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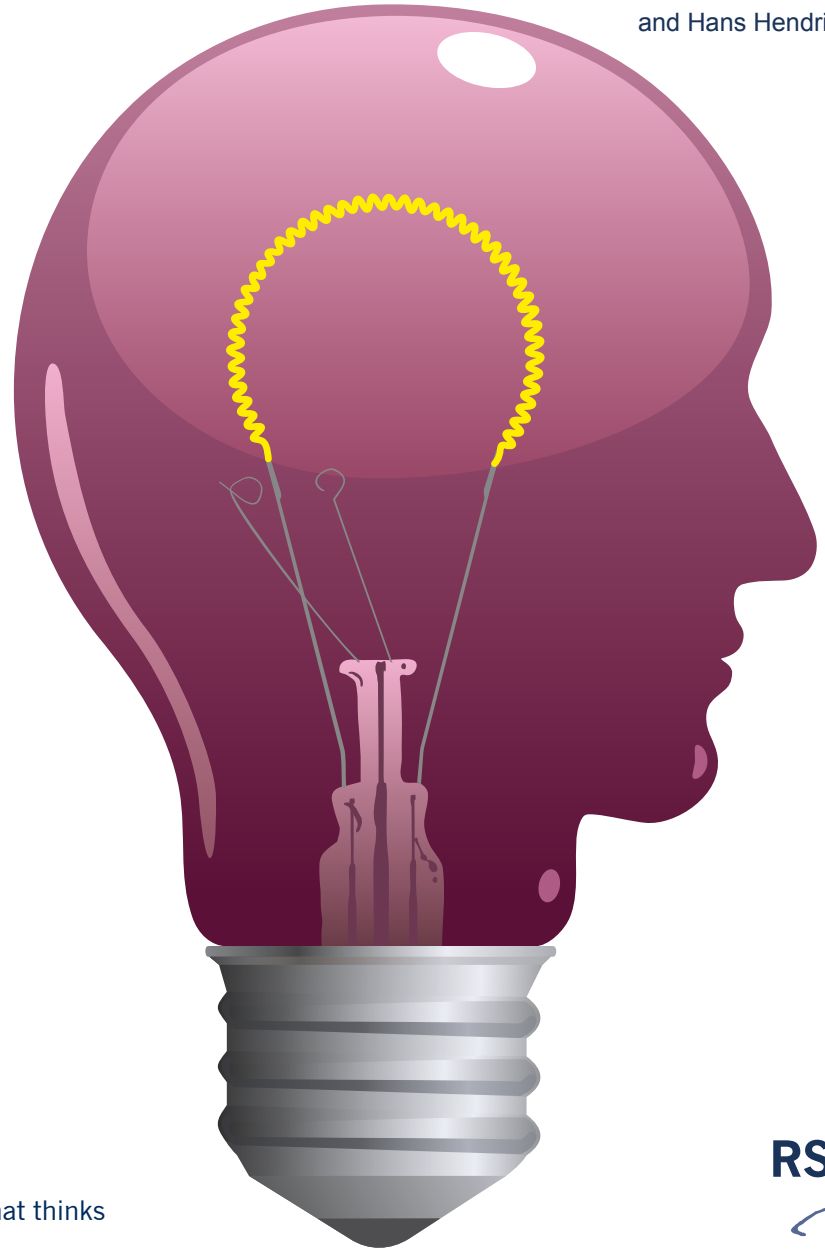

The business school that thinks and lives in the future

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Chinese insolvency law lacks teeth

By Barbara Krug, Nathan Betancourt & Hans Hendrischke

The speed by which China has moved towards a market economy has not been accompanied by a similar development of its judiciary system. Since the early 1990s, foundational national legislation with a direct effect on firms, such as laws dealing with contract, investment, liability and insolvency have been introduced, sometimes reluctantly.

This recent legislation should have established court-rulings as a legitimate alternative form of dispute resolution to the often arbitrary bureaucratic intervention inherited from the socialist past. Yet this switch-over from administrative interference to court rulings did not materialise and firms question the usefulness of taking business disputes to court.

Complaints regarding the court system are corroborated by empirical studies. One survey of 89 arbitral awards enforcements cases in 2001 found that only 47 per cent of rulings issued in disputes involving foreign firms have been enforced (as opposed to 53 per cent for Chinese firms). In addition, enforcement remains weak: on average, only 30 per cent of the stipulated compensation payment was actually secured. Since arbitration is usually regarded as superior to more formal dispute resolution venues, such as courts, it cannot come as a surprise that the law appears underused and is considered toothless.

China's recent Insolvency Law serves as a prime example. After 12 years of legislative wrangling the 2006 PRC Enterprise Bankruptcy Law (EBL) is viewed by the Chinese press and by international law firms as 'state of the art' since it follows the UNCITRAL (United Nation Commission on International Trade Law) 'Model Law on Cross Border Insolvency'.

The EBL replaced a patchwork of insolvency legislation that had existed since 1986. Three changes in the EBL were intended to bring Chinese insolvency practices closer to international standards. First, the new EBL gives priority to restructuring over liquidation. Second, an administrator is put in charge of the daily operation of the firms during the insolvency procedure. The administrator, who needs to be a qualified lawyer or have proven corresponding competence, is authorised to design a restructuring plan and coordinate the different claims of creditors. Third, the new EBL revised a remnant from the socialist past that had given primacy to the claims of employees. Under the new law secured claims are prioritised ahead of employees' claims and non-secured claims are in last position.

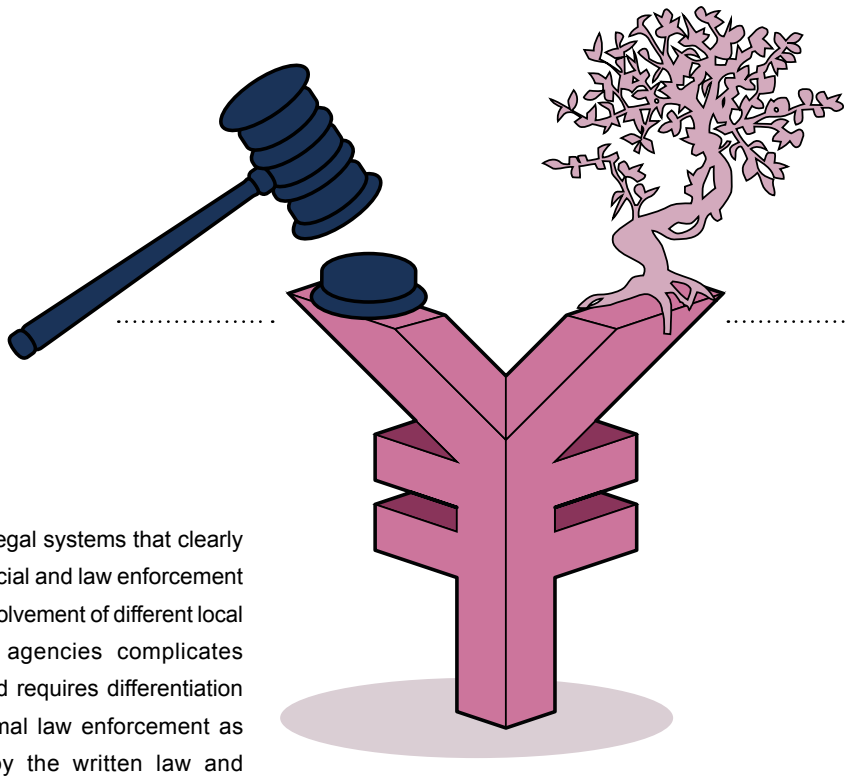
And yet just three years after the introduction of the EBL, the general uptake is discouraging:

- The use of litigation in insolvency cases in the Chinese legal system has declined. Instead, courts often stipulate out-of-court settlement.
- Out of court settlement – taking the form of mediation at the local community level – is regarded as a superior forum for dispute settlement. Local communities even pride themselves as being 'zero litigation' districts.
- By transferring cases to administrative rulings, or 'grassroots mediation', the law no longer functions as an external coordination/enforcement agency but rather succumbs to intra-administrative informal negotiations.

In the end, dispute settlement rarely depends on formal rules and procedures.

The role of local government agencies

One factor that helps to explain the under-usage of the law is the peculiar role of local government in the insolvency process, something



unknown in legal systems that clearly separate judicial and law enforcement agencies. Involvement of different local government agencies complicates decisions and requires differentiation between formal law enforcement as suggested by the written law and informal practices that characterise the handling of specific cases often through arbitration.

As in conventional legal systems, the advantage of arbitration lies in the perceived fairness and the speed by which a settlement can be reached. In reality, however, informal procedures and reliance on uncodified practices by various actors tend to make outcomes unpredictable.

Legal design flaws

Another set of factors explaining the under-usage of the EBL derives from the design of the written law, which sets incentives for parties to seek out-of-court settlements. The first problem is *ambiguity*. In particular, the creation of a bifurcated insolvency system for State-owned Enterprises (SOEs) and non-SOEs between 1986 and 2006 generated massive confusion over the employment of the legal process. The state responded to this complicated situation with a series of legal clarifications and amendments, which, in fact, added to the confusion.

To clear up this confusion, the new EBL equally applies to SOEs and enterprises of any other ownership form, including joint venture and private enterprises. However, the EBL makes exceptions for firms in certain strategic industries identified by the State Council, such as chemical and pharmaceutical industry or mining.

The second problem is *verifiability*. The usage of courts depends crucially on the verifiability of claims; otherwise courts will dismiss the case. In China, the problems of verifiability take two forms. The first is the identification of the plaintiff and defendant. The second relates to the identification of creditors and debtors.

For example, in the late 1980s, local government agencies forced local banks to convert their non-performing loans into shares. The effect was that banks were no longer creditors but became owners of bankrupt firms. Studies also reveal the difficulties of distinguishing the following items on a firm's balance sheet: cash management by banks and bank loans; the buying of shares or private credit in family run businesses where family members or friends can be either silent partners, and offer informal loans.

Similarly, cross share-holding and unrecorded bank loans by private investors make the identification of claimants in a bankruptcy case difficult and time-consuming.

As the law differentiates in procedures for plaintiffs (who are often creditors) and defendants (who are often debtors) when pursuing insolvency, the murky situation of ownership, loopholes in corporate law, and poor auditing procedures do not allow for easy calculation of the balance sheet or for the determination of a party's rights under the law. Litigation is often used simply as a mechanism to verify claims. For example, creditors and the firm in question may use formal court procedures to establish the net debt position of the firm and withdraw the case from the court as soon as they have received an official statement about the net assets.

The problem of verifying claimants and the value of their claims or the net ▸

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debt position of a firm is connected with the missing ranking scheme for claims stipulating which debts will be served first. One peculiarity of the EBL is that before the net debt position of a firm is calculated, all housing estates owned by the firm are set aside and transferred to the local government agency in charge of the 'resettlement' of the retrenched workforce.

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Unsurprisingly, the value of land and the allocation of decision making rights, over the distribution of returns from land sales or from the disposal of other industrial assets, often unleashes a 'race for assets' between competing courts and local government agencies rushing to execute confiscation orders, even before court orders are issued. This asset scrapping can lead to a situation where firms that otherwise would have had a chance to restructure are left without the means to serve their debts.

There is also evidence that the courts know enforcement lacks power due to 'out of court' settlements. Both the confiscation of assets and the pressure to privately settle the case prior to any court order create a kind of unravelling effect. As has been shown in other sectors, this contributes to the 'thinness' of the market, i.e. to an insufficient number of parties making full use of the EBL, which leaves those parties that insist on using the EBL with fewer courts and weaker enforcement agencies at their disposal than is required for market clearing.

In short, courts cannot offer safe participation as there are coordination failures in the proceedings that force all parties concerned to wait for court orders and court mediated ranking of debts and claims. Instead, outcomes are inconsistent and locally determined. Local government agencies use their discretionary power to manipulate procedures in favour of firms under their jurisdiction even if they are not immediate players in insolvency cases.

Foreign companies therefore need to beware that the written law in China is not the only indicator of judicial practice. On paper, the EBL may conform to international standards and theoretically ease court mediation processes when compared to the old laws. However, legal practice is more complicated as it involves additional actors and justice is typically served through extrajudicial conciliation.

To reach the best possible outcome, it is necessary for parties to take into account both the formal legal process and extra-judicial practices, and forms of enforcement. To outsiders, legal action through the court system by itself is likely to be unpredictable and to hinge more on local economic and political interests than on straightforward adherence to the letter of the law. ■

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