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THE WORLD BANK
East Asia and Pacific Region
Private Sector Development Unit

BANKRUPTCY OF STATE ENTERPRISES IN CHINA

-- A CASE AND AGENDA FOR REFORMING THE INSOLVENCY SYSTEM --

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PREFACE

Many state-owned enterprises in China are today loss-making or non-viable, and a large number have since long been in default to their creditor banks. Credit allocation and asset reallocation are thus not as efficient as they could be. The importance of this issue has been recognized by the authorities and both short term targets to curtail loss-makers among the state owned enterprises, and the longer term objective of fundamental enterprise and financial sector reform are high priorities for the country's leadership.

As business failures are a universal feature of competitive markets, effective insolvency and creditor rights systems are fundamental building blocks of sustainable development. While there are a wide variety of national insolvency regimes, all effective systems provide clear procedures to manage financial distress, facilitate predictable risk sharing and establish a binding, collective proceeding to maximize the value of the firm's assets, whether as a going concern or in liquidation. The existence of such a framework facilitates access to credit and underpins contract enforcement. Hence, effective insolvency and creditor rights systems are important to both domestic and international investors and creditors, and are crucial to reducing the risks of financial instability and handling financial crises when they occur.

The bankruptcy regime in China has had a number of positive outcomes. It has allowed the bankruptcy of more than 20,000 enterprises, of which more than half were SOEs. In the process, it has reallocated many assets, often to stronger firms, to more efficient uses, and/or to non-state operators. Most fundamentally, this has been achieved while maintaining social stability and avoiding financial system collapse. Moreover, the system has built practical experience in courts and local administrations, as well as in valuations and auctioning, and it has helped to create some public understanding of bankruptcy, and acceptance of the principle by workers and officials.

However, these achievements have come at high costs. With social stability and municipal development interests prevailing over creditor interests, creditors have generally achieved very low recovery rates. This result has affected banks' balance sheets directly; has deterred banks from initiating bankruptcy themselves; and has affected their willingness to lend. The absence of personal bankruptcy legislation is further hampering the development of lending to small/micro enterprises and consumers. For managers and owner representatives of SOEs, bankruptcy has been a temptation rather than a threat. Bankruptcy has lost much of its motivating force for good governance and management, and for corporate restructuring. Although the court process itself has generally been quite fast, it often takes a long time for the local government to decide on the bankruptcy route and secure the debt write-off. It has also been difficult to liquidate assets under the current process which often leads to unrealistically high valuations. The long run-up to bankruptcy filing, and to a certain extent the proceedings while management stays in place, could lead to asset stripping.

Moreover, the environment has been changed drastically since the Bankruptcy Law was introduced in 1988, and even since the debt write-off program was initiated in 1994. Social liabilities such as pensions and unemployment benefits are now rapidly becoming pooled beyond the individual enterprise, town, and sector. Financial sector stability is now receiving higher priority than before the region's financial crisis. The bankruptcy regime is based on the notion of a wholly state-owned enterprise with state banks as creditors and with workers interested solely in job security and wage or severance/pension income. Today, however, many SOEs have non-state minority shareholders or joint venture partners. Trade creditors are becoming more sophisticated, and large firms have bondholders or borrow abroad through window companies. Employees have large deposits in banks and 30 million citizens own stock, giving them stakes beyond their wage income. The technical capacity of courts, restructuring agents, and support professions has been growing, albeit at uneven pace and with important gaps. Finally, the important role of the private sector has been embraced constitutionally, as well as practically for employment generation. These changes call for less administrative

intervention in bankruptcy cases, for more regard for non-state creditors, and for ensuring that private debtors are subject to an effective bankruptcy system.

This study reviews the principles and actual implementation of China's bankruptcy system for state enterprises, assesses the system in light of the changing environment and lays out a large number of specific recommendations, concerning the policy, legal framework, procedures, and institutional capacity for state owned enterprise bankruptcy, and China's credit system more broadly.

The main empirical basis were interviews in five cities, with an emphasis on a sample of 15 specific bankruptcy cases. The cities Shanghai, Shenyang, Changsha, Wuhu, and Loudi represent a wide range of town size, and legal/business infrastructure development. Some of them were included in the government's pilot debt write-off program ("Capital Structure Optimization Program"). Apart from the case studies, interviews were conducted in these cities as well as at the national level with representatives of government agencies (responsible for SOEs, banks, labor/social security, land, etc.), the judicial and legislative system, banks and other creditors, service professionals (valuators, accountants, lawyers, etc.), and debtor enterprises.

The study team was led jointly by Klaus Lorch and Loup Brefort, and included Messrs./Mmes. Cliff Garstang, Carmen Genovese, Gordon Johnson, Shenhua Wang, from the World Bank and Li Shuguang (China University of Law and Politics), Wu Yalin (Deloitte Touche Tohmatsu). Messrs. Chunlin Zhang and Daochi Tong (World Bank) provided additional inputs.

The State Economic and Trade Commission (SETC), particularly through the Merger & Bankruptcy Office and Loss-Making Enterprises Turnaround Office within its Enterprise Reform Department supported and facilitated the study for its successful implementation. Messrs. Shao Ning, Qin Yongfa, Liu Wenbin, Zhou Fangsheng and many of their colleagues provided valuable guidance and support throughout, and the fieldwork was supported by the Economic and Trade Commissions in each locality. A range of other government and non-government institutions and members of the judiciary at the central level and in the five municipalities also contributed information and perspectives. In particular, the study team owes a lot to ETCs of Shanghai, Shenyang, Changsha, Wuhu and Ludi for their assistance, insights and hospitality. A number of experts from government and academic institutions in Beijing participated in the discussion of the first draft of this report and made valuable contribution, among them are Prof. Wang Weiguo (China University of Law and Politics), Mr. Zhou Fangsheng and Ms. Liang Yan (SETC), Prof. Feng Tongqing (China Labor College), Messrs. Niu Nanjie and Li Li (Orient AMC). The Chinese version of the final report was translated by Prof. Wang Weiguo.

We hope this study will provide all those interested in the development of a sound financial and enterprise sector in China with new ideas concerning the future development of an effective insolvency regime in China.

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EXECUTIVE SUMMARY

The Importance of a Good Bankruptcy System. Many state-owned enterprises (SOEs) in China are today loss-making or non-viable, and a large number have since long been in default to their creditor banks. Credit allocation and asset re-allocation are not efficient. The importance of addressing this issue is recognized in particular since China experiences slower economic growth, a regional investment climate still affected by the Asian crisis, and the challenges of global competition under WTO accession. A three-year target to curtail loss-makers among large SOEs and a longer-term objective of fundamental enterprise reform are high priorities of the country's leadership. So are the resolution of non-performing loans through asset management companies to improve solvency in a fragile banking sector, and a shift of resources towards the increasingly private small and medium enterprise sector.

All these initiatives require an effective and efficient system of reorganizing insolvent enterprises, and transferring resources out of non-viable uses and into more productive ones. In case of liquidation, the asset distribution to creditors should be fair and transparent. A well-working bankruptcy system, with its underlying threat to those who under-perform, should also be a driving force in the corporate governance exercised by the managers and owner representatives of enterprises. Neighboring countries further learned off late the necessity of an effective bankruptcy threat for resolving widespread corporate distress. With China's move to a market economy, wider issues must be addressed as well: The inability of workers to share a large portion of the social burden of transition due to widespread employment and the redefinition of firms' social responsibilities; the risks for state-owned banks to continue assuming a large financial burden from SOE insolvency; and the desirability of transforming enterprise ownership and promoting market-led restructuring to permit the state to concentrate on its core responsibilities.

Purpose and Methodology of the Study. This study reviews China's bankruptcy system for state enterprises, assesses it in light of the changing environment, and lays out recommendations for the short and longer term. The report gives primary attention to financial aspects, social dimensions, legal principles, and institutional issues. The main empirical basis were interviews conducted in a diverse set of five cities (Shanghai, Shenyang, Changsha, Wuhu, and Loudi) in mid-1999, and a special sample of 15 bankruptcy cases. The main counterpart of the study has been the State Economic and Trade Commission (SETC), particularly its offices on Merger & Bankruptcy and on Loss-Making Large Enterprises.

Summary Assessment. The study finds that bankruptcy of state and non-state enterprises has been quite widespread since the mid-90s, with more than 25,000 cases. Recent years saw even bankruptcy cases of very large SOEs, listed firms, foreign joint ventures, financial institutions, and debtors with large foreign liabilities. By now, the notion and importance of bankruptcy are widely accepted among China's leadership and public. Considerable experience has been gained and capacity built. This has allowed state enterprise bankruptcies, once filed, to proceed quickly in the courts. Most importantly, social and financial stability have been maintained. All this also provides a foundation on which to build an improved insolvency system.

The current insolvency system does need reform. While there are today several parallel insolvency regimes -- for SOEs under a pilot program, other SOEs, non-state corporations, and some special economic zones -- most are quite spotty, and practically none applies to natural person enterprises. A new bankruptcy law, whose drafting is well advanced, should be introduced without delay and apply in principle to all forms of enterprises. Its application to SOEs that are not incorporated or operate in special public interest areas, however, would best be phased in within 3-4 years after further strengthening of the social security system.

The study concentrates on the bankruptcy of SOEs. It finds, first, that their bankruptcy process is unfriendly to creditors and hardly an effective "stick" to motivate enterprise performance. Creditors have little influence on the process, are treated inconsistently, and suffer violation of their secured claims for the sake of settling

affected workers. Creditor banks commonly recover only 3-10% of their claims. Second, bankruptcy seems often not to lead to an efficient reallocation of resources. Procedural and institutional shortcomings make the insolvency process vulnerable to irregularities; secondary markets for assets are underdeveloped; and restructuring alternatives to liquidation are few. The newly established asset management companies could foster positive changes here if they enjoyed sufficient freedom of action. Third, the entitlements of labor affected by SOE bankruptcy are quite substantial under a special program that applies to the larger SOEs. Combined with incomplete pooling across firms, this has deferred many bankruptcies a long time for lack of funds. Tight limits on the debt write-off by banks have also delayed many bankruptcies. In the meantime, many workers languish in half idle factories with neither full current nor lay-off pay, assets are neither efficiently used nor recycled to better uses, and moral hazard further weakens the firm.

To address these various deficiencies, the report makes a large number of specific recommendations concerning the policy, legal framework, procedures, and institutional capacity for SOE bankruptcy, and China's credit system more broadly. While concerns for social stability will remain the overriding constraint to the scope and nature of SOE bankruptcies, and local-center tensions will continue to affect implementation practice, a window of opportunity for reform is gradually opening up. Social security is increasingly getting pooled; the Asian crisis brought more attention to financial system soundness; the rule of law has lately been enshrined in the Constitution; and ownership diversification and private enterprise are now officially acknowledged.

The Evolution of Bankruptcy. A Trial Law for State Enterprise Bankruptcy (hereinafter: Bankruptcy Law) was introduced as early as 1986. For years, it remained rarely applied. This started to change in 1994 with a special Capital Structure Optimization Program (CSOP) for industrial SOEs in a few pilot cities. This program addressed social constraints by earmarking land use rights (LURs) of the liquidated debtor to pay for the "rehabilitation" of its workers, and ensuring that the firm's main social facilities are taken over by the municipality. The firms for this program have been selected quite administratively and the process, although involving the courts, has largely been handled by local government representatives. The creditor banks have little choice but to allocate to these cases a substantial portion of their annual write-offs, which are tightly capped by tax rules; this created the notion of a "debt write-off quota" under the CSOP. Later, a degree assigned even mortgaged LURs to labor rehabilitation, and the program was expanded to most large towns. With these changes, the number of SOE bankruptcies under this program skyrocketed in 1996 to some 1,100 cases that involved 680,000 workers, RMB 43 billion liabilities and more than RMB 10 billion write-off quota. More recently, the program got concentrated on larger firms so as to help achieve a three-year target of slashing the number of loss-makers among large and medium SOEs. Hence, the number of new cases dropped to 133 last year but still involved about half a million workers and RMB 18 billion debt write-off quota.

Bankruptcies multiplied in the mid-90s not only under the CSOP, though. The annual number of all bankruptcies together rose from 277 in 1989-93 to 2,100 in 1994-95 and further to 5,640 in 1996-97. In that latter period, more than half the cases were SOEs, of which three quarters were small SOEs outside the CSOP. In these two years together, as many as 1.5 percent of all SOEs entered bankruptcy proceedings.

Unifying the Bankruptcy System. Non-SOE bankruptcies involved mainly firms with collective, private, and mixed ownership. Such cases fall under some rudimentary provisions in the Civil Procedures Law and Company Law, and Opinions of the Supreme Court, and sometimes additional provisions of Special Economic Zones. The deficiencies of this sketchy framework have shown in the bankruptcy of Guangdong International Trust & Investment Corp. (GITIC) and other cases involving large listed debtors or foreign creditors. Natural person enterprises and individual persons are not yet subject to any bankruptcy regime. In total, we see a proliferation of bankruptcy regimes and yet many gaps and flaws.

A new bankruptcy law has been drafted in 1995-96. It would apply to state and non-state enterprises, and cover also natural person enterprises. The draft largely resembles the bankruptcy laws of market economies.

For example, it envisages a proper trustee function, strengthens the role of creditor committees, and provides an elaborate option of court-supervised reorganization that can be initiated by debtors. Despite its quality, the draft has not yet been submitted to parliament. The Government and Party seem concerned that the social implications of SOE bankruptcy, if pursuant to the new uniform law, could slip out of their control. Legal experts, on the other hand, have been reluctant to give up the notion of uniformity and inject a chapter on special treatment of SOEs. This study recommends to introduce the draft new bankruptcy law in the near future, with minimal delays for further drafting improvements. We suggest that the new law not differentiate between state and non-state enterprises but that its effectiveness for state-owned debtor enterprises that are not incorporated or operate in non-competitive sectors be left at the discretion of the Government to decide but in any case no later than the year 2003. Until such time, those enterprises would remain under the present SOE bankruptcy law. The CSOP be ended no later as well, and apply improvements in the meantime. For incorporated SOEs in competitive sectors the new law would be effective immediately. To minimize the transition period, financial and social system reform should be deepened and accelerated. This will create the conditions that will ultimately permit the state enterprise sector as a whole to be subject to the new bankruptcy law and to abandon the old bankruptcy law altogether.

Deepening the Involvement of Creditors. SOE bankruptcy has largely served to cleanse the assets of liabilities after the authorities have decided on the future use of the business (under “whole takeover” of the entire asset bundle and employees) or key assets (such as land use rights). Protecting the interests of creditors has been a lesser priority. The bankruptcy process lacks the transparency that would come with independent decision-making and involvement of the creditors. The court-appointed liquidation commissions include mainly agencies that represent enterprise owner and employee interests. They should ideally be replaced with independent experts or, less desirably, supplemented by creditor representatives; even if the latter had no vote their participation could raise transparency. There is also a creditor assembly, but as long as they get engaged only late in the process, have few powers, and are not more actively encouraged by the courts few creditors other than the main state-owned commercial banks show up. To enhance their influence, courts could choose to treat the assembly’s right to be consulted as a veto right. Moreover, the creditor meeting could be given more legal recourse, for instance, to contest the fairness of the proceedings rather than merely the denial of a bankruptcy petition.

Treating Claims More Consistently. In implementation practice, SOE bankruptcy does not always stay all creditor claims in a systematic manner. For example, the purchaser under a “whole takeover” might assume bank debt but not other payables. Trade creditors in particular are often virtually ignored. The order of priorities among social claims has varied at times from the law, too. Even the payment of employee rehabilitation fees has occasionally been inconsistent among the employees of a firm beyond a desirable degree of flexibility. Such instances stem often from weak procedures or institutional capacity.

Reducing the Vulnerability to Irregularities. Disregard for creditor interests, inconsistent treatment, and inefficient reallocation of assets are frequently the result of irregularities to which the SOE bankruptcy regime is vulnerable. (i) The review of pre-bankruptcy transactions by the liquidation commission tends to perfunctory. It should be mandated to present a report on its review to the court. (ii) The firm’s top management often remains in place throughout the bankruptcy proceedings. More rapid replacement would reduce moral hazard. (iii) Asset valuations are carried out by entities that are licensed by and commonly affiliated to the local government that dominates the bankruptcy process. A recent policy by the Ministry of Land and Resources to spin off land valuation entities and have them supervised at a higher administrative level should be resolutely implemented. (iv) Not for all assets of the estate are attempts made to dispose on competitive markets with open access and wide and early advertisement. The establishment of land exchanges should be accelerated. Auction rules should ensure more transparency and accountability (conflicts of interest, legal recourse against auction houses, etc.). (v) The purchaser under “whole takeover” is often selected before the bankruptcy application and, if state-owned, may get its arms twisted to rescue a non-viable facility. In such takeovers, too, competition and transparency should be fostered. Public tender,

including negative-price tenders and investment tenders, could be used more widely. The access of potential non-state and foreign buyers to bankrupt SOEs could be facilitated in non-critical sectors.

Limited institutional capacity has been another source of irregularities and inefficiencies. While groups of judges in large cities have accumulated considerable bankruptcy experience, small-city courts have not. Moreover, courts are not entirely independent from the authorities. One might contemplate more frequent transfer of cases to higher courts, more rotation of judges, and perhaps specialized bankruptcy chambers for entire regions. Bankruptcy should also get more attention in the education of judges, and at accounting institutes, business schools and law schools in general. Special training and certification could help build the trustee profession that will most likely be needed under future bankruptcy legislation. The capabilities of AMC and banks in bankruptcy and work-out would benefit from enhanced technical skills, stronger incentives for credit collection, and insolvency specialists contracted with adequate incentives. A central institution could be appointed to help, under and beyond the CSOP, to help reveal irregularities in bankruptcies, disseminate good practice, promote relevant education, and develop the trustee profession.

Realizing the Potential of the Asset Management Companies. Four AMCs have lately taken over many non-performing loans from state-owned banks. These AMCs could become driving forces for bankruptcy and reorganization if they had adequate autonomy, tools, and capabilities. The AMCs could use various strategies to enhance their voting power in the creditor assembly. To facilitate the cooperation of AMCs with banks in cases where both hold credit claims, the banks need more scope for debt write-off and debt restructuring. Government-owned AMCs could get the right to initiate bankruptcy against SOEs without line bureau approval, at least in non-critical sectors. A first bankruptcy filing by an AMC incurred last winter, against a large listed firm. To send the right signals, it is important that the country's leadership fully support such pilot cases.

Broadening the Options for Reorganization. Many insolvent enterprises might become financially viable after thorough reorganization. For Chinese SOEs, however, there are only few options for out-of-court and in-court reorganization, and creditors have only limited influence on the process. As a result, restructuring has often not taken place at a point when the debtor still has a fair chance of recovery. Out of court, the main restructuring option for an insolvent SOE is merger. Such mergers are eligible to debt write-off quota under the CSOP. However, the CSOP and its quota are limited in scope, and tax rules discourage banks from write-off by banks outside the quota. Court supervised reorganization is foreseen under the Bankruptcy Law, but it is rare since the creditors have no right to initiate it and the debtor and its line bureau would rather initiate merger or "whole takeover" instead. The "whole takeover" is a liquidation, legally speaking, but the whole bundle of assets, most employees, and the pension liabilities are transferred to the acquiring firm. Not transferred are the liabilities towards banks and other creditors. What's more, the creditors have little influence on the decision to pursue "whole takeover" and can not ensure accurate valuations and sale at fair value. Since it often is little more than a cleansing of debt at the expense of creditors, Beijing has lately discouraged "whole takeover". The report recommends to revisit the regulatory framework for conventional workout practices such as maturity extensions and "haircuts" of loan principal. Since reorganization is often dependent on new capital, a legal framework remains to be developed for super-priority or debtor-in-possession lending of fresh money to firms under insolvency proceedings. To allow better pricing of risk, the interest rate ceiling could be raised in the short term at least for loan rescheduling or new lending to firms under court-supervised reorganization. Also, the 1% cap on the tax recognition of loan loss provisions should urgently be lifted.

A framework for secondary markets of debt should also be developed. The sale of loans should not be dependent on the cooperation of the debtor. Controls against state sector entities selling loans or assets from liquidation beneath their appraisal value could be relaxed if the sale is done competitively. The access of foreign or foreign-invested financial institutions to distressed yuan debt could be facilitated. The legal framework for industrial investment funds, which covers also turnaround funds that buy distressed debt or equity to restructure them for profit, should be finalized.

Safeguarding Secured Interests of Creditors. The protection of secured interests is critical for the stability of the financial system and the scope of bank lending. The Bankruptcy Law excludes secured claims from the estate. However, a ministerial decree subsequently allowed mortgaged land use rights (LURs) to be used for employee rehabilitation expenses under the CSOP. It failed to stipulate that they be applied only after unencumbered LURs, and even indicated that they be applied prior to unsecured claims on non-land assets. This priority of worker rehabilitation over security interests has allowed more bankruptcies since it addressed concerns about socio-political stability and shifted financial burden from local governments (for covering shortfalls in worker rehabilitation fees) to the central authorities (for bank recapitalization). However, this priority should be carefully revisited as reforms in the social security systems and other parts of the environment are taking hold. Moreover, the occasional practices to use mortgaged LURs for labor compensation even in bankruptcies outside the CSOP, or to give worker entitlements priority even over secured non-land assets, need to be suppressed.

There are further, general limitations to security rights. Many mortgages and guarantees by SOEs date back to a time when their legal framework was weak, and were later upon bankruptcy ruled invalid on various technical grounds. Even after the new Security Law of 1995, security interests are not easy to enforce. Courts in the debtor's town appear often reluctant to recognize security interests held by out-of-town creditors, or to enforce the rulings of courts from there; this enforcement problem needs sustained attention by the Supreme Court. To relieve the workload of courts, some self-help could be permitted to secured creditors. There are also various difficulties stemming from security registration that more standard registration practices and better legal recourse against registration agencies could help to address. Guarantees could be better evaluated and enforced if they were more strictly disclosed. Security interest in movable assets would benefit from a broader range of instruments than currently applied.

Funding the Settlement of Labor. SOE employees who are laid off by bankruptcy are commonly eligible to "rehabilitation" payments whose level has been substantial. Protests by workers or retirees of insolvent firms seem to often concern the non-payment of their entitlements and perceived corruption rather than the level of their rehabilitation or pension claims. The rehabilitation fee aims in part at maintaining average rather than minimum living standards. Since the fee is determined by a city's average wage in the SOE sector, the presence of well-paying national or provincial SOEs can drive the fee up to a level that prevents the bankruptcy filing for smaller local SOEs. The fee is also seen as a compensation for a worker's loss of status and security as SOE employee although benefits get increasingly monetized and social services moved out of SOEs. Furthermore, housing of the bankrupt enterprise usually gets transferred to the municipality which then lets the laid-off employees continue to use it without rent, or they end up getting ownership of the housing at a low charge. Some distressed SOEs have used their last resources and a final bank credit to construct apartments, thus sealing the fate of the business but providing the employees with the windfall of apartment ownership. The subsidy inherent in either approach to housing could be taken into account when calculating the rehabilitation fee.

Urban land used by the SOE is commonly the most valuable asset in bankruptcy. Under the CSOP, it is used with priority for rehabilitation expenses. The proceeds from "allocated" (i.e. free-of-charge) LURs of a bankrupt SOE have not been systematically pooled across bankruptcy cases. Consequently, an insolvent SOE that used little land may not be allowed to go bankrupt, while another SOE with a large lot does enter bankruptcy but the excess value of its LUR may get channeled to some municipal development project or disappear through non-transparent valuation and sale. Last March, the Ministry of Land and Resources called for independent valuers and for sale through land exchanges. It also asked to establish municipal funds that pool the proceeds from selling hitherto "allocated" LURs that have been taken back from any bankrupted SOE of the city and earmark the fund with priority to rehabilitation fees. Implementing these policies should now be a high priority. The government might consider going further and adopt a universal policy to phase out the hitherto grandfathered use of "allocated" LURs by SOEs except for special public-interest areas. By levying substantial annual charges on "allocated" LURs SOEs could be motivated to convert them into

granted status, i.e. buy the use right and make it their asset. Eventually, the conversion could be made mandatory. This would give municipalities more revenue that could be pooled for bankruptcy related and other social expenditures. It would also lead to more efficient use of valuable urban land, less local rent-seeking, and better disclosure of a firm's true efficiency.

The Changing Environment of Bankruptcy. Social factors have indeed been a critical constraint to SOE bankruptcy. If half of all those SOEs that made losses in 1998 were liquidated on grounds of insolvency, some 20 million people would join the ranks of the urban laid-off and unemployed in the short term. Moreover, SOEs traditionally provided their workers comprehensively with social facilities and security. However, these constraints are gradually loosening as social security is undergoing fundamental reform. SOEs are transferring their health and educational facilities to the municipalities and selling their housing to their employees. Medical insurance has been introduced, pension systems are being pooled, minimum social welfare is being improved and, as noted above, municipal funds are to be established for lay-off related expenses. Such fundamental reforms take time, though.

SOE bankruptcy has also been circumscribed by institutional capacity and incentives. Creditor banks suffer from weak corporate governance. Local-level enterprises and administrations tend to cooperate against national-level creditor banks, at times even in collusion with such a bank's local branch manager. The owner of a local SOE is at the same time responsible for labor welfare and local development. It might also control the valuation firms, and even courts are not entirely independent. Some of these factors, too, have started changing and will continue doing so in the coming years. For example, the large state-owned commercial banks may soon get corporatized and eventually listed. Banks are also revamping their internal incentives and capabilities for loan approval and credit management. Valuation offices are to become independent, and the rule of law has recently been enshrined in the Constitution.

Finally, reluctance to involve private and foreign investors in the ownership of hitherto state-owned firms has constrained their bankruptcy or restructuring. In many cases, such investors may have stronger restructuring expertise, better synergies, clearer incentives, and deeper pockets than the bureaucratic organs that represent the state ownership. In September 1999, the Fourth Party Plenum of the Party Central Committee decided to focus the state's ownership control on a few special areas. Only in national security, natural monopolies and some pillar industries would the state retain control. Other SOEs should be corporatized, and changes of their ownership would be possible.

It is those SOEs that are still not corporatized, and those in non-competitive industries that shall remain in state control, that we recommend to submit to a new bankruptcy law not immediately but only after some more years of reform in social security and institutional capacity. In the meantime, various interim improvements could be made to their existing bankruptcy regime. Other state-owned enterprises could be subject to a new bankruptcy law without delay. Introduction of such a new bankruptcy system is a particular priority for the non-state sector which is playing an increasingly important role in China's economic transition and growth.

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BANKRUPTCY OF STATE ENTERPRISES IN CHINA

- A CASE AND AGENDA FOR REFORMING THE INSOLVENCY SYSTEM -

I. INTRODUCTION

In China today, many state-owned enterprises (SOEs) are loss-making or non-viable, and a large number of debtors have since long been in default to banks and trade creditors.¹ Credit allocation and asset re-allocation are not efficient. The urgency to address this issue has been recognized in particular as the country has been experiencing slower economic growth, a regional investment climate still affected by the Asian crisis, and the challenges of global competition under future WTO accession. A three-year target to curtail the number of loss-makers among large SOEs, as well as a longer-term objective of fundamental enterprise reform are high priorities of the country's leadership. So are the resolution of non-performing loans through asset management companies to improve solvency in a fragile banking sector, and a shift of resources towards the increasingly private small and medium enterprise sector.

All these initiatives require an effective and efficient system of reorganizing insolvent enterprises and transferring resources out of non-viable ones and into more productive uses. A well-working bankruptcy system, with its underlying threat to those who under-perform, should also be a driving force in the corporate governance exercised by the managers and owner representatives of enterprises. Moreover, the recent experience of neighboring countries has demonstrated the critical importance of an effective bankruptcy threat for resolving widespread corporate distress.

Overriding concerns for labor welfare and social stability have hitherto been the main constraint to the scope and nature of bankruptcies in China. The administrative reallocation of enterprise assets for sundry development initiatives on the local level at the expense of creditors from other jurisdictions within China and beyond has added distortions to the process. A multiplicity of, and yet gaps in, bankruptcy regimes in China, has created further lack of clarity and legal security.

While these social constraints and local-center tensions will persist in the foreseeable future, various other developments offer nonetheless an opportunity for substantial reform of the country's bankruptcy system. Social security is rapidly getting "pooled" beyond the individual enterprise, and supplemented by the transfer of housing ownership to employees. Political leaders, enterprise managers, and common citizens have become familiar with the concept of bankruptcy. Basic implementation capacity for bankruptcy has emerged through half a decade of practice in courts, liquidation commissions, and valuation offices. The rule of law has lately been enshrined in the Constitution, and important bankruptcy cases are signaling to enterprises not to count on bail-out by the state. Private enterprises are now formally acknowledged as an important element of the market economy that should be ruled by competition and law rather than administrative decision. A Plenum of the Party Central Committee has decided that state control needs to be retained only in natural monopolies, special public interest areas, and some pillar enterprises. The time has come to reform China's bankruptcy system.

This study reviews China's bankruptcy system and assesses it in light of the changing environment. On this basis, the paper lays out recommendations for reform both in the short run and longer term. The bankruptcy system as defined here includes the policy approach, legal framework, processes and institutions. The note looks at the sequence from recognizing insolvency and deciding to file bankruptcy all the way to asset reallocation and worker settlement.

¹ For 1998, loss-making state-owned and state-controlled industrial firms reported Yuan 101 billion losses, while profitable ones reported Yuan 155 billion profits. In 1999, the situation improved with Yuan 85 billion losses and Yuan 182 billion profit.

The main empirical basis of the study were interviews in five cities conducted in May 1999, with an emphasis on a sample of 15 bankruptcy cases. The cities Shanghai, Shenyang, Changsha, Wuhu, and Loudi represent a range of situations in terms of town size, development of the legal/business infrastructure, and inclusion in the government's debt write-off program for bankruptcies and mergers. Apart from the case studies, interviews were conducted in these cities and at the national level with representatives of government agencies responsible for state-owned enterprises, financial sector, labor/social security, land, etc., as well as with representatives of the judicial and legislative system, service professionals (valuators, accountants, lawyers, etc.), banks, other creditors, and debtor enterprises. The main counterpart of the study has been the State Economic and Trade Commission (SETC), particularly the offices on Merger & Bankruptcy and on Loss-Making Large Enterprises within the Enterprise Reform Department.

A supplementary informal background note on credit securities has been produced subsequently with the benefit of additional interviews conducted in August.² Key recommendations are reflected in this report.

II. THE DEVELOPMENT OF CHINA'S BANKRUPTCY SYSTEM

A Trial Bankruptcy Law for State-Owned Enterprises (henceforth: Bankruptcy Law) was enacted in 1986 and became effective in 1988. The Supreme Court issued a set of related opinions in 1991. Also in 1991, the Civil Procedures Law introduced rudimentary provisions on the bankruptcy of legal persons in general, and the Company Law later added provisions on voluntary liquidation. Still, the period from 1988-1993 saw only 277 bankruptcy cases per annum, mainly due to concerns about the impact on labor.

In 1994, this barrier was overcome through State Council Circular No. 59. It stipulated that land-use rights be used first to support affected workers and retirees. In a way, it linked the main off-balance liabilities of enterprises (pensions and severance, as well as other labor "rehabilitation" entitlements stemming from the SOE employee status) to the main under-valued or off-balance assets (land use rights). The Circular also excluded enterprise-owned employee housing and other social assets from the bankruptcy estate. Circulars No. 113 and 130 introduced merger as the main restructuring alternative to bankruptcy, and set standard terms for debt restructuring in mergers.

This set of regulations starting with Circular No. 59 created the so-called "Capital Structure Optimization Program" (CSOP). It applied initially to 18 large pilot cities. SETC assigned debt write-off "quota" to SOE bankruptcies and mergers in these cities, based on applications received from local Economic and Trade Commissions (ETCs) and involving consultation with the central bank. Since the Big-Four state commercial banks are only allowed to write off against existing provisions and this stock of provisions is effectively capped through tax regulations at 1% of the portfolio, this meant that the Government through the quota decided on the banks' utilization of their limited scope for debt write-off.

In 1994-95, the quota was some Yuan 7 billion. A third thereof was used for 113 bankruptcies under the pilot and the other two thirds for mergers. Encouraged by this signal and a general atmosphere of reform, bankruptcies outside the CSOP also accelerated, reaching 2,100 per year in 1994-95.

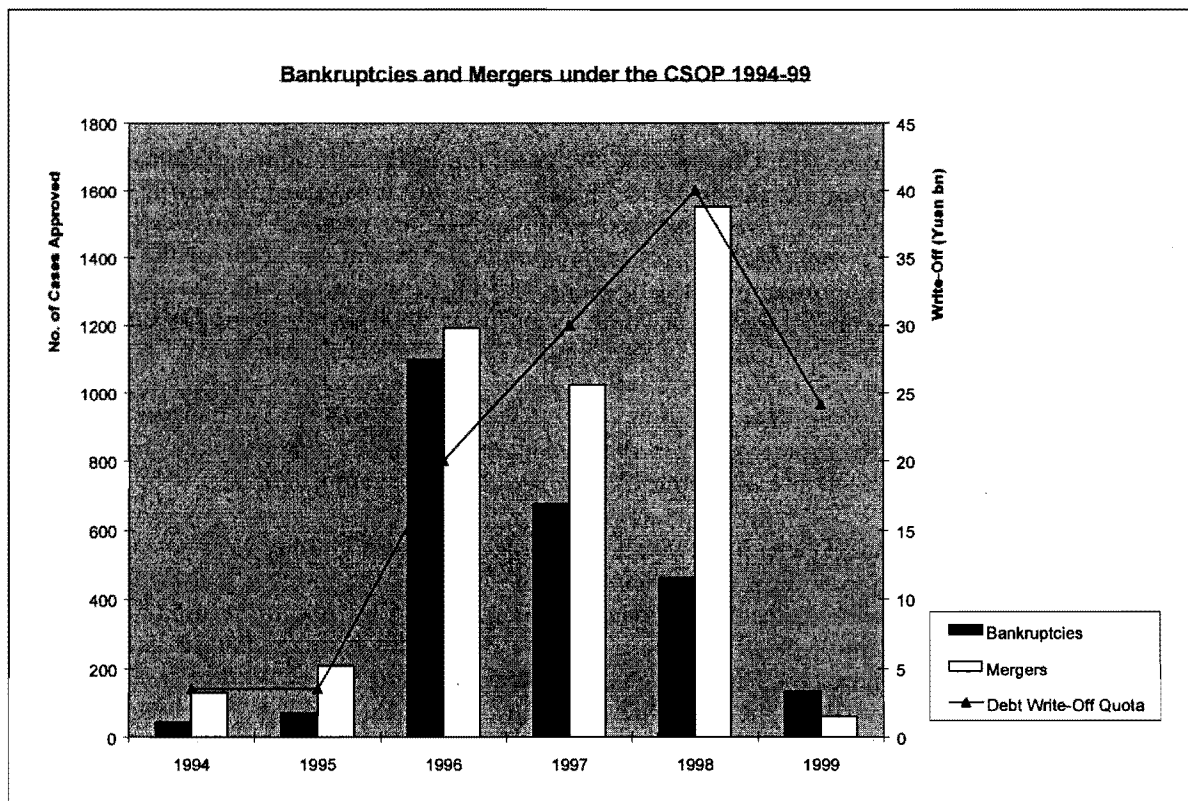
Applications for the quota still came in slowly, however, and the Yuan 7 billion were not entirely utilized. Labor concerns continued to prevent many bankruptcies. This was the case particularly where land use rights had been mortgaged and, therefore, under the Bankruptcy Law had to be used with priority to satisfy the mortgage holders. Such mortgages became even more frequent since a new Commercial Banking Law in 1995 required the Big-Four banks to henceforth secure their lending to all but the most creditworthy borrowers. In 1996, the authorities issued a Circular No. 492 that gave labor rehabilitation

² Yan Zhang and Klaus Lorch: Taking and Enforcing Credit Security in China (forthcoming).

and pension expenses priority claims on land use rights even when these rights had been mortgaged by the SOE, notwithstanding basic principles of the Bankruptcy Law. At the same time, the write-off quota was expanded to Yuan 20 billion for 56 cities. In that year, the number of bankruptcies under the CSOP rose to 1,100 SOEs with some 700,000 employees.

In 1997 and 1998, the quota was further expanded to Yuan 30 billion and 40 billion, respectively, for now 111 cities. The bulk of loan loss provisions in the Big-Four banks was thus allocated to write-offs through administrative decision. However, ever louder complaints by creditor banks about their low recovery rates led to restricting bankruptcy, particularly bankruptcy involving “whole takeover” of the entire asset bundle and its continued operation by another firm. Mergers got favored instead. Circular No. 10 discouraged bankruptcies through “whole takeover”, broadened debt restructuring in mergers, and made also some downsizing that does not involve merger or bankruptcy eligible to write-off quota. Inter-agency working groups with secretariats at the ETCs were set up at the national and municipal levels to “regularize” the administration of the quota. The number of bankruptcies under the CSOP quota dropped by half to some 570 per annum in 1997-98, whereas mergers rose to 1,300.

Disappointed with the lack of genuine restructuring under mergers, committed to drastically cutting the share of loss-makers among large SOEs within a three-year timeframe ending March 2001, and finding many non-viable SOEs among the thousands of firms being transferred from the military and police to economic bureaus, the Government changed the CSOP once more for 1999-2000. Bankruptcy receives again higher priority than merger. Central control of the process has been strengthened. Bankruptcies under the program are henceforth proposed by SETC and implementation is supervised by the provinces rather than the cities. The Big-Four banks are still able to negotiate changes to the list proposed by SETC, but they now do so on the central rather than local level. The write-off quota is no longer fixed for a year but assigned case by case. In 1999, 133 major bankruptcy cases were approved, with an average write-off quota of Yuan 135 million or a total of 18 billion. These cases focus on large loss-making SOEs in order to support the broad three-year target of slashing the number of loss-makers among large SOEs.



Since large bankruptcies take often more than a year to complete and the three-year target ends in March 2001, the priority is now shifting towards another policy objective, namely, the rationalization of some industries with severe excess capacity. Industries selected so far include wool and silk textiles, iron and steel, non-ferrous metals, sugar, and some defense industries.

The Capital Structure Optimization Program (CSOP) for Insolvent State-Owned Enterprises, 1994-99

	1994	1995	1996	1997	1998	1999
Key Circulars Issued	No. 59 No. 113	No. 130	No. 492	No. 10		
Cities in the Program	18		56 (including all province capitals)	111 (plus textiles, defense, and "major" firms elsewhere)		Any location (medium or large loss- making firms)
Bank Debt Write-Off Quota (Yuan billion)	7.0		20.0	30.0	40.0	24.1 /a
* Bankruptcy	2.4		n.a.	17.0	n.a.	17.9
* Merger	4.6		n.a.	9.0	n.a.	6.2
* Other	-		-	5.0	n.a.	-
No. of Cases Approved	171	278	2,291	2,486	2,721	199
* Bankruptcy	44	69	1,099	675	459	133
* Merger	127	209	1,192	1,022	1,550	58
* Other	-	-	-	789	712	-
No. of Cases Implemented	145	263	1,375	1,930	2,552	1,700-1,800 /a
* Bankruptcy	18	54	858	804	425	na
* Merger	127	209	517	1,126	1,453	na
* Other	-	-	-	n.a.	674	na
Firms in Bankruptcy (approved)						Bankruptcy + Merger:
* Number	113		1,099	675	459	199
* Employees	76,800		680,000	n.a.	n.a.	776,000
* Assets (Yuan bn)	2.9		25.0	n.a.	>24.9	67.9
* Liabilities (Yuan bn)	4.9		43.0	n.a.	n.a.	75.9
Firms Absorbed through Merger (approved)						
* Number	336		1192	1,022	1,550	
* Employees	164,000		1,130,000	n.a.	n.a.	
* Assets (Yuan bn)	64.6		29.2	n.a.	>180.7	
* Liabilities (Yuan bn)	n.a.		27.8	n.a.	n.a.	

/a In 1999, 199 cases were approved, with write-off quota of Yuan 24.1 billion. In addition, some 1,600 bankruptcy and mergers cases that had been approved earlier started or continued being implemented in 1999, requiring additional write-off quota of Yuan 20.2 billion.

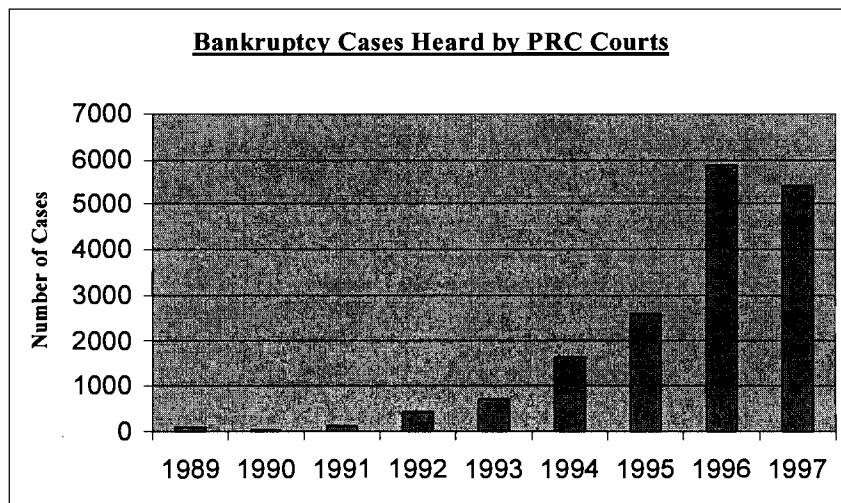
Sources: SETC White Books; SETC Handbook on the Capital Structure Optimization Experiment; Wang Mengkui, Facing the Financial Crisis; data obtained from SETC

Bankruptcies have also occurred outside the quota system. Many SOEs of small size, non-industrial sectors, or outside the large pilot cities were taken through bankruptcy particularly since 1996. This happened at times without consequent debt write-off by the local bank branch. In 1997, for instance, 2,400 SOEs went into bankruptcy outside the quota system, as compared to 700 under the quota; the latter were of larger size, though. Together, SOEs accounted for 56% of all bankruptcy cases in that year. Almost 1.5 out of every one hundred SOEs went into bankruptcy in 1996-97.

In the future, the newly established asset management companies (AMCs) related to the Big-Four state-owned commercial banks (SOCBs) should further accelerate the bankruptcy of SOEs. These AMCs are assuming non-performing loans (NPLs) from the associated banks at full book value. The AMCs see as their objective to maximize the real value of these assets. Moreover, upon transfer to AMCs, the write-off on a loan is no longer bound by the small stock of loan-loss provisions in the banks. Combined with their mandated focus on debt resolution, this should theoretically motivate the AMCs to combat the manipulation of bankruptcy procedures by local authorities for municipal development initiatives and to recalibrate the balance between labor and creditor interests. However, the AMCs are expected generally not to take over NPLs rated loss, which would leave the most destitute small and medium SOEs now outside both the above quota program and the AMCs. Moreover, some AMCs are today still negotiating not to take over a large number of very small NPLs because of their limited staff resources. Nor are the AMCs supposed to take over NPLs from 1996 onwards when banks started enjoying more autonomy in lending decisions.

Collective enterprises have often received similar treatment as SOEs, with local authorities and courts applying the concepts of the SOE Bankruptcy Law. Other non-state enterprises have gone into bankruptcy less frequently. If incorporated, they are subject to some insolvency provisions in the Civil Procedures Law of 1991. This law applies also to the bankruptcy of joint ventures. There have been some first major court adjudications of joint venture bankruptcy in 1999. Enterprises in natural person form, which include all firms with eight or less employees, have not been subject to any bankruptcy regime. The notion of physical person bankruptcy still raises widespread concerns of ideology and socio-political stability. It would in the short term also encounter technical difficulties such as the widespread opening of deposit accounts under pseudonyms and the limited capacity of courts.

Bankruptcies of all forms of enterprises together rose from 277 per annum in 1989-93 to 2,100 p.a. in 1994-95, and further to 5,640 per year in 1996-97.



III. REVIEW OF THE BANKRUPTCY SYSTEM FOR STATE ENTERPRISES

a. A STEREOTYPICAL STATE-OWNED ENTERPRISE BANKRUPTCY

Before analyzing various aspects of SOE bankruptcy in detail, it may be helpful to look briefly at the process as a whole. A stereotypical SOE bankruptcy under the Capital Structure Optimization Program (CSOP) prior to 1999 can be paraphrased as follows.

(i) The management of a distressed SOE jointly with the relevant sector bureau under the local ETC and in agreement with the mayor's office come to consider bankruptcy as a potential option. Several factors figure prominently in their deliberations:

- The firm's inability to pay workers and pensioners, increasing difficulty in getting its banks to roll over credit, and its losses and consequent lack of tax payments;
- whether worker and retiree entitlements could be settled from liquidation proceeds without substantial municipal contribution, or whether another firm has been or will likely be found that is willing, with some moral suasion and incentives, to take over the assets as well as the workers and their entitlements;
- the likely militancy of the employees, in light of the local social strains through already high unemployment;
- whether the firm uses land that could serve attractive development purposes; and
- whether approval of debt write-off can likely be obtained from Beijing for the local branch of the main creditor bank, particularly under the CSOP quota.

The main alternative to bankruptcy is a merger done out-of-court with standard debt restructuring formula stipulated for SOEs by decree under the CSOP. Given these standard formula and some assumptions and understandings about asset valuation and worker entitlements, the city officials can compare upfront the financial consequences of such merger versus bankruptcy.

(ii) The plan to pursue bankruptcy by using part of the CSOP write-off quota that the municipality expects to get this year is then discussed with the local branch of the relevant SOCB. The application for write-off quota under the CSOP is launched to the Merger & Bankruptcy Office located at SETC. The application is reviewed together with more than a thousand others by a temporary taskforce of that Office, involving mainly SETC staff but also liaison with PBOC. The taskforce takes into account the merits of the case and also seeks a certain balance of quota in terms of provinces, sectors, banks, and current policy prerogatives. The emerging list gets finetuned in discussion with the SOCBs, and formally approved. Let us assume our debtor enterprise made it into the list.

(iii) The firm with formal endorsement by the local sector bureau then files for bankruptcy at the local People's Court. The court applies a somewhat flexible balance sheet test, and verifies the sector bureau consent prior to starting bankruptcy proceedings. In larger cities, the local court commonly has a group of judges that handle all bankruptcy cases and have thus gained substantial experience. The role of the court is largely limited, however, to pronouncing decisions taken by the Liquidation Commission (LC). The court-appointed LC consists usually of representatives from various municipal agencies (for economy & trade, labor, land, finance, etc.) and the central bank branch. The LC is often headed by an official of the local ETC, such as the head of the ETC's Office for Bankruptcy and Mergers that oversees the CSOP at the municipal level. The old SOE management commonly continues managing the SOE or maintaining its assets until liquidation is completed.

(iv) After the bankruptcy declaration, substantial creditors are notified and invited to present their claims. For most state-owned creditors, particularly trade creditors, the importance of the announcement lies in that it allows them to write off their claims with personal impunity and with recognition for tax purposes. In any case, trade creditors rarely receive significant proceeds from the estate. Debtors are notified as well, but only limited effort is made to collect from them. There is little incentive to collect from debtors located in the town just for the benefit of a nationwide creditor bank, and claims on debtors

in other jurisdictions would be hard to enforce. Next, valuations are done by valuation enterprises sponsored by local government agencies, including land valuations by a valuator affiliated with the Land Bureau. It seems that the value of the land use right often happens to be found roughly commensurate with the worker and retiree entitlements. (In this case, the local acquirer of the land use right will not be burdened, beyond the local social needs, by payments to the estate that end up with a nationwide bank and other out-of-town creditors.) Eventually a creditor meeting is held, with typically few if any trade creditors showing up and the main purpose being to confirm officially the consent of the local branch of the relevant state bank. Although the Bankruptcy Law has some clauses on court-supervised reorganization, they are rarely used. The Law allows application for such reorganization only to the SOE or its owner organs, and those parties had anyway already upfront decided in favor of bankruptcy and against merger despite the fact that the latter is also eligible to debt write-off quota.

(v) Liquidation commonly takes one of two forms:

- “Whole takeover” is a bulk sale of the assets. In this case, all the assets including the land use right, together with most workers, “rehabilitation” costs of laid-off employees, and pension claims are taken over by another firm. Since the acquirer is seen as taking over the burdens of employing these workers and paying the retirees, the value of their total entitlements is subtracted from the asset value upon purchase. Since the land use right is often valued comparable to these entitlements, and other assets are of little value, little cash changes hands.
- In the case of unbundling the assets, the city takes back the land use right and sells it in some way or another, for example, to a local development company. The proceeds are used to pay pensions and labor rehabilitation costs. Again reflecting prior valuations, often little additional cash is obtained. Other assets are offered at auction, for instance at a local Property Rights Transaction Center. Often, though, they get no offer at or above their valuation and hence remain unsold for years, until a special petition is launched to higher authorities for permission to sell such a state asset below valuation.

(vi) According to the Bankruptcy Law, secured assets are separated from the estate for satisfaction of the secured creditors. However, the CSOP Circular No. 492 of 1996 had made even mortgaged land use rights available for worker claims. Mortgages on other assets are hard to enforce through the court system, and “self-help” by the secured creditor is not permitted. Cross guarantees from other SOEs, especially those predating the Security Law of 1995, are hard to enforce as well; courts may rule them invalid on grounds that they were given involuntarily upon instruction by the authorities. Pledges of securities are not common by small and medium SOEs. Pledged movables are then often the most reliable credit security. In practice, most assets are liquidated, with the proceeds going first and foremost to the retirees and workers, unless it is a case of “whole takeover” as described above. The workers are entitled to a package equivalent to about three annual average wages among the SOEs in town, typically amounting to some US\$ 1,500-2,000. This is seen not just as minimum living expenses but also as buying out the person’s rights as a state sector employee. It is often paid as a lump-sum to the worker or to the re-employment center that takes care of him for the coming three years (or, in case of whole takeover, to the acquirer). Retirees receive their pension entitlements as a lump-sum as well. If the total proceeds do not suffice to satisfy these worker and pension claims the municipality is expected to chip in, but such situations are rather avoided by not initiating bankruptcy in the first place.

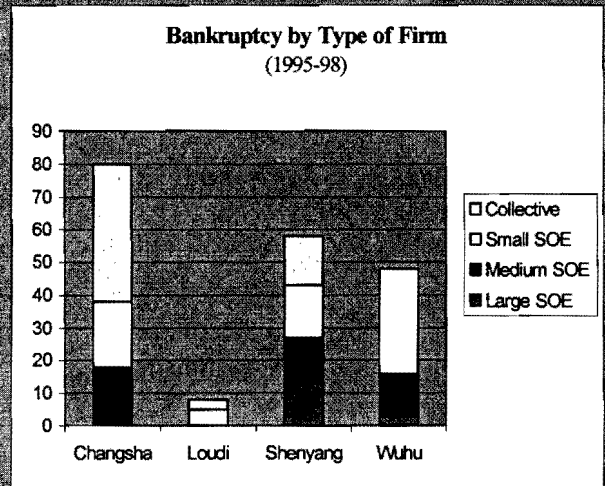
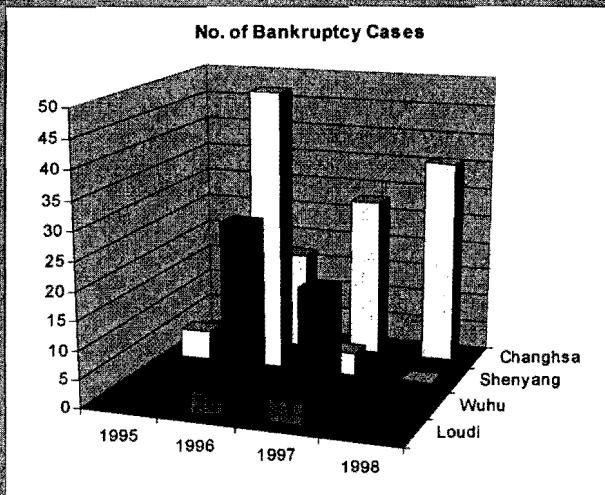
The Profile of Bankruptcies in Four Cities

Data on bankruptcies of state-owned and collective enterprises in four of the five cities participating in this study shows the following picture for the period 1995-1998. (For more detail see Appendix 1)

Courts in the four cities (Changsha, Loudi, Shenyang and Wuhu) completed 195 bankruptcy cases. Changsha had the largest number of cases, but most were small to medium firms. Shenyang cases were the largest in size, averaging 1,200 employees and retirees per firm. Wuhu also saw many medium to large bankruptcies. Loudi, a much smaller town, had 3 bankruptcies, although it was outside the CSOP and received no debt write-off money.

Only Shenyang completed cases as early as 1995. In fact, this city had earlier been one of the first in China to carry out bankruptcies, initially under municipal regulations. All but Changsha ceased bankruptcies in 1998.

All the cities except Wuhu saw bankruptcies not only of state-owned but also collective enterprises.

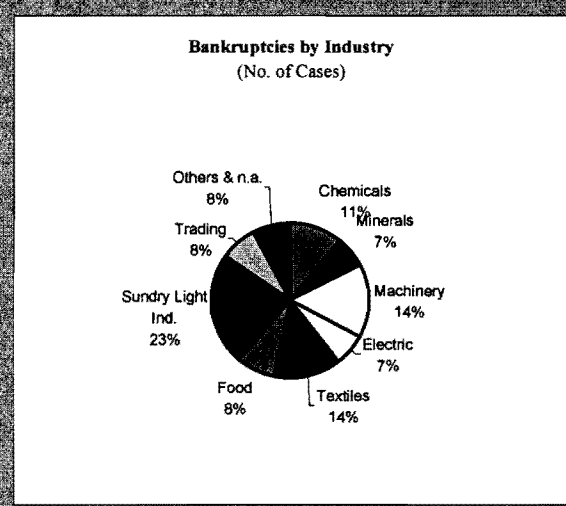
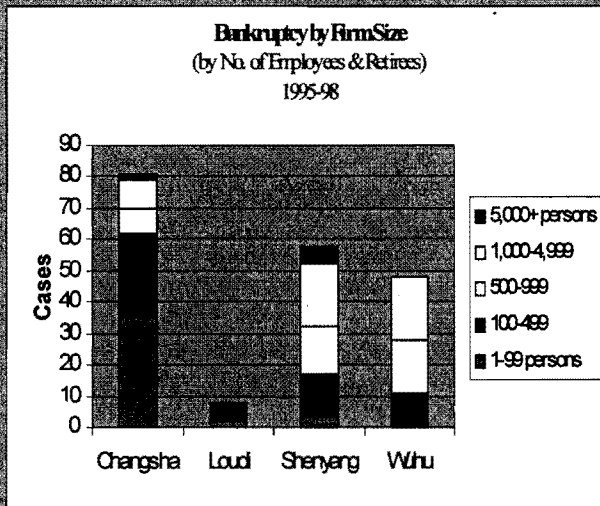


The bankrupt firms had an average 691 employees and 232 retirees, for a total of 923 persons. Eight of the 195 bankrupt firms had more than 5,000 persons each, and only 40 had fewer than 100 persons.

Many of the bankrupted firms were in the machinery, textile and sundry non-food light industries. These firms tended to be slightly larger than those in other industries, and had more bank debt among their liabilities. The machinery industry alone accounted for 33% of all employees and retirees of the 195 bankrupted firms, and the textile industry for another 23%.

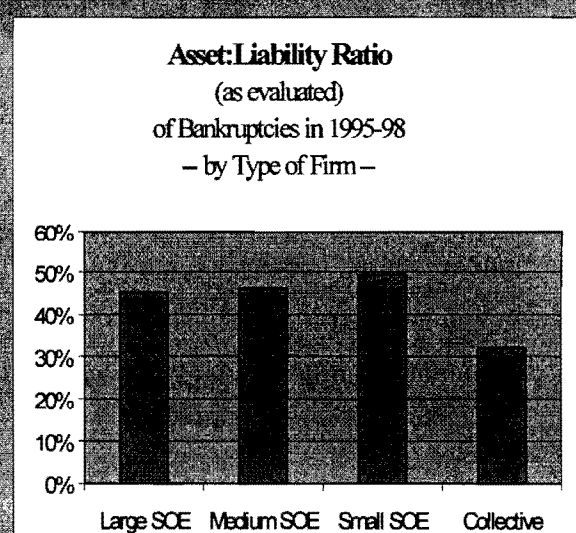
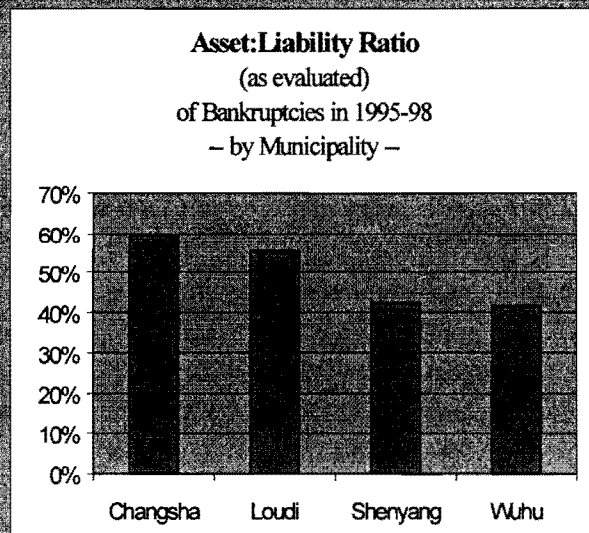
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The average bankrupted firm had Yuan 23 million assets, as evaluated during the bankruptcy process. At the same time, average liabilities were recorded as Yuan 52 million. In other words, liabilities were more than twice as high as assets. This amounted to an asset:liability ratio of 45%. This ratio was worst among collective enterprises (32%) and among trading/distribution enterprises (37%). (These figures do not include allocated land use rights and worker rehabilitation entitlements, neither are in the firms' balance sheets.)

Altogether, the 195 bankruptcy cases involved liabilities of Yuan 10.2 billion. Thereof 67% was bank debt.



Data on the settlement of claims under these bankruptcy cases is unfortunately incomplete. For those firms where data is available on the settlement with workers, these settlement expenses amounted to 73% of the firms' asset value, and were about half as high as total liabilities (in which they are not included). Repayment of other claims has been very low. In Loudi, for instance, less than 5% of liabilities were repaid although no debt write-off quota under CSOP was available to the city. In Changsha, repayment of non-employee liabilities is reported in only about half the bankruptcy cases, and even in these cases it amounted to only 9% of liabilities. In this city, the write-off quota of the CSOP was used in over two thirds of all bankruptcy cases; a total Yuan 1.0 billion bank debt was written off, amounting to 96% of the bank loan principal of those debtor enterprises where the quota was applied. In Wuhu, by contrast, the write-off quota covered often a much smaller portion of the debtor's bank debt.

b. FINANCIAL DIMENSIONS OF THE BANKRUPTCY SYSTEM

The financial position of SOEs and banks in China tends to be weak. A 1995 survey found that 37% of non-financial SOEs were insolvent based on the book value of assets and liabilities. This figure was likely understated due to poor accounting standards and reporting. The average SOE is encumbered with excessive bank debt, and is in need of ongoing financing and working capital to continue modernizing and improving operations while playing its role in meeting social obligations. The amount of losses generated by industrial SOEs in 1998 was reported as Yuan 80 billion, while profits amounted to some Yuan 120 billion.

Another attempt to assess SOE losses is to look at the losses incurred by the large state owned commercial banks ("SOCBs"). The lack of accurate loan loss provisioning complicates this. Market analysts have estimated non-performing loans (NPLs) anywhere from 25% to 60% of SOCB portfolios. The recently established AMC's have been purchasing approximately 20% of the loan portfolios of the SOCBs. Even after these transfers, the SOCBs will still have substantial amounts of NPLs on their books.

The financial position of SOEs and banks is influenced by the political and fiscal environment. In the state planned economy, SOEs were obliged to meet the social needs of their communities, including full employment and comprehensive social services to their employees, retirees, and their families. Even in the transition to a market economy, SOEs are often expected to prioritize employee-related expenses over debt service for social and political stability.

China's move to a market-led economy is at a critical stage. Premier Zhu Rongji has stated a target of reducing by early 2001 the share of loss-makers among large and medium SOEs to a level similar to that among large firms in developed market economies, by either restoring a firm's profitability or closing or merging it. At the same time, SOCBs, which have borne the greatest financial burden of the cumulative losses over the years, are being transformed into more autonomous and profit motivated institutions. The development of a commercial and legal framework that clearly establishes rights and responsibilities of the various stakeholders while meeting well articulated social policy objectives is essential at this stage.

The objectives of bankruptcy legislation and procedures in developed countries are generally to:

- provide a fair and commercial basis for resolving the affairs of bankrupt entities. It should give the current and future creditors a transparent and binding framework that provides a clear option for recovery of debt and, thus, allows commercial decisions on a risk basis;
- permit the rehabilitation of an honest but unfortunate debtor whose debt repayment burden cannot realistically be met, so as to permit to restore the person and assets to productive and efficient use; and
- allow for the orderly and fair distribution of all assets to creditors in a transparent and equitable manner.

China's bankruptcy system focuses on the rehabilitation of assets with little consideration of creditor interests and the resultant commercial environment. The recovery to banks in SOE bankruptcies has rarely surpassed 20% of the book value of their loans, and has typically been in the range of 3 to 10%.

With the move to a market economy, the policy makers must address wider issues such as:

- a systematic process of transforming enterprise ownership and control, and introduction of market incentives to promote enterprise restructuring, in order to reduce the financial burden of the state;

- a commercial framework with clearly articulated rights and responsibilities of debtors, creditors, government, employees and other stakeholders based on the rule of law. These rights must take into consideration:
 - a redefinition of social liabilities and responsibilities of enterprises and government;
 - the inability of the workers to share a large portion of the social and fiscal burden during the transformation, due to widespread unemployment and industrial adjustment; and
 - the inability and resulting risks for SOCBs to continue assuming the financial burden.

With the creation of the AMCs to resolve pre-1996 NPLs, these issues have to be addressed. The AMCs are authorized to convert debt to equity and sell such equity, restructure or sell off loans, or foreclose on collateral. As most of the AMC portfolios are SOE debt, weaknesses in the SOE bankruptcy regime and the lack of special AMC powers that would help overcome some such weaknesses have created ambiguity about the operations of the AMCs. Yet, while the AMCs have been mandated to maximize the recovery from these NPLs it would not be realistic to assume that, as part of the state sector, they would be permitted to disregard social and political stability concerns.

Case Study: Bankruptcy and Good Management Can Lead to Good Use of Liquidated Assets

The bankrupted enterprise in this case, a small municipal SOE, had been making losses for several years. Its low technology equipment, in poor condition, was operating at 5% of installed capacity, but the enterprise was maintaining its full complement of over 200 employees. At the time of bankruptcy, the enterprise had accumulated over 15 million Yuan in debts, 80% of which to banks, and its debt to asset ratio exceeded 200%.

A petition for bankruptcy was finally filed in early 1996. The Court closed the case in 1997, after delay occasioned by the difficulty to agree on the price of the assets and the compensation of the workers. The municipality convinced another municipal SOE to absorb the assets. This buyer, however, was already overstaffed and did not want to take over any of the employees from the bankrupt firm. The Court finally approved the sale against cash payment of slightly more than half of what the Liquidation Commission originally wanted to obtain for the assets. The workers received, in installments over a one-year period, rehabilitation fees of 12,000 Yuan per person (on average). This was considerably less than three times average annual wages in this town, but was accepted by the workers who had received little more than minimum wage for quite a while. They now also obtained their salary arrears and reimbursement for cash that they had advanced to the old firm to keep it operating. The social security and tax arrears have been cleared but the creditors, mostly the banks, recovered only 1.5% of their original claims.

Following the acquisition of the assets, the acquiring SOE signed a six-year lease with a private individual to operate the facility. The lease contract provides for a fixed fee to be paid to the SOE, with provision for an annual percentage increase, with the lessee keeping all the profit he can make from the operation and a right of first refusal for renewal of the lease. 17 of the original employees of the bankrupted enterprise have been hired by the lessee under six-year contracts, and he has hired another dozen unemployed workers. These are small numbers compared with the original staffing, but these jobs appear financially viable and sustainable.

Although he saw potential in the facility, the lessee was not interested in buying the assets and did not have the resources to do so. However, he has invested his own money and used retained earnings to pay the lease, provide the working capital, and start rehabilitation of the assets.

At the time of bankruptcy, the facility had an output of 20,000 tons/year with 216 workers. It now operates at a profit, selling over 100,000 tons/year with 30 employees. In spite of good results, however, the banks have not yet resumed lending to this private lessee.

This section will highlight five sets of issues:

- (i) SOE bankruptcy has been an administrative process, with little creditor involvement and transparency. The process can hinder the unfolding of market-based lending and borrowing. However, incentive problems in the main creditor institutions themselves are only now changing, which means that some administrative control over bankruptcy may remain necessary for an interim period.

- (ii) The incentives of key stakeholders in the administered bankruptcy process have caused a bias against creditor interests and against timely reallocation of assets to their best alternative uses. Therefore, while some administrative control may still be needed, it should be adjusted to reduce such bias.
- (iii) Secured interests are hard to enforce against insolvent enterprises. This discourages new lending.
- (iv) The treatment of creditors has been inconsistent across municipalities, within classes of creditors, and – through vulnerability to irregularities -- case-by-case between SOEs. More consistency could increase predictability and, thus, the security perceived by creditors as well as employees.
- (v) Effective reorganization alternatives once bankruptcy has been chosen and filed, and mechanisms to provide credit to viable but insolvent firms, have been few. This has limited the options for rescuing potentially viable firms as going concerns and obtaining better results for creditors.

Bankruptcy as an Administrative Process

In 1994-98, proposals for debt write-off under the CSOP were initiated on the municipal and provincial levels by debtor enterprises and their line bureaus. The local multi-agency CSOP taskforces then proposed candidates for debt write-off to the national CSOP taskforce. The latter reviewed the proposals and selected a nationwide list, taking into account a certain balance of allocations across provinces and sectors. Since 1999, most proposals originate at the national and provincial levels, since the quota is now used with priority for large enterprises and in the context of nationwide rationalization plans for certain industries. The CSOP taskforces include representatives of the central bank, and the SOCB headquarters approve the list before its finalization. Still, the main creditor banks have been only one of many parties involved, and not the main decision-maker. In particular, they have not been able to use write-off quota under the CSOP without taskforce approval, and their scope for debt write-off beyond the quota has been increasingly limited. In 1998, for instance, the write-off quota amounted to Yuan 40 billion. The total SOCB provisions for doubtful loans were less than Yuan 60 billion in that year, since they are effectively capped at 1% of loans outstanding. (Higher provisions are not recognized in assessing profit tax.) This left only some Yuan 20 billion outside the quota.

SOE bankruptcy has largely been an administrative process to cleanse the assets of liabilities after the authorities have decided on the future use of the business (under “whole takeover” of the entire asset bundle and employees) or key assets (such a land use rights). The bankruptcy process of SOEs did generally not serve the function of allowing creditors to protect their interests. State agencies that represent borrower interests have been the main decision-makers in almost every aspect of the bankruptcy process from the selection of the enterprises, the actions taken during the bankruptcy, and the valuations involved, to finding the purchaser, negotiating the sale and settling the claims. The state also owns the SOCBs, but their supervisory organ (People’s Bank of China) has been playing a minor role in industrial bankruptcies, except in the allocation of the national write-off quota. This government control of the process has lacked the transparency that would come with independent decision making and involvement of the creditors. While it is unavoidable to have the state play a role in bankruptcy for the time being, increasing the independence between the SOCBs, SOEs, the courts and government will be important for future economic development.

The administrative nature of the bankruptcy process is rooted in a lack of market principles when the Bankruptcy Law originated in the mid-eighties. It also reflects the priority concern for social stability as the state sector started to lay off excess staff in the mid-nineties, when the CSOP was designed. The underlying model is that of a wholly state-owned debtor and wholly state-owned creditors, with the state as owner of both entities not leaving the bankruptcy process between them to market mechanisms because of the state’s additional responsibility for controlling social stability and its stewardship of state sector employees. “Hierarchy” within the state sector has been used instead of “markets”. This system, however, is increasingly at odds with a reality where many SOEs have multiple owners and non-state

creditors, and where employment is contractual and increasingly market-based. In other words, many parties affected by a bankruptcy are no longer clearly part of the state sector “hierarchy”. Indeed, China’s economy today is supposed to rely on markets, underpinned by the rule of law. Moreover, in the implementation practice, SOE bankruptcy procedures seem sometimes used conveniently by the local authorities to further certain development interests rather than to maximize social security.

The SOE bankruptcy legislation provides for a creditor meeting as a vehicle for creditors to prevent unfair treatment. In practice, this opportunity is only notional. Decisions are rather made by the LC. The creditor meeting has no control over the assets, and little legal recourse against the LC if something was done improperly. Moreover, contrary to the practice in many developed countries, creditor representatives don’t have opportunities to participate in the decision process before the formal creditor meeting. Furthermore, the creditor meeting with the court and LC does generally not seem to be very helpful in making the process transparent to all interested parties.

The LC includes mainly agencies that represent debtor and employee interests. This anti-creditor bias could be addressed by enhancing the role of the creditor meeting. This would help in particular banks other than SOCBs, as well as trade creditors from inter-enterprise or “triangular” debt, to express their legitimate interests and help ensure transparency of the process. Secondly, debtor and worker representatives on the LC should ideally be replaced with independent experts or, alternatively, creditor representatives should be added to the LC (as “other parties” as per the Law). The latter alternative would be the least desirable but might be practical during the phase-out period of the SOE Bankruptcy Law, since independent trustees are still an unfamiliar notion. It should be noted that creditor representatives are only considered in view of the fact that owner representatives of the debtors are already on the LC.

SOCBs have in the past not had the right internal incentives to press for their interests in the SOE bankruptcy process. Bank managers have been evaluated on the performance of their portfolio and there has been no personal incentive to identify non-performing loans. Rules on interest accrual and asset write-down have kept many portfolio problems unrevealed. Moreover, although local branch managers formally report to the next higher-level branches, in practice many are also concerned about their relations with the local authorities who care less about the profitability of a nationwide bank.

The creation of AMCs and commercialization of SOCBs indicate that creditors are supposed to henceforth play a role in enterprise restructuring. Creditors have now also started playing an active role in the reorganization and bankruptcy of some insolvent trust and investment companies and similar vehicles.

Still, these changes in incentives and the related build-up of capabilities on the creditor side will take some time to take roots. This suggests that a certain degree of administrative control over the bankruptcy of genuine SOEs is still advisable for a few more years before it can give way to mere market forces. In the interim, however, the process should be made more participatory, transparent, consistent, and immune to misuse. An exception in this phased approach to reform will likely be the AMCs. Their entire operation and employee incentives are supposed to focus on NPL resolution. This could justify giving AMCs a more powerful role than other domestic banks in SOE cases under the Bankruptcy Law.

AMCs have more debt restructuring options available to them than commercial banks. However, since each AMC assumed old NPLs of only one SOCB, each AMC will in many insolvency cases remain only one of several substantial creditors. Several steps could be considered to strengthen the role of the AMC in such cases. (i) The AMCs could establish a coordination committee among themselves, not to involve government representatives, that would facilitate negotiations between AMCs about individual debtor cases. The AMCs might even voluntarily agree to grant such a committee the right in certain situations to make decisions that bind each signatory AMC. In the case of 601 debt:equity swaps proposed by SETC for large loss-making SOEs in 1999-2000, the AMCs have agreed to give the lead to the AMC with the

largest claim on such an SOE; in case of dissatisfaction by another AMC, a meeting is convened between them and including also MOF, PBOC, and SETC. (ii) AMCs could swap loans among themselves in order to concentrate the claims on each creditor. AMCs could also purchase at a negotiated "market" price some claims that other creditors, including their patron SOCBs, have on the same debtor enterprises. In addition, AMCs could agree bilaterally or jointly with other large state-owned creditors, such as railroad, shipping, or telecom companies, on a framework to regularly coordinate their stance vis-à-vis important debtors. AMCs might even enter into agency agreements under which they would collect, against a commission, claims on behalf of other state-owned creditors.

State-owned AMCs in other countries have sometimes been given a few carefully defined, special rights that are not available to other creditors. One example would be to lower for a limited number of years the qualified majority needed in votes of the creditor assembly for those bankruptcy cases where the debtor is a non-incorporated and wholly state-owned enterprise and a central Government-owned AMC holds at least one third of the unsecured creditor claims. Another example would be to give Government-owned AMCs the right to file bankruptcy against SOEs under the existing Bankruptcy Law without prior approval of the local line bureau. Any such special legal privileges of AMCs alone should be very limited, however, since they drive a wedge between different kinds of creditors, create further multiplicity in the legal regime, and affect legal stability. Where possible, the removal of obstacles to loan resolution should apply to all kinds of creditors.

AMCs won't exist for all commercial banks, and will take over only part of the NPL portfolio of the SOCBs. To help banks resolve NPLs on their own, the 1% cap on the loan loss provisions that can be accounted as costs for tax purposes should be raised. Giving banks more scope for debt write-off would facilitate also their cooperation with the AMCs in the bankruptcy or workout of joint debtors.

Stakeholder Biases against Creditor Interests

Biases against creditor interests have resulted in part from tensions between social and financial priorities. They have played themselves out at the central and local level, and in the center/local relationship.

Socio-political instability from mass unemployment without adequate social protection has been a key concern of policymakers. Stability of the financial system had historically been a comparatively lesser worry. Hence, in determining the speed and nature of lay-offs from insolvent firms the safeguarding of socio-political stability has prevailed over the safeguarding of creditor interests. Moreover, the leadership preferred until recently to implicitly transfer the social costs of bankruptcy to the creditors, assuming that the main creditors are SOCBs for which the state would ultimately take the responsibility through recapitalization, rather than explicitly bear these social costs through budget transfers for the affected workers. Introduction of the Banking Law and Credit Security Law in 1995 suggested a shift of these priorities. However, conflicting social concerns continued virtually blocking SOE bankruptcy until important creditor rights were moved aside under the CSOP, and a new bankruptcy law which had been prepared in parallel to supplement the two new laws has since been put on hold. Some recent developments have been weighing in for an adjustment in socio-political versus financial priorities, though. The Asian financial crisis has made policy-makers more aware of the potential for economic and socio-political destabilization from crisis in the financial sector. Slower economic growth has made higher demands on the Treasury, tightening the scope for bailing out the financial system. And WTO entry will expose banks to competition that will limit their ability to cover loan losses through high spreads. The current emphasis on reforming the social security system will help reduce the recourse to creditors to implicitly bear social costs of enterprise reform.

Still, biases against creditor interests remain at work. Although the true quality of many loans has already deteriorated over time, pension claims have already accrued, and the future "rehabilitation" of labor has already become inevitable, there has been an inclination to avoid making such losses explicit and funding

them, for instance through the sale of bonds or state assets. Rather, such costs have been kept hidden in the balance sheets of financial institutions. What's more, as long as their loan losses are not revealed banks can be taxed for their apparent "profit", as witnessed by the tight cap on tax deductibility of loan provisions. And the longer action is deferred against debtor enterprises, taxes and rents can be extracted from their operations as well. The recent transfer of large amounts of NPLs to AMC's is an important step in recognizing costs incurred in the past, especially once the Government guarantee for AMC's bonds will be explicitly documented.

The historical prevalence of socio-political over financial sector priorities has also a center/local dimension. The SOCBs at the core of the financial system are national institutions with financial backing of the central government. Social security, by contrast, is largely a local matter with local financial support. National policy and legislation may at times protect creditors but their implementation relies on the cooperation by local authorities. Through their influence on local valuation agencies, courts, enforcement organs and other institutional infrastructure, the local authorities have been able to blunt pro-creditor initiatives of the central authorities. This might change over time as the rule of law, now enshrined in China's Constitution and driven also by WTO membership, gets strengthened. Moreover, the "pooling" of social security, including the pension system, may change the incentive structure on the local level.

Still, social and political stability will remain an important local prerogative. Lay-off often leads to local protests not just because of employee concerns over income security but also due to their emotional ties and historical reliance on state sector employer from cradle to grave. What's more, there are indications from protests by laid-off workers in various Chinese cities that irregularities are often as much or more a source of their discontent than the lay-off per se. There may be discontent with managers of distressed firms who drain enterprise coffers through dubious transactions, buy enterprise assets at low price, or steal or misuse them outright, or with managers and officials who move valuable assets of weak firms into other firms without effort to capture their true value for the benefit of those stakeholders who are left behind. This means that, rather than just controlling the speed of lay-off in the cities and compensating those who get laid-off, the authorities should step up their fight against such irregularities. In the sphere of SOE bankruptcy, for instance, the management of a bankrupt firm could be replaced more routinely with an administrator, pre-bankruptcy transactions could be investigated more rigorously, and asset appraisals should be removed from direct control by the municipalities.

Center/local relationships are also important within the main creditor banks. Although a SOCB has a nationwide balance sheet its branch managers take lending decisions (within thresholds), are supposed to act against defaulters, and find ways to conceal deteriorating loan quality. Several factors may get the manager or officers in a local SOCB branch to lean towards local concerns rather than their bank's overall interests. Information asymmetry and weak rule of law makes close local relationships important for new lending. Low salaries caused by overstaffing make bank employees vulnerable to local rent-seeking. Managers who are not frequently rotated "go local" more easily. Branch networks that mirror state administrative boundaries are particularly susceptible to administrative influence. Weak internal information, evaluation and incentive systems further undermine the efforts of bank headquarters to align local staff to bank-wide prerogatives. Penalties against loan officers in case of loan default may encourage them to conceal loan problems rather than take early action. The AMC's bear less risk of staff being beholden to local powers to the extent that they will be organized across provincial boundaries, focus entirely on asset recovery rather than new lending, and incentivize staff appropriately.

Protection of Secured Interests

The Bankruptcy Law ranks secured claims ahead of other creditors. Such protection of secured interests is critical for stability of the financial system. Credit securities are key for banks' ability to extend credit particularly to small and medium-size borrowers, and to finance trade in an efficient manner. The

recognition of secured interests in potential bankruptcy would be critical especially for creditors' willingness to help distressed enterprises restructure themselves.

In practice, however, secured interests are quite insecure in mainland bankruptcy cases:

- SETC and PBOC stipulated in their Circular No. 492 of 1996 regarding the CSOP that land use rights (LURs) can be used for employee rehabilitation expenses even if these are granted LURs that have been mortgaged. This was reconfirmed in 1997 by the State Council in its Circular No. 10. Although seemingly at odds with the Law passed by the legislature, this decision of the executive branch is accepted and applied by the courts. This has contributed to the low recovery rates by creditor banks in SOE bankruptcies, which we found typically in the 3-10% range almost irrespective of security interests. LURs are often the only valuable item in SOE bankruptcy. The decision to overrule security interests on land, therefore, has played an important role in allowing more bankruptcies -- short of transferring the social burden to the fiscal authorities. This policy decision may have been appropriate in the circumstances of the time. Due to its severe repercussions on the credit system, however, it should be carefully reconsidered as reforms in the social security system and other parts of the environment are taking hold.
- Circular No. 492 has even gone further. Mortgaged LURs are to be applied to employee rehabilitation under the CSOP even prior to unsecured claims on other assets. And assets other than LURs can under No. 492 also be used to settle rehabilitation expenses if the estate of non-mortgaged assets does not suffice. Moreover, the subordination of land mortgages to employee entitlements has in practice been applied sometimes also in SOE bankruptcies outside the CSOP cities, and to some collective enterprises.
- Many of the security interests in SOEs that went bankrupt in recent years dated back prior to the effectiveness of the Security Law that was enacted in 1995. Without a clear legal framework at the time, many of these guarantees and mortgages were subsequently ruled invalid by the courts upon bankruptcy. For instance, guarantees issued by one SOE for another were later often rejected on the ground that they were given involuntarily upon instruction by local authorities. Or a mortgage was declared invalid because the LUR was found ineligible for mortgaging, on the ground that it had not been effectively "granted" to the debtor because the debtor never paid the granting fee.
- Even under the new Security Law, security interests are often not easy to enforce in practice. Creditors complain that courts in the debtor's town or province often appear reluctant to recognize security interests, or to enforce locally the rulings of a court from another jurisdiction. They may be particularly reluctant to enforce guarantees given by SOEs of the same locality. Moreover, self-help by secured creditors is not permitted under Chinese law. There are also some difficulties stemming from registration practices (e.g., reluctance to register mortgages with a maturity longer than the stated loan maturity, or requiring frequent re-registration). Some of these questions would take us beyond bankruptcy. Suffice to say that they add overall to the weakness of security rights.³

In order to facilitate the flow of new credit to SOEs, especially to small and medium firms that create new jobs, security interests other than on land use rights should definitely take priority over employee claims, including rehabilitation expenses. Practices that violate this principle should be suppressed since they can severely undermine the validity of credit securities and, thus, the flow of credit in the economy.

As to land, the priority of worker rehabilitation over claims mortgaged with granted land use rights under the CSOP could be revisited. This review would need to take into account, though, the resulting shift of

³ The legal rights and implementation issues of credit securities are discussed by Yan Zhang and Klaus Lorch in "Taking and Enforcing Credit Security in China" (forthcoming).

financial burden from the central authorities (for bank recapitalization) to local governments (for covering shortfalls in worker rehabilitation fees). (See section III.c below)

Consistency in the Treatment of Claims

The treatment of creditors has been inconsistent within classes of creditors, across municipalities, and case-by-case between SOEs.

One of the objectives of bankruptcy legislation is to stay all creditor claims in a systematic manner to ensure that all creditor rights are addressed transparently. In Chinese SOE bankruptcies, there is often inconsistency in how creditor claims are addressed. There were cases where the purchaser under a “whole takeover” assumed bank debt but not payables to trade creditors. Many trade creditors were virtually ignored and were not necessarily notified of the bankruptcy in writing, as LCs have often notified only major creditors.

The payment of employee rehabilitation fees has varied across cities and cases. In some cases, the fee was paid directly to the laid-off employees and in others to the reemployment service centers who would in turn support them. Under whole takeover, many of the employees are usually taken over but others are laid off with a rehabilitation fee. These differences should be seen as useful flexibility where employees themselves are given the choice between options. Inconsistency has been an issue, however, where assets did not suffice to pay the entire rehabilitation fee. In some such cases the local government contributed to the deficiency, but more often the employees did not receive full payment. In extreme cases, the employees would have to rely on the minimum monthly social security benefits, which is considerably lower.

Inconsistent treatment can also stem from irregularities in the following areas:

- **Pre-Bankruptcy Transactions:** Under the Bankruptcy Law, transactions prior to the bankruptcy should be reviewed to find any preferences that may have been given to certain creditors and to determine if there were any fraudulent transactions or illegal assets transfers. The LC has the power to review such transactions but the courts require no formal report. No such illegal acts were raised in the sample of cases that we studied.
- **Control of Assets during the Bankruptcy Process:** Until the appointment of the LC, the assets remain in the possession of the debtor. Even thereafter the manager often remains in place until the bankruptcy process is completed. The moral hazard arising from this situation might lead to loss of assets. To which extent this risk is reduced by the involvement of the line bureau, asset management bureau and other agencies, and by the heavy penalties that misappropriation of state assets carries in China, our study has not been able to assess.
- **Transparency of Asset Valuation and Disposition:** Asset valuations⁴ are carried out by licensed valuation enterprises for land use right and other assets, respectively. Only rarely are independent non-state valuers involved. Rather, they have in the past commonly been affiliated to and licensed by the local government, such as the land bureau in case of land valuation. Asset appraisals were not always ensured by the LC or the auction centers. The disposal of assets under liquidation is usually carried out with the help of property rights transaction centers or other auction facilities under the municipal government. Auctions seem to often not advertised widely and early. In the case of whole takeover, purchasers are usually found by the debtor enterprise, the LC, or the line bureau; transparent

⁴ Paragraph 4 of Circular No. 10 provides that the “value of property-in-bankruptcy should be based on the appraisal and be the basis to determine the up-set price and fixed according to State stipulations. The property will then be auctioned in most cases and transferred according to relevant legislation, laws and regulations. The transfer price is determined by the market.”

competitive procedures seem to be the exception. The purchaser has usually been an SOE, and in many cases had been identified before the bankruptcy was filed.

Case Study: Bankruptcy as a Form of Insider Privatization

The bankrupted enterprise, a municipal SOE with around 200 employees, produced component for the electronic industry, using very simple technology. It had been operating profitably at full capacity prior to bankruptcy but had borrowed heavily in 1994 from a SOCB to reconstruct and refurbish its production and office building. In 1996, it decided to "restructure" its debt and successfully filed a petition for bankruptcy.

The Court approved the reorganization of the bankrupted enterprise into a new legal entity, a shareholding cooperative formed by employees and investors, through "whole takeover" of the old firms' assets and most employees. There is no evidence that the Liquidation Commission attempted to organize a competitive tender for the enterprise and, as a result, a few insiders became large shareholders of the new entity.

Approximately 40% of the original employees refused to, or were not invited to, join the new entity and were paid their rehabilitation fees in cash installments. The capital of the new shareholding cooperative is divided into three parts: (i) shares paid in lieu of rehabilitation fees, held by those workers who joined the new entity; (ii) "compulsory shares" that had to be bought by each participating employee for 4,000 Yuan in cash, and which was used mainly to pay the bankruptcy fees and part of the rehabilitation fees of the workers who did not join; and (iii) "free shares" purchased by five inside and outside investors for cash. The General Manager of the former firm, in addition to his rehabilitation fee and compulsory shares purchased also some free shares and thus, with a relatively modest cash investment, became the largest single shareholder. He is now Chairman of the Board and General Manager of the new shareholding cooperative. The new firm agreed to take responsibility for the settlement of Social Security arrears of the bankrupted enterprise. However, the bankruptcy case closed with nothing paid to the banks or other creditors.

The new shareholding cooperative continues, as before, to operate the same business line at close to full capacity and sells profitably all of its production. Indeed, the production costs of the new entity have been dramatically reduced through the complete elimination of debt service and the large reduction in employment. The SOCB has tried without success to block the process which it views as a scheme to wipe out a debt by an entity that should and could service at least part of it, to the sole benefits of the shareholders.

To enhance consistency and transparency, and thus predictability, it should be mandatory to offer all assets of the estate on an open market, not just "primarily" or "in most cases" as stipulated in Circular No. 10. Lowering the minimum price if a first auction or tender failed would help bring about a sale. Even LURs should be disposed through such open markets rather than administrative decision, albeit remaining subject to applicable regulations on zoning, registration, and title transfer documentation. Auctions should be subject to regulations that safeguard transparency, fairness, and efficiency. Interested parties that are treated unfairly through irregularities in auctions should have legal recourse against the auction house even if it is a municipal agency such as a Property Rights Transaction Center or Land Exchange. Auction rules for estate assets (except for small-value items) should require public announcement in media with national coverage, with a certain minimum of information, and with adequate lead time between advertisement and auction. Consideration could be given to eventually establishing at the national level an electronic Website where such media announcements are replicated. More broadly, the government should support the creation of nationwide markets for the assets of failed SOEs.

Where "whole takeover" is chosen, the access of potential acquirers to bankrupt businesses should be broadened as well. Last year's Decision of the 4th Plenary Session allows for more non-state ownership in all but a few sectors deemed key for the nation. It also reconfirmed that there should be less state control over SMEs. In implementing the Decision, local authorities should be explicitly encouraged to transfer bankrupt businesses in non-critical sectors to non-state buyers. Second, in sectors such as retail, wholesale, and transport where foreign ownership faces various restrictions until some time after WTO membership, these restrictions could be relaxed for cases of "whole takeover" of SOEs under bankruptcy. Third, as in the case of individual assets, the sale of entire businesses under whole takeover should require wide public advertisement so as to give potentially stronger buyers, including those from other towns or provinces, a chance to make an offer. The award of licenses and other practices must not discriminate against firms from other provinces.

Encouragement could be given to efforts to conduct "whole takeover" through tender. Where the business including certain clearly specified social and employment obligations would have a negative value, bidders would not offer a significant price to be paid by them but rather the fiscal incentives that they want to obtain. Alternatively, tenders could be "investment tenders" where the social and other obligations are not specified in advance but, instead, each bidder indicates which social, employment, and other commitments he offers to assume. The difficulties of such investment tenders lie in, first, assessing the value and realism of these commitments in an objective and transparent manner and, second, monitoring and enforcing these commitments in the future. All this being said, the risk remains that a state-owned or even non-state firm may be armtwisted to bid for whole takeover of a non-viable business for the sake of protecting unproductive jobs and getting write-off quota for cleanse the business of its debt. Starting with Circular No. 10 from 1997, the central government has therefore sought to discourage whole takeover.

Reorganization and Financing Alternatives

Many insolvent enterprises, in China as elsewhere, might become financially viable after thorough reorganization. This can be advantageous for the creditors who trust that they will thus get more repayment in the longer run than they would get under liquidation in the short run.

In developed market economies, such restructuring can take place out of court, or through court-supervised proceedings under bankruptcy laws. In either case, the creditors have to approve it. In court, a qualified majority of the creditor assembly has to approve the reorganization proposal. This gives creditors a say in the decision, yet protects such reorganization from unilateral actions of those few creditors who want payment immediately. Out of court, creditors who disagree with the reorganization proposal can threaten to cut off further funding, foreclose on collateral, or file bankruptcy. In some countries that suffer from widespread corporate crisis, the main financial institutions have voluntarily signed agreements that bind them to accept coordination or even arbitration decisions by an inter-creditor committee, across a large number of debtor enterprises.

For insolvent SOEs in China, there are also out-of-court and in-court reorganization alternatives. However, each of these alternatives is de facto restricted to a narrow set of options, and creditors have limited influence on the process.

- Out of court, the main restructuring option for an insolvent SOE is merger with another firm. Under certain circumstances, such mergers are eligible to debt write-off quota under the CSOP. Since 1997, CSOP quota is theoretically also available for debt write-off in the context of other forms of SOE restructuring that involve major lay-offs, but little quota has been approved for this purpose. Combined with the limited scope for debt write-off by banks outside the quota, this has meant that out-of-court restructuring other than merger has been relatively rare.⁵
- Under court supervision, i.e. after bankruptcy application, reorganization could be pursued under some special provisions of the Bankruptcy Law. However, the creditors have no right to initiate it. The debtor and its supervisory organs, on the other hand, have little reason to pursue it: Had they wanted reorganization without cleansing the assets of liabilities, they would probably have chosen the above merger route rather than filing bankruptcy in the first place. Indeed, the reorganization route under the Bankruptcy Law seems to be used rarely, if ever.

The "whole takeover" under bankruptcy is, in a legal sense, a liquidation. The old firm is dissolved as a legal entity. The whole bundle of assets, many or all employees, and the pension liabilities are transferred

⁵ A study on mergers of SOEs has been conducted with World Bank support by a Survey Group on SOE Mergers & Acquisitions in Shenyang and Zibo (mimeo, Beijing, 12/1998).

to the acquiring firm, but not commonly the liabilities towards banks and other creditors. The creditors have little influence on the decision to pursue “whole takeover”, and can effectively not ensure accurate valuations and sale at fair value (for further elaboration see Section III.d.). The central authorities have lately discouraged the practice of “whole takeover”.

The expectation to take over all employees is commonly the main deterrent for potential acquirers in “whole takeover”. Most insolvent SOEs have excessive labor. In one case, the acquirer found 20 employees needed to run a facility that previously employed over 300. Acquirers might also prefer to staff their operations with employees of their own choice. The obligation to take over employees under “whole takeover” appears negotiated case by case. Over time there has been less of an obligation to assume all the employees. In Shanghai, for instance, a policy has emerged to separate the employee rehabilitation from the asset takeover. This has helped Shanghai to attract more offers and purchasers who were able to successfully turn around the companies. The resulting higher purchases prices for the unencumbered assets can help, in turn, to rehabilitate the laid-off workers.

The limited set of options is not satisfactory for creditors. As a result, restructuring rarely takes place at an early point in time when the debtor firm would still have a better chance of recovery. And it often does not take place at all, meaning that more SOEs eventually get liquidated than would be the case under a better insolvency regime. To an unnecessary degree, economic value gets destroyed, creditors become reluctant to lend, and banks suffer from portfolio problems.

Financial restructuring of distressed enterprises has been further obstructed by rigid limits on actions by creditor banks.⁶ SOCBs need special permission to extend credit maturity more than once. They cannot write down debt beyond their narrow 1% provisions (much of which is absorbed by the CSOP quota), and even from doing this they have been discouraged by Government calls for taxable bank profits. Moreover, commercial banks are not allowed to hold equity in non-financial institutions, which has greatly complicated any debt:equity conversions. These constraints will not apply to the AMCs. However, where debtor enterprises have not only non-performing debts to AMCs but also residual performing debts to SOCBs, or debts to other commercial banks, it will be difficult for the AMCs to negotiate a financial restructuring as long as these other creditors continue to be as severely constrained in their actions.

For reorganization to succeed, it often requires fresh money for the debtor enterprise at a point when the reorganization is still under way and the firm may still be insolvent. In view of their very low recovery rates in SOE bankruptcy, and their lack of control over the process, creditor banks should be expected to be reluctant to provide credit to SOEs that face bankruptcy or are already in the court process. The fact that lending to highly insolvent firms shortly before bankruptcy did occur in the first half of the nineties in a number of cases that we studied was explained by government suasion, distorted branch manager incentives, and weak internal controls. Our study suggests also that, while old creditor banks were usually not lending to new enterprises that emerged from some bankruptcy cases, an SOCB other than the bank that took the original loss would sometimes advance funds with strong encouragement of the local authorities. Today under the new Commercial Bank Law, banks seem to become somewhat more reluctant to engage in such practices. To make funding available for reorganization without jeopardizing creditor rights will require new practices and legal procedures.

In developed market economies, the creditor assembly under the court-supervised reorganization can agree to a fresh borrowing by the insolvent debtor, with a super-priority given to this new credit claim over all old creditor claims. Fresh credit from some or many creditors can also be agreed outside court,

⁶ Some recent Recommendations by the Supreme Court (announced on October 27, 1999) on solving disputes over debts of SOEs aim at giving distressed debtors further relief from creditors so that they can restructure and recover more easily. For example, courts are to suspend the execution of foreclosure on credit securities if the debtor has marketable products with good potential; debt/equity swap should require debtor approval if the debtor has strong products and would be able to recover; and distressed SOEs are encouraged to settle debt with intangible assets or in-kind with labor services.

with such new credit usually getting securitized with debtor assets or other means; this, again, requires the consent of the other creditors, lest they take unilateral action in court that would undermine the reorganization.

In China, court-supervised reorganization is rare and the potential role of a persistent creditor assembly is still largely untested. Out of court, truly voluntary inter-creditor coordination seems to be rare as well. In 1998 the Government introduced a special program of so-called "closed loans" by SOCBs to firms that were insolvent but had strong export potential for some of their products. These loans were given on the merits of just the export production itself without regard for the overall financial distress of the company. The lender expected to be repaid with priority. This priority was based on regulations rather than laws, however, and not formally agreed by the other existing creditors. It has been a temporary initiative with a limited credit amount, aimed at macro-economic stimulation. More systemic arrangements to allow funding of reorganizations remain to be developed. The new bankruptcy law should include effective provisions to allow reorganization of insolvent enterprises. The current draft does indeed include an extensive chapter on such reorganization.

Case Study: Bankruptcy May be a Better Deal than a Merger for an Acquirer, but not for the Creditors

The bankrupt enterprise was established in 1956 on a large piece of land in the immediate suburbs of a fast growing city. It was initially a collective, and became a shareholding cooperative in 1994. Its only product – utilized mainly in agriculture – used to be sold and distributed under the central planning system. With the introduction of market mechanisms in the agricultural sector. The company, however, proved unable to adapt.

Between 1990 and 1996, the company borrowed very heavily to purchase new high-tech machinery to produce a completely different type of products. The investment, however, was apparently made without thorough market analysis or knowledge of, and contacts with, an entirely new potential client base. In addition, the company experienced constant technical problems with its new machines and never managed to produce to stated equipment specifications until just before bankruptcy. At the time of bankruptcy, the company operated at less than 25% of capacity, but had retained its full complement of over 400 workers and 140 pensioners. Its debt to asset ratio exceeded 60%. In particular, it owed over 50 million Yuan to a single state-owned bank, with only one-tenth of this amount subsequently recognized as properly collateralized by the Court.

The petition for bankruptcy was handled under the Civil Procedure Code. As a shareholding cooperative, the case was supposedly not subject to the Bankruptcy Law and the CSOP rules. Bankruptcy was filed in the last quarter of 1996 and the Court closed the case within six months. The bankrupt enterprise was sold as a whole through a somewhat competitive process. The Liquidation Commission received three offers. The winning bidder – an SOE group from the Province – was selected because it offered the largest price, and was demonstrably very successful in producing and marketing similar types of products that the bankrupt enterprise had failed to develop with its new machinery. However, its growth was severely constrained by its poor location. The group saw a good opportunity to acquire a large and well located piece of land and a series of buildings in good condition in a dynamic city with good communications. It wanted to use them to relocate their headquarters as well as some of their existing production facilities. It was also interested in acquiring the relatively new production line, to expand its production in a market that it already knew well.

The municipality was keen on securing a deal with a financially solid group from the same province that would take on all the workers, guarantee a high level of manufacturing activity on the premises and offer good prospect of significant additional tax revenue. The group acquired both the land-use rights and the assets of the bankrupt enterprise for about 30 million Yuan, half paid in cash and half by assuming part of the bankrupt firm's bank debt. The land use right had been an "allocated" right of the bankrupt factory, valued at some 40 million Yuan. The acquiring group agreed to take on all the workers and pensioners, and no rehabilitation fees were paid. As a result of the bankruptcy process, the creditors of the shareholding cooperative recovered around 7 million Yuan (a recovery ratio of approximately 12%), with a further 15 million Yuan (or 25%) worth of secured loans transferred to the account of the acquirer.

Had the group been convinced to acquire the assets of the collective through merger rather than bankruptcy, it would have had to assume a far greater share of the debt of the collective (although potentially involving some debt reduction). This would have been to the benefit of the creditor banks in the short run. In the long run, it would depend on whether a higher debt burden might have jeopardized the acquirer's financial viability.

Consideration should also be given to improving the legal framework to promote secondary debt and distressed lending markets to develop, since workout and restructuring are vitally dependent on new

capital. A range of actions could help promote such markets. The interest rate ceiling could be relaxed for new lending to firms under court-supervised reorganization and for NPLs that get rescheduled. Write-offs from sale of NPLs beneath face value could be exempted from the write-off limit of banks. The common requirement that a debtor confirm receipt of the notification of the intended loan transfer to a new creditors and confirm the status of the loan should be relaxed so that the debtors cannot cast doubt on the validity of the transfer simply by withholding his confirmation. The controls against state sector entities selling assets beneath their valuation should be relaxed in the case of assets from foreclosure or liquidation. The draft regulatory framework for industrial investment funds, which would also cover turnaround funds that purchase loans or equity of distressed firms to turn them around with the objective to sell them later with a profit, should be finalized without much delay. The approval processes concerning foreign-exchange lending should be reviewed so as to remove undue obstacles to the purchase or sale of distressed foreign-exchange loans, including by foreign financial institutions. Moreover, the access of foreign financial institutions to the future market in yuan-denominated distressed debt should be facilitated as well.

Case Study: Bankruptcy is Unsuccessful if the Use of the Assets Remains Non-Viable

The bankrupted enterprise, a municipal level SOE with approximately 250 employees was engaged in light manufacturing activity. For the past several years, the factory had been operating at less than 30% capacity with equipment in very poor condition, resulting in continuous losses. It had financed a large part of its operating costs initially with bank loans but, more recently, by asking its employees to contribute cash towards working capital. When it entered bankruptcy in mid-1996, the enterprise had a debt/asset ratio of over 250% and owed its employees almost 1 million Yuan in salary arrears and for their working capital loans. The premises were dilapidated, and located at an unpaved road out of town.

The assets were valued slightly higher than the potential rehabilitation fees. This would have allowed to pay full rehabilitation fees without help by the municipality. However, no buyer was easily found to buy at that price. This might have obliged the municipality to financially support the affected workers. Instead, the employees were persuaded to buy the assets themselves, by forming a shareholding cooperative. The valuation of the assets was retained, which meant that the workers had to inject into this new firm not only their rehabilitation fee entitlement but also some 3,000 Yuan cash each. All employees agreed to participate in the new shareholding cooperative since it looked like, short of an outside buyer, there would be no cash to pay their rehabilitation fees.

The Court approved this scheme within three months after accepting the case. The extra cash injection from the employees was used to settle part of the bankruptcy fees, and the Court agreed that the rest be settled in installments. The new firm also assumed the social security arrears of the old one. It did not assume, however, any of its other debts, and the creditors had to write off all their claims.

The new shareholding cooperative has resumed the same production, with the same management and workforce, and the same outdated machinery as the bankrupt enterprise. Part of the cash contributed by the employee has been used to continue some production and the new entity has not, so far, been able to make good on its agreed schedule of payments to the Court and the Social Security. The former creditor banks of the bankrupted enterprise, understandably so, have not been willing to resume lending to the new entity. However, a different state-owned bank has recently been convinced by the local government to provide a new working capital loan.

Without operational changes and, possibly, fresh capital to upgrade the equipment, adjust the product mix, improve product quality and find new markets, the new entity is doomed to continue struggling with the same problems that led it into bankruptcy in the first place. It might well end up bankrupt itself shortly, with new loss for the bank, suppliers and workers.

c. SOCIAL DIMENSIONS OF THE BANKRUPTCY SYSTEM

In transition economies, social welfare systems are often directly funded and operated by SOEs. China has so far been no exception. The Chinese Government has relied on SOEs to provide urban employment, housing, education, health care, and retirement benefits to the urban population. In the late 1990s, SOEs in China provided 40 percent of jobs in urban areas, 57 percent of pension funds, and three quarters of urban housing. Medical institutions that belong to SOEs serve one-fifth of China's population.

The number of employees in loss-making industrial SOEs accounted in 1997/98 for about 40 percent of total employment in all industrial SOEs, and the whole SOE sector provides about 40 percent of urban employment. Very widespread bankruptcy in the SOE sector would severely affect the number of laid-off and formally unemployed persons in urban areas. If half of all the above loss-making SOEs were liquidated on the grounds of insolvency some 20 million people would join the ranks of the urban laid-off and unemployed in the short term. In light of this consideration, the government has been cautious in carrying forward the bankruptcy process. Only a minor part of the technically insolvent SOEs, particular if weighted with their size, have been submitted to bankruptcy.

The direct link of social welfare to employers has complicated the bankruptcy process in China and has made bankruptcy a difficult financial and political choice for the government. There are two primary dimensions to the problem: (i) In the short-term, there is a lack of adequate funds within distressed SOEs to finance employee severance packages; and (ii) in the medium-term, bankruptcy on a broad scale would lead to increases in urban unemployment and potentially to social unrest. These two issues are related to the extent that the concern over unemployment and social unrest are somewhat mitigated by the current practice of providing generous severance packages to workers affected by bankruptcy. Their generosity derives from the concept of a social protection "contract" (iron rice bowl) between the urban SOE worker and the State that these workers largely continue to consider their right. It is clear then that, without a social insurance and welfare system de-linked from SOEs, bankruptcy cannot be a truly efficient and effective mechanism for protection of creditor rights, creditor-led restructuring or exit of distressed SOEs, or improvements in labor mobility.

The policies of prioritizing social claims in SOE bankruptcy even over some secured creditors and of affording redundant SOE workers quite generous compensation packages have a dramatic impact on the scope and pace of reform of insolvent SOEs. Until a few months ago, only in SOE bankruptcies under the CSOP were municipalities supposed to permit SOEs the use of "allocated" land use rights to finance lay-off expenses, namely, rehabilitation fees. Where highly indebted SOEs elsewhere in China do not have funds to pay for social claims, they are more likely not allowed to go bankrupt. Even under the CSOP where the allocated land use right can be used, the total assets are frequently insufficient to cover compensation costs in a potential SOE bankruptcy, and some municipalities lack budgetary funds to fill the gap. This is particularly the case in cities with an old industrial base and, thus, many insolvent SOEs and an aged workforce. Moreover, creditor banks and trade creditors suffer whether bankruptcy is declared or not: If bankruptcy is pursued, their claims rank below the employee compensation packages which means that they de facto subsidize these social claims; if bankruptcy is avoided, the quality of their credit usually deteriorates further. As a result, policies designed to deal with the social dimensions of bankruptcy have the potential to exacerbate financial instability.

The government has sped up the establishment of a social insurance and welfare system de-linked from enterprises, including unemployment insurance, pensions, medical insurance, and housing. As these systems come into place, worker rehabilitation fees could be reduced and social claims could be settled without sacrificing the rights of other creditors. In the interim period, however, if the scope of reform of insolvent SOEs is to be expanded, either the levels of compensation must be reduced or alternative arrangements to finance them must be found. Given that the current levels of compensation serve to some extent a political function by mitigating the negative reactions of workers to bankruptcy (an understandable concern of the government), it is unlikely that compensation levels could be dramatically reduced. However, there should be room to spread out the burden of social claims among workers, the central or local governments, and creditors. Such changes to the basis for financing compensation costs, combined with some gradual reductions in rehabilitation fees, would appear to offer the most promise for addressing the constraints that social issues pose on the reform of distressed SOEs.

The Level and Variation of Lay-Off Compensation

There is some question about the appropriateness and sustainability of the level of compensation. Rehabilitation fees often amount to 20,000 to 30,000 Yuan per employee, compared with monthly average salaries of a few hundred Yuan in most cities. Redundant SOE workers are receiving as much as three to six times their annual salary in rehabilitation fees. In many bankrupt SOEs, workers had already for years received partial wages only, often just the minimum wage for occasional work. In these situations, the rehabilitation fees may amount to eight or even twelve times the actual annualized pay they had been receiving for some time prior to bankruptcy. These are generous packages, even relative to the standards of wealthier countries.

Several factors help to explain the high levels of such compensation, and also significant degrees of variation.

First, the rehabilitation fee aims in part at maintaining average rather than minimum living standards. Rehabilitation fees are determined by a city's average wage in the SOE sector. In cities where there are many SOEs owned by the central or provincial governments, both of which generally pay higher average wages than municipal SOEs, the severance package for workers laid-off even by municipal SOEs is significantly higher than in other locations. A preponderance of well-paying central and provincial SOEs tends to raise the average living standard in a town, but raises the minimum living expenses much less. The high rehabilitation fees in such a city imply that the objective is to maintain the overall living standard of those who get laid off rather than ensure a minimum living standard. This appears expedient for political stability rather than social security.

Second, the rehabilitation fee is seen in part as compensating a worker for his/her loss of status and security when he/she ceases to be an SOE sector employee. Indeed, employees of bankrupt non-state enterprises do in principle not receive rehabilitation compensation (although it is sometimes applied in collective enterprises). This reflects an era when SOE provided the "iron rice bowl" to lifelong employees with a wide array of benefits and services. As these benefits get increasingly monetized in the salaries of contractual employees, and as social services are transferred from SOEs to municipalities, this rationale weakens. The perception of entitlement among affected employees may change more slowly, though. While some of them jump into the non-state economy without looking back, others appear almost traumatized by being ejected from the state sector.

The notion that an SOE worker should be compensated for the breach of the "iron rice bowl contract" is not just linked to salary but extends to social services. Many urban SOE workers still consider that they are entitled to benefit, for life, from the social services that were provided by their enterprise. As a result, social assets are under the CSOP kept out of the bankruptcy estate from which claims are settled according to their order of priority. Housing of the bankrupt enterprise, in particular, usually gets transferred to the municipality which then lets the laid-off employee continue to use it without rent, or ownership of the housing ends up transferred to the former employee at a low charge. The intrinsic subsidy involved in both approaches is not counted as part of the rehabilitation fee. When a creditor bank that had helped finance the construction of these dwellings does not recover its loan, it is in fact providing a subsidy to the workers of the bankrupt SOE. This has even led to situations where a distressed SOE tries to use its last resources and a final bank credit to construct apartments or convert office space into apartments, thus probably sealing the fate of the business but providing employees with the windfall of apartment ownership. By contrast, employees of non-state enterprises are usually not provided housing by their employers. As the market develops for the resale of housing by those who received its ownership from their employers, jobless people could theoretically tie over a period without job by mortgaging the apartment, or by selling it and moving into a rented flat instead. This could in the future be taken into account when calculating the rehabilitation fees paid in cash to those laid-off workers who receive the ownership or use of their housing well below market price.

To some extent, the rehabilitation fees for employees laid off through bankruptcy are being pooled through the local re-employment centers. A laid-off brings her/his rehabilitation fee into the center upon lay-off but may find a new job shortly thereafter.⁷ Part of the money that she/he did not use can serve to support workers laid-off by firms that are too poor in assets to pay rehabilitation fees. This bears the risk, though, of discouraging laid-off workers from taking new jobs quickly, or from disclosing that they have got new jobs. Moreover, the municipality may still discourage the bankruptcy filing of a firm that is too poor to even pay labor rehabilitation, since it would worsen the financial strains of the re-employment center. Finally, larger cities often have different re-employment centers affiliated to different sector administrations or even individual large enterprise group, with no explicit pooling across these centers. Ultimately, the best pooling system will be provided by an unemployment insurance scheme.

The Ranking and Funding of Social Claims in Bankruptcy

In most developed countries, the priority ranking of claims is as follows: secured creditors, legal and administrative expenses involved in the bankruptcy case, wage arrears, contributions for employee benefit plans (including pensions and insurance, etc.), tax arrears and finally, unsecured creditors. The order in China's Bankruptcy Law is similar.⁸ But in China, it is taken one social step further by requiring that employees of bankrupt SOEs be provided with minimum living support, and ranking this requirement with wage arrears and contributions to employee benefit plans. Article 4 of the Bankruptcy Law specifies that the government – and, by implication, not the creditors – is responsible to fund the basic living standards of unemployed workers before they are re-employed. In the framework of the CSOP, however, this requirement to provide living support, concretized as “rehabilitation fees”, overrides the first priority granted in the law to secured creditors in cases where payment of these fees requires the utilization of secured assets. In this case, the secured creditors are de facto contributing to the funding of this obligation. This conflicts with the Government policy of commercializing the SOCBs. Further, some banks have claimed that local governments are negotiating high rehabilitation fees so as to capture as much as possible of the assets to the benefit of local firms, agencies or workers – rather than centrally-owned creditors. As discussed earlier, this has led to inconsistency between the Bankruptcy Law and practice in handling the distribution of assets. The order of priority among social claims is also unclear. Under the Bankruptcy Law, unpaid wages and salaries receive priority over other social claims and should be settled first with the firm's assets. In practice, pension fund arrears are sometimes settled with the same priority as wage arrears.

As discussed above, additional funds are needed to meet the social costs of an expanded reform program for insolvent SOEs. We will now explore options for generating additional revenue, and policy changes necessary to deal more effectively with the social aspects of bankruptcy.

⁷ This points to the possibility that some municipal authorities might prefer to see a high rehabilitation payment. Through the CSOP regime, the costs of the rehabilitation payment are de facto borne by the creditors, the largest of which are commonly the nationwide SOCBs, i.e., parties from out of town. If the worker joins the local re-employment center his entire rehabilitation payment is transferred to that center, which then takes care of him. The higher his rehabilitation payment, the less fiscal resources the municipality has to contribute to the center. Moreover, if the laid-off worker leaves the center soon for a new job, the remainder of his rehabilitation payments remains in the center. Alternatively, if the bankrupt enterprise is subject to “whole takeover”, the high rehabilitation payment goes to the acquiring firm who then takes care of this worker. The acquiring firm is often from the same municipality.

⁸ The Bankruptcy Law specifies that the “bankruptcy assets”, i.e. all property of the enterprise except that which has been encumbered and used to pay secured creditors, are to be used to pay claims in the following order of priority: (i) expenses incurred in administration, liquidation and distribution of the estate; (ii) legal expenses incurred in the bankruptcy case; (iii) other expenses incurred for the joint benefit of creditors during the proceedings; (iv) wages and labor insurance costs; (v) taxes; and (vi) unsecured creditors' claims. Like the Bankruptcy Law, Articles 196 to 204 of the Civil Procedure Law provide that secured claims get paid before all other claims to the extent that such claims are covered by the value of the security. Remaining assets constitute the bankruptcy assets and are used to pay, in the following order: (i) costs of administration; (ii) wages and labor insurance costs; (iii) taxes; and (iv) unsecured creditors' claims. In both laws, the rule of proportionate distribution within each class of claims applies.

The founding circular No. 59 of the CSOP enhanced the social benefits of workers laid off through SOE bankruptcy. At the same time, however, it arranged for the municipality to be a funding source of last resort for these social costs. It did so by stipulating that land use rights (LURs) shall be used to pay for such social claims if the estate assets don't suffice. In many SOEs, these urban LURs are of the "allocated" kind. Such LURs had been given to firms for use over a unspecified period of time but remain municipal property. Circular No. 492 later added that even granted land use rights that are mortgaged shall be used with priority for the rehabilitation fees. In many and perhaps most SOE bankruptcies, the urban land used by the SOE is in fact the most valuable asset. It is often the key asset on which liquidation commissions rely to pay worker rehabilitation fees.

"Granted" and "Allocated" Land Use Rights

Under Chinese law, land use rights (LURs) can be "granted" or "allocated".¹¹ A granted LUR has a term of 40, 50 or 70 years depending on the sector. The user pays an upfront fee that is meant to be the equivalent of an annual user fee for the whole term. The granted LURs can be mortgaged and transferred. When transferred by one user to another, the latter theoretically pays a pro rata of the granting fee reflecting the residual number of years, but market conditions may vary the actual payment. A granted LUR is commonly recognized as an asset of the using firm and is supposed to show in the balance sheet. Granted LURs can also be brought into a firm as a contribution to equity; in other words, a firm can acquire the LUR by paying with its own shares rather than cash or other means.

An allocated LUR is a permission given by the state to an enterprise, revocable at will, to use land for an unspecified time. It carries no user fee, although some minor amount of taxes may be charged. The user is not supposed to show the allocated LUR in its balance sheet. Since 1992 the new allocation of land has been discontinued in all but a few special public-interest areas, but existing allocated LURs were grandfathered and can be retained by firms even when they change their ownership form. Old allocated LURs can even be transferred by one user to another, which commonly involves payment to the former by the latter. In the case of such transfer, the LUR is to be converted into a granted one, however, and the acquirer has to pay some additional money to the Land Bureau. To mortgage an allocated LUR, it should first be converted into a granted LUR with payment of the granting fee; in practice, though, the granting fee might not be paid and the validity of the conversion remain disputed. Finally, an allocated LUR can not be contributed to equity unless, here again, it is first converted into granted status.

An enterprise is effectively entitled to the value of allocated LURs only at the moment it is using them. It has no right to compensation should it lose those rights in the future, and creditors should never have the illusion that they might rely on the value of such rights in order to satisfy their claims. Allocated LURs are assets belonging to the state and like all such assets, may be sold for cash to fund obligations the state wishes to take upon itself, such as the resettlement of unemployed urban workers. Creditors would have reason to see granted LURs become part of the estate or accrue to a mortgageholder, though, had not administrative circulars assigned even these LURs to worker rehabilitation. In any case, there is today simply no necessary relationship between the amount of money required to resettle employees of an enterprise and the amount of money that can be realized through sale of this firm's LURs.

¹¹ There are also less frequent forms of LURs. Land can be "leased" for a fixed term against annual lease fees. Land can also be assigned to foreign-invested enterprises for a fixed term against a "site-using fee". Moreover, under "delegation of land management" the right to manage land on behalf of the state can be delegated for a limited number of years to special state institutions or large state enterprise groups, instead of the land bureaus. This delegated right gets evaluated and contributed to the equity of the group's head firm, and the latter can then allocate, grant, or lease this LUR to other enterprises and retain whatever payment in cash or shares it receives in return. (For more detail see Klaus Lorch and Chunlin Zhang, "Urban Land Policy as an Instrument of Enterprise Reform", forthcoming.)

The municipality can take the "allocated" LUR back from the bankrupt firm and sell it to a third party as a "granted" LUR, thus obtaining cash with which to subsidize the social costs. It can also allow the "allocated" LUR to be transferred into the firm that absorbs the bankrupt SOE in "whole takeover", thus subsidizing the firm that will bear the social costs.⁹ Since a municipality practices cash accounting and has no balance sheet that would show its stock of allocated LURs, this subsidization of social costs

⁹ Opinion No. 433 of the Ministry of Land and Resources, issued in 11/1999 and published in 3/2000, allows another option. An insolvent SOE that wishes to use its LUR for employee rehabilitation expenses can convert its allocated LUR into a granted one without having to pay the granting fee, and can thus liquidate the LUR at a higher price since the buyer won't have to bear fees for granting. This provision is supposed not to be limited to the CSOP.

through allocated LURs remains practically off budget. This protects these subsidies for SOE bankruptcy to some extent against other funding priorities.

This system has drawbacks, though. There is little incentive for the municipality to capture in a transparent manner the full market value of the LUR, beyond what is needed to support the rehabilitation fees. The valuation of the LUR is commonly done by a local valuation firm affiliated with the municipality's Land Bureau. There is evidence that when a local enterprise takes over the assets and the workforce of a bankrupt enterprise, the value of the land transferred often seems to be assessed at just about the amount that is required to cover the rehabilitation fees of these workers that the acquirer takes over. This can lead to significant differences in the assessment value of similar pieces of land in the same municipality. If the land is assessed beneath market values, the differential may be captured by the party that acquires the LUR (e.g., a real estate development company, or an industrial firm that injects the LUR into a joint venture as capital contribution, or the acquirer in whole takeover), or by rent-seeking, or can be lost through reallocation to inefficient uses. Independent valuation, sale through open competition, and more transparent management of municipal land would help to capture better the market value of these LURs. Moreover, a policy that strongly favors the "granting" of LURs over their re-"allocation" would further increase the capture of their true value.

In November 1999, the Ministry of Land and Resources issued an Opinion No. 433, published in March 2000, that addresses some of these points. (i) Land valuation firms are to become independent from government agencies by mid-2000, and their licensing and regulatory supervision would be carried out by higher-level administrations. (ii) Municipal land bureaus are called upon to establish land exchanges, so as to facilitate competitive land sale and market-based land pricing. (iii) Land bureaus are to streamline their procedures and meet tight deadlines for response or completion time in common matters; this would further increase transparency and remove rent opportunities. Important is now the implementation of such national instructions on the local level.

There is a further drawback to the current funding of rehabilitation fees. The proceeds from transferring the LURs have generally not been pooled across bankrupt firms. They are used only for the one bankrupt firm that had occupied this land. A bankrupt SOE that used little land relative to its number of employees and has few other valuable assets may thus be unable to pay the full rehabilitation fee and, for that reason, might not be allowed to go bankrupt in the first place. At the same time, the acquirer of an SOE that happened to occupy much land might receive (through the above valuation practices) far more LURs than it needs to cover the social costs that it assumes. To facilitate SOE bankruptcy and avoid unequal treatment of workers across SOEs, it would be preferable to establish a municipal fund that pools the proceeds from selling LURs that have been taken back from all bankrupted SOEs of the city. The pooled fund would be earmarked to cover rehabilitation fees (and potentially other social expenses) associated with SOE bankruptcies. It would be available to all SOE bankruptcies where such funding is needed, i.e., where social claims exceed estate assets). Such a policy appeared to be practiced in Shanghai already by 1999. In its Opinion No. 433 made public in March 2000, the Ministry of Land and Resources calls for such pooling as a general policy. It asks municipal and county governments to put the entire proceeds from disposal of hitherto allocated LURs in the course of SOE bankruptcy into a special account for use with priority for rehabilitation expenses of workers of bankrupt SOEs within the municipality or county. Again, implementation of this Opinion on the local level should now be a high priority.

The government might consider to eventually go even further and adopt a universal policy to "grant" urban LURs to all SOEs. Today, most of the SOEs still use allocated land since they were grandfathered when land "allocation" became limited to a few public-interest sectors. Therefore, they receive an implicit subsidy through practically free use of a valuable asset. One solution would be to mandate that all state enterprises convert hitherto grandfathered allocated LURs into granted ones by paying the granting fee. Alternatively, such conversion could be incentivized by levying substantial annual charges

on allocated LURs¹⁰, or by offering them a small discount from the standard granting fee, or both.¹¹ What would be the benefits? First, SOEs would have land assets that are marketable and can be easily secured by creditors. More use of mortgages would reduce the need for loan write-off by banks, and thus permit more bankruptcies. The municipality might have to help fund social costs in cases where land is mortgaged, but would find this easier due to its revenue from having granted LURs. Second, the funds generated could be collected in a pool to fund future municipal contributions to rehabilitation fees and other lay-off related costs. This would allow to significantly expand the reform program for insolvent SOEs. Third, the true costs of land would become more transparent, especially through more resale of LURs, and thus lead to more efficient use of this scarce and valuable resource. It should be noted that these various benefits are possible because such a policy would better capture the value of land that is today either lost through inefficient use or shared between various parties in a less transparent manner. Such a general phase-out of allocated LURs would require careful consideration, though, because of its many implications.¹²

¹⁰ So-called “zero-equity” SOEs which the state left severely under-capitalized at the time when they were created, could get a part of this value as a grant.

¹¹ If a discount from the standard granting fee were offered, it could be made contingent on using this discount for settling some debt. Moreover, firms willing to give up allocated land that they do not badly need could be offered some modest compensation by the municipality, financed with part of its proceeds from subsequently granting the LUR to another party against payment of the granting fee.

¹² The above-mentioned recent Opinion of the Ministry of Land and Resources does in fact promote more conversion of allocated into granted LURs. However, it aims to do so by waiving in various instances the granting fee rather than by raising charges on allocated LURs.

Case Study: Issues of Housing and Land Use can Defer Bankruptcy

The state-owned producer of light manufactured goods is located in a prime area close to the city center of a provincial capital. (This town was not among the five cities that collaborated with this study.) The enterprise had done well under the planned economy. However, in the emerging market economy it lost its competitiveness and markets to state-owned competitors of larger scale and to non-state firms that were more nimble in the marketplace. By end-1996, production had ceased. The 1,000 workers have been sent on administrative leave with only partial wage that remained unpaid for long periods. Vehicles and some other movable assets have been sold off to pay some wages, and the municipality has been providing additional support.

Liabilities to other creditors amount to Yuan 32 million. Half are owed to banks. The equipment and office buildings, recorded as Yuan 15 million, are in poor condition. However, the enterprise has an "allocated" LUR of 55,000 square meters. An annual tax for its use is as little as Yuan 0.2 million. The buildings did not use the space efficiently and, in any case, it is no longer used for any production or administration. Local experts estimate the market price of land in such an attractive location as roughly Yuan 1,200 per square meter, or Yuan 65 million for the entire lot. By contrast, a lot of the size actually needed by such a factory and located in an industrial area at the outskirts of town would cost some Yuan 5 million. If the current downtown lot were sold at market price by the municipality, the revenue would suffice to pay all rehabilitation packages and retiree pensions and still leave Yuan 30-35 million in excess, while creditor claims might be satisfied by about half through the other assets. As a theoretical alternative, the revenue from selling the LUR could also be help to finance investment in new productive capacity at the outskirts of town that could create new and sustainable employment for most of the workers.

However, neither has happened so far. Management have instead been pursuing an idea to enter into the real estate business. They wish to obtain a new loan and team up with a real estate developer to build and manage a shopping and commercial center on the site. Management hope to get permission to do this on the basis of the allocated LUR without having to purchase the LUR as a granted right. As long as the original enterprise retains the LUR, its allocated status can indeed remain grandfathered. This, of course, requires to keep the firm legally intact by avoiding a bankruptcy process. In addition to making some apartments in this future building available to their employees, the managers have also sought to convert some of the old office buildings into employee housing. This housing would be transferred into the ownership of the respective employees at a low price under China's housing reform policy. To complete this conversion of offices into apartments also requires deferral of the bankruptcy filing.

Some municipal authorities are reluctant to approve these plans and are pursuing different possibilities to develop the attractive piece of land. The line bureau, meanwhile, tries to attract a buyer for "whole takeover" who is willing to employ all the 1,000 workers and resume production on the old downtown site. While the discussions about the various alternatives protract the assets remain idle, and so do those workers who have not found other work yet. The economic opportunity costs of leaving the real estate unused in the meantime amount to Yuan 3 to 5 million per year.

d. LEGAL AND INSTITUTIONAL ISSUES IN THE BANKRUPTCY SYSTEM

A country's bankruptcy system¹³ can be a vital tool to re-deploy assets and workers from inefficient to more efficient market uses. The utility of the process should be measured by: Its efficiency; the potential to preserve viable assets or businesses; the ability to maximize asset values by application of open and transparent procedures; the balance of social and creditor interests in a way that promotes optimal market activity and safeguards social stability; and the integration within the broader legal, institutional and cultural framework.

In China, there has been a rapid increase in the number of bankruptcy cases in the past few years. The courts have been able to process the number of bankruptcies seemingly with little or no difficulty. Most cases, once they enter the court, are completed within a short time, rarely exceeding one year. The people's courts in large cities commonly assign a small number of judges to handle all the bankruptcy cases, who thus acquire substantial experience and easily exchange lessons among themselves. Policy-makers, local government officials and enterprise managers have become more familiar with the concept and process of bankruptcy. Labor representatives, workers themselves, and the general public have come

¹³ The bankruptcy system refers broadly to the set of bankruptcy laws and procedures, the institutional administrative infrastructure, specialized professionals, information systems and other relevant segments of the legal and commercial framework that are impacted by the bankruptcy of an enterprise.

to accept bankruptcy as a painful but inevitable ingredient of a market economy. All these are major achievements, considering that only half a decade ago bankruptcy was still rare and raised extraordinary fears.

The process of bankruptcy in China has become recognized as a meaningful instrument for state enterprise reform, and is utilized with varying degrees of success in addressing the problems of loss-making enterprises. However, it contains inherent limitations that prevent it from effectively addressing the needs of a modern market economy. There is a disparity in the application and implementation of the procedures, and a number of weaknesses and inconsistencies in policies underpinning the legal rights of participants continue to plague the process. Changes in the legal basis of bankruptcy will have to be introduced, including efforts to avoid conflicts between pieces of legislation. In addition, the judicial and other relevant infrastructure would warrant strengthening.

The Multiplicity of Bankruptcy Systems

The legal and regulatory framework for insolvency has developed in response to needs and problems. The process is not static, and the legal framework is continually evolving to meet the needs of society. By some estimates, the laws directly addressing or indirectly impacting bankruptcy, restructuring and mergers number in excess of sixty separate documents. These range from the initial Bankruptcy Law and implementing regulations to relevant provisions in banking, commercial, company, labor and security laws (see Appendix B). Since 1994, the overall legal and commercial frameworks in China have undergone enormous change. While this is to be expected as the country realigns its legal systems to better achieve or promote reforms towards a market economy, such a myriad of laws and regulations bears some risk of inconsistencies, confusion and distorted outcomes.

Today, there are several bankruptcy regimes in the People's Republic of China:

- (i) All SOEs are subject to the Bankruptcy Law that was enacted in 1986 and became effective in 1988.
- (ii) Industrial SOEs in 111 pilot cities, including most large cities, can be covered in addition by the CSOP with its regulations. Since 1997, firms in certain sectors but outside the 111 cities have also become eligible to the CSOP.
- (iii) The bankruptcy of legal persons not governed by the Bankruptcy Law is subject to insolvency provisions of the Civil Procedure Law (Articles 106 to 204). This is the main legal basis for insolvency of non-state companies.
- (iv) Some special economic zones have issued regulations on bankruptcy, such as those that apply to foreign-related companies in the Shenzhen SEZ.

In addition, many mainland groups have "window companies" in the Hongkong Special Administrative Region with its bankruptcy regime.

Developed market economies commonly have a unified insolvency regime, albeit with special provisions super-imposed for the insolvency of financial institutions. Unification of its multiple systems should also be a longer-term objective for China. First, as social security gets reformed, the stock of excess labor in SOEs gets transferred, and SOCBs become better incentivized, the distinction between SOE and non-SOE bankruptcy could be phased out. Such convergence would also suit an environment where enterprises have increasingly mixed state and non-state ownership. Second, introduction of a new bankruptcy system (initially applying to non-state enterprises and incorporated SOEs) would establish more similarity with Hong Kong's bankruptcy regime, which applies to many "window companies" of mainland groups, and with other markets economies with whom China is engaged in trade and investment. It would be one of the steps to better link China with its trading partners under the WTO.

On the other hand, special bankruptcy provisions for natural persons and financial institutions that are common in developed market economies are still missing in China.

There is no special regime for financial institutions, despite important insolvency cases such as Guangdong International Trust and Investment Corporation (GITIC). However, special regulatory provisions for resolving insolvencies of financial institutions are now being drafted by the central bank.¹⁴

Case Study: An AMC Sets a Precedent of Filing Bankruptcy against a Listed Firm

In March 2000, Cinda AMC filed a bankruptcy suit against the distribution company Zhengzhou Baiwen, located in the capital of Henan Province. This is the first bankruptcy filing against a mainland-listed firm, and the first by an asset management company. There had been prior cases of distress or insolvency among mainland-listed firms but they did not lead to formal bankruptcy filings. The domestic stock exchanges had put several such cases under "special treatment" that allows to suspend the trading until the firm resumes profits, within a prescribed deadline.

The state-owned Zhengzhou Baiwen had been converted into a shareholding company and listed at the Shanghai A-share market in early 1996. The firm expanded at a frantic pace, establishing a dozen outlets across China at a time when consumer demand started to slacken. Despite the expansion, Zhengzhou Baiwen's sales dropped by more than half in 1998 and again by about half in early 1999. In 1998 the firm entered into an exclusive distribution arrangement with a TV set producer, but suffered losses on inventory when overcapacity in TVs caused prices to fall. Problems mounted in collecting payments from retailers, which settled the firm with major interest costs on its working capital financing. Poor management was on display also when Zhengzhou Baiwen eventually became the first listed firm whose auditors refused to comment on its performance.

Operating profit had dropped already in 1997, but major extraordinary gains on securities investments had pushed the total profit up in that year. Helped by these reported earnings, the firm had in mid-98 raised Yuan 147m by issuing additional shares. Overall, however, the expansion was mainly debt-financed. Together with the losses, this drove the liability:asset ratio up from 69% in 1996 to almost 100% at end-98, and 159% by end-99. The share price started to drop after half-year 1998 results revealed losses. The share drop reached the 10% daily limit several times. By May 1999, the stock had fallen 70% from its issue price a year earlier. Mid-term 1999 losses amounted to Yuan 530 million.

The local branch of the China Construction Bank (CCB) had been the main lender. In an arrangement hailed at the time as an innovative "triangular credit relationship" CCB had also provided the working capital for the firm's supplier credit to TV retailers secured with acceptance drafts by the latter, many of which later went into arrears when the TV market slumped. In December 1999, the bank transferred its claims of Yuan 1.9 billion to Cinda AMC. This amounted to 86% of Zhengzhou Baiwen's reported liabilities, and compared with 1.5 billion total assets reported by mid-99. In early 2000, Cinda AMC gave an advisory mandate covering this asset to a domestic consulting firm. With this support, Cinda filed bankruptcy against ST Zheng Bai Wen at the Zhengzhou Intermediate People's Court in March, with claims now risen to Yuan 2.1 billion. For Cinda and the other AMCs, this first bankruptcy application by an AMC and a high profile case at that, is a critical precedent to show their "teeth" and curtail moral hazard among their debtors.

This being a joint stock corporation, the filing is under the Civil Procedures Law in combination with the Company Law. The Civil Procedures Law sets serious losses and inability to service debt as bankruptcy criteria, and does not require government approval of a filing. Wage and social insurance arrears would rank ahead of common creditors, but the labor rehabilitation requirements from the CSOP would *de jure* not apply. If no reconciliation agreement were reached with the creditors, a Liquidation Commission would be formed.

Surprisingly, the share price rose after the bankruptcy application. On two days, the increase reached the 10% ceiling. One factor seems to be speculation that the authorities might persuade Cinda AMC to bail the firm out through a generous debt/equity swap or other means, or that some other reorganization plan would be agreed, or that Cinda had in filed at court merely to put pressure on the firm to accept a future restructuring plan. Analysts have also pointed out that the mere fact of being listed has a high value per se, given the restricted access to the stock market and the widespread use of such window companies to raise funds for a variety of purposes. Zhengzhou municipality seems keen to avoid bankruptcy not only because of this factor, or the likely lay-offs. The firm is said to have between 50,000 and 100,000 shareholders, with perhaps a third or more residing in the town.

Source: Media reports

¹⁴ A discussion of the specifics of financial institution insolvency lies outside the scope of this study.

Natural persons are not covered by any bankruptcy legislation in the mainland. This includes, inter alia, so-called private enterprises in the form of partnership or sole proprietorship¹⁵, business households (*getihu*, also called self-employed), and individuals who are not registered as businesses. The development of small and micro enterprises, which is vital for employment generation and dynamic growth, will require bankruptcy provisions for natural person enterprises, which is indeed foreseen as part of the new bankruptcy law. Eventually, the concept of bankruptcy should also apply to individual persons. This would promote consumer lending, including credit cards. Appropriate bankruptcy provisions would give individuals the protection of an orderly court process when pursued by creditors, permit them to retain some necessary assets for a minimum living standard, and allow them to make a fresh start in their life. So far, the widespread use of bank deposits under pseudonym would have blunted the specter of bankruptcy especially for individual debtors. The legal requirement since early this year to identify oneself upon opening a deposit account, and potentially in future also identification requirements for existing accounts, will gradually improve this situation.

Inconsistencies in PRC Bankruptcy Regimes

Under the Bankruptcy Law (Article 28), the claims of secured creditors are recognized. They are to be paid to the extent of the value of the assets securing the debt before any other claims. Similarly, Articles 106 to 204 of the Civil Procedure Law provide that secured claims get paid before all other claims to the extent that such claims are covered by the value of the security. In the face of serious concern about worker welfare and socio-political stability, the State Council introduced in 1994 the CSOP, under which enterprise-owned employee housing and other social assets are excluded from the bankruptcy estate, and land use rights are used with priority to pay rehabilitation fees to laid-off workers. After a new Commercial Banking Law required banks to securitize credit and a Security Law provided a clear legal foundation for such security, both in 1995, the rapid spread of real property mortgages seemed to undermine the intentions of the CSOP. In response, SETC and PBOC issued document No. 492, followed by State Council Circular No. 10, that subordinate even some secured creditor claims to the payment of rehabilitation fees. Circular No. 10 specifically states that LURs that have been encumbered with security interests are to be used for funding rehabilitation costs before any of the income from their disposition is used to pay off secured creditors. In addition, there is no stipulation that unencumbered LURs are to be used before encumbered LURs. Further, in case the proceeds from sale of other unencumbered property is still insufficient to fund resettlement costs, No. 10 calls for the use of proceeds from selling other encumbered property for that purpose. All this puts lenders with a security interest in LURs in a worse position than all other secured lenders.

Circulars Nos. 59 and 10 and other CSOP documents cover only industrial SOEs, and only in 111 cities. Since 1997, the CSOP has been extended also to SOEs elsewhere if they are in certain special industries or of particular size. When SOEs not covered by the CSOP go bankrupt, their case can in theory only be handled in accordance with the provisions of the Bankruptcy Law. That is, income realized from the disposition of assets of the bankrupt SOE must be used for the proportionate repayment of debts, and any additional expenses for the resettlement of employees of the bankrupt enterprise should come from channels such as local government subsidies, civil affairs relief funds and social security. In practice, however, some concepts of the CSOP, including the assessment and satisfaction of rehabilitation fees, have occasionally been applied also to SOEs outside the CSOP, or to non-state collective enterprises in the CSOP cities.

¹⁵ The Law on Sole Proprietorships (wholly individually-owned enterprises) that became effective on 1/1/2000 includes some provisions on liquidation in Art. 26-32 and 42 that relate also to bankruptcy by implication. Liquidated property shall be used first to arrears in salaries, wages, and social insurance contributions, second to tax arrears, and third to other liabilities; liquidator expenses, labor rehabilitation costs or secured liabilities are not specifically mentioned. In case the enterprise property is insufficient to settle liabilities, the investor shall make repayment with other property of his/hers.

It can be argued that the bankruptcy framework for SOEs has been developed primarily to provide for the orderly exit of loss-makers from the state sector with a minimum of social disruption, rather than to protect creditors or to address concerns about the fate of the bankrupt firm. The CSOP further enhanced the social protection and relieved the residual fiscal burden on the local authorities, in the process putting a greater burden on creditors, the main ones being SOCBs whose balance sheets are of national rather than local concern. In this sense, Circular No. 10 may not conflict with the spirit of the Bankruptcy Law (although it does with the letter of the Security Law) but does raise serious issues for the judiciary and for creditors. It also complicates improvements of the legal framework regarding enterprise property as it makes it hard to know for certain in advance which assets belong to the enterprise and are available to creditors.

At the same time, the significance of non-state bankruptcies cannot be underrated. Roughly half of all bankruptcies in Shanghai in 1998 were in the non-state sector. As these cases are not governed by the rules pertaining to worker resettlement, creditor participation and recoveries are more in line with bankruptcy recoveries in other countries. Likewise, because collateral rights are respected, secured creditors enjoy significantly higher returns. As banks become more commercially oriented, the variance in treatment of creditor and secured rights between state and non-state sector bankruptcies may create distortions in lending practices or risk management that will tend to favor lending to the private sector over SOEs. If the State's objective is to retain and strengthen SOEs in key sectors of the economy, it may have to eventually revisit the current anti-creditor bias in SOE bankruptcy.

Preparation of a New Bankruptcy Regime and its Phase-In for SOEs

When the Bankruptcy Law was passed in 1986, banks were still seen as financial agents of the state rather than autonomous commercial entities. Moreover, when the CSOP got its regulatory basis in 1994-96, social objectives received priority over creditor rights because social security was still entirely enterprise-based and bankruptcy was not yet a widely accepted feature of the emerging market economy. By tilting the balance towards labor, SOE bankruptcies became possible without being socially destabilizing. This was a major achievement at the time.

However, this also made SOE bankruptcy unattractive for creditors. They have rarely initiated bankruptcy, and have not been using it as a threat to force discipline on debtors. Instead, bankruptcy became an option pursued by the debtors and their owner (the state) to cleanse assets of debt, and by local administrations to preserve employment in the short term.

Now at the entry into a new decade, changes in the environment are rapidly eroding the original rationale for this anti-creditor bias. Social security is increasingly being pooled beyond the firm, re-employment service center are cushioning the transition to new jobs, and bankruptcy has become accepted as an inevitable element of the market economy. The SOCBs are becoming autonomous commercial entities, and other creditors such as non-state banks, trade creditors, foreign lenders, and bondholders are becoming more important sources of SOE financing. The regional financial crisis has taught the importance of sound financial systems and an effective threat of bankruptcy, and one outcome of this has been the creation of AMCs to accelerate the resolution of bad debt. More broadly, the rule of law and the "survival of the fittest" are now emphasized as key features of a well-functioning market economy.

These changes in the environment suggest, and permit, to adjust the SOE bankruptcy regime towards more regard for creditor rights, less administrative control over bankruptcy, and more reliance on the social security and re-employment system.

For non-state enterprises in particular, a bankruptcy law akin to those in developed market economies should be introduced without delay, accompanied by accelerated improvements in the institutional

infrastructure. Aware of the need to revise the bankruptcy regime, the State Council decided in fact to commission work on a new bankruptcy law as early as 1994. A first draft was completed in the fall of 1995, and some further modifications were made in 1996. The work is based on a different theory from that which guided the existing Bankruptcy Law, in that it incorporates the notions of general obligations and financial law (given that bankruptcy law is closely related to the financial system).

There are two main differences between the new proposed draft law and the old 1986 law. First, the new law would cover all enterprises, not just state-owned enterprises and not only legal persons but also partnerships, sole proprietorships, and the individual owners of these enterprises. Secondly, it would include detailed reorganization procedures, designed against the background of recent international experience, such as the US Chapter 11, the French 1988 law, the UK 1986 law and to some extent the 1994 German law. The draft is indeed much improved relative to the older legislation (both the Civil Procedures Law and Bankruptcy Law), and largely resembles the bankruptcy laws of developed market economies. Among many other things, the draft new law:

- envisages a proper trustee function,
- strengthens the role of creditor committees, and
- provides an elaborate option of court-supervised reorganization.

While the technical content of the draft law has not been fundamentally challenged, the leadership chose not to submit the law to parliament. The main concern appears to be the potential social impact of a bankruptcy law that gives creditors stronger rights, and that can trigger proceedings even if the local authorities and line bureau do not support such action. Given the poor financial status of many SOEs, the new law could lead to a rapid increase in SOE bankruptcies. Another concern relates to the need to improve the commercial law system and institutional capacity in parallel. There are also still discussions on a few technical issues, such as:

- the handling of secured creditors in the context of the law's provisions for treating "sick horses" early, before it is too late;
- cross-border insolvencies, which at present is handled in the draft simply by saying that foreign proceedings do not apply to assets in China;
- preferential rights, including the possibility of eliminating to a large extent the prioritization of claims, in order to restore the notion of collective action instead of individual satisfaction; and,
- the precise definition and measurement of bankruptcy.

In reaction to the primary concern about the impact on the SOE sector, consideration has been given to include a special chapter on SOE bankruptcy. However, a number of Chinese legal scholars are uncomfortable with the idea of a law that treats some debtor enterprises differently than others. The result has been a gridlock and the absence of a well-functioning bankruptcy regime for the increasingly important non-state economy.

To overcome this gridlock, we recommend to introduce the new draft bankruptcy law in the near term, with further improvements in the draft only if they do not lead to long delays. The law should be uniformly applicable to all state and non-state enterprises. However, its effectiveness date could be deferred for some categories of SOEs. This could be done by stating in the law that the law shall apply to all enterprises immediately, except that its effectiveness for non-incorporated SOEs and SOEs in non-competitive sectors shall be decided by the State Council but no later than 2003. This is in recognition that the reforms in the social security system surrounding the SOE sector are yet to be completed, and that the sheer magnitude of lay-offs required to reform this sector bear risks of socio-political destabilization. Moreover, banks are still on their way towards better incentive structure and capabilities. These temporarily continuing constraints suggest for the SOE sector a gradual shift rather than big leap towards a uniform new bankrupt regime.

The new law would apply immediately, however, to incorporated SOEs in competitive sectors. These are enterprises which, in line with the Decision of 4th Plenum of the Party's Central Committee, have adopted the Modern Enterprise System and operate in sectors where state ownership control is not considered critical. Mixed state/non-state enterprises are generally incorporated (as joint stock or shareholding companies, or as joint ventures with foreign investment) and would thus fall under the new law from the outset. Subjecting such more advanced firms to the new bankruptcy regime from the beginning would enhance competition and the provision of credit, and impose more discipline on their management.

Under their deferral provision, SOEs that are non-incorporated or in non-competition sectors would for the time being still use the old SOE Bankruptcy Law despite its deficiencies. To reduce the negative effects in this interim period, some features in the application of this old law should be changed. And to minimize the period, the strongest possible efforts should be made to further reform the social security system so as to create the conditions that will permit even such SOEs to then join the new bankruptcy law and abandon the old one altogether.

The Need for Transparency and Standardization of Implementation Procedures

For procedures to be efficient, they need to be governed in a transparent manner by a set of clearly articulated rules and procedures. Some flexibility is important, given vast variations in the nature of problems and the multi-faceted transition to a fully market-economic system. Flexibility must be balanced, however, against predictability, equity, and transparency. Lack of standardized procedures bear the potential for inconsistent applications of the law, which can lead to aberrations and misuse in implementation and, consequently, distort the economic incentives that should make bankruptcy a tool for market discipline and reform. Gradual standardization and an effort to reduce existing procedures ultimately to a single set of uniformly applicable rules under a new bankruptcy law would improve procedural efficiency.

Initially, there were numerous gaps in the procedural framework of bankruptcy. Many of these gaps were later filled for the CSOP by Circulars Nos. 59 and 10 together with a host of regulations on worker treatment and resettlement procedures. Even these rules, however, leave considerable discretion to local authorities (see sections III.b and c). This has led to some unpredictability, occasional unfairness, and local "protectionism" practices.

For non-CSOP SOE bankruptcies such specific directives were largely absent. Some cases initially adopted CSOP practices. This prompted a notice by the Supreme People's Court¹⁶ to desist from such practice outside the CSOP. However, it appears that these practices still occur, although the extent to which they prevail is difficult to ascertain.

Clear rule of law would be especially important for the bankruptcy of non-state enterprises, where administrative guidance ("hierarchy") cannot replace "market" based resolution. Bankruptcies of non-state corporations are governed by Chapter 19 of the Civil Procedure Law. The implementation provisions for such bankruptcies are sparse, however. Courts have borrowed from practices and procedures pertaining to SOEs to supplement the gaps in the procedural framework.

More transparency could be ensured by the creditors themselves if they played a more active role in SOE bankruptcy proceedings. In practice if not by law, general creditors and the Creditors Committee have no meaningful role or opportunities for involvement, other than perhaps at the initial creditor meeting. Even banks, traditionally the most active participants in western insolvencies, are relatively passive. This can be explained in part by the fact that the current insolvency regime leaves them with little hope for significant recovery rates. Another factor is the virtual absence of rights for bankruptcy participants to

¹⁶ Urgent Notice regarding Problems in Enterprises Bankruptcy Cases, No. 431 Fa Min Chuan [1996].

appeal decisions, unless an applicant's petition for bankruptcy has been denied. With no practical right of recourse if they want to contest the fairness of proceedings, creditors have become disenfranchised.

Case Study: The Realization of Significant Land Value Is Not Shared with the Creditors

The bankrupt enterprise was established in 1950 in a prime downtown location of a large city. It started as a small chemical manufacturing facility and subsequently became a municipal SOE. The last major investment took place in the 60s. It reached its peak of profitability in 1983, but with completely outdated technology, it lost its market and started incurring losses in 1989. The losses increased year after year and, coupled with growing concern about the plant's environmental pollution in the center of town, the municipality decided to stop all production in 1995. However, only when debt write-off quota became available in 1997 did the authorities and banks agree to let this firm go bankrupt. A petition for bankruptcy was finally filed, and the Court closed the case within seven months.

At the time of bankruptcy, the enterprise still had its full complement of 757 workers and 477 pensioners, owed approximately 150 million Yuan to over 100 creditors, and had a debt to asset ratio of over 220%. In particular, it had accumulated over 40 million Yuan in principal and 35 million in interest arrears to its largest creditor, a state-owned bank. The loans had been "secured" through third party guarantees, but none of the securities were now recognized as binding by the Court.

Through the bankruptcy process itself, the Court approved the transfer of all the assets and about half of the "allocated" land use rights to shareholding cooperative organized by the employees. The other half of the land use rights was recovered by the Municipality and subsequently sold to another SOE. The creditor banks recovered less than 1 million Yuan (about 1%) of their claims and wrote-off the balance under the CSOP quota system. The other creditors recovered nothing.

The shareholding cooperative subsequently brought its land use rights and main factory building, located in a busy shopping street in the city's center, into a new limited liability company organized for the purpose of converting this building into a department store. Outside investors and some employees brought in cash to pay the rehabilitation fee of 200 workers that now left the company, finance the conversion of the building, and provide working capital. The shareholding cooperative received a 12% share in this new company.

Soon thereafter, the new company entered into a joint venture with a foreign investor to develop the land unused by the department store itself, or about half the original land allocated to the shareholding cooperative (close to 30,000 square meters) as a result of the bankruptcy process, into a series of apartment towers with many hundred high-quality apartments. The foreign investor contributed its capital in cash. The local company contributed its land use right as capital. The land use right as valued earlier would have been only 20% of the total equity value, but at this point now a "premium for first-class location" was recognized and the company received a 40% share in the joint venture. The profits of the joint venture are accordingly shared 40:60. The joint venture is successful, with all apartments completed and rapidly sold at up-market prices.

Transparency would improve also if the LC were mandated to present a report on its review of pre-bankruptcy transactions to the Court. Among other things, this report should include asset sales in the prior year. For sale of real estate, the period could be extended to three years. The court should review the report and ensure that appropriate actions are taken.

The need for procedural guidelines is further illustrated by the valuation and auction techniques used. Valuation techniques have been criticized as subject to influence. The inherent distrust likely stems from lack of transparency in the process for licensing valuers, as well as the municipal ownership of all but very few valuations offices used in SOE bankruptcy. A similar lack of transparency appear to exist in auction procedures, making it difficult to conclude that the highest and best value has been received for assets sold and that most auctions were subject to genuine public bidding by multiple parties. (See prior section III.b)

Conflicted Institutional Roles and Need to Strengthen Capacity

Local governments play numerous roles in SOE bankruptcy. They commonly own the debtor, are among the creditors (social security and tax organs), hold equity stakes in some of the trade creditors, are affiliated with guarantors of some debt involved, and own and charge levies on the land used by the debtor enterprise. Local governments are also responsible for social stability and minimum welfare.

Moreover, they usually license and fund the valuation and auction houses involved in bankruptcy. By providing most members of the liquidation commissions and often chairing them, local government representatives are also arbiter in the bankruptcy process. The Government decides which SOEs shall be placed into bankruptcy and acts as matchmaker with the firm that acquires the assets or business.¹⁷ This high level of orchestration has been deemed necessary to control social stability.

Notably absent from the multiple roles of the local governments is ownership or fiscal responsibility of the main creditor banks. These are first and foremost the nation-wide SCOBs under the *central* government. In an attempt to control financial stability and limit fiscal impact, the central government has been deciding the debt write-off quota under the CSOP and curtailing additional debt write-off through, among other things, the tight cap on loan loss provisions. The creation of AMCs has now for first time drastically broadened the financial scope for bankruptcy. The quota approach had created an artificial environment for bankruptcy that operated in an almost mathematical formulaic fashion. In some cities, SOE bankruptcies started only when CSOP quota became available, and ended when the quota dried up. Otherwise bankrupt and unviable enterprises had to wait their turn to be put to rest. In the meantime, they continued to absorb scarce financial resources in value-subtracting activities, or to keep valuable assets like land under-utilized.

At the local level, the interventions of government tend to distort the bankruptcy process by marginalizing the court, the state-owned banks and other creditors (particularly from outside the Province). Local governments faced with local problems are prone to exert pressure on all of the above to “rubber-stamp” solutions that they believe are beneficial to the local community. But these solutions may not lead to the kind of operational and managerial changes that are necessary to ensure that the enterprise restructuring is sustainable, or that the asset are reallocated in the most economically efficient manner.

The multiple roles of the local government create potential conflicts of interests especially with respect to functions of the LC. Through the government representatives the debtor, acquirer, and employees are commonly spoken for in the LC, but this is not the case for the main creditors. As long as the owner of a state-owned debtor enterprise is represented on the LC, one might perhaps justify also the inclusion of some creditor representatives. Even without voting right on this Commission, membership would at least ensure greater transparency. For example, the largest creditor or two (which will often include an AMC) could be on the LC.

The deliberations of the LC are also not fully transparent. While we found no hard evidence of abuse, the lack of transparency could create opportunities for self-dealing. The LC does not *de jure* take possession of the bankrupt enterprises but is supposed to control the management team that continues managing the firm, or its assets, during the bankruptcy proceedings until an acquirer is found. Liability for mismanagement and abuse by the LC, enterprise management, and others in bankruptcy is not well defined. Circular No. 10 requires an audit after completion of a bankruptcy under the CSOP, but this seems take the form of a completion report rather genuine audit. In the end, there are weak incentives for management coupled with equally weak disincentives to protect against abuses.

In a number of cases reviewed, the bankruptcy process amounted to little more than a realignment on paper of the rights and interests of creditors based on appraised asset values. In such cases, operations continued during bankruptcy proceedings, and did so with reduced debt after “whole takeover”. That the company was acquired as whole, not liquidated, was viewed by some judges as a deliberate disregard of their decisions. The country’s leadership also questioned the practice of debt cleansing for “whole

¹⁷ Article 8 of the Bankruptcy Law provides that “[t]he debtor, upon agreement of the superior departments in charge, may apply for the declaration of bankruptcy.” Pursuant to Circulars 59 and 10, the State Leadership Group takes responsibility for the organization and coordination of enterprise merger, bankruptcy and re-employment in CSOP cities through subgroups. Much of the decision-making has centered around the “pre-assigned scale of provisions for canceling doubtful and bad debts” (para. 1 of Decree 10).

takeover” and have lately discouraged it, most notably by concentrating the write-off quota now on a smaller number of large, genuine bankruptcies under stronger central supervision.

The People’s Courts that administer most bankruptcies, have broad competencies over many areas, bankruptcy being one. Certain judges on the local People’s Courts are commonly designated to handle bankruptcy cases. A number of issues call for attention:

- While the number of bankruptcy judges has so far apparently been sufficient, the capacity of the courts will need to increase as the cases continue to increase. This would be the case especially if the AMCs fulfilled their mandate and autonomy in realizing asset values.
- The number of bankruptcy cases handled by a judge and, hence, his relevant experience, differs a lot between municipalities. Smaller towns, particularly those outside the CSOP, simply offer fewer opportunities to handle bankruptcies. To ensure experience through a certain critical mass of bankruptcy cases handled by a judge, consideration could be given to approaches such as rotating some bankruptcy judges regularly among small courts or lowering the threshold above which bankruptcy cases are transferred to higher-level courts. An alternative could be the establishment of specialized bankruptcy judges or courts, which focus exclusively on bankruptcy cases.¹⁸
- The aforementioned measures would also weaken the bonds between the judges and the local authorities, and thus strengthen the rule of law in bankruptcy.
- Competency varies between judges. To some extent this may have roots in the limited legal education of some judges, and the low attention given to bankruptcy in this education. The need for stronger training in bankruptcy-related topics further increases as bankruptcy proceedings gradually give judges a more important role, open more to active creditor participation, and provide for more court-supervised reorganization.

The institutional capacity needs improvements in other respects as well. Professional trustees and liquidators are virtually lacking. As they will be required under the future bankruptcy law, efforts to train, (self-)regulate, qualify, and license these professions should be an urgent priority. Many local government employees that are experienced members of liquidation commissions might find rewarding career opportunities in these fields. Improvements are also desirable in the areas of valuation and auctioning, aimed at ensuring greater independence from local authorities, greater legal accountability, and competition that motivates improvements in skills and service.¹⁹ Moreover, bankruptcies will inevitably involve increasing numbers of lawyers, accountants, and financial advisors working for the various parties in the cases. Their training at law schools, accounting institutes, business schools, etc. should give appropriate attention to bankruptcy and related matters. Finally, the newly established AMCs as well as other financial institutions would be well advised to boost their staff training in bankruptcy and workout. Generally speaking, as business practices become increasingly sophisticated and corporate structures increasingly complex, so will bankruptcies.

Consideration might be given to a central institution to oversee the administration of bankruptcy. This entity would assess bankruptcy practices in the country, disseminate advice on good practice, and monitor the activities of appointed LCs to suppress irregularities. This institution could also promote the development of professional trustees that will likely be important in future under a new bankruptcy law.

¹⁸ There are already a number of specialized courts in China. The general intention at present seems to be to reduce rather than increase their number, however.

¹⁹ The Minister of Finance indicated publicly in May this year the thrust of reforming specialized “intermediate business services” like accountants, appraisers and tax advisors. First, by end-2000 all such companies should become independent of their sponsoring government agencies in terms of financing, personnel, titles and operations. Second, several supervisory bodies such as the China Association of Certified Asset Appraisers, China Association of Certified Tax Agents and China Association of Certified Accountants already have or would be merged. The independent authority of professional associations might be enhanced.

IV. SUMMARY ASSESSMENT

The bankruptcy regime has had a number of positive outcomes:

- It has allowed the bankruptcy by now of more than 20,000 enterprises, of which more than half were SOEs. In the process, it has reallocated many assets, often to probably stronger firms, more efficient uses (especially of land), and/or non-state operators.
- Most fundamentally, this has been achieved while maintaining social stability and avoiding financial system collapse.
- Moreover, it has built practical experience in courts and local administrations, as well as in valuations and auctioning.
- Finally, it has helped to create some public understanding of bankruptcy, and acceptance in principle by workers and political leaders.

However, these achievements came at high costs:

- With social stability and municipal development interests prevailing over creditor interests, creditors have suffered low recovery rates. In a way, a fiscal function has been assigned to creditors that distorts normal credit allocation and collection decisions. This has affected banks directly on their balance sheet, deters them from initiating bankruptcy themselves, and affects their willingness to lend. The absence of bankruptcy provisions for natural persons is further deterring loans to small and micro enterprises, which are key for future growth.
- For managers and owner representatives of SOEs, bankruptcy has been a temptation rather than a threat. Bankruptcy has lost much of its motivating force for good governance and management, and for corporate restructuring.
- Although the court process itself has generally been fast, it often took long beforehand for the local government to decide on the bankruptcy route and secure the debt write-off, and it has also at times taken long to liquidate assets with unrealistic valuations. In the long run-up to bankruptcy filing, and perhaps also during the proceedings while management stays in place, moral hazard exists and asset stripping might occur. The local courts and LCs do not spend much energy on examining transactions that took place prior to filing, as required by law.
- Upon the urging of local authorities, probably many cases of “whole takeover” involved labor absorption beyond the recipient’s needs, and the protracted operation of some economically inefficient production. If properly compensated through a lower purchase price or other benefits, this many not harm the acquirer in the short term and does indeed contribute to social stability. However, it delays the reallocation of labor to efficient uses, and does so in a less than transparent manner.

Moreover, the environment has been changing drastically since the Bankruptcy Law was introduced in 1988, and even since the debt write-off program was initiated in 1994:

- Social liabilities (pensions, unemployment benefits, etc.) are now rapidly becoming pooled beyond the individual enterprise, town, and sector. Moreover, the entitlement as a state sector worker has been losing value as SOEs divest their social assets, join social security pools with non-state enterprises, engage employees on a contractual basis, and default on wages and pensions. The main residual entitlement, the right to purchase the apartment at low prices or with a supplementary subsidy from the employer, is being exercised by an increasing number of SOE employees. Moreover, with the role of the private sector now formally acknowledged in the amended Constitution and supported by many authorities, the anxieties of leaving the state sector and “jumping into the sea” of market employment should lessen.

- Financial sector stability is now receiving higher priority than before the region's financial crisis. A system where bank branch managers collude in matters of bankruptcy against their national headquarters with the local public owners of debtor enterprises, and with the tacit consent of a judiciary system that is not fully independent, is increasingly recognized as a burden to longer-term stability rather than a guarantor of short-term stability. It has also become more difficult since banks have started some centralization of internal control lately. The creation of the AMCs is evidence of this increasing emphasis on banking sector stability. Concerns about the effectiveness of AMCs, in turn, have led to calls for changes in, or exceptions to, the bankruptcy regime.
- Owners, creditors, and employees have become increasingly complex. The current bankruptcy regime is based on the notion of a wholly state-owned enterprise with only state banks as substantial creditors and with workers interested solely in job security or severance/pension income. Today, however, many state-controlled enterprises have non-state minority shareholders or joint venture partners, and many more will follow under the "strategic readjustment of the state sector" as decided by the recent 4th Plenum of the Party's Central Committee. Trade creditors are becoming more sophisticated, and large firms issue bonds or borrow abroad through window companies. Employees have large deposits in banks and almost 40 million citizens own stock, which gives them financial security and stakes beyond their wage income.
- The technical capacity of courts, non-state acquirers of bankrupt assets, and support professions has been growing, albeit at uneven pace and with important gaps. Those judges who have been concentrating on bankruptcy could by now be entrusted with more decision-making. Local officials who have participated in many LCs could enter a trustee career. Asset valuers could set up non-state valuation firms. Experts from property transactions centers could set up more auction houses.
- The concept of a market economy is now widely accepted. The principle of the rule of law has been inserted into the Constitution. And the important role of the private sector has been embraced constitutionally, as well as practically for employment generation. This calls for less administrative intervention in bankruptcy cases, for more regard for non-state creditors, and ensuring that private debtors are subject to an effective bankruptcy system. The GITIC bankruptcy case has signaled the recognition of such trends.

V. CONCLUSION: RECOMMENDATIONS FOR REFORM

To conclude, we will here summarize the recommendations made in this report, notably sections III.

a. RAPID INTRODUCTION OF A NEW BANKRUPTCY REGIME FOR NON-STATE ENTERPRISES AND INCORPORATED SOES

A new Bankruptcy Law has been drafted in 1995-96. It would apply to state-owned and non-state enterprises. The draft is much improved relative to the older legislation, and largely resembles the bankruptcy laws of market economies. Among other things, it envisages a proper trustee function, strengthens the role of creditor committees, provides an elaborate option of court-supervised reorganization that can be initiated by debtors. While the technical content of the law has not been fundamentally challenged since it was drafted, the country's leadership has so far chosen not to submit the law to parliament. The Government and Party seem mainly concerned that the social implications of SOE bankruptcy, if pursuant to a uniform new law, could slip out of their control. In reaction to this concern, an alternative version of the draft includes a special chapter on SOE bankruptcy. However, the legal profession tends to reject the idea of a law that treats state-owned debtor enterprises differently than non-state ones. The result of this gridlock is the absence of a well-functioning bankruptcy regime for the increasingly important non-state economy.

- 1) We recommend to introduce the draft *new bankruptcy law* in the near future. Further improvements to the draft as of end-1996 are warranted only if they don't lead to long further delays.
- 2) We recommend that the new bankruptcy law not differentiate between state-owned and non-state enterprises. However, the law could state that its *effectiveness in the case of non-incorporated state-owned debtor enterprises and SOEs in non-competitive sectors* is left at the discretion of the Government to decide but in any case no later than the year 2003. Until such time, those enterprises would remain under the present old SOE bankruptcy law. The CSOP would be ended no later than that date as well. For incorporated SOEs in competitive sectors the new law would be effective immediately. To minimize the transition period, financial and social system reform should be deepened and accelerated. This will create the conditions that will ultimately permit the state enterprise sector as a whole to be subject to the new bankruptcy law and to abandon the old bankruptcy law altogether.
- 3) *Natural person* enterprises would be included from the beginning in the new bankruptcy system. Eventually, the concept of bankruptcy should also apply to individual persons. Appropriate bankruptcy provisions would give individuals the protection of an orderly court process when pursued by creditors, permit them to retain some necessary assets for a minimum living standard, and allow them to make a fresh start in their life.

b. INTERIM IMPROVEMENTS IN THE BANKRUPTCY REFORM FOR STATE-OWNED ENTERPRISES

Under the existing Trial Bankruptcy Law for SOEs, the leverage of the local governments in the bankruptcy process should be reduced, since local governments often give too little importance to creditor interests and the rule of law relative to narrow municipal development and employee interests. This could be achieved by measures such as the following:

- 4) *Transactions prior to the bankruptcy* of an SOE should be reviewed as a matter of principle, to find any fraudulent transactions, illegal asset transfers, or preferences given to certain creditors. The liquidation commission should be mandated to present a report on its review of pre-bankruptcy transactions to the court, and include all real estate sales of the last 3 years and other asset sales of the last one year. Moreover, it might be advisable more often than has been practice in the past to replace the top management of debtor enterprises after appointment of the liquidation commission, so as to minimize situations of moral hazard.
- 5) The threshold above which bankruptcy cases get referred to *higher-level courts* could be lowered. Moreover, this referral could be made automatic. Creditors should possibly also get more rights of recourse, beyond today's right to appeal the denial of a bankruptcy petition, to contest the fairness of bankruptcy proceedings.
- 6) *Land valuation* offices should be made independent from government agencies. The recent Opinion of the Ministry of Land Resources to this effect should be resolutely implemented. Also as per that Opinion, land valuation offices should be subject to licensing and regulatory supervision by higher-level bureaus, i.e., at the provincial or national level. Wherever possible, land valuations should be based on recent transactions of similar land between independent parties.
- 7) Courts could be asked by the Supreme Court or through changes in regulations to give *creditor assemblies* a larger role in SOE bankruptcy proceedings. For example, the consultation of the creditor assembly as required by the current Bankruptcy Laws could be interpreted as a de facto veto right for a reorganization or asset distribution plan. Moreover, as long as the state-owned debtor enterprises are represented on the liquidation commissions through their owner representatives, one could contemplate also the participation of key debtors on those commissions. Even if they had no vote on the commission, their participation would promote greater

transparency. So as to further raise transparency, the audit of a bankruptcy case after its completion, as mandated under the CSOP, could be implemented more rigorously. Generally, more attention needs to be paid in SOE bankruptcy to trade creditors, i.e., creditors of inter-enterprise or “triangular” debt. Courts and LCs should actively seek the participation of not only the SOCB but also other creditor banks and trade creditors in the creditor assembly.

Transparency and competition should be raised in asset disposal or restructuring:

- 8) For all assets of the debtor’s estate attempts should be made to ***sell on competitive markets with generally open access***. The establishment of land exchanges at the municipal level should be accelerated. For asset auctions greater openness, transparency and accountability should be ensured through appropriate regulations and procedures. Auction rules should address conflicts of interest. Legal recourse should be possible against an auction house even if it a municipal agency. Auctions should require public announcement in media with national coverage, with a certain minimum of information, and appropriately early before the auction. A Website could be established at the national level where all such media announcements are replicated.
- 9) “***Whole takeover***” is vulnerable to armtwisting of local firms by local authorities to rescue non-viable production and allow it to be cleansed of debt. If and when “whole takeover” is used, competition and transparency should be fostered. Among other things, the access of potential acquirers to bankrupt businesses destined for whole takeover could be broadened. Local authorities should be explicitly encouraged to transfer bankrupt businesses in non-critical sectors to non-state buyers, consistent with the 4th Plenum Decision. Restrictions on foreign ownership in sectors such as retail and wholesale could be relaxed for cases of “whole takeover” of bankrupted SOEs. “Whole takeover” through tender, with wide public advertisement, should be encouraged. In some cases, these could be negative-price tenders where buyers bid for the amount of fiscal incentives as a condition for acquisition, or as so-called investment tenders where a bidders indicate the social, employment, and other commitments that they offer to assume.

The Capital Structure Optimization Program (CSOP) has already been significantly modified last year. The Program should be further modernized in view of the changing environment:

- 10) The formula to calculate the ***rehabilitation fees*** of workers laid-off through bankruptcy under the Program, including its linkage to the average local salary, should be revisited. Among other things, the subsidy inherent in transferring housing to an employee below market price, or in letting him continue to use the housing free of rent after it has been taken over from the bankrupt firm by the municipality, could be taken into account to some extent when calculating the rehabilitation fees.
- 11) The practice, not based on legislation, of giving worker entitlements priority even over creditors with ***security on non-land assets*** needs to be suppressed. The State Council circular that gave worker entitlements priority over credit secured by land mortgages should be carefully revisited towards a phase-out over time. The resulting higher burden on social security pools should be shared by those national authorities who benefit from such a measure ultimately through lower costs of bank recapitalization.
- 12) A ***municipal or higher-level fund*** that covers part of the financing gap for the rehabilitation expenses would allow bankruptcy in cases where worker entitlements exceed asset value and a white knight, i.e., buyer for “whole takeover” cannot be found. It could also help overcome the unequal treatment of employees whose bankrupt firm gets wholly taken over versus those employees whose firms gets truly liquidated. The recent instruction of the Ministry of Land Resources to establish such special funds should be implemented on the local level.
- 13) A broader issue is an accelerated ***transition from “allocated” to “granted” urban land use rights***, i.e. the de facto purchase of the land use right by an enterprise and its recording as an asset in the balance sheet. To motivate more enterprises to do so, the attractiveness of using allocated relative to granted land needs to be reduced. One option would be to reduce the fee for granting a land use

right, but this would lower the granting fee relative to market prices and thus create further distortions and rent-seeking opportunities. Instead, it might be preferable to levy higher taxes or charges on the use of allocated land by entities other than public-interest bodies, i.e. by enterprises that benefit today from the grandfathering of allocated land use rights. Such changes regarding land use rights would have implications far beyond bankruptcy, of course, such as more efficient use of valuable urban land, a better reflection of a firm's true efficiency in its financial statements, less local rent-seeking, and more fiscal revenue. Some of the increased revenue could also help to finance social security costs associated with bankruptcy.

The newly created asset management companies (AMCs) are supposed to become driving forces for the reorganization and bankruptcy of insolvent enterprises. To achieve this, the government-owned AMCs should be ensured adequate leverage in driving bankruptcy cases against SOEs.

- 14) *AMCs could enhance their voting power* in the creditor assembly. To do so, AMCs could: (i) swap loans between themselves so as to concentrate the claims on one debtor in fewer hands; (ii) purchase at negotiated "market" prices loan claims of banks on the same debtors; (iii) enter into agency agreements to collect claims on behalf of other state-owned creditors; (iv) establish a coordination committee among AMCs, and decide whether to grant such a committee the right in certain situations to make decisions that bind each signatory AMC; and (v) agree with other large state-owned creditors (such as railroad, shipping or telecom companies) on a framework to coordinate their stance towards important debtors. (vi) Giving banks more scope for debt write-off and debt restructuring (see below) would facilitate their cooperation with the AMCs. In addition, AMCs owned by the Ministry of Finance might be given an enhanced vote in the creditor assembly in the case of non-incorporated state-owned debtors under the SOE Bankruptcy Law who owe at least one third of their unsecured liabilities to AMCs. This could be done, for instance, by lowering for a limited number of years the percentage of claims that is needed among the relevant class of unsecured creditors to initiate reorganization or approve a liquidation or reorganization plan.
- 15) Government-owned AMCs should have the right to *initiate bankruptcy against SOEs without approval of the local line bureau*, subject perhaps only to a veto right of an inter-agency committee (including SETC) at the national level. Moreover, directly government-owned AMCs that are creditors to a non-incorporated SOE could be given the right to be appointed member of liquidation commission (see above), and perhaps on a trial basis in some cases even be the only member and thus operate akin to a trustee. In the coming months, the first series of bankruptcies pursued by AMCs against defaulters, especially high profile cases such as listed or other large companies, should receive full backing from the country's leadership so as to send appropriate signals to defaulters.

c. ENHANCEMENT OF INSTITUTIONAL CAPACITY

The capacity, practices and independence of key institutions in the bankruptcy process should be enhanced so as to reduce abuse of the present regime, bring creditors to the table, and prepare for the future reform in the bankruptcy framework.

- 16) To enhance the *capacity of AMCs*, they should individually or jointly introduce programs to train staff in bankruptcy and work-out, and supplement this capacity with a roster of qualified local and foreign bankruptcy experts as contractual consultants. To engage professional experts for such training and consultancy, the AMCs should appropriate an adequate internal budget.
- 17) The *work-out departments of banks* should be boosted through enhanced technical skills, some rotation of their managers among branches, and a stronger incentive system for credit collection by local branches. At the same time, credit analysis and credit management skills should be further enhanced so as to contain the need for future work-outs.

- 18) The compensation rules for *bankruptcy professionals* should be revisited to provide more incentive for their development. Training programs should be introduced for potential trustee professionals and liquidators. As they will likely be required under the future bankruptcy law, efforts should proceed to not only train but also regulate, qualify, and license such professions. (Until their roles are legally introduced, they can be engaged by LCs as members or as professional support.) Non-state valuation companies should be licensed in far greater numbers than today.
- 19) The *teaching of bankruptcy* and related matters should be enhanced at law schools, accounting institutes and business schools.
- 20) The shortage of experience with bankruptcy in small-city *courts*, especially those who had not been among the pilot cities in the CSOP, could be addressed by: (i) revisiting rules about the transfer of cases to higher courts; (ii) rotating individual judges more actively among courts so as to impart, and learn from, experience in bankruptcy and related matters; and (iii) perhaps some system of specialized bankruptcy chambers that abdicate bankruptcy cases for a large region. Moreover, bankruptcy should get more attention in the initial and continued education of judges.
- 21) A *central institution*, perhaps located in or spun off from an existing government agency or office, could be appointed to monitor the administration of SOE bankruptcy so as to disseminate good practice and help suppress irregularities in the bankruptcy process. This would not be limited to the CSOP and, thus, exceed the current mandate of the Merger and Bankruptcy Office at SETC. Moreover, it would also promote education in bankruptcy-related matters. In addition, it could help develop the profession of trustees that will likely be important under the future new bankruptcy law, and might be given the responsibility to license trustees.

d. GENERAL IMPROVEMENTS IN THE CREDIT SYSTEM

The system of bankruptcy in China would, in addition, benefit from improvements in the credit system in a broader sense:

- 22) The 1% cap on the deductibility of *loan loss provisions* for tax purposes should urgently be revisited. Similarly, write-off from sale of non-performing loans beneath face value could be exempted from limits on the fiscal recognition of such costs.
- 23) The *interest rate ceiling* that prohibits the pricing of risk should be revised as well. This will appear more easily feasible once the need for macro-economic stimulation eases. Already in the short term, the interest rate ceiling could be relaxed at least for new lending or loan rescheduling to firms under court-supervised reorganization.
- 24) The legal framework for conventional *workout practices* should be strengthened to make it easier for banks to engage in rationalized debt treatment, such as maturity extensions and reductions of loan principal (“haircuts”), to help avoid the bankruptcy of potentially viable firms. Consideration should also be given to develop the legal framework for secure “super-priority” or “debtor-in-possession” financing of distressed firms, since workout and restructuring are often dependent on new capital.
- 25) The framework for *secondary markets of debt* should also be developed. The sale of loans could be facilitated, for instance, by considering the transfer per se valid even if the debtor does not confirm the precise status of the loan. Consideration should be given to relaxing the controls against state sector entities selling loans, as well as assets from liquidation, foreclosure, or debt/equity conversion, beneath their appraisal value; at a minimum, such relaxation should apply to government-owned AMCs. The draft regulatory framework for industrial investment funds, which would also cover turnaround funds that buy distressed debt or equity to restructure them for profit, should be finalized. The approval processes concerning foreign-exchange lending should be reviewed so as to facilitate the purchase or sale of distressed foreign-exchange loans, including by

foreign financial institutions. The access of foreign or foreign-invested financial institutions to the future market in yuan-denominated distressed debt could be facilitated as well.

- 26) The implementation of *credit information systems* should proceed without delay. Obstacles that may be faced by credit rating agencies should be addressed. The requirements that individual depositors identify themselves should also be further implemented, and expanded from new accounts to also existing accounts. The publication of defaulter lists that has been piloted in some cities could be encouraged more broadly.

Closely related to bankruptcy are questions of credit securities like mortgage, pledge, and guarantee. Research conducted under our purview parallel to this bankruptcy study suggests potential improvements in the following areas:

- 27) The operating practices of entities involved *registering credit securities* need to be improved. For instance, stronger uniformity in mortgage registration could help prevent local misuses (regarding requirements for repeated re-registration, or the maturity of mortgages in the case of default), as could better legal recourse against registration agencies. Guarantors should be required to disclose the credit guarantees that they have issued, so as to make it easier for creditors to evaluate such guarantees.
- 28) The legal framework and institutional practices regarding *security interests in movable assets* such as inventory could be enhanced to provide a broader range of instruments. Moreover, as mentioned above, the notions of super-security (or debtor-in-possession financing) could be introduced to help provide financing to distressed debtors if it is in the best interest of the creditors.
- 29) Similar to bankruptcy itself, more consistent qualification and independence of judges would help strengthen credit securities. To relieve the burden on courts, future amendments to security legislation could contemplate allowing some degree of "self-help" of secured creditors. Last but not least, the *enforcement of court judgments* related to credit securities, especially across local boundaries, needs sustained attention by the higher authorities.

APPENDIX A

Statistics on the Bankruptcy of State-Owned Enterprises in Four Cities, 1995-98

	Volume /a				Share of Total			Firm Size	Condition of the Firm		
	Firms	Persons	Assets Yuan m	Liabilit. Yuan m	Firms	Persons	Assets	Persons per firm	Liabilit/ Assets	Bank Debt/ Liabilities /b	Retirees/ Persons /c
TOTAL	195	187,800	4,589	10,205	100%	100%	100%	963	222%	67%	29%
TOWN											
Changsha	81	39,500	1,014	1,706	41%	21%	22%	487	168%	72%	32%
Loudi	8	1,000	27	49	4%	0.5%	0.6%	125	181%	63%	n.a.
Shenyang	58	100,700	2,589	6,143	30%	54%	56%	1,736	237%	n.a.	27%
Wuhu	48	46,100	946	2,282	25%	25%	21%	961	241%	63%	29%
INDUSTRY											
Chemistry	21	15,360	356	930	11%	8%	8%	732	261%	62%	26%
Minerals, Coal	13	5,230	152	292	7%	3%	3%	402	192%	48%	28%
Machinery	30	61,230	1,270	3,114	15%	33%	28%	2,041	245%	72%	27%
Electronic	13	14,960	366	828	7%	8%	8%	1,151	226%	62%	21%
Textile	27	46,730	1,245	2,451	14%	25%	27%	1,730	197%	73%	31%
Food Ind.	15	7,750	194	465	8%	4%	4%	516	240%	72%	24%
Other Light Ind.	46	33,200	931	1,806	24%	18%	20%	722	194%	57%	32%
Trading	15	1,610	30	173	8%	1%	1%	107	570%	60%	30%
Other and n.a.	15	1,690	42	146	8%	1%	1%	112	350%	87%	41%
OWNERSHIP & SIZE /d											
Large SOE	17	79,600	2,340	5,172	9%	43%	51%	4,684	221%	72%	27%
Medium SOE	44	56,000	1,252	2,713	23%	30%	27%	1,273	217%	68%	30%
Small SOE	73	36,100	735	1,491	37%	19%	16%	494	203%	58%	29%
Collective	60	16,000	260	813	31%	8%	6%	267	312%	74%	34%
YEAR (COURT COMPLETION)											
1995	5	4,600	90	203	3%	2%	2%	908	226%	n.a.	27%
1996	99	119,800	2,813	7,001	51%	64%	61%	1,209	249%	68%	28%
1997	55	51,800	1,309	2,192	28%	28%	29%	941	167%	65%	30%
1998	36	11,700	377	808	18%	6%	8%	324	214%	67%	34%

/a A few missing data entries are estimated based on averages of comparable cases in the municipality.

/b Not including Shenyang

/c Not including Loudi

/d Formal size classification used by the Government. One enterprise (a joint venture) not included.

Source: Data provided by the respective Municipalities

APPENDIX B

Legal Texts Relevant for Bankruptcy in the People's Republic of China

Laws

- Law of the PRC on Enterprise Bankruptcy (For Trial Implementation), promulgated on 12/2/1986 and effective from 11/1/1988
- Civil Procedure Law, effective from 4/9/1991 (Part 19: Procedure for Debt Repayment by Bankrupt Enterprises with the Status of a Legal Person)
- Company Law, promulgated on 12/29/1993 and effective from 7/1/1994 (Chapter VII: Merger and Division of Companies; Chapter VIII: Bankruptcy, Dissolution and Liquidation of Companies)
- Labor Law, promulgated on 7/5/1994 and effective from 1/1/1995.
- Law on the Administration of Urban Real Property, promulgated on 7/5/1994 and effective from 1/1/95
- Commercial Banking Law, adopted on 5/10/1995 and effective from 7/1/1995
- Credit Security Law, effective from 10/1/1995
- Securities Law, adopted on 12/29/1998 and effective from 7/1/1999
- Other laws including the Accounting Law, General Civil Law, Law on Wholly People-Owned Industrial Enterprises, Law on Foreign-Owned Enterprises, Law on Sole Proprietorships, etc.

Government Regulations and Decisions

- Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone, promulgated on 11/29/1986 and effective from 7/1/1987
- Provisional Measures Governing Enterprise Merger, issued jointly by the State Commission for System Reform, the State Planning Commission, the Ministry of Finance, and the State Administration of State-Owned Assets on 2/19/1989
- Measures for the Administration of State Asset Valuation, promulgated by the State Council in 1991 and effective on 11/16/1991
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- Circular 1998 No. 10 on Ensuring the Basic Living Standard of Laid-Off Workers of State-Owned Enterprises and Helping them Getting Re-Employed, issued by the Central Committee of the Chinese Communist Party and the State Council, 6/9/1998
- Notice 1998 No. 28 concerning the Implementation of the Provincial Pooling of the Basic Pension Funds of Enterprises’ Staff and the Transfer of the Administration of Industrial Pooling to the Local Governments, issued by the State Council on 8/6/1998
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