Note

Bankruptcy of Foreign Enterprises in the PRC: An Interpretation of the "Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone"

Throughout the 1980s foreign investment in the People's Republic of China (PRC) grew rapidly. The PRC's vast domestic markets coupled with the availability of low cost labor provided incentives that foreign investors found difficult to resist. By the end of the decade, however, the initial enthusiasm of foreign investors gave way to a more realistic view of the practical difficulties of investing in the PRC.[1] The events culminating in the Tian'anmen Square tragedy and the subsequent political crackdown caused further erosion in foreign investors' confidence and deterioration of the PRC's investment climate. Changes in the investment climate have been reflected in the performance of foreign investments in the PRC, many of which now face poor profit outlooks, chronic operating losses and no real hope of financial success. As the investment climate has deteriorated an increasing number of foreign investors and creditors of foreign ventures in the PRC have been faced with the specters of business failure and bankruptcy.[2]

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1. For an overview of the difficulties facing US-Sino joint ventures in the PRC see, Wagner, *A Survey of Sino-American Joint Ventures: Problems & Outlook for Solutions*, E. ASIAN EXEC. REP., Mar. 15, 1990, at 7-11.

2. *See* Chang & Olofsson, *Worse Case Scenarios*, CHINA BUS. REV., Sept.-Oct. 1989, at 16; Wagner, *supra* note 1. Although few foreign joint ventures are reported to have gone bankrupt, as early as 1986 in the Shenzhen Special Economic Zone, a total of 121 joint ventures out of 980 were said to be operating in the red. *Guangdong Approves Bankruptcy Law for Shenzhen*, Foreign Broadcast Information Service—Daily Report, China [FBIS—China], Dec. 2, 1986, at P4.

The PRC's legal framework for addressing problems of foreign investment business failure is only now beginning to develop. As yet, provisions for foreign investment enterprises have not been promulgated on a national level. Although a national bankruptcy law, the Law of the People's Republic of China on Enterprise Bankruptcy (National Bankruptcy Law) became effective in 1988,[3] this law applies only to state-owned enterprises. Cooperative and private enterprises are excluded, as are business enterprises with some component of foreign ownership.[4]

Bankruptcy provisions for foreign enterprises have, however, been developed on a local level in the Shenzhen Special Economic Zone (Shenzhen). These provisions, the Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone (Rules),[5] are the only bankruptcy law in the PRC that is currently applicable to foreign investment enterprises. Although the Rules apply only to those foreign investment enterprises established in Shenzhen,[6] they represent the PRC's first attempt to address bankruptcy issues relating to foreign investment enterprises.

The Rules' significance far exceeds their apparent geographic limitation. Shenzhen has the largest number of foreign investment enterprises in the PRC. Moreover, Shenzhen has traditionally been the testing ground for the PRC's foreign investment legal regime.[7]

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3. Zhonghua Renmin Gongheguo Qiye Pochanfa (Law of the People's Republic of China on Enterprise Bankruptcy) (promulgated Dec. 2, 1986, effective Nov. 1, 1988) [hereinafter National Bankruptcy Law], 2 CHINA LAWS FOR FOREIGN BUSINESS: BUSINESS REGULATIONS ¶ 13-522 (CCH Austl.).

4. State-owned enterprises are those enterprises owned directly by and accountable only to the central or provincial government and are generally large-scale industrial plants. Collectively-owned enterprises are sponsored and controlled by local communities. Private enterprises are generally small and represent individuals who provide the capital and share the risks. *See* Peng, *Characteristics of China's First Bankruptcy Law*, 28 HARV. INT'L L.J. 373, 375-76.

5. Shenzhen Jingji Tequ Shewai Gongsi Pochan Tiaoli, (Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone) (promulgated Nov. 29, 1986, effective July 1, 1987), [hereinafter Rules], 1 CHINA LAWS FOR FOREIGN BUSINESS: SPECIAL ZONES & CITIES ¶ 73-540 (CCH Austl.).

6. *Id.* art. 2.

7. *See* Chen Ming, *China: Special Economic Zones a Picture of Success*, Int'l Press Serv., Mar. 12, 1990, (LEXIS, NEXIS library). Shenzhen is credited with over one third of the total foreign funded enterprises in the PRC. *Shenzhen Establishes Export Oriented Economic Network*, Xinhua General Overseas News Service, Nov. 16, 1989 (LEXIS, NEXIS library).

Many components of the PRC's foreign investment regime originated in Shenzhen and were thereafter adopted by other local jurisdictions and on a national level. *See* Cohen & Valentine, *Foreign Direct Investment in the People's Republic of China: Progress, Problems and Proposals*, 87 J. CHINESE L. 161, 177 (foreign investment contract law); Chen, Qian & Scromeda, *Order Amid Chaos: Security Devices for Credit Transactions in China*, 4 INT'L LAW. 85, 88-89 (regulations on secured loans); Lubman, *Technology Transfer to China: Policies, Law, and Practice*, in FOREIGN TRADE, INVESTMENT AND THE LAW IN THE PEOPLE'S

Thus, the Rules apply directly to a significant number of PRC foreign investment enterprises, located in Shenzhen, and may be applied by analogy to the remaining foreign investment enterprises nationwide. They, therefore, provide insight into the development and ultimate form of bankruptcy law for foreign investment enterprises on the national level.

This note analyzes the Rules' practical significance to creditors of foreign investment enterprises. Part I reviews the political and historical setting from which the Rules emerged and briefly examines the Rules' general structure.[8] Part II first analyzes the substantive and procedural content of the Rules to determine the implications of the Rules' express statutory language. Part II then explores the legislative policies that underlie the Rules to determine how, in the PRC's legal environment, they are likely to be interpreted and applied. Because no direct legislative history of the Rules exists, legislative policies will be divined by looking at the legislative history of the National Bankruptcy Law. Both the Rules and the National Bankruptcy Law emerged from the same political debate and were developed simultaneously. Therefore, the legislative history of the National Bankruptcy Law provides insight into the policies upon which the Rules are based. This note concludes with the finding that the Rules were structured to encourage resolution of debtor-creditor disputes through a process of extrajudicial conciliation rather than through judicial determination.

I. INTRODUCTION TO THE RULES

A. Historical Background of the Rules

Debtor-creditor law in the PRC has been slow to develop. Even now, the PRC lacks any national law governing such basic concepts as hypothecation, pledge of assets and other forms of security.[9] The PRC's existing debtor-creditor law is a patchwork of codes, statutes and regulations promulgated in various localities and limited to dis-

REPUBLIC OF CHINA [hereinafter FOREIGN TRADE] 380, 390 (M. Moser ed. 1987) (technology transfer law); Moser, *Foreign Investment in China: The Legal Framework*, in FOREIGN TRADE, *Id.*, 90, 126 (law on wholly foreign-owned enterprises).

8. This note does not provide a detailed description of the bankruptcy process under the Rules or the National Bankruptcy Law. For articles that provide such narrative, *see*, H. ZHENG, CHINA'S CIVIL AND COMMERCIAL LAW, 158-198 (1988) (chapter on Bankruptcy Law); Peng, *supra* note 4 at 373; Minor and Minor-Stevens, *China's Emerging Bankruptcy Law*, 22 INTL. LAW. 1217; *New Law Texts*, CHINA LAW & PRACTICE, Mar. 1987, at 30; Pan Qi, *Bankruptcy Law: A Newborn in China*, CHINA LAW REPORTER, Vol. 4 No. 4 at 41.

9. *See* Conroy & Moser, *Selected Aspects of Financing Transactions with the People's Republic of China*, in FOREIGN TRADE, INVESTMENT AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 380, 390 (M. Moser ed. 1987).

putes in those localities.[10] Acquiring a security interest in the PRC remains extremely problematic. To begin with, no registration system exists to publicize security interests.[11] Creditors who do obtain some form of security interest then encounter legal and practical difficulties perfecting that interest. Although there are laws establishing the priority of secured creditors over unsecured creditors, there is no national or regional system for determining priority as among secured creditors.[12] Unsecured creditors must rely upon those limited remedies arising from PRC contract law or bankruptcy proceedings.[13] Unlike the United States, where bankruptcy is seen primarily as a debtor's shield against legal attacks from creditors, in the PRC, bankruptcy is one of the few avenues available for creditors to pursue claims against debtors.

Unfortunately, the PRC's bankruptcy laws have developed no more quickly or comprehensively than its debtor-creditor laws. Currently, there are only two discrete bodies of law addressing the issue of bankruptcy in the PRC, the Rules, which focus on foreign investment enterprises in Shenzhen, and the National Bankruptcy Law, which is limited to state-owned domestic enterprises.

The concept of a uniform national bankruptcy law was contemplated in 1980,[14] but serious discussion did not begin until 1983.[15] These initial discussions coincided with the first failure of a wholly-owned foreign enterprise in Shenzhen. In October of 1983, LMK Nam Sang Dyeing Factory, Ltd., the first wholly-owned foreign enterprise to be established in the PRC, was declared bankrupt by a Hong Kong court.[16] The enterprise was an operating subsidiary of a Hong

10. For a comprehensive discussion of the current stage of development of debtor-creditor law, see Chen, *supra* note 7, 85.

11. *Id.* at 112.

12. *Id.* at 114.

13. *Id.*

14. The driving force behind the bankruptcy law was Cao Siyuan, an advisor and supporter of Zhao Ziyang. Unfortunately, as a proponent of reform and an ally of Zhao, he was caught in the political turmoil of June 1989 and placed in prison. Cao's role in the development of the National Bankruptcy Law and in the reform of the PRC's legal system generally is documented in Howson, *Cao Siyuan: A "Responsible Reformer" Silenced*, 8 UCLA PAC. BASIN L. J. 267. It has been reported that Cao has recently been released from prison. Kristof, *China Announces Release from Jail of 211 Dissidents*, NY Times, May 11, 1990, A1, col. 1. For a detailed discussion of the legislative process that resulted in the National Bankruptcy Law, see Chang, *The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process*, 28 HARV. INT'L L.J. 333.

15. Formal consideration of a national bankruptcy law was initiated by the publication of a study conducted by the Technology and Economics Research Center of the State Council. *Id.*

16. Fung, *Factory in China is Placed Under Receivership*, Asian Wall St. J. Weekly, Oct. 10, 1983, at 6.

Kong holding company already in receivership. The Hong Kong court appointed the international accounting firm of Peat Marwick as receiver for purposes of liquidating the Shenzhen factory's assets. At the time no law existed in Shenzhen to address issues of bankruptcy. Lacking any legal directive, the Shenzhen authorities negotiated an agreement with Peat Marwick which gave the accounting firm possession of the factory and, subject to approval by Shenzhen, the authority to liquidate the factory's assets.[17] Shortly thereafter, and perhaps as a result of this factory's failure, Shenzhen began an independent inquiry into the need for a bankruptcy law relating to foreign investment enterprises and, in 1984, began to draft its own bankruptcy law.[18]

Shenzhen's drafting of the Rules is purported to pre-date the National People's Congress' (NPC) drafting of the National Bankruptcy Law. However, as drafting of the national legislation gained momentum, Shenzhen authorities put their efforts to develop a bankruptcy law on hold.[19] Because the national bankruptcy law initially contemplated foreign investment enterprises,[20] Shenzhen's efforts were apparently subsumed by the proposed national bankruptcy law. As NPC drafters revised the national bankruptcy law, provisions covering bankruptcy of foreign investment enterprises were dropped and the national law was restricted to state-owned enterprises.[21] The failure of the NPC to develop a national bankruptcy law for foreign enterprises compelled Shenzhen to once again push ahead with its own rules.[22] On November 29, 1986, the Guangdong Provincial People's Congress promulgated the Rules.[23] Subsequently, on December 2, 1986, the NPC passed the National Bankruptcy Law.[24]

17. Fung, *Foreign Receiver Moves Ahead in Effort to Manage Insolvent Factory in China*, Asian Wall St. J. Weekly, Oct. 17, 1983, at 8.

18. H. ZHENG, *supra* note 8, at 171.

19. *Id.*

20. Sun Yaming, *Liaowang Explains Bankruptcy Law*, FBIS—China, Feb. 13, 1986, at K21-K23.

21. In addition to foreign investment enterprises, domestic cooperative and private enterprises were also excluded. There is little in the public record as to why foreign enterprises were dropped. One possible explanation is the difficulty of harmonizing a national law with the relatively independent legal regime developed for foreign investment. For commentary on why the National Bankruptcy Law was restricted to state-owned enterprises, see Chang, *supra* note 14, at 361-64. Despite the failure of the National People's Congress to adopt bankruptcy laws for foreign enterprises, interest in such a national law remains and a separate national bankruptcy law for these enterprises is contemplated. *See* Gu Ming, *Jingji Ribao on Necessity of Bankruptcy Law*, FBIS—China, Dec. 2, 1986, at K12, K14.

22. H. ZHENG, *supra* note 7, at 171-72.

23. *Guangdong Approves Bankruptcy Law for Shenzhen*, *supra* note 2.

24. Chang, *supra* note 14, at 334. MacCartney, *Chinese Can Now Go Bankrupt*, United Press Int'l, Nov. 3, 1988, BC cycle (LEXIS, NEXIS library).

B. *Overview of the Rules*

The Rules apply only to those Shenzhen enterprises having some component of foreign investment and enjoying the status of a separate legal entity under the PRC's foreign investment laws.[25] Included are joint ventures, cooperative joint ventures, wholly-owned foreign enterprises and "Sino-foreign limited stock companies."[26] These foreign investment vehicles share the common characteristic of qualifying for limited liability protection and are all treated as separate legal entities in the PRC.[27] Other forms of foreign business activity are excluded, notably those where no legal entity is created, such as representative offices, countertrade agreements, contracted projects and technology transfer agreements.[28]

Creditors and debtors of Shenzhen enterprises both have the right to initiate action under the Rules. Creditors may only petition for the enterprise to be declared "bankrupt."[29] Debtors, however, may petition the court for either a declaration of "bankruptcy" or "conciliation."[30] "Bankruptcy" under the Rules is analogous to Chapter 7 proceedings under the U.S. bankruptcy code,[31] where the corporation is liquidated to satisfy creditors' claims against the corporation. "Conciliation" is similar to a Chapter 11 reorganization,[32] where a debtor negotiates with creditors to develop a plan to satisfy creditors' claims while continuing to operate the business.

The Rules contain no express limitations on the types of creditors that may petition for bankruptcy.[33] Under the PRC's 1982 Civil Procedure Law for Trial Implementation, therefore, foreign creditors would likely be able to pursue remedies in the People's Courts.[34] The Shenzhen Municipal Intermediate People's Court (Court) is designated in the Rules as the competent judicial body to oversee Shenzhen bankruptcy proceedings.

The formal procedures for initiating a petition under the Rules are relatively simple. A creditor petitions for a debtor's involuntary bankruptcy by presenting the Court with: (1) evidence of the credi-

25. Rules, *supra* note 5, art. 2.

26. *Id.*

27. For a general discussion of the legal characteristics of these entities, see Moser, *Foreign Investment in China: The Legal Framework*, in FOREIGN TRADE, *supra* note 7, 90.

28. *Id.*

29. Rules, *supra* note 5, art. 7.

30. *Id.*

31. COWANS BANKRUPTCY LAW AND PRACTICE § 3.4 (1989).

32. *Id.*

33. Rules, *supra* note 5, art. 2.

34. *See* Zheng Zhaohuang, *On the Adjudicatory Jurisdiction of Chinese Courts Over Foreign Investment Disputes*, in FOREIGN TRADE, *supra* note 7, 532, 537-38.

tor's claim against the debtor and (2) proof that the debtor is unable to satisfy the claim.[35] Upon receiving the petition, the Court makes a preliminary determination of whether to accept the case for a formal bankruptcy hearing.[36] If the Court chooses to hear the case, it presumably sets a date for hearing,[37] after which, it has ten days to appoint a liquidation committee for the debtor.[38] The liquidation committee takes complete control of the debtor enterprise and becomes responsible for managing the enterprise during the bankruptcy proceedings.[39] It is unclear when the liquidation committee actually takes control. Article 12, however, implies that the committee is empowered before the hearing has taken place.[40] Since the debtor has yet to be declared bankrupt, the placing of the debtor under control of the liquidation committee seems premature. Nonetheless, there is no language in the Rules to contradict this unusual conclusion.

The bankruptcy hearing is held some time after the Court makes its preliminary determination. It is at this hearing that the Court makes the bankruptcy determination.[41] If the Court does declare bankruptcy, a debtor would expect some form of judicial protection from continuing legal claims of various creditors. Curiously absent from the Rules, however, is any provision for a stay of judicial proceedings against the bankrupt enterprise.[42] Apparently, secured or unsecured creditors are free to pursue independent action against the debtor. If legal remedies such as repossession, judicial sale or foreclosure were available to creditors, the lack of a judicial stay could negate the Rules' potential ability to provide for an orderly means of resolving debtor-creditor disputes. These remedies are, however, either non-existent or difficult to pursue under Shenzhen's existing

35. Rules, *supra* note 5, arts. 6-8.

36. *Id.* art. 9.

37. The Rules are in fact silent as to when or how a date is selected for the hearing.

38. *Id.* art. 12.

39. *Id.* art. 15.

40. Article 12 states: "Within ten days of a case being placed on file for investigation and hearing the court shall appoint . . . a liquidation committee." The phrase "being placed on file for . . . hearing" suggests that the Court has made the preliminary determination to accept the case for hearing. The Court then has a ten day period within which to appoint a liquidation committee. It appears unlikely that the final hearing could be conducted within this ten day period and prior to the appointment of the liquidation committee. *Id.* art. 12.

41. Again there is no reference to the date of the hearing. This may have been a drafting oversight. It may, however, be possible that the drafters never envisioned bankruptcy proceedings reaching the point where a hearing would be required. See *infra* notes 71-74 and accompanying text for a possible explanation.

42. This omission is particularly unusual since the National Bankruptcy Law does provide a stay in domestic bankruptcy proceedings. *See* National Bankruptcy Law, *supra* note 3, art. 11.

patchwork of debtor-creditor law.[43] Therefore, the Rules' failure to protect debtors (and indirectly other creditors) is less acute, at least for now. Nevertheless, the absence of a stay is a significant gap in the Rules.

The Rules clearly delineate the procedures to be followed once an enterprise is declared bankrupt. Upon a finding of bankruptcy, the Court issues a public announcement which tolls the beginning of a 180-day period within which the bankruptcy proceedings are to be concluded.[44] The liquidation committee calls a creditors' meeting to compile and evaluate secured and unsecured creditors' claims.[45] Secured creditors are given "preferential repayment rights" to all other creditors through an unusual approach that excludes assets securing liabilities from the total enterprise assets subject to bankruptcy proceedings.[46] This process satisfies secured creditors' claims prior to employee wage claims, taxes and even bankruptcy expenses. It is not surprising, then, that the Rules give unsecured creditors the primary voice in approving the liquidation committee's decisions.[47] Creditors holding at least half of the unsecured debt must approve all major decisions affecting assets, legal rights or obligations of the bankrupt enterprise.[48] Both unsecured creditors and the Court must approve the liquidation committee's final plan for distribution of the bankruptcy assets.[49] Once this plan has been approved, the bankruptcy assets are distributed first to satisfy bankruptcy administration expenses, then to satisfy employee wage claims and State taxes, respectively, and finally to satisfy unsecured creditor claims.[50] The conclusion of bankruptcy proceedings acts as a discharge of any and all liabilities of the bankrupt enterprise.[51]

As noted above, a debtor enterprise may apply for either "bankruptcy" or "conciliation."[52] If a debtor chooses bankruptcy, the debtor enterprise must submit a resolution of its Board of Directors, a "statement of affairs" and a list of assets and liabilities (*i.e.*, a balance sheet).[53] The Court then makes a preliminary determination whether

43. Chen, *supra* note 7 at 118-19.
44. Rules, *supra* note 5, art. 27.
45. *Id.* art. 17.
46. *Id.* art. 39.
47. Unsecured creditors holding claims that comprise more than one-half of the total of unsecured claims must approve any bankruptcy or conciliation plan as well as other actions of the liquidation committee. *Id.* art. 18, 42.
48. *Id.* art. 42.
49. *Id.* arts. 18, 47.
50. *Id.* arts. 48-49.
51. *Id.* art. 53.
52. *Id.* art. 7.
53. *Id.* art. 8.

to hear the case.[54] If the Court decides to hear the case the same bankruptcy procedures are followed as those followed when a creditor initiates the action.

Rather than file for bankruptcy, a debtor may instead file for conciliation. The procedure for filing a conciliation petition is similar to that of a bankruptcy petition.[55] The debtor must submit the same information to the Court that is required for a bankruptcy petition.[56] Upon receiving the petition the Court, again, makes a preliminary determination whether to hear the case.[57] If the Court approves the conciliation petition the enterprise is allowed to continue operating. Once again, a liquidation committee is appointed to oversee all of the debtor's activities.[58] The liquidation committee, with the assistance of the creditors develops a conciliation plan and, as in the case of bankruptcy, both the unsecured creditors and the Court must approve the plan.[59] Once a plan has been approved, both the Court and the unsecured creditors have the right to police the debtor's performance. If the debtor fails to follow the plan the Court may revoke its approval and declare the debtor bankrupt *sua sponte*. At any time following approval of the conciliation plan a majority of the unsecured creditors may apply to the Court for a declaration of bankruptcy.[60] The debtor that fully complies with the plan is apparently discharged of creditors' claims to the extent permitted by the terms and conditions of the conciliation plan.[61]

II. ANALYSIS

As with most legislation, the Rules contain ambiguities, procedural gaps and internal inconsistencies. Nonetheless, the Rules do offer a consistent approach to the problem of debtor-creditor relationships in the context of bankruptcy. An analysis of the substantive law, the procedural aspects and the legislative intent of the Rules, suggests that the Rules were drafted not to provide a judicial remedy and forum for resolving debtor-creditor disputes but rather to encourage the resolution of such disputes through extrajudicial means.

54. *Id.* art. 9.
55. *Id.* art. 7.
56. *Id.* art. 8.
57. *Id.* art. 9.
58. *Id.* art. 23.
59. *Id.* art. 18.
60. *Id.* art. 26.
61. *Id.* art. 21 (ii).

A. The Substantive Law

The substantive standard of bankruptcy in the Rules encourages parties to resolve disputes without resorting to the Courts. Under the Rules, an enterprise having "insufficient total property to discharge its matured liabilities" may be found bankrupt.[62] This substantive standard comprises a two part inquiry. An enterprise must first fail a liquidity test, *i.e.*, the enterprise must be unable to "discharge its matured liabilities."[63] An enterprise failing the liquidity test is then subjected to a balance sheet test. Only when "matured liabilities" exceed "total property"[64] can the enterprise be declared bankrupt.[65]

On their face, the Rules allow any party believing it has an unsatisfied "claim" against an enterprise to file a bankruptcy petition. They provide no limiting language as to what may be considered a "matured liability." Under the procedures for filing a bankruptcy petition, the creditor has no burden to provide evidence to support the balance sheet requirement of the bankruptcy standard.[66] The creditor must only show that it has a claim which the debtor has not discharged (*i.e.*, illiquidity).[67] As a result, a creditor may, upon failure of the debtor to meet any payment deadline, file a petition for involuntary bankruptcy and thereby raise the threat that the debtor may lose control of the enterprise to a liquidation committee. No judicial determination of the validity of a claim is necessary, no notice to the debtor is required or stipulated and no grace period is provided by way of ancillary proceedings to determine the nature of the claim against a debtor enterprise. Because the creditor need not establish the second part of the bankruptcy standard (the balance sheet test) in order to file a petition for bankruptcy, temporary illiquidity or failure to recognize a claim could trigger a bankruptcy petition.

Although creditors may easily show a debtor has failed the liquidity test, the balance sheet test (matured liabilities exceed total assets) will, in most cases, preclude creditors from successfully obtaining a declaration of bankruptcy. The balance sheet test goes beyond a simple liquidity standard or a negative net worth standard (*i.e.*, total liabilities in excess of total assets), requiring that the aggregate of *matured* and unsatisfied liabilities exceed total assets.[68] Under this standard, even a debtor with a negative net worth would be able

62. *Id.* art. 3.
63. *Id.*
64. *Quanbu caichan* or "total property" may also be translated as "total assets."
65. Rules, *supra* note 5, art. 3.
66. *Id.* art. 8.
67. *Id.*
68. *Id.* art. 3.

to continue operating, depleting assets or accumulating additional liabilities as long as enough liabilities remain unmatured. Unsecured creditors of an enterprise with a negative net worth may be forced to stand by, unable to do anything but file unsuccessful bankruptcy petitions while their *pro rata* share of enterprise assets is depleted. The liquidation preference given to secured creditors[69] takes assets out of the bankruptcy proceedings, exacerbating the already unfavorable position of unsecured creditors. Only if all of an enterprise's liabilities mature simultaneously and the amount of those liabilities slightly exceeded total assets could unsecured creditors expect to recover the full amount of their claims through bankruptcy. The likelihood of this occurring is small except in those enterprises with relatively uncomplicated liability portfolios. It is far more likely that before a debtor enterprise could be forced into bankruptcy, its net worth would be sufficiently negative to substantially erode the assets available to satisfy unsecured creditors' claims in bankruptcy. The bankruptcy standard's balance sheet test, therefore, effectively denies the very bankruptcy remedy to unsecured creditors that it is ostensibly designed to provide.

The two-part bankruptcy standard entices creditors to file bankruptcy petitions but ultimately denies them any real remedy. Under the Rules, creditors may easily satisfy the liquidity test required for the initial bankruptcy filing. Any creditor who demonstrates that a debtor has failed to satisfy its matured claim may threaten the debtor with involuntary bankruptcy proceedings. The practical effects on a debtor of this action could be to erode the company's "good will" as well as restrict its ability to maintain working relationships with suppliers, employees and other creditors. The most important threat raised by a bankruptcy petition, however, is the possibility of the debtor's losing control of the enterprise to a liquidation committee. This threat gives the creditor an important coercive tool. Nonetheless, the debtor is protected from any ultimate declaration of bankruptcy by the high threshold of the balance sheet test. A creditor's petition for bankruptcy will succeed only when the unsecured creditor itself is harmed. Thus, the interests of both the debtor and creditor are best served by negotiating a settlement rather than pursuing bankruptcy remedies that harm both parties. There will be circumstances where the only solution will be bankruptcy. These circumstances are, however, substantially limited by the Rules' bankruptcy standard.

69. *Id.* art. 39.

B. Procedural Structure

A bias toward extrajudicial resolution of disputes is also reflected in the Rules' procedural requirements. Under the Rules, a creditor files a bankruptcy petition by submitting evidence of: (1) the amount of the claim, (2) whether or not the claim is secured by property and (3) the debtor's failure to satisfy the matured claim.[70] The Court must then make a preliminary determination of whether to hear the case. It is important to note that the Rules fail to specify the procedure for this preliminary hearing. In the case of a creditor's petition, there may be important questions of fact that a debtor may wish to challenge. The Rules, however, fail to expressly detail whether a debtor would be permitted to present evidence to the Court in response to the creditor's petition. The substantive bankruptcy standard requires the debtor to fail both the liquidity test and the balance sheet test. The preliminary hearing requires the creditor to supply evidence that the debtor has failed the liquidity test. This is reasonable because the creditor generally has access to the evidence necessary to establish a claim and the debtor's failure to satisfy the claim. Facts needed for the balance sheet test (mature liabilities in excess of total assets), however, are invariably in the hands of the debtor. The Rules make no mention of how, if at all, this evidence is to be gathered, whether a debtor may participate in the preliminary hearing or how the Court is to reach a determination of whether matured liabilities exceed total assets. The Rules do expressly require the debtor to provide evidence needed to evaluate the balance sheet test when the debtor petitions for bankruptcy. The absence of procedural clarity with respect to creditor petitions may, therefore, have been intentional. Whether intentional or not, the Rules create significant ambiguity regarding the procedural requirements for the presentation of evidence and the process for establishing a debtor's bankruptcy. This procedural ambiguity is particularly significant because the preliminary hearing not only determines whether the Court hears the bankruptcy petition, but also whether control of an enterprise is retained by the debtor or transferred to a liquidation committee.

Petitions surviving the preliminary hearing are then set for a final hearing. Although the Rules require a final hearing, they remain silent on when it occurs or what procedures are followed.[71] The Rules seem to ignore the final hearing, describing only the procedures to be followed after the Court has declared an enterprise bankrupt in

70. *Id.* art. 8.

71. It is conceivable that procedures and clarifications of the Rules exist in the form of *neibu* or internal regulations. Such regulations, if they do exist, are not publicly available.

the hearing. Ambiguity surrounding this final hearing creates uncertainty as to how, if at all, a creditor would be able to successfully pursue a claim through bankruptcy.

In fact, the only references to the final hearing in the Rules are in Article 11 and Article 12. Article 11 indicates that the hearing date is used as a benchmark to establish the time period during which certain transactions of a bankrupt enterprise will be voided to prevent or restore any asset wastage.[72] Article 12 stipulates that within ten days of a case being "placed on file for investigation and hearing" (*i.e.*, following the determination of the preliminary hearing), the Court must appoint a liquidation committee to manage the operations of the enterprise.[73] Once the Court appoints a liquidation committee, the debtor loses control of the enterprise.[74] This occurs *before* the final hearing is held and *before* the Court's pronouncement of bankruptcy. Therefore, even though the Rules require a final hearing to determine bankruptcy, the preliminary hearing determines whether the debtor will be placed under the control of a liquidation committee. Accordingly, it is the preliminary hearing that should be the focus of a creditor's efforts.

These facts - first, that the preliminary hearing may trigger the formation of a liquidation committee and, second, that no procedure is detailed for the final hearing - work together to encourage extrajudicial resolution of disputes. The creditor holds substantial coercive power due to the low threshold of proof in the preliminary hearing coupled with the possibility of loss of control to a liquidation committee that can occur at the preliminary hearing stage. A debtor may prefer to negotiate with a creditor rather than risk damaging the enterprise's business. Nonetheless, a creditor that decides to pursue a bankruptcy remedy is faced with substantial uncertainty by virtue of the apparently nonexistent procedures of both the preliminary and final hearing. The procedural uncertainty may not absolutely bar a creditor from seeking a bankruptcy remedy. However, the prospect of submitting to potentially unpredictable proceedings may encourage a creditor to negotiate an agreement with the debtor as provided in Article 10. The procedural aspects of the Rules appear to be crafted to encourage both debtors and creditors to resolve disputes without recourse to the Rules.

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72. Rules, *supra* note 5, art. 11.

73. *Id.* art. 12.

74. In a bankruptcy proceeding the liquidation committee is empowered to take control of the enterprise's assets, keep all accounting records and other business documents and carry out all civil matters of the enterprise. *Id.* art. 15.

C. *Legislative Intent*

In any jurisdiction an understanding of legislative intent is essential to understand how a law will actually be applied. Legislative intent is particularly informative in the PRC where legislation is often treated more as guidelines for dispute resolution than as formalistic tools of the judiciary system.[75] Ironically, however, legislative and administrative records comprising legislative history are rarely available in the PRC. Legislative intent must, therefore, be divined from the historical, political, social and economic context in which the laws arise.[76]

Little direct information is available regarding the Rules. The Rules did, however, emerge from the same political and intellectual foment that gave rise to the National Bankruptcy Law. Absent any direct public record on the Rules' drafting process, the legislative history of the National Bankruptcy Law provides the best opportunity to gauge the political context in which the Rules came forth and to determine the fundamental policy objectives at which the Rules were aimed.

A rich body of public information is available with respect to the National Bankruptcy Law. The public and legislative debates surrounding the National Bankruptcy Law were widely published and represent one of the most unrestricted views of the legislative process yet seen in the PRC.[77] NPC Standing Committee debates were published in newspapers and periodicals.[78] Draft copies of the bankruptcy law were even circulated in journals concurrent with their consideration by legislative bodies.[79] Unlike many laws in the PRC, publicly available information about the drafting of the National Bankruptcy Law remains abundant, providing ample opportunity to explore the fundamental policy considerations woven into the fabric of the final law.

The legislative debate surrounding the National Bankruptcy Law and the Rules must be understood within the historical context of bankruptcy in the PRC. Bankruptcy is a concept often identified with the pre-revolution Nationalist Government which enacted China's previous bankruptcy law. As a result, the PRC leaders view bankruptcy as a cornerstone of the capitalist system and a symbol of the philosophical distinctions between the PRC and pre-communist

75. Fang & Tang, *The Wholly Foreign-Owned Enterprise Law: Defining the Legislative History and Interpreting the Statute*, 2 J. CHINESE L. 151, 154.

76. *Id.*

77. Chang, *supra* note 14, at 333-34.

78. *Id.*

79. *Id.* at 338.

China.[80] The PRC's aversion to businesses going bankrupt and people losing their jobs is so great that the Constitution guarantees the right to work.[81] Moreover, the "iron rice bowl" policy[82] has long been accepted as a paramount government policy. The notion of bankruptcy, that implies breaking the "iron rice bowl," undermines the guarantees of economic livelihood on which the Communist revolution was in part founded.[83] By permitting bankruptcy the Communist Party weakens its philosophical integrity and acknowledges its failure to provide the economic security it has traditionally promised.[84] In the United States, bankruptcy is seen exclusively as a legal solution to debtor-creditor disputes and a component in the dynamic of a market economy. In contrast, bankruptcy in the PRC represents a principle distinction between the communist and capitalist system.[85] It is therefore not surprising that the debate surrounding the National Bankruptcy Law often focused on political and economic issues rather than legal issues relating to debtors and creditors.[86]

In the PRC, bankruptcy has been regarded first and foremost as an ideological statement. The PRC's promulgation of a bankruptcy law was recognition that the past economic programs and the economic system itself had serious failings and was in need of restructuring.[87] With as much as 20% of the state-owned enterprises showing consistent operating deficits[88] and annual subsidies to these enterprises of approximately $9.7 billion (15% of total government spending),[89] the need to invigorate enterprises and change the overall responsibility structure of the economy was obvious. Despite the ideological implications, bankruptcy provided a tool to accomplish some

80. H. ZHENG, *supra* note 8, at 163-64.

81. THE CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA art. 42. For an interesting defense of the constitutionality of bankruptcy, see Hu Ge, *Bankruptcy and Unemployment are not in Contradiction with the Principles of the Constitution*, FBIS—China, Nov. 10, 1986, at K6-K7.

82. This refers to the policy of the State guaranteeing and providing for the livelihood of every citizen.

83. Chang, *supra* note 14, at 368-69.

84. For insight into the debate on the implications of breaking the "iron rice bowl," see Gao Ling, *Liaowang on Reasons Bankruptcy Law Not Adopted*, FBIS—China, Oct. 7, 1986, at K1-K3.

85. H. ZHENG, *supra* note 8, at 163.

86. Chang, *supra* note 14, at 354-70.

87. *See* Cao Siyuan, *Liaowang Views Bankruptcy of Enterprises*, FBIS—China, Mar. 30, 1984, at K16-K12; Sun Yaming, *supra* note 20, at 21-22.

88. Goosen, *China's Bankruptcy Law: Taking Legal Reform to the Next Level*, E. ASIAN EXEC. REP., July 15, 1987, at 8.

89. O'Neill, *Millions of Chinese Workers Face Threat of Bankruptcy*, Reuter's Business Report, Dec. 7 1987 (LEXIS, NEXIS library) (quoting Finance Minister Wong Bingqian).

of these objectives. Nonetheless, the NPC recognized that the vigorous use of a bankruptcy law could have potentially left millions of workers unemployed, creating substantial social and political problems.[90]

In response to these concerns, two key policies emerged. First, the bankruptcy law was to be used only on a selective basis. Widespread application of bankruptcy was to be avoided. The national law was intended to create only the threat of bankruptcy to motivate ailing enterprises to improve. The NPC hoped that applying the bankruptcy law on a selective basis might avoid the severe economic dislocation that widespread bankruptcy could bring.[91] The NPC saw the mere existence of a bankruptcy law as reinforcing the important economic policy objective of making enterprises and their managers more responsible.[92] This selective enforcement policy, though nowhere reflected in the wording of the law, is evident in the public debates[93] and is substantiated by subsequent application of the approved law. To date, only one money losing state-owned enterprise has actually been declared bankrupt.[94] Three collective enterprises have been declared bankrupt even though the National Bankruptcy Law applies only to state-owned enterprises.[95] Considering the estimated 93,000 state-owned enterprises, the 360,000 collective enterprises and the millions of private enterprises, the number of bankruptcies is extraordinarily small.[96] It must therefore be concluded that the bankruptcy law was not intended to enjoy immediate widespread use but rather was put in place to provide a "threat" to inefficient managers in the hope of improving their performance.

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90. *Id.*; MacCartney, *supra* note 24; Kynge, *China Declares First Bankruptcy of State-Owned Firm*, Reuter's Business Report, Dec. 7, 1989 (LEXIS, NEXIS library).

91. Cao Siyuan, *Third Talk on Bankruptcy Law*, FBIS—China, Dec. 10, 1985, at K18; Yang Guoliang, *Jingji Ribao on Enterprise Bankruptcy System*, FBIS—China, July 16, 1986, at K13, K14.

92. Cao Siyuan, *supra* note 91, at K18; Sun Yaming, *supra* note 20, at K22.

93. *See* H. ZHENG, *supra* note 8, at 163.

94. On December 7, 1989, one year after the effective date of the National Bankruptcy Law, the Nanchang Motorcycle Factory in Jiangxi Province was declared bankrupt. The factory employed 631 workers. Kynge, *supra* note 90. This bankruptcy is particularly significant since it occurred after the Tian'anmen Tragedy of June 4, 1989. It demonstrates that National Bankruptcy Law may still be viable notwithstanding the changing political landscape.

95. By August 1987, 28 enterprises had been placed on a bankruptcy warning list, 22 had subsequently recovered, four were restructuring and two had been declared bankrupt. *See More Firms on China's Bankruptcy Warning List Improve or Face the Consequences*, Xinhua General Overseas News Service, Nov. 7, 1987 (LEXIS, NEXIS library) [hereinafter *Bankruptcy Warning List*]; *see also* O'Neill, *supra* note 89. Since then one state-owned enterprise and one collective enterprise have been reported as bankrupt. Kynge, *supra* note 90. This brings the total of bankrupt enterprises to four.

96. *Peng Zhen on Bankruptcy*, FBIS—China, Dec. 2, 1986, at K6-K7.

The second policy emerging from NPC debates was that "conciliation" was to be encouraged as the preferred alternative to bankruptcy. The published debates often refer to the importance of "taking conciliation as the main factor while making bankruptcy subsidiary"[97] and stressing rectification and reform rather than bankruptcy.[98] Avoiding bankruptcy through a process of negotiation and conciliation represents an opportunity to rectify management while avoiding the politically charged problem of laying off workers.[99] Moreover, the potential threat of bankruptcy looming over conciliation efforts is a strong incentive for unprofitable enterprises to make needed improvements.

The emphasis on conciliation is also reflected in the actual application of the National Bankruptcy Law by government authorities. The administrative authorities have applied bankruptcy sanctions reluctantly. In fact, in those few localities where the bankruptcy law has been used, the local authorities have followed a policy of providing extensive support to potentially bankrupt companies in the hope of avoiding bankruptcy. Some local jurisdictions have implemented ad hoc regulations not found in the National Bankruptcy Law itself that place potentially bankrupt enterprises on "bankruptcy watch" lists.[100] During this probationary period these enterprises are expected to improve their performance.[101] If performance does not improve, the authorities can move to have the enterprises declared bankrupt. While on the bankruptcy watch, however, enterprises qualify for tax relief and special subsidies to facilitate their return to profitability.[102] The incentives can be so attractive under these local regulations that being given a "yellow card" - notice of being placed on bankruptcy watch - is highly prized.[103] Not surprisingly, the majority of enterprises placed on bankruptcy watch have recovered, with only a small number ultimately being declared bankrupt.[104]

The policy objectives of the National Bankruptcy Law are clear.

97. Li Quande, *Set Up a Bankruptcy System With Special Chinese Characteristics*, FBIS—China, Sept. 21, 1984, at K24-K25.

98. Sun Yaming, *supra* note 20, at K23.

99. A major concern generating substantial debate was the fate of unemployed workers and how to provide a social net for them. *See* Chang, *supra* note 14, at 368-70.

100. *Supra* note 95 and accompanying text. The cities of Shenyang, Taiyuan, Chongqing and Wuhan have all implemented procedures that provide for "bankruptcy watch" lists and other means of assistance to troubled enterprises to help prevent bankruptcy. *Bankruptcy Warnings Save Six Enterprises*, FBIS—China, Nov. 10, 1986 at K7.

101. *Bankruptcy Warning List*, *supra* note 95.

102. Hutchings, *Factory Chiefs Find Loopholes in China Bankruptcy Law*, Daily Telegraph, Nov. 11, 1988, at 17 (LEXIS, NEXIS library).

103. *Id.*

104. *See* O'Neill, *supra* note 89.

First, bankruptcy is to have limited use so that the economic threat exists but the substantial social costs of widespread bankruptcy are avoided. Second, the law encourages conciliation with and reform of unprofitable enterprises rather than bankruptcy. The extent to which these policies are reflected in the Rules is not, however, self-evident. For one thing, the Rules are limited to foreign investment enterprises operating in the relatively free-market economic environment that Shenzhen provides. Many of the economic policy aspects the National Bankruptcy Law addresses are already built into the economic system in Shenzhen. In addition, the limited geographic reach of the Rules reduces the economic and political issues needed to be addressed by a bankruptcy law implemented on a national level.[105] Nonetheless, the principle policies underlying the National Bankruptcy Law of limiting application and encouraging conciliation also appear as principle policies of the Rules.

As with the National Bankruptcy Law, widespread use of a bankruptcy law in Shenzhen could have considerable economic and political effects within Shenzhen. Although Shenzhen's economic system may already reflect economic policies that encourage individual responsibility of enterprises, Shenzhen nonetheless has an interest in avoiding social and political costs of unemployed workers that could occur with widespread bankruptcy. Perhaps more important, Shenzhen also wishes to maintain a favorable image in the eyes of the international investment community. Word that enterprises are failing in Shenzhen could chill the investment climate, adversely affecting Shenzhen's ability to attract new foreign investment and undermining its long-term viability.[106] The dual policies of limiting actual use of bankruptcy remedies and emphasizing conciliation over bankruptcy appears consonant with Shenzhen's interests.

The Rules expressly encourage attempts to resolve debtor-credi-

105. A comparison of the introductory articles of the Rules and the National Bankruptcy Law shows that while both laws address debtor-creditor disputes, the National Bankruptcy Law contemplates economic and political issues that are apparently outside the scope of the Rules. Article 1 of the National Bankruptcy Law reads:

> This Law has been formulated to suit the needs of socialism's planned development of the commodity economy and reform of the economic system, to promote enterprises owned and operated by the State, to strengthen the economic responsibility system and democratic administration, to improve economic conditions, to increase economic benefits and to protect the legal rights and interests of creditors and debtors.

Article 1 of the Rules reads:

> These Rules are formulated in accordance with the relevant laws of the People's Republic of China to safeguard the economic order of the Shenzhen Special Economic Zone . . . and to protect the legal rights and interests of creditors.

106. H. ZHENG, *supra* note 8, at 170-71; Fung, *supra* note 17, at 18.

tor disputes outside the framework of the Rules. Besides the major sections in the Rules detailing the conciliation option,[107] the Rules include two sections recognizing the validity of negotiated settlements.[108] During the initial stages of a bankruptcy proceeding, Article 10 gives full force to settlement agreements.[109] Article 51 covers agreements made after a declaration of bankruptcy.[110] Under Article 51, the Court may terminate bankruptcy proceedings, even after declaring bankruptcy, if creditors submit a conciliation agreement approved by all creditors of the bankrupt enterprise.

A policy of limiting actual use of the Rules is evident in the lack of actual bankruptcy cases that have been brought since the Rules' promulgation. As of this writing no foreign enterprises have been found bankrupt under the Rules.[111] At first glance, this fact is surprising because of the existence of a considerable number of troubled foreign investments.[112] Such a result is understandable, however, in light of Shenzhen's interest in maintaining its international image and an apparent policy to discourage use of the bankruptcy option.

The Rules have been influenced by the debates and policy considerations of the National Bankruptcy Law. The policy of emphasizing conciliation and avoiding bankruptcy emerges from the legislative debate of the national law and is consonant with Shenzhen's interests of avoiding social costs of bankruptcy and maintaining its international image. The Rules structurally reflect the National Bankruptcy Law approach to conciliation. Moreover, the extent to which creditors have actually used (or more accurately not used) the Rules is consistent with a policy of bankruptcy avoidance.

CONCLUSION

Apparently, the Rules have been crafted to encourage conciliation and negotiated settlements between parties without judicial intervention. They were never intended to create a substantive judicial remedy for debtor-creditor disputes. Under the Rules creditors may employ bankruptcy as a threat against a debtor but will ultimately fail to achieve the judicial remedy they seek.

The substantive standard of bankruptcy under the Rules requires

107. Rules, *supra* note 5, ch. V.

108. *Id.* arts. 10, 51.

109. *Id.* art. 10.

110. *Id.* art. 51.

111. With the exception of the LMK Nam Song Dyeing Factory bankruptcy, which predates the Rules, there are no press accounts of foreign enterprises being declared bankrupt under the Rules. *See* Fung, *supra* note 17.

112. *See Guangdong Approves Bankruptcy for Shenzhen, supra* note 2.

a debtor to suffer both a liquidity failure and a severe capital failure. The liquidity failure is easily shown. Thus, creditors may initiate bankruptcy proceedings - and harass a debtor - with a minimal level of proof. The capital failure standard, however, requires that a debtor's matured liabilities exceed total assets. Such a high standard inevitably leads to losses for the unsecured creditor that successfully pursues a bankruptcy remedy. The Rules, therefore, encourage debtors to negotiate rather than incur the negative effects of a bankruptcy proceeding. They also, however, force creditors to negotiate rather than face the losses that occur once a debtor reaches the capital failure standard mandated by the Rules.

Procedurally, the Rules also promote resolution of disputes without recourse to courts. Creditors have easy access to a preliminary hearing, the consequences of which can be the appointment of a liquidation committee to take control of the debtor enterprise *before* a final hearing is held. This potentially coercive power is offset, however, by the absence of clear procedures concerning both the preliminary hearing and the final hearing. The ambiguity that surrounds these two hearings encourages creditors to work directly with debtors rather than submit to an unpredictable judicial process. The procedural context thereby balances the effects of the Rules on debtors and creditors, encouraging both to avoid a judicial solution.

Policy considerations that are readily apparent in the legislative history of the National Bankruptcy Law on which the Rules rely reinforce this interpretation of the Rules. These considerations suggest that the political and social costs of widespread application of a bankruptcy law were to be minimized by limiting the Rules actual application and emphasizing conciliation over bankruptcy. The implications of this analysis of the Rules as they relate to creditors are important and clear. The Rules do establish bankruptcy as a *possible* remedy. The remedy itself is ineffective but the threat of initiating bankruptcy proceedings can and should be used by creditors as a means of coercing debtors to more vigorously pursue solutions to debtor-creditor disputes. Creditors should, therefore, view the Rules as an additional tool to be used in extrajudicial resolution of disputes with debtors.

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