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**Book Section:**

Tomasic, R and Zhang, Z (2016) The Political Determinants of Corporate Reorganization in China. In: Antons, C, (ed.) Routledge Handbook of Asian Law. Routledge , pp. 125-146. ISBN 9780415659406

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This is an Accepted Manuscript of a book chapter published by Routledge in the Routledge Handbook of Asian Law on 1st July 2016, available online:  
<http://www.routledge.com/9780415659406>

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## 8 The Political Determinants of Corporate Reorganisation in China

Roman Tomasic<sup>v</sup> and Zinian Zhang<sup>w</sup>

In Christoph Antons (ed), *Routledge Handbook of Asian Law* (Routledge 2017) 125-146.

### Introduction

This chapter examines the political factors that have influenced the management of court-supervised corporate reorganisations in the People's Republic of China (PRC) following the passage of the PRC Enterprise Bankruptcy Law 2006 (EBL 2006). It follows a wider body of research that has pointed towards the political determinants affecting the way in which corporate governance is structured in different countries, including China.<sup>1</sup> Examples of political considerations affecting the implementation of the EBL 2006 are discussed. China's new bankruptcy law has been hailed as representing 'a large step forward in clarifying and strengthening' the rights of creditors (Peerenboom and He, 2009: 13). To some degree, this is true. The Law has sought to move away from the largely political and administrative mechanisms for dealing with corporate insolvency, and to make much greater use of the courts. However, China's law reforms seeking to support the rapidly developing market economy have taken place in an environment in which the state remains a dominant player in markets and in shaping and implementing legal reforms.

Professors Peerenboom and He (2009: 13) have reminded us that '[w]hile the government's role has been diminished, there are still various opportunities for the government to intervene to pursue non-economic policy goals such as social stability'. This problem is especially evident in regard to corporate reorganisations, in which local protectionism remains a powerful factor. Indeed, the eminent China scholar Jerome Cohen (2001: 403) has described local protectionism as 'the greatest weakness in China's judicial system'.<sup>2</sup> This problem continues to be felt in the way in which corporate reorganisation has taken place in China since 2006.

With regard to the handling of commercial disputes in China generally, it has been suggested that local protectionism may be decreasing in some major urban areas, such as in Guangdong; as a result of successful reform efforts, this has led some to note that, in urban areas in this region, 'the direct influence of major political forces on the courts has decreased' (He, 2009: 453). Whilst this may be so in regard to routine contractual disputes between commercial

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<sup>v</sup> Professor of Law, University of South Australia, and Visiting Professor at University of Durham, Email: roman.tomasic@unisa.edu.au.

<sup>w</sup> Lecturer of Commercial Law, University of Leeds, and Associate Fellow at School of Law, Singapore Management University, Email: z.zhang2@leeds.ac.uk.

<sup>1</sup> See generally M. J. Roe, (2003) *Political Determinants of Corporate Governance: Political Context, Corporate Impact*, Oxford: Oxford University Press, and Jingxia Shi, (2007) 'Twelve Years for One Sword: Does 2006 Bankruptcy Law Symbolize a Market Economy in China?' *West-Norton Journal of Bankruptcy Law and Practice*, 17: 745-777.

<sup>2</sup> See J. A. Cohen, 'Settling Business Disputes with China' in R. P. Appelbaum, W. L. F. Felstiner and V. Gessner (eds), *Rules and Networks: The Legal Culture of Global Business Transactions*, Oxford: Hart Publishing 2001: 403.

parties, the picture may not be as clear-cut in regard to company law and corporate insolvency matters, especially where well-connected corporate entities are involved. Professor He (2009: 427) has noted that ‘big companies and SOEs were infrequent users of the courts’ and that, ‘[w]hen there are major and significant disputes affecting the interests of large companies, local officials may not even allow a court to take on the dispute: they will straighten everything out using political channels’. He did, however, point out that there is still a paucity of detailed empirical evidence in regard to such matters (He, 2009: 421). This chapter will seek to fill this gap to some degree.

Some other detailed research has already pointed to difficulties that arise in the handling of company law cases involving public companies in China. In a study of the company law cases dealt with by the Shanghai People’s Courts between 1992 and 2008, Professor Howson (2010b: 143) reported that these company law cases illustrated that the courts acted primarily as administrative units and that, in conformity with bureaucratic instructions, the courts often simply gave priority to ‘national social and economic policy over and above more specific mandates (and rights) set forth in the Company Law’.

In passing, Howson (2010b: 143–144) also noted that Shanghai courts were hesitant to accept or allow company dissolution or liquidation pleadings and rarely considered cases involving public companies or joint stock companies. A number of reasons can be given for this failure of leading Chinese courts to consider cases involving public companies, one of which has been suggested to be the reluctance of shareholders to bring actions. Howson (2010b: 145) has argued that there are a number of other more important explanations for the lack of public company cases in Shanghai courts, including that these courts ‘(i) voluntarily avoid taking such cases, and (ii) are specifically directed not to take such cases’. Exploring why this may be so, Professor Howson (2010b: 146–147) offered the following explanations:

One rationale [for judicial inaction] dictates that courts be told to decline or voluntarily refuse listed company cases for fear of large plaintiff groups, and the attendant perceived threat of social instability or impact on the ‘super-value’ in Chinese administrative-political culture: social harmony ... A second rationale can also be perceived, albeit more subtly, in the Shanghai court system’s consistent bias in favour of stability (including ... business entity preservation at all costs) over values that might be held high in corporate law ... A third, largely unspoken rationale perhaps informing the rejectionist stance toward public company cases is twofold: (i) that such firms involve what were state-owned assets ... , and (ii) that the promoters, controlling shareholders, and directors, officers, and supervisory board members and other insiders are tied to superior political power, whether the state, the party, or the military. There is evidence that the courts will avoid cases concerning state-owned asserts.<sup>3</sup>

Donald Clarke and Nicholas Howson (2012: 279) painted a similar picture in regard to the absence of minority shareholder derivative claims under company law brought by shareholders against companies limited by shares or publicly listed companies in China; this is despite the

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<sup>3</sup> See Howson (2010a) for a more detailed report on this body of research.

existence of legal rights in the new PRC Company Law 2005 permitting the bringing of such legal proceedings.

In spite of the difficulties in enforcing corporate laws in practice, China's stated commitment to integrate into the global legal community is clear. This is reflected in its recent enactment of the rescue-oriented EBL 2006, which responded to the global wave of rescue-centred bankruptcy law reforms (Booth, 2008). In the EBL 2006, the area of corporate reorganisation is given some priority, being located before chapters on the use of compromises and liquidation (Zou, 2007: 50–51). The EBL 2006 sought to adopt many corporate reorganisation 'best practices' from abroad and has been acclaimed by some as a modern law on corporate rehabilitation (Falke, 2007). But this is not to say that it does not have some serious shortcomings.

The EBL 2006 has not been implemented to the extent that some foreign observers might have expected.<sup>4</sup> The predicaments encountered during the making of this Law might have signalled future difficulties in its enforcement. After over a decade of slow bankruptcy law reform debates, it was clear that there was considerable reluctance in many quarters in China to enact such a wide-ranging law.<sup>5</sup> Halliday and Carruthers (2007: 284) have discussed the lead-up to the enactment of the EBL 2006, and have noted that this reluctance continued despite the urgings of international experts and multilateral bodies, such as the Asian Development Bank and the World Bank:

[T]he Chinese government resisted the urgings of the World Bank for rapid enactment [of a new bankruptcy law] and repeatedly delayed putting the [draft Enterprise Bankruptcy] bill before the Standing Committee of the National People's Congress (NPC) until 2003. It moved stop-and-start through successive readings until enactment suddenly took place in August 2006 ... The twelve-year marathon demonstrated simultaneously the overwhelming influence of domestic issues and the comparative weakness of international influence.

Reviewing the politics of law making in China after the Asian financial crisis, Halliday and Carruthers (2009: 407) pointed towards the limited capacity of multilateral financial institutions such as the World Bank to place direct leverage on China (in contrast to Indonesia and Korea) and noted that this meant that they 'had to be satisfied with the passage of a comprehensive bankruptcy law in 2006 that deviated from global norms in its insistence on preserving many "Chinese characteristics"'. One of these characteristics was China's retention of power exercised by administrative agencies over bankruptcy cases. This was a consequence of Chinese fears 'that law may not have the capacity to cope with market demands or public imperatives' (Halliday and Carruthers, 2009: 407). This reflected a focus on 'domestic concerns while symbolically expressing adherence to the broad contours of global standards' (Halliday and Carruthers, 2009: 408).

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<sup>4</sup> See, e.g., the papers delivered at the Organisation for Economic Co-operation and Development (OECD) Fifth Forum for Asian Insolvency Reform (FAIR), held in Beijing on 27–28 April 2006, shortly before the enactment of the PRC Enterprise Bankruptcy Law 2006, available online at <http://www.oecd.org/daf/ca/corporategovernanceprinciples/5thforumforasianinsolvencyreformfairbeijingchina27-28april2006.htm> [accessed 3 January 2014].

<sup>5</sup> See generally Shi (2007); Tomasic and Wang (2006).

The passage of the 2006 legislation had been delayed by resistance from state agencies that were determined to preserve their powers over state-owned enterprises (SOEs), as well as by the ‘loose coalition of SOE managers, provincial leaders, and senior [State Economic and Trade Commission] SETC administrators [who] viewed the diminution of the SETC’s leading role with anxiety’ (Halliday and Carruthers, 2007: 284). There was also ideologically based opposition to the idea of introducing a capitalist instrument, such as a new bankruptcy law, into China. Halliday and Carruthers (2009: 285) insightfully observed that:

It is no surprise that the final road-block to enactment came in the form of a struggle between factions that supported the priority of workers versus those who favoured secured creditors and banks. Most fundamentally, to implement the ADB and World Bank reports [proposing bankruptcy law reform in China] presupposed institutions China does not yet have (such as a comprehensive welfare safety net for unemployed workers) and entailed political risks (such as large-scale economic disaster and social unrest) that the Party will not tolerate.<sup>6</sup>

The problem of dealing with the ‘implementation gap’ created by the enactment of the EBL 2006 has remained a significant one for China.<sup>7</sup> In 2009, Halliday and Carruthers tentatively predicted a major implementation gap that would arise as a result of the bringing into force of the EBL 2006:

Although the novelty of China’s bankruptcy law does not permit any analysis of implementation, the severe limitations of [China’s] implementing institutions, together with the government’s continued administrative controls, suggest that national and local politics will open up a substantial implementation gap that varies significantly across China.

(Halliday and Carruthers, 2009: 409)

This prediction was to prove quite prescient. Before the EBL 2006 came into effect in June 2007, it was somewhat optimistically expected that there would be a proliferation of corporate reorganisations following its passage (Li, 2002: 58). This hope was based on the theory that the new rescue Law sought to effectively preserve the going-concern value of troubled companies (Wang, 1996: 91) as well as to curb destructive corporate liquidations (Wang, 2002: 83). But, as with other recent Western-influenced legislation enacted in China (Economy, 2007: 51), the EBL 2006 was not well enforced or implemented during the first few years after its enactment (Tomasic and Zhang, 2012); notably, only a small number of large companies were allowed to file for reorganisation in China under the Law.

Furthermore, it soon became clear that there would continue to be heavy government intervention in corporate reorganisations in China, although in theory these cases were to be managed through court-supervised judicial processes. In many such corporate reorganisations, political interests came to prevail over compliance with basic legal rules. It is appropriate to ask why local governments were so keen to intervene in corporate reorganisations and what

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<sup>6</sup> For a further discussion of the process of making and implementing the PRC Enterprise Bankruptcy Law 2006, see further Halliday and Carruthers (2009: 321–327, 406–414).

<sup>7</sup> See generally Halliday (2007).

their expectations were. The geographic factors should also be kept in mind, because Chinese companies are effectively tied to the place where they are domiciled; thus section 3 of the EBL 2006 provides that: ‘Jurisdiction in a bankruptcy case shall lie with a people’s court of the place where the debtor is domiciled.’ This nexus gives significant power to local courts in dealing with corporate reorganisations in China and creates a major concern for creditors dealing with a well-connected local company, because local protectionism remains ‘the biggest concern of most commercial litigants’ (Peerenboom and He, 2009: 23).

The level of protectionism is probably greater in less-developed rural areas than in urban areas. But legal disputes involving key SOEs or key industrial sectors may still be of significant interest to both national and provincial governments, especially where government policies seek to protect domestic companies or industries (Peerenboom and He, 2009: 23).

This chapter discusses the impact of these factors on corporate reorganisations and it does so by drawing upon publicly available information, such as relevant newspaper reports regarding these reorganisations. In addition, one of the authors conducted some twenty face-to-face interviews in Zhejiang Province with lawyers, judges, accountants, creditors and government officials who had participated in corporate rescue cases.

The remainder of this chapter is organised as follows. First, the chapter describes the legal context of China’s corporate rescue legislation. This is followed by a discussion of government roles in allowing the commencement of corporate reorganisation procedures. Thereafter, there is a discussion of political considerations affecting value distribution in corporate reorganisations. Finally, the chapter concludes by discussing the likely impact of the political dimensions of corporate reorganisation upon the future development of China’s corporate reorganisation regime.

## **An overview of China’s corporate reorganisation regime**

Under the EBL 2006, three main bankruptcy procedures were created to cope with corporate bankruptcy. Chapter 8 of this Law deals with reorganisation and seeks to facilitate the rescue of financially troubled companies (Baird, 1998: 580), and Chapter 9 focuses on compromise, and is intended to assist renegotiations between a debtor and its creditors, whilst Chapter 10 governs liquidation and is designed as a conventional mechanism to sell assets of bankrupt companies either piecemeal or as a going concern. Zou (2007: 50–51) argued that the order of these three chapters suggests that China’s lawmakers were willing to see more corporate reorganisations; for this purpose, many pro-rescue mechanisms were included in the EBL 2006.

To encourage the use of the new corporate reorganisation procedure under the EBL 2006, companies in danger of bankruptcy or likely to become bankrupt are permitted to file reorganisation petitions – that is, a company that seeks to use a bankruptcy reorganisation procedure in court has the opportunity to avoid bankruptcy (Li, 2005: 15). The Law provides an early opportunity for the rescue of troubled businesses. More importantly, contrary to the old PRC Enterprise Bankruptcy Law of 1986 (for Trial Implementation) (EBL 1986) (Tomasich and Wang, 2006), the EBL 2006 abolished the need to obtain government permission as a precondition to commencing a court-supervised corporate bankruptcy procedure, which meant

that a corporate reorganisation petition could now be directly filed by companies without first asking for government approval.

So as to provide a breathing space for troubled companies entering into the corporate reorganisation procedure, the Law stays all claims of creditors, including secured creditors (Wang, 2005b: 40). Thus the new corporate reorganisation regime could be used by beleaguered companies to keep aggressive creditors at bay. This, in turn, creates a legal shelter for companies in difficulty, allowing them to be better rehabilitated (Woodward, 2008: 146).

To build a market-driven corporate bankruptcy system, the EBL 2006 included for the first time rules to facilitate the emergence of a body of insolvency practitioners in China. Under sections 13 and 24, at the time that a corporate bankruptcy petition is accepted, the court is required to appoint a qualified insolvency practitioner as the administrator to take control of the company's assets and to manage the company's affairs (Wang, 2005a: 8). This reform sought to abolish the practice of appointing government-organised liquidation committees as administrators, as occurred under the old EBL 1986; these committees had long been criticised as lacking competence and accountability (Wang, 2005b: 39; Wang, 2005a: 8).

On the basis that corporate reorganisation is rehabilitating companies in distress rather than liquidating their assets, section 73 of the EBL 2006 now permits the debtor being reorganised to recover control from the administrator, adopting the debtor-in-possession approach found in the United States (Li, 2006: 19). However, this procedure is slightly different from its US counterpart: China's debtor-in-possession approach has a court-appointed administrator remaining as a monitor overseeing the rescue process (Parry, 2009: 50).

Moreover, because a viable corporate reorganisation requires firm-specific knowledge and information possessed by the debtor, with certain limits, the EBL 2006 has relaxed the absolute priority principle to motivate a debtor to engage in the corporate rescue. This principle normally gives priority to creditors over shareholders. Section 87 stipulates that deviating from the absolute priority principle could occur with the consent of creditors; this means that the debtor, especially its shareholder-managers, could bargain to share the company value even if creditors were not paid in full (Blum and Kaplan, 1974).

Finally, to improve efficiency and to promote rescue outcomes, section 87 provides that a 'cram-down' can be requested to confirm a plan of reorganisation that has not been accepted by one or more impaired parties, if the plan can meet the prescribed statutory standards (Zou, 2012: 28–29; Wang, 2007: 61).

Overall, a cutting-edge legal framework for corporate reorganisation has been established in China with the promulgation of the EBL 2006 (Rapisardi and Zhao, 2010; Shi, 2007). However, as noted earlier, the greater challenges lie in its enforcement, especially given China's legal development and poor infrastructure (Peerenboom, 2002; Lubman, 2000; Naughton, 2007, 2010). The next section sheds light on the political determinants regarding entry into formal corporate reorganisation procedures in China.

## **Finding government support to initiate a corporate reorganisation**

In theory, under the EBL 2006, it seems to be easy to commence a corporate reorganisation process in the courts. In practice, however, it is almost impossible for a company to trigger this procedure in the absence of government support. From research looking at cases over the first three-and-a-half years of the effort to implement the EBL 2006 (between June 2007 and November 2010), only ninety-two reported corporate reorganisation cases (which were opened to rescue 120 companies) could be found in China as a whole (Zhang, 2013: ch. 5). As Figure 1 shows, forty-eight cases (52 per cent) were concentrated in three economically well-developed provinces (Guangdong, Zhejiang and Jiangsu), with other provinces having relatively smaller numbers: Shaanxi and Henan had five reorganisation cases each, while Beijing had four, with Shanghai having only three cases.<sup>8</sup>

It should nevertheless be emphasised that the social and economic impact of these reorganisations cannot be measured merely by their number, because nearly all of them involved the rescue of large companies; in particular, twenty-nine out of all ninety-two reorganisations (31.52 per cent) sought to rescue publicly traded companies (Zhang, 2013: ch. 5).

In reality, courts have required government support before being able to accept corporate reorganisation petitions. Without government support, courts simply ignore corporate reorganisation petitions, although this appears to be unlawful (Wang, 2010: 26). Two reasons could help to explain why government support has been needed. First, government support could exempt the court from being negatively assessed under China's social stability assessment systems. These assessment systems are complex and political in nature, but largely unwritten (Minzner, 2011); all state agencies, including courts, are required to meet the social stability targets set up by the government (Li, 2012a). Discussing such systems is outside the scope of this chapter, but, put simply, according to one of the key criteria of these systems, the court (and especially its president and the judge in charge) will be negatively assessed, and may even be disciplined if there is a social stability incident that takes place and is related to the court's business (Yu, 2012).

A 'social stability incident' is, in effect, a euphemism for a protest or group petition made by a number of people (Lum, 2006). In response to these assessment systems, since 2000, most of China's courts have sought to avoid cases that would involve a large number of individuals (Gan, 2004). A corporate reorganisation case may trigger such concerns because it always has many disgruntled individual parties who are either employees or creditors. Empirical evidence suggests that the fear of a negative assessment by the social stability assessment systems would be the court's most serious concern when a corporate reorganisation petition is presented (Godel and Ong, 2012: 43). The court would simply remain silent if there were a corporate rescue petition: the petition would not even be registered by the court at the first stage, let alone formally dismissed afterwards under section 12 of the EBL 2006. Most insolvency-related practitioners and officials interviewed by the author confirmed that the new corporate

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<sup>8</sup> See further Tomasic and Zhang (2012: 312).



bankruptcy law is generally unavailable in practice, mainly because courts do not accept bankruptcy petitions, whether corporate reorganisations or liquidation filings.

Things would be very different if courts were instructed by local government to accept a reorganisation case. In such circumstances, the government steps in and the court would be protected by the provision of a political shield, because it would be the government rather than the court that would take responsibility for social stability issues. Such a practice has now been formalised in China. In 2012, China's Supreme People's Court issued a judicial notice urging courts to obtain local government support regarding social stability issues before accepting a corporate reorganisation petition regarding a publicly traded company (Supreme People's Court, 2012). By implication, in the case of reorganisation petitions for other types of company, courts usually react in the same way (Tang and Shi, 2011: 105). So one of the *de facto* preconditions for judicial initiation of a corporate reorganisation procedure is that the court must first obtain government support in regard of potential social stability concerns.

Secondly, many of those interviewed by Zhang indicated that the courts need to secure government support to gain assistance or cooperation from other government agencies so as to facilitate the corporate reorganisation process. Without the involvement of local government, the court will usually be too weak to persuade government agencies to provide administrative and regulatory services. In substance, however, it can be argued that the lack of cooperation from some government agencies is partly attributable to the oversimplification of the EBL 2006 (Xi, 2013: 3), and partly a result of the less-developed state of the rule of law in China.

Two typical illustrations can help to explain this pattern. The first of these was the 2009 Reorganisation of Tianting Paper Co. Ltd.<sup>9</sup> When Tianting entered into the reorganisation procedure, it continued trading so as to maintain confidence of both its employees and suppliers – but the local tax authority stopped providing Tianting with tax-approved receipts on the grounds that the company had an unpaid tax liability that had accrued prior to its bankruptcy. Without tax-approved receipts, the company could not continue its business operations, because, in China's business environment, the company had to issue tax-approved receipts to its customers before they could collect payment. This then created a deadlock. The local tax authority's refusal was lawful under China's tax regulations,<sup>10</sup> because the tax authority could restrict and even cease providing tax-approved receipts if a company were to fall behind in its tax payments. A key problem is that the EBL 2006 is so skeletal in nature that it has no mechanism for coping with such a conflict, which could be anticipated in advance. The oversimplified EBL 2006 lies at the core of this deadlock, because the Law is not synchronised with the tax law.

However, in the Tianting case, an interim committee was established by local government to support the company reorganisation, the local government was able to apply pressure so that the tax authority conceded, and by circumventing the tax law, the tax authority resumed the supply of these receipts. In the absence of local government involvement, the Tianting rescue

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<sup>9</sup> Reorganization of Tianting Paper Co. Ltd, Pujiang Lower People's Court, Zhejiang, 1 September 2009.

<sup>10</sup> China State Administration of Taxation, 'Unpaid Taxation Regulation' (Beijing China, 7 June 2004).

might not have proceeded, since it was highly unlikely that the local court could have persuaded or pressured the tax authority to provide the necessary exemption.

Thus, on the face of it, whilst the court might complain that it is difficult to obtain administrative services from the tax authority, in substance it is the oversimplification of the EBL 2006 that has left gaps that have impeded the rescue process by creating too many obstacles. A similar lack of statutory synchronisation of the EBL 2006 with other laws also arises with the PRC banking and public utility laws (Wang and Yi, 2009: 23).

An illustration of the underdeveloped state of the rule of law in China can be found in the 2009 Reorganisation of Dadi Paper Co. Ltd.<sup>11</sup> In the Dadi case, the judge, who was subsequently interviewed by the author, noted that the local police played a critical role in investigating the company's assets, which were spread over many provinces in China. The police department took part in the Dadi corporate rescue because it was ordered to do so by the local government. In principle, however, investigating the company's assets should be undertaken by the lawyer administrator; in this case, the lawyer was largely denied access to the company's property records possessed by government agencies such as the Land Registration Authority. The judge stated that the whole reorganisation process of Dadi would have been impossible if the local police had not been involved: without the aid of the police service, the administrator would not have known of, and could not have verified, the existence and whereabouts of the company's assets.

The Dadi case raises two serious concerns regarding the rule of law in China. First, some laws are simply not respected by authorities. Under section 35 of China's Lawyer Law 2007, lawyers are given rights and privileges of access to, and the right to obtain copies of, the company's property records held by government. But this does not occur in practice. As a result, government agencies will not be held accountable when they breach the law by denying a lawyer's rights (Wang and Guo, 2010: 4), as happened in the Dadi case. Secondly, some laws are often abused by public authorities. In the Dadi case, police involvement led to controversies over issues of legality. Police officers used their criminal investigation powers to intervene in the reorganisation process, even though this process was commercial in nature. It was legally inappropriate for the police to be involved in corporate reorganisations in this way.

Thus, to a large extent, the need for government support arises in corporate reorganisations because the EBL 2006 lacked sufficiently detailed rules and because China's rule of law is not as well developed as it might be. Faced with these difficulties, it is not surprising that most courts have therefore shunned corporate reorganisations.

We can now turn to examine government incentives for helping to initiate corporate reorganisations. From the perspective of government, it is easy to exploit corporate rescue laws to pursue governmental agendas. The corporate reorganisation regime may even give government a new tool with which to tackle political and economic problems. By and large, government control and financing of courts hearing corporate reorganisations had a number of goals (Li S., 2012). First, a concern for maintaining social stability has forced governments to intervene in business failures. As noted above, the social stability assessment system applies

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<sup>11</sup> Reorganization of Dadi Paper Co. Ltd, Fuyang Lower People's Court, Zhejiang, 1 June 2009.

not only to courts, but also to local government. If a court becomes embroiled with a social stability incident, the court will be negatively evaluated by government, but the local government is also, in turn, assessed by the government at a superior level (Minzner, 2009). This is because of the existence of multilevel, hierarchical evaluation systems. The court can avoid criticism by remaining silent when a petition is likely to be social-stability sensitive, but the local government has nowhere to which to escape if such an incident arises in, or originates from, its area of responsibility.

In general, the threat to social stability has taken two forms in corporate reorganisation cases. First, this threat was occasioned by unpaid employees. In most cases, when the company was financially distressed, it delayed paying wages; if employees lost patience – and particularly if they lost confidence – they would collectively petition local government in the belief that section 85 of China’s Labour Law 1994 requires the government to ensure that employers honour employment contracts, including wage payments.

In the province of Zhejiang, for example, it was found that group petitions by unpaid angry employees were received in at least eleven out of twenty corporate reorganisations (55 per cent). In this way, business failure escalated into a political event. Local government was therefore forced to intervene in dealing with the company’s economic distress, since its own political interests were under threat owing to the social stability assessment system. In such circumstances, local governments have sought to buy peace by preventing employees from continuing group petitions or from petitioning a superior government – effected by means of the government paying employees on behalf of the company. This has happened in most corporate reorganisations in China.

For example, in the 2009 Reorganisation of Jingwoni Manufacture Co. Ltd, Guangdong,<sup>12</sup> the local Qingxi Township government paid employees accrued unpaid wages of ¥7 million (about £700,000) (Chu, 2009). And in the 2009 Reorganisation of Xingxing Artefacts Co. Ltd,<sup>13</sup> the local Haichang District government spent ¥24 million (about £2.4 million) to satisfy aggrieved employees (Kang and Chen, 2009). Although such a practice has been widely criticised by academics as being counterproductive (Tsinghua University, 2010), this approach has been sanctioned by China’s Supreme People’s Court. In the judicial notice issued in 2009, China’s Supreme People’s Court ordered that, in corporate reorganisation cases, courts should rely on local government to meet unpaid wages of employees so as to prevent them from causing social instability.<sup>14</sup>

After the commencement of a corporate reorganisation procedure, local government would take the place of employees, claiming what it had paid the company’s debts owed to employees. Usually, these debts would be fully reimbursed, because, under section 113 of the EBL 2006, employee claims are regarded as priority claims and so should be paid even before tax arrears are paid. Before paying employees, local governments would usually have consulted the local court, which would assess the situation so as to ensure that the payment to employees would be fully recovered if a formal bankruptcy process were to begin.

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<sup>12</sup> Reorganization of Jingwoni Manufacture Co. Ltd, Dongguan Intermediate People’s Court, Guangdong, 28 May 2008.

<sup>13</sup> Reorganization of Xingxing Artefacts Co. Ltd, Haichang Lower People’s Court, Xiamen, Fujian, 27 February 2009.

<sup>14</sup> Supreme People’s Court, Notice on Corporate Bankruptcy Affairs, 12 June 2009.

A second form of social stability threat arose in the violent seizure by creditors of a company's assets. Unlike employees, it was rare for creditors to collectively petition the government to claim defaulted debts. Creditors understood that the government was not duty-bound to force debtors to pay their debts; as a result, they had no cause to pressure the government to take action. Instead, creditors who were dissatisfied by available legal remedies would be likely to seize the debtor company's assets by themselves. In the province of Zhejiang, it was found that violent seizure of the company's assets by creditors took place in at least four out of twenty corporate reorganisations (20 per cent). The violent seizure of company assets was definitely seen as a sign of social chaos, which might lead to destructive social consequences. This danger was a major concern for governments, at both the local level and above (Tong and Lei, 2010: 497).

One typical example of this fear arose in the 2008 Reorganisation of Kehong Steel Manufacture Co. Ltd, Jiangsu.<sup>15</sup> When Kehong's business operations ceased because of its sudden illiquidity, several hundred creditors surrounded the company's compound on the morning of 8 October 2008 and were infuriated when told that Kehong's boss had absconded abroad some days before the crisis. Some creditors attempted to enter the company's premises to seize property. Shortly afterwards, the local Changshu government deployed the police force and took over the company's compound. The Changshu government understood that this situation might easily escalate into social unrest if Kehong's crisis were allowed to get out of control.

After preventing a violent seizure of Kehong's assets, the local government organised meetings with the main creditors so as to discuss the fate of the company. One month later, supported by the Changshu government, Kehong entered into the corporate reorganisation procedure in the local Changshu Lower People's Court (Ding, 2009). Thus, because of the social stability assessment system, local governments intervened in a company's business crisis and, if properly advised, the government would arrange for the local court to begin a formal corporate reorganisation procedure.

Apart from the goal of maintaining social stability, local governments would also support a corporate reorganisation case in order to stabilise the local economy, as well as to protect its tax base. Because the health of the local economy is reflected in the annual growth of the gross domestic product (GDP), this can be both politically and economically important for local government. At present, the GDP figure is still one of the key elements in assessing China's local government performance and in determining the promotion of local government leaders (Landry, 2008: 162). As a result, rescuing a large local company was also politically significant to local government in the light of the likely impact that the company had on GDP figures.

For example, when the Hualun Group Co. Ltd<sup>16</sup> was financially distressed in 2009, the local Fuyang County government did not treat such business failure lightly. As one of the three largest companies in the county, Hualun's annual turnover was about ¥2.1 billion (approximately £210 million), contributing about 5 per cent of the county's annual GDP (in

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<sup>15</sup> Reorganization of Kehong Steel Manufacture Co. Ltd, Changshu Lower People's Court, Jiangsu, 18 November 2008.

<sup>16</sup> Reorganization of Hualun Group Co. Ltd, Fuyang Lower People's Court, Zhejiang, 1 June 2009.

2009, Fuyang County's GDP was ¥37 billion). Therefore, it was not surprising that the Fuyang County government formed an ad hoc crisis committee chaired by its mayor and supported the local Fuyan Lower People's Court to rescue this failing company (Ying and Wu, 2009).

Maintaining the local GDP figure was also important so as to stabilise the local tax base. This motivation appeared to be more visible in some economically less-developed areas in China. Local governments would give more consideration to the tax base when deciding whether to support local courts in the rescue of a large, local company. For example, in the 2009 Reorganisation of Tianting, referred to above, Tianting was the only company that had contributed over ¥10 million in tax (about £1 million) during the previous seven consecutive years in the comparatively less-developed Pujiang County in East China. Losing Tianting would have meant the local Pujiang County government losing its largest taxpayer (Pujiang Lower People's Court, 2009).

To sum up, by commencing a corporate reorganisation procedure, the courts have required government support, so as to have a political shield to prevent them from being scapegoated; such government support would also be essential to tackle the legal gaps that remained unfilled in the bankruptcy law and to cope with the less-developed rule of law in China. From local government's point of view, supporting a local company's reorganisation served the maintenance of social stability, as well as the stabilisation of the local economy.

The converse is also true: if a company's failure had not led to social stability concerns for local government, and if the company were not strategically vital for the local GDP and revenue, it would be highly unlikely that this company would be able to access the formal corporate reorganisation process. It is therefore clear that many corporate reorganisations in China's courts were, in effect, initiated by local government. Because a corporate reorganisation procedure was usually entered because of political concerns, political concerns would be likely to influence how assets of the company were distributed in the rescue procedure. The next section will look more closely at this issue.

## **Political considerations affecting value distributions in reorganisations**

The application of the EBL 2006 allows for some flexibility in regard to corporate reorganisations; this flexibility is provided by two fundamental value distribution norms – the *pari passu* rule and the absolute priority principle – which serve as default rules in regard to reorganisations (Mokal, 2001; Han, 2002; LoPucki and Whitford, 1990). This means that the distribution of the company's value may be subject to negotiation between the parties; if no agreement is reached, the *pari passu* and the absolute priority principle must apply.

### **The *pari passu* principle**

In the absence of sufficient assets to pay all creditors in full, the *pari passu* rule calls for the payment of creditors of the debtor company to be made in proportion to the respective size of its claim. The application of the *pari passu* principle (Tomasic, 1998) can be perceived in sixty-nine corporate reorganisations among those studied: it was found that this principle was applied

in fifty-one cases (73.91 per cent); deviations from this rule occurred in the remaining eighteen reorganisations (26.09 per cent). At first, many deviations from the pari passu principle were made in favour of small unsecured creditors in an effort to obtain their support for reorganisation plans. This strategy was commercially motivated: the amount of a small creditor's claim may be insignificant in regard to the passage of a reorganisation plan, but the number of such claims often matters. This is because section 84 of the EBL 2006 stipulates that a reorganisation plan is deemed accepted by each class of impaired parties only if more than half of impaired parties who vote to accept the plan represent at least two-thirds of claims in the class.

For example, the 2008 Reorganisation of Beishen Pharmaceuticals Co. Ltd<sup>17</sup> provides an excellent illustration of the operation of this principle. The company had 226 unsecured creditors, 112 of which had a claim of less than ¥50,000. Nearly half of unsecured creditors were small creditors. To gain the support of these small creditors, the Beishen reorganisation plan provided for the full payment of each unsecured claim of up to ¥50,000; a 50.04 per cent payment was made to claims above ¥50,000. In fact, the first ¥50,000 in unsecured claims combined amounted to only ¥7 million, representing less than 1 per cent of the total ¥1,187 million in unsecured debts. Not surprisingly, the reorganisation plan was endorsed by 204 of the 211 unsecured creditors voting on the plan (96.68 per cent) and it is likely that all small creditors voted in favour of the plan.<sup>18</sup>

However, a limit upon deviations from the pari passu principle is that such a plan must be accepted by the disadvantaged parties (under section 87 of the EBL 2006). If this does not occur, the reorganisation plan cannot be confirmed by the court. In the case of Beishen, large unsecured creditors voted for the plan. In other cases, however, it was found that large creditors voted against a reorganisation plan that contained a deviation from the pari passu principle, yet the court still confirmed the plan. This took place, for example, in the 2007 Reorganisation of Chuangzhou Chemical Co. Ltd,<sup>19</sup> even though the court's confirmation of the plan was a breach of section 87.

Paying unsecured creditors at a higher rate can result in many uncertainties. Although the amount paid to small creditors might constitute only a tiny proportion of unsecured claims, it still deviates from the basic principle of fairness in corporate reorganisations (Tomasik, 1998). Such a practice was likely to be occasioned by the vaguely worded section 82 of the EBL 2006. According to the priority order for payments made in bankruptcy proceedings, section 82 divides those creditors who can vote on a reorganisation plan into four classes: secured, employee, taxation and unsecured creditors. But there is a second paragraph in section 82, which provides that 'a class of small unsecured creditors can be separately established at the discretion of the court to vote on the reorganization plan, if necessary'. This gives rise to two ambiguities – namely, how small claims are to be quantified and whether small creditors are to be paid differently from larger creditors.

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<sup>17</sup> Reorganization of Beishen Pharmaceuticals Co. Ltd, Beihai Intermediate People's Court, Guangxi, 27 November 2008.

<sup>18</sup> Administrator of Beishen Pharmaceuticals Co. Ltd, Public Notice on Voting of the Reorganization Plan, Beihai Guangxi China, 23 February 2009.

<sup>19</sup> Reorganization of Chuangzhou Chemical Co. Ltd, Chuangzhou Intermediate People's Court, Hebei, 16 November 2007. See also Securities Daily (2008).

In the Beishen case, unsecured creditors holding less than ¥50,000 in claims were defined as small; in the Chuangzhou Chemical case, an amount of ¥500,000 was used to separate unsecured creditors. Because there was a tenfold difference between these classifications of small creditors, this threshold is somewhat unclear. This has created a lack of legal certainty and predictability, and as a result might produce only more disputes. Moreover, it must be asked whether small unsecured creditors should, or could, be paid at a higher level, as has happened from time to time. Section 82 does not clarify this issue, leading to the emergence of two different views of this matter in academic circles in China.

One interpretation of section 82 has been that it cannot be interpreted to refer to the legislature's intent to offer a higher recovery rate to small creditors, because the *pari passu* principle should apply to all unsecured creditors, whether a class comprising small unsecured creditors is created or not (Wang, 2012: 19). A second view has been that, for the sake of efficiency, small creditors should be paid in full rather than only at a higher recovery rate (Wang, 2006: 136; Tang, 2005: 35). Arguably, both views are not totally wrong, but they have to be understood in the statutory context. As noted earlier, the EBL 2006 treated the *pari passu* principle as a default norm. This means that, in the case of any deviation from this principle, the consent of all disadvantaged unsecured creditors must be obtained. More specifically, such consent cannot be assumed merely by looking at whether a class of unsecured creditors has voted for a plan (Wang, 2012: 19); the required consent should be unanimous.

But this raises two practical issues. The first is that if there is a deviation from this principle, the fact that a class of unsecured creditors votes in favour of the reorganisation plan does not demonstrate that this class has agreed to the deviation, because the issue of the deviation is usually not separated and singled out in a vote. The second issue is that all disadvantaged unsecured creditors must have unanimously voted in favour of the deviation (Tomasic, 1998). These technical details should be addressed and enforced.

To some extent, the confusion attributed to section 82 of the EBL 2006 appears to be the result of an incomplete legal transplantation from Chapter 11 of the US Bankruptcy Code. Section 1122(b) of the US Bankruptcy Code 1978 states that: '[A] plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.' So, under Chapter 11, it is clear that the objective of designating a class of small creditors arises for administrative convenience rather than to offer a higher recovery rate for them. When borrowing from the US Chapter 11, China's lawmakers may have created confusion by forgetting to add the goal of setting up a class of unsecured creditors.

Thus, in general, this first type of deviation from the *pari passu* principle in China's corporate reorganisations was allowed by the EBL 2006 only if certain statutory conditions were met. But the second type of deviating from *pari passu* seemed to have gone too far.

Some deviations from the *pari passu* principle have been politically motivated. The beneficiaries of this second type of deviation have been individual unsecured creditors who were seen as social stability troublemakers. Under the influence of government, the courts relaxed the *pari passu* principle so as to prevent them from protesting by paying them in full. The maintenance of social stability clearly outweighed the *pari passu* norm.

The first such case involved the 2009 Reorganisation of Zhonggu Sugar Co. Ltd, Guangdong,<sup>20</sup> a company had about 300,000 sugar farmer creditors. After being told that Zhonggu was bankrupt, many farmer creditors sought to express their grievances and formed a group that then petitioned the local Zhanjiang government. This action was what the local government had feared. To alleviate the tension, the Zhanjiang Intermediate People's Court supervising the case decided that the sugar farmers' debts, of about ¥24 million, should be paid in full, whereas other unsecured creditors recovered only 28.3 per cent of their claims. Interestingly, the judges in charge knew that the case raised legality concerns when farmer creditors were paid in full, whilst other unsecured ones were not. To cover up this inconsistency, the buyer of the company was asked to pay farmer creditors in full outside the reorganisation plan. Thus, on the one hand, the political problem was solved – farmer creditors were placated and judges were praised by local government for being politically wise; on the other hand, under the Zhonggu reorganisation plan, there was no written evidence of the improper deviation from the *pari passu* principle that would hold the court and the judges accountable in the future (Feng et al., 2010).

The second such case involving a deviation from this legal principle took place in the 2008 Reorganisation of Qingtai Trust Co. Ltd, Qinghai.<sup>21</sup> In contrast to the large number of sugar farmer creditors in the Zhonggu case, Qingtai had only ninety-four individual unsecured creditors, but on average each of these had a claim of about ¥350,000 (roughly £35,000). Before Qingtai was brought into the reorganisation procedure, these individual creditors had repeatedly protested before the local Qinghai Provincial government; this was probably because Qingtai was a state-owned finance company. Under political pressure based on concerns for social stability, the Qingtai reorganisation plan arranged for full payment to be made to these individual unsecured creditors who held ¥33 million in claims; while the institutional unsecured creditors who held a total of ¥818 million in claims were paid only 10 per cent of their pre-bankruptcy claims (Sun, 2008).

Moreover, some deviations from *pari passu* have been hidden or disguised, because they could not be identified simply by reading the reorganisation plans; hence some unsecured claims were treated as preferential debts. This can also be seen to be politically motivated because the beneficiaries were employees who had become unsecured creditors not because the company owed them wages or pension contributions, but because the company had borrowed from them. The literature indicated that some of China's companies, the majority of which were state-owned or collectively owned companies, borrowed from their employees after the 1990s. In many such cases, it was compulsory for employees to allow this borrowing to occur; although China's central government sought to ban such borrowing from 1993, this decree was not well enforced (Qi and Liu, 1996). In a legal sense, the employees who made loans to their companies were unsecured creditors, but they were more likely to be treated differently if they applied political leverage through social protest.

In the cases of Tianting and Zhonggu, mentioned above, employees who had lent to their companies collectively petitioned local governments when their companies' reorganisation

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<sup>20</sup> Reorganization of Zhonggu Sugar Co. Ltd, Zhanjiang Intermediate People's Court, Guangdong, 22 December 2009.

<sup>21</sup> Reorganization of Qingtai Trust Co. Ltd, Qinghai Supreme People's Court, 10 September 2009.



procedures commenced. These employees understood that they were likely to face a sharp ‘haircut’ if they were treated as unsecured creditors in the forthcoming value distribution under the pari passu principle. The employees in the Tianting case protested by collectively sitting outside the local Pujiang County government buildings, holding a banner that proclaimed ‘protecting our debts’ (Chen, 2011). In both the Tianting and Zhonggu cases, these protestors were rewarded: the employees’ unsecured claims were elevated into preferential debts, which meant that they were paid in full. Shortly afterwards, a prominent lawyer in China argued that such an approach was short-sighted and counter-productive, because it placed short-term political expediency ahead of a commitment to the rule of law (Wu, 2013).

In sum, when applying the pari passu principle in China’s corporate reorganisations, political considerations have been relevant in handling the claims of those individual creditors who had pressured local government by using group petitioning or protests. But it should be noted that the pari passu principle was strictly applied in other reorganisations in China.

### **The absolute priority principle**

The absolute priority principle provided that creditors would be given priority over shareholders in the handling of bankruptcy claims. Examining the application of the absolute priority principle, sixty-two out of all eighty-seven corporate reorganisations studied (71.26 per cent) were found to have publicly available information in regard to this matter. It was found that the deviation from this principle took place in thirty-three of these cases (53.23 per cent) – a surprisingly high percentage. This meant that, in these cases, holders of equity joined in receipt of the distributions that were made, even though creditors were not first paid in full. Unlike deviations from the pari passu principle, most of the deviations from the absolute priority principle occurred for political reasons.

In reorganisations of publicly traded companies, it was the norm, rather than the exception, to depart from the absolute priority principle when making distributions of assets. In particular, twenty-seven out of all thirty-three such deviations occurred in publicly traded company reorganisations. As argued earlier, under section 87 of the EBL 2006, the absolute priority principle is a default rule; however, two months before the promulgation of the EBL 2006, Mr Song Xiaoming, a member of China’s Supreme People’s Court, gave a speech in which he stated that, in cases of publicly traded company reorganisations, some equity in new companies must be reserved for old medium and small shareholders (who were public securities holders) in order to maintain social stability regardless of whether these companies were insolvent (Song, 2006).

Several key points made in Judge Song’s speech should be noted. First, Song’s statement should be seen as a decree from China’s Supreme People’s Court. In practice, although this kind of statement will not directly appear in court judgments, its spirit will bind all judges in China. Secondly, the purpose of this kind of decree was to prevent holders of public securities from causing social instability. The number of holders of public securities in a publicly traded company is a serious political issue in China. Unlike stock exchanges in developed countries where the majority of investors are usually institutions, the vast majority of investors in China’s stock exchanges are members of the general public (Yuan et al., 1999). Most of these

companies have more than 10,000 individual shareholders. For example, Guangxia Co. Ltd. Ningxia, a publicly traded company, had more than 65,500 general public shareholders who spread across China when it entered reorganisation in 2010 (Zhang and Zhao, 2012).<sup>22</sup> If these individual shareholders were unhappy and took action as a group by petitioning Beijing's central government against the strict application of the absolute priority principle in the reorganisation, it would have been seen as a national event that was destructive of social stability in China. This was something to be prevented and Judge Song's speech was probably aimed at doing this. Thirdly, because only general public shareholders are given special protection, this means that institutional and controlling shareholders are not in a position to benefit in this way.

In theory, however, Judge Song's speech would have been in conflict with the EBL 2006. The EBL 2006 set up a precondition for any such deviation, which Song's speech removed. In reality, Song's statement was used to justify deviations from the absolute priority principle in publicly traded company reorganisations – and this strategy has been widely relied upon in many reorganisation in China cases.

Deviations of this kind in publicly traded company reorganisations have taken two forms. The first sought to ensure that the equity of the company was kept intact, which meant that the reorganisation was undertaken entirely at the expense of unsecured creditors. For example, in the 2007 Reorganisation of Haina Tech Co. Ltd, Zhejiang,<sup>23</sup> unsecured creditors recovered 25.35 per cent of their claims, but shareholders did not make any economic sacrifices as a result of the application of the absolute priority under its reorganisation plan.<sup>24</sup>

The second, and perhaps more common, form of deviation arose where shareholders joined unsecured creditors to share the costs of the reorganisation. In such situations, all shareholders forfeited a percentage of their equity to the administrator, who then sold it in order to increase recoveries for unsecured creditors. A typical example of this was the 2008 Reorganisation of Changling Group Co. Ltd, Shaanxi.<sup>25</sup> In the Changling case, under its plan of reorganisation, the general public shareholders each surrendered 10 per cent of their equity; the largest shareholder (the local government) conceded 80 per cent of its equity and the remaining shareholders contributed 50 per cent of their shares. After selling the forfeited equity, the administrator was able to make an 18 per cent payment to unsecured creditors, who otherwise would not have received any payment (Changling Group Co. Ltd, 2009).

Ironically, even in this situation, deviations in favour of general public shareholders have not appeared to serve the goal of maintaining social stability very well. In some cases, individual investors still protested, arguing that they should not have to bear any reorganisation costs at all, because the controlling shareholders had abused their positions and they should therefore have shouldered all costs. For example, during the 2011 Reorganisation of Guangxia Co. Ltd, Ningxia, on 12 December 2011 disgruntled general public shareholders assembled in Beijing, protesting and blocking the entrance of the China Securities Regulatory Commission (Li,

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<sup>22</sup> Reorganization of Guangxia Co. Ltd, Yinchuan Intermediate People's Court, Ningxia, 16 September 2010.

<sup>23</sup> Reorganization of Haina Tech Co. Ltd, Hangzhou Intermediate People's Court, Zhejiang, 14 September 2007.

<sup>24</sup> Administrator of Haina Tech Co. Ltd, The Reorganization Plan of Haina Tech Co. Ltd. Zhejiang, Hangzhou Zhejiang China, 24 October 2007.

<sup>25</sup> Reorganization of Changling Group Co. Ltd, Baoji Intermediate People's Court, Shaanxi, 15 May 2008.

2012b). Paying for peace does not always work and the general public shareholders sometimes wanted to receive just treatment as well.

Two main concerns were raised by these routine deviations. First, Song's speech seems to have been misused. As noted above, under this decree, general public shareholders of publicly traded companies are given special protection, but other categories of shareholders are not. Yet the practice of reorganisations has also led other shareholders to take advantage of this decree by retaining their equity in full or in part. For instance, in the Haina case, as noted above, all shareholders, including the general public and institutional investors, relied upon this judicial statement and retained their equity intact.

Secondly, using this statement to justify deviation was not entirely unlawful, because the absolute priority principle is a default rule; departures from it have been agreed upon by disadvantaged parties through voting processes. This means that if creditors, especially unsecured creditors, vote against a plan of reorganisation that contains such a deviation, the court cannot confirm such a plan. Unfortunately, the use of the cram-down confirmation occurred in eight out of twenty-nine deviations (27.59 per cent) among the cases studied even though this means of enforcing agreement was arguably unlawful (Wang, 2012: 18).

Leaving aside deviations made for the benefit of public securities holders, most deviations have also occurred to protect the interests of the state. In particular, in thirty out of thirty-three deviations (90.90 per cent), the company had at least one SOE among its shareholders. This meant that the absolute priority rule was bent to serve state interests. In the 2010 deviation case involving Jinhua Co. Ltd. Liaoning,<sup>26</sup> for example, 55.89 per cent of the company's equity was owned by a local SOE, Jinhua Holding Co. Ltd. To overcome the objections of creditors against such deviations, ten out of thirty deviations (33 per cent) used the 'cram-down' procedure to forcibly confirm reorganisation plans (Jinhua Co. Ltd. Liaoning, 2010).

Apart from these thirty deviations (which were made either to comfort general public shareholders or to serve the state's interests), the remaining three deviations appeared to be commercially motivated. In these three deviation cases (Dadi in Zhejiang, Xingxing in Fujian and Jingwoni in Guangdong), the reorganisation had to rely on the former equity managers because there were no ready buyers of the company. To induce the equity managers to restructure their companies, creditors agreed to set aside the absolute priority rule by retaining the former's ownership of the company, as a result of which creditors could recover more than they would have in a company liquidation. In sum, most of the deviations from the absolute priority rule in China's existing corporate reorganisations were heavily influenced by political considerations.

## **Conclusion**

By examining China's much-heralded corporate reorganisation law in action, this chapter has sought to show that political considerations have played a major role in shaping corporate reorganisation practice in China. Three main points could be made in conclusion. First, in

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<sup>26</sup> Reorganization of Jinhua Co. Ltd, Huludao Intermediate People's Court, Liaoning, 19 March 2010.

choosing between providing judicial services on corporate reorganisation under the EBL 2006 and meeting the requirements of China's social stability assessment system, most Chinese courts have had to be realistic and have had to prioritise the latter. This has shown that local courts in China have been very weak, in a political sense.<sup>27</sup> Most courts superficially satisfy the requirements of the social stability assessment system by deliberately refusing corporate reorganisation petitions. Obviously, this suggests a lack of judicial accountability (Gewirtz, 2002), because it has been argued that it is wrong for courts to remain silent when a corporate reorganisation petition is lodged (Wang, 2010: 26).<sup>28</sup>

Secondly, it should be noted that most of China's existing corporate reorganisations were, in effect, initiated and used by governments in pursuit of political ends. This is in contrast to the usual Western assumption that formal corporate reorganisation systems were primarily created to serve business purposes. This emphasises the dominance of the state in China's legal and economic systems.<sup>29</sup> In such a system, government has often triggered the formal corporate reorganisation procedures so as to tackle social stability problems caused by business failures. Also, because the local GDP and tax base are firmly associated with local government leaders' political promotions, local governments have had more incentive to order or support local courts to reorganise troubled large local companies. This was especially reflected in the fact that the continuity of companies in reorganisation was always a preferred option for local government, as a result of which all corporate reorganisation plans were confirmed by courts regardless of whether or not they conformed to the EBL 2006 (Liu and Chi, 2011: 89).

Thirdly, in regard to government expectations from corporate reorganisations, it is clear that both political and economic interests are highlighted. To allay social stability concerns, people who voiced their concerns most loudly and who might pose potential social stability threats were simply paid more, or even in full, during a reorganisation; most deviations from the *pari passu* and absolute priority principles were made in this way (Phan, 2005). As a result, the social stability goal was largely satisfied, even though it may have produced only short-term stability and even though, in the long run, it may have damaged the rule of law in China. As far as economic interests are concerned, governments have exploited the corporate reorganisation procedure so as to protect state interests. This was clearly demonstrated in reorganisations of publicly traded companies, in which the absolute priority principle was relaxed in the interests of state-owned companies that were shareholders. Additionally, governments expected large companies to continue to exist because local government needed

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<sup>27</sup> It is not our purpose here to get into a debate about the nature of judicial independence, a notoriously slippery subject. See further the discussion on this matter in Peerenboom (2010).

<sup>28</sup> It is interesting to note that the problem of political meddling in court affairs has become a matter of concern to the Supreme People's Court in China. See, e.g., *The Economist* (2013: 34). Also, the Third Plenum of the Eighteenth Chinese Communist Party Congress held in November 2013 also pledged to introduce judicial reforms that would seek to protect the independence of local courts from the influence of local government (Meng and Zhai, 2013). It is too early to know how these promised reforms will be implemented. However, the proposed removal of local courts from the direct political supervision of local government could enhance the independence of local courts in corporate reorganisation cases. But courts would still be subject to political decisions at higher levels of government, as well as those made by the Communist Party.

<sup>29</sup> See generally Y. Huang, (2008) *Capitalism with Chinese Characteristics: Entrepreneurship and the State*, Cambridge: Cambridge University Press, Justin Yifu Lin, (2010) 'The China Miracle Demystified' (*The Econometric Society World Congress*, Shanghai, China, 19 August 2010), C. A. McNally, (2008) 'Introduction: The China Impact' in C. A. McNally (ed), *China's Emergent Political Economy – Capitalism in the Dragon's Lair*, London: Routledge 3-16, and J. C. Oi, (1995) 'The Role of the Local State in China's Transitional Economy' *The China Quarterly* 144: 1132-1149.

them to produce GDP and to generate taxes. Again, this was achieved by confirming reorganisation plans at any costs.

Enforcing the corporate reorganisation law in China is difficult, but failing to enforce this law may be worse. In planning for the future of China's corporate reorganisation regime, considerations may need to be given to the following matters.

- 1 The corporate rescue law should be better synchronised with other related statutes, which are mainly concerned with business regulation. The first several years' implementation of the EBL 2006 has provided a chance to expose these inconsistencies.
- 2 Existing corporate reorganisations have given rise to concerns over the lack of judicial independence, as well as judicial accountability, of most Chinese courts. Perhaps an informal or voluntary corporate reorganisation regime without court involvement should be established.<sup>30</sup>
- 3 Given the weak position of courts in China, the entire corporate bankruptcy system would be improved if a government agency were to be established to supervise future corporate bankruptcy procedures, including corporate reorganisations (Li, 2010).

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<sup>30</sup> In Australia, for example, such a non-judicial system of corporate reorganisation exists in the form of the system of voluntary administration under Part 5.3A of the Corporations Act 2001. But such a voluntary system is unlikely to be used in mainland China for a number of reasons, including the underdeveloped state of the insolvency practitioner profession in China. Such a profession does, however, exist in Hong Kong.

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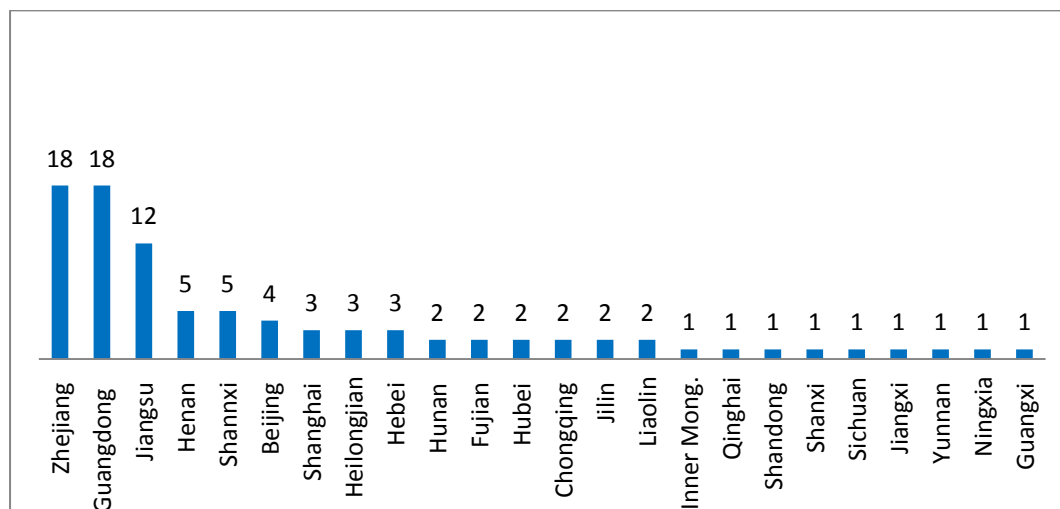
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Figure 1 Number of corporate reorganisations by province in China, 2014



Source: Author’s own data