Focus Abroad: China

September/October 2006

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Twenty years after it first implemented trial corporate bankruptcy legislation in 1986 and twelve years after setting out to reform laws that quickly became obsolete as market reforms swept the country, China finally enacted a permanent bankruptcy law designed to establish a legal framework for corporate bankruptcy and the discharge of debts and interests, and governed by clear procedures. China's National People's Congress approved the PRC Enterprise Bankruptcy Law on August 26, 2006, although the legislation is not slated to become effective until June 1, 2007.

With limited exceptions, the law applies to all types of business entities, including state-owned enterprises and foreign invested enterprises. For the first time, the law sets out clear procedures regarding the bankruptcy of China's financial institutions, an issue that had long been a grey area. It also creates a mechanism for corporate reorganizations similar to chapter 11 of the U.S. Bankruptcy Code — a clear departure from current rules, which focus on liquidation as the sole mechanism for dealing with a bankrupt enterprise.

The new law, consisting of twelve chapters and 136 articles, is far more comprehensive than the previous version, which had six chapters and 43 articles and was widely considered incomplete

when it was enacted. In addition, the 1986 version also had no provision for personal bankruptcies and applied primarily to state-owned enterprises.

The new law establishes procedures governing the discharge of creditor claims, bringing it more in line with international conventions. It also gives enhanced protection to investors and lenders. Bankruptcy proceedings commenced after the effective date of the legislation will afford the highest priority to the claims of secured creditors, after which available unsecured assets will be used to pay the claims of employees for wages, medical costs, insurance and other compensation. Previously, employee claims had first priority and could even be paid from lenders' collateral, a rule that was widely criticized as being contrary to market practices.

It is anticipated that the new bankruptcy law will bring an end to the government's rescue of non-financial enterprises experiencing financial woes as a result of poor management or negligence. Going forward, most corporate bankruptcies will have to follow market-oriented rules and procedures, which means that managers will be held accountable if an enterprise is not well run.

The Chinese government drew up plans before the new law was approved to close down another 2,000 state-owned enterprises by 2008. It set aside 33.8 billion yuan ($4.2 billion) this year to help those companies settle claims from laid-off workers. Although these companies will benefit from the bailouts, other state owned enterprises will have to rely on the new legislative framework to work out their financial problems. It remains to be seen to what extent the new rules and procedures will make the bankruptcy process more efficient and encourage a greater

degree of foreign commerce with, or investment in, Chinese companies. The U.S. has repeatedly urged China to adopt national bankruptcy standards, characterizing the existing climate as a trade barrier. Meanwhile, the European Union has pointed to China's lack of a national bankruptcy law as one of its primary reasons for refusing to grant China coveted market economy status as a trade partner.