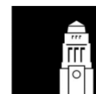

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Evolutionary Traditions and Corporate Law: The Effectiveness and Development of Liquidation Duty in China

Keyword: liquidation duty, wrongful trading, directors' duties, private enforcement, corporate law, insolvency law

Abstract

This paper argues for updating and reform of the liquidation duty under Chinese corporate law. It adopts an evolutionary perspective on corporate law in the sense of asking whether the corporate laws co-evolve with, and adapt to the changing conditions of a country, rather than whether laws are converging towards a certain 'developed' model.

In some jurisdictions, directors have a creditor-regarding duty when the company is insolvent or near insolvency and this duty is intended to constrain 'moral hazard' issues on the part of corporate insiders. In China, such moral hazard issues are mitigated by the liquidation duty. This paper argues that while the liquidation duty is relatively effective, it has created unfairness and undermined the value of formal insolvency law. Drawing on the experience of other jurisdictions especially the UK in relation to wrongful trading law, this paper suggests that a wrongful trading remedy and further restructuring measures might be introduced in China.

I. Introduction

As a majority of companies in China were resolved without formal insolvency, legal protection for creditors is usually enforced through the provisions of company law. Previous research has criticised the limited access to the formal bankruptcy procedure in China[1] but there has not been much discussion of other creditor protection mechanisms that are embedded in China's unique corporate governance structure.

This paper fills the gap by asking how the liquidation duty in Chinese corporate ~~law~~law - an effective complement to formal insolvency - might change and develop by selectively borrowing from so-called advanced jurisdictions such as the UK, the EU and the US. In China, shareholders in LLCs (~~private companies~~Limited Liability Company) and directors/controlling shareholders of JSLCs (~~public companies)~~ Joint Stock Limited Company)[2] are subject to a liquidation duty (*qingsuan yiwu 清算义务*) that requires them to put the company into liquidation within a specified time i.e. making provision for the collection and realisation of assets and making distributions to creditors. Breach of the liquidation duty can result in joint and several liability for

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[1] Roman Tomasic and Zinian Zhang, 'From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China' (2012) 12 Journal of Corporate Law Studies 295 and see also Stacey Steele; Andrew Godwin; Jin Chun; Han Changyin; Ren Yimin, 'Trends and Developments in Chinese Insolvency Law: The First Decade of the PRC Enterprise Bankruptcy Law' (2018) 66 American Journal of Comparative Law 669.

[2] LLCs and JSLCs crudely corresponds to private companies and public companies. The discussion of this article will focus on LLCs that are used as vehicles for small and medium-sized enterprises (SMEs). Despite the fact that LLCs are not exclusively SMEs, the LLC form is most attractive for SMEs in China. Compared to LLCs, JSLCs are characterised by more dispersed ownership and larger sizes. See R.C. Art & M. Gu, 'China Incorporated: The First Corporation Law of the People's Republic of China' (1995) 20 Yale Journal of International Law 273.

the relevant parties, including shareholders and directors. Breaching the liquidation duty is regarded as a statutory ground for veil piercing in China and it has been found that cases brought for breaching liquidation duty has the highest success rate in terms of veil piercing (85.19%), even ~~outranking~~ outranking fraud which ranks the first among the other veil piercing factors.[3] One of the main circumstances that triggers the liquidation duty is where the company's business license is revoked by the relevant administrative authority; a circumstance confirmed in Guiding Case No.9 issued by the Supreme People's Court (SPC).

The liquidation duty is a measure unique to China that addresses opportunistic advantage-gaining ~~behavior~~ behaviour by corporate insiders when a company is insolvent or near insolvency. The liquidation duty resembles the UK wrongful trading provision which ~~incentivise~~ incentivises both directors and controlling shareholders to liquidate a company through formal procedures, with the threat that they might lose limited liability protection if they fail to do so. They differ however, in that the liquidation duty also applies to liquidation for reasons other than insolvency and it is enforceable by creditors individually outside the formal insolvency procedure. Moreover, reflective of the 'shareholder-centred' model of corporate governance in

[3] An empirical study has found that veil-piercing is used more frequently in China than in jurisdictions such as the US and UK. In addition to breaching liquidation duty (statutory ground), ~~The~~ the major factors considered by Chinese courts for veil-piercing include commingling of assets, business, or personnel, fraud, undue control, and undercapitalisation. See Hui Huang, 'Piercing the Corporate Veil in China: Where Is It Now and Where Is It Heading' (2012) 60 American Journal of Comparative Law 743.

China, the liquidation duty is imposed on all shareholders in LLCs as well as controlling shareholders in JSLCs, in addition to directors of JSLCs.

This paper argues that the liquidation duty is relatively effective in creditor protection as it can deter debt evasion and compensate the creditors. Nevertheless, the liquidation duty allows individual creditor to enforce directly against directors or shareholders and thus might encourage a 'race to the courthouse' and bypass the equality of treatment norm in insolvency law. In addition, the liquidation duty may not adequately address moral hazard concerns in respect of directors and shareholders nor encourage early restructurings that maximise value for creditors, employees and other stakeholders. In the UK and other countries, there are reform efforts ongoing to facilitate restructuring for financially distressed companies. In light of the international experience, this paper makes the case for reforms to the current Chinese framework.

The rest of the paper is structured as follows. The second section sets the stage by addressing the main features of corporate governance and insolvency law in China including directors' or shareholders' duties to creditors. The third section analyses the development and application of the liquidation duty by the SPC, including a discussion of Guiding Case No.9. The fourth section examines the effectiveness of the liquidation duty in creditor protection. The fifth section examines critically, comparable rules in other jurisdictions, especially the UK wrongful trading rule. The last section concludes.

II. Setting the scene - Corporate Governance and Insolvency Law with Chinese characteristics

A. Uniqueness of Chinese Corporate Governance and Insolvency Law

Corporate governance in the US, UK and other Anglo-Saxon jurisdictions seemingly pursue two seemingly paradoxical aims---shareholder primacy and board primacy. Board primacy means that the decision-making power within the company is vested in the board of directors and even shareholders cannot interfere with the exercise of this power except in exceptional circumstances. The board can decide on the allocation of cash flows and the distribution of profits to shareholders.[4]

The board however is bound to maximise shareholder wealth as required by the 'shareholder primacy' principle. The notion of 'shareholder primacy' is something of a misnomer as shareholders do not have the primacy in decision-making connoted by this term and this decision-making right in fact resides with the board of directors. Shareholder primacy over other corporate constituencies can be better described as 'shareholder exclusivity' in the sense that management decision-making is exclusively for the interests of the shareholders.[5] Section 172 UK Companies Act 2006 requires directors to have regard to stakeholder interests in fulfilling their duty to

[4] Marc T Moore, *Corporate Governance in the Shadow of the State* (Hart Publishing Limited 2013), p 29.

[5] Ibid.

'promote the successes of the company for the benefit of its members as a whole'. This section is aimed at ameliorating the side effects produced by the single-minded pursuit of shareholder value but it has not changed the general position in the UK corporate law. Since the board is running the business for the interests of the shareholders, a primary aim of corporate governance in both the UK and US is to address the agency problem between shareholders and the board. To hold the board of directors accountable to shareholders, fiduciary duties have been developed to constrain the discretion of the board.

By way of contrast, Chinese company law has developed a shareholder-centred corporate governance regime with no clear authority given to the board. It appears from the legislation and relevant literature, that the objective of corporate governance is to maximise shareholder wealth and this objective has been used to justify State intervention when the State is the dominant shareholder. In small and medium sized companies where the management and shareholding overlap, the 'shareholder primacy' theory has been misinterprted to support the dominant role of controlling shareholders in the corporate decision-making. The board of directors usually lacks the independence or power to challenge the controlling shareholders.[6] This has been confirmed by an empirical study, which has found that minority shareholder oppression is likely to occur in SOEs and other large companies. It is also uncommon for controlling shareholders

[6] Deng Feng, 'The Role, Function and Theoretical Origins of Chinese Board [董事会制度的起源, 演进与中国的学习]' (2011) Chinese Social Sciences 164.

of small companies to abuse their power to harm the interests of minority shareholders.[7]

By way of contrast, Chinese company law has developed a shareholder-centred corporate governance regime with no clear authority given to the board. It appears from the legislation and relevant literature, that the objective of corporate governance is to maximise shareholder wealth and this objective has been used to justify State intervention when the State is the dominant shareholder. In small and medium sized companies where the management and shareholding overlap, there is a tendency for the 'shareholder primacy' theory to be interpreted as meaning that shareholders are the owners of the company and free to use company's assets as they please. Controlling shareholders usually dominate corporate decision making and the board of directors lack the independence or power to challenge the controlling shareholders.[8] To summarise, corporate governance in China has two main characteristics that distinguish it from the Anglo-American outsider model[9]: (1) A concentrated shareholding (and concentrated debt) system; the separation of ownership from management is usually illusory and the main agency problem is controlling shareholder abuse, rather than board-shareholder conflict. (2) Excessive state control; government intervention and a substantial state ownership has brought about a hybrid model which has both

[7] Colin Hawes and others, 'The Chinese "Oppression" Remedy: Creative Interpretations of Company Law by Chinese Courts' (2015) 63 American Journal of Comparative Law 559.

[8] Deng Feng, 'The Role, Function and Theoretical Origins of Chinese Board [董事会制度的起源，演进与中国的学习]' (2011) Chinese Social Sciences 164.

[9] Mark J Roe, 'Some Differences in Corporate Structure in Germany, Japan, and the United States' (1993) 102 Yale Law Journal 1927.

administrative and economic governance characteristics in China.[10]

Previous comparative studies have often assumed that some models are more effective than the others and corporate governance and insolvency law across the world is evolving and converging towards the ‘best’ model.[11] The highly influential Doing Business project of the World Bank also contains this assumption. By assigning scores to a jurisdiction based on evaluation of the formal law or law on the ~~book~~books, it encourages countries to adopt deregulation measures and change formal law in order to converge towards the US model.[12]

For the past decades, China has carried out various deregulation reforms and imported many legal rules, most notably from the US. During the overhaul of company law at the end of 2013, the minimum legal capital requirement was removed[13] and the annual

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[10] Andrew Keay and Jingchen Zhao, ‘Transforming Corporate Governance in Chinese Corporations: A Journey, Not a Destination’ (2018) 38 Northwestern Journal of International Law & Business 187.

[11] For example, the ‘legal origins’ theory raised by LLSV has concluded that countries that adopted the common law performed better economically than those with a civil law origin. See La Porta and others, ‘The Economic Consequences of Legal Origins’ (2008) 46 Journal of Economic Literature 285. See also H Hansmann and R Kraakman, ‘The End of History for Corporate Law’ (2000) 89 Geo. LJ 439; David A Skeel Jr, ‘An Evolutionary Theory of Corporate Law and Corporate Bankruptcy’ (1998) 51 Vanderbilt L. Rev. 1323; John Armour, Brian R Cheffins and David A Skeel Jr, ‘Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom’ (2002) 55 Vanderbilt L. Rev. 1699.

[12] Gerard McCormack, ‘Why “Doing Business” with the World Bank May Be Bad for You’ (2018) 19 European Business Organization Law Review 649.

[13] The legal capital regime in China has been transformed from 'paid-up' capital into ‘subscribed’ capital. The minimum capital requirement has been removed and thus companies can determine the amount of registered capital and the time to pay the capital in their articles of association. As shareholders do not need to make a initial capital contribution to register a company, the requirement for verification of capital by the Industry and Commerce Administrative Bureau (ICAB) is also scrapped. See generally Company Law 2013, articles 7, 23, 25, 26, 27, 32. Also see Shuangge Wen and Jingchen Zhao, ‘Contextualizing Legal Norms: A Multi-Dimensional View of the 2014 Legal Capital Reform in China’

inspection system is replaced with an annual reporting system.[14] Upon release of the Doing Business Report 2019, the press in China celebrated China's great leap from 78th to 46th in the league tables.[15] In order to improve further the business environment, China is carrying out reforms to reduce the time for starting a business as well as speeding up the process of acquiring necessary licenses and enhancing the efficiency of litigation.[16] In terms of insolvency law, another notable effort to promote convergence and harmonisation is the UNCITRAL Legislative Guide to Insolvency Law,[17] which has clearly influenced Chinese insolvency law.[18]

The unique corporate governance model is likely to persist in China however, with

(2018) 19 European Business Organization Law Review 93.

[14] The annual reports will disclose the total amount of paid-up capital, the capital subscription, paid-up capital of each shareholder, and the time limit on paying up the capital as specified by the articles of association. Authorities will choose a sample of companies to check the authenticity of the information provided by in the annual reports. See ibid.

[15] Tan Xinyu, 'Doing Business in China Becomes Easier' (*Chinadaily,* 30 November 2018) <http://www.chinadaily.com.cn/a/201811/30/WS5c00d071a310eff30328c123.html> accessed 11 December 2018.

[16] Liang Xiangbin, Kong Xiangxin and Gao Jianjun, 'Beijing's Business Environment Reform Was Recognized by the World ~~Bank as "~~ Bank: Amazingly Fast and Effective [北京营商环境改革受到世界银行认可："令人惊叹的快速且有效"]' (*Xinhua news*, 2018) <https://mp.weixin.qq.com/s/3UkfcZLGGzsdarnR4mXzJg> accessed 29 December 2018; Chu Xiumin, 'Interpretation of the Latest Policy of Optimizing Business Environment Reform in Shanghai Part IX: Handling Bankruptcy [上海优化营商环境改革最新政策解读之九：办理破产]' (2018) <https://mp.weixin.qq.com/s/3FJilBM68omG_tqZqwV70A> accessed 29 December 2018.

[17] See generally Susan Block-Lieb and Terence C. Halliday, 'Harmonization And Modernization In UNCITRAL's Legislative Guide On Insolvency Law' (Papers.ssrn.com, 2007) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=965710#> accessed 23 August 2019.

In recent years, Working Group V (Insolvency Law) of the UNCITRAL has considered the shifting of directors' duties in some jurisdictions. See Part 4 ('Directors' Obligations in the Period Approaching Insolvency') of UNCITRAL's Legislative Guide on Insolvency Law (2013), available at www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf.

[18] See Terence Charles Halliday and Bruce G Carruthers, *Bankrupt: global lawmaking and systemic financial crisis* (Stanford University Press 2009), p 394.

capital markets in the process of development, a powerful Communist Party and deep rooted traditions of ~~State capitalism and~~ top-down regulation.[19] Because of entrenched differences between political and legal systems, legal transplants in the corporate governance sphere are often ineffective and fail to perform in the same way in the ‘importing’ jurisdiction as they do in the ‘exporting’ jurisdiction. For example, China has transplanted fiduciary duties of directors in order to constrain directorial discretion and protect shareholder interests, but these rules have not been effectively applied. This may be due to the fact that it is challenging for Chinese courts to apply discretionary rules (e.g. fiduciary duties) imported from common law jurisdictions because of insufficient knowledge, lack of authority and the absence of a system of binding precedent (*stare decisis)*.[20] A more fundamental problem however, is that board-centred liability rules are designed to address shareholder/board conflicts. Such rules are not capable of resolving abuses from majority shareholders or State intervention, which are the more striking issues for Chinese corporate governance. This illustrates the proposition that imported laws usually work less effectively than internally developed laws as they may not be compatible with the local circumstances.[21]

Mismatches between law and reality can be also observed in Chinese insolvency law, which has largely remained as ‘law on the books’ during the past decade. China’s

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[19] Wen and Zhao (n 10).

[20] Guangdong Xu and others, ‘Directors’ Duties in China’ (2013) 14 European Business Organization Law Review 57.

[21] Jan Torpman ~~Jan~~ and Fredrik Jörgensen, ‘Legal Effectiveness: Theoretical Developments Concerning Legal Transplants’ (2005) 91 Archiv für Rechts-und Socialphilosophie 515.

Enterprise Bankruptcy Law (EBL) 2006 incorporated many concepts from the 1978 US Bankruptcy Code and the UNCITRAL Legislative Guide on Insolvency Law. It introduces the idea of an external administrator being in charge of the bankruptcy procedure and contains advanced notions such as maximising creditor value and giving a second chance to failing businesses. Empirical research however, has found that most businesses failures in China are resolved without making use of the formal bankruptcy procedure and the procedure itself has featured significant State government intervention and certain outcomes that are arguably inefficient and unfair for creditors.[22]

Some scholars have argued that Chinese insolvency law should emulate the US and adopt a debtor-in-possession (DIP) norm allowing management to stay in charge and thereby incentivizing them to make use of the formal procedure.[23] Such suggestions however, have not considered the uniqueness of the corporate ~~govnernance~~ governance system in China. Rather than piggybacking on legal rules that are board-centred and reflect 'board primacy', future reform in China should concentrate on the issues thrown up by State intervention and the opportunism of controlling shareholders. Current application and enforcement of fiduciary duties in relation to controlling shareholders is highly inconsistent and problematic. These imported rules should be adapted to the

[22] Tomasic and Zhang (n 1).

[23] Xu Meizheng and Wang Zuofa, 'Chinese Bankruptcy Law Needs to Be Improved [我国破产重整制度亟待完善]' (2016) <http://dz.jjckb.cn/www/pages/webpage2009/html/2016-08/30/content_22975.htm> accessed 11 December 2018.

Chinese context and applied to the liability of majority shareholders and State shareholders.[24]

In addition, if internally developed rules are available to be adjusted and modified, they might be better options than imported law as they are more responsive to the local demand and consistent with the political economy of the country. Internally developed rules are more familiar to local constituencies including local lawyers and judges. The liquidation duty, for example, is internally developed and has proved relatively effective in constraining shareholder opportunism and protecting creditors. Since the SPC published the Guiding Case No. 9 that confirmed the liquidation duty for minority shareholders of LLCs in 2012, the number of liquidation duty cases has increased significantly.[25] Shangshang Liang, a leading scholar on Chinese corporate law even argues that the liquidation duty leads to the unbalanced situation where creditors are overprotected while the shareholders of the small and medium companies might be jointly liable for the company's debts.[26] But before analyzing this duty in more detail, it is useful to sketch out the legal framework for creditor protection in China.[27]

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[25] Shangshang Liang, "Questioning the Status of Shareholders of LLCs as Liquidation Obligatee [有限公司股东清算义务人地位质疑]" (2019) 2 China Legal Study.

[26] Ibid.

[27] It is worth noting that regulations promulgated by public regulators might be more important in determining the liability of directors and controlling shareholders in listed companies. Also, rules for Party members might contain main sanctions for directors in SOEs. These issues have already been discussed by many other scholars and will not be considered in this article. See Jiangyu Wang, 'The

B. Directors or shareholders' duty to creditors under Chinese corporate and insolvency Law

Under the EBL, a director shall bear civil liability according to law when her failure to comply with duties of loyalty and diligence leads to bankruptcy of a company. Such director will also be disqualified from serving as a director, supervisor or senior manager of any enterprise within three years from the date when the procedure for bankruptcy is terminated**.**[28]

Chinese Company law also provides that directors may bear civil liability for causing damage to creditors when they breach their duties of loyalty and diligence.[29] This provision however, is too vague to be enforceable since the Chinese judiciary is rather rigid in interpreting directors' duties of loyalty and diligence.[30] Therefore, it is unlikely that a creditor-regarding duty of directors will be developed by judicial interpretation.

The EBL also provides that the legal representative[31] of the debtor company and the

Political Logic of Corporate Governance in China's State-Owned Enterprises' (2014) 47 Cornell International Law Journal.

[28] EBL 2006, article 125.

[29] Company Law 2013, articles 148-149. The duty of diligence is equivalent to the duty of care under common law.

[30] Xu and others (n 16).

[31] The legal representative under Chinese law is a person who represents the company to outsiders and has the power to bind the company. The role can be assumed by the executive director, the chairman of

person directly responsible are liable to pay compensation if the debtor company is responsible for an action or transaction detrimental to creditors that is void or voidable.[32] What constitutes a void or voidable action or transaction is provided in Articles 31-33 of the EBL. The objective of these provisions is to prevent the concealment of assets and preferential payments to individual creditors through the nullifications of transactions and restoration of the company's property. The provisions play a similar role to those on fraudulent ~~transfer~~transfers, undervalue ~~transaction~~transactions, and ~~preference~~ preferences under UK and US insolvency law.[33] The imposition of personal liability in respect of void and voidable transactions is too general however, and in reality rarely used by creditors. Misbehaviour such as concealment and transfer of assets and preferential payments are usually challenged through a claim for breach of the liquidation duty.[34]

The preceding analysis shows the difficulties in establishing and enforcing liability to creditors under Chinese insolvency law. The rules are vague and centred around the duty/liability of directors. The underlying assumption is that the board of directors is in charge of, and responsible for, opportunistic advantage-gaining at the expense of creditors. This assumption is inconsistent however, with the dominant position of

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the board of directors or manager of the company - see Company Law 2013, article 13.

32 EBL 2006, article 128

33 UK Insolvency Act 1986, ss 238 (fraudulent transfer), 239 (undervalue) & 423 (preference). US Bankruptcy Code s 547 (preferences), s 548 (fraudulent transfers and undervalue transactions (constructively fraudulent transfers).

34 Xiao Xiong, 'The Recast of Corporate Liquidator Centralism [论公司清算人中心主义的回归与重建]' (2017) Politics & Law 141.

controlling shareholders in Chinese companies. The formulation of the relevant provisions could be improved. In particular, given the 'shareholder-centred' model of corporate governance in China, they should impose liability on controlling shareholders. But even if these rules are better drafted, it is doubtful that they will be used by creditors as many companies in China cease to engage in commercial activities without going through the formal insolvency procedures. As such, insolvency law only plays a very limited role in creditor protection whereas important rules are mostly embedded in company law.

The effectiveness of the liquidation duty is also disputable. The fact that many companies ceased trading without formal insolvency or orderly liquidation seems to suggest that the liquidation duty is not well observed and its deterrent effect is limited. However, the reason for this might be that shareholders of small companies are either unaware of the liquidation duty or bet on not being caught. As more cases are being enforced and reported, it is likely that the liquidation duty will become more effective in deterring shareholder abuse. This will be further analysed in the following sections.

III. The liquidation duty under Chinese Law

A. Origins and development of the liquidation duty

In China, the expression 'liquidation duty' refers to an obligation to collect and then

distribute the assets of company to creditors and other claimants. To be specific, where reasons for terminating the existence of a company have arisen, a liquidation team should be formed within 15 days to carry out the task of liquidation.[35] The failure to carry out the liquidation within a certain time or making it impossible for carry it out through concealment of assets etc. will result in joint and several liability. In LLCs, all shareholders are subject to the liquidation duty, while the liquidation duty only falls on the controlling shareholders and directors in JSLCs.[36]

Under Chinese law, the liquidation duty is triggered once legal reasons for terminating the existence of a company (dissolution or *Jiesan*) have arisen and the company's legal personality comes to an end as a result of the liquidation process. In addition to insolvency, a company's existence may also be brought to an end as a result of administrative dissolution (revocation of business license etc.), voluntary dissolution (dissolution by shareholders' resolution etc.), and judicial dissolution demanded by shareholders.[37]

In the past, liquidating a failed business in China was often triggered by revocation of business license by the administrative authority rather than a formal bankruptcy filing.

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[35] Company Law 2013, article 183. Before the amendment in 2013, this provision was article 184 under Company Law 2005.

[36] Ibid.; also see Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law (II), i.e. Judicial Interpretation II, articles 18-21. This will be further discussed below.

[37] Company Law 2013, article 180. Also see Wang Jiangyu, *Company Law in China : Regulation of Business Organizations in a Socialist Market Economy* (Edward Elgar Publishing 2014), p 339.

It is often difficult for companies to enter the bankruptcy procedure.[38] The liquidation duty is an important complement to the bankruptcy law for it is not uncommon for a company's assets to be transferred away by the directors and controlling shareholders leaving it without assets in its possession. The liquidation duty may be employed to combat this abuse and is relatively well used by creditors.[39] A search of the keyword 'liquidation duty' in *Chinese Judgments Online*[40] from 2009 to 2018 results in an average of *857* cases per year. The number of cases related to 'liquidation duty' peaked in 2017 at *1,925* and may continue to rise with the increasing business failures under the current economic slowdown in China.

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[38] But this has changed with recent governmental efforts to make greater use of formal bankruptcy procedures, particularly for zombie companies. See WR Lam and others, 'Resolving China's Zombies: Tackling Debt and Raising Productivity' (2017) <https://www.imf.org/en/Publications/WP/Issues/2017/11/27/Resolving-China-Zombies-Tackling-Debt-and-Raising-Productivity-45432> accessed 11 December 2018.

[39] For example, the report by Changzhou Intermediate Court of Jiangsu Province states:"...as long as evidence can prove a creditor-debtor relationship as well as the fact that the liquidation obligatees did not notify the creditor, it can be determined that there is ~~a~~ an illegal act of liquidation. As to the situation where the company's assets has been illegally disposed, the main issue is to determine the losses of creditors....Articles 31 and 33 of the Enterprise Bankruptcy Law also have similar provisions." Also, the report states that all of the 42 cases accepted by the court from 2008 to 2011 are filed by creditors against 'liquidation obligatees' although in theory the company (represented by its directors or controlling shareholders) can raise a claim against wrongdoers as the company has suffered losses in the liquidation procedure. See Changzhou Intermediate Court, 'On Practical Problems in Cases Regarding Liquidation Duty: Based on the Trial of Two-Tier Courts in Changzhou [不当履行清算义务案件审判实务若干问题探析——以常州市两级法院的审理情况为研究基础]' (2012) Law Application 61.

Also, the judiciary in Wenzhou city, Zhejiang province reports a sharp rise in the number of liquidation duty cases from 11 in 2011 to 143 in 2015. The report points out that liquidation duty cases ~~has~~ have complemented the bankruptcy procedure and 'become a sharp weapon to combat evasion of debts'. In 92.3% of 247 cases sampled by the report, the main circumstance for enforcing the liquidation duty is that the debtor company has no assets to distribute to creditors. Wenzhou Intermediate Court, 'Difficulties in Wenzhou Court's Trial of Cases Regarding Shareholders' Delay in Performing Liquidation Duty [温州法院审理股东怠于履行清算义务案件若干疑难问题梳理]' (2017) Law Application 23.

[40] *China Judgments online* is the official website for case reports in China, available at http://wenshu.court.gov.cn/.

The liquidation duty was in fact created many years before the enactment of the first comprehensive corporate bankruptcy law in the EBL. It was developed by the SPC based on interpretations of the first modern company law in contemporary China -- Company Law 1993. This law provided for a mandatory 'administrative liquidation' conducted by the 'department in charge' (*zhuguan danwei)*[41] when a company is ordered to close down for violating the law or regulations.[42] In 2001, the SPC confirmed through a reply[43] to a lower court that the 'department in charge' would be liable for a company's debts when it failed to put the company into liquidation after the revocation of its licence.[44] Later local courts followed this approach to address the widespread problem of debt evasion. In this way, the liquidation duty for 'department in charge' has been established.[45]

In 2005, the new company law was enacted, which scraps the 'administrative liquidation' provided under Company Law 1993 and shifts the liquidation duty from the 'department in charge' to shareholders and directors. To be specific, when a

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[41] In the old days of the planned economy, every economic organisation ~~is~~ was a unit embedded in the administrative hierarchy and overseen by a 'department in charge'. The legal status of shareholders was only formally recognised when Company Law was promulgated in 1993.

[42] Company Law 1993, article 192.

[43] The SPC can substitute lower courts' decisions with its own 'replies' to local courts regarding individual cases, as illustrated by its reply to local courts regarding the liquidation duty. These replies are *final* in the sense that both the lower courts and the appellate courts have to comply with them. The replies have, in fact, nullified the right to appeal of litigants. They have also undermined the judicial independence and discretion of the lower courts. See Fengjing Liu, 'The Definition and Exercise of Judicial Interpretation Authority [司法解释权限的界定与行使]' (2016) 3 China Legal Science 207.

[44] Jiang Daxing, *Company Law Report [公司法律报告]* (CITIC Press 2003), p 425.

[45] Ibid., p 428.

company's business license is revoked or it is ordered to close down for violating laws or regulations, its shareholders or directors have the duty to initiate liquidation,[46] instead of the 'department in charge'.

The liability for breach of the liquidation duty is further specified in the judicial interpretation issued by the SPC in 2008 (hereafter Judicial Interpretation II).[47] It provides that all shareholders in LLCs are 'liquidation obligatees' while in the JSLCs, 'liquidation obligatees' refer to controlling shareholders and directors. It also states that in the event of breaching the liquidation duty and making it impossible to carry out liquidation, 'liquidation obligatees' will be jointly and severally liable. Two provisions further detail the circumstances where joint and several liability arises. Article 18 (2) states that if 'liquidation obligatees'[48] fail to set up the liquidation team within 15 days, causing the loss of main assets and important documents of the company and therefore making it impossible to carry out a liquidation, the 'liquidation obligatees' will be jointly and severally liable for the debts of the company. Article 20 provides that if liquidation obligatees deregister the company without liquidating the company first (usually through the use of false documents), they will be liable for the debts of the company.

[46] Company Law 2005, article 184

[47] Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law (II)(2008, revised in 2014), articles 18-21.

[48] Judicial Interpretation II does not use the expression-'liquidation obligatees' in the text, which is formally referred to for the first time in General Provisions of the Civil Code (2017). However, the term has already been widely used in scholarly discussion and court judgments.

Judicial Interpretation II permits shareholders to apply for a judicial liquidation when a cause for dissolution arises.[49] It also provides that shareholders can claim a contribution or compensation from other shareholders, *de facto* controllers, directors, based on the extent of the latter's fault, after the claimants have paid the creditors.[50] The right to demand liquidation however, may not provide a sufficient safeguard for passive shareholders who are not aware that they face the choice of either demanding a judicial liquidation or being liable to creditors when the controlling shareholders fail to carry out a timely liquidation. It seems unfair that the burden falls on the minority shareholders to prove the fault of controlling shareholders before being able to recoup their payments to creditors.

Nevertheless, the liability of minority shareholders in LLCs is confirmed by the No.9 Guiding Case issued by the SPC in 2012. This case holds two minority shareholders jointly liable for the company's debts because they breached their liquidation duty, despite their claim of not being involved in the management. In a subsequent case, the SPC clarified that unlimited liability for breaching the liquidation duty is based on article 20 (3) of Company Law 2005, which specifies the consequences of discarding the doctrine of corporate legal personality.

[49] Ibid., article 7

[50] Ibid., article 21

It is clear that the main objective of the liquidation duty is to address the problem of malicious debt evasion. In its further explanation of the No.9 Guiding Case, the SPC states that it is common for companies not to go into liquidation and some even use dissolution to escape debts, undermining the interests of creditors and endangering the order of the market economy. The liquidation duty aims to mitigate against such a phenomenon.

The latest major development on the liquidation duty is the promulgation of the General Provisions of the Civil Law (Civil Law). In a 2015 conference on the drafting of the Civil Law, scholars were divided on whether minority shareholders should be exempted from the liquidation duty.[51] The draft Civil Law promulgated by the Civil Law Council of the Standing Committee of National People's Congress (NPC) largely replicated the provisions on joint liability of 'liquidation obligatees' from the Judicial Interpretation II. However, the official Civil Law enacted in 2017 provides that failure to fulfil the liquidation duty and consequent loss to creditors will result in civil liability without reference to 'joint liability'. It also defines 'liquidation obligatees' as directors and members in the decision-making or executive bodies, without stating that all shareholders in LLCs are 'liquidation obligatees' as provided by the Judicial Interpretation II.[52] The Civil Law, however, also clarifies that special legislation shall

[51] Civil Law Office of the Law Committee of the Standing Committee of the National People's Congress, *Legislation Background and Discussions on General Provisions of the Civil Law [民法总则立法背景与观点全集]* (Law Press 2017), p 525-526.

[52] General provisions of the Civil Law, article 70

prevail in regard to the liquidation procedure and Company Law shall apply in the absence of other provisions.[53] This means that the provisions on the liquidation duty in Company Law and Judicial Interpretation II continue to apply and minority shareholders of LLCs are still open to joint and several liability for breaching the liquidation duty.[54]

The SPC has played an essential role in the development of the liquidation duty in China. By filling the gaps left by the statutes, the SPC has provided a pragmatic solution to the problem of debt evasion in China. Nevertheless, the expanding lawmaking power of the SPC gives rise to the concern that it has become a 'quasi-legislator' and thereby undermining the established order of rule-making in China. Some scholars even cite this as the emergence of 'judicial activism' in China.[55]

The SPC in particular has been criticised for encroaching upon the legislative power of the National People's Congress (NPC).[56] The judicial interpretations are usually not based on the accumulation of individual cases, but formulated in accordance with the reading of the legislation by the SPC. The judicial interpretations sometimes deviate

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[53] Ibid., article 71

[54] Wang Changhua, 'On Definition of Liquidation Obligatee of Limited Liability Company: The Application of Article 70 of the General Principles of Civil Law in China [论有限责任公司清算义务人的界定———以我国《民法总则》第 70 条的适用为分析视角]' [2018] Law Science Journal 89

[55] Chenguang Wang, 'Law-Making Functions of the Chinese Courts: Judicial Activism in a Country of Rapid Social Changes' (2006) 1 Frontiers of Law in China 524.

[56] Chen Su, 'Analysis of Constructing Concept of Judicial Interpretation [司法解释的建构理念分析]' (2012) 2 Chinese Journal of Law.

from the legislative purpose and assert the SPC's own policies which find no basis in the 'legislative spirit'.[57] Moreover, the SPC's authority to clarify legislation is questionable as its judicial interpretation power is limited to 'specific application of laws and decrees in court trials'. As to the clarification of the specific meaning of provisions or the application of the law in new circumstances, the SPC should only request the Standing Committee of the National People's Congress (NPC) to issue a legislative interpretation.[58]

Compared with judicial interpretations, the guiding case system established by the SPC in recent years may be more legitimate and sustainable.[59] Since 2010, the SPC starts to issue guiding cases in order to improve the uniformity and consistency of adjudication among different levels of courts.[60] For this purpose, the SPC has set up an Office for

[57] Ibid.

[58] Resolution of the Standing Committee of the National People's Congress Providing an Improved Interpretation of the Law [全国人民代表大会常务委员会关于加强法律解释工作的决议](Adopted at the 19th Meeting of the Standing Committee of the Fifth National People's Congress on June 10, 1981); Legislation Law 2000, articles 45 and 104.

[59] See Provisions on Case Guidance [关于案例指导工作的规定] (No. 51 [2010] of the Supreme People's Court); Detailed Rules for the Implementation of the Provisions on Case Guidance [关于案例指导工作的规定实施细则] (No. 130 [2015] of the Supreme People's Court).

[60] Detailed Rules for the Implementation of the Provisions on Case Guidance, article 1.

Case Guidance Work[61] to select typical cases[62] that can offer guidance for future adjudications. ~~It should be noted that the legal effect of guiding cases are fundamentally different from the binding precedents in common law as they are not an independent source of law and could only be cited as a reason for adjudication instead of the basis.~~

~~Courts are required~~ The guiding case system has injected an element of *stare decisis* into China's codified civil law system, however, it is doubtful to ~~cite~~ what extent it will fulfill the objective of unifying the application of the law.[63] Most importantly, the ~~guiding case in their adjudication although~~ guiding cases distinguish from the binding precedents in common law as they are not ~~explicitly binding on~~ an independent source of law and could only be cited as a reason for adjudication instead of the ~~local courts~~basis.[64] In addition, guiding cases have been selected and edited by the SPC but not directly adjudicated by the SPC. For example, guiding case No.9 - the case clarifying the liquidation duty - was adjudicated by a court in Shanghai and then published by the SPC. Cases adjudicated by the SPC are not binding on the local courts. Local courts however, are very likely to consult these cases to assist their judgments; they are indicative of the general trajectory

61 Ibid., article 3.

62 Ibid., article 2.

63 See JA Cohen, "Chinese Common Law? Guiding Cases and Judicial Reform." (2016) 129 Harvard Law Review 2213; Mei Gechlik Stanford Law School China Guiding Cases Project, "China's Guiding Cases System: Review and Recommendations " (August 2016) <https://cgc.law.stanford.edu/guiding-cases-analytics/issue-5/> accessed February 6, 2018.

64 ~~Ibid.~~Detailed Rules for the Implementation of the Provisions on Case Guidance, articles 9 and10.

of the judicial approach. The next section will discuss guiding case No.9 and some cases adjudicated by the SPC that deal with the liquidation duty.

B. Guiding Case No.9 and SPC Cases on the liquidation duty

In *Shanghai Cunliang Commercial Co., Ltd v Jiang Weidong & Wang Weiming*, (Guiding Case No.9) the SPC clarified that all LLC shareholders are subject to the liquidation duty and can be held liable for the company's debts despite not being involved in the management of the company.[65] In this case, Cunliang was owed payments for steel delivered to Tuoheng. Cunliang sued the shareholders of Tuoheng for not putting the company into liquidation in time after its business license was revoked for failure to accomplish its annual inspection on time. The court found that the Tuoheng shareholders were subject to the liquidation duty and their delay caused the loss of the main assets and financial accounts of the company, making it impossible to liquidate the company; therefore, they should be jointly liable for the debts of the company. The court also rejected the minority shareholder claim that they were not involved in the management of Tuoheng on the ground that Tuoheng was a LLC whereby its shareholders as a whole are the 'liquidation obligatees' under company law. All of them have the duty to liquidate the company in time regardless of the extent of their shareholding and involvement in management. The minority shareholder also

[65] Guiding Cases of the SPC have been translated by the ~~Standford~~ Stanford Law School Chinese Guiding Cases Project. A translation of Guiding Case No.9 is available at https://cgc.law.stanford.edu/guiding-cases/guiding-case-9/?lang=zh-hans.

argued that the company had already depleted its assets before the revocation of the business license. While this was dismissed by the SPC, it ~~hinted~~ indicated that shareholders could defend themselves by arguing that there was a lack of causal link between the breach of liquidation duty and the company's loss of assets.

Guiding Case No.9 has effectively imposed strict liability on shareholders in LLCs as they cannot defend themselves on the basis of an absence of fault or lack of involvement in the management. In *Shanghai Fengrui Investment Consulting Co., Ltd. vs. Shanghai Automotive Industry Sales Co., Ltd,*[66] however, the SPC seems to have corrected this position by holding that a shareholder may not be liable for creditor losses where such losses cannot be attributed to any fault on the part of the shareholder. In this case, after the license of an LLC was revoked, a creditor sought to hold two shareholders liable for the company's debts because of their failure to put the LLC into liquidation. As one shareholder (hereafter company A) had also lost its business licence and ceased trading, the focus turned on the other shareholder (hereafter company B). The creditor argued that all LLC shareholders had the duty to liquidate the company despite not being involved in management, citing Guiding Case No.9.

The SPC asserted that the basis for the liquidation duty was 'disregarding legal personality' (equivalent to piercing the corporate veil) and general theories of tort law liability. In establishing liability, three factors need to be satisfied including: first,

[66] SPC MinZai No.37 (2016)

liquidation obligatees failed to carry out the liquidation in time or did so inappropriately; second, their negligence or wrongdoing caused direct losses to creditors; third, a causal link could be established between breach of the liquidation duty and the creditors' losses. On such basis, the SPC found that company B was not liable. It had extended loans to the LLC and applied for judicial enforcement of the debt. It also made efforts to trace the assets of the LLC. There was no causal link between the action of company B and the loss by the LLC of main assets. The SPC also said that the LLC's license was revoked in 2001 when cases on the liquidation duty were still rare. While the principles laid down by the Judicial Interpretation II should apply retrospectively, it was unfair to impose joint liability when company B had made considerable efforts but was still unable to recover its own debts owed by the LLC.

Some commentators have viewed this case as a move towards a laxer judicial approach on the liquidation duty.[67] However, this case is not a guiding case and therefore it cannot change the general approach of the judiciary. SPC's leniency in this case is fact-specific in that the shareholder was also a creditor of the company and it seems unfair to impose liability on the shareholder when it cannot recover its own debts. In recent cases, the SPC has pointed out that shareholders of LLCs still bear 'strict liability' for breaching their liquidation duty. For example, in *Zhang Weizhong v Laiying Asset Management Co., Ltd.*[68], a shareholder was held liable for the company's debts despite

[67] Xiong (n 28).

[68] SPC MinShen No.808 (2017)

claiming that the company was placed in the custody of an investment company through contractual arrangement when the company's business license was revoked and that an impostor had used his identification to register as a shareholder. The SPC found that the shareholder could not prove that his identity was stolen and as a shareholder, he had failed to fulfill his capital commitment to the company. He had also reached an agreement with some creditors to pay them before others.

In general, the SPC has adopted a formal and rigid application of the liquidation duty. Under the Judicial Interpretation II, a LLC is presumed to be a 'quasi-partnership' in which all shareholders are closely involved in the business in contrast to the JSLC where there is greater involvement by a board of directors. The liquidation duty is imposed on all shareholders in LLCs. Guiding Case No.9 has confirmed the liability of passive shareholders in LLCs and the SPC has largely insisted on this approach, even though in reality there are many passive investors in LLCs, especially when they are used as vehicles for venture capital and private ~~equities~~equity funds.

For example, in 2014, a venture capital company based in Shenzhen was held liable for the debts of a LLC, in its capacity as a minority shareholder, on the ground that it failed to put the company into liquidation in time after the company's business license was revoked, following an annual inspection by the local governmental authority. The venture capital company claimed that it was not involved in the management and the controlling shareholder had taken away the LLC's financial accounts, main assets and

documents. Despite this, the venture capital company was still held liable for the LLC debts, with its bank accounts frozen and offices closed by the court.[69] It is a common strategy for Chinese venture capital companies to diversify their investments by holding shares in a variety of LLCs while not being involved in the daily running of the business. The liquidation obligation has undermined such a strategy and may have chilling effects on venture capital investments.

In ~~a word~~the light of the discussion above, it is necessary for the courts to consider business substance and develop exceptions when some shareholders actually have no control over the business or there is no causal link between failure of discharging the liquidation duty and the loss of assets. This will be further considered in the next section, which provides a theoretical discussion on the effectiveness of the liquidation duty.

IV. Effectiveness of the liquidation duty in creditor protection

A. Effectiveness of the liquidation duty as a private enforcement mechanism

If law is viewed as a tool for social engineering, i.e. regulating or shaping behaviour, then the effectiveness of the law must be measured by the extent to which it fulfils its objectives. Based on the objectives, law can be divided into preventive or curative. A preventive law is effective only if it could deter undesirable behaviour and prevent wrongs from happening. In contrast, a curative law must remedy a wrong *ex post facto*

[69] Liao Jiehua, 'A Dangerous Precedent[危险的判例 Weixian De Panli]' (February 2014) <http://www.eeo.com.cn/2014/0127/255576.shtml> accessed 26 December 2018.

and compensate the wronged party.[70]

The liquidation duty is designed to perform both objectives by constraining debt evasion and protecting creditors. Therefore, the effectiveness of the liquidation duty should be measured based on both preventive and curative standards. It should offer a credible threat that wrongdoers will be punished and thereby deter directors and controlling shareholders from causing losses to creditors. It should also contain a credible commitment to compensating the creditors who have suffered losses.

Measured by such standards, the liquidation duty is relatively effective and can ameliorate the agency problem between creditors and directors/shareholders. Breaching the liquidation duty will result in a joint and several liability on shareholders in LLCs and directors/controlling shareholders in JSLCs. They owe a tort liability to creditors, which is an exception to the limited liability rule. Under general tort law, joint and several liability applies in cases where the plaintiff's loss is attributable to multiple parties. The plaintiff can litigate against any of the tortfeasors and recover full damages from the defendant.[71] As any of the potential tortfeasors ~~is~~ are regarded as fully accountable, they have the incentive to take measures to avoid liability. Therefore, joint and several liability appears more effective than proportionate liability in deterring

[70] Antony Allott, 'The Effectiveness of Law' (1980) 15 Val. UL Rev.

[71] Lewis A Kornhauser and Richard L Revesz, 'Joint and Several Liability' in De Gerrit Geest (ed), *Encyclopedia of Law and Economics* (2017) <https://www.elgaronline.com/view/nlm-book/9781782547457/b1_chapter4.xml>.

misconduct.[72]

This reasoning can apply to the liquidation duty which incentivises shareholders/directors to avoid conducts that cause loss to creditors. If each defendant is only liable for a share of damages (proportionate liability), they might lack the incentive to monitor each other and take effective measures to preserve assets and documents that are necessary for liquidation. A proportionate liability scheme requires the plaintiff to sue all the defendants in order to recover 'full' damages. As 'outsiders', creditors are shielded by the corporate veil and are unlikely to know the financial status of each defendant and their share of liability for the delay or ~~misbehavior~~ misbehaviour in the liquidation. Given the informational disadvantages of creditors, it is fair to shift burden and risk to directors and shareholders for monitoring each other.

In addition, joint and several liability for breaching the liquidation duty is effective in compensating the creditors since the shareholders/directors must pay the plaintiff first before they apportion the damages among themselves according to their share of fault. If one of them is insolvent or disappears, the rest of the 'liquidation obligatees' rather than the creditors bear the loss.

[72] Law Commission of Ontario, 'Joint and Several Liability Final Report' (2011) <https://www.lco-cdo.org/en/our-current-projects/joint-several-liability/joint-and-several-liability-final-report-february-2011/vi-advantages-and-disadvantages-of-joint-and-several-liability/> accessed 26 December 2018.

Moreover, the liquidation duty has provided a private enforcement mechanism for creditors in addition to the formal and collective bankruptcy procedure. China has already made numerous deregulation efforts in the corporate and financial sector including the removal of the minimum legal capital requirement and the annual inspection system for companies. These measures are aimed at encouraging and facilitating private ordering by market forces. With less public regulatory rules for creditor protection, creditors have incentives to enforce the liquidation duty so as to protect their own interests.

In countries such as China that have 'incomplete' law and a far from robust judiciary, public regulation usually plays a more important role than private enforcement. Compared with judges who are reactive, regulators are proactive enforcers.[73] Regulators also have more expertise and political incentive to sanction socially undesirable ~~behaviours~~behaviour. For example, the China Securities Regulatory Commission (CSRC) has played a dominant role in enforcing securities laws and fiduciary duties of directors in listed companies.

Relying solely on public regulation however, can be problematic. Regulators may, for example, be 'captured' by the sectors they regulate. Rather than correcting market failures, regulation can be used to create barriers to competition and 'rent seeking

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[73] Chenggang Xu and Katharina Pistor, 'Law Enforcement under Incomplete Law: Theory and Evidence from Financial Market Regulation (LSE Research Paper No. TE442~~) ~~)' (2003) <http://www.ssrn.com/abstract=396141>.

behaviour'.[74] It has been found that there is serious regulatory capture problem among regulators in China~~. The power of a financial regulator is proportional to the degree of corruption~~.[75] Public regulation has also been criticised for imposing too many *ex ante* controls in China, whereas *ex post* enforcement is poor.[76] Most pertinently, excessive *ex ante* control and heavy State intervention have undermined the accessibility and effectiveness of insolvency law in China.[77]

Private enforcement is indispensable for a country that seeks to develop a 'market economy'. For some scholars, private enforcement is even more important than public enforcement in the development of the financial market in a country. For instance, a major strand in the 'law and finance' literature has argued that private enforcement can facilitate the development of stock markets.[78] The World Bank Doing Business Report has adopted this reasoning and promotes private enforcement and deregulation over public regulation.[79]

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[74] George J Stigler, 'The Theory of Economic Regulation' (1971) 2 The Bell Journal of Economics and Management Science 3; Christopher Carrigan and Cary Coglianese, 'Capturing Regulatory Reality: Stigler's the Theory of Economic Regulation (U of Penn, Inst for Law & Econ Research Paper No. 16-15*)*' (2016) <http://www.ssrn.com/abstract=2805153>.

[75] Some scholars have found that the power of a financial regulator is proportional to the degree of corruption, but this is gradually changing with the deregulatory reforms in China. Xie Ping and Lu Lei, *Economic Analysis on Financial Corruption in China [中国金融腐败的经济学分析]* (Ping Xie and Lei Lu eds, CITIC Press 2005).

[76] Fang Zhang and Xiang Li, 'Empirical Analysis of the Regulatory Intensity of the CSRC [对证监会执法强度的实证分析]' (2016) 38 Modern Law Science 173 (questioning the 'regulatory intensity' of the CSRC and arguing that its enforcement is weak, particularly when imposing the sanctions against directors and supervisors in listed companies).

[77] Tomasic and Zhang (n 1).

[78] Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, 'What Works in Securities Laws?' (2006) 61 The Journal of Finance 1.

[79] Gerard McCormack, 'Why "Doing Business" with the World Bank May Be Bad for You' (2018) 19

As a private enforcement mechanism, the liquidation duty can complement public regulation in three ways: first, it constitutes an additional deterrence to misbehaviour of directors and shareholders; second, it can provide compensation for claimants who cannot be compensated through public sanctions; third, as creditors are more capable of protecting themselves through private enforcement, there will be less need for public regulation and unnecessary *ex ante* control.

Compared with imported laws such as directors' duty to creditors, the liquidation duty is more compatible with the legal and institutional environment of the country. It has been formed gradually by the SPC through judicial interpretation and the Guiding Case, instead of being inserted in the statute. Chinese lawyers and judges are already familiar with the liquidation duty and are more likely to rely on it. Law is a cognitive institution and its effectiveness therefore depends on whether it can be understood and embraced by users of law.[80] In practice, the liquidation duty has been found to be relatively effectively used by creditors.[81]

B. Criticisms of the liquidation duty in practice

European Business Organization Law Review 649.

[80] Thomas W Waelde and James L Gunderson, 'Legislative Reform in Transition Economies: Western Transplants—A Short-Cut to Social Market Economy Status?' (1994) 43 International & Comparative Law Quarterly 347; Jacques deLisle, 'Lex Americana: United States Legal Assistance, American Legal Models, and Legal Change in the Post-Communist World and Beyond' (1999) 20 University of Pennsylvania Journal of International Economic Law.

[81] See above (n 32).

It should be noted, however, that the current judicial interpretation and application of the liquidation duty may ‘over-deter’ by exposing shareholders and directors to disproportionate liability, especially minority shareholders in LLCs. As Chinese companies are usually dominated by majority shareholders, minority shareholders are excluded from the decision-making. The report of the judiciary in the city of Wenzhou finds that it is usual for minority shareholders in LLCs to raise invalid defences such as only having a small shareholding, not being involved in the management or not being in charge of the company's financial documents. The report also admits however, that it is unfair and can undermine investments to impose the same extent of liquidation duty on majority and minority shareholders in small and medium companies.[82]

Imposing liability on passive shareholders also seems intuitively unfair because it contradicts the principle that punishment must be proportionate to the culpability and one must only be responsible for one’s own wrong. The approach is inconsistent with the principles of the rule of law and is reminiscent of the *Baojia* system in China that lasted from the Song dynasty (960–1279) to the early twentieth century, under which ‘the legal consequences of individual criminal behaviour often became the shared responsibility of family members who then had collectively to bear the brunt of the state’s insistence on morality and public order. ’[83]

[82] Wenzhou Intermediate Court (n 33).

[83] Ronald Keith and Zhiqiu Lin, *New Crime in China* (Routledge 2005), p 64.

In comparison, the allocation of the liquidation duty to controlling shareholders and directors in JSLCs is more consistent with their access to information and power in ~~the~~ corporate governance. Although JSLCs are subject to more demanding reporting requirements, including the obligation to provide minutes of relevant meetings; financial and accounting reports[84] and the information disclosure requirements in the governance code for listed companies, information asymmetries still exist between minority shareholders and corporate controllers, as well as between creditors and corporate insiders. Controlling shareholders and directors are familiar with the operations and financial conditions of the company and have control over the company's assets and financial books. Moreover, controlling shareholders can use their voting rights to dominate the governance decisions including those on liquidation and asset distributions. It is legitimate and necessary to require them to put the company into liquidation in time.

In the future, it might be reasonable for the courts to exonerate defendants upon evidence that he or she has no control of the business or there is no causal link between delay in conducting liquidation and the company's loss of assets. Without safeguards and excusing circumstances, the liquidation duty might create perverse incentives on shareholders to run away instead of being dragged into the court, while those who stay will be responsible.

[84] Company Law 2013, articles 90, 96 and 97.

~~In addition, under Anglo-American systems, claims to reverse pre-insolvency transactions such as the payment of one creditor ahead of others in the same category - 'preferential payments' - are enforced by the insolvency administrator. Creditor claims are also resolved collectively under the principle of *'pari passu'* which requires that unsecured creditors shall be treated equally. This means that unsecured creditors receive the distribution of any available assets and bear losses in proportion to the amount of their debts. This principle however, can be circumvented in certain circumstances.~~[85]

~~The~~ In addition, the liquidation duty, on the other hand, allows individual creditors to enforce directly against directors and shareholders. This may encourage a 'race to the courthouse' and bypass the '*pari passu*' principle of insolvency law, which requires that unsecured creditors shall be treated equally. ~~Since liability for breaching~~ This means that unsecured creditors receive the distribution of any available assets and bear losses in proportion to the amount of their debts.[86] Under the Anglo-American system, the '*pari passu*' principle is safeguarded by the insolvency administrator, who can bring claims to reverse pre-insolvency transactions such as the payment of one creditor ahead of others in the same category - 'preferential payments'. As discussed above, similar

[85] For an account of the *pari passu* principle see Lord Collins in *Belmont Park Investments v BNY Corporate Trustee Services Ltd* [2012] 1 AC 383. But for criticism of the fundamentality of the *pari passu* principle see Rizwaan Jameel Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60 Cambridge Law 581.

[86] This principle however, can be circumvented in certain circumstances. For an account of the *pari passu* principle see Lord Collins in *Belmont Park Investments v BNY Corporate Trustee Services Ltd* [2012] 1 AC 383. But for criticism of the fundamentality of the *pari passu* principle see Rizwaan Jameel Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60 Cambridge Law 581.

provisions on pre-insolvency transactions also exist in Chinese insolvency law but are less enforced than the liquidation duty.[87]

Based on the discussion above, the liquidation duty actually nullifies limited liability and separate legal personality, a and contravenes the equal treatment of creditors in the same class. A balanced consideration of the interests of shareholders and creditors requires that the liquidation duty should be used as a last resort by creditors after they cannot enforce their claims through insolvency law.

5. International comparisons - directors' duty to creditors in insolvency and wrongful trading

A. Creditor regarding duty of directors

It is a clearly established rule under Anglo-American law that directors must exercise the powers given by company law as fiduciaries for the company as a whole and not for any collateral purpose.[88] UK case law has established that the focus of directors' duty to the company shifts from shareholders as a whole to creditors in the vicinity of insolvency.[89] This to a certain extent also reflects the position in some states in the US

[87] See above note (26) and accompanying texts.

[88] *Re Smith & Fawcett Ltd* [1942] Ch 304 at 306; [1942] 1 All ER 542 at 543 and for relevant US case law see *Harff v Kerkonian*, 324 A.2d 215 (Del. Ch. 1974), rev'd in part on other grounds, 347 A.2d 133 (Del. 1975); *Aronson v Lewis,* 473 A.2d 805, 811 (Del. 1984); *Smith v Van Gorkom*, 488 A.2d 858, 875-73 (Del. 1985); *Revlon Inc. v MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986); *Katz v Oak Industries Inc.*, 508 A.2d 873 (Del. Ch. 1986); *Geyer v Ingersoll Publ'ns Co.*, 621 A.2d 784 (Del. Ch. 1992); *Re Amcast Indus. Corp.*, 365 B.R. 91 (Bankr. S.D. Ohio 2007).

[89] *West Mercia Safetywear v Dodd* [1988] BCC 30; *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187; *Yukong Lines Ltd of Korea v Rendsburg Investments Corpration of Liberia* (No 2) [1998] 4 All ER 82*;Stone & Rolls Ltd (in liq) v Moore Stephens* (a firm) [2009] 4 All ER 431; *Bilta (UK) Ltd (in liq) v Nazir* [2013] 1 All ER 375.

~~where~~ US. Most notably, the influential Delaware Court of Chancery has held that '[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers (i.e. the shareholders) but owes its duty to the corporate enterprise (i.e. primarily the creditors)'.[90]

The creditor regarding duty is justified on the ground that creditors will replace shareholders as the residual claimants of the company's value once the company becomes insolvent. Therefore, to constrain directors' incentive to take excessive risks, directors should be required to consider ~~the~~ creditor interests when the company is insolvent or approaching insolvency.[91]

In the UK, the relevant case law can be traced back to *West Mercia Safetywear v Dodd*,[92] where a director of a company authorised the payment of a debt owed to its parent company. The defendant was also a director of the parent company and both companies were insolvent. The payment has been used to discharge the debt owed by the parent company to the bank, which was guaranteed by the director. In addition to discouraging excessive risk taking, the *West Mercia* rule has also been regarded as a

[90] *Credit Lyonnais Bank Nederland, N.V. v Pathe Communications Corp*., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). For discussion see *Gregory V. Varollo* and Jesse A Finkelstein, 'Fiduciary Obligations of Directors of the Financially Troubled Company' (1992) 48 Business Lawyer; Jonathan C Lipson, 'Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' (2002) 50 UCLA Law Review; Cory Dean Kandestin, 'Duty to Creditors in Near-Insolvent Firms: Eliminating the Near-Insolvency Distinction' (2007) 60 Vanderbilt Law Review; J William Callison, 'Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities Is Incorrect as a Matter of Theory and Practice' (2006) 1 Journal of Business & Technology Law.

[91] Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 Modern Law Review 665.

[92] 8 (1988) 4 B.C .C. 30.

complement to the preference action[93] which prevents one creditor from receiving a payment in contravention of the *pari passu* rule.[94]

The duty is owed by directors indirectly to creditors as part of their fiduciary duty to act in the interests of the company and can only be enforced by the company (usually an insolvency practitioner on behalf of the company).[95] Professor Prentice has advanced three strong reasons for this position: 'it eliminates any problems of double recovery; it preserves the *pari passu* principle in insolvency law and thirdly, it maintains the procedural monopoly of liquidation proceedings for handling the claims of creditors against an insolvent company'.[96] This will require the liquidator when a company enters insolvency proceedings to undertake action to enforce the duties on behalf of the company as a whole. If the duties were direct, then every single creditor could claim for compensation from directors directly.

It is clear that the creditor regarding duty of directors is triggered when the company is insolvent.[97] When the companies are in the vicinity of insolvency, directors should monitor the company's position to ascertain whether the company will remain solvent

[93] IA 1986, section 239.

[94] For a development of this line of reasoning see Kristin van Zweiten, 'Director Liability in Insolvency and Its Vicinity' (2018) 38 OJLS 382.

[95] However, in the US corporate creditors have been permitted to bring derivative actions on behalf of the company. Andrew R Keay, *Company Directors' Responsibilities to Creditors*, (Routledge, 2007), 274.

[96] D.D. Prentice, 'Creditor's Interests and Director's Duties' (1990) 10 OJLS 265 at 276.

[97] For Instance, see *Re Pantone 485, Ltd* [2002] 1 BCLC 266 at 285.

after the contemplated action is carried out.[98] Nourse LJ also said in *Brady v Brady*[99] that 'where a company is even doubtfully solvent 'the interests of the company are in reality the interests of the existing creditors alone.'[100] Similar ideas are expressed in other leading cases[101] which confirm directors' duties to creditors where a company is in 'doubtful insolvency'. Nevertheless, the 'doubtful insolvency' trigger is far from being precise~~. The stage~~ . In a recent case, *BTI 2014 LLC v Sequana SA,* the Court of ~~doubtful solvency~~ Appeal states that the creditor regarding duty arises when the 'directors know or should know that the company is ~~far broader than insolvency and it would~~ or is likely to become insolvent'.[102] This at least confirmed that the directors' creditor-regarding duty under the common law could be ~~a very difficult to define what constitutes doubtful solvency~~triggered before the company falls into actual insolvency.

Section 172 UK Companies Act 2006 imposes on directors a statutory duty to consider the interests of creditors as part of the duty to promote the success of the company for the benefit of its shareholders (members) as a whole. There is explicit inclusion of various stakeholder including employees as internal stakeholders; creditors, suppliers and customers (as the primary external stakeholders), and local communities, environment and the media (as secondary external stakeholders). Section 172 is also

[98] Andrew R Keay, *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish 2007), p 206.

[99] [1988] 3 BCC 533.

[100] Ibid., at 552.

[101] *Nicholson v Permakraft (NZ) Ltd* [1985] 3 ACLC 453 at 459, 463, 464; *Re Hoursley & Weight Ltd* [1982] 1 Ch 442 at 455; *Geyer v Ingersoll Publications Co* 621 A 2d 784.

[102] [2019] EWCA Civ 112, at para 220 (see the statement by David Richards LJ).

stated to be ‘subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company’.

B. The wrongful trading remedy in the UK

Under the UK Insolvency Act 1986 when a company becomes insolvent, if directors act to the detriment of the company's creditors, they can also be held liable for malfeasance (s.212), fraudulent trading (s.213) and wrongful trading (s.214). Moreover, a person liable for wrongful trading, fraudulent trading and misfeasance can be the subject of a disqualification order of between 2 and 15 years at the discretion of the court.[103] To be specific, section 212 provides that if directors have misappropriated the company's assets for their own benefits (malfeasance), they can be ordered by the court to contribute to the company's assets as the court thinks just. Section 213 states that if in the course of a winding up or administration of a company, it appears that any business of the company has been carried on with the intent to defraud creditors, the liquidator or administrator can apply to the court to obtain a contribution from anyone who was knowingly party (not just directors) to the fraudulent business. As the intention to defraud creditors is difficult to establish, cases on fraudulent trading are rarely successful.[104]

[103] Under section 6 of the Company Directors Disqualification Act 1986 (CDDA 1986) (as amended by the Insolvency Act 2000), a director of an insolvent company can be disqualified by the court if his ~~conducts~~ conduct makes him unfit in the management of the company.

[104] *Re Patrick v Lyon Ltd* [1933] Ch 786; *Goldfarb v Higgins* [2010] EWHC 613 (Ch). See Keay (n 71), p 122.

The wrongful trading rule stated in s 214[105] provides that where directors knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation or administration, they should take 'every step with a view to minimising the potential loss to the company's creditors'. The result of failure to comply with this provision is a contribution set by the courts. Courts have wide discretion as to the amount of compensation, but the contribution is usually compensatory in the sense that the amount is the difference between the value of the assets of the company at the date of a hypothetical liquidation when the company should have ceased trading and their value at the actual date of liquidation.[106]

The Cork Committee on Insolvency Law, in proposing the wrongful trading provision, states that the provision is intended to 'strike a balance between encouraging the inception and growth of business and creating a climate in which downright irresponsibility is discouraged and those who abuse the privilege of limited liability can be made personally liable for the consequences of their conduct'.[107] Further, as directors of thinly-capitalised companies are liable to be caught by the wrongful trading provision, this provision will encourage directors to ensure the adequate capitalisation of a company thereby compensating for the absence of a paid-in minimum share capital

[105] IA 1986 s 214 (liquidation); s 246ZB (administration), introduced by the Small Business, Enterprise and Employment Act 2015. It should be noted that there is no statutory equivalent to the wrongful trading rule in the US Bankruptcy Code.

[106] *Re produce marketing consortium* [1989] (No 2) 5 BCC 569; *Brooks and another (Joint Liquidators of Robin Hood Centre plc in liquidation) v Armstrong and another* [2016] EWHC 2893.

[107] Insolvency Law Review Committee Chaired by Sir Kenneth Cork, *Insolvency Law and Practice: Report of the Review Committee (Cmnd 8558)* (London: HMSO 1982), at para 1805.

regime in the UK.[108]

The trigger of directors' duty under the wrongful trading provision is when there is no reasonable prospect of avoiding an insolvent liquidation, a point earlier than the onset of formal insolvency procedures. The insolvency procedure is only a condition of bringing actions for wrongful trading.[109] In a majority of reported cases, the UK courts have adopted a 'cash flow' test, instead of a 'balance sheet' test to determine whether there is no reasonable prospect of avoiding an insolvent liquidation.[110] The duty will only arise when the company cannot pay its debts as they fall due and the mere fact that the company's debts exceed its assets will not trigger the duty.[111] This is justified as many companies that are operating with large debts are still viable and directors are still incentivised to maximise the value of the company rather than gamble with it.

Moreover, even if directors cease trading immediately after they are aware that there is no reasonable prospect of the company avoiding insolvency liquidation, they still can be held liable if they fail to take necessary steps to reduce losses to creditors. Behaviour of this type includes failure to collect the company's debts, failure to preserve assets,

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[108] Ibid., at para 1785.

[109] Paul Davies, 'Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 European Business Organization Law Review 305.

[110] *Re Purpoint Ltd* [1991] B.C.C. 121; *Re Rod Gunner Organisation* [2004] B.C.L.C. 110. See also Thomas Bachner, 'Wrongful Trading before the English High Court' (2004) 5 European Business Organization L. Rev. 195; Peter O Mülbert, 'A Synthetic View of Different Concepts of Creditor Protection: A High Level Framework for Corporate Creditor Protection' (2006) 7 European Business Organization L. Rev. 357; C Gerner-Beuerle, P Paech and EP Schuster, 'Study on Directors' Duties and Liability' (2013) <http://eprints.lse.ac.uk/50438/> accessed 11 December 2018.

[111] Ibid.

excessive compensation to directors and causing the company to enter into undervalue transactions.[112] As the ultimate test for wrongful trading is whether directors have taken necessary steps to minimise losses to creditors, it is also possible for premature cessation of trading to incur liability.

C. Effectiveness of the wrongful trading provision

In theory, wrongful trading liability can incentivise directors to avoid taking excessive risks and incurring additional losses to creditors when the shareholders' equity is nearly depleted. In reality however, the application of the UK wrongful trading provision is problematic and remains controversial. Not many actions are brought and few cases are successful. Wrongful trading is significantly less used compared with other insolvency law provisions on directors' liability including malfeasance (s.212), undervalue transaction (s.238), and preferences (s.239). Wrongful trading is also cited infrequently in director disqualification cases.[113]

The low use of wrongful trading cases may be caused by an insolvency practitioner's lack of funds to bring such actions, especially when the company's assets are few. A possible solution to this problem is to give individual creditors a direct right of action but this solution may cause multiplicity of procedures, undermine the *pari passu*

[112] Kristin Van Zwieten Goode on *Principles of Corporate Insolvency Law* (5th edition, Sweet & Maxwell, 2018), p 768.

[113] Richard Williams, 'What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?' (2015) 78 Modern Law Review 55.

principle and create unfair distribution among creditors.[114] It is also questionable whether individual creditors are motivated to bring an action given uncertainties about the prospects of success and the amount of compensation held to be payable. English courts are usually wary of hindsight bias and unwilling to second-guess the business judgment of directors.[115]

It has been argued that wrongful trading should be triggered earlier than currently provided e.g. when directors know or ought to have known that a cash-flow insolvency is more probable than not.[116] This is consistent with the proposal made by the UK Company Law Review Steering Group that directors' duty to take measures to reduce losses to creditors should arise once there is a substantial probability of an insolvent liquidation.[117] However, even under the 'more probable than not' test, the trigger point for directors' duty to creditors may be too late and not provide enough incentive for directors to take early and preventive measures for the interests of creditors and other stakeholders.

Due to the low number of cases, the deterrent and compensatory effects of the wrongful

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[114] Bachner (n 100).

[115] Law Commission and Scottish Law Commission, *Company Directors : Regulating Conflicts of Interests and Formulating a Statement of Duties : A Joint Consultation Paper Paper*, (Stationery Office 1998), at para 15.30; Andrew Keay, 'Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective' (2005) 25 Legal Studies 431.

[116] Bachner (n 100).

[117] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy Final Report*, (Department of Trade and Industry 2001), at para 3.17.

trading provision are doubtful. It might be argued that the existence of the wrongful trading has already constrained directors' conducts but there is no real empirical evidence to support the assumption that wrongful trading constitutes a credible threat. Even after reforms to extend the power to bring wrongful trading actions to administrators and allow liquidator/administrator to assign causes of action,[118] it is unlikely that the use of wrongful trading will increase substantially.[119]

However, despite the criticism, the wrongful trading rule is regarded as indispensable by many jurisdictions. In 2002, the High Level Group of Company Law Experts, established by the European Commission, recommended that an EU wrongful trading rule should be introduced based on the UK model to promote the dual goals of protecting creditors and allowing directors' the choice to rescue the company or put it into liquidation.[120] Recently, Hong Kong and Singapore, two major financial centres, have made major reforms regarding wrongful trading. The Hong Kong government has announced that it is going to propose a bill in the Legislative Year 2018/2019 that will introduce corporate rescue procedure and insolvent trading provisions (equivalent to

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[118] Small Business, Enterprise and Employment Act 2015 (SBEE), ss 117–119.

[119] It has been argued the low use of wrongful trading might indicate that risk-taking behaviour, as suggested by Cork Report, are actually uncommon. Also, wrongful trading can overlap with other insolvency provisions such as ~~preference~~preferences. Therefore, eliminating the perceived constraints of the wrongful trading will not increase its usage - see Richard Williams, 'What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?' (2015) 78 Modern Law Review 55.

[120] J Winter, "Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe", (4 November 2002), available at http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf (accessed on April 30, 2013); Andrew Keay, 'The Shifting of Directors' Duties in the Vicinity of Insolvency' (2015) 24 International Insolvency Review 140.

UK wrongful trading).[121] In Singapore, the Insolvency, Restructuring and Dissolution Act 2018 contains a new wrongful trading provision. It discards the current requirement that civil liability only arises where there has been a criminal conviction.[122] These reform attempts have provided some evidence that the problem of excessive risk taking may be real and serious across the jurisdictions and it is necessary to design specific legal rules to address the problem.

D. Proposed new reform measures in the UK and EU

It is often difficult to recover assets from directors *ex post* and preventive measures that can facilitate restructuring may be better in increasing value for creditors when a company is in financial difficulty. The collapse of British Home Stores (BHS), one of the most high-profile corporate failures in the UK, is a case in point. In running the company into insolvency and transferring wealth from it, the company controllers arguably caused massive job losses and left a huge deficit in the pension funds.[123] The unethical practices in BHS have been criticised as 'the unacceptable face of

[121] 'Companies Registration and Insolvency Administration' (2018) <https://www.cr.gov.hk/en/publications/factsheets.htm> accessed 29 December 2018.

[122] Under s 230 Insolvency, Restructuring and Dissolution Act 2018, a company will 'trade wrongfully' if it incurs debt or liabilities, when insolvent (or becomes insolvent as a result of incurring such debt or liability), without reasonable prospect of meeting them in full. The provision is in fact much closer to the Australian wrongful trading provision than the English provision. On this see chapter 9 of the Report of the Insolvency Law Review Committee https://www.mlaw.gov.sg/content/dam/minlaw/ipto/assets/documents/Report%20of%20the%20Insolvency%20Law%20Review%20Committee.pdf

[123] Alastair Hudson, 'BHS and the Reform of Corporate Law' (2016) 37 Company Lawyer 364; Neshat Safari and Martin Gelter, 'British Home Stores Collapse: The Case for an Employee Derivative Claim' (2018) Journal of Corporate Law Studies 1.

capitalism'.[124] Currently, the liquidators of BHS are investigating whether directors have breached their fiduciary duties and might bring litigation in respect of undervalue transaction and wrongful trading. With hindsight, one could argue that a preventive restructuring framework that gives early warning to shareholders and directors and require them to reduce losses at an early stage might be more useful than insolvency-triggered provisions.

In response to high profile corporate failures such as BHS and Carillion, the UK government has announced major reform plans on restructuring and bankruptcy that aim at facilitating rescue for financially-distressed companies, improving transparency and strengthening directors' duties.[125] They have certain similarities with the reorganization chapter of the US Bankruptcy Code – Chapter 11 – and recent legislative reforms in Singapore.[126] In the EU, legislative measures to facilitate restructuring before the commencement of formal insolvency procedures have been ~~proposed~~ passed by the European Commission[127] in order to promote jobs and economic growth and to

[124] Paddy Ireland, 'From Lonrho to BHS: The Changing Character of Corporate Governance in Contemporary Capitalism' (2018) 29 King's Law Journal 3.

[125] See 'A Review of the Corporate Insolvency Framework' 25th May and 'Consultation on insolvency and corporate governance: government response' 26th August 2018 which are both available on https://www.gov.uk/government/consultations/a-review-of-the-corporate-insolvency-framework

[126] See the Singapore Insolvency, Restructuring and Dissolution Act 2018 which is expected to come into force some in 2019 and the reports of two committees, Insolvency Law Review Committee (2016) available at https://www.mlaw.gov.sg/content/dam/minlaw/ipto/assets/documents/Report%20of%20the%20Insolvency%20Law%20Review%20Committee.pdfand Committee to Strengthen Singapore as an International Centre for Debt Restructuring, 'Report of the Committee' (2016) available at https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Report of the Committee.pdf

[127] ~~COM~~Directive (~~2016)723 final 2016~~EU) 2019/~~0359 (COD). Political agreement was reached~~ 1023 of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the ~~text~~ efficiency of procedures concerning restructuring, insolvency and discharge of debt – OJ L

reduce significant barriers to the free flow of capital arising from divergent restructuring and insolvency law regimes in the EU Member States. At the present, there is no specific duty in most Member States that requires directors to take preventive actions.[128]

Although the new ~~proposal~~ Directive will not create a uniform EU-wide restructuring and insolvency regime, it will establish a minimum legal framework for preventive restructurings in all EU States that ensures restructurings are undertaken at an early stage and limits the role of the courts and administrative authorities. The ~~proposed~~ new regime has absorbed elements from both the English scheme of arrangement and the US Chapter 11.[129] In particular, Article ~~18 of the proposal~~ 19 requires Member States to impose specific duties on directors in the vicinity of insolvency and thereby incentivise directors to pursue early restructuring and preserve the value of the business.[130]

172/18 – and available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019L1023&from=EN

According to Article 34 of the ~~minimum harmonisation restructuring directive on 19th December 2018 but~~ Directive, EU Member States are obliged to implement the ~~necessary linguistic revisions have yet~~ provisions of the Directive in their domestic law by 17th July 2021 though they are also entitled to a one year extension to ~~be completed and the text published~~ this time frame if they encounter particular difficulties in ~~the Official Journal - see https://www.consilium.europa.eu/en/press/press-releases/2018/12/19/eu-agrees-new-rules-on-business-insolvency/~~implementation.

[128] In some Member States in the EU, represented by the UK, the duty of directors will shift when a company is near insolvency or is insolvent. In most EU countries, such as Germany, the nature of director's duty has not changed when the company is approaching insolvency, but the directors are usually obliged to file for insolvency. See Gerard McCormack, 'Corporate Restructuring Law-A Second Chance for Europe?' (2017) 42 European Law Review 532; 'Business restructuring law in Europe: making a fresh start' (2017) 17 Journal of Corporate Law Studies 167.

[129] N Tollenaar, 'The European Commission's Proposal for a Directive on Preventive Restructuring Proceedings' <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2978137> accessed 11 December 2018.

[130] ~~COM(2016)723 final 2016/0359 (COD).~~ The phrasing of Article ~~18~~ 19 is quite general and broad:

E. Comparative analysis of wrongful trading and the liquidation duty in China

The wrongful trading provision might be the closest analogy under the UK law to the liquidation duty under Chinese law. Both regimes can incentivise directors/controlling shareholders to address a company's financial difficulties in a timely fashion. If they fail to do so and cause losses to creditors, they will lose their limited liability protection and be held liable to creditors. As creditor protection paradigms shift from *ex ante* legal capital requirements,[131] ~~–~~wrongful trading liability and the liquidation duty can be meaningful *ex post* measures to safeguard creditor interests.

The rationales however, behind the liquidation duty and the wrongful trading provision are strikingly different. Wrongful trading is designed to alleviate the problem of

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'Member States shall ~~lay down rules to~~ ensure that, where there is a likelihood of insolvency, directors, ~~directors~~ have due regard, as a minimum, to the ~~following obligations:~~

following: (a~~)to take immediate steps to minimise~~) the ~~loss for~~ interests of creditors, ~~workers, shareholders~~ equity holders and other stakeholders~~;~~

; (b~~)to have due regard to~~) the ~~interests of creditors and other stakeholders;~~

~~(c)~~need to take ~~reasonable~~ steps to avoid insolvency~~;~~

; and (~~d)~~c) the need to avoid deliberate or grossly negligent conduct that threatens the viability of the ~~business~~business .'

[131] John Armour, 'Legal Capital: An Outdated Concept?' (2006) 7 European Business Organization Law Review 5; W Schön, 'The Future of Legal Capital' (2004) 5 European Business Organization Law Review 429; RA Booth, 'Capital Requirements in United States Corporation Law' [2005] Villanova University Legal Working Paper Series 102; Wen and Zhao (n 7).

excessive risk taking when the company is approaching insolvency. By way of contrast, the liquidation duty is intended to force directors/shareholders to put the company into the formal liquidation procedure and thereby constrain the widespread debt evasion problem in China. It has not specifically contemplated the problem of excessive risk taking in a financial distress scenario.

The liquidation duty and wrongful trading have a very different scope of application and the analogy breaks down however when it comes to solvent liquidation. Wrongful trading is confined to formal insolvency procedures while the liquidation duty also applies to liquidation caused by reasons other than insolvency and is enforced outside of the formal insolvency. For example, the UK wrongful trading will not catch deregistering the company without liquidation, while this is explicitly prohibited under the liquidation duty. The liquidation duty will not prevent directors from liquidating the company prematurely and causing losses to creditors but this may be subject to the UK wrongful trading provision. .[132]

There are other differences. Individual creditors have standing to sue shareholders/directors for breach of the liquidation duty and compensation will go to the claimant if the action is successful. In contrast, under wrongful trading, the insolvency practitioner will enforce the claim; compensation will accrue to the debtor's

[132] Kristin Van Zwieten Goode on *Principles of Corporate Insolvency Law* (5th edition, Sweet & Maxwell, 2018), p 768.

estate and is available for creditors as a whole.

F. Potential introduction of a wrongful trading remedy and other reforms in China

We have seen that the liquidation duty and the wrongful trading provision have different functions and there is actually no equivalent provision to wrongful trading in China. This raises the question whether something like a wrongful trading remedy that contains an obligation to file for formal insolvency proceedings and further restructuring measures should be introduced in China. To consider the feasibility of the transplantation, we should first recall the fact that although the liquidation duty is relatively effective in addressing the debt evasion problem, it can create unfair results for minority shareholders and creditors who fail to raise the claim before others. Compared with the liquidation duty action, an efficient formal insolvency law can apportion liability and compensation in a fairer and more equitable manner.

In addition, dramatic changes have taken place ~~upon the~~ in relation tothe business environment in China since the liquidation duty was first developed and in the current context, it can no longer fully serve the purpose of creditor protection. Since China's accession to the WTO, it has become a major destination for foreign direct investment[133] and an increasing number of Chinese companies turn to the offshore bond market to raise funds from overseas creditors.[134] The lack of a well-functioning

[133] Li Weida, 'China the Largest Recipient of FDI in H1, Says Report' (2018) <https://gbtimes.com/china-the-largest-recipient-of-fdi-in-h1-says-report> accessed 29 December 2018.

[134] Han Jingyan, 'Rise in Offshore Bond Issuance May Continue' (*Chinadaily*, 2018) <http://www.chinadaily.com.cn/a/201803/05/WS5a9ca7a2a3106e7dcc13f8d7.html> accessed 29

formal insolvency regime has increased risks for international investors[135] and may discourage foreign investment and push the price of capital up for Chinese companies.

In order to improve the use of the formal insolvency procedure in China, it might be necessary to impose a duty on directors and controlling shareholders to file for insolvency. The effectiveness of such a duty however, are complicated by government intervention and other factors impeding the use of formal insolvency procedures in China. If a duty to file for insolvency is introduced into China, it needs to provide certainty on issues such as when the liability will arise, how to calculate compensation and the defences available to directors and controlling shareholders. Although one would sacrifice the benefit of flexibility, a provision that leaves too much discretion to the courts may be unrealistic and problematic in the Chinese context.

Measures to promote early stage restructuring should also be considered. The lessons for China from recent international reforms is that when the company is approaching insolvency, directors and controlling shareholders should have the duty to take early actions to reduce losses and to initiate out-of-court restructuring before formal insolvency proceedings become necessary. There is a need to avoid premature liquidation, to rescue viable businesses and to protect the interests of creditors, employees and other stakeholders. Under the current law, even if the company enters

December 2018.

[135] Rebecca Parry and Nan Gao, 'The Future Direction of China's Cross-Border Insolvency Laws, Related Issues and Potential Problems' (2018) 27 International Insolvency Review 5.

into reorganisation, which is one of the formal insolvency procedures in China, the whole process may be time-consuming and costly.[136]

To achieve a balance between timely resolution and rescuing viable businesses, a preventive restructuring framework that promotes early, out-of-court restructurings needs to be established in China. ~~When the company becomes financially distressed and before the duty to file for insolvency arises, directors and controlling shareholders should have the duty to inform creditors about the financial conditions of the company with a view to facilitating early negotiations.~~ In the EU, it has been found that countries where restructuring is most common, recovery rates are higher. [137] Preventive restructuring can promote economic growth and employment, reduce losses to creditors and other stakeholders, and address the bad loans in the banking system.[138]

A preventive restructuring framework can also provide a forum for employees to be involved in the early negotiations. Although Chinese company law does not contain a provision that requires directors to consider the interests of employees, employee welfare and social stability is an important social policy in China.[139] Employees also

[136] Zinian Zhang and Roman Tomasic, 'Corporate Reorganization Reform in China: Findings from an Empirical Study in Zhejiang' (2016) 11 Asian Journal of Comparative Law 55.

[137] See COM(2016)723 final 2016/0359 (COD), Explanatory Memorandum.

[138] ~~See COM(2016)723 final 2016/0359~~ For a discussion on the effects of corporate rescue in the EU context, see McCormack (~~COD~~n 125)~~, Explanatory Memorandum~~.

[139] Social stability is also an important benchmark for local officials and the collapse of large companies ~~would~~ could cause social instability. The central government has reiterated that political stability is essential for the economy and made it an essential assessment criterion for local officials. See Yanling He and Guanglong Wang, 'Order in Chaos: Re-Understand Social Instability in China' (2016) 1 Journal of Chinese Governance 228.

have preferential claims under the EBL.[140] In practice, local governments usually intervene in the insolvency process for fear of large-scale unemployment and social instability.[141] A preventive framework that can facilitate communication and cooperation among all parties including shareholders (State as well as non-State shareholders), creditors, employees and the local government can greatly enhance the possibility of rescuing the business and an orderly resolution if the restructuring fails.

If China does not make necessary reforms to enhance fairness and efficiency in resolving corporate insolvency, it is possible that large Chinese conglomerates with international shareholders and creditors could be forced to resort to 'forum shopping' and choose jurisdictions that are more effective for resolving cross-border insolvency. With its flexible and advanced regime for corporate restructuring, Singapore might

[140] EBL 2006, article 113

[141] Bankruptcy of large enterprises has frequently led to the 'mass accidents' by laid-off workers, namely collective protests in the public arena. See He and Wang (n 127).

become a major destination for cross-border restructuring of Chinese conglomerates[142] though the large degree of State participation in such enterprises in China may militate against this prospect coming to pass. It is possible, however, for judgments and orders from Singapore courts to be recognised and enforced by Chinese courts. In *Kolmar Group v Jiangsu Textile Industry* (2016), the Nanjing Intermediate People's Court in Jiangsu recognised a Singapore judgment thereby reciprocating the enforcement of a Chinese court judgment by the Supreme Court of Singapore.[143]

Forum shopping in the context of cross-border insolvency may secure the benefits of more advantageous 'restructuring friendly' law. International creditors can choose advanced jurisdictions so as to avoid perceived uncertainty and unfairness in the legal procedures of the debtor's home country. But forum shopping can be used to protect the interests of the directors and controlling shareholders or to benefit certain groups of

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[142] Promoting flexible restructuring is a focus of reform in Singapore. In 2017, Singapore enacted a new law with the aspiration to become an international restructuring centre and "a natural choice for business undergoing cross-border debt restructurings in the Asia Pacific region". The Act has not only adopted the UNCITRAL Model Law on Cross Border Insolvency but also established a restructuring regime that combines the advantages of the English scheme of arrangement and the US Chapter 11. Foreign debtors now can seek to restructure under the Singaporean scheme of arrangement through re-domiciliation in addition to relying on the "substantial connection test". On the reforms see Report of the Committee to Strengthen Singapore as an International Centre for Debt Restructuring (2016) - https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Report of the Committee.pdf; Gerard McCormack and Wan Wai Yee, 'Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges' (2019) Journal of Corporate Law ~~Studies~~Studies 69-104.

[143] Ibid.

creditors at the cost of involuntary or non-adjusting creditors.[144] The insolvency of a large company may have disastrous effects on the community where it operates, and if its insolvency resolution is conducted in a foreign jurisdiction, major stakeholders such as employees and trade creditors may, in practice, be excluded from participating in the insolvency proceedings.

To sum up, although the liquidation duty can serve as an expedient means to constrain debt evasion, China should make further reforms to strengthen its insolvency and restructuring law and keep pace with the international developments. This is particularly important for the ongoing government efforts to deleverage the corporate sector, reduce non-performing loans in the financial system and resolve zombie companies.[145]

VI. Conclusion

For many years, China has been importing legal rules from developed jurisdictions with mixed results. On the one hand, the use of legal transplants have saved time and resources in addressing problems that arise as China is transitioning from a planned economy to a market based economy. On the other hand, some imported legal rules are

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[144] Horst Eidenmüller, 'Abuse of Law in the Context of European Insolvency Law' (2009) 6 European Company and Financial Law Review 1 .

[145] European chamber, 'Overcapacity in China: An Impediment to the Party's Reform Agenda' <http://static1.squarespace.com/static/5537b2fbe4b0e49a1e30c01c/t/56cc3017cf80a1fc057c84e4/1456222242257/Overcapacity_in_China_An_Impedim.pdf>.

ineffective and underused, as they do not fit well with the local economic and political conditions. Directors' duties might be a case in point and there are no comparable rules under Chinese law to impose creditor-regarding duties on directors when the company is in the vicinity of insolvency. Chinese corporate law has however, provided an alternative solution in the form of the liquidation duty and this duty has been mainly shaped by the SPC.

This paper has argued that the liquidation duty, as an internally developed rule, is relatively effective in deterring debt evasion and compensating creditors. It provides creditors with a private enforcement mechanism to fill the gaps of public regulation brought about by deregulatory efforts. The analysis on the liquidation duty has led us to the conclusion that a country such as China might develop functional rules that are embedded in its legal, economic and political institutions and that are products of its own history. The divergence from the 'developed' model of corporate governance does not mean that there are no rules to address relevant problems.

Nevertheless, the analysis shows that the liquidation duty may undermine the value of the formal insolvency law and lead to unfairness and inefficiency. Also, as China is further integrated into the global economy and corporate insolvency becomes a transnational matter, it is important for China to keep pace with the international developments and improve the business environment for international investors. This paper proposes that insolvency filing duties and rules for preventive restructuring

should be introduced into the current framework though we have also stressed the necessity for careful drafting. The future for creditor protection in China lies in an effective and efficient formal insolvency law and a flexible framework for out-of-court restructuring.

~~In a word~~To emphasise, this paper advocates ~~for~~ a pragmatic and contextual approach to legal reform. It suggests that the important question in comparative legal study is not whether certain laws are being transplanted and are converging towards the same model, it is whether laws are compatible with unique social and political conditions of a country. For countries with emerging economics, a hybrid corporate governance model with double agency problems,[146] and constantly changing external conditions, it is important for the law to continue to evolve and adapt. After all, the message from Darwin's *Origin of Species* is that it is not the strongest species survives but the one that is able best to adapt and adjust to the changing environment.[147]

[146] Double agency problems refer to conflicts between boards of directors and shareholders and conflicts between controlling and minority shareholders while the latter kind of problem can well involve ~~state~~ State and government agencies. See Zhao and Keay (n 7).

[147] Leon C Megginson, 'Lessons from Europe for American Business' (1963) 44 Southwestern Social Science Quarterly 3.