirty-four per cent of their pre-bankruptcy claims; this is far higher than the less than the ten per cent in liquidations in China. Corporate reorganization has provided a valuable alternative to liquidation.

As to how preserved value in rescues is distributed, this thesis has focused on the two main distributional norms, namely the *pari passu* and absolute priority rules.

To the *pari passu* rule, it was found that it was applied in seventy-four per cent of existing corporate reorganizations in China. A closer examination has revealed that this rule was more likely to be relaxed in listed company reorganizations; in particular, forty-three per cent of listed company reorganizations have relaxed the *pari passu* rule; by contrast, such a departure only happened in fifteen per cent of non-listed company rescues.

Two main aims were identified that explained the intention of deviating from the *pari passu* rule. In most of the deviations , the *pari passu* principle was adjusted so as to buy votes from small creditors, since the number of their votes was material in gaining support for the passage of reorganization plans. In other cases, this principle was relaxed so as to facilitate maintenance of social stability, as usually, it was individual creditors who were paid in full so as to prevent them from protesting collectively.

For the absolute priority principle, the departure from this principle was found in fifty-three per cent of China's corporate reorganizations. More specifically, in listed company

[6] Bing Zhang and Jingting Zhao, 'The Dilemma of Ying'guang'xia Restructuring' *Caixin Online* (Beijing China, 20 February 2012, in Chinese) <http://finance.qq.com/a/20120220/000260.htm > accessed 12 July 2013 (Professor Li Shuguang replied to the media interview, saying that sometimes the rescue regime had been politicized by local government for the local economic and political gains).

reorganizations, there was an automatic deviation from this rule because of the decree issued by China's Supreme People's Court; by contrast, such departures only occurred in fifteen per cent of non-listed company reorganizations.

The departure from the absolute priority principle shared one common feature with the departure from the *pari passu* rule; this was the intent to maintain social stability. In listed company reorganizations, general public shareholders were shielded from the absolute priority rule, because the government was worried of the potential threat to social stability, given that there were usually large numbers of general public shareholders.

2.4. Is Court Confirmation of Reorganization Plans Adequate to Fulfil Policy Goals?

The thesis found that confirming reorganization plans by courts was largely to fulfil a formality, partly because courts were deeply involved in composing these plans. Put differently, the courts appeared to have lost their neutrality in approving these reorganization plans.

More importantly, when imposing cram-downs, many Chinese courts superficially applied the creditor-best-interest test, failed to conduct the fair and equitable test, and unable to carry out the feasibility test.

Thus, China's courts have not fared as expected to accomplish the declared policy goals of protecting creditors and safeguarding some basic legal rules in China's corporate reorganization cases.

3. MAJOR FINDINGS OF THIS THESIS

(i). Before the passage of the EBL 2006, China's courts needed government permission before starting a corporate bankruptcy procedure. After the EBL 2006, such permission was dispensed with, but courts need government support to commence a corporate bankruptcy procedure. Although government permission was, literally, replaced by government support, the situation wherein China's courts have felt unable to cope with corporate bankruptcy issues by themselves has not radically changed.

(ii). Because of difficulties in opening bankruptcy proceedings in court, using a liquidation petition as a powerful debt collection tool is generally not available for creditors in China. As a result, in the absence of liquidation pressure from creditors, troubled companies in China have no incentive to voluntarily enter a corporate reorganization procedure.

(iii). Because there is no effective corporate bankruptcy system in China, ninety-five per cent of controllers of bankrupt companies in China choose to 'walk away', without using formal bankruptcy procedures to deal with outstanding debts.

(iv). In existing corporate reorganizations in China, although there are two options of control, the administrator-in-possession model was preferred and was used in seventy-four per cent of cases, whilst the debtor-in-possession model was used in the remaining cases. More importantly, nearly half of administrators were appointed from local government organized liquidation committees.

(v). China's new corporate reorganization regime has shown its strength in preserving the going concern value of troubled companies, as it has increased the average debt recovery rate for unsecured creditors from below ten per cent in the case of liquidations to thirty-four per cent in the case of reorganizations.

(vi). As for value distribution, in listed company reorganizations, the absolute priority principle was routinely bypassed because China's Supreme People's Court has given the green light to this, and the application of the *pari passu* principle has been relaxed in forty-three per cent of these cases. In non-listed company reorganizations, by contrast, these two principles were largely complied with.

(vii). It has been a formality for courts to confirm reorganization plans. Given the heavy presence of government in rescue procedures, China's courts have never rejected reorganization plans, i.e., all reorganization plans were eventually confirmed. Cram-downs have been imposed in forty-one per cent of existing corporate reorganizations in China.

4. THE POTENTIAL FOR FUTURE REFORM

In regard to establishing an effective corporate rescue regime, China is still in a state of transition; the experiences of the last five years have been somewhat experimental in nature.

Given the importance of the corporate rescue regime, however, especially in case of a financial crisis, some reforms seem to be necessary for China to further develop its corporate rescue system.

First, China's current judicial service regarding corporate bankruptcy issues should be substantially improved and strengthened. As noted above, China's corporate reorganization regime is strictly court-centred; however, given that courts are quite hesitant in accepting corporate rescue filings, it seems necessary to remove obstacles encountered by courts. The underlying cause of the courts' hesitation seems to be the lack of judicial independence. There may well still be a long way to go regarding the development of fully-fledged judicial independence in China,[7] since this will require political reforms.

Pragmatically, however, the lessons gained from experience in some local areas may be worth applying more broadly in order to solve this problem. In one pioneering city, Hangzhou, the capital city of the economically advanced province of Zhejiang, the local intermediate court asked the local Communist Party Committee to establish an *ad hoc* co-ordinating panel so as to support local courts in handling rescue cases. The panel included several relevant governmental departments, namely the business development service, the financial regulating authority, the police, the revenue authority, the land management department and the labour and pension service.[8] This panel was responsible for assisting and backing local courts to process corporate rescues.

Establishing such a co-ordinating panel would be very useful in encouraging courts to fully open the door to accepting corporate rescue filings; this is because it has at least overcome two main problems. First, the court's fear of being negatively assessed in cases where a mass petition was brought by individual small creditors (such as employees) would be solved; this is because the Communist Party local committee and the government were also be involved in the process through their involvement with the panel. Second, and more importantly, this panel could effectively tackle the lack of cooperation from government departments, because nearly all relevant departments would have been directly required to participate in corporate rescue processes.

[7] See generally Liebman (n 4) 620. Also see generally, Randall Peerenboom, (ed), *Judicial Independence in China*, (Cambridge University Press, 2010).

[8] Hangzhou Intermediate People's Court, 'Report on Corporate Reorganization' (Hangzhou Zhejiang China, 5 January 2010, in Chinese).

Admittedly, this solution may seem to be myopic but is pragmatic in the context of China's current social and judicial development. Such a panel may even fill the gap created by the absence of a bankruptcy administrative service in China.

In many developed jurisdictions, bankruptcy issues at large are handled jointly by the court system, by insolvency practitioners and, more commonly, by the government's bankruptcy administrative service. For example, in Britain, in addition to a group of insolvency practitioners standing beside the court system, the British central government has created the Insolvency Service, an executive agency of the Department of Business Innovation and Skills, to assist courts in dealing with bankruptcy issues.[9] Similarly, the US has its own Trustee Program, which is part of the Department of Justice of the federal government, overseeing and regulating bankruptcy issues.[10] But, in China, there is no administrative agency which bears responsibility on behalf of the government for dealing with bankruptcies. Such a panel might be an alternative mechanism that can be used to fill this gap.

Opening the door of courts is essential but is not enough. Consideration should also be given to encouraging rescue petitions filed by debtors and sometimes by creditors.

Second, developing a debtor-friendly corporate rescue regime would be a crucial step in the right direction in China. As discussed earlier, debtors are rescue-averse because they fear for losing control and exposing their potential wrongdoings to third parties if a formal corporate reorganization procedure is entered. Under the current legal framework in China, it is desirable for a debtor to be allowed to automatically remain in control if it voluntarily files for reorganization. This is in line with Article 73 of the EBL 2006, although the court can appoint an insolvency practitioner as the supervisor monitoring the debtor-in-possession. If this is clarified in this way, the uncertainty over the use of the debtor-in-possession model may be eliminated, and as a result, it may tremendously encourage debtors to use the formal rescue regime. To prevent potential abuse, creditors should be empowered to appoint a trustee to exercise control over the company in the event that the company's failure is caused

[9] The Insolvency Service, 'Insolvency Service Framework Document' (May 2013) <http://www.bis.gov.uk/assets/insolvency/docs/about%20us/frameworkdocumentapril2013.pdf> accessed 12 August 2013.

[10] The United States Department of Justice, 'The United States Trustee Program' <http://www.justice.gov/ust/eo/ust_org/index.htm> accessed 12 August 2013.

by fraud or dishonesty; in other words, a fair balance should be struck between creditor and debtor.

Granted, that a debtor-in-possession may not be sufficient to persuade debtors to file for reorganization, because this only gives control to debtors, they may receive nothing in the rescue processes under the absolute priority rule. Therefore debtors could be rewarded with some value in exchange for their experience and information. This gives rise to the possibility of deviating from the absolute priority principle in rescues. In this regard, China could learn something from Chapter 11 in the US, where deviations from absolute priority are possible but are subject to creditors' consent. Put differently, creditors should be given the option to invite debtors to join rescue processes and even share something with them, if the debtors' involvement could increase recoveries for creditors.

Overall, to induce debtors to voluntarily file for reorganization, the debtor-in-possession approach is complementary to deviating from absolute priority in incentivizing debtors to take early and effective rescue action. But we should not forget the key role played by creditors in pressuring debtors to seek bankruptcy protection.

As has been learnt from Chapter 11 in the US, in spite of the debtor-in-possession model, most voluntary Chapter 11 filings arise because of imminent liquidation threats from creditors.[11] This suggests that the current debt enforcement system in China must be strengthened.[12] In particular, creditors should be genuinely empowered to file a liquidation petition; otherwise a voluntary corporate rescue filing is still unlikely.

In brief, in order to reform and improve China's corporate reorganization regime, a regular and routine administrative service provided by government should be available. In the meantime, some pro-debtor rescue mechanisms, such as a debtor-in-possession system and the conditional deviation from the absolute priority rule, should be rationally used in the interests of both creditors and debtors.

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

[12] See generally Donald C Clarke, 'Power and Politics in the Chinese Court System: the Enforcement of Civil Judgements' (1996) 10 *Columbia Journal of Asian Law* 1.

5. CONCLUSIONS

In answering four research questions, this thesis has sought to offer some insight over China's newly-established corporate rescue law both in the books and in action. Some significant points made in this thesis are worth reiterating. First, the relatively infrequent use of China's new corporate reorganization regime can be attributed to a range of factors, but the deep-rooted problem is that China has a less-developed approach to the rule of law.[13] In the meantime, the prevalence of the administrator-in-possession system in China's existing formal rescue processes considerably deters debtors from seeking a bankruptcy rescue solution. In addition, there is too much political intervention which affects value distribution in China's formal corporate rescues, especially in the case of the reorganization of listed companies.

Some future research questions are also raised. First, given that China has committed itself to building a profession of insolvency practitioners, it remains largely unexplored as to how these insolvency practitioners have contributed to the efficiency and fairness of Chinese corporate reorganization procedures. Secondly, as the formal rescue threshold is still too high in China, the vast majority of corporate rescues may still remain informal. Little research has been conducted on how these informal rescues take place and on what the main difficulties of these informal rescues are. Further academic research in these areas could prove very fruitful.

[13] See generally Eric W Orts, 'The Rule of Law in China' (2001) 34 *Vanderbilt Journal of Transnational Law* 34. See also Randall Peerenboom (ed), *Judicial Independence in China: Lessons for Global Rule of Law Promotion* (Cambridge University Press 2009).

APPENDIX 1

CORPORATE REORGANIZATIONS ACCEPTED IN CHINA

(1 JUNE 2007- 30 NOVEMBER 2010)

Sequence	Company	Ownership	Court	Acceptance	Miscellaneous
1	Zarva Technology (朝华科技)	State-controlled (Listed)	Chongqing	16 Nov 2007	
2	Stellar Mega Union (星美联合)	State-controlled (Listed)	Chongqing	11 Mar 2008	
3	Amoi Electronics (夏新电子)	State-controlled (Listed)	Xiamen Fujian	15 Sept 2009	
4	Hualong Group (广东华龙)	State-controlled (Listed)	Yangjiang Guangdong	10 Mar 2008	
5	Shengxing Taifeng (深信泰丰)	State-controlled (Listed)	Shenzhen Guangdong	10 Nov 2009	
6	Suntek Tech (新太科技)	State-controlled (Listed)	Panyu Guangdong	11 Mar 2009	
7	Beisheng Medicine (北生药业)	State-controlled (Listed)	Beihai Guangxi	27 Nov 2008	
8	Hebei Baoshuo (宝硕股份)	State-controlled (Listed)	Baoding Hebei	03 Jan 2008	
9	Chuangzhou Chemistry (沧州化学)	State-controlled (Listed)	Chuangzhou Hebei	16 Nov 2007	
10	Dixian Textile (帝贤纺织)	State-controlled (Listed)	Chende Hebei	10 Nov 2008	
11	Guangming Furniture (光明家具)	State-controlled Listed	Yichun Heilongjiang	09 Nov 2009	
12	Beiya Industry (北亚集团)	State-controlled (Listed)	Harbin Heilongjiang	03 Feb 2008	

Sequence	Company	Ownership	Court	Acceptance	Miscellaneous
13	Xi'an Technology (鑫安科技)	State-controlled (Listed)	Jiaozuo Henan	07 Nov 2008	
14	Tianfa Petroleum (天发石油)	State-controlled (Listed)	Jinzhou Hubei	13 Aug 2007	
15	Tianyi Science (天颐科技)	State-controlled (Listed)	Jinzhou Hubei	12 Aug 2007	
16	Lanbao Science (兰宝科技)	State-controlled (Listed)	Changchun Jilin	16 Nov 2007	
17	Liaoyuan Dehen (辽源得亨)	State-controlled (Listed)	Liaoyuan Jilin	13 Apr 2010	
18	Dandong Chemistry (丹东化学)	State-controlled (Listed)	Dandong Liaoning	13 May 2009	
19	Jinhua Group (锦化化工)	State-controlled (Listed)	Huludao Liaoning	19 Mar 2010	
20	Changling Group (长岭集团)	State-controlled (Listed)	Baoji Shaanxi	15 May 2008	
21	Qinling Cement (秦岭水泥)	State-controlled (Listed)	Tongchuan Shaanxi	28 Aug 2009	
22	Xianyan Pianzhuan (咸阳偏转)	State-controlled (Listed)	Xianyan Shaanxi	25 Nov 2009	
23	Jiufa Food （九发股份）	State-controlled (Listed)	Yantai Shandong	28 Sep 2008	
24	Shanghai Worldbest (华源股份)	State-controlled (Listed)	Shanghai	27 Aug 2008	
25	Haina Sci-Tech (浙江海纳)	State-controlled (Listed)	Hangzhou Zhejiang	14 Sep 2007	
26	Sunrise Holdings (广东盛润)	State-controlled (Listed)	Shenzhen Guangdong	06 May 2010	
27	Powerise Tech （创智科技）	State-controlled (Listed)	Shenzhen Guangdong	23 Aug 2010	

Sequence	Company	Ownership	Court	Acceptance	Miscellaneous
28	Guangxia Industry (银广夏)	State-controlled (Listed)	Yinchuan Ningxia	16 Sep 2010	
29	Worldbest Industry (上海源发)	State-controlled (Listed)	Shanghai	27 Aug 2008	
30	Huaqiang Real Estate (华强房产)	Private	Beijing	Early 2009	
31	Wugu Daochang Food (五谷道场)	Private	Beijing	30 Oct 2008	
32	Xianju Hospital (仙琚医院)	Private	Beijing	21 Apr 2007	
33	Xingchan Real Estate (兴昌博达)	Private	Beijing	16 Nov 2007	
34	Xiamen Star (厦门星星)	Foreign Invested	Xiamen Fujian	27 Feb 2009	Consolidated with One Subsidiary
35	Fenghua Group (风华集团)	State-Owned	Zhaoqing Guangdong	11 Jul 2007	
36	Jingwoniu Industry (金卧牛)	Private	Dongguan Guangdong	28 May 2008	Failed to Enforce the Plan
37	Huabao Forage (华宝饲料)	State-participated	Shenzhen Intermediate People's Court	15 Jan 2010	
38	Huabao Industry （华宝实业）	State-participated	Shenzhen Intermediate People's Court	15 Jan 2010	
39	Taifeng Tech （泰丰科技）	State-participated	Shenzhen Intermediate People's Court	15 Jan 2010	
40	Xibu Real Estate （西部房产）	State-participated	Shenzhen Intermediate People's Court	15 Jan 2010	
41	Yaxing Electronics (东莞雅新)	Foreign Invested	Dongguan Guangdong	27 Aug 2008	Converted to Liquidation

Sequence	Company	Ownership	Court	Acceptance	Miscellaneous
42	Yaban Electronics (雅邦电子)	Foreign Invested	Dongguan Guangdong	13 Aug 2008	Converted to Liquidation
43	Yaxian Electronics (雅线电子)	Foreign Invested	Dongguan Guangdong	13 Aug 2008	Converted to Liquidation
44	Xiangfa Electronics (祥发电子)	Foreign Invested	Dongguan Guangdong	13 Aug 2008	Converted to Liquidation
45	Yongsheng Computer (永胜电脑)	Foreign Invested	Dongguan Guangdong	20 Jan 2009	
46	Wanghai Yikang (旺海怡康)	Private	Shenzhen Guangdong	09 Aug 2007	
47	Zhonggu Sugar (中谷糖业)	Private	Zhanjiang Guangdong	22 Dec 2009	Consolidated with Seven Subsidiaries
48	Anxing Tongwei (安信酒精)	Private	Daqing Heilongjiang	30 Jul 2007	
49	Maisui Food （麦穗味精）	Privatized	Jinshi Hunan	19 Sep 2007	
50	Taizinai Milk (太子奶)	Private	Zhuzhou Hunan	23 Jul 2010	Consolidated with Two Subsidiaries
51	Haiji Lujian (海吉氯碱)	State-Participated	Wuhai Inner Mongolia	17 Sep 2008	
52	Hongjie Electronics (弘捷电路)	Foreign Invested	Suzhou Jiangsu	23 Sep 2009	
53	Kehong Steel (常熟科弘)	Foreign Invested	Suzhou Jiangsu	18 Nov 2008	Consolidated with Four Related Firms
54	Nantong Steel (南通有色)	Privatized	Nantong Jiangsu	18 Nov 2009	
55	Changhong Steel (长鸿特钢)	Private	Suzhou Jiangsu	25 Dec 2009	

Sequence	Company	Ownership	Court	Acceptance	Miscellaneous
56	Jiatong Tech （佳通科技）	Foreign Invested	Suzhou Jiangsu	09 Mar 2009	
57	Yaxing Electronics (苏州雅新)	Foreign Invested	Suzhou Jiangsu	29 Apr 2008	
58	Yaxing Blocks (雅新线路板)	Foreign Invested	Suzhou Jiangsu	29 Apr 2008	
59	Changchun Steel (长椿金属)	Foreign Invested	Wuxi Jiangsu	17 Jul 2008	Failed to Enforce the Plan
60	Defa Dye (德发印染)	Privatized	Wuxi Jiangsu	2007	
61	Xiangjuan Real Estate (香娟房产)	Private	Xinghua Jiangsu	06 Jul 2009	
62	Qiangshen Gas (强盛煤气)	Private	Xuzhou Jiangsu	14 Jan 2010	
63	Yangdong Engine (江苏扬动)	Privatized	Yangzhou Jiangsu	29 Apr 2009	
64	Xingzhen Medicine (心正药业)	State Owned	Pingxiang Jiangxi	08 May 2009	
65	Qingta Trust (庆泰信托)	State Controlled	Qinghai	Late 2009	Financial Firm
66	Qingjian Real Estate (秦建房产)	Private	Xi’an Shaanxi	31 Mar 2009	
67	Sanqin Cement (三秦水泥)	Privatized	Tongchuan Shaanxi	07 Apr 2008	
68	Juxing Electronics (钜鑫电子)	Foreign Invested	Shanghai	25 Apr 2008	Converted to Liquidation
69	Weidong Mine (卫东煤矿)	State Owned	Yangquan Shanxi	Early 2008	
70	Zhonghen Steel (中恒特钢)	Private	Jiangyou Sichuan	03 Feb 2009	

Sequence	Company	Ownership	Court	Acceptance	Miscellaneous
71	Jurenxin Rubber (聚仁兴橡胶)	Private	Kunming Yunnan	10 Mar 2008	
72	Dadi Paper (大地纸业)	Private	Hangzhou Zhejiang	01 Jun 2009	
73	Hualun Group (华伦集团)	Private	Hangzhou Zhejiang	01 Jun 2009	Consolidated with Five Subsidiaries
74	Guangsai Power (广赛电力)	Private	Hangzhou Zhejiang	20 May 2008	
75	Nanwang Group (南望集团)	Private	Hangzhou Zhejiang	20 May 2008	
76	International Hotel (国际酒店)	Privatized	Hangzhou Zhejiang	01 Jul 2010	
77	Yijiaxiang Food (溢佳香)	Private	Hangzhou Zhejiang	15 Jul 2010	
78	Nongji (杭州农机)	Private	Hangzhou Zhejiang	15 Jul 2010	
79	Jiamei Food (佳美食品)	Private	Hangzhou Zhejiang	15 Jul 2010	
80	Medier (杭州麦地尔)	Private	Hangzhou Zhejiang	15 Jul 2010	
81	Jingxin Trust (金信信托)	State Controlled	Jinghua Zhejiang	26 Oct 2009	Financial Firm
82	Huachen Real Estate (华辰君临)	Foreign Invested	Ningbo Zhejiang	29 Apr 2009	
83	Tianting Paper (天听纸业)	Privatized	Shaoxing Zhejiang	01 Sep 2009	
84	Yalun Paper (亚伦纸业)	Privatized	Quzhou Zhejiang	22 Jun 2009	Converted to Liquidation
85	Huatai Petrol (华泰石油)	Private	Zhoushan Zhejiang	08 Jan 2010	
86	Zonghen Group (纵横集团)	Private	Shaoxing Zhejiang	12 Jun 2009	Consolidated with Five Subsidiaries

Sequence	Company	Ownership	Court	Acceptance	Miscellaneous
87	Jiande Steel (建德镍合金)	Privatized	Hangzhou Zhejiang	09 Oct 2010	

Notes:

1. Taking into account twenty-four affiliated companies mentioned in the Table, there were 111 companies that entered the corporate reorganization procedure in China between 1 June 2007 and 30 November 2010.

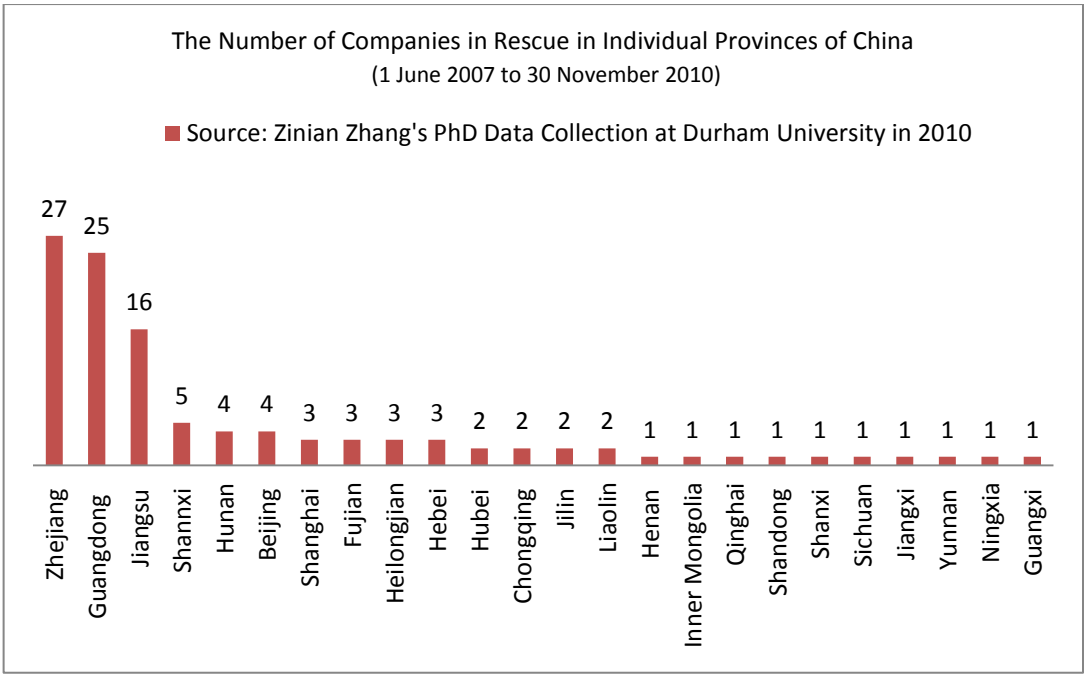
2. Within these 111 reorganized companies, there were twenty-nine companies that were listed in either the Shanghai or Shenzhen Stock Exchanges (26.13%).

3. There were thirty-nine reorganized companies which were state-owned, state-controlled or state-participated out of all 111 companies (35.14%). And there were nine privatized companies (8.11%). Within these 111 companies, there were forty-four private companies (39.64%) and nineteen foreign invested companies (17.12%).

4. There were eight companies whose reorganization procedures ended in liquidation, which means that the failure rate was only 7.21% (eight out of 111). More specifically, four companies failed to propose reorganization plans, and the remaining four companies failed to enforce the confirmed reorganization plans. It is noteworthy that six out of all eight failed companies were foreign invested, and none of these eight companies had the direct state links, i.e., they were not state-owned, state-controlled or state-participated.

5. The Trend of Corporate Reorganization Acceptance in China

6. Most of the corporate reorganizations took place in the economically developed areas in China. The chart below gives a glimpse as to provincial differences in accepting corporate reorganization in China. There were no reported reorganizations in nearly one-third of China's provinces. Probably, there were really no formal corporate rescues dealt with in these regions, such as Tibet and Anhui which are not well economically developed even by China's standards.


The Number of Companies in Rescue in Individual Provinces of China
(1 June 2007 to 30 November 2010)
Source: Zinian Zhang's PhD Data Collection at Durham University in 2010
27
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Zhejiang
Guangdong
Jiangsu
Shannxi
Hunan
Beijing
Shanghai
Fujian
Heilongjian
Hebei
Hubei
Chongqing
Jilin
Liaolin
Henan
Inner Mongolia
Qinghai
Shandong
Shanxi
Sichuan
Jiangxi
Yunnan
Ningxia
Guangxi

APPENDIX 2

CORPORATE REORGANIZATION PETITIONS REJECTED IN CHINA

(1 JUNE 2007- 30 NOVEMBER 2010)

	Company	Ownership	Petitioner	Filing	Court	Rejecting	Reason
1	China Bicycle (深圳中华)	Listed	Creditor	14 Jan 2010	Shenzhen Guangdong	28 Dec 2010	No Enough Supporting Documents
2	China Kejian (科健股份)	Listed	Creditor	15 Jan 2010	Shenzhen Guangdong	20 Sep 2010	No Enough Supporting Documents
3	Hongshen Technology (上海宏盛)	Listed	Creditor	04 Feb 2010	Shanghai	06 Nov 2010	No Explanation
4	East Star Airlines (东星航空)	Private	Creditor	08 Apr 2009	Wuhan Hubei	12 Jun 2009	No Explicit Govt. Support

APPENDIX 3

UNSECURED CREDITOR RECOVERY RATES IN CHINESE CORPORATE REORGANIZATIONS

(1 JUNE 2007- 30 NOVEMBER 2010)

	Company	State Link (state controlled, owned, participated or privatized)	Unsecured Debt (¥)	Recovery Rate	Additional
1	Zarva Technology (朝华科技)	Yes	1,334,096.900	10%	
2	Stellar Mega Union (星美联合)	Yes	1,229,435,986	30%	
3	Amoi Electronics (夏新电子)	Yes	2,158,314,805	21.77%	Combination of Recovery Rates
4	Hualong Group (广东华龙)	Yes	N/A	13%	
5	Shengxing Taifeng (深信泰丰)	Yes	1,265,300,068	20%	
6	Suntek Tech (新太科技)	Yes	326,865,404	21.77%	Combination of Recovery Rates
7	Beisheng Medicine (北生药业)	No	1,194,722,631	50.44%	Combination of Recovery Rates
8	Hebei Baoshuo (宝硕股份)	Yes	4,080,000,000	13%	Combination of Recovery Rates
9	Chuangzhou Chemistry (沧州化学)	Yes	5,091,953,300	14.28%	Combination of Recovery Rates
10	Dixian Textile (帝贤纺织)	Yes	1,333,529,777	2%	
11	Guangming Furniture (光明家具)	Yes	381,700,073	18%	Combination of Recovery Rates
12	Beiya Industry (北亚集团)	Yes	1,657,000,000	19%	

	Company	State Link (state controlled, owned, participated or privatized)	Unsecured Debt (¥)	Recovery Rate	Additional
13	Xin'an Technology (鑫安科技)	Yes	423,812,264	17.05%	Combination of Recovery Rates
14	Tianyi Science (天颐科技)	Yes	N/A	10.07%	
15	Lanbao Science (兰宝科技)	Yes	N/A	22%	
16	Liaoyuan Dehen (辽源得亨)	Yes	N/A	41.85%	
17	Dandong Chemistry (丹东化学)	Yes	547,438,292	10%	
18	Jinhua Group (锦化化工)	Yes	2,366,355,726	5%	Combination of Recovery Rates
19	Changling Group (长岭集团)	Yes	1,143,000,000	18%	
20	Qinling Cement (秦岭水泥)	Yes	763,967,576	50%	(20% in cash and 30% in equity)
21	Xianyan Pianzhuan (咸阳偏转)	Yes	28,898,990	100%	
22	Jiufa Food （九发股份）	Yes	2,253,916,069	20.04%	Combination of Recovery Rates
23	Shanghai Worldbest (华源股份)	Yes	2,240,374,233	14%	
24	Haina Sci-Tech (浙江海纳)	Yes	405,228,900	25.35%	
25	Sunrise Holdings (广东盛润)	Yes	2,162,375,585	30.05%	Combination of Recovery Rates
26	Powerise Tech （创智科技）	Yes	236,620,872	15.58%	Combination of Recovery Rates
27	Guangxia Industry (银广夏)	Yes	206,800,000	50%	Combination of Recovery Rates
28	Worldbest Industry (上海源发)	Yes	1,795,945,316	14%	

	Company	State Link (state controlled, owned, participated or privatized)	Unsecured Debt (¥)	Recovery Rate	Additional
29	Wugu Daochang Food (五谷道场)	No	400,000,000	15.75%	
30	Xianju Hospital (仙琚医院)	No	22,000,000	41%	
31	Xingchan Real Estate (兴昌博达)	No	344,297,105	100%	
32	Xiamen Star (厦门星星)	No (F)	95,820,000	16%	Combination of Recovery Rates
33	Fenghua Group (风华集团)	Yes	2,287,000,000	21.95%	
34	Jingwoniu Industry (金卧牛)	No	662,893,094	20.05%	
35	Yaxing Electronics (东莞雅新)	No (F)	561,000,000	23%	
36	Yaban Electronics (雅邦电子)	No (F)	210,690,000	20%	
37	Yongsheng Computer (永胜电脑)	No (F)	260,000,000	20%	
38	Wanghai Yikang (旺海怡康)	No	N/A	100%	
39	Zhonggu Sugar (中谷糖业)	No	1,300,000,000	28.3%	Sugar Farmer Creditors Paid at 100%
40	Anxing Tongwei (安信酒精)	No	240,341,136	30%	
41	Taizinai Milk (太子奶)	No	947,000,000	7.99%	
42	Haiji Lujian (海吉氯碱)	Yes	1,247,032,600	36%	Combination of Recovery Rates
43	Hongjie Electronics (弘捷电路)	No (F)	192,419,018	20.82%	Combination of Recovery Rates
44	Jiatong Tech （佳通科技）	No (F)	481,420,642	50%	

	Company	State Link (state controlled, owned, participated or privatized)	Unsecured Debt (¥)	Recovery Rate	Additional
45	Yaxing Electronics (苏州雅新)	No (F)	351,994,490	100%	
46	Yaxing Blocks (雅新线路板)	No (F)	583,296,428	100%	
47	Changchun Steel (长椿金属)	No (F)	600,000,000	40%	
48	Defa Dye (德发印染)	Yes	N/A	50.8%	
49	Qiangshen Gas (强盛煤气)	No	600,000,000	28.52%	Combination of Recovery Rates
50	Yangdong Engine (江苏扬动)	Yes	315,000,000	12.7%	
51	Qingta Trust (庆泰信托)	Yes	850,713,224	10%	Individual Creditors Paid at 100%
52	Sanqin Cement (三秦水泥)	Yes	184,088,073	3%	
53	Weidong Mine (卫东煤矿)	Yes	150,000,000	90%	
54	Zhonghen Steel (中恒特钢)	No	30,476,323	100%	
55	Dadi Paper (大地纸业)	No	600,119,493	15%	
56	Hualun Group (华伦集团)	No	1,305,197,783	12%	
57	Guangsai Power (广赛电力)	No	366,168,435	44.24%	
58	Nanwang Group (南望集团)	Yes	870,166,800	22.51%	
59	International Hotel (国际酒店)	Yes	358,984,301	78%	
60	Yijiaxiang Food (溢佳香)	No	455,881,533	20%	
61	Nongji (杭州农机)	No	171,346,431	20%	
62	Jiamei Food (佳美食品)	No	396,740,635	20%	

	Company	State Link (state controlled, owned, participated or privatized)	Unsecured Debt (¥)	Recovery Rate	Additional
63	Medier (杭州麦地尔)	No	347,405,251	20%	
64	Jingxin Trust (金信信托)	Yes	5,533,517,500	100%	
65	Huachen Real Estate (华辰君临)	No (F)	325,661,406	100%	
66	Tianting Paper (天听纸业)	Yes	403,520,359	15%	
67	Huatai Petrol (华泰石油)	No	225,280,027	60%	
68	Zonghen Group (纵横集团)	No	7,914,948,495	28%	
69	Jiande Steel (建德镍合金)	Yes	938,000,000	4.625%	
				Average: 33.67%	

Notes:

1. The average recovery rate for unsecured creditors in the listed company rescues was 24.15%, and it was at 40.13% in the non-listed companies.

2. Within the above sixty-nine reorganizations, the *pari passu* principle was relaxed in eighteen cases (26.09%). More specifically, the deviation took place in twelve out of twenty-eight listed company reorganizations (42.86%), and it happened in six out of forty-one non-listed company reorganizations (14.63%).

3. Out of the above sixty-nine reorganizations, there were thirty reorganizations that dealt with the private companies, and in the remaining thirty-nine cases, the companies were state owned, state controlled, state participated, or privatized former state owned companies. The average recovery rate for unsecured creditors in the reorganizations of entirely private companies was 41.70%, and this rate was 27.45% in the reorganizations of state linked companies.

4. There were nine foreign invested companies in reorganization, and their average recovery rate for unsecured creditors was 48.87%.

APPENDIX 4

CEASING TRADING BEFORE THE CORPORATE REORGANIZATION PROCEDURE IN CHINA

(1 JUNE 2007- 30 NOVEMBER 2010)

Sequence	Company	Trading Ceased?	Information Source	Miscellaneous
1	Zarva Technology (朝华科技)	Yes	People Court Daily	
2	Stellar Mega Union (星美联合)	Yes	Chongqing Court Report	
3	Amoi Electronics (夏新电子)	Yes	Shanghai Stock Daily	
4	Hualong Group (广东华龙)	Yes	Hualong Public Report	
5	Shengxing Taifeng (深信泰丰)	No	Its Reorganization Plan	
6	Suntek Tech (新太科技)	Unknown		
7	Beisheng Medicine (北生药业)	Unknown		
8	Hebei Baoshuo (宝硕股份)	No	Stock Weekly	
9	Chuangzhou Chemistry (沧州化学)	Yes	Shanghai Stock Daily	
10	Dixian Textile (帝贤纺织)	Yes	Legal Daily	
11	Guangming Furniture (光明家具)	Unknown		
12	Beiya Industry (北亚集团)	Unknown		
13	Xi'an Technology (鑫安科技)	Yes	Its Reorganization Plan	
14	Tianfa Petroleum (天发石油)	Unknown		

Sequence	Company	Trading Ceased?	Information Source	Miscellaneous
15	Tianyi Science (天颐科技)	Yes	Dehen Law Firm Study	
16	Lanbao Science (兰宝科技)	Yes	Oriental Morning News	
17	Liaoyuan Dehen (辽源得亨)	No	Its 2009 Annual Report	
18	Dandong Chemistry (丹东化学)	Yes	Ifeng Finance Analysis	
19	Jinhua Group (锦化化工)	No	Its 2009 Annual Report	
20	Changling Group (长岭集团)	No	Its 2008 Annual Report	
21	Qinling Cement (秦岭水泥)	No	Its 2009 Annual Report	
22	Xianyan Pianzhuan (咸阳偏转)	Yes	Yikuo Daily Finance	
23	Jiufa Food （九发股份）	Yes	21st Century News	
24	Shanghai Worldbest (华源股份)	No	Its 2009 Annual Report	
25	Haina Sci-Tech (浙江海纳)	No	Legal Daily	
26	Sunrise Holdings (广东盛润)	Yes	Its Own Public Notice	
27	Powerise Tech （创智科技）	Yes	Its Reorganization Plan	
28	Guangxia Industry (银广夏)	Yes	Its Reorganization Plan	
29	Worldbest Industry (上海源发)	Yes	Shanghai Stock Daily	
30	Huaqiang Real Estate (华强房产)	Unknown		
31	Wugu Daochang Food (五谷道场)	Yes	Democracy and Legal Daily	
32	Xianju Hospital (仙琚医院)	Yes	Legal Daily Weekend	
33	Xingchan Real Estate (兴昌博达)	Yes	Its Reorganization Plan	

Sequence	Company	Trading Ceased?	Information Source	Miscellaneous
34	Xiamen Star (厦门星星)	Yes	Haixia City News	
35	Fenghua Group (风华集团)	No	Nanfang City Daily	
36	Jingwoniu Industry (金卧牛)	Yes	Dongguan Daily	
37	Yaxing Electronics (东莞雅新)	Yes	Dongguan Daily	
38	Yaban Electronics (雅邦电子)	Yes	Dongguan Daily	
39	Yaxian Electronics (雅线电子)	Yes	Dongguan Daily	
40	Xiangfa Electronics (祥发电子)	Yes	Dongguan Daily	
41	Yongsheng Computer (永胜电脑)	Yes	Dongguan Intermediate Court	
42	Wanghai Yikang (旺海怡康)	Yes	Nanfang City News	
43	Zhonggu Sugar (中谷糖业)	Yes	Life Weekly Magazine	
44	Huabao Forage （华宝饲料）	No	The Reorganization Plan of Taifeng	
45	Huabao Industry （华宝实业）	No	The Reorganization Plan of Taifeng	
46	Taifeng Tech （泰丰科技）	No	The Reorganization Plan of Taifeng	
47	Xibu Real Estate （西部房产）	Yes	The Reorganization Plan of Taifeng	
48	Anxing Tongwei (安信酒精)	Yes	Siyang Law Firm	
49	Maisui Food （麦穗味精）	Yes	Jinshi Court	
50	Taizinai Milk (太子奶)	No	21st Economy News	
51	Haiji Lujian (海吉氯碱)	Yes	21st Economy News	

Sequence	Company	Trading Ceased?	Information Source	Miscellaneous
52	Hongjie Electronics (弘捷电路)	Yes	Its Own Reorganization Plan	
53	Kehong Steel (常熟科弘)	Yes	Daily Economy News	
54	Nantong Steel (南通有色)	Yes	Gangzha Court, Nantong	
55	Changhong Steel (长鸿特钢)	Yes	Its Auction Notice	
56	Jiatong Tech （佳通科技）	Yes	Suzhou Daily	
57	Yaxing Electronics (苏州雅新)	No	Its Reorganization Plan	
58	Yaxing Blocks (雅新线路板)	Yes	Its Reorganization Plan	
59	Changchun Steel (长椿金属)	Yes	Yangzi Evening News	
60	Defa Dye (德发印染)	Unknown		
61	Xiangjuan Real Estate (香娟房产)	Unknown		
62	Qiangshen Gas (强盛煤气)	No	People's Court Daily	
63	Yangdong Engine (江苏扬动)	Yes	Legal Daily	
64	Xingzhen Medicine (心正药业)	Yes	Pingxiang Daily	
65	Qingta Trust (庆泰信托)	Yes	21st Century Economy News	
66	Qingjian Real Estate (秦建房产)	Yes	Huashang Daily	
67	Sanqin Cement (三秦水泥)	Yes	Its Reorganization Plan	
68	Juxing Electronics (钜鑫电子)	Unknown		
69	Weidong Mine (卫东煤矿)	Unknown		
70	Zhonghen Steel (中恒特钢)	No	Mianyan Evening News	
71	Jurenxin Rubber (聚仁兴橡胶)	Yes	City News	

Sequence	Company	Trading Ceased?	Information Source	Miscellaneous
72	Dadi Paper (大地纸业)	No	Its Reorganization Plan	
73	Hualun Group (华伦集团)	Yes	Chengdu Commercial News	
74	Guangsai Power (广赛电力)	No	Its Reorganization Plan	
75	Nanwang Group (南望集团)	No	1ST Financial News	
76	International Hotel (国际酒店)	No	Xiaoshan Daily	
77	Yijiaxiang Food (溢佳香)	Yes	Xinhua News Agency	
78	Nongji (杭州农机)	Yes	Xinhua News Agency	
79	Jiamei Food (佳美食品)	Yes	Xinhua News Agency	
80	Medier (杭州麦地尔)	Yes	Xinhua News Agency	
81	Jingxin Trust (金信信托)	Yes	Economy Reference Daily	
82	Huachen Real Estate (华辰君临)	Yes	People's Court Daily	
83	Tianting Paper (天听纸业)	Yes	Jinghua Daily	
84	Yalun Paper (亚伦纸业)	Yes	Zheshang Magazine	
85	Huatai Petrol (华泰石油)	Yes	Pingzhen Henlian Law Firm	
86	Zonghen Group (纵横集团)	Yes	21st Economy News	
87	Jiande Steel (建德镍合金)	Yes	Xinyun Law Firm	

Notes:

1. Out of the above eighty-seven reorganizations, there were at least fifty-seven reorganized companies whose trading ceased before the formal rescue process (65.52%). This means that their formal rescue petitions were filed too late.

2. In all listed company reorganizations, there were sixteen out of these twenty-nine companies where the trading ceased prior to the formal rescue (55.17%). In all non-listed company reorganizations, there were forty-one out of these fifty-eight companies (70.69%) whose trading ceased before the formal rescue filings.

APPENDIX 5

APPLICANTS AND COURT JURISDICTIONS FOR CORPORATE REORGANIZATIONS IN CHINA

(1 JUNE 2007-30 NOVEMBER 2010)

Sequence	Company	Applicant	Court	Miscellaneous
1	Zarva Technology (朝华科技)	Creditor	The 3rd Intermediate Court of Chongqing	
2	Stellar Mega Union (星美联合)	Creditor	The 3rd Intermediate Court of Chongqing	
3	Amoi Electronics (夏新电子)	Creditor	Xiamen Intermediate Court	
4	Hualong Group (广东华龙)	Debtor	Yangjiang Intermediate Court	
5	Shengxing Taifeng (深信泰丰)	Creditor	Shenzhen Intermediate Court	Applicant is a son company of the debtor
6	Suntek Tech (新太科技)	Shareholder	Panyu Lower Court	
7	Beisheng Medicine (北生药业)	Creditor	Beihai Intermediate Court	
8	Hebei Baoshuo (宝硕股份)	Debtor	Baoding Intermediate Court	
9	Chuangzhou Chemistry (沧州化学)	Debtor	Chuangzhou Intermediate Court	
10	Dixian Textile (帝贤纺织)	Creditor	Chende Intermediate Court	
11	Guangming Furniture (光明家具)	Creditor	Yichun Intermediate Court	
12	Beiya Industry (北亚集团)	Creditor	Harbin Intermediate Court	

Sequence	Company	Applicant	Court	Miscellaneous
13	Xi'an Technology (鑫安科技)	Creditor	Jiaozuo Intermediate Court	
14	Tianfa Petroleum (天发石油)	Creditor	Jinzhou Intermediate Court	
15	Tianyi Science (天颐科技)	Creditor	Jinzhou Intermediate Court	
16	Lanbao Science (兰宝科技)	Creditor	Changchun Intermediate Court	
17	Liaoyuan Dehen (辽源得亨)	Creditor	Liaoyuan Intermediate Court	
18	Dandong Chemistry (丹东化学)	Creditor	Dandong Intermediate Court	
19	Jinhua Group (锦化化工)	Creditor	Huludao Intermediate Court	
20	Changling Group (长岭集团)	Debtor	Baoji Intermediate Court	
21	Qinling Cement (秦岭水泥)	Creditor	Tongchuan Intermediate Court	
22	Xianyan Pianzhuan (咸阳偏转)	Creditor	Xianyan Intermediate Court	
23	Jiufa Food （九发股份）	Creditor	Yantai Intermediate Court	
24	Shanghai Worldbest (华源股份)	Creditor	The 2nd Intermediate Court of Shanghai	
25	Haina Sci-Tech (浙江海纳)	Creditor	Hangzhou Intermediate Court	
26	Sunrise Holdings (广东盛润)	Creditor	Shenzhen Intermediate Court	
27	Powerise Tech （创智科技）	Creditor	Shenzhen Intermediate Court	

Sequence	Company	Applicant	Court	Miscellaneous
28	Guangxia Industry (银广夏)	Creditor	Yinchuan Intermediate Court	
29	Worldbest Industry (上海源发)	Creditor	The 2nd Intermediate Court of Shanghai	
30	Huaqiang Real Estate (华强房产)	shareholder	Fangshan Lower Court	
31	Wugu Daochang Food (五谷道场)	Debtor	Fangshan Lower Court	
32	Xianju Hospital (仙琚医院)	Debtor	Haidian Lower Court	
33	Xingchan Real Estate (兴昌博达)	Shareholder	Changping Lower Court	
34	Xiamen Star (厦门星星)	Debtor	Haichuang Lower Court	
35	Fenghua Group (风华集团)	Debtor	Zhaoqing Intermediate Court	
36	Huabao Fodder (华宝饲料)	Creditor	Shenzhen Intermediate Court	
37	Taifeng Tech (泰丰科技)	Creditor	Shenzhen Intermediate Court	
38	Huabao Industry （华宝实业）	Creditor	Shenzhen Intermediate Court	
39	Xibu Real Estate （深信西部）	Debtor	Shenzhen Intermediate Court	
40	Jingwoniu Industry (金卧牛)	Debtor	Dongguan Intermediate Court	
41	Yaxing Electronics (东莞雅新)	Creditor	Dongguan Intermediate Court	
42	Yaban Electronics (雅邦电子)	Creditor	Dongguan Intermediate Court	
43	Yaxian Electronics (雅线电子)	Creditor	Dongguan Intermediate Court	

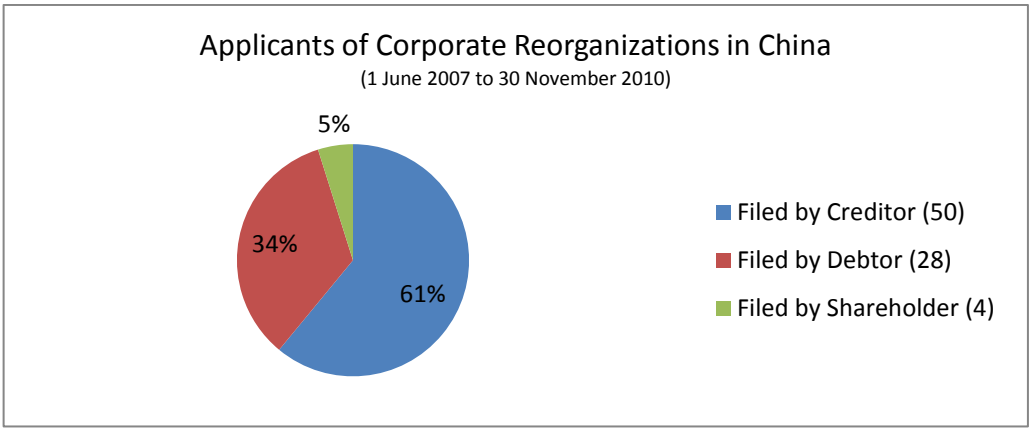
Sequence	Company	Applicant	Court	Miscellaneous
44	Xiangfa Electronics (祥发电子)	Creditor	Dongguan Intermediate Court	
45	Wanghai Yikang (旺海怡康)	Creditor	Shenzhen Intermediate Court	
46	Zhonggu Sugar (中谷糖业)	Creditor	Zhanjiang Intermediate Court	
47	Anxing Tongwei (安信酒精)	Debtor	Datong Lower Court	
48	Maisui Food （麦穗味精）	Debtor	Jinshi Lower Court	
49	Taizinai Milk (太子奶)	Creditor	Zhuzhou Intermediate Court	
50	Haiji Lujian (海吉氯碱)	Creditor	Wuhai Intermediate Court	
51	Hongjie Electronics (弘捷电路)	Debtor	Changshu Lower Court	
52	Kehong Steel (常熟科弘)	Creditor	Changshu Lower Court	
53	Changhong Steel (长鸿特钢)	Creditor	Changshu Lower Court	
54	Jiatong Tech （佳通科技）	Debtor	Wuzhong Lower Court	
55	Yaxing Electronics (苏州雅新)	Creditor	Wuzhong Lower Court	
56	Yaxing Blocks (雅新线路板)	Creditor	Wuzhong Lower Court	
57	Changchun Steel (长椿金属)	Creditor	Wuxi Intermediate Court	
58	Qiangshen Gas (强盛煤气)	Creditor	Jiawang Lower Court	
59	Yangdong Engine (江苏扬动)	Creditor	Jiangyan Lower Court	
60	Xingzhen Medicine (心正药业)	Debtor	Anyuan Lower Court	
61	Qingta Trust (庆泰信托)	Debtor	Qinghai Supreme Court	
62	Sanqin Cement (三秦水泥)	Debtor	Yaozhou Lower Court	

Sequence	Company	Applicant	Court	Miscellaneous
63	Juxing Electronics (钜鑫电子)	Debtor	Minghang Lower Court, Shanghai	
64	Weidong Mine (卫东煤矿)	Debtor	Pinding Lower Court	
65	Zhonghen Steel (中恒特钢)	Debtor	Jiangyou Lower Court	
66	Jurenxin Rubber (聚仁兴橡胶)	Debtor	Kunming Intermediate Court	
67	Dadi Paper (大地纸业)	Creditor	Fuyang Lower Court	
68	Hualun Group (华伦集团)	Creditor	Fuyang Lower Court	
69	Guangsai Power (广赛电力)	Creditor	Hangzhou Intermediate Court	
70	Nanwang Group (南望集团)	Creditor	Hangzhou Intermediate Court	
71	International Hotel (国际酒店)	Creditor	Xiaoshan Lower Court	
72	Yijiaxiang Food (溢佳香)	Debtor	Hangzhou Intermediate Court	
73	Nongji (杭州农机)	Debtor	Hangzhou Intermediate Court	
74	Jiamei Food (佳美食品)	Debtor	Hangzhou Intermediate Court	
75	Medier (杭州麦地尔)	Debtor	Hangzhou Intermediate Court	
76	Jingxin Trust (金信信托)	Shareholder	Jinghua Intermediate Court	
77	Huachen Real Estate (华辰君临)	Creditor	Beilun Lower Court	
78	Tianting Paper (天听纸业)	Debtor	Pujiang Lower Court	
79	Yalun Paper (亚伦纸业)	Debtor	Longyou Lower Court	
80	Huatai Petrol (华泰石油)	Creditor	Putuo Lower Court	

Sequence	Company	Applicant	Court	Miscellaneous
81	Zonghen Group (纵横集团)	Debtor	Shaoxing Intermediate Court	
82	Jiande Steel (建德镍合金)	Creditor	Jiande Lower Court	

Notes:

1. As for applicants of the existing reorganizations, there were eighty-two reorganizations whose relevant information was publicly available; there were fifty reorganizations that were filed by creditors (60.98%), twenty-eight filed by debtors (34.15%) and four by shareholders (4.88%).



2. As to the court jurisdictions, there were sixty-nine companies in rescue that were dealt with by intermediate courts (65.09%), thirty-six companies were processed by lower courts (33.96%), and one company was handled by a provincial supreme court (0.94%).

Nearly all listed company reorganizations were supervised by intermediate courts. There was just one case, the reorganization of *Xingtai Co. Ltd*, which was handled by Panyu Lower Court, Guangdong out of all 29 listed company reorganizations.

APPENDIX 6

ADMINISTRATOR APPOINTMENTS AND MANAGEMENT IN CHINESE CORPORATE REORGANIZATIONS

(1 JUNE 2007-30 NOVEMBER 2010)

	Company	Administrator	Control Returned to Debtor?	The Reorganization Plan Proposed by	Miscellaneous
1	Zarva Technology (朝华科技)	Liquidation Committee	N/A	Debtor	Professionals Included in the Committee
2	Stellar Mega Union (星美联合)	Liquidation Committee	N/A	Administrator	Professionals Included in the Committee
3	Amoi Electronics (夏新电子)	Liquidation Committee	N/A	Administrator	Professionals included
4	Hualong Group (广东华龙)	Liquidation Committee	N/A	N/A	Professionals included
5	Shengxing Taifeng (深信泰丰)	Law Firm	N/A	Administrator	
6	Suntek Tech (新太科技)	Liquidation Committee	No	N/A	Professionals Included
7	Beisheng Medicine (北生药业)	Liquidation Committee	No	Administrator	Professionals Included
8	Hebei Baoshuo (宝硕股份)	Liquidation Committee	No	Administrator	Professionals Included
9	Chuangzhou Chemistry (沧州化学)	Restructuring Committee	N/A	Administrator	Professionals Included
10	Dixian Textile (帝贤纺织)	Liquidation Committee	N/A	Administrator	Professionals Included
11	Guangming Furniture (光明家具)	Liquidation Committee	No	Administrator	Professionals Included

	Company	Administrator	Control Returned to Debtor?	The Reorganization Plan Proposed by	Miscellaneous
12	Beiya Industry (北亚集团)	Liquidation Committee	No	Administrator	Professionals Included
13	Xi'an Technology (鑫安科技)	Liquidation Committee	N/A	Administrator	
14	Tianfa Petroleum (天发石油)	Liquidation Committee	No	Administrator	Professionals Included
15	Tianyi Science (天颐科技)	Liquidation Committee	N/A	Administrator	Professionals Included
16	Lanbao Science (兰宝科技)	Liquidation Committee	N/A	Administrator	Professionals Included
17	Liaoyuan Dehen (辽源得亨)	Liquidation Committee	No	Administrator	Professionals Included
18	Dandong Chemistry (丹东化学)	Liquidation Committee	N/A	Administrator	Professionals Included
19	Jinhua Group (锦化化工)	Liquidation Committee	No	Administrator	Professionals Included (Zhong Lun Law Firm)
20	Changling Group (长岭集团)	Liquidation Committee	No	Administrator	
21	Qinling Cement (秦岭水泥)	Liquidation Committee	Yes	Administrator and Debtor	Professionals Included (Zhong He Yin Tai Management Firm)
22	Xianyan Pianzhuan (咸阳偏转)	Liquidation Committee	Yes	Debtor	No Professionals in Liquidation Committee
23	Jiufa Food (九发股份)	Liquidation Committee	No	Administrator	
24	Shanghai Worldbest (华源股份)	Liquidation Committee	No	Administrator and Debtor	

	Company	Administrator	Control Returned to Debtor?	The Reorganization Plan Proposed by	Miscellaneous
25	Haina Sci-Tech (浙江海纳)	Liquidation Committee	No (But Business Operation Conducted by the Old Management)	Administrator	
26	Sunrise Holdings (广东盛润)	A Liquidation Firm	Yes	Debtor	
27	Powerise Tech （创智科技）	Zhonglun Law Firm	No	Administrator	
28	Guangxia Industry (银广夏)	Liquidation Committee	N/A	Administrator	Professionals Included
29	Worldbest Industry (上海源发)	Liquidation Committee	N/A	Administrator	Professionals Included
30	Huaqiang Real Estate (华强房产)	Xinghe Law Firm	No	Administrator	
31	Wugu Daochang Food (五谷道场)	Liquidation Committee	N/A	Administrator	Professionals Included
32	Xingchan Real Estate (兴昌博达)	Liquidation Committee	No	Administrator	All Liquidation Committee Members Are Local Officials
33	Xiamen Star (厦门星星)	Lianhe Law Firm and Tianjian Accountant Firm	No	Administrator	
34	Fenghua Group (风华集团)	Liquidation Committee	N/A	Debtor	
35	Jingwoniu Industry (金卧牛)	Zhongtai Accountant Firm	N/A	Debtor	

	Company	Administrator	Control Returned to Debtor?	The Reorganization Plan Proposed by	Miscellaneous
36	Huabao Forage（华宝饲料）	King & Wood Law Firm	N/A	N/A	
37	Huabao Industry（华宝实业）	King & Wood Law Firm	N/A	N/A	
38	Taifeng Tech（泰丰科技）	King & Wood Law Firm	N/A	N/A	
39	Xibu Real Estate（西部房产）	King & Wood Law Firm	N/A	N/A	
40	Yaxing Electronics (东莞雅新)	Deloitte Accounting Firm	N/A	Administrator	
41	Yaban Electronics (雅邦电子)	Deloitte Accounting Firm	N/A	Administrator	
42	Yaxian Electronics (雅线电子)	Deloitte Accounting Firm	N/A	Failed	
43	Xiangfa Electronics (祥发电子)	Deloitte Accounting Firm	N/A	Failed	
44	Yongsheng Computer (永胜电脑)	Kingda Law Firm	N/A	Administrator	
45	Wanghai Yikang (旺海怡康)	Liquidation Committee	N/A	Administrator	
46	Zhonggu Sugar (中谷糖业)	2 Law Firms and 4 Accountant Firms	No	Administrator	
47	Anxing Tongwei (安信酒精)	Siyang Law Firm	N/A	Debtor	

	Company	Administrator	Control Returned to Debtor?	The Reorganization Plan Proposed by	Miscellaneous
48	Taizinai Milk (太子奶)	Dehen Law Firm	N/A	Administrator	
49	Haiji Lujian (海吉氯碱)	Zhenhan Law Firm	No	Administrator	
50	Hongjie Electronics (弘捷电路)	Xingrui Accounting Firm	No	Administrator	
51	Kehong Steel (常熟科弘)	Zhuwei law Firm	No	Administrator	
52	Nantong Steel (南通有色)	Liquidation Committee	No	Administrator	
53	Changhong Steel (长鸿特钢)	Xingrui Accounting Firm	No	Failed to Propose a Reorganization Plan	
54	Jiatong Tech （佳通科技）	Wuzhou Law Firm and Ernst & Young Accounting Firm	Yes	Debtor	
55	Yaxing Electronics (苏州雅新)	Ernst & Young Accounting Firm	No	Administrator	
56	Yaxing Blocks (雅新线路板)	Ernst & Young Accounting Firm	No	Administrator	
57	Changchun Steel (长椿金属)	Jingkui Law Firm	Yes	Debtor	
58	Xiangjuan Real Estate (香娟房产)	Liquidation Committee	No	Administrator	
59	Qiangshen Gas (强盛煤气)	Liquidation Committee	No	Administrator	Professionals Included
60	Yangdong Engine (江苏扬动)	Guangming Accounting Firm	No	Administrator	
61	Qingta Trust (庆泰信托)	Shentong Law Firm	N/A	Administrator	

	Company	Administrator	Control Returned to Debtor?	The Reorganization Plan Proposed by	Miscellaneous
62	Qingjian Real Estate (秦建房产)	Fengrui Law Firm	Yes	Debtor	
63	Sanqin Cement (三秦水泥)	Lantian Law Firm	Yes	Administrator and Debtor	
64	Juxing Electronics (钜鑫电子)	Xingming Law Firm	N/A	Failed to Propose a Rescue Plan	
65	Weidong Mine (卫东煤矿)	Chuankai Liquidation Firm	N/A	N/A	
66	Zhonghen Steel (中恒特钢)	Xingyong Zhonghe Accounting Firm	Yes	Debtor	
67	Jurenxin Rubber (聚仁兴橡胶)	Henye Law Firm	Yes	Debtor	
68	Dadi Paper (大地纸业)	Liquidation Committee	Yes	Debtor	Professionals Included
69	Hualun Group (华伦集团)	Restructuring Committee	N/A	Administrator and Debtor	Professionals Included
70	Guangsai Power (广赛电力)	Liquidation Committee	No	Administrator	Professionals Included
71	Nanwang Group (南望集团)	Liquidation Committee	N/A	N/A	Professionals Included
72	International Hotel (国际酒店)	Liquidation Committee	Yes	Debtor and Administrator	Professionals Included
73	Yijiaxiang Food (溢佳香)	Liuhe Law Firm	No	Administrator	
74	Nongji (杭州农机)	Liuhe Law Firm	No	Administrator	
75	Jiamei Food (佳美食品)	Liuhe Law Firm	No	Administrator	

	Company	Administrator	Control Returned to Debtor?	The Reorganization Plan Proposed by	Miscellaneous
76	Medier (杭州麦地尔)	Liuhe Law Firm	No	Administrator	
77	Jingxin Trust (金信信托)	Liquidation Committee	Yes	Administrator (not the debtor)	
78	Huachen Real Estate (华辰君临)	Jinhan Law Firm	No	Creditor committee and the Purchaser	
79	Tianting Paper (天听纸业)	Zhicheng Accounting Firm	Yes	Administrator (not the debtor)	
80	Yalun Paper (亚伦纸业)	Qingfeng Law Firm	No	Failed to Propose a Reorganization Plan	
81	Huatai Petrol (华泰石油)	Fangzhou Accounting Firm	No	Administrator	
82	Zonghen Group (纵横集团)	Zhentian Law Firm	No	Administrator	
83	Jiande Steel (建德镍合金)	Xinyun Law Firm	No	Administrator	

Notes:

1. In the above eighty-three reorganizations, liquidation committees were appointed as administrators in thirty-nine rescues (46.99%), law firms were appointed in twenty-six reorganizations (31.33%), accounting firms were appointed in thirteen reorganizations (15.66%), law and accounting firms were jointly appointed in three reorganizations (3.61%), and professional liquidation firms were appointed in two reorganizations (2.41%).

2. In the majority of listed company reorganizations, it was liquidation committees appointed by courts as administrators. Specifically, liquidation committees were appointed in twenty-six out of the total twenty-nine listed company reorganizations (89.66%). By contrast, there were only thirteen out of fifty-six non-listed company reorganizations (23.21%) where the liquidation committees were made the administrators.

3. In thirty-nine reorganizations that had the liquidation committees as the administrators, there were at least twenty-five rescues that had professionals, especially lawyers, included as members of such liquidation committees. This means that there was more involvement of professionals in China's corporate reorganizations.

4. As to whether the company's control was returned to the debtor, there were fifty reorganizations where such information was publicly available. Debtors regained control in thirteen reorganizations (26%), and administrators continued managing reorganization processes in the remaining thirty-seven reorganizations (74%).

5. As for which parties proposed reorganization plans, there were seventy reorganizations where such information was publicly available. Reorganization plans were proposed by administrators in fifty reorganizations (74.29%), by debtors in twelve reorganizations (17.14%), jointly by debtors and administrators in five rescues (7.14%) and jointly by creditors' committees and business buyers in one case (1.43%).

APPENDIX 7

CRAM-DOWNS AND DEVIATIONS FROM ABSOLUTE PRIORITY IN CHINESE CORPORATE REORGANIZATIONS

(1 JUNE 2007-30 NOVEMBER 2010)

Sequence	Company	A Deviation from Absolute Priority?	A Cram-Down Imposed? (against whom)	New Investor Solicited?
1	Zarva Technology (朝华科技)	Yes	No	Yes
2	Stellar Mega Union (星美联合)	Yes	No	Yes
3	Amoi Electronics (夏新电子)	Yes	No	Yes
4	Hualong Group (广东华龙)	Yes	No	Yes
5	Shengxing Taifeng (深信泰丰)	Yes	No	Yes
6	Suntek Tech (新太科技)	Yes	No	No
7	Beisheng Medicine (北生药业)	Yes	No	Yes
8	Hebei Baoshuo (宝硕股份)	Yes	Yes (unsecured creditors)	Yes
9	Chuangzhou Chemistry (沧州化学)	Yes	Yes (unsecured creditors)	Yes
10	Dixian Textile (帝贤纺织)	Yes	Yes (both secured and unsecured creditors)	Yes
11	Guangming Furniture (光明家具)	Yes	Yes (both secured and unsecured creditors)	Yes
12	Beiya Industry (北亚集团)	Yes	No	No

Sequence	Company	A Deviation from Absolute Priority?	A Cram-Down Imposed? (against whom)	New Investor Solicited?
13	Xi'an Technology (鑫安科技)	Yes	No	Yes
14	Tianfa Petroleum (天发石油)	N/A	Yes (both secured and unsecured creditors)	Yes
15	Tianyi Science (天颐科技)	N/A	Yes (both secured and unsecured creditors)	Yes
16	Lanbao Science (兰宝科技)	Yes	No	Yes
17	Liaoyuan Dehen (辽源得亨)	Yes	No	Yes
18	Dandong Chemistry (丹东化学)	Yes	No	Yes
19	Jinhua Group (锦化化工)	Yes	Yes (Both secured and unsecured ones)	Yes
20	Changling Group (长岭集团)	Yes	No	Yes
21	Qinling Cement (秦岭水泥)	Yes	No	Yes
22	Xianyan Pianzhuan (咸阳偏转)	Yes	No	Yes
23	Jiufa Food （九发股份）	Yes	No	Yes
24	Shanghai Worldbest (华源股份)	Yes	No	Yes
25	Haina Sci-Tech (浙江海纳)	Yes	No	Yes
26	Sunrise Holdings (广东盛润)	Yes	No	Yes
27	Powerise Tech （创智科技）	Yes	No	Yes
28	Guangxia Industry (银广夏)	Yes	Yes (both unsecured creditors and shareholders)	Yes

Sequence	Company	A Deviation from Absolute Priority?	A Cram-Down Imposed? (against whom)	New Investor Solicited?
29	Worldbest Industry (上海源发)	Yes	No	Yes
30	Huaqiang Real Estate (华强房产)	N/A	N/A	Yes
31	Wugu Daochang Food (五谷道场)	No	No	Yes
32	Xianju Hospital (仙琚医院)	No	No	Yes
33	Xingchan Real Estate (兴昌博达)	No	Yes (shareholders and secured creditors)	No
34	Xiamen Star (厦门星星)	Yes	No	No
35	Fenghua Group (风华集团)	Yes	Yes (both secured and unsecured creditors)	Yes
36	Jingwoniu Industry (金卧牛)	Yes	Yes (both the revenue authority and employees)	No
37	Yaxing Electronics (东莞雅新)	No	No	Yes
38	Yaban Electronics (雅邦电子)	No	No	Yes
39	Yongsheng Computer (永胜电脑)	N/A	No	Yes
40	Wanghai Yikang (旺海怡康)	No	No	Yes
41	Zhonggu Sugar (中谷糖业)	No	No	Yes
42	Anxing Tongwei (安信酒精)	No	No	Yes
43	Maisui Food （麦穗味精）	N/A	Yes (both secured and unsecured creditors)	N/A
44	Taizinai Milk (太子奶)	No	No	Yes

Sequence	Company	A Deviation from Absolute Priority?	A Cram-Down Imposed? (against whom)	New Investor Solicited?
45	Haiji Lujian (海吉氯碱)	N/A	Yes (unsecured creditors)	Yes
46	Hongjie Electronics (弘捷电路)	No	No	Yes
47	Kehong Steel (常熟科弘)	N/A	No	Yes
48	Nantong Steel (南通有色)	N/A	N/A	Yes
49	Jiatong Tech （佳通科技）	No	No	Yes
50	Yaxing Electronics (苏州雅新)	No	Yes (shareholders)	Yes
51	Yaxing Blocks (雅新线路板)	No	Yes (shareholders)	Yes
52	Changchun Steel (长椿金属)	N/A	No	No
53	Defa Dye (德发印染)	N/A	N/A	Yes
54	Qiangshen Gas (强盛煤气)	N/A	N/A	Yes
55	Yangdong Engine (江苏扬动)	No	Yes (shareholders)	Yes
56	Xingzhen Medicine (心正药业)	N/A	No	Yes
57	Qingta Trust (庆泰信托)	No	No	Yes
58	Sanqin Cement (三秦水泥)	Yes	Yes (the revenue authority and unsecured creditors)	No
59	Weidong Mine (卫东煤矿)	N/A	No	No
60	Zhonghen Steel (中恒特钢)	N/A	Yes (secured creditor)	N/A
61	Jurenxin Rubber (聚仁兴橡胶)	N/A	No	N/A
62	Dadi Paper (大地纸业)	Yes	No	No
63	Hualun Group (华伦集团)	No	Yes (shareholders)	Yes

Sequence	Company	A Deviation from Absolute Priority?	A Cram-Down Imposed? (against whom)	New Investor Solicited?
64	Guangsai Power (广赛电力)	No	Yes (shareholders)	No
65	Nanwang Group (南望集团)	No	Yes (shareholders)	No
66	International Hotel (国际酒店)	No	No	Yes
67	Yijiaxiang Food (溢佳香)	No	Yes (shareholders)	Yes
68	Nongji (杭州农机)	No	Yes (shareholders)	Yes
69	Jiamei Food (佳美食品)	No	Yes (shareholders)	Yes
70	Medier (杭州麦地尔)	No	Yes (shareholders)	Yes
71	Jingxin Trust (金信信托)	No	Yes (shareholders)	Yes
72	Huachen Real Estate (华辰君临)	No	Yes (shareholders)	Yes
73	Tianting Paper (天听纸业)	No	Yes (shareholders)	No
74	Huatai Petrol (华泰石油)	No	No	Yes
75	Zonghen Group (纵横集团)	No	Yes (shareholders)	Yes
76	Jiande Steel (建德镍合金)	No	Yes (shareholders)	Yes

Notes:

1. With regard to deviating from absolute priority, there were sixty-two reorganizations where the relevant information was publicly obtainable. Deviations took place in thirty-three reorganizations (53.23%). In fact, most of the deviations happened in listed company rescues. In particular, there was a routine deviation from absolute priority in listed company reorganzations, because China's Supreme People's Court had a decree that authorised this. Deviating from absolute priority, however, was less likely in non-listed company reorganizations. Specifically, it was found that deviations were only found in five out of the thirty-four non-listed company reorganizations (14.71%).

2. As to cram-downs, this thesis examined seventy-one reorganizations where such information was publicly accessible, and it was found that cram-downs were imposed in twenty-nine reorganizations (40.85%).

Specifically, in these twenty-nine cram-downs, seventeen of them were used to override shareholders' objections; twelve were to force unsecured creditors; nine against secured creditors; two against revenue creditors and one was to overrule the objection of employee creditors. It should be noted that these figures overlap, because one cram-down was sometimes to override more than one class of impaired parties, e.g. a cram-down was used to override the objections of both shareholders and unsecured creditors.

3. As for so-called strategic investors, which were essentially company buyers, there were seventy-three reorganizations examined by this thesis because the related information was publicly available, and it was found that company buyers were successfully solicited in sixty-one out of these seventy-three reorganizations (83.56%), which means that going concern sale rescues were used in 83.56% of the existing China's corporate reorganizations.

APPENDIX 8

DURATION OF CORPORATE REORGANIZATIONS IN CHINA

(1 JUNE 2007-30 NOVEMBER 2010)

Sequence	Company	Acceptance	Plan Confirmation	Duration (days)	Miscellaneous
1	Zarva Technology (朝华科技)	16 Nov 2007	24 Sep 2007	38	Listed
2	Stellar Mega Union (星美联合)	11 Mar 2008	22 Apr 2008	42	Listed
3	Amoi Electronics (夏新电子)	15 Sept 2009	23 Nov 2009	69	Listed
4	Hualong Group (广东华龙)	10 Mar 2008	23 Apr 2008	43	Listed
5	Shengxing Taifeng (深信泰丰)	10 Nov 2009	30 Apr 2010	290	Listed
6	Suntek Tech (新太科技)	11 Mar 2009	3 Nov 2009	237	Listed
7	Beisheng Medicine (北生药业)	27 Nov 2008	30 Dec 2008	33	Listed
8	Hebei Baoshuo (宝硕股份)	03 Jan 2008	5 Feb 2008	33	Listed
9	Chuangzhou Chemistry (沧州化学)	16 Nov 2007	24 Dec 2007	38	Listed
10	Dixian Textile (帝贤纺织)	10 Nov 2008	31 Dec 2008	50	Listed
11	Guangming Furniture (光明家具)	09 Nov 2009	5 Aug 2010	269	Listed
12	Beiya Industry (北亚集团)	03 Feb 2008	24 Apr 2008	81	Listed

Sequence	Company	Acceptance	Plan Confirmation	Duration (days)	Miscellaneous
13	Xi'an Technology (鑫安科技)	07 Nov 2008	23 Dec 2008	41	Listed
14	Tianfa Petroleum (天发石油)	13 Aug 2007	11 Oct 2007	89	Listed
15	Tianyi Science (天颐科技)	12 Aug 2007	11 Oct 2007	60	Listed
16	Lanbao Science (兰宝科技)	16 Nov 2007	21 Dec 2007	35	Listed
17	Liaoyuan Dehen (辽源得亨)	13 Apr 2010	11 Aug 2010	120	Listed
18	Dandong Chemistry (丹东化学)	13 May 2009	27 Nov 2009	198	Listed
19	Jinhua Group (锦化化工)	19 Mar 2010	30 Jul 2010	133	Listed
20	Changling Group (长岭集团)	15 May 2008	17 Nov 2008	163	Listed
21	Qinling Cement (秦岭水泥)	28 Aug 2009	14 Dec 2009	108	Listed
22	Xianyan Pianzhuan (咸阳偏转)	25 Nov 2009	7 May 2010	163	Listed
23	Jiufa Food（九发股份）	28 Sep 2008	9 Dec 2008	72	Listed
24	Shanghai Worldbest (华源股份)	27 Aug 2008	17 Dec 2008	66	Listed
25	Haina Sci-Tech (浙江海纳)	14 Sep 2007	23 Nov 2007	70	Listed
26	Sunrise Holdings (广东盛润)	06 May 2010	22 Oct 2010	169	Listed
27	Powerise Tech（创智科技）	23 Aug 2010	27 May 2011	276	Listed

Sequence	Company	Acceptance	Plan Confirmation	Duration (days)	Miscellaneous
28	Guangxia Industry (银广夏)	16 Sep 2010	9 Dec 2011	449	Listed
29	Worldbest Industry (上海源发)	27 Aug 2008	29 Nov 2008	67	Listed
30	Wugu Daochang Food (五谷道场)	30 Oct 2008	12 Feb 2009	105	
31	Xianju Hospital (仙琚医院)	21 Apr 2007	1 Jun 2007	42	
32	Xingchan Real Estate (兴昌博达)	16 Nov 2007	4 Sep 2008	293	
33	Xiamen Star (厦门星星)	27 Feb 2009	6 Nov 2009	252	
34	Fenghua Group (风华集团)	11 Jul 2007	6 Mar 2008	239	
35	Jingwoniu Industry (金卧牛)	28 May 2008	8 May 2009	345	
36	Huabao Forage （华宝饲料）	15 Jan 2010	30 Apr 2010	105	
37	Huabao Industry （华宝实业）	15 Jan 2010	30 Apr 2010	105	
38	Taifeng Tech （泰丰科技）	15 Jan 2010	30 Apr 2010	105	
39	Xibu Real Estate （西部房产）	15 Jan 2010	30 Apr 2010	105	
40	Yaxing Electronics (东莞雅新)	27 Aug 2008	1 Feb 2010	533	

Sequence	Company	Acceptance	Plan Confirmation	Duration (days)	Miscellaneous
41	Yaban Electronics (雅邦电子)	13 Aug 2008	26 Nov 2009	470	
42	Yongsheng Computer (永胜电脑)	20 Jan 2009	29 Oct 2009	285	
43	Wanghai Yikang (旺海怡康)	09 Aug 2007	9 Nov 2007	91	
44	Zhonggu Sugar (中谷糖业)	22 Dec 2009	31 Aug 2010	262	
45	Anxing Tongwei (安信酒精)	30 Jul 2007	30 Nov 2007	123	
46	Maisui Food（麦穗味精）	19 Sep 2007	5 Jul 2008	290	
47	Taizinai Milk (太子奶)	23 Jul 2010	8 Nov 2011	472	
48	Haiji Lujian (海吉氯碱)	17 Sep 2008	16 Apr 2009	195	
49	Hongjie Electronics (弘捷电路)	23 Sep 2009	31 Mar 2010	180	
50	Kehong Steel (常熟科弘)	18 Nov 2008	31 Aug 2009	296	
51	Nantong Steel (南通有色)	18 Nov 2009	14 May 2010	165	
52	Changhong Steel (长鸿特钢)	25 Dec 2009	24 Jun 2010	182	
53	Jiatong Tech（佳通科技）	09 Mar 2009	18 Sep 2009	193	
54	Yaxing Electronics (苏州雅新)	29 Apr 2008	19 Dec 2008	234	
55	Yaxing Blocks (雅新线路板)	29 Apr 2008	19 Dec 2008	234	

Sequence	Company	Acceptance	Plan Confirmation	Duration (days)	Miscellaneous
56	Changchun Steel (长椿金属)	17 Jul 2008	11 Nov 2008	117	
57	Qiangshen Gas (强盛煤气)	14 Jan 2010	14 Jan 2011	364	
58	Yangdong Engine (江苏扬动)	29 Apr 2009	8 Mar 2010	313	
59	Xingzhen Medicine (心正药业)	08 May 2009	20 Oct 2009	163	
60	Qingjian Real Estate (秦建房产)	31 Mar 2009	4 Aug 2010	491	
61	Sanqin Cement (三秦水泥)	07 Apr 2008	8 Jan 2009	277	
62	Zhonghen Steel (中恒特钢)	06 Feb 2009	9 Mar 2009	31	
63	Jurenxin Rubber (聚仁兴橡胶)	10 Mar 2008	10 Nov 2008	245	
64	Dadi Paper (大地纸业)	01 Jun 2009	7 Dec 2009	214	
65	Hualun Group (华伦集团)	01 Jun 2009	28 May 2010	361	
66	Guangsai Power (广赛电力)	20 May 2008	15 Dec 2008	209	
67	Nanwang Group (南望集团)	20 May 2008	15 Dec 2008	209	
68	International Hotel (国际酒店)	01 Jul 2010	17 Jun 2011	351	
69	Yijiaxiang Food (溢佳香)	15 Jul 2010	29 Jun 2011	349	
70	Nongji (杭州农机)	15 Jul 2010	29 Jun 2011	349	
71	Jiamei Food (佳美食品)	15 Jul 2010	29 Jun 2011	349	

Sequence	Company	Acceptance	Plan Confirmation	Duration (days)	Miscellaneous
72	Medier (杭州麦地尔)	15 Jul 2010	29 Jun 2011	349	
73	Jingxin Trust (金信信托)	26 Oct 2009	22 Dec 2009	71	
74	Huachen Real Estate (华辰君临)	29 Apr 2009	25 Sep 2009	149	
75	Tianting Paper (天听纸业)	01 Sep 2009	18 Jan 2010	260	
76	Huatai Petrol (华泰石油)	08 Jan 2010	28 Jun 2011	536	
77	Zonghen Group (纵横集团)	12 Jun 2009	16 Dec 2009	151	
78	Jiande Steel (建德镍合金)	09 Oct 2010	20 Apr 2011	193	

Notes:

1. Regarding how long reorganization processes took on average, there were seventy-eight reorganizations where such information was publicly available. This thesis measured efficiency by calculating the period of time from the date of acceptance to that of the reorganization plan confirmation. In these seventy-eight reorganizations, it took on average 198.77 days to complete a reorganization process.

A further investigation found that there was, in relation to efficiency, a considerable difference between listed company and non-listed company reorganizations. It took on average 120.76 days to conclude a listed company reorganization; it took on average 244.94 days to finish a non-listed company reorganization.

APPENDIX 9

ZHEJIANG INTERVIEWS

Venue: Zhejiang Province, P. R. China

Time: January 2012

Interviewer: Zinian Zhang

Supervisor: Professor Roman Tomasic

Interviewees: ten lawyers and accountants who were appointed as administrators in Zhejiang corporate reorganizations, five creditors or creditor representatives in corporate reorganizations, three judges handling corporate reorganizations, one government official involved in a corporate reorganization procedure, and one director of a debtor company in reorganization.

For anonymity and simplification, these interviewees are marked as administrator, creditor, judge, official and director together with the number sequence.

Interview Comments

Question 1: What are the causes of the failure of the company that enters the rescue procedure?

Interviewee	Response
Administrator 1:	To a large extent, it was because of the incompetence of the management.
Administrator 2:	It was the inconsistency of the local government's land plan that led the company to bear unexpected and unaffordable costs. Of course, the poor management should also be counted.
Administrator 3:	It was the industry downturn that hit the company hard, and the company was also a victim of shark loans in Zhejiang.
Administrator 4:	Over-expansion might be the key reason for the company's failure. Meanwhile, the shark loans precipitated the company's bankruptcy.

Interviewee	Response
Administrator 5:	Over-expansion and the sudden economic recession led to the company's irreversible distress.
Administrator 6:	Over-expansion and poor cash flow management of the company caused its deep distress.
Administrator 7:	The incompetence of the management.
Administrator 8:	The major reason was likely to be the internal mismanagement, and, as a result, the company was considerably vulnerable when there was an economic recession. Meanwhile, over-expansion should also be taken into account. The company was a victim of shark loans.
Administrator 9:	The poor cash flow management.
Administrator 10:	The internal mismanagement, especially the cash flow management.
Creditor 1:	The failure was largely due to over-expansion. And the lack of supervision to the board was also liable to the failure. The management were irresponsible.
Creditor 2:	Over-expansion might be the culprit. At the same time, the shark loans expedited the distress of the company.
Creditor 3:	Poor management caused business trouble.
Creditor 4:	Poor management together with economic recession.
Creditor 5:	Over-expansion caused the company's distress.
Judge 1:	The failure was largely exogenous. Because of the unexpected withdrawal of the bank loans, the company resorted to the shark loan financer to solve the short-term cash problem, but unfortunately the company failed to get rid of the unhealthy, and even toxic, shark loans quickly, and it was brought down instead.
Judge 2:	Over-expansion would be the main reason for the companies' failure.
Judge 3:	It was likely to be the industry distress which struck the company hard. It should also be noted that the shark loans exacerbated and precipitated the distress.
Official 1:	Over-expansion would be the culprit of the company's failure. The previous CEO was a diligent and responsible businessman, but he was absolutely irresponsible to his fellow shareholders.
Director 1:	The company's financial management before the crisis was out of

Interviewee	Response
	order. Not surprisingly, the company was deeply distressed because of excessive interest payment to shark loans.

Question 2: Is government support critical for the reorganization petition to be accepted by the court?

Interviewee	Response
Administrator 1:	In the past, without the government's guarantee to tackle the social stability trouble, courts were too cautious to accept corporate bankruptcy filings. At present, however, the government may be pleased to see as many corporate reorganizations as possible, because corporate reorganizations are in the interests of local economy.
Administrator 2:	It is impossible for courts to accept corporate reorganization filings without government support.
Administrator 3:	The court's acceptance of a corporate reorganization filing is conditional upon an agreement reached by local government and the court. No agreement, no acceptance.
Administrator 4:	Without local government support, the court would never accept a corporate reorganization petition.
Administrator 5:	The court only deals with the legal affairs, whereas the government handles the local economic development. There was no government support in this case.
Administrator 6:	An interim committee formed by the local government to back the corporate reorganization procedure.
Administrator 7:	The court lacks confidence in processing corporate reorganization without local government support.
Administrator 8:	Without government support, the court will not accept corporate reorganization filings.
Administrator 9:	The corporate reorganization procedure cannot be entered if there is no government support.
Administrator10:	The government support must be available, because, without the involvement of local government, the court cannot obtain the cooperation from the government agencies whose regulation services are critical to handling corporate bankruptcy issues. The court alone is basically helpless.

Interviewee	Response
Judge 1:	Government support is very important. The court itself cannot mobilize the governmental administrative services in aid of corporate bankruptcy procedures, as bankruptcy affairs need the cooperation of many governmental departments. These departments will not listen to the court unless there is a strong government body involved. For example, the police service is vital to investigating properties of the company, as we lack the means and human sources to do that. In the absence of the government support, however, we are unable to obtain the police service.
Judge 2:	When a corporate reorganization filing is petitioned to our court, we will focus on assessing whether the application meets legal requirements. Of course, when deciding to accept or to reject a petition, we will seriously take into account government support, the rescue proposal agreed between the debtor and main creditors and its potential impacts on the local economy.
Judge 3:	For fear of the social stability troubles directed to the court, we tend to avoid the trouble by rejecting corporate bankruptcy petitions. As to the acceptance of a corporate reorganization petition, we draw attention to whether the company's going concern value could be preserved through a rescue process.
Official 1:	Without our support, the court would have definitely rejected the reorganization petition. The government intervention is essential to redeploy the company's assets, and in particular, our purpose is to prevent the chain reaction of bankruptcy, to maintain the social stability and to avert the destructive damage to local economy.
Director 1:	Government support is the prerequisite for the rescue petition to be accepted by the court.

Question 3: What factors can explain courts' hesitation to hear corporate reorganizations?

Interviewee	Response
Administrator 1:	The court fears mass petitions or protests launched by people in huge number involved in corporate bankruptcy procedures including corporate reorganization ones. In practice, to handle the potential mass petitions, the administrator will contact with the local government for helps if a corporate bankruptcy process starts.
Administrator 2:	Courts do not have sufficient judges to handle corporate rescues.
Administrator 3:	The court cannot afford the human resources.
Administrator 4:	Bankruptcy is like a hot potato, and courts will get into trouble if they accept bankruptcy petitions. Meanwhile, the lack of detailed bankruptcy rules makes it difficult for courts to manage corporate bankruptcy.
Administrator 5:	It is a complicated project for both courts and administrators.
Administrator 6:	Corporate bankruptcy or reorganization is firmly related with social stability concerns, and obviously courts are unable to deal with social issues that should be handled by the government. At the same time, bankruptcy needs a large amount of manpower of courts, and courts do not have enough judges to do this job.
Administrator 7:	Maintaining social stability associated with corporate bankruptcy is an insurmountable challenge faced by courts.
Administrator 8:	Potential mass petitions are the main worries of courts when they decide whether to accept a corporate reorganization filing.
Administrator 9:	To courts, corporate bankruptcy is excessively time-consuming.
Administrator 10:	Corporate reorganization involves intense conflicts, and courts are unable to deal with them properly. Apart from social stability concerns, too many government administrative services are needed in bankruptcy procedures, but courts are unable to persuade these government agencies to give full cooperation.
Judge 1:	Government support is very important. The court itself cannot mobilize the government services in support of corporate bankruptcy. But bankruptcy processes need the cooperation of many government departments. These departments will not listen to the court unless the local government is directly involved.
Judge 2:	When a corporate reorganization petition is filed to our court, we

Interviewee	Response
	will focus on assessing whether the petition meets the legal requirements. Of course, to decide to accept or reject the petition, we will seriously take into account the availability of government support, a draft rescue agreement between the debtor and the main creditors and its economic impacts on the local economy.
Judge 3:	We try to avoid corporate bankruptcy for fear that we will put ourselves in difficult situations because of potential bankruptcy-related mass petitions. If we accept a corporate reorganization filing, we mainly consider whether the company's going concern value can be preserved through a formal corporate rescue procedure.
Official 1:	Corporate reorganization is complex and time-consuming. And more importantly, courts do not have political and financial incentives to deal with corporate reorganizations. Accepting and supervising corporate reorganization may make courts get into trouble, because corporate reorganization may involve protests of disgruntled parties, such as unpaid employees and creditors. Such protests will negatively affect courts in China's political performance assessment system.

Question 4: Why are there so few early rescues?

Interviewee	Response
Judge 1:	The government will not pay attention to companies that are in trouble unless a business failure causes a political problem where there is either a mass petition launched by unpaid employees or seizure of the company's property by disgruntled creditors. Without government intervention, a formal corporate rescue procedure cannot be entered.
Judge 2:	To avoid exposing business misbehaviours, companies are reluctant to file for reorganization because they have to give the control on the company's assets, books and accounts to a court-appointed administrator if a formal reorganization procedure is entered. They cannot accept losing control in rescue.
Judge 3:	There were many rescue efforts made by the companies before the formal rescue process, but all these efforts failed.
Administrator 4	Debtors fear exposing tax evasion, because they will lose control on business operation and books to administrators if they enter a formal

	corporate reorganization procedure. Most companies commit tax evasion in China, so they fear that the books are inspected by a third party.
Director 1:	Actually, the company was a family-run business, and regrettably we did not want to spoil family harmony by sacking the chief manager earlier.

Question 5: Why is the involvement of government officials important to the effectiveness of the corporate reorganization? (This was designed to government official interviewees)

Interviewee	Response
Official 1:	The government is reliable, so our involvement can give confidence to impaired parties in support of a rescue. More importantly, the government can more effectively use public services to enhance a corporate rescue.

Question 6: If there is a debtor-in-possession, or if your company itself can appoint an administrator, will the company be more confident to file for reorganization earlier to the court?

Interviewee	Response
Director 1:	Definitely.

Question 7: What factors are essential for your firm to be included in the Zhejiang insolvency practitioner list? (This question was designed for administrator interviewees)

Interviewee	Response
Administrator 1:	My firm is large, and our high quality lawyers also played an important role in making us to be included.
Administrator 2:	The number of accountants was essential for our firm to be selected. As for experience, honestly, we did not have, since all accountants in my firm had never handled corporate bankruptcy cases before.

Interviewee	Response
Administrator 3:	The large number of lawyers in my firm played the crucial role in making us to be selected. And our good business reputation was also considered by the authorities when they made the decision.
Administrator 4:	The number of accountants was critical for our firm to be listed. With regard to the prior experience in dealing with bankruptcy, actually, we did not have.
Administrator 5:	A combination of the size, experience and the authority-rewarded credentials made our firm succeed in being listed.
Administrator 6:	It was the size of our firm which occupied the attention of the selecting authorities. At the same time, our firm's commercial expertise and the high quality lawyers were also considered by the authorities.
Administrator 7:	First, it was the size of the firm; second, our expertise in commercial and civil law made us more competitive.
Administrator 8:	It should be admitted that the size of our firm was the main factor. Furthermore, our high quality lawyers and our good business reputation were also considered by the authorities.
Administrator 9:	The size of our firm and the similar business law experience were critical for our firm to be listed.

Question 8: As the administrator, can you fully access the company's books and other financial records? (This question was designed for administrator interviewees)

Interviewee	Response
Administrator 1:	We had the full access to the company's books. The books could not be inspected or examined by creditors as these books contained trade secrets.
Administrator 2:	Full access. In my opinion, an auditor report may be unnecessary if the administrator is an accounting firm because we are already experts in this area.
Administrator 3:	We could fully access the company's books.
Administrator 4:	Yes.

Interviewee	Response
Administrator 5:	Of course. And all the company's books and financial documents were physically in the custody of the administrator.
Administrator 6:	Yes.
Administrator 7:	Yes. There was an accounting firm hired by us to audit the company, and the accounting firm analysed and reported the causes of bankruptcy. As to whether there were commercial crimes committed by the company, the accounting firm would have drawn their conclusions.
Administrator 8:	Yes.
Administrator 9:	Definitely.
Administrator 10:	Yes.

Question 9: Are the company's books and other financial records available for creditors to inspect so as to increase transparency?

Interviewee	Response
Administrator 1:	No.
Administrator 2:	In three reorganizations handled by us, there were no specific requests from creditors to examine or inspect the company books. But, it would be meaningless to examine them, as these books had been fabricated. These books did not accurately record and reflect company transactions.
Administrator 3:	The request to examine the record of an individual transaction may be allowed, but a general request to examine all books will not be allowed.
Administrator 4:	No.
Administrator 5:	In theory, creditors should be allowed to inspect the books, but in fact there were no requests from creditors. Some creditors once asked to verify their own transactions and were allowed.
Administrator 6:	There were requests to inspect the company's books from creditors and their lawyers, but such requests were refused. They could read the auditor report which was the formal information disclosure document made for all interested parties, and creditors did not have the right to inspect the company books.

Interviewee	Response
Administrator 7:	In principle, creditors could access the books, however, in fact there were no creditors requesting to inspect the company's books. I remembered that there were some banks which examined some of the company's transactions. Reading the books was allowed, but photocopying was prohibited, because we did want them to be disclosed to third parties.
Administrator 8:	All the company's books were available for creditors to inspect, as they had been audited.
Administrator 9:	No. Creditors were not permitted to access the books to assess the causes of the company's bankruptcy.
Administrator 10:	Some creditors requested to inspect the books to verify their own transactions and were allowed.
Creditor 1:	Of course, we wanted to know the real causes of the company's failure, but we could not afford to do so individually. The costs would outweigh the potential gains.
Creditor 2:	The company information provided to us was very general. And, the company's books and other financial records were not accessible to us. Inspecting the company's books was, under the current law, impractical for creditors.
Creditor 3:	We could access the company's books.
Creditor 4:	In theory, we could inspect the company's books, but in fact it was the secured creditors that were interested in examining the company's books. By contrast, unsecured creditors, in anticipation of low recovery rates, had no intention to do that.
Creditor 5:	We have never considered inspecting the company's books, and, for an individual creditor, it was uneconomic to do that; it was not cost-effective.
Judge 2:	In theory, company books should be available for inspection by creditors.
Judge 3:	There were not specific requests from creditors to inspect these books. But these books did not reflect real business activities, as they were apparently fabricated.

Question 10: Who proposes the reorganization plan in the rescue process?

Interviewee	Response
Administrator 1:	It was the administrator who proposed the reorganization plan in reorganizations of *Nanwang* and *Guangsai*. In the reorganization of *Haina*, it was the company's buyer who prepared the reorganization plan.
Administrator 2:	In my case, it was the local government that proposed the main elements of the reorganization plan.
Administrator 3:	It was the debtor that prepared the reorganization plan to a vote.
Administrator 4:	The administrator.
Administrator 5:	The administrator. During the process of drafting the plan, the strategic investor, local government and creditors were also involved. The local government played a critical role in facilitating the rescue process, as it provided some benefits to the company.
Administrator 7:	In the reorganizations of *International Hotel* and *Hualun Paper Group*, it was the administrator who proposed the reorganization plan. In the reorganization of *Dadi Paper Co. Ltd.*, the plan was proposed by the debtor itself.
Administrator 8:	The plan was prepared by the administrator, as we were in charge.
Administrator 9:	The administrator.
Administrator 10:	The administrator.
Judge 2:	The plans were prepared by the administrators.
Judge 3:	It was the administrator who prepared the reorganization plan, as the debtor had exhausted all its rescue efforts before the formal rescue process.

Question 11: Is there evidence of fraud committed by the company before bankruptcy? (This was designed for administrator interviewees)

Interviewee	Response
Administrator 1:	I did not have the duty to investigate the company's potential fraud. Even if there were evidence of fraud, I would have not

Interviewee	Response
	reported to police. In the reorganization case dealt with by me, I found that the old equity-manager used the company's money to buy him houses, but I have not reported to police in spite of that it was an alleged criminal offence, because I was not obliged to do that.
Administrator 2:	I was unwilling to report any criminal offences to police, in spite of the fact that there was the evidence of unlawful capital withdrawal in the reorganizations of *Huatai Oil*, *Yongji Ship Manufacturing* and *Ouweibao*.
Administrator 3:	We did not find any evidence of fraud in the reorganization case.
Administrator 4:	There was the evidence of commercial crimes in the reorganization case, but I was not bothered.
Administrator 5:	There was no evidence of commercial crimes in the company.
Administrator 6:	No any evidence of commercial crimes was found.
Administrator 7:	There was the evidence of unlawful capital withdrawal, a criminal offence under China's criminal law, in the reorganization of *Xiaoshan Int'l Hotel* before bankruptcy, but we did not report to police.
Administrator 8:	There appeared to have commercial crimes, such as embezzlement or capital withdrawal, but we, as the administrator, were concerned with maximising the company's value, instead of reporting crimes to police.
Administrator 9:	The police had investigated the crimes before the formal reorganization procedure started, and the old equity-manger and other senior managers were arrested and later prosecuted.
Administrator 10:	We did not find any evidence of commercial crimes in the case. But, it would be a grey area if shareholder-managers put the company's money into his own pocket, since there were no well-defined boundaries between controlling shareholders' personal properties and the company's properties.

Question 12: Do you think the creditors' committee has well represented all creditors? (This was designed for creditor interviewees)

Interviewee	Response
Creditor 1:	It was impossible for them to represent us. They represented themselves and prioritised their own interests.
Creditor 2:	The creditors' committee played its role reasonably.
Creditors 3:	Generally, it could represent creditors as a whole.
Creditor 4:	It largely represented the secured creditors. It was always unsecured creditors that suffered heavy financial losses.
Creditor 5:	As the creditor's representative, I have never directly contacted the creditors' committee. Instead, I contacted the administrator several times to get up to date information about the progress of the reorganization.

Question 13: Do you think that the administrator is impartial in striking a balance between debtor and creditor?

Interviewee	Response
Creditor 1:	The administrator was impartial, but I was concerned with the recovery rate that was disappointing.
Creditor 2:	The administrator represented the local government, acting on behalf of local government.
Creditor 3:	Generally speaking, the administrator was unbiased.
Creditor 4:	As an unsecured creditor, we felt hopeless and reluctant to meet the administrator. The administrator only focused on how to maximise his service fees. Apart from being paid out of the company's value, the administrator charged the secured creditors much through selling the mortgaged assets.
Creditor 5:	The recovery rate was unacceptable, and we did not know the genuine causes of the company's bankruptcy. Meanwhile, we knew little about how the assets were valuated.

Question 14: Do you agree that creditors would be better protected if the creditors' committee could hire a lawyer paid out of the company's assets?

Interviewee	Response
Creditor 1:	There was a lawyer in the creditors' committee, but it was useless.
Creditor 2:	Of course, it would be very useful.
Creditor 3:	Definitely.
Creditor 4:	Given the fact that the members of the creditors' committee just represented themselves, hiring a lawyer paid out of the company's assets might only increase these individual members' interests. It might make things worse to hire a lawyer.
Creditor 5:	I agree.

Question 15: What can the administrator do to improve the transparency of the reorganization?

Interviewee	Response
Creditor 1:	It was already transparent.
Creditor 2:	Creditors should be allowed to examine the company's books, and the books should be audited by professionals. More importantly, the administrator must disclose the genuine causes of the company's failure as well as all transactions between the debtor and creditors.
Creditor 3:	I was satisfied with the transparency of the reorganization process.
Creditor 4:	I was given some documents that contained skeletal financial data and few or no explanations. The real causes of the company's bankruptcy were not explained by the administrator.
Creditor 5:	Some documents were available, but the real causes of the company's failure were not disclosed.

Question 16: Do you think that the administrator has charged too much in the reorganization procedure?

Interviewee	Response
Creditor 1:	Definitely, the fee was extortionate, and it did echo my view that both the

	administrator and the members of the creditors' committee represented themselves and served their individual interests.
Creditor 2:	It was normal.
Creditor 4:	It was too high.
Creditor 5:	It was reasonable.
Director 1:	Yes, it was too high.

Question 17: Do you think the administrator is competent to deal with the corporate reorganization affairs?

Interviewee	Response
Judge 1:	It varied from case to case.
Judge 2:	The commitment of the administrators, especially the lawyers and accountants, could not be questioned; however, they did lack experience in this area.
Judge 3:	Basically, they could cope with the reorganization issues.
Director 1:	The administrator would be competent to investigate the company's debts and assets and to supervise cash management activities during the reorganization process; however, as to restructuring the company's business, it was the debtor, instead of the administrator, that could construct a feasible plan.

Question 18: In your experience, which party is in control of the corporate reorganization case?

Interviewee	Response
Judge 1:	The corporate reorganization procedure was a collective bargaining forum, because all parties including the administrator, the government officials and the court played their own roles so as to achieve the rescue objectives.
Judge 2:	The administrator had the full control of the company, although there was a heavy presence of local government.
Judge 3:	The reorganization procedure was controlled by the court and participated by other interested parties.

Question 19: Do you think that shareholder-managers should be rewarded something in exchange for their continued service in the new company?

Interviewee	Response
Administrator 1:	The old shareholder-manager, the CEO, left the company after the reorganization procedure began. The company's business areas have changed, so it seemed unnecessary to retain him in the new company.
Administrator 2:	The old shareholder-manager was a gentleman, but we have never considered distributing some value to him in the reorganization plan.
Administrator 3:	It was impossible for me to consider distributing something to him (the old equity-manager). But, I would not object if the company's buyer had agreed to give him something for his continued involvement in the new company.
Administrator 4:	In my case, the old chief manager retained his position as the manager, but all his old shares were cancelled.
Administrator 5:	It depended on whether the company continued its business model after rescue. The old equity-managers may be rewarded something for their continued service if the company's business model was kept intact; otherwise, it might be meaningless to give them something in the form of either equity or control.
Administrator 7:	Yes, old equity-managers could be incentivized to engage in the new company because they have the experience and information of running the company.
Administrator 8:	In principle, I agree with this idea. The old management are vital for the company's business if it is a traditional reorganization, but if it is a business sale rescue, they would be nuisances, because the new owner will set up its new management team.
Administrator 9:	All old shareholders had left before the formal rescue procedure started, so we did not consider rewarding something for their continued service.
Administrator 10:	It would be very difficult to persuade creditors to accept the deviation from absolute priority. And more importantly, the old shareholder-manager would play a less important role in the new company.
Creditor 1:	Yes. The old shareholder-mangers would have incentives to improve the company's business if they had been given share options in the new company, such as management incentive

Interviewee	Response
	shares.
Creditor 2:	I don't think so. The new management team should be appointed by the new owner, and the old chief manager was not trustworthy any more.
Creditor 3:	Yes. The departure of the old chief manager would have definitely affected the company's going-concern value.
Creditor 5:	It is worth considering. But, the then situation did not allow giving anything to the shareholder-manager for his continued involvement in the company, since so many creditors during the creditors' meeting fiercely condemned him of his wrongdoings that brought the company into bankruptcy.
Judge 2:	It is a good question worth considering.
Judge 3:	We desperately needed the old equity-manager to involve in the reorganization process, because he knew the company most. Unfortunately, he was arrested and placed behind the bars at that time, so we could not access the information possessed by him.

Question 20: How do you assess the feasibility of the reorganization plan? Have you consulted some management experts to support your judgement? (This was designed for judge interviewees)

Interviewee	Response
Judge 1:	In fact, the feasibility of the reorganization plan had been assessed before the plan was voted, because many parties, including the court, local government and main creditors, had been involved in preparing the main elements of the plan. The court did not consult any management experts, as local government business development department would be the best party to make such a judgement.
Judge 2:	We only assessed the plans' legality.
Judge 3:	When selecting the company's buyers, the local government business development departments had considered whether it was feasible for the potential buyer to turn the company around. The government assessed the buyers' business experience and their financial capacities. So, the feasibility of the reorganization plan had in fact been assessed and ensured by local government.

Interviewee	Response
	We did not need to make a second guess, let alone hire an expert to do so.

APPENDIX 10

ZHEJIANG CORPORATE REORGANIZATONS

(1 June 2007 to 31 December 2011)

Source: Zinian Zhang's PhD Data Collection

	Company	**Court**	**Date of acceptance** (yyyy/mm/dd)	**Miscellaneous**
1	Haina Science (海纳科技)	Hangzhou Intermediate Court	20070914	
2	Dadi Paper (大地纸业)	Fuyang Lower Court	20090601	
3	Hualun (华伦集团) In combination with 5 son companies	Fuyang Lower Court	20090601	
4	Guangsai Energy (广赛电力)	Hangzhou Intermediate Court	20080520	
5	Nanwang (南望集团)	Hangzhou Intermediate Court	20080520	
6	International Hotel (国际酒店)	Xiaoshan Lower Court	20100701	
7	Yijiaxiang Food (溢佳香)	Hangzhou Intermediate Court	20100715	
8	Nongji (农业机械)	Hangzhou Intermediate Court	20100715	
9	Jiamei (佳美旅游)	Hangzhou Intermediate Court	20100715	
10	Medier (麦地尔食品)	Hangzhou Intermediate Court	20100715	
11	Jinxing Trust (金信信托)	Jinghua Intermediate Court	20091026	
12	Huachen Junling (华辰君临)	Beilun Lower Court	20090429	
13	Tianting Paper (天听纸业)	Pujiang lower Court	20090901	
14	Yalun Paper （亚伦纸业）	Longyou Lower Court	20090622	Converted to Liquidation
15	Huatai Oil (华泰石油)	Putuo Lower Court	20100108	

16	Zonghen Group (纵横集团) In combination with its 5 son companies	Shaoxing Intermediate Court	20090612	
17	Jiande Special Steel (建德镍合金)	Jiande Lower Court	20101009	
18	Ouweibao (欧威宝) in combination with its 2 related companies	Putuo Lower Court	20110829	Converted to Liquidation
19	Hengyu ship (恒宇造船) In combination with its 3 related companies	Putuo Lower Court	20111021	Pending at the time of writing
20	Yongji ship (永吉造船)	Putuo Lower Court	20111129	Pending at the time of writing

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