

# NATIONAL REPORT FOR THE PEOPLE'S REPUBLIC OF CHINA

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## 1. History and present law

In the long history China had neither concept of bankruptcy nor insolvency legislation under the traditional legal culture based on Confucianism. The first bankruptcy law was enacted in 1906 by Qing Dynasty as one of the results of Chinese legal modernization. It was tragically abolished in 1908 because of the internal debate on whether the foreign claims should keep the priority over the domestic ones. After the 1911 Revolution the Beijing government tried to draft a new bankruptcy law but failed. In 1935 the Nanjing government enacted the second bankruptcy law which remains effective in Taiwan today.

In 1949 the Communist Party annulled all the existing laws when taking over the Mainland and established a new regime which led to a belief that the socialist enterprises could not become bankrupt. Such a myth was broken after the economic reform since 1978 when state-owned enterprises (SOEs) were transformed to assume sole responsibility for their own profits and losses. In 1986 the Enterprise Bankruptcy Law was adopted for trial implementation. It was simply with only 43 articles and merely applicable to SOEs, with the character of deep involvement of government intervene. In 1990 the legislature added a new chapter in the revised Civil Procedure Law to expand the application of bankruptcy proceeding to all sorts of non-SOE enterprises. In 1991 and 2002, the Supreme People's Court released two judicial interpretations for implementation of the Laws.

During 1994-97 the central government issued a series of regulations to set up a substantially administrative procedure for SOE bankruptcy. Up to April 2004 there were 3,377 SOEs closed down via this procedure, with RMB 223.8 billion of bad loans written off and 6.2 million employees reinstalled. Such a movement ended up ultimately in 2008.

In 1994 the National People's Congress, the legislature, organized a drafting work for a new bankruptcy law with the guideline of "establishing socialist market economy". After a long time process that was full of difficulties and reverses the new Enterprise Bankruptcy Law (EBL) containing 12 chapters and 136 articles was promulgated in August 2006 and became effective in June 2007. In April 2007, the Supreme People's Court released two judicial interpretations, the one governing the appointment of administrators and the other regulating their remunerations, as authorized by the new legislation. Now the Court is drafting a comprehensive judicial interpretation for dealing with various issues for implementation of the EBL.

Indeed the EBL is just a start-point for the market-oriented insolvency legislation in mainland China. In recent years some scholars and practitioners have proposed further drafting works for laws on individual bankruptcy and procedure for cross-border insolvency.

## 2. The types of insolvency proceedings

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## 2.1 Types of insolvency proceedings available to general business debtors and their main characteristics

### 2.1.1 Overview

#### *Types of insolvency proceedings*

The EBL contains three types of insolvency proceedings: reorganization, composition and bankruptcy liquidation.

In the framework of the EBL the chapters are divided into two parts: those commonly applicable to all the proceedings<sup>1</sup> and those applicable to each of them separately.<sup>2</sup>

There are some channels among the three proceedings. Firstly, after acceptance a case filed for liquidation the case may convert to reorganization or composition in certain circumstances. This is purporting to explore opportunity to rescue the distressed business as far as possible. Secondly, an ongoing proceeding of reorganization or composition may be terminated and convert to liquidation by reason of failure or other specified situations. This is to avoid abuse of rescue instrument and spur the parties to seek compromise under the shadow of liquidation as the worst ending.

Furthermore, there are two supplementary provisions related to state-owned enterprises (SOEs) and financial sectors in the EBL. Firstly it stipulates that some special matters e.g. resettlement of workers, in the bankruptcy of SOEs within a specified scope shall be handled according to the regulations of the State Council, the central government of the nation. Secondly it provides some special rules to the proceedings of commercial banks, securities companies and insurance companies and authorizes the State Council to formulate the corresponding measures for the implementation.

There is no special provision that applies with regard to proceedings with a large number of creditors or in respect of debtors with a substantial or minimal amount of assets in the EBL. However such matters will be dealt with in the upcoming regulations on the insolvency of banking institutions.

#### *Eligible debtors*

The proceedings can be open against a debtor which is an enterprise with status of legal person. Any natural person, non-legal-person business such as partnership and sole proprietorship or non-enterprise entity such as government agency or other non-profit association is not subject to these proceedings. Foreign corporate entities that have business existence in China are included in the scope of the applicable enterprises.

All the claims and recourse rights against the insolvent debtor are governed by the proceedings.

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<sup>1</sup> Namely, Chapter I General Provisions, Chapter II Application and Acceptance, Chapter III Bankruptcy Administrator, Chapter IV The Debtor's Assets, Chapter V Bankrupt Expenses and Community Liabilities, Chapter VI Filing of Claims, Chapter VII Creditors' Meeting and Chapter XI Legal Liabilities.

<sup>2</sup> Namely, Chapter VIII "Reorganization", Chapter IX "Composition" and Chapter X "Bankruptcy Liquidation".

In the circumstances of bankruptcy liquidation of corporations there is no need to set the rule on discharge of the bankrupt. The unpaid claims upon the conclusion of liquidation proceeding is still enforceable and may be further satisfied should additional assets of the debtor are found afterwards or any guarantor or other kind of joint debtor is available.

### *Duration of proceedings*

There is no limit to the duration of the proceedings as whole, even though a limited term for reorganization planning is stipulated in the EBL.<sup>3</sup>

#### 2.1.2 Informal restructurings

Informal restructurings and workouts are generally subject to contract law and company law as well as the relative regulations. However, the EBL contains some special rules to leave a room for out-of-court workout or pre-package arrangement. For instance, Article 105 stipulates that, after the court accepts an application for bankruptcy, if the debtor and all the creditors conclude an agreement on settlement by themselves, they may request the court to confirm it and terminate the proceeding. As regard to reorganization the limitation on the period was set by the drafters under the consideration that the parties could have chance, and should be encouraged, to negotiate before starting the proceeding. Where there is new investment involved in the reorganization plan that leads to the change of the capital structure an additional voting process is given by the EBL.<sup>4</sup>

## 2.2 Special proceedings for particular types of debtors

### 2.2.1 Credit institutions and insurance companies

The proceedings of reorganization and bankruptcy liquidation in the EBL are generally applicable to financial institutions such as commercial banks, securities companies and insurance companies. Additionally, there are some special provisions to them in the Commercial Bank Law, the Insurance Law, the Securities Law and the Regulations on Risk Treatment of Securities Companies. These proceedings shall be filed by the corresponding financial supervision organs under the State Council, namely the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission. Each of the Commissions is empowered to take such measures as take-over and custody for early rescue of an institution carrying major business risks before filing of a bankruptcy proceeding. When taking such measures it may apply with the court for suspending the procedures for civil litigation or execution against the said institution.

State aids have long been used as instruments to prevent the opening of formal insolvency proceedings, especially for distressed SOEs. Sometimes the approach of privatization, rather than nationalisation, is adopted. A notable example reported on the international forum is

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<sup>3</sup> Art. 79 of EBL stipulates that a draft reorganization plan shall be submitted within 6 months as of the day when the court approves the reorganization proceeding and the period may be extended up to 3 months upon request on a justifiable ground.

<sup>4</sup> Art. 85(2) reads: "Where a draft of reorganization plan involves the adjustment of the right and interest of capital investors, a group of capital investors shall be formed to vote this issue."

“Changchun approach” adopted by Chinese government to rescue distressed SOEs from 1996 to early 21<sup>st</sup> century.<sup>5</sup>

### 2.2.2 Other regulated businesses

No special insolvency proceedings exist regarding non-commercial entities including public ones. Peasant household as the majority of the farming businesses in China are not subject to any insolvency proceeding but the commercial entities having business in agricultural industry are taken as eligible debtors in the EBL.

### 2.2.3 Individuals/consumers

Up to now individual businesses are not subject to bankruptcy law though the future legislation in such field is expected. In the draft EBL individual concerns such as partnership and sole proprietorship along with their individual partners and owners were subject to the proceedings of composition and bankruptcy liquidation. Unfortunately such a design was not adopted by the legislature. In recent years some discussions in the law circle proposing further legislation on individual bankruptcy in order to regulate the individual debtors. This proposal may be taken into account when the next National Congress formulates its legislation plan.

## 3. The conditions for the opening of insolvency proceedings

### 3.1 Requirements/pre-conditions for the opening of insolvency proceedings

#### 3.1.1 Commencement standards

##### *Overview*

According to Article 2 of the EBL,<sup>6</sup> for commencement of any of the proceedings, one of the following two general standards is required for commencement of insolvency proceedings. Further, for commencement of reorganization proceedings, an additional standard is available.

##### *Illiquidity (cash flow test)*

This standard was adopted from the very beginning of the draft EBL, now formulated with the combination of “unable to pay its due debts” and “it is obviously incapable of clearing off the debts”. It seems a double wording. The real story is that the first sentence was the original one and the second was added in the process of discussion by the legislature when a top leader ordered to plus the wording “and its assets are not enough to pay off all the debts” in the Article so as to change the standard to a combination of cash flow test and balance sheet test. By the clever move to maintain the cash flow test the narrowed door was broadened again. Now this standard is widely used in practice.

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<sup>5</sup> See, Wang Weiguo and Charles Booth, *Study on Alternative Approaches for Debt Restructuring on Enterprises in China*, <http://www.iiiglobal.org/component/jdownloads/?task=finish&cid=1044&catid=148>.

<sup>6</sup> Art. 2 of EBL: “Where an enterprise legal person is unable to pay its due debts and its assets are not enough to pay off all the debts or it is obviously incapable of clearing off the debts, all its debts shall be liquidated in accordance with the provisions of the Law.” “When an enterprise legal person is under the aforesaid circumstances or if it has the possibility of being unable to pay its debts, it may be subject to Reorganization in accordance with the provisions of the Law.”

### *Balance sheet test*

The lately added standard is formulated with the combination of “unable to pay its due debts” and “its assets are not enough to pay off all the debts”. Since this standard relies on the information controlled by the debtor and is often doubtful or debatable, it is rarely used in practice.

### *Additional ground for reorganization*

Apart from the above grounds, reorganization proceeding may be commenced by reason of “the possibility of being unable to pay its debts”. It means that the door of judicial rehabilitation of a distressed business is not merely open to those who have already become insolvent. This policy is based on the idea that an early cure is more likely to save a sick horse.

#### 3.1.2 Qualified petitioners

##### *Overview*

Theoretically speaking, there are two types of petitions for insolvency proceedings in the EBL: initial petition and subsequent petition. In case of initial one, debtor may petition any of the proceedings and one or several creditors may petition for reorganization or bankruptcy liquidation, and where an enterprise already under ordinary liquidation meets the above-mentioned standard the person(s) responsible for the ordinary liquidation shall petition bankruptcy liquidation. In case of subsequent one, where the case is petitioned by a creditor for bankruptcy liquidation, the debtor or its investor(s) whose capital investment makes up 1/10 or more of the debtor’s registered capital may subsequently petition for reorganization, or otherwise the debtor may petition for composition.

In addition, according to the special provision in Article 134 of the EBL governing insolvency of financial institutions, any of the financial supervision organs under the State Council is empowered to file a petition for reorganization or bankruptcy liquidation of its corresponding financial institution.<sup>7</sup>

Anyone who files petitions must submit a petition form and the relevant evidences. The petition form shall contain the following matters: (1) basic information of the petitioner and the respondent(s); (2) purpose of petition; (3) facts and ground of the petition; (4) any other matter that the court deems necessary.

##### *Initial petition by debtor for any of the proceedings*

When a debtor is under the circumstances as prescribed in Article 2 of the EBL, it may file an application with the court for reorganization, composition or bankruptcy liquidation. The debtor shall file a petition and relevant documents when applying for bankruptcy liquidation, composition or reorganization to the people’s court. The petition shall state the name and address of the debtor and creditors, the purpose of the application, the reason and grounds for the application, and other matters that the people’s court may deem necessary on documentation.

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<sup>7</sup> Art. 134 of EBL.

When a debtor files a petition, it shall submit, in addition to the above-mentioned documents, a statements on financial status, a checklist of debts, a checklist of the claims, relevant financial statements, a pre-arranged plan for settlement of employees as well as a statement on payment of wages and social insurance premiums.

*Initial petition by creditor(s) for reorganization or bankruptcy liquidation*

When a debtor fails to pay off its due debts, its creditor(s) may file a petition for reorganization or bankrupt liquidation. It is not required for creditors to prove the obviousness of the debtor's illiquidity or its excess of liabilities over assets. When the court accepts the petition, the debtor shall be ordered to submit the statements on financial status and other documents as required in case of debtor's petition. If the documents show that the debtor does not meet the commencement requirement, the court may reject the petition and cancel the case before the declaration of bankruptcy.

A plurality of creditors is not required in petition.

*Initial petition by pre-petition liquidators for bankruptcy liquidation*

When a legal-person enterprise dissolves according to the articles of association or the law, it shall be liquidated. In such circumstances someone shall be responsible to deal with the liquidation matters. Thus the shareholders of a limited liability company or the directors of a company limited by shares shall make up a liquidation team to see after the liquidation affairs.<sup>8</sup> Where they find that the assets of the liquidated are not sufficient to meet the liabilities, they are in duty to file a bankruptcy petition at the court.<sup>9</sup> It should be noted that this duty is binding not only in case of pre-petition liquidation already in process but also in case of its delay. If the responsible persons who have not started to liquidate the dissolved company fail to perform the duty of petition they shall be liable for the losses as result of the omission.

*Subsequent petition by debtor or its shareholders for reorganization*

Where a case petitioned by one or several creditors for bankruptcy liquidation has been accepted by the court but the declaration of bankruptcy has not been ruled, the debtor or its capital investor(s) whose capital contribution makes up 1/10 or more of the debtor's registered capital have a chance to file a subsequent petition for reorganization. In such circumstances the EBL does not require the evidence to show that the debtor is recoverable. However, if it is evident that the debtor is hopeless to be rescued, the court may rule the termination of the reorganization proceeding and declare the debtor to be bankrupt.<sup>10</sup>

*Subsequent petition by debtor for composition*

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<sup>8</sup> Art. 184 of the Company Law.

<sup>9</sup> Art. 7(3) of EBL and Art. 188 of the Company Law.

<sup>10</sup> Art. 78 of EBL reads: "In the duration of reorganization, under any of the following circumstances, the people's court shall, upon the request of a bankruptcy administrator or any interested party, rule to terminate the procedures for reorganization and declare the debtor bankrupt: (1) Where the business operation or financial situation of the debtor goes worse off and cannot be remedied in any way; (2) Where a debtor has any act of cheating or maliciously deducting its assets or has any act obviously against its creditors; or (3) Where the act of a debtor makes its bankruptcy administrator unable to perform its duties and functions."

The proceeding of composition in EBL is a simple procedure designed for small case which usually contains limited business scale and small amount of assets and liabilities. It follows the offer-acceptance process in conclusion of a contract: first, the debtor submits the petition with a draft composition agreement containing terms on concession of the claims; second, the court calls up the creditors' meeting and let them discuss and vote the draft agreement; finally, when the meeting passes the bill, the agreement is concluded and the proceeding shall be terminated, or otherwise the case shall turn to bankruptcy liquidation. Therefore only the debtor is allowed to petition for composition as an offeror, either initially or subsequently. In practice, if creditors are willing to reach a composition, they may negotiate with the debtor and have it make the petition, or may conclude an out-of-court agreement and then request the court to confirm it and then terminate the proceeding in accordance with Article 105 of the EBL.

### *Relative issues*

There is no request for a minimum number of creditors or for holders of a minimum amount of claims. Such a request was never mentioned during drafting the EBL.

Non-petition clauses are never effective in China.

An eligible party cannot be prohibited to petition the proceeding unless it does not meet the relevant requirement of the Law. If the petitioner abuses the power or it has no legitimate interest to petition of proceeding, the respondent(s) may object it and the court may decide to terminate the case after trial. A respondent who suffers damage from the abuse may file a separate action for compensation in accordance with the Tort Liability Law.

Even though there is no direct provision and no precedent, it is proper to say that, on the basis of the legal policy of the EBL, in case there are concurring petitions for opening of different types of insolvency proceedings, the proceeding of reorganization or composition shall prevail.

What needs to be proved for petition is the debtor's obvious inability to pay due debts. A cessation of payment by the debtor is usually presumed as inability to pay but a mere fact of cessation is not enough to meet the obviousness of illiquidity.

The proceedings cannot be opened in case of the debtor's unwillingness to pay debts without proof of its inability to pay.

As haveing been shown, without proving the debtor's inability to pay due debts, only balance sheet insolvency cannot establish a ground for the opening of the proceedings.

Sufficiency of assets is not a precondition for the opening of the proceedings. It is sometimes a case in China that a proceeding is terminated at the end where the bankrupt has no means to pay either the claims or the administrator's remunerations.

Under the EBL the debtor shall be a corporate entity. The eligibility of such a debtor to open the proceeding is provided by the Law and recognized by the court. Prior approval of the general meeting of shareholders is not required by the EBL. As regard to direct petition of a debtor company, no such requirement exists in the Company Law. It is however possible that a company takes such requirement in its articles of association.

Article 8 of the EBL requires while filing a petition the debtor shall submit, among others, a pre-arranged plan for settlement of employees. In practice such a plan shall be discussed with the employees, usually via labor union, and agreed by them.

Actually worker's rights are strongly stressed on in the drafting process and embodied by several provisions of the EBL. For example, "the people's court shall guarantee the legitimate rights and interests of the employers in the insolvent enterprise" is stipulated as a general principle in Article 6.

### 3.2 Liability for not filing in good time or filing too early

#### 3.2.1 Liability for not filing in good time

For all the ineligible petitions except pre-petition liquidators, generally speaking, it is an option to seek solution against corporate distress through bankruptcy proceedings. No legal obligation pushes or holds a debtor to file a petition for opening of insolvency proceedings. In practice there are various incentives for it to do so. For example, when its assets have been seized by creditors and a new investor hope to buy them with lower price the debtor may open a reorganization proceeding in order to find a chance to make compromise with the creditors.

However, as mentioned above, when a company is dissolved and meet the requirement of the EBL, for instance that liabilities exceed the assets of the company, the shareholders of limited liability company or directors of company limited by shares are obliged to petition bankruptcy proceeding. Omission of this obligation usually leads to civil liability for the losses as results of the delay. It may be a case, though very rare, that the omission constitutes a criminal offence where it brings on serious losses with intention or gross negligence, or it goes with some other offences, e.g. corruption, appropriation, etc.

#### 3.2.2 Liability for filing too early

The EBL does not contain any special provision regarding liability for premature filings or any other abuses of the proceedings to achieve an unjustifiable purpose. Where it proves a case the court may reject the petition or terminate the proceeding after the petition is accepted. In such circumstances, furthermore, any party who suffers from this conduct may bring a separate action against the wrongdoer for damages. Generally, Chinese law does not penalize premature filings unless it constitutes some other offence.

### 3.3 Procedural and jurisdictional issues

#### 3.3.1 Domestic insolvency proceedings

It is clearly stipulated in Article 3 of the EBL that a bankruptcy proceeding shall be governed by the people's court where the relevant debtor is domiciled. According to the judicial interpretation of the Supreme People's Court in 2002, "domicile" here refers to the place where the major organ (e.g. headquarter) of the debtor locates.

After filing a request to open insolvency proceedings there are very limited time, usually 10 - 15 days, before the court accept the case and after the acceptance the debtor shall be controlled by the administrator so that the debtor has almost no chance to change its domicile



and even when it is a case the change has normally no affect to the ongoing insolvency proceeding.

Now the legislation does not require every court to keep a specialized body to deal with insolvency cases even in some cities where such bodies really exist. However some experts have proposed to establish a special system of insolvency courts in the future.

The opportunity to appeal against the court's decision in a bankruptcy proceeding is merely at the entrance at the occasion that the petition is rejected. According the Article 12 of the EBL, where the court decides not to accept an application for bankruptcy, it shall serve its decision on the applicant within 5 days from the day when the decision is made and the applicant is dissatisfied with the decision, it may, within 10 days from the day when the decision is served, file an appeal with the court at the next higher level, or where an accepted application is subsequently rejected by the court during the period from the date of the acceptance and before the date of bankruptcy declaration, by reason that the debtor is found not really under insolvency, and the applicant is dissatisfied with the decision, it may, within 10 days from the day when the decision is served on, file an appeal with the court at the next higher level.

### 3.3.2 Cross-border insolvency proceedings

The issue of cross-border insolvency was left pendent in the 1986 Enterprise Bankruptcy Law. During the drafting process of the EBL the draft team had a meeting with the UNCITRAL secretariat and made a consensus that China would adopts the principle of universalism introduced by the UNCITRAL Model Law on Cross-Border Insolvency with some limitation. This principle is shown in Article 5 of EBL. It provides that, at first, the insolvency proceedings initiated in China in accordance with the Law shall have binding effect over the debtor's assets situated out of the territory of China. Secondly, it provides that where a Chinese court is required to recognize and enforce a legally effective insolvency judgment or ruling made by a foreign court involving the debtor's assets situated within the territory of China, it shall conduct an examination thereon according to the relevant international treaties that China has concluded or acceded to or according to the principles of reciprocity, and grant recognition and enforcement when believing that it does not violate the basic principles of the laws of China, does not damage the sovereignty, safety or public interests of the state, and does not damage the legitimate rights and interests of the creditors within the territory of China.

However, the EBL has no special provision to establish a case ancillary to a foreign insolvency proceeding involving assets/claims in China. Under such circumstances the assets can only be enforced through the regimes of civil litigation and civil execution under the Civil Procedure Law and the domestic creditors can only file their claims at the foreign court. This seems costly to either the foreign administrators or the domestic creditors and very hard to avoid any individual recourse, by action or other ways, to the local assets. It has been proposed to enact a law on cross-border insolvency.

## 3.4 Costs and funding of the proceedings

### 3.4.1 Costs of the proceedings

Generally speaking all the costs of the proceeding are assumed by the debtor's assets and costs of creditors and other claimants for participation in the proceeding are borne by themselves.

Up to now there is no special provision concerning the standard of payment of bankruptcy proceedings. In practice the court acceptance fee is charged in accordance with the standard of action on properties prescribed in the Measures on the Payment of Litigation Costs issued by the State Council in 2007, which is calculated on the basis of the total amount of the assets with the rate in climactic order. For instance, if the assets amount to RMB 10 million, the rate is 0.7% and the court acceptance fee is RMB 70 thousands. If the assets are valued RMB 20 million, the rate is 0.5% and the fee is RMB 100 thousands. Additionally, according the instruction of the Supreme People's Court, the court acceptance fee shall be charged in half of that in ordinary cases for property disputes.

In case of debtor's petition, the debtor pays the fee. However, when the case is filed by a creditor, it is sometimes asked to advance the fee on behalf of the debtor and to be repaid later by debtor's assets, though the practice lacks legal basis and may be refused by creditor.

No fee is charge to creditors for filing their claims.

#### 3.4.2 Funding of the proceedings

A petitioning party cannot be ordered to make a down-payment on the costs of the proceedings except the insolvency administrator's salary. If the petitioner is in difficulty to pay the court may defer the payment.

Post-commencement finance arrangements may be made during the period of reorganization. According to Article 75 (2) of the EBL the debtor or the administrator controlling the assets and business operation may borrow money for business continuation and set a security on the loan. This is up to the debtor or the administrator and not subject to court approval. The security set on the loan may be mortgage or pledge over the assets that have not been attached to any security right previously.

State funds are not directly available to finance any actions of the insolvency administrator. If it is needed to take an action to combat wrongful trading and fraudulent transactions the administrator may report the court or procurator to seek an involvement of the public power.

#### 3.5 Publicity of filing and opening of the proceedings

When opening bankruptcy proceedings the court is required to give a ruling and have it published. Article 14 of the EBL provides that the court shall, within 25 days from the day when it decides to accept an application for bankruptcy, notify the relevant creditors and announce its decision as well. The notifications are served to individual creditors that are already known while the announcement is served to all the creditors, either known or unknown.

The following matters shall be indicated in the aforesaid notice and announcement: (1) name of the applicant and respondent; (2) the time when the court accepts the application for bankruptcy; (3) the term, place and issues to be heeded for filing claims; (4) name of the administrator and the address where it undertakes its business; (5) requirements that obligors

to the debtor shall pay off the due debts, and holders of the debtor's property shall return the property, to the administrator; (6) the date and venue of the first creditors' meeting; and (7) any other matter that the court deems necessary to be notified and announced.

The aforesaid announcement shall be published on the national and local newspapers, especially the People's Court Daily. It may also be published online, e.g. on the bulletin board of the website of the Supreme People's Court at <http://www.chinacourt.org/fygg/>.

### 3.6 Group/parallel proceedings

#### 3.6.1 Joint administration

China has no concept of joint administration. Therefore it is impossible to let a joint administration automatically consolidate jurisdiction over group members with seats in different court districts. An insolvency administrator who serves several proceedings in way of consolidation as mentioned above may get remunerations from the deferent insolvent estates respectively.

#### 3.6.2 Substantive consolidation

When group or affiliated companies come into court for insolvency they are deemed separate cases and treated in deferent proceedings. However they may be dealt with jointly by a same court and managed by a same administrator in accordance with the principle of consolidation of action under the Civil Procedure Law. Sometimes the group or affiliated companies are treated in different ways, for instance the holding company is ended up by bankruptcy liquidation while the subsidiary, a listed company, is rescued by reorganization.

## 4. Institutions, participants and the conduct of/control over the proceedings

### 4.1 The debtor

#### 4.1.1 General position of debtor

Once a proceeding under the EBL is commenced, all the assets and business affairs shall be taken over by the court-appointed administrator. It does not mean that the legal person is divested from its civil capacity. The administrator plays the role like representative and management of the company with some special functions and limitations that serve the objectives of the proceedings.

Anyway, upon the ruling of acceptance of petition the debtor company's legal capacity is subject to the proceeding. It cannot repay any debt individually unless it is necessary to keep the business operation, especially to the benefit of its rehabilitation.<sup>11</sup> The business operation and other acts related to the assets shall be under the supervision of creditors.<sup>12</sup>

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<sup>11</sup> In the EBL, Art. 16 reads: "After the people's court accepts an application for bankruptcy, the repayment of debts made by a debtor to individual creditors shall be invalidated." Art. 42 reads: "The following debts that occur after the people's court accepts an application for bankruptcy are debts of common benefit: (1) The debts as generated from an executory contract that the administrator or the debtor requests to perform; . . . (4) The labor cost for the continuance of business operations, social insurance premiums as well as other liabilities as incurred therefrom; . . ."

<sup>12</sup> Art. 68 of EBL reads: "The creditors' committee shall perform the following functions and duties: (1) Supervising the management and disposal of the debtor's assets; . . ."

After the commencement of the proceeding the debtor company as a legal entity may retain its powers under general company law within the needs of the proceeding until it is adjudged bankrupt. However the meeting of shareholders and board of directors shall not perform their functions and ought to cooperate with the administrator. It is no need for administrator to discharge directors of the company.

Where a corporate entity is adjudged to be bankrupt it loses the powers under general company law. Substantially, it is deemed in a sense as a body of assets subject to disposition and distribution under the proceeding of bankruptcy liquidation.

#### 4.1.2 Duties of management

According to Article 15 of the EBL, during the whole period of the bankruptcy proceedings the relevant personnel of the debtor shall bear the following duties: (1) properly preserving the assets, seals and account books as well as documents under its occupation and management; (2) working in light of the requirements of the people's court and administrator and answering their inquiries in a faithful manner; (3) attending the creditor's meeting and answering the creditors' inquiries; (4) not leaving its domicile in the absence of permission of the people's court; and (5) not assuming any post of director, supervisor or senior manager in any other enterprise. The term "relevant personnel" as mentioned in the preceding paragraph are the legal representatives of an enterprise, which may, upon approval of the people's court, include the financial managers and other operators of the enterprise.

#### 4.1.3 Debtor in possession

A debtor-in-possession concept is adopted in the EBL with some limitation. It is stipulated in Article 73 that in the period of reorganization the debtor may manage, upon filing an application and obtaining an approval from the court, its assets and business operation by itself under the supervision of its administrator. Under such circumstances the administrator that has taken over the assets and business according to the EBL shall transfer them to the debtor, and the administrator's functions and duties in controlling assets and operating business shall be exercised by the debtor.

In case that the debtor does not manage its assets and business operation by itself, the administrator who takes charge of assets and business operations may employ the business managers of the debtor to take care of the business affairs.<sup>13</sup>

#### 4.1.4 Sanctions for breach of duty

There are some sanctions applies if the debtor performs acts which breach the duty. For example, where a debtor refuses to transfer its assets, seals or such materials as book accounts and documents, or fabricating or destroying the relevant materials of financial evidences, thereby making its financial status ambiguous, the court may impose a fine upon the directly liable person.<sup>14</sup>

### 4.2 The insolvency administrator

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<sup>13</sup> Art. 74 of EBL.

<sup>14</sup> Art. 127 (2) of EBL.

#### 4.2.1 Functions

According to Article 25 of the EBL, an administrator shall undertake the following functions: (1) taking over the assets, seals as well as the account books and documents of the debtor; (2) investigating into the financial status of the debtor and formulating the financial statements; (3) deciding the internal management of the debtor; (4) deciding the daily expenditure and other necessary expenditures of the debtor; (5) deciding, before the first creditors' meeting is held, to continue or suspend the debtor's business; (6) managing and disposing of the debtors' assets; (7) participating litigation, arbitration or any other legal procedure on behalf of the debtor; (8) proposing to hold creditors' meetings; and (9) performing any other functions and duties that the people's court believes it should perform.

#### 4.2.2 Appointment and replacement

The post of an administrator may be assumed by a liquidation group comprised of the department concerned and institutions or by such a social intermediary agency as law firm, accounting firm or bankruptcy liquidation firm. Each case could have one administrator which could be assumed by one or several agencies. When an agency plays the role it could assign a team to assume the task.

The EBL stipulates that an administrator shall be designated by the court. Accordingly, the Supreme People's Court issued in April 2007 a judicial interpretation to deal with the affairs of appointment of administrators. It establishes a uniform policy in admitting agencies and persons on a nominee list for future appointments, providing that a higher court or intermediate court shall, corresponding to the number of the related intermediary agencies and bankruptcy cases in its jurisdiction, keep a list of qualified administrators

Creditors have no influence in respect of the appointment of an insolvency administrator. However, the creditors' meeting may apply with the court to dismiss and replace an administrator who is deemed failing to perform its functions lawfully or competently. The EBL provides that an administrator shall accept the supervision of the creditors' meeting and the creditors' committee.

#### 4.2.3 Qualifications

The personnel to assume the task of administrator shall, according to Article 24 of the EBL, have relevant experience, knowledge and have obtained the practice qualification. In China there are license systems for lawyers, accountants and other practitioners with strict procedure for title examination. When an individual assumes the post of administrator, he or she shall be covered professional liability insurance.

One who is under any of the following circumstances shall not assume the post of administrator: (1) having been given a criminal punishment for deliberate crime; (2) having been deprive of the relevant practice qualification certificate of related specialty; (3) having any interest relation to the case; or (4) being under any other circumstance where the court deems it improper to act as an administrator.

#### 4.2.4 Disposition of assets

An insolvency administrator is empowered to dispose the debtor's assets. When a sale is made for the purpose of keeping the business running, it does not need to occur in public and however the sale of major property such as real estate, intellectual property and entire of inventory or business shall be under the supervision of the creditors' committee.<sup>15</sup> When sale is made for purpose of liquidation, the administrator shall sell the insolvent assets by means of conversion in accordance with the conversion plan of insolvent assets that has been adopted at the creditor's meeting.<sup>16</sup>

If the insolvent estate comprises shares, no special rights under general company law could be invoked by the insolvency administrator. Shares to other companies held by the insolvent debtor are esteemed as a part of the assets and could be exercised by the administrator according to the EBL.

#### 4.2.5 Independence

Insolvency administrator in China is deemed as a statutory body authorized by the Law, acting in form of representation of the debtor enterprise within the legal authorization. It shall respect and protect the rights and interests of the debtor and creditors but must not obey the will of either shareholders of the debtor or the creditors.<sup>17</sup>

The independence of insolvency administrator as a statutory body carries weight in the EBL. As regards to the affairs concerning the assets and business of the debtor there is generally no need to obtain prior authorization from the court. As exception, before the first creditors' meeting is held, if an administrator decides to continue or suspend the business operation of the debtor or has any of the acts to dispose the major assets of the debtor it shall be subject to the approval of the court.<sup>18</sup> As to the procedural matters, however, it shall follow the directions of the court. For instance, an administrator is on duty to notify the creditors when the court decides to convene a creditors' meeting.<sup>19</sup>

#### 4.2.6 Publicness

During the proceeding no information is legally required to be made publicly available except some of the rulings of the court, the decisions of the creditors' meeting and the matters that the administrator needs to circulate publicly. However an interested person, e.g. a creditor, may contact the administrator for relevant information.

#### 4.2.7 Obligations from administrator's acts

Obligations arising from acts performed by the insolvency administrator are classified as debts of common benefit, including debts arising from performance of executory contracts, the payment for labors and social insurance premiums needed for the continuance of debtor's business operation, liabilities for damages caused by carrying out duties of administrator and

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<sup>15</sup> Arts. 25, 69 of EBL.

<sup>16</sup> Art. 111 of EBL.

<sup>17</sup> See, Wang Weiguo, "The Role of the Administrator in China's New Bankruptcy Law", *Credit Risk and Credit Access in Asia*, published by OECD Publishing, 21 Mar 2006, pp. 169-172. Online reading: <http://browse.oecdbookshop.org/oecd/pdfs/browseit/2606021E.PDF>

<sup>18</sup> Art. 26 of EBL.

<sup>19</sup> Art. 63 of EBL.

relevant personnel or by the property of bankrupt enterprise, and the liabilities as generated from any damage due to the debtor's assets.

#### 4.2.8 Duties and liabilities

Generally, an administrator shall follow the fundamental duties of good faith and diligence when performing its functions and shall be liable for breach of one of the duties.<sup>20</sup> It is stipulated in Article 130 of the EBL that where an administrator fails to perform its functions and duties in a diligent and faithful manner as provided in the provisions of EBL, the court can impose upon it a fine; if any loss is incurred thereby to the creditors, the debtor or a third party, the administrator shall be liable to compensation.

#### 4.2.9 Remunerations

The EBL provides that the remuneration of administrator shall be decided by the court. In case the creditors' meeting has any different opinion to the remuneration of an administrator, it has the right to file an objection with the court.<sup>21</sup> According to the judicial interpretation of the Supreme People's Court the general remuneration rate of insolvency administrators is fixed by the court at the total value of the assets at the final settlement with consideration of the workload. The remuneration is paid by instalments or by lump sum at the end of the case. In practice there are sometimes insufficient funds to remunerate the insolvency administrator in full and no state fund available to fill the gap. The court has no power to order the termination of the proceeding in case the administrator cannot be fully paid.

#### 4.2.10 Association

There has not yet been an association of insolvency practitioners operate in China. However the All China Lawyers Association is to establish a professional committee in insolvency business.

### 4.3 Court supervision

In present China there is no statutory stipulation concerning particular qualification requirements applicable for judges to be appointed as an insolvency judge, or supervisory judge either.

The court can give binding instructions to an insolvency administrator on condition that the instruction has legal basis. For example, when the court decides to convene a creditors' meeting it shall instruct the administrator to notice the creditors.<sup>22</sup>

Up to now China has no national discussion platform of insolvency judges, though there are some occasions for them to discuss the relevant matters.

Generally speaking insolvency cases usually take quite long time and sometime the workload is heavy, but there is no statistics to show the average workload of insolvency judges.

### 4.4 Government regulator/supervisor

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<sup>20</sup> Art. 27 of EBL.

<sup>21</sup> Art. 28(2) of EBL.

<sup>22</sup> Arts. 62, 63 of EBL.

#### 4.4.1 Government regulator

Insolvency legislation is within the power of the National People's Congress, the legislature of China. Additionally, the EBL recognizes that the regulations on special issues of insolvency of state-owned enterprises issued by the State Council is applicable within the specified scope and authorizes the State Council to work out the implementation measures for insolvency of financial institutions.

#### 4.4.2 Government supervisor

There is no government agency or supervisor in China who is responsible in overseeing individual case administration and carrying administrative responsibility.

### 4.5 Creditors

#### 4.5.1 Types of creditors

##### *Basic categories*

The basic categories of creditors in Chinese bankruptcy law are secured creditors and ordinary (unsecured) creditors. Secured creditors are those whose claims are secured with mortgage, pledge or lien and enjoy the status of right to separate satisfaction in the proceeding of bankruptcy liquidation. Ordinary creditors are those whose claims have not any security or priority in bankruptcy distribution.

Besides, employees' claims based on labor laws and social security laws owed by the debtor are dealt with as a special category.<sup>23</sup>

##### *Status of secured claims*

After the court accepts an petition for bankruptcy proceedings, secured claims shall be stayed until the debtor is adjudged bankrupt and thereby the procedure turns into bankruptcy liquidation. In the proceeding of liquidation the secured creditors are entitled to be satisfied with the collaterals separately.

The rights to separate satisfaction based on the existing real rights for security, i.e. mortgage, pledge and lien, which are governed by general private law, majorly the Real Rights Law and the Security Law.

Before adjudication of bankruptcy which brings the case into proceeding of bankruptcy liquidation, all the security rights are suspended except two situations. First, for the needs of continuation of business operation the administrator may take back the property occupied by a holder of pledge or lien through satisfying the secured claim.<sup>24</sup> Second, in the duration of reorganization, where the collateral has possibility of damage or significant depreciation that is sufficient to injure the secured right, the secured claimant may apply with the court for realizing the collateral.<sup>25</sup>

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<sup>23</sup> See 4.6.1 of this Report.

<sup>24</sup> Art. 37 of EBL.

<sup>25</sup> Art. 75 of EBL.



### *Unenforceable claims*

The claims that cannot be enforced in the insolvency proceedings are mainly the following: (1) interests to any claim after the acceptance of the case;<sup>26</sup> (2) expenses of a creditor for participating in the proceedings; (3) any fine or penalty imposed on the debtor by an administrative or judicial agency; (4) any late fee on a non-paid debt imposed after the acceptance of the case; (5) claims based on the right on the share or stock; (6) claims that exceed the statute of limitations.<sup>27</sup>

#### 4.5.2 Filing of claims

##### *Filing process*

All claims shall be filed to the administrator after the acceptance of an application for bankruptcy within the term as decided by the court, which is no less than 30 days and no more than 3 months calculated as of the day when the court announces the acceptance.<sup>28</sup> The administrator shall register the claims into a book, conduct an examination and formulate a list of claims as well. The list shall be submitted to the first creditors' meeting for verification. The verified claims shall be confirmed by a ruling of the court where both the debtor and the creditors have no objection. Anyone who has an objection to a claim on the list may raise an action at the court that deals with the bankruptcy case.<sup>29</sup>

A creditor who fails to file its claim within the term as decided by the court may make up the filing before the final distribution of bankrupt assets. However, if any distribution has been done before the filing, no more compensation may be made. The expenses for examining and confirming the supplementary filing shall be borne by the creditor itself.<sup>30</sup>

##### *Special rules for claim filing*

The EBL contains some provisions concerning special issues for filing of claims.

Undue claim. Any undue claim shall be deemed as due when the petition for bankruptcy proceeding is accepted.<sup>31</sup>

Interest. The calculation of interest of any claim shall be stopped when the petition for bankruptcy proceeding is accepted.<sup>32</sup>

Pending claim. Any claim subject to conditions or time limit or pending in litigation or arbitration may be filed.<sup>33</sup>

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<sup>26</sup> Art. 46 (2): "The calculation of the interest of any claim shall be stopped when the relevant application for bankruptcy is accepted."

<sup>27</sup> For items (2) – (6) see Art. 61 of the Stipulations on Some Issues in Dealing with Enterprise Bankruptcy Cases issued by the Supreme People's Court on 18 July 2002.

<sup>28</sup> Arts. 45, 48 of EBL.

<sup>29</sup> Arts. 57, 58 of EBL.

<sup>30</sup> Art. 56 of EBL.

<sup>31</sup> Art. 46(1) of EBL.

<sup>32</sup> Art. 46(2) of EBL.

<sup>33</sup> Art. 47 of EBL.

Joint and several claim. A joint and several claim may be filed by a representative of its creditors or by all of them jointly.<sup>34</sup>

Joint and several debt. Where a guarantor of the debtor or any other joint-and-several debtor has paid off the debt on behalf of the debtor, it may file its right of recourse against the debtor. If the guarantor or the joint-and-several debtor has not yet paid off the debts on behalf of the debtor, it may file claim on the basis of its future right of recourse against the debtor, unless the creditor have filed the entire claim at the administrator.<sup>35</sup>

Claim against joint and several debtors. Where several joint-and-several debtors are ruled to be under the insolvency proceedings, their creditor may file the entire claim in each of the bankruptcy cases respectively.<sup>36</sup>

Claim from rescission of executory contract. Where the administrator or the debtor rescinds an executory contract according to the EBL,<sup>37</sup> the counterparty may file its claim for damages as generated from the rescission.<sup>38</sup>

Agent's post-opening claim. Where the debtor as a principal of an agency contract has become under the insolvency proceedings, the agent is not aware of the fact and continues to deal with the entrusted affairs, the agent may file its claims as generated therefrom.<sup>39</sup>

Drawee's post-opening claim. Where the debtor as a drawer of a negotiable instrument has become under the insolvency proceedings and the drawee still pays or accepts it, the drawee may file its claim as generated therefrom.

### *Unfiled claims*

Where a creditor fails to file its claim within the term as decided by the court, it may make a supplementary filing until the final distribution of bankrupt assets. However, it shall bear the expenses for examining and verifying the supplementary filing and may not get compensation for a distribution that has already been done before the filing. A creditor who fails to file its claim in accordance with the EBL may not exercise its right under the insolvency proceedings.<sup>40</sup>

### 4.5.3 Creditors' meeting

#### *Functions of creditors' meeting*

According to paragraph 1 of Article 61 of the EBL, creditors' meeting shall exercise the following functions: (1) verifying the filed claims; (2) applying with the court for replacement of administrator and examining the expenses and remunerations of administrator; (3) supervising the administrator; (4) selecting and replacing the members of the creditors' committee; (5) deciding to continue or stop the debtor's business operation; (6) deciding

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<sup>34</sup> Art. 50 of EBL.

<sup>35</sup> Art. 51 of EBL.

<sup>36</sup> Art. 52 of EBL.

<sup>37</sup> See 5.7.1 of this Report.

<sup>38</sup> Art. 53 of EBL.

<sup>39</sup> Art. 54 of EBL.

<sup>40</sup> Art. 56 of EBL.

whether to adopt a reorganization plan; (7) deciding whether to adopt a composition agreement; (8) deciding whether to adopt a plan for management of the debtor's assets; (9) deciding whether to adopt a plan for realizing the bankrupt assets; (10) deciding whether to adopt a plan for distribution of the bankrupt assets; and (11) any other function that the court deems necessary.

### *Membership of the meeting*

Any creditor that has filed its claim enjoys the membership of creditors' meeting and has the right to attend the meeting.<sup>41</sup>

### *Voting rights at the meeting*

Creditors with claims having already been examined and verified by the first meeting according to Article 58 of the EBL may exercise their rights to vote. Anyone whose claim have not yet been verified is not entitled to exercise the right to vote unless the court temporarily decides the amount of its claim for the sake of exercising the right to vote.<sup>42</sup>

Any secured creditor who has not given up the priority may not vote for such matters as deciding whether to adopt a composition agreement and whether to adopt a plan for distribution of the bankrupt assets.<sup>43</sup>

A creditor may entrust its agent to attend the creditors' meeting and exercise the right to vote. Where an agent attends the meeting, it shall submit a Power of Attorney with the court or the chairman of the creditors' meeting.<sup>44</sup>

### *Attendance of employees*

The employees and the labor union of the debtor shall have their representatives to attend creditors' meeting and air their views on the relevant issues.<sup>45</sup>

### *Convening of the meeting*

Creditors' meeting convenes in the following circumstances: (1) the first creditors' meeting shall be convened within 15 days as of expiration of the term for filing of claims;<sup>46</sup> (2) subsequent creditors' meetings may be held when the court deems necessary or where the administrator, the creditors' committee, or creditor/creditors representing one-fourth or more of the total claims proposes to the chairman of the creditors' meeting;<sup>47</sup> (3) creditors' meetings, either the first one or the subsequent one, shall be held by the court within 30 days when a submitted draft of reorganization plan is received or when proceeding of composition is commenced.<sup>48</sup>

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<sup>41</sup> Art. 59(1) of EBL.

<sup>42</sup> Art. 59(2) of EBL.

<sup>43</sup> Art. 59(3) of EBL. These two matters are prescribed in Item (7) and (10), para. 1 of Art. 61 of EBL.

<sup>44</sup> Art. 59(4) of EBL.

<sup>45</sup> Art. 59(5) of EBL.

<sup>46</sup> Art. 62(1) of EBL.

<sup>47</sup> Art. 62(2) of EBL. According to Art. 60 the chairman of creditors' meeting is designated by the court from among the creditors with right to vote.

<sup>48</sup> Arts. 84, 96 of EBL.

When convening the creditors' meeting the court shall appoint a chairman from among the creditors with the right to vote and the chairman shall preside over the meeting.

#### *Voting rules*

As a general rule, a resolution of the creditors' meeting shall be adopted on two conditions. First, as for number of participants, it is voted for by more than half of the creditors that attend the meeting and have the right to vote. Second, as for amount of claims, the vote-for creditors represent half or more of the total sum of the unsecured claims.<sup>49</sup>

Special rules are applied to two occasions. Firstly, a resolution for approving a reorganization plan shall be adopted where in each of the voting group more than half of the creditors vote for it, representing two-third or more of the total sum of the claims in that group.<sup>50</sup> Secondly, a resolution for approving a composition agreement shall be adopted where it is voted for by more than half of the creditors that attend the meeting and have the right to vote, and where the vote-for creditors represent two-third or more of the total sum of the unsecured claims.<sup>51</sup>

#### *Court's intervene*

The EBL observes the principle of "autonomy of creditors" generally and specially authorizes the court to intervene when there is a deadlock on some issue at the meeting. Article 65 provides that the matters prescribed in items (8) and (9) of Article 61 of the EBL that has not been adopted at the creditors' meeting and the matter prescribed in item (10) of the same Article that has not been adopted after a second voting at the creditors' meeting shall be ruled by the court.<sup>52</sup>

The creditors who disagree the above-mentioned ruling may apply with the court for review within the period as prescribed by the EBL. The execution of the ruling shall not stop during of the review.<sup>53</sup>

#### 4.5.4 Creditors' committee

##### *Functions of creditors' committee*

The purpose of creditors committee is to keep the day-to-day supervision on administrator's functions. It is also purporting to create opportunity for the relevant parties to communicate and compromise.

Article 68 of the EBL provides that the creditors committee shall perform the following functions: (1) supervising the management and disposal of the debtor's assets; (2) supervising the distribution of the insolvent assets; (3) proposing to hold a creditors' meeting; and (4) other functions as entrusted by the creditors' meeting. When performing its functions the creditors' committee has the right to require administrator, debtor and relevant persons to give an explanation or provide the relevant documents on any matter within the scope of its functions. Where any of those persons refuses to accept the supervision in violation of

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<sup>49</sup> Art. 64 of EBL.

<sup>50</sup> Art. 84(2) of EBL.

<sup>51</sup> Art. 97 of EBL.

<sup>52</sup> See the first subtitle of 4.5.3 of this Report.

<sup>53</sup> Art. 66 of EBL.

provisions of the EBL, the creditors' committee has the right to plead the court to make a decision on the supervision matter, and the latter shall make a decision thereon within 5 days.

### *Establishment of the committee*

Establishment of a creditors' committee is quite a common practice in China. Article 67 of the EBL provides that the creditors' meeting may decide to establish creditors' committee, which shall comprise of representatives as selected at the creditors' meeting and in addition a representative of employees or the labor union in the debtor. The members of the creditors' committee shall be no more than 9 persons. The members of the creditors committee shall be confirmed by the court in written form.

The Law has no limit to the qualification of the creditor representatives in the committee. In practice, they are usually representatives of major creditors. Practitioners such as lawyers or accountants may be appointed as members of the committee even though the case is actually rare.

The establishment and composition of creditors committee is matters under the notion of "autonomy of creditors" so that the issue of conflicts of interests in respect of the composition, processes of decision making and other issues of the creditors committee is up to the consensus of creditors' meeting.

No distinction between provisional and definite creditors' committees is made in Chinese bankruptcy law.

### *Information*

According to Article 69 of the EBL, administrator shall report to the creditors' committee timely when it conducts any of the following acts: (1) transfer of real estate; (2) transfer of such property rights as right to mine exploitation, mining right and intellectual property rights; (3) transfer of all the inventory or business operation; (4) borrowing money; (5) setting security on the property; (6) transfer of claims and securities; (7) performance of executory contracts; (8) waiver of rights; (9) withdrawal of collaterals; and (10) any other property disposal that has important impact on the creditor's interests. In case that creditors' committee has not established yet, the administrator shall make such reports to the court timely.

### *Remunerations*

Remuneration to the members of creditors committee is decided by the creditors' meeting. In practice they are usually rewardless.

## 4.6 Other stakeholders

### 4.6.1 Employees

#### *General principle*

Since employees are supposed not to participate personally in the insolvency proceedings, the Law has paid special attention to their interests. It is a general provision in the EBL that in

dealing with bankruptcy proceedings the court shall safeguard the legitimate rights and interests of the employees in the insolvent enterprises.<sup>54</sup>

### *Employee-related information disclosure*

When a debtor petitions a proceeding under the EBL, it shall submit, among other documents, a pre-arranged plan for settlement of employees that has been agreed by the employees via their assembly or the union. When a proceeding is petitioned by creditor(s), the debtor shall submit, among other documents, a statement on the payments of wages and social insurance premiums.<sup>55</sup>

### *Treatment of employees' claims*

In the process of filing of claims, the employees' claims such as wages, subsidies for medical treatment and disability, comfort and compensatory funds as defaulted by the debtor, the fundamental old-age insurance premiums, fundamental medical insurance premiums that should have been transferred into the employees' personal accounts as well as the compensation for the employees as prescribed by the relevant laws and administrative regulations are not required to be filed, for which the administrator shall formulate a corresponding checklist upon investigation and have it announced. Any employee who has objection to the checklist may request the administrator to make correction. Where the administrator fails to do so, the claimant may raise an action with the court.<sup>56</sup>

In the proceeding of bankruptcy liquidation employees' claims shall be paid in priority over the taxation, the non-labor social insurance premiums and the ordinary claims.<sup>57</sup>

### *Labor and social rights*

Insolvency administrator has no power to terminate employment contracts unless a termination of individual contract is justified in accordance with the labor laws, regulations or the contract itself.<sup>58</sup>

When a debtor's business is purchased within the context of a going-concern sale during insolvency proceedings the employment contracts usually remain unchanged.

Collective redundancy fund or a wage guarantee scheme specifically prepared for enterprise bankruptcy does not exist in China. However there are some social insurance schemes available to aid the employees in difficulties.

### *Participation in procedure*

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<sup>54</sup> Art. 6 of EBL.

<sup>55</sup> Arts. 9, 11 of EBL.

<sup>56</sup> Art. 48 of EBL.

<sup>57</sup> Art. 113 of EBL.

<sup>58</sup> The major legislations related to employment contracts include the Labor Law, the Labor Contract Law, the Law on Mediation and Arbitration of Labor Disputes, the Regulations for Implementation of the Labor Contract Law.

A creditors' meeting shall be attended by representatives of the employees as well as the labor union, who may therefore air their opinions on the relevant issues. Further, the employees shall have a representative in the creditors committee.

In the proceeding of reorganization employees' shall be one of the voting groups and their claims shall be fully paid in the reorganization plan.

#### *High-ranking staffs*

Where any director, supervisor or senior manger has taken advantage of his power to obtain abnormal incomes from his/her enterprise or embezzled enterprise assets, the administrator shall recover it. Thus if they have obtained yearly salary, bonus or other rewards in the circumstances that the debtor was money-losing or on an unreasonable or fraudulent basis the gains shall be retrieved by the administrator; if the money is unpaid the administrator shall refuse to pay it.<sup>59</sup>

#### 4.6.2 Shareholders

In the EBL there is no provision concerning shareholders' claim to distribution. It is very exceptional that there remains surplus of assets after all the claims of the creditors are fully satisfied in bankruptcy liquidation.

Shareholders' loans or other claims rather than share-based ones are treated as ordinary claims that have equal status with other ordinary claims.

Inquiry proceedings or other special dispute proceedings under general company law held during insolvency proceedings is not prohibited by bankruptcy law but such actions may not affect the insolvency proceedings. The EBL does not intend to deal with a dispute between a shareholder and the company or between different shareholders. The only chance for them to exercise their shareholder rights is the right to vote a scheme of change of shares in a reorganization plan. In such circumstances a judgement to an action of share dispute may be taken into account in the insolvency proceedings.

### **5. Effects of the opening of insolvency proceedings**

#### 5.1 The effects of the filing versus the effects of the opening judgment

In China the legal effects of insolvency proceedings start from the court's acceptance of the petition. Mere a filing of a request for the opening of insolvency proceedings cannot lead any special interim/provisional measures be ordered.

During the period between the petition and the acceptance neither counterparty nor third party is supposed to involve in. Only after the court accepts the petition, the ruling shall be known by all the relevant parties.

#### 5.2 Protection and preservation of the insolvent estate

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<sup>59</sup> Art. 36 of EBL.

When an insolvency proceeding is open all the assets that has been, or can be, controlled by the debtor shall be taken over by the administrator. If there is any property that belongs to the assets and remains out of the debtor's control the administrator may request the court to take some measure of attachment.

General stay on enforcement actions applies automatically. According to the EBL, after the court accepts the petition the following effects shall arise.

First, the debtor is forbidden to pay off any debt to any creditor individually.<sup>60</sup>

Second, the relevant measures for preserving the debtor's assets shall be released and the procedures for execution shall be suspended.<sup>61</sup>

Third, any ongoing civil litigation or arbitration that the debtor involves shall be suspended until the administrator has taken over the control of the debtor's assets.<sup>62</sup>

Fourth, any exercise of rights of mortgage, pledge or lien over the debtor's property shall stop until the adjudication of bankruptcy is ruled.<sup>63</sup>

### 5.3 Assets constituting the insolvent estate

According to the EBL, the insolvent debtor's assets refer to all the property, tangible or intangible, located domestically or abroad, that belongs to the debtor at the time when the petition for insolvency proceedings is accepted by the court, as well as the assets obtained by the debtor during the entire period of the insolvency proceedings.<sup>64</sup>

The property that is co-owned by the debtor with someone else shall be divided physically or in value.

Any capital contribution to the debtor that has not been fulfilled is deemed as a part of the assets so that the administrator is entitled to require the contributor to pay the owed sum irrespective of the term for capital contribution.<sup>65</sup>

### 5.4 Divestment of the debtor

#### 5.4.1 Effects of opening to the debtor

As a general rule, upon opening of insolvency proceedings the debtor is divested and the insolvency administrator is exclusively entitled to manage and dispose the assets comprised in the insolvent estate.<sup>66</sup>

Accordingly, for example, where any assets have been sold in advance by the debtor but the title have not been transferred to the buyer prior to the opening of insolvency proceeding, it

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<sup>60</sup> Art. 16 of EBL.

<sup>61</sup> Art. 19 of EBL.

<sup>62</sup> Art. 20 of EBL.

<sup>63</sup> Art. 109 of EBL.

<sup>64</sup> Arts. 5, 30 of EBL.

<sup>65</sup> Art. 35 of EBL.

<sup>66</sup> Art. 65 of the Provisions on Some Issues in Dealing with Enterprise Bankruptcy Cases, released by the Supreme People's Court on 18 July 2002.



shall apply the rule concerning executory contract as stipulated in Article 18 of the EBL. If it is transferred to the buyer after the opening judgment, it shall be retrieved by the administrator because at that time any individual satisfaction made by the debtor is prohibited.

#### 5.4.2 Pre-proceeding transactions

The EBL establishes several articles to cope with the debtor's pre-proceeding transactions.

First, Article 31 provides that the administrator has the right to plead the court to avoid any of the following acts relating to the debtor's assets if they happened within one year before the opening of insolvency proceeding: (1) transferring the assets gratis; (2) trading at an obviously unreasonable price; (3) providing security to a debt that has not been secured; (4) paying off the undue debts in advance; or (5) giving up a claim.

Second, Article 32 provides that within six months before the opening of the case, if the debtor has become insolvent but still satisfied a creditor, the administrator is entitled to plead to the court to revoke it, except where an individual repayment benefits the debtors' assets.

Third, Article 33 provides that any of the following acts involving the debtor's assets shall be deemed as invalid: (1) concealing or transferring the assets in order to evade the debts; or (2) fabricating any debt or acknowledging any unreal debt.

As to any of the assets of the debtor as obtained under the circumstances as prescribed by Articles 31, 32 or 33 of the EBL, the administrator is entitled to recover it.

#### 5.4.3 Effects to third parties

According to Article 17 of the EBL, after opening of insolvency proceedings, obligors to the debtor shall pay off their debts and the holders of the debtor's property shall return the property to the administrator.

Where the obligors to the debtor pay off their debts or the holders of the debtor's property return the property to the debtor in violation of the rules in the EBL, they may not be exempted from the duties to continue paying off debts or returning property to the administrator. Since the opening of the proceeding is publicly noticed, nobody doing in that way can be deemed in good faith. Anyhow, if in result the payment or return benefits the assets, the administrator has no reason to deny it and the liability of the obligor or the holder shall be discharged.

Upon the announcement of the ruling to appoint an insolvency administrator, everybody is supposed to be aware of the fact that without authorization of the insolvency administrator the debtor cannot bind the insolvent estate by unilateral acts, except that the debtor is permitted to control the assets and business operation itself during the period of reorganization.

#### 5.4.4 Effects to agency and transfer order

According to Article 18 concerning executory contracts,<sup>67</sup> if a third party has been authorized as an agent to represent the debtor by conducting acts of management or disposition regarding

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<sup>67</sup> See 5.7 of this Report.

assets comprised in the insolvent estate, the administrator has the right to decide continuation or termination of the authorization. If it fails to do so and the agent does not remind it, the authorization keeps alive.

Upon the opening of the proceedings the court shall notice the debtor's banks to stop settlement activities in the debtor's account until the administrator takes over the assets.<sup>68</sup> When the administrator controls the bank account it is entitled to decide any payment on the account. In principle it shall refuse to pay individual debts which exist prior to the opening of proceeding. Therefore if a transfer order issued by the debtor prior to the opening of the proceedings is not cleared yet the administrator may refuse to pay. If it has been cleared, the administrator may reclaim it in accordance with Article 32 of the EBL.<sup>69</sup> However this reclaim is subject to some restrictions, for instance the rule of set-off as prescribed in Article 40 of the EBL.<sup>70</sup>

## 5.5 Fixation of the position of creditors

### 5.5.1 Fixation to creditors

The fixation of the position of creditors is not expressly stressed as a fundamental principle in the EBL. The so-called fixation principle is impliedly adopted as an effect of the opening of insolvency proceeding, not a general one, but only to claims.

As regard to the insolvency claims, the EBL adopts the fixation principle. Article 44 provides that creditors that have claims against the debtor when the court accepts the application for insolvency proceedings may exercise their rights according to the procedures as prescribed of the EBL. Article 46 further provides that the undue claims shall be deemed as due upon the commencement of the proceeding. In the meantime the calculation of the interest of a claim shall be stopped.

The EBL grants a prioritized treatment to the claims occurred after the opening of the proceeding. Some of them come under the category of "bankruptcy expenses" and some come under "debts of common benefit" which shall be paid off by the debtor's assets at all times.<sup>71</sup>

It is not allowed to establish new security to the claims occurred before the opening of insolvency proceedings. New security for new claim after the opening is allowable in two occasions. First, when the administrator decides to continue an executory contract, it shall provide security for its return performance if the counterparty requests to do so.<sup>72</sup> Second, in

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<sup>68</sup> Art. 15(4) of the Provisions on Some Issues in Dealing with Enterprise Bankruptcy Cases, released by the Supreme People's Court on 18 July 2002.

<sup>69</sup> See 5.4.1 of this Report.

<sup>70</sup> Art. 40 of EBL reads: "When a creditor is indebted with its debtor before the acceptance of bankruptcy application, it may claim for set-off against the administrator. However, under any of the following circumstances, the relevant debts shall not be set-off: (1) When a obligor to the debtor obtains the claim of any other party against the debtor after the acceptance of bankruptcy application; (2) When the creditor becomes indebted with the debtor when learning the fact of debtor's insolvency or petition for bankruptcy proceeding, except where the creditor assumes debts to the debtor according to the provisions of law or for such reason as incurred one year before the petition for bankruptcy proceeding; (3) When a obligor to the debtor obtains a claim against the debtor when learning the fact of debtor's insolvency or petition for bankruptcy proceeding, except where the obligor obtains the claim according to the provisions of law or for such reason as incurred one year before the petition for bankruptcy proceeding."

<sup>71</sup> Art. 41, 42 and 43 of EBL.

<sup>72</sup> Art. 18 (2) of EBL.

the period of reorganization, it is allowed to set a security with the debtor's assets on the loan borrowed for continuing the business operation.<sup>73</sup>

### 5.5.2 Fixation to insolvency estate

As regard to the insolvency estate, the EBL adopts the principle of so-called expansionism, i.e. maximizing the estate of assets as far as possible. This is partly based on the fact that the EBL is applicable to enterprises which are responsible to invest all their assets to perform their liabilities. Therefore, in China the insolvency estate shall include not only the assets that belong to the debtor upon the opening of the proceedings, but also the assets as obtained by the debtor during the period of the proceedings.<sup>74</sup>

### 5.5.3 Retroactive effect

The EBL does not adopt such a notion that the fixation has retroactive effect of the divestment of the debtor to 00.00 hours of the day on which the proceedings commenced. According to Article 15, the binding force of the proceeding starts from the date when the court's ruling of commencement is served to the debtor. From then the debtor bears the duty, among others, to preserve the assets properly until the administrator takes them over.

## 5.6 Pending lawsuits and other proceedings

As mentioned above,<sup>75</sup> legal actions concerning rights and obligations of the insolvent estate are suspended upon the opening of insolvency proceedings. The action can be resumed after an administrator takes over the debtor's assets, except such actions as purporting to recover debts against the insolvent debtor. During insolvency proceedings the civil actions related to the debtor, either continued or newly filed, shall come within the jurisdiction of the court that accepts the application for bankruptcy proceeding.

Similarly, upon the opening of insolvency proceedings the relevant measures for preserving the debtor's assets shall be released and the procedures for execution shall suspend.<sup>76</sup> Release of preserving measures such as attachment, detention, account-frozen and so on is justified with the principle of collectivity. For the same reason a procedure of execution to enforce a judicial judgment or an arbitral award for individual claim shall be suspended until the proceeding is terminated so that the execution procedure may be continued before adjudication of bankruptcy, that may happen in one of the following occasions: (1) where the debtor is found not under insolvency and the court rejects the bankruptcy petition;<sup>77</sup> (2) where a third party provides full-amount guarantee to, or pays off, all the due debts for the debtor;<sup>78</sup> (3) where the debtor has paid off all the due debts itself.<sup>79</sup>

## 5.7 The impact on contracts

### 5.7.1 Executory contracts

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<sup>73</sup> Art. 75 (2) of EBL.

<sup>74</sup> Art. 30 of EBL.

<sup>75</sup> See 5.2 of this Report.

<sup>76</sup> Art. 19 of EBL.

<sup>77</sup> Art. 12(2) of EBL.

<sup>78</sup> Art. 108(1) of EBL.

<sup>79</sup> Art. 108(2) of EBL.

The basic idea of the EBL is to provide as much opportunity to rescue the distressed enterprises as possible. Therefore it does not adopt the scheme of terminating the existing contract automatically upon the opening of insolvency proceedings. The EBL grants the administrator an initiative to deal with the contracts. Therefore no automatic termination and acceleration clause is valid and enforceable.

According to Article 18 of the EBL, after the opening of insolvency proceedings, the administrator shall decide whether to rescind or continue to perform a contract that has been established previously but not been fully performed by the parties concerned and notify the counterparty of its decision. Where the administrator fails to inform the counterparty within 2 months from the opening date, or has no reply within 30 days upon the counterparty's remainder, it shall be deemed as rescission of the contract. When the administrator decides to continue the contract, the counterparty shall perform its obligation and meanwhile has the right to request the administrator to provide security. Where the administrator fails to provide any security, it shall be deemed to rescind the contract.

In the proceeding of reorganization, the debtor as permitted to control the assets and business operation is in the same position as administrator in dealing with executory contracts.<sup>80</sup>

When the administrator decides to continue the contract, the counterparty that has performed its obligation may claim the performance in return in accordance with Article 42 of the EBL concerning debts of common benefit.

Where the administrator or creditor rescinds a contract according to the provisions of the EBL, the counterparty may file its claims on the basis of the right to compensation for the damage as generated therefrom.

#### 5.7.2 Contracts not performed by counterparty

If the debtor has performed its obligations under a contract prior to the opening of the proceedings, and the counterparty has not performed its own, the administrator has right to claim for the performance in return or rescind the contract. For instance, if the debtor has delivered goods and the counterparty has not paid the price, the administrator may request the payment. If the debtor has paid the price and the counterparty has not delivered the goods, in case that the goods are not needed for the debtor's business continuation, the administrator may rescind the contract and request repayment of the money and the counterparty may file the damages brought about from the rescission as an ordinary claim in the insolvency proceedings.

#### 5.7.3 Nominated contracts

There is no special rules applicable with regard to certain nominated contracts in the EBL.

### 5.8 Other effects of the opening of insolvency proceedings

#### 5.8.1 Exclusive power to invoke the Actio Pauliana

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<sup>80</sup> Art. 73(2) of EBL.

Substantially, the insolvency administrator is exclusively entitled to invoke the Actio Pauliana, even though such a term is not used in China. Article 31 of EBL lists 5 pre-petition fraudulent conducts related to the debtor's assets and entitles the administrator to avoid the transaction,<sup>81</sup> and Article 34 entitles the administrator to recover the property as transferred as a result of the fraudulent transactions.

#### 5.8.2 Right to open correspondence

When opening bankruptcy proceedings the court shall make notice to the relevant creditors and announcement to the public. One of the issues contained in the notice and announcement is the information of the administrator, including the correspondence thereof. It goes without saying that the administrator is entitled to open correspondence of the debtor.

Particular telephone and online messenger services scrutinized by insolvency administrator do exist in practice, within the scope of the needs to perform its functions.

The duration of insolvency administrator's right to open correspondence has no limit. Even after the proceeding the relative parties may contact it for any subsequent need.

#### 5.8.3 Mobility constraints

Particular mobility constraint applies to an insolvent debtor. It is provided in the EBL that during the entire proceeding the relevant personnel of the debtor shall not leave his/her domicile in the absence of permission of the court. The "relevant personnel" refers to the legal representative of an enterprise, and further includes, upon approval of the court, the financial manager and other operators of the enterprise.<sup>82</sup> The one who violates the constraint by unlawfully leaving his/her domicile, the court can give an admonition or detainment, and may impose a fine upon him/her concurrently.<sup>83</sup>

### 6. Direction of the insolvency proceedings

#### 6.1 Purposes of the insolvency proceedings

The EBL is enacted for purposes of regulating the procedures for enterprise insolvency, dealing with the claims and debts fairly, protecting the legitimate rights and interests of creditors and debtors, and maintaining the order of the socialist market economy.<sup>84</sup>

Social interest such as the continuation of the business is underlined in the legislation which attempts to keep balance and compromise the interests of different stakeholders, including debtor, creditors, employees and sometimes investors.

Up to now there is no plan for amendment of the EBL to further enable corporate reorganization and going concern sales of business in financial distress

#### 6.2 Conversion of the type of proceedings

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<sup>81</sup> See 5.4.2 of this Report.

<sup>82</sup> Art. 15 of EBL.

<sup>83</sup> Art. 129 of EBL.

<sup>84</sup> Art. 1 of EBL.

### 6.2.1 Voluntary conversion

The three proceedings in the EBL, namely reorganization, composition and bankruptcy liquidation, are convertible from each other in certain circumstances. At first place, the parties may choose to apply for conversion voluntarily aiming at the rehabilitation of the debtor. Where a proceeding of bankruptcy liquidation petitioned by one or several creditors is open, the following applications filed before adjudgement of bankruptcy may be accepted:

(1) The debtor or its capital investors whose capital contribution makes up 1/10 or more of the debtor's registered capital apply for reorganization.<sup>85</sup>

(2) The debtor applies for composition.<sup>86</sup>

### 6.2.2 Non-voluntary conversion

In the circumstances as prescribed by the EBL, the insolvent debtor that is under the proceeding of reorganization or composition shall be adjudged and announced bankrupt so that the case turns into the proceeding of bankruptcy liquidation.

#### *From reorganization to liquidation*

In some occasions the on-going proceedings shall be converted from reorganization to bankruptcy liquidation.

First, during the period of reorganization, under any of the following circumstances, the court shall rule, upon the request of administrator or any interested party, to terminate the reorganization proceeding and adjudge the debtor to be bankrupt: (1) where the business operation or financial situation of the debtor goes worse off and cannot be rescued in any way; (2) where a debtor has any act obviously against its creditors such as cheating, maliciously deducting its assets and so on; or (3) where the debtor's behavior makes the administrator unable to perform its functions.<sup>87</sup>

Second, where the court fails to approve a draft reorganization plan that has not been adopted at the creditors' meeting in accordance with the "cram-down" rule as provided in Article 87 of the EBL, or fails to approve a draft plan that has been adopted at the creditors' meeting, it shall terminate the proceeding of reorganization and adjudge the debtor to be bankrupt.<sup>88</sup>

Third, where the debtor fails or refuses to implement the reorganization plan, the court may, upon request of the relevant administrator or interested party, terminate the implementation of the reorganization plan and adjudge the debtor to be bankrupt.<sup>89</sup>

#### *From composition to liquidation*

There are two channels from composition to bankruptcy liquidation, the one happens during the proceeding and the other happens after the proceeding.

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<sup>85</sup> Art. 70(2) of EBL.

<sup>86</sup> Art. 95 of EBL.

<sup>87</sup> Art. 78 of EBL.

<sup>88</sup> Art. 88 of EBL.

<sup>89</sup> Art. 93 of EBL.

First, during the proceeding of composition, where the draft composition agreement fails to be adopted at the creditors' meeting or fails to be confirmed by the court after adopted at the creditors' meeting, the court shall terminate the proceeding of composition and adjudge the debtor to be bankrupt.

Second, after the proceeding of composition, where the composition agreement is found to be established by fraud or based on any illegal act of the debtor, or where the debtor is unable or fails to implement the composition agreement, the court shall rule it as ineffective and adjudge the debtor to be bankrupt.

### 6.3 Dissolution of the debtor

A corporate debtor is subjected to dissolution upon the conclusion of the insolvency proceedings.

To dissolve the bankrupt debtor, the administrator shall go to the registration office where the debtor was originally registered, with the ruling of concluding the proceeding of bankruptcy liquidation and handle the formalities for write-off of the debtor.<sup>90</sup>

### 6.4 Conclusion of the insolvency proceedings

#### 6.4.1 Circumstances of conclusion

After the opening of the proceeding, upon the occurrence of the following circumstances the insolvency proceedings are terminated by ruling of the court<sup>91</sup>:

- (1) Where a reorganization plan is confirmed by the court on the basis of approval of creditors' meeting or the "cram-down" provision.<sup>92</sup>
- (2) Where a composition agreement is adopted at the creditors' meeting and confirmed by the court.<sup>93</sup>
- (3) Where the debtor's assets are not enough to clear off the bankrupt expenses, the administrator applies with the court for concluding the proceeding.<sup>94</sup>
- (4) Where the debtor and all the creditors conclude an out-of-court agreement on settlement of claims and debts by themselves and they request the court to confirm it.<sup>95</sup>
- (5) Where a third party provides any full-amount guarantee to, or pays off, all the debts as due for the debtor.<sup>96</sup>

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<sup>90</sup> Art. 121 of EBL.

<sup>91</sup> The term "conclusion" discussed here does not include the circumstances of termination of proceeding of reorganization or composition with conversion to bankruptcy liquidation as described in 6.2 of this report.

<sup>92</sup> Art. 86, 87 of EBL.

<sup>93</sup> Art. 98 of EBL.

<sup>94</sup> Art. 43(4) of EBL.

<sup>95</sup> Art. 105 of EBL.

<sup>96</sup> Art. 108(1) of EBL.

(6) Where the debtor has paid off all the due debts itself.<sup>97</sup>

(7) Where all the assets have been distributed or there is no assets for distribution in the proceeding of bankruptcy liquidation.<sup>98</sup>

Since the EBL is only applicable to enterprise legal persons, the termination of insolvency proceedings does not lead to discharge of the debtor

#### 4.6.2 Additional distribution

According to Article 123 of the EBL, within two years as of the day when the insolvency proceeding is concluded in the above circumstances (3) and (7), while under any of the following circumstances, a creditor may request the court to make an additional distribution according to the plan of distribution of bankrupt assets:

(1) Where the assets that shall be recovered according to the provisions of Article 31, 32, 33 or 36 of the EBL are discovered;<sup>99</sup>

(2) Where the bankrupt has any other asset that shall have been distributed.

Under any of the above circumstances, where the amount of assets are not enough to meet the expenses for distribution, no additional distribution may be held and the relevant assets shall be turned over by the court into the state treasury.

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<sup>97</sup> Art. 108(2) of EBL.

<sup>98</sup> Art. 120(1) of EBL.

<sup>99</sup> See, 4.6.1 and 5.4.2 of this Report.



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