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**Article:**

Chen, D. and Deakin, S. (2025) The birth of insolvency in China: judicial innovation during the Wenzhou curb crisis. *Journal of Corporate Law Studies*. ISSN 1473-5970

<https://doi.org/10.1080/14735970.2025.2458360>

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**To cite this article:** Ding Chen & Simon Deakin (21 Mar 2025): The birth of insolvency in China: judicial innovation during the Wenzhou curb crisis, Journal of Corporate Law Studies, DOI: [10.1080/14735970.2025.2458360](https://doi.org/10.1080/14735970.2025.2458360)

**To link to this article:** <https://doi.org/10.1080/14735970.2025.2458360>



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# The birth of insolvency in China: judicial innovation during the Wenzhou curb crisis

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## ABSTRACT

In this article, through a case study focusing on the evolution of China's insolvency law, we test the 'transplant effect' hypothesis, in particular the claim that transplanted laws can only work when there is local or 'endogenous' demand for them in the 'host' or 'receiving' state. We also test claims made for a 'co-evolutionary' understanding of the law-economy relationship in the context of China's development. In addition to documentary sources, this article draws on interviews we carried out in Wenzhou in September 2017 and December 2018. Our study shows that aspects of the transplant and coevolution hypotheses are in need of some modification if they are to explain China's legal and economic development. It also suggests that formal rules can be operationalised at the level of practice once they are seen as legitimate. While this is a process which takes time, a period of crisis provides opportunities for the learning process around the use of formal rules and procedures to be accelerated.

**ARTICLE HISTORY** Received 1 October 2024; Accepted 21 January 2025

**KEYWORDS** Law and economic growth; transplant effect; co-evolution; Wenzhou curb crisis; China's insolvency law; judicial innovation

## 1. Introduction

Over the past four decades, law has come to be at the centre of development discourse and practice. The idea that the role of the legal system in protecting property rights and enforcing contracts is crucial for economic growth has become a core dogma of development theory.<sup>1</sup> As a result,

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<sup>1</sup>D North and R Thomas, *The Rise of the Western World: A New Economic History* (Cambridge University Press 1973); D North, *Institutions, Institutional Change, and Economic Performance* (Cambridge University Press 1990).

international institutions and aid agencies have sponsored tens of thousands law reform projects in developing or transition economies since the 1990s.<sup>2</sup> However, many of the laws and legal practices that were transplanted or adopted through law reform projects did not operate successfully in host countries, repeatedly failing to deliver their anticipated outcome:<sup>3</sup> the 'transplant effect', that is, the mismatch between preexisting conditions and institutions and transplanted law'.<sup>4</sup> In their seminal article, Berkowitz et al. argued that for transplanted law to be effective, a prior demand for law had to exist if 'the law on the books' were to be actually used in practice, and that the legal intermediaries responsible for developing the law would need to be responsive to this demand.<sup>5</sup> Despite the importance of this observation, empirical studies of transplants are rare, and relatively little is known about the circumstances in which they can be effective. In this article, we take up the challenge through a case study focusing on the evolution of China's insolvency law.

Insolvency law is widely believed to play an important role in financial development and therefore in economic growth. However, this paradigm does not seem to be consistent with China's development trajectory. China has passed two insolvency laws since 1986, but neither appears to be well received in practice. Until recently, the relevance of insolvency law to China's private sector, the driving force of its economy, was practically negligible. Regardless of this, China's economy has achieved a remarkable growth rate over the past four decades and has lifted millions of people out of poverty. Since 2013, however, the usage of China's insolvency law in the private sector started to rise sharply. This change began in the city of Wenzhou, a location with a

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<sup>2</sup>By 2002, the World Bank alone has supported nearly 330 'rule of law' projects dealing with legal and judicial reform in over 100 countries. Legal Vice Presidency, The World Bank, *Legal and Judicial Reform Observations, Experiences, and Approach of the Legal Vice Presidency* (IBRD 2002) 14 <[www4.worldbank.org/legal/publications/ljobservations-final.pdf](http://www4.worldbank.org/legal/publications/ljobservations-final.pdf)>.

<sup>3</sup>See O Chukwumerije, 'Rhetoric Versus Reality: The Link Between the Rule of Law and Economic Development' (2009) 23 *Emory International Law Review* 383.

<sup>4</sup>D Berkowitz, K Pistor and J Richard, 'The Transplant Effect' (2003) 51 *American Journal of Comparative Law* 163, at 171. The literature on legal transplants is often associated with Alan Watson, who introduced the concept and claimed that legal rules can be transferred with relative ease and integrated into different legal systems without significant challenges. He explains the 'transplant bias' observed in Western legal systems is due to the nature of the legal profession itself. See A Watson, *Legal Transplants: An Approach to Comparative Law* (2nd edn, University of Georgia Press 1993), first published in 1974.

At the other extreme, Pierre Legrand, a comparative legal sociologist, has consistently argued that legal transplants are inherently impossible. His position builds on epistemological principles and anthropological theory, asserting that law cannot be separated from its cultural and societal context. See P Legrand, 'The Impossibility of Legal Transplants' (1997) 4 *Maastricht Journal of European and Comparative Law* 111.

Between these perspectives, Otto Kahn-Freund offers a more nuanced view. He contends that not all legal rules or institutions are equally transplantable, suggesting a continuum of transferability. His analogy ranges from 'organ transplants' – which require careful integration to function effectively within a new system – to 'mechanical transplants', which can operate independently of cultural and contextual factors. See O Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37(1) *The Modern Law Review* 1.

<sup>5</sup>Berkowitz, Pistor and Richard (n 4).

long history of commercial and mercantile activity and more recently core to the revival of China's private economy. The Wenzhou case provides us with an opportunity to closely study the process of legal transplantation and to test specific aspects of the transplant effect hypothesis, in particular the claim that transplanted laws can only work when there is local or 'endogenous' demand for them in the 'host' or 'receiving' state.

We also test claims made for a 'co-evolutionary' understanding of the law-economy relationship in the context of China's development.<sup>6</sup> This theoretical framing suggests that the rule of law state and market-based exchange are complementary institutions, with the evolution of one providing the context for the development of the other. Transplants are likely to work well when they respond to, and catalyse further changes in, the underlying social and economic conditions of the host state. An emphasis on evolution can be read as implying an incremental and mutual embedding of formal laws and informal institutions, a process which cannot be expected to happen overnight.

In addition to documentary sources, this article draws on interviews we carried out in Wenzhou in September 2017 and December 2018. We were able to conduct extensive interviews with judges, officials and entrepreneurs, over the course of two visits to the city. The focus of the interviews was the period of the so-called curb crisis which the Wenzhou business system had experienced in 2011, and the period in the aftermath of the crisis, when insolvency law was being actively used to restructure the affected businesses. The unusual level of access we were able to achieve with judges in particular make these interviews a valuable resource, which we use here to expand the understanding of China's insolvency law beyond what can be achieved via a purely formal or doctrinal understanding of its operation.

Our study shows that aspects of the transplant and coevolution hypotheses are in need of some modification if they are to explain China's legal and economic development. The embedding of legal transplants is less a response to the demands of business actors, and more the result of proactive interventions on the part of judges and officials. Rather than incremental change, we see rapid evolution being triggered by financial crisis. The practice of insolvency law in China is no longer used as it once was, an instrument of state policy; it is increasingly concerned, as elsewhere, with identifying and protecting private rights and obligations. Chinese courts, perhaps to a greater extent than their western counterparts, operate in response to, and in conjunction with, other state agencies, including the executive branch. However, this close inter-agency cooperation is one reason for the courts' effectiveness. At the same time, judges and officials alike recognise that

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<sup>6</sup>D Chen and S Deakin, 'On Heaven's Lathe: Rule of Law, State, and Economic Development' (2015) 8 *Law and Development Review* 123.

the judicial branch has a distinct role in dispute resolution. Moreover, the growing influence of insolvency law is a function not so much of the enforcement powers available to Chinese courts, as of the willingness of the judges to build trust in the use of the legal system on the part of civil actors. As it is through the actions of the judicial branch that Chinese insolvency law has finally become more than a formality, we may with justification refer to the birth of insolvency in China as one of the unexpected outcomes of the Wenzhou crisis.

Our analysis is structured as follows: section 2 sets the scene by seeking to clarify the nature of the theoretical claims at stake; section 3 sets out our methodology; section 4 provides an overview of the Wenzhou curb crisis of 2012, drawing on archival and legal sources and on our interviews; section 5 makes more detailed use of the interviews to provide an account of the practical operation of insolvency law and procedures during and after the Wenzhou crisis; section 6 provides a concluding assessment of the evidence in the light of the article's theoretical framing, with specific reference to the transplant effect and coevolution hypotheses; and section 7 concludes.

## 2. Theoretical framing: the transplant effect and coevolution hypotheses

### 2.1. Contrasting views on formal and informal institutions

The existing literature is divided on the respective role of formal and informal institutions in economic growth. On one side, the institutional approach to development taken by North regards formal legal rules protecting property rights and enforcing contracts as a necessary prerequisite to a nation's economic development. In the absence of effective formal legal institutions, it is implied, sustained economic development is unlikely to occur.<sup>7</sup> Over the past three decades this view has been very much in vogue, and has been associated with the growing use of metrics purporting to measure the quality of legal rules and of the rule of law, including the World Bank's Rule of Law Index, a complex composite index built up from a wide range of data sources on the operation of legal institutions. The idea that the rule of law is essential to growth has been advanced in several high-profile and influential publications.<sup>8</sup>

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<sup>7</sup>North and Thomas (n 1); North (n 1).

<sup>8</sup>For an early discussion of this point see H de Soto, *The Other Path: The Invisible in the Third World* (Basic Books 1989); Max Weber, in E Shils and M Rheinstein (eds), *Max Weber on Law in Economy and Society* (Harvard University Press 1954). Other important contributions include North (n 1); R La Porta and others, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113; D Rodrik, S Arvind and T Francesco, 'Institutions Rule: The Primacy of Institutions over Geography and Integration in the Economic Development' (2004) 9 *Journal of Economic Growth* 4; K Dam, *The Law-Growth Nexus: The Rule of Law and Economic Development* (Brookings Institution 2006).

The need for formal legal institutions to support economic growth has, however, been downplayed by an alternative school of thought, which emphasises the importance of informal norms. Stewart Macaulay's seminal article of 1963 emphasised the role of repeat trading, reputation and inter-personal trust, element of business relations he referred to as 'non-contractual', in engendering contractual co-operation. Formal institutions of contract law, such as written agreements and court-based sanctions, seemed to play a marginal role at best in shaping the strategies and behaviour of the managers Macaulay interviewed.<sup>9</sup> An extensive literature on relational contracts following Macaulay argues similarly that long-term dealing and the existence of communal and/or personal ties between contracting parties may be more effective in building trust than reliance on court-based sanctions.<sup>10</sup> The relative rigidity of the formal law and its tendency to lag behind economic and technological developments, leading to avoidance strategies, means that even in developed economies such as the USA, contracting between business parties generally takes place in isolation from the court system, which deals with a tiny fraction of all commercial disputes.<sup>11</sup>

Franklin Allen, Jun Chan and Chenying Zhang offered a further challenge to the rule of law paradigm.<sup>12</sup> On the basis of empirical studies of Asian systems, they argue that the rule of law is not merely unnecessary, but a potential barrier to development. They characterise the legal system as a monopoly which can be captured by private interest groups. The fixed costs of revising the law and modifying legal institutions become highly problematic in emerging markets which may lack effective state capacity but also have the potential for rapid growth, rendering laws out of date. As a result, businesses tend to sidestep the law, relying on reputation, relational contracting and inter-personal trust to support economic and financial transactions, in preference to state-backed legal enforcement through the courts.

However, the contrast between formal and informal institutions in these critiques of the rule of law orthodoxy may be somewhat overdrawn. A

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<sup>9</sup>S Macaulay, 'Non-Contractual Relationships in Business: A Preliminary Study' (1963) 28 *American Sociological Review* 55.

<sup>10</sup>See in particular J Landa, 'A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law' (1981) 10 *Journal Legal Studies* 349, and *Trust, Ethnicity, and Identity: Beyond the New Institutional Economics of Ethnic Trading Networks, Contract Law, and Gift-Exchange* (University of Michigan Press 1994); L Bernstein, 'Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry' (1992) 21 *Journal of Legal Studies* 115; 'Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms' (1996) 144 *University of Pennsylvania Law Review* 1765, and 'Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions' (2001) 99 *Michigan Law Review* 1724; A Greif, 'Contract Enforceability and Economic Institutions in Early Trade: the Maghribi Traders Coalition' (1993) 83 *American Economic Review* 525; M Fafchamps, *Market Institutions in Sub-Saharan Africa, Theory and Evidence* (MIT Press 2004).

<sup>11</sup>H Collins, *Regulating Contracts* (Oxford University Press 1999).

<sup>12</sup>F Allen, J Qian and C Zhang, 'An Alternative View on Law, Finance, Institutions and Growth' (2011) Working Paper 11-64, University of Pennsylvania, Wharton School, Weiss Center <[repository.upenn.edu/fnce\\_papers/14](http://repository.upenn.edu/fnce_papers/14)>.

minoritarian but still significant strand in the empirical literature on contracting suggests while informal institutions may provide a foundation for interpersonal, formal laws, where they enjoy legitimacy and effectiveness, constitute important trust-assurance mechanisms in situations of impersonal exchange.<sup>13</sup> In a similar vein, there is evidence to suggest that the absence of formal legal mechanisms limits the availability of external finance for firms in emerging markets, in circumstances where overseas investors and other non-insiders are unable to access local reputational resources for generating trust.<sup>14</sup>

A distinction may then be drawn between 'private ordering in the shadow of the law', that is, alternative forms of contracting which operate in the presence of the rule of law, and 'private ordering under a dysfunctional public order', that is, forms which operate in the absence of a neutral and effective mechanism for contract enforcement. In developed countries where courts are used as a last resort and business contracting takes place largely autonomously from the legal system, the law still operates as a 'back-stop' in a way which affects contractual strategies.<sup>15</sup> In emerging markets which lack fully effective legal ordering, the costs of using alternative mechanisms of contract enforcement based on interpersonal trust may become a dragon growth as the economy develops. This implies a sequencing approach to building legal institutions: a given mix of public and private enforcement may work well at early stages of development but may not be sustainable over the longer term.<sup>16</sup>

In this co-evolutionary understanding of law and economy relations, formal law can be understood as both cause and effect of sustainable economic development.<sup>17</sup> According to this framework, formal legal institutions meet needs arising in the context of an economy which is moving from interpersonal trust within small-scale exchange to large-scale, impersonal transacting. In this approach, legal institutions are endogenous to the economic growth path of a particular country. It follows that they are unlikely to be functional in the absence of certain social and commercial practices to which public enforcement is complementary. For successful transplants of formal institutions to occur, therefore, a certain pre-existing level of economic development is needed. Once functioning legal mechanisms are in place,

<sup>13</sup>A Arrighetti, R Bachmann and S Deakin, 'Contract Law, Social Norms and Inter-Firm Cooperation' (1997) 21 *Cambridge Journal of Economics* 171.

<sup>14</sup>R Rajan and L Zingales, 'Which Capitalism? Lessons from the East Asian Crisis' (1998) 11 *Journal of Applied Corporate Finance* 40; R Cooter and H-B Schäfer, *Solomon's Knot: How Law Can End the Poverty of Nations* (Princeton University Press 2011).

<sup>15</sup>J McMillan and C Woodruff, 'Private Order under Dysfunctional Public Order' (2000) 98 *Michigan Law Review* 2421; D Chen, *Corporate Governance, Enforcement and Financial Development: The Chinese Experience* (Edward Elgar 2013a); D Chen, 'Developing a Stock Market Without Institutions – the China Puzzle' (2013) 13 *Journal of Corporate Law Studies* 151.

<sup>16</sup>Chen, 'Developing a Stock Market' (n 15).

<sup>17</sup>Chen and Deakin, 'On Heaven's Lathe' (n 6).



however, they have the potential to foster further growth. Thus, the relationship between legal institutions and economic growth is one of incremental coevolution.<sup>18</sup>

## 2.2. *Insolvency law and economic growth*

Since the mid-1990s, a large body of quantitative empirical research has accumulated on the role of formal legal institutions in promoting growth.<sup>19</sup> Many of these studies make the claims that legal protection of investor rights is a prerequisite for the growth of capital markets and that legal protection for creditors is essential for the growth of credit markets.<sup>20</sup> Studies claim that improvements in insolvency law have a positive impact on debtors and creditors, and that they contribute to economic development in the following aspects.

Three main claims are identified. The first is that insolvency law lowers the cost of credit by providing lenders with greater assurance that the debts of failed businesses will be recovered. Consistently with this claim, there is evidence that pro-creditor reforms in several countries have led to overall reductions in the costs of debt recovery and to an increase in the availability of credit.<sup>21</sup> A second effect operates at macro level: as inefficient businesses are closed and viable ones rescued through the operation of insolvency law, the wider economy benefits.<sup>22</sup> A third effect is to promote enabling entrepreneurship. 'Forgiving' personal bankruptcy laws can stimulate entry by 'latent' entrepreneurs who would otherwise be too risk-averse to start their own business.<sup>23</sup> As shown by a number of studies, there are more entrepreneurs in US states with higher asset exemptions.<sup>24</sup> For these various reasons, a

<sup>18</sup> *ibid.*

<sup>19</sup> R La Porta and others (n 8) 1113–55; R King and R Levine, 'Finance and Growth: Schumpeter Might Be Right' (1998) 108 *Quarterly Journal of Economics* 717; R La Porta, F Lopez-de-Silanes and A Shleifer, 'The Economic Consequences of Legal Origins' (2008) 46 *Journal of Economic Literature* 285.

<sup>20</sup> S Djankov and others, 'The Law and Economics of Self-Dealing' (2008) 88 *Journal of Financial Economics* 430; S Djankov and others, 'Debt Enforcement Around the World' (2008) 116 (18) *Journal of Political Economy* 1105; S Djankov, C McLiesh and A Shleifer 'Private Credit in 129 Countries' (2007) 84 *Journal of Financial Economics* 299.

<sup>21</sup> B Funchal, 'The Effects of the 2005 Bankruptcy Reform in Brazil' (2008) 101 *Economics Letters* 84; G Rodano, N Serrano-Velarde and E Tarantino, 'The Causal Effect of Bankruptcy Law on the Cost of Finance' (2012) Oxford University Centre for Business Taxation Working Paper 12/18; S Davydenko and J Franks, 'Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK' (2008) 63 *Journal of Finance* 565; K Bae and V Goyal, 'Creditor Rights Enforcement and Bank Loans' (2009) 64 *Journal of Finance* 823; L Klapper, 'Saving Viable Businesses' (2011) World Bank Viewpoint 328.

<sup>22</sup> J Aron, 'Growth and Institutions: A Review of the Evidence' (2000) 15 *World Bank Research Observer* 99; Y Lim and C Hahn, 'Bankruptcy Policy Reform and Total Factor Productivity Dynamics in Korea: Evidence from Macro Data' (2003) NBER Working Paper 9810; X Giné and I Love, 'Do Reorganization Costs Matter for Efficiency? Evidence from a Bankruptcy Reform in Colombia' (2010) 53(4) *The Journal of Law & Economics* 833; J Armour and D Cumming, 'Bankruptcy Law and Entrepreneurship' (2008) 10 *American Law and Economics Review* 303.

<sup>23</sup> Armour and Cumming (n 22).

<sup>24</sup> W Fan and MJ White, 'Personal Bankruptcy and the Level of Entrepreneurial Activity' (2003) 46(2) *The Journal of Law & Economics* 543.

formal corporate bankruptcy or insolvency law can be expected to play a positive role in promoting growth.

### 2.3. *The evolution of China's insolvency laws*

The concept of bankruptcy or insolvency as a means to discharge a debt is relatively new to China. Traditionally, it was believed that debts always had to be repaid, and children inherited those of their parents.<sup>25</sup> Bankruptcy laws<sup>26</sup> based on various overseas models were enacted by Chinese governments in the early twentieth century but appear to have been ignored or ineffective in practice.<sup>27</sup> The last of these, the Bankruptcy Law of 1935, was repealed along with other legislation of the Kuomintang era when the Chinese Communist Party (CCP) came to power in 1949. In the command economy which developed under Communist rule, bankruptcy laws were not needed: the state owned the means of production in their entirety, with the result that individual enterprises were essentially branches of government, operating under the auspices of state budgets.

From the late 1970s, as China began to abandon Soviet-style central planning, the issue of bankruptcy re-emerged. Under the new commercial logic, a significant segment of state-owned enterprises were found to be running at a loss.<sup>28</sup> The Law of State Enterprise Bankruptcy of 1986 (EBL 1986) was enacted to address this issue, with a later measure, Chapter 19 of the Civil Procedure Law of 1991 (CPL 1991), applying to non-SOEs. Both these laws suffered from broad and over-simplistic drafting and an absence of rules of procedure of the kind needed to put them into practice.<sup>29</sup> As a result, the law at this point was regarded as little more than a statement of policy.

<sup>25</sup>N Mrockova, *Corporate Bankruptcy Law in China: Principles, Limitations and Options for Reform* (Hart 2021) 7, citing J An and G Wu, *A Practical Text on Enterprise Bankruptcy Law* (2006) 1, cited in J Chen, *Chinese Law: Context and Transformation* (Martinus Nijhoff 2008) 537.

<sup>26</sup>In the Chinese context, the term 'bankruptcy' tends to be used, both in the Mandarin Chinese language in English translation, to refer to both corporate bankruptcy or insolvency and to personal bankruptcy, following US practice. See Mrockova, *Corporate Bankruptcy Law* (n 25). In what follows our discussion refers to corporate bankruptcy or insolvency and not to personal bankruptcy, unless the latter is specifically indicated.

<sup>27</sup>Mrockova (n 25) 67; T Mitrano, *The Chinese Bankruptcy Law of 1906–1907: A Legislative Case History* (1973) 259.

<sup>28</sup>The World Bank estimated that more than 40% of the 302,000 non-financial SOEs were bankrupt in the mid-1990s. S Tenev and C Zhang, 'Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets' World Bank and International Financial Corporation (2000) 29–30 <[www2.ifc.org/publications/pubs/corp\\_gov/China-Corp-Cov.pdf](http://www2.ifc.org/publications/pubs/corp_gov/China-Corp-Cov.pdf)>.

<sup>29</sup>S Li, 'Bankruptcy Law in China: Lessons of the Past Twelve Years' (2006) 3 *Harvard Asia Quarterly* 1; J Shi, 'Twelve Years to Sharpen One Sword: The 2006 Enterprises Bankruptcy Law and China's Transition to a Market Economy' (2007) 16(5) *Norton Journal of Bankruptcy Law and Practice*; R Tomasic and M Wang, 'The Long March towards China's New Bankruptcy Law' in R Tomasic (ed), *Insolvency Law in East Asia* (Ashgate Publishing Limited 2006) 93–124.

The Enterprise Bankruptcy Law of 2006 (EBL 1986), which came into force in 2007,<sup>30</sup> marked a major change. This law is both extensive and detailed and is supplemented by Supreme Court interpretations.<sup>31</sup> It draws on aspects of US, English and German insolvency laws, recommendations of the WTO and IMF, and the UNCITRAL Legislative Guide on Insolvency Law. Its enactment was enthusiastically received, being described as a 'landmark in the legislative history of China'<sup>32</sup> and 'a watershed moment for Chinese capital markets'.<sup>33</sup> However, take up of the new law was initially very limited, continuing earlier trends. Even with the introduction of the 2006 law, most insolvencies were 'policy-oriented bankruptcies' designed to assist the restructuring of state-owned enterprises (SOEs), in which 'the courts only played a rubber-stamp role'.<sup>34</sup>

The low usage rate of China's bankruptcy law prior to the 2010s apparently contradicts the 'law matters' thesis, since the absence of effective bankruptcy law did not appear to obstruct China's record economic growth. However, it is consistent with transplant effect and also with the co-evolutionary conception of the law-economy relation. Both these two theoretical positions argue that the formal legal system can only be functional if there is a demand for it. Demand for formal legal institutions can arise where an economy is moving from interpersonal trust within small-scale exchanges to large-scale, impersonal transacting, but before reaching this turning point, informal rather than formal institutions would be providing the underpinning for economic growth.

Notwithstanding the move away from the command economy which began over four decades ago, China's financial system is still dominated by state-owned banks (SOBs). SOBs have a strong preference for lending to SOEs. As a consequence, a large share of bank funding has gone to SOEs, leaving companies in the private sector relying heavily on informal finance.<sup>35</sup> In contrast to arm's length transactions using formal financing, informal financing is characterised by interpersonal transactions occurring among a small number of actors who know each other and deal on a

<sup>30</sup>For a more complete analysis of the EBL, see Mrockova (n 25) 72. Also see Z Zhang, 'Resolving Corporate Insolvencies in China: The Gap Between Law and Reality' (2020) 27 U. Miami Int'l & Comp. L. Rev. 370; X Zhang, 'Why Do People Apply for Bankruptcy Insolvency in China: Empirical Evidence and Policy Analysis' (2022) 22(1) Journal of Corporate Law Studies 431; S Lin, 'The Empirical Studies of China's Enterprise Bankruptcy Law: Problems and Improvements' (2018) 27(1) International Insolvency Review 77.

<sup>31</sup>SPC's Provisions (I) concerning the Application of the EBL 2011 ('Judicial Interpretation No. 1'); SPC's Provisions (II) concerning the Application of the EBL 2013 ('Judicial Interpretation No. 2').

<sup>32</sup>Tomasic and Wang (n 29).

<sup>33</sup>D Eaton and others, 'China's New Bankruptcy Law' (October 2006) <[www.kirkland.com/siteFiles/kirkexp/publications/2272/Document1/Chinas\\_New\\_Enterprise\\_Bankruptcy\\_Law.pdf](http://www.kirkland.com/siteFiles/kirkexp/publications/2272/Document1/Chinas_New_Enterprise_Bankruptcy_Law.pdf)>.

<sup>34</sup>C Wei, 'Bailouts and Bankruptcy Law in China: A Confusion of Law and Policy' (2017) 4 Cambridge Journal of China Studies at 56 <<https://doi.org/10.17863/CAM.21536>>. See also Li (n 29); Shi (n 29).

<sup>35</sup>K Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Cornell University Press 2002); F Allen, J Qian and M Qian, 'Law, Finance and Economic Growth in China' (2005) 77 Journal of Financial Economics 57; K Linton, 'Access to Capital in China: Competitive Conditions for Foreign and Domestic Firms' (2006) SSRN Working Paper; F Allen and others, 'China's Financial System: Opportunities and Challenges' in J Fan and R Morck (eds.) *Capitalizing China* (University of Chicago Press 2012) 63–148.

repeated basis. Personal knowledge about the capabilities and trustworthiness of the parties saves on the search, monitoring and verification costs associated with impersonal exchange in the formal or regulated sector.<sup>36</sup> The risk of being excluded from the group provides strong incentives for parties not to cheat.<sup>37</sup> Accordingly, in contrast with creditors in formal financing, who need a formal legal system to enforce their contracts, or collect and distribute assets in the case of bankruptcy, lenders in informal financing mainly rely on the reputation mechanism for protection. Where reputation breaks down, lenders may go to professional debt collectors for help. Physical violence and death threats were until recently among the means used by debt collectors, and in some context may remain so.<sup>38</sup> Thus a closer look at the Chinese context suggests that a focus on formal institutions alone is unlikely to be capturing all aspects of the way credit works in the economy.

### 3. Methodology

Evidence in favour of the claim that insolvency law promotes growth mostly consists of analyses of quantitative studies based on regression analyses which seek to infer causal relationships from statistical correlations. There are two problems with relying on exclusively on studies of this type to assess the economic benefits of insolvency laws. The first is that quantitative measures of the strength or weakness of insolvency laws may not be very good at capturing informal norms and practices which lie beyond the scope of formal legal rules.<sup>39</sup> The second is that despite the efforts devoted to distinguishing between correlation and causation, culminating in the recent ‘credibility revolution’ in econometrics,<sup>40</sup> there continues to be an active debate across the data sciences about the legitimacy of drawing causal inferences from regression analysis.<sup>41</sup> This has been a long-standing problem in the literature on law and development, given the high likelihood that legal rules respond to their economic context, rather than simply

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<sup>36</sup>L Guiso, P Sapienza and L Zingales, ‘The Role of Social Capital in Financial Development’ (2004) 95 *American Economic Review* 526; A Madestem, ‘Informal Finance: A Theory of Moneylenders’ (2014) 107 *Journal of Development Economics* 157; C Guiringer, ‘Understanding the Coexistence of Formal and Informal Credit Markets in Piura, Peru’ (2008) 36 *World Development* 1436.

<sup>37</sup>Greif (n 10).

<sup>38</sup>According to one of our interviewees, within the informal system ‘most contracts were just performed; where there was default, the parties didn’t use the courts, they would seek to resolve by other means such as debt collectors and even organised crime using violence ... this type of collection is pretty common because it is effective’. Interview IFC.23, Lawyer, interviewed in Shenzhen, January 2018. See also Mrockova (n 25) 55.

<sup>39</sup>For discussion on this point in the context of the parallel question of the use of labour law indices, see S Deakin, ‘The Use of Quantitative Methods in Labour Law Research: A Defence and Reformulation’ (2018) 27 *Social and Legal Studies* 456.

<sup>40</sup>J Angrist and J-S Pischke, *Mastering Metrics: The Path from Cause to Effect* (Princeton UP 2014).

<sup>41</sup>J Pearl and D McKenzie, *The Book of Why: The New Science of Cause and Effect* (Penguin 2019).

shaping economic outcomes in a linear fashion. Case studies involving in-depth qualitative analyses should, in principle, provide an alternative approach, capable of verifying or qualifying as the case may be, the claims of the quantitative literature.

The problems with qualitative studies, and in particular with fieldwork-based interviewing, are also well known.<sup>42</sup> Interviews are unlikely to be representative, no matter how wide the net is drawn when constructing a sample. Nor are interviews straightforwardly replicable: even with the same interview protocol and the same respondent, different answers, or at least different emphases, might be received were the interview to be repeated only a short time later.

However, interview-based fieldwork can provide what is often lacking from econometric studies: firstly, a specific and deep (in contrast to a more representative but also shallow) account of the research phenomenon, drawing on interviewees' first-hand experiences of practices and processes; and, secondly, a sense of causal sequences, based on a respondent's interpretation of past events and their present relevance.<sup>43</sup> Interviews may be particularly useful in contexts where formal and informal institutions intersect and overlap: Informal institutions are a core case of 'scarce and difficult-to-access data' which fieldwork-based methods can reveal.<sup>44</sup> Nor should it be thought that qualitative research is inherently less resource intensive or more straightforward to conduct than desk-based quantitative research. Qualitative research requires:

a substantial period of fieldwork, keen observational skills, thorough record keeping, and a high degree of self-awareness and ethical management of social relations. For fieldwork, researchers must have appropriate language skills and sufficient understanding of the local context to gain access, recognize informal institutions, and accurately interpret culturally coded observations.<sup>45</sup>

In the context we are considering, interview-based fieldwork should in principle throw light on questions which have remained unclear, or unanswered, in quantitative studies: how are legal transplants absorbed into the processes and practices of the 'host' system; how do judicial actors manage the translation of laws 'on the books' into legal practice; and, what conditions are conducive to the displacement of informal institutions with more formal ones? The interviews we conducted were designed to address these issues. Altogether we conducted a total of 27 interviews and focus groups with over 60 individuals in four cities (Beijing, Hangzhou, Shenzhen and Wenzhou) between April 2017 and December 2018. In this article, we draw

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<sup>42</sup>A Poteete, M Janssen and E Ostrom, *Working Together: Collective Action, The Commons, and Multiple Methods in Practice* (Princeton UP 2012) 37.

<sup>43</sup>*ibid* 35.

<sup>44</sup>*ibid* 23.

<sup>45</sup>*ibid* 16.

principally on interviews with judges, officials and entrepreneurs in two visits to Wenzhou, in September 2017 and December 2018. The focus of these interviews was the legal and regulatory response to the Wenzhou curb crisis and its legacy. Although several years had passed since the events of the Wenzhou crisis, these were still fresh in the minds of our interviewees when we spoke to them, and the intervening time had given them an opportunity to reflect on the lasting impacts of those events. The interviews were conducted at length, in some cases over the course of several days. Being able to make a second visit to Wenzhou provided us with the opportunity to follow up on and clarify points arising from the first set of interviews we conducted there.

The interviews were conducted in each case by the two authors of the current article. Because of confidentiality concerns, the interviews were not recorded, but were transcribed in writing during the interview process, and finalised immediately following the interview. Following anonymisation, English-language translations of the interviews were lodged with the UK Data Service Archive, where they can be viewed.<sup>46</sup> References below to individual interviews refer to the identifiers used in the version of the dataset deposited with the UK Data Service. This deposit also contains a datalist with details of all the interviews conducted, and a sample aide memoire and participant data sheet.

#### 4. The Wenzhou curb crisis

The role of informal institutions in overcoming financial constraints and fostering economic growth is well illustrated by the case of Wenzhou. Wenzhou is a prefectural-level coastal city located in Zhejiang province with a population of approximately 9 million. It has a number of distinctive features.<sup>47</sup> It is located in a mountainous region with little arable land. It received little investment from the state after 1949 due to its geographic location opposite the island of Taiwan.<sup>48</sup> With the advent of economic reform in the late 1970s, Wenzhou was faced with fundamental problems in lifting itself out of poverty and backwardness. Nevertheless, since 1978, Wenzhou has achieved an exceptionally high growth rate, with its annual GDP per capita reaching twice the national average. The absence of state investment and formal

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<sup>46</sup>S Deakin and others (2020). *Informal Finance in China 2017–2018* [Data Collection]. (UK Data Service) doi:10.5255/UKDA-SN-853742.

<sup>47</sup>K Forster, 'The Wenzhou Model for Economic Development: Impressions' (1990) 3 *China Information* 53.

<sup>48</sup>Even compared to small and medium sized enterprises (SMEs) in other parts of China, SMEs in Wenzhou have been disadvantaged in their access to formal credit. The bank lending to GDP ratio in Wenzhou remained substantially below the national level up to 2005. D Qin, Z Xu and X Zhang, 'How Much Informal Credit Lending Responded to Monetary Policy in China? The Case of Wenzhou' (2014) 31–32 *Journal of Asian Economics* 22.

credits was made up by Wenzhou's informal financial system.<sup>49</sup> Loans for millions of RMB could be arranged by a few phone calls, with no contract or collateral. A government report in 2010 reported that 71% of enterprises in Wenzhou received credit from the informal lending market without any guarantees, and that 96% of loans were paid back.<sup>50</sup> Our interviews tell a similar story, with the following typical account:

The proportion of lending between people based on relations without a contract at all is around 30–40%. They never intend to go to court, it's about mutual help and cooperative lending. In Wenzhou it is mostly interpersonal, without collateral or a guarantee. Generally, the borrower has no collateral, by definition, otherwise they would have got bank finance. Beyond these 30–40% of cases, creditors may ask for a personal guarantee from a third party, often known to the borrower and lender, so again this is based on interpersonal relations ... In Wenzhou, if there is a big project, there may be many lenders but even then, the authorities may not get involved. If a default on a big project took place elsewhere, the creditors might go to government officials to get protection, but that would not happen here.<sup>51</sup>

The following account of how one family-owned firm survived the financial crisis through reliance on informal lending illustrates the exceptional flexibility of the system:

On informal lending, I have some experience of it from friends and family during the crisis. At that time my husband could not borrow because he was the legal representative of the company and people were cautious about lending to the company, but I borrowed from my female friends, 10 million RMB, with no receipt and no contract.<sup>52</sup>

Given its reliance on informal financing, the traditional Wenzhou economy made little use of insolvency procedures. By the end of 2012, Wenzhou's GDP reached 365.06 RMB billion and it had a total of 117,805 registered companies;<sup>53</sup> but between 2006 and 2011, a total of only 24 insolvency cases, the large majority relating to SOEs, had been accepted by the Wenzhou courts.<sup>54</sup> The turning point came in 2013. In that year the number of accepted insolvency cases in Wenzhou rose sharply to 198 in

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<sup>49</sup>The role and importance of informal lending in Wenzhou economy has nevertheless changed over time. In the early stages of the reform process initiated after 1978, there was still a strong hostility to private enterprise even in Wenzhou, and informal lending equated to almost the entire amount of external financing. It is estimated that in the period 1980–1985, 95% of capital flows took place outside the formal financial sector. Bank lending to the private sector stood at 3.9% of total bank credit in 1990 and had risen to only 6.9% by 1996.

<sup>50</sup>People's Bank of China, Wenzhou Branch (2011) 温州民间借贷市场报告 ('A Report on Wenzhou Informal Lending Market').

<sup>51</sup>Interview IFC.7, Judge, interviewed in Wenzhou, September 2017.

<sup>52</sup>Interview IFC.27, Executive, interviewed in Wenzhou, December 2018.

<sup>53</sup>Data source: Wenzhou Statistical Yearbook: <<https://wztj.wenzhou.gov.cn/col/col1467318/index.html>>.

<sup>54</sup>2013 Wenzhou Intermediate Court Report on Insolvency Cases 2013 年温州法院企业破产审判报告 <[www.zjcourt.cn/art/2014/1/13/art\\_138\\_3232.html](http://www.zjcourt.cn/art/2014/1/13/art_138_3232.html)>.



2013,<sup>55</sup> nearly 10 times as many as in the previous year.<sup>56</sup> Between 2013 and 2017, the Wenzhou courts accepted a total of 929 insolvency cases. They then accepted 673, 605, 728, 701 cases in 2018, 2019, 2020 and 2021, respectively.<sup>57</sup> From 2013, private sector companies formed the majority of insolvency cases.<sup>58</sup>

What triggered the rise in insolvency cases was a major shock to Wenzhou's economy, the so-called curb crisis which began in 2012. The crisis stemmed from the practice of 'group lending' (*lian bao*).<sup>59</sup> Group lending had been initiated by the Grameen Bank in Bangladesh in the 1990s. In an idealised form of the Grameen model, borrowers are organised into groups of five to ten members. Lending is based on joint liability, or the idea that a second member of the group cannot get a loan until the first is paid back, thereby creating an incentive for 'peer monitoring'. Because borrowers all live in the same part of the village, they have tacit knowledge of other group members.<sup>60</sup> The original model of group lending was therefore an informal institution that operated in a closely-knit community, with the principle of members' joint liability essential to its operation. Group lending was introduced into China as early as in January 2000,<sup>61</sup> but it did not gain much attention till 2008. After 2008, to carry out central government's stimulus scheme, banks ended up extending credit to SMEs that were unable to provide credit history or collateral; group lending was promoted as an alternative risk control mechanism. Unlike the original Grameen model, group lending during this period was largely detached from social networks; but like the Grameen model, it relied heavily on joint liability. Many of the groups formed at the request of banks consisted of companies which had little knowledge of each other. This form of group lending effectively

<sup>55</sup> 2013 Wenzhou Intermediate Court Report on Insolvency Cases 2013年温州法院企业破产审判报告 <[www.zjcourt.cn/art/2014/1/13/art\\_138\\_3232.html](http://www.zjcourt.cn/art/2014/1/13/art_138_3232.html)>.

<sup>56</sup> 27 cases were accepted in 2012.

<sup>57</sup> Data source: Wenzhou Intermediate Court Annual Report on Insolvency Cases (various years), Zhejiang Provisional Court Annual Report on Insolvency Cases (various years).

<sup>58</sup> 2013 Wenzhou Intermediate Court Report on Insolvency Cases 2013年温州法院企业破产审判报告 <[www.zjcourt.cn/art/2014/1/13/art\\_138\\_3232.html](http://www.zjcourt.cn/art/2014/1/13/art_138_3232.html)>.

<sup>59</sup> The initial inspiration for this came from model initiated by the Grameen Bank in Bangladesh in the 1990s. In an idealized form of the Grameen model, borrowers are organized into groups of five to ten members. Lending is based on joint liability, or the idea that a second member of the group cannot get a loan until the first is paid back, thereby creating an incentive for 'peer monitoring'.

<sup>60</sup> D Adams and JR Landman, 'Lending to the Poor Through Informal Groups: A Promising Financial Market Innovation?' (1979) 2 Savings and Development 85; J Stiglitz, 'Peer Monitoring and Credit Markets' (1990) 4 World Bank Economic Review 351; A Haldar and J Stiglitz, 'Group Lending, Joint Liability, and Social Capital: Insights From the Indian Microfinance Crisis' (2016) 44 Politics & Society 459.

<sup>61</sup> It was first applied to rural households via a PBOC 'Guiding Opinion on Group Borrowing from Rural Credit Cooperatives' (*Nongcun Xinyong Hezhuoshe Nonghu lianbao Daikuan Guanli Zhidao Yijian*) and then extended to SMEs in the 2003 Law on Promoting Medium-small sized Enterprises (*Zhongxiao Qiye Cujinfa*) and 2006 CBRC 'Guidelines on Small Enterprises Credit Loans and Group Lending in Rural Credit Cooperatives' (*Nongcun Xinyongshe Xiaoque Xinyong Daikuan he Lianbao Daikuan Zhiyin*). But until 2008, its applicability was still very limited and did not involve the major commercial banks.



helped many private companies gain access to formal financing for the first time, and undoubtedly facilitated the transition from relation-based transactions to impersonal transactions. It is thought to have represented as much as 40% of total lending in this period across the country as a whole,<sup>62</sup> but in Wenzhou the figure was estimated to be between 60% and 70%.<sup>63</sup> In the case of the Xintai group, a major Wenzhou enterprise, the group

made mutual guarantees so in total there were 730 firms involved. The size of the debt was 15 billion RMB. There was a mutual guaranteed scheme. There was a core, the arrangement was like a hub and spoke. In the first circle there were 19 firms, another 135 in the second circle, and then, another 411, and altogether 730 firms were related.<sup>64</sup>

The artificial acceleration of the transition from relation-based informal lending to impersonal formal lending proved to be disastrous. Banks were left with little protection. Group lending was not only unable to mitigate the risks they faced;<sup>65</sup> it triggered a domino effect which extended the failure of a single company to dozens of others. This was at the root of Wenzhou's 2011 curb crisis.<sup>66</sup> Yet just as the move to formal lending triggered the crisis, it also catalysed an institutional response: there was suddenly a new demand for a formal bankruptcy law, as indicated in the rapid rise in the number of insolvency cases in 2013.

## 5. Judicial innovation in Wenzhou: evidence from interviews

Even if a demand for bankruptcy law arises, it cannot be automatically translated into a higher rate of use. According to the transplant literature, for a transplanted law to be effective, legal intermediaries responsible for developing the law must be responsive to growing demand for the law. Yet judicial actors themselves may also have a role in stimulating greater use of formal procedures.

### 5.1. Actively promoting use of the courts

Although EBL 2006 was seen as well drafted, there were still many obstacles, both conceptual and practical, to bringing the 'law on the books' into

<sup>62</sup>China Economic Weekly, 'Weixian de danbaolian: Zhejiang Minqi ranshang jinrong wenyi' ('Dangerous Chain of Group Lending: Zhejiang Private Enterprises are Infected with Financial Plague') 23 October 2012 <<http://business.sohu.com/20121023/n355456479.shtml>>.

<sup>63</sup>Shen, 'Zhejiang Minqi hubao daikuan weiju, yinhang yi songyong qiye jie gaolilai' ('Zhejiang Private Enterprises were Trapped into Dangerous Group Lending, Banks were Suspected to Encourage Them to Borrow from Usury') 13 August 2012, *Huanqiu qiyejia*, <[https://finance.qq.com/a/20120813/002574\\_3.htm](https://finance.qq.com/a/20120813/002574_3.htm)>.

<sup>64</sup>Interview IFC.8, Judge, interviewed in Wenzhou, September 2017.

<sup>65</sup>The Indian microfinance crisis reaffirmed this. See Haldar and Stiglitz (n 60).

<sup>66</sup>For a detailed discussion of the Wenzhou financial crisis, see D Chen and S Deakin, 'When Formal Finance Meets the Informal-the case of Wenzhou' (2021) 22 *Journal of Banking Regulation* 208.

practice. Prior to 2012, insolvency was still an unknown concept for most entrepreneurs. Rather, they continued hold to beliefs typical of the network-based nature of informal lending, such as the ancient beliefs that 'one must pay his debts' and 'a son must pay his father's debts'. Thus, the first reaction of many was flight or suicide, rather than filing for insolvency option. Judicial initiative was needed to increase legal awareness of the possibility of the insolvency option, to help overcome the cultural obstacles to using it, and to remove the stigma which attached to it:

The general public, they have a lack of understanding of the issues, and they hate the term 'insolvency', everyone tries to distance themselves from being insolvent ... The outbreak of crisis in Wenzhou in September 2011 ... caused many suicides and runaways. On one day, 22 September 2011, more than 10 entrepreneurs committed suicide or ran away.<sup>67</sup>

It was urgent to act since the collapse of several firms in a single day was threatening not just an economic collapse but a wider social disorder, and had drawn the attention of senior national politicians:

This caused a domino effect, it was chaos, it threatened both the economic and the social order. Once creditors knew that debtors were committing suicide or running away, they started enforcing their debts however they could, they ran to the factories and grabbed what they could. This was causing social chaos, so it drew nationwide attention. Premier Wen Jiabao came to Wenzhou and decided to start a reform. The reform took place in March 2012.<sup>68</sup>

The nature and scale of the crisis were such that a proactive response was needed:

On the development of insolvency practice in Wenzhou, the background is that, due to the crisis, the government and the party faced enormous pressure. The then party Secretary of Wenzhou used to work in an SOE [state owned enterprise] and he had some experience before of how insolvency law applied to SOEs, and he knew about how this worked. He had learned that insolvency law could be used to solve financial problems, so he called on the courts to play a role in solving the crisis. The court was given a quota of receiving and accepting 100 cases per year, and that was very challenging because we had little experience of insolvency law. The new insolvency law took effect from January 2007, up to 2012, this court in Wenzhou only had 27 insolvency cases, and suddenly we had 100 to deal with per year.

Under these circumstances, it was not enough for the courts to wait for insolvency cases to come to them. Businesses had to be actively persuaded to use the courts:

After 2012 when [we] were given the quota [of insolvency cases to try], the first thing we had to do was to find the cases because no one came to court to file a

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<sup>67</sup>Interview IFC.8 (n 64).

<sup>68</sup>*ibid.*

case. So all the judges including the Chief Justice had to go to the local media and to promote the court and explain to public the protection function of insolvency. It took about a year, but this seemed to have a positive effect because by the end of 2013 the parties started to take the initiative to approach the court to ask about insolvency procedures ... In the crisis many ran away or committed suicide, so we invented a slogan, it is better to apply for protection of insolvency rather than running away, and over the year they kept promoting this idea, the idea of the protective function of insolvency.<sup>69</sup>

In other words, the Wenzhou judges were not simply responding to a greater demand, on the part of business entities, for formal insolvency procedures; they were actively promoting the use of the courts as an alternative to more traditional, informal mechanisms of enforcement.

## **5.2. Inter-agency collaboration**

A major reason for the failure of legal transplants is that only the rules can be transplanted, but not the underlying institutions enforcing them. Although EBL 2006 was modelled on what was taken to be international best practice, in particular US legislation, this in itself could be no guarantee of it working in practice. A fundamental difference between the Chinese court and its US counterpart is the status of the court. The Chinese court lacks independence from the executive branch of government, and in practice is heavily dependent on the executive for its operation.<sup>70</sup> Relatedly, the Chinese court has no authority over government departments, and is in practice dependent on their collaboration, rather than on their compliance with court orders, to put judicial decisions into effect. Insolvency cases raised particularly challenging issues in this regard as they often involved multiple governmental bodies including the tax authority and Industry and Commerce Bureaux, without whose support and assistance, insolvency proceedings are unlikely to succeed.

As the Wenzhou curb crisis unfolded, there were several instances of inter-agency collaboration. These included taking steps 'to establish an enterprise insolvency working party, a group of leading people, tackling risk in relation to insolvency',<sup>71</sup> which included the mayor and deputy mayor of the city and the Chief Justice of the local court. The judges found that other officials 'had no knowledge of insolvency law', to the point that the judges 'had to explain to all the parties why it was important to file a claim in order to establish creditors' rights, and to explain that the tax authority could use the legal process as proof to write off the debts and to create an incentive for the debtors to participate'.<sup>72</sup> Conversely the judges recognised that in order for

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<sup>69</sup>Interview IFC.8 (n 64).

<sup>70</sup>See Mrockova (n 25) 38–39.

<sup>71</sup>Interview IFC.8 (n 64).

<sup>72</sup>*ibid.*

them to progress the forma resolution of insolvency-related claims, it would be 'important to have the support of the government, to collaborate with them and with all the actors'.<sup>73</sup>

A specific example of inter-agency collaboration arose from the interaction of insolvency cases with the operation of the tax system. To facilitate the effective resolution of insolvency proceedings, and in particular to assist restructuring, the Wenzhou courts 'agreed an MOU with the tax authority for an evaluation mechanism, to enable them to assess the tax effects of a restructuring'.<sup>74</sup> To illustrate the practical difference that could be made by involving the tax authorities directly in restructurings, the following example was explained to us:

When the company [a property developer] planned to go into a restructuring there were three different evaluations of tax liabilities. The tax administration employed tax accountants to do an assessment, and they arrived at a figure of 104 million RMB. The company's investors then arrived at another, 70 million. The tax authorities came up with another 20 million. These were big differences. The tax authority knows best in such cases. They had the authority to make the decision in the end. It's best to involve the tax bodies in this process. Now after the MOU was agreed the tax authority is routinely involved in evaluating tax debts.<sup>75</sup>

Another example of inter-agency collaboration arose from the need to resolve all outstanding tax claims before a restructuring could be completed:

To remove the name [of an insolvent company] from the register you need to provide proof of tax being paid and the point is this is not available in most cases. So the solution was that the court took the responsibility and the court provided proof to the administration. But because this is not normal procedure it has to go through with the support of the leading group of creditors who issue a written document to allow this procedure. So, this is how they did it. The court spends most of its time on these issues rather than legal issues *per se*. This is what happens in practice.

According to the judge who explained this problem to us, the solution arrived at 'could not have been done without the support of the leading group' of senior officials from different agencies: you have to have support from the top of the government, to enable the collaboration, between different parts of government and the various actors'.<sup>76</sup>

### ***5.3. Experimentation and learning***

A consistent theme from our interviews with judges and officials was that they themselves were engaging in a learning process as they were called

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<sup>73</sup>ibid.

<sup>74</sup>ibid.

<sup>75</sup>ibid.

<sup>76</sup>ibid.

on to respond to the circumstances of the crisis. Among the many obstacles facing the courts were the 'lack of experience' of the judges themselves. This interviewee had 'finished my undergraduate degree in 2006, and finished post-graduate study in 2008, only two years after the insolvency law was passed, so I had little knowledge of insolvency law', which she said was 'common among judges in China' at that point. It was not just the general public that had a 'lack of understanding of the issues; there were many judges who 'did not want to get involved' in insolvency cases on the grounds of their complexity and the length of time it took to resolve them. Similarly, many legal practitioners 'lacked experience of practice' in the insolvency field.<sup>77</sup>

At the same time, for this judge and her colleagues, the crisis provided an opportunity to establish the Wenzhou court as a pioneer:

Because the crisis began in Wenzhou, we had the chance to start things, to make the first move. Our experience accumulated; other provinces learned from us. We were the pioneers of insolvency law; our experience has been introduced to other places.<sup>78</sup>

To disseminate the lessons they had learned, the Wenzhou court arranged for judges and insolvency practitioners (administrators) to train together, and then began disseminating the lessons learned to other provinces:

The court initially provided annual training for judges and then for the administrators as well, they trained together. There was no fee for this, and it helped the administrators a great deal. Now thanks to the development of the Wenzhou insolvency law practice currently we have 38 administrator teams at firm level and they have dealt with 1,000 cases so far, this is comparable to any other region, which gives Wenzhou-based administrators the chance to develop their expertise. Now we have been invited by other provinces such as Fujian to share our expertise.<sup>79</sup>

Prior to the Wenzhou crisis, nearly all bankruptcy cases in China concerned SOEs and as such were mainly governed by administrative rules. Following the crisis, there was a wider national change in the court system and a move towards greater specialisation. Up to 2016, bankruptcy cases were treated as ordinarily commercial cases tried in the Second Division of the Commercial Court. With a rise in bankruptcy cases, SPC established a specialised bankruptcy division in June 2016.<sup>80</sup> The Wenzhou court was already well advanced in this regard, as a judge told us in the course of our interviews:

We had our [insolvency] court in place by May 2015. Now we already have seven insolvency courts in this region alone. I believe that this change was

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<sup>77</sup>ibid.

<sup>78</sup>ibid.

<sup>79</sup>ibid.

<sup>80</sup>SPC, 'Work Plan in Relation to Establishing A Division of Liquidation and Bankruptcy Trial in Intermediate Courts' 关于在中级人民法院设立清算与破产审判庭的工作方案, 21 June 2016, Fa(2016)209.

necessary and very helpful. Using myself as an example, I used to work in the second division of the commercial court, and because for insolvency cases there is no deadline as there is for other cases and the judges would prioritise the other cases. This was a reason for insolvency cases taking too long. But with specialization, the efficiency of the court improved, it was more focused. It was spending more time on the issues which mattered. There were other advantages to establishing a specialized court. Firstly, it solved the incentive problem facing judges. Insolvency law cases take a long time and there is a big workload. It is hard to focus on the key issues. Now it is better.<sup>81</sup>

A particular feature of the innovations introduced in Wenzhou was the treatment of SMEs. The high proportion of SMEs coming before the Wenzhou courts required a distinct response. The EBL 2006 was not drafted with SMEs as such in mind and it is only recently that the issue had begun to be addressed in not just China but more widely.<sup>82</sup> It was against this background that the Wenzhou court introduced introducing a summary procedure to bankruptcy in 2013:

There is no summary or speedy procedure in insolvency law currently. We [the court] tried within the existing framework to simplify the procedure and to speed up the process, the trial. For example, while the law provides that the creditors must file their claims between 1 and 3 months, now we have said here that this must be done within 1 month. We believe that we could merge certain procedures.<sup>83</sup> By June 2017 there had been a significant improvement in efficiency, at least of the speed of trials. We used to average 2 and a half years now it is 7 months. In one insolvency case where there were no assets, the case was disposed of within 34 days.<sup>84</sup>

#### **5.4. Encouraging formality: corporate form, registrations, and restructurings**

When the crisis began, the judges were dealing with a situation in which informal relations were still the norm. As one of our interviewees put it,

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<sup>81</sup>Interview IFC.8 (n 64).

<sup>82</sup>It was only recently that international agencies started to respond to the specific position of SMEs in bankruptcy. Important examples include: W Bergthaler and others, 'Tackling Small and Medium Sized Enterprise Problem Loans in Europe' (IMF Staff Discussion Note, March 2015) 28–30; World Bank, *Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency* (IBRD 2018); A Martinez, 'Micro, Small and Medium Enterprise Insolvency in Africa: A Comparative Study' (paper at UNCITRAL's 50th Anniversary Colloquium) <[www.uncitral.org/pdf/english/congress/papers\\_for\\_programme/135-martinez-sme\\_enterprise\\_insolvenyc\\_in\\_africa.pdf](http://www.uncitral.org/pdf/english/congress/papers_for_programme/135-martinez-sme_enterprise_insolvenyc_in_africa.pdf)>.

<sup>83</sup>For details of how this was done, see Wenzhou Intermediate Court's Minutes on the Trial Implementation of Simplified Insolvency Procedures (Wen zhongfa [2013] No.54) 温州市中级人民法院《关于试行简化破产案件审理程序的会议纪要》的通知(Wenzhou shi zhongji renmin fayuan 'guanyu shixing jianhua pochan anjian shenli chengxu de huiyi jiyao' de tongzhi); Mrockova (n 25) 270. This is now incorporated in SPC guidance, see SPC Notice concerning the Promotion of Efficient Review of Bankruptcy Cases (Fafa [2020] No.14) 最高人民法院印发《关于推进破产案件依法高效审理的意见》的通知 zuigao renmin fayuan yinfa 'guanyu tuijin pochan anjian yifa gaoxiao shenli de yijian' de tong.

<sup>84</sup>Interview IFC.8 (n 64).

Most firms don't keep good books. They don't have accounts to the level needed in an insolvency. It is a problem even to remove the company name from the register .... In insolvency cases it was normal to find no assets, no book keeping (no accounts, or at least not regular ones) and no staff, we called them the 'three no's'.<sup>85</sup>

Relatedly, it was not unusual to find that the corporate veil operated in name only: 'typically there is no clear distinction between the corporate person and the shareholders',<sup>86</sup> with most SMEs operating as 'quasi-partnerships with little separation between owners and the company'.<sup>87</sup> In response, the courts took steps to clarify the position of shareholders in the event of an insolvency and to encourage efforts to recover sums from them where the share capital had not been fully paid up. Where there were accounts of some kind, then the court requires that the administrators must do a comprehensive audit of the accounts, to see whether the shareholders have made sufficient capital contribution. The shareholders will be personally liable for not paying capital in'. Secondly, creditors were encouraged to take claims directly against the shareholder in situations where an insolvency had not been properly conducted. Thirdly, evidence of criminal activity by an owner-shareholder, as in cases where the accounts had been withheld or destroyed, was also used as a basis for allowing a direct claim by creditors against the shareholders' personal assets.<sup>88</sup>

A related innovation was to emphasise the importance of loans being registered if they were to be enforced. As the regulatory authorities were encouraging registration of loans through local state-run credit bureau set up in the aftermath of the crisis, a complementary role was being carved out by the courts:

There is a possible and active role for the courts in shaping law, leading the practice, for example on registration. The courts in Wenzhou can give more weight to registration. If a contract is registered the court will more likely decide it is valid. If the party has registered the contract and the court is less likely to find that there is a crime, it is more likely to treat it as a civil case, the court can play a proactive role pending national law reform.<sup>89</sup>

Reorganisations and restructurings provided a further context for judicial attempts at formalisation. It was recognised that restructurings would effectively be impossible, as a result of the difficulty in coordinating the different actors. Courts approached their task, however, not by seeking to impose solutions on the parties but by emphasising that the 'protection function'<sup>90</sup> of

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<sup>85</sup> *ibid.*

<sup>86</sup> *ibid.*

<sup>87</sup> *ibid.*

<sup>88</sup> *ibid.*

<sup>89</sup> Interview IFC.7 (n 51).

<sup>90</sup> Interview IFC.8 (n 64).

insolvency law, which meant that businesses could be shielded from certain liabilities even if individual entrepreneurs were not:

The situation is that the insolvency law relieves firms, but not really the entrepreneurs, from financial distress. This is because of the use of personal guarantees. The entrepreneur will still be liable for various guarantees, and this affects restructurings, because the entrepreneur can no longer be a shareholder or start a new business. At best they can work as a manager or start a business using another name, because there is often joint liability, mutual guarantees, individuals are always involved.<sup>91</sup>

This involved a degree of inter-agency cooperation, with the government providing 'protection' or 'assistance' for those firms deemed to be in need of it and not simply evading debt, but with the resolution of claims and restoration of the business 'left up to the judicial branch, using legal remedies'.<sup>92</sup> The key role of the court was:

mostly about getting the secured creditors to go along with it. The banks have collateral so it's easier for them to enforce the collateral than to go into a restructuring. The administrators lead the creditor's meeting. If they fail to reach agreement the court has a discretionary power to intervene, and if they think that a restructuring plan is feasible, they can enforce this by a judicial order.<sup>93</sup>

The power to order restructurings was extended to large listed companies and to multi-company insolvencies arising from the practice of firms providing each other with mutual guarantees:

We tend to consolidate insolvency cases involving mutually guaranteeing enterprises. One case involved 19 different firms. Mutual guarantees create a serious problem. Some healthy and well managed firms get dragged down by one or two badly run or poorly performing firms, firms with irregularities.<sup>94</sup>

Between 2013 and 2017, around 40 restructurings had been completed in Wenzhou, which was seen as a good outcome:

40 restructurings ... is 5–6% of cases, but actually 40% of the debts, so in that sense it is very significant. This 40% figure is high by comparison with elsewhere, for example, Shenzhen. There have been only 40 restructurings in total in Shenzhen since 1993.

Positive assessments such as these are balanced by an understanding that informal finance remains a reality, with attendant risks of a kind that the formal system can only go so far to channel or control:

Question: What is the effectiveness of the Wenzhou reforms?

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<sup>91</sup>ibid.

<sup>92</sup>Interview IFC.9, Official, interviewed in Wenzhou, September 2017.

<sup>93</sup>Interview IFC.8 (n 64).

<sup>94</sup>Interview IFC.24, Judge, interviewed in Hangzhou, December 2018.



Response: It's hard to answer. Another side of the story is to offer investors more diversified investment channels. All this money in informal lending hot money seeking higher returns for capital is a problem. People go to informal lending because of the lack of other channels. These are market issues. The market must solve them, not the visible hand.<sup>95</sup>

But when asked whether informal or inter-personal forms of business interaction continue to take priority over the use of formal laws and procedures, a not untypical response was the following:

I think that things have changed over the years, so that nowadays, ordinary people have a better understanding and appreciation of the courts' authority. It is now commonly understood that people need to respect courts' judgments, so if there is news that people fail to comply with judgments, most people will consider that to be wrong. This change of attitude towards the courts applies both to ordinary people and to government officials.<sup>96</sup>

## 6. Assessment and conclusion: crisis, punctuated equilibrium, and judicial innovation in the birth of Chinese insolvency

Building on the theoretical framework set out above, we take the transplant hypothesis to indicate the need for an endogenous demand if an imported law is to bed down 'in fact' and not simply 'on the books', while the coevolution hypothesis similarly emphasises the need for conditions in the host state to be receptive to the transplant. The early history of insolvency law in China suggests support for both claims: the various iterations of bankruptcy legislation prior to the 2006 reforms were either ignored altogether or used for purposes far removed from the western models which inspired them, as in the case of SOE restructurings using the 1993 law. The 2006 law, while seen as well drafted, was also something of a deal letter for several years after its enactment.

However, with the onset of the Wenzhou crisis in 2011, the 2006 law was not only put to use, but very rapidly evolved at the level of practice. This suggests a role for crises in stimulating the adaptation of laws which is somewhat underplayed in both the transplant and coevolution narratives. Crises can trigger novel uses for laws which had hitherto remained underused and underenforced.

Nor does the incremental pace of mutual adjustment implied by the language of coevolution entirely capture the discontinuities which crises can induce rather than being endogenously generated, the evolutionary process here is more akin to the 'punctuated equilibrium' which follows

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<sup>95</sup>ibid.

<sup>96</sup>Interview IFC.23, Lawyer, interviewed in Shenzhen, January 2018.

on from an exogenous shock which stimulates learning and experimentation.<sup>97</sup>

A further qualification to the transplant and coevolution hypotheses concerns the relative weight of demand-side and supply-side factors in stimulating institutional change. The predominant account of the transplant effect highlights the importance of the demand for legal rules on the part of market actors. Yet in the Wenzhou case, the courts were not just responding to the needs of the business community. Initially, entrepreneurs resisted judicial intervention while creditors sought to bypass it: physical flight, on the one hand, and a self-defeating race to collect, on the other, were the first responses to impending failure. The courts, with the support of other government agencies, had to make a positive case to businesses and creditors for the use of insolvency law and procedures; and far from reacting passively to what they saw as business needs, the judges acted strategically and proactively in making the case for insolvency as the preferred mode of restructuring.

Our case study has wider implications for debates about the role of legality in China's social and economic development. It is striking that insolvency laws were explicitly being used, in the Wenzhou crisis, to resolve private rights and claims, and not as part of a wider process of administrative adjustment of different organs of the state, as had been the case in the earlier use of the bankruptcy law to reorganise SMEs. While our interviews contain abundant references to inter-agency cooperation and to the role of the government in triggering judicial interventions, they also show that judges and officials were aware of distinctions between the roles of the executive and judicial branches.

Nor were the courts' interventions simply aimed at enforcement per se. Instead, judges sought to legitimise restructurings by continuously emphasising the 'protection' function of the insolvency law and its role in allowing businesses to continue even when individual entrepreneurs remained liable for their personal commitments. Judges and officials saw their role more in terms of building trust in the legal process than in using the law to discipline or punish.

This perspective suggests that the problem with transplants is not so much that they operate at the level of 'law in the books' as opposed to 'law in practice'. Rather, our case study suggests that formal rules can be operationalised at the level of practice once they are seen as legitimate. While this is a process which takes time, a period of crisis provides opportunities for the learning process around the use of formal rules and procedures to be accelerated.

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<sup>97</sup> S Gould, *The Structure of Evolutionary Theory* (Harvard UP 2002) 872. 'On the application of this concept to the legal context, see S Deakin, 'Evolution for Our Time: A Theory of Legal Memetics' (2002) 55 *Current Legal Problems* 1.

For the judges we interviewed, the Wenzhou crisis, which had seemed to threaten both the economic order and the wider civil or social one, proved to be just such an opportunity.

### Disclosure statement

No potential conflict of interest was reported by the author(s).

### Funding

This work was supported by Economic and Social Research Council [ES/P004091/1].

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