



ISSUES IN THE ACCEPTANCE OF BANKRUPTCY CASES BY CHINESE COURTS

by Yu Junfu and Chen Dong

**Meeting held on
27-28 April 2006**

This document reproduces a report by Mr. Yu Junfu and Mr. Chen Dong written after the Fifth Forum for Asian Insolvency Reform (FAIR) which was held on 27-28 April 2006 in Beijing, China. It will form part of the forthcoming publication “Legal & Institutional Reforms of Asian Insolvency Systems”.

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*by Yu Junfu and Chen Dong**

Bankruptcy occurs when a debtor is unable to repay debts due, according to the original intent of bankruptcy legislation, and in accordance with the provisions of Article XXXI of the Regulations of the Supreme People’s Court on Several Issues Concerning the Trial of Enterprise Bankruptcy Cases (the Regulations). The “inability to repay the debts due” means that the time limit for the debtor to perform on debts has expired and the debtor is unable to repay.

In the practice of bankruptcy liquidation, “bankruptcy” is often mixed up with “bankruptcy proceedings”. Bankruptcy proceedings take place when the debtor is unable to repay the debts due. Their objective is to safeguard a majority of the creditors’ interests while giving due consideration to the debtor’s interests. The court distributes the debtor’s properties upon application of the parties concerned.

The application and acceptance of a bankruptcy case is an important phase in bankruptcy proceedings, and covers such issues as which civil subject can become bankrupt, the conditions under which the bankrupt can enter into a proceeding, and how the people’s court is to exercise jurisdiction and examine the issues, and make a final decision to start the proceedings. This article discusses the legal issues concerning the application and acceptance of bankruptcy cases from an attorney’s viewpoint.

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1) The debtor's bankruptcy ability

a) The debtor's bankruptcy ability under Chinese law and regulation

The debtor's bankruptcy ability means the debtor's competency for applying bankruptcy proceedings to solve the problem of debt service, that is, the civil subject's competency for being declared bankrupt. In view of the applicability principle, there exist two legislative doctrines in the provisions of every country's bankruptcy laws on the debtor's bankruptcy ability: the businessman bankruptcy doctrine, and the general bankruptcy doctrine. The difference between the businessman bankruptcy doctrine and the general bankruptcy doctrine is shown mainly in the applicability of bankruptcy laws to natural persons.

Chinese bankruptcy legislation is thought to adopt the businessman bankruptcy doctrine, and also the business corporation bankruptcy doctrine. Only a businessman with corporate capacity has bankruptcy competency (the new draft bankruptcy law will extend to natural persons).

According to the provisions of Article ILV of the General Principles of the Civil Law, a business corporation shall terminate upon being declared bankrupt in accordance with the law. In addition, it is provided under Article II of the Enterprise Bankruptcy Law (Trial) and according to the provisions of Article 199 of the Civil Procedural Law that this is applicable to people's enterprises.

In any case, when a business corporation is unable to repay its debts due to losses, both its creditors and the debtor may apply to the people's court to declare it bankrupt for liquidation. Thus, the subject of bankruptcy must first be a corporate organisation with independent capacity for civil liability, and next, a for-profit organisation engaged in productive operations. Only a business corporation and no other civil subject has bankruptcy ability for the moment.

In particular, any business corporation (owned by the people, or not), including collective enterprises with corporate capacity, affiliated enterprises, private enterprises, contractual joint ventures, co-operative ventures, solely foreign-funded enterprises set up within the territory of China, general joint-stock enterprises, etc. have bankruptcy competency. Article IV of the regulations also enumerates civil subjects without bankruptcy ability (including enterprises without corporate capacity, other organisations, non-corporate public institutions, small industrial or

commercial businesses, lease holding rural households, individual partnerships, natural persons, etc.)

b) Several classes of bankruptcy subjects

1. Pro forma going concern business corporations

The so-called pro forma going concern business corporation is a business corporation that is already set up, does not go out of business or have its license revoked, and is legally regarded as a going concern. According to Chinese legislation and regulations, any business corporation that is legally a going concern may submit a bankruptcy application to the court in accordance with the law when there is a reason (such as the inability to repay debts and the inability to arrange a settlement with creditors).

The concept of “pro forma” going concern is raised here because the following issues may appear in practice. In one case, the so-called pro forma going concern means that the debtor may start bankruptcy proceedings once bankruptcy conditions are met, if the business license has not been revoked and the business continues to operate. In another case, the debtor is not able to pursue bankruptcy proceedings (even if the business license has not been revoked) because the business continues to operate only nominally. In another case, the debtor goes out of business for various reasons, has its business license revoked, and continues to operate or have its whereabouts unknown. It is questionable whether this type of enterprise is able to enter into bankruptcy proceedings in theory or in practice.

2. Enterprises going out of business, or with revoked licenses

In practice, more and more enterprises are going out of business or having their business licenses revoked. Most are not liquidated. They leave a considerable amount of outstanding debt, and thus make it hard to safeguard creditor interests. Regulations on enterprises that go out of business or that have revoked licenses are incomplete. Law and practice should specify how to deal with such enterprises, especially with respect to whether they can use bankruptcy proceedings to distribute assets.

There have always been different theories on the legal nature of business corporations going out of business and on the revocation of licenses. One theory is the “personality elimination theory”, which denies that a liquidated legal person has an independent personality. Other theories include the “personality discontinuance theory”, the “personality semi-continuance theory” and the “personality continuance theory”. These theories recognise

the liquidated legal person's personality, but have different opinions on the basis of the origin of such personality.

Among them, the “personality continuance theory” is used in practice, and is recognised by most scholars and in most countries' legislation. According to this theory, a business corporation's personality is not eliminated until the liquidation is completed and the enterprise is terminated. The enterprise continues to have personality as the original business corporation during the period of liquidation, but with a different purpose. A business corporation at this time is called a “liquidated legal person”.

We agree with the “personality continuance theory” for the following reasons: 1) if one does not recognise that enterprises going out of business or with revoked licenses have corporate personality, it would be hard to explain how these enterprises have the rights and powers to carry out liquidation activities, and dispose of credits and debts before they close; and 2) it is of significance for the settlement of legacy debts and the prevention of debt vacancy to recognise that business corporations going out of business or with revoked licenses have bankruptcy competency.

Because laws and regulations lack definitive provisions on these exit and liquidation issues, a large number of enterprises have appeared that are not liquidated (even though they have gone out of business or have had their licenses revoked,) or are terminated without liquidation. If these enterprises are not recognised as having corporate personality, barriers will be created for proceeding against these enterprises. It follows that evading liquidation has become a means for enterprises and shareholders to evade paying debts, or for shareholders to evade capital contributions, or for enterprise managers to appropriate the enterprises' properties.

The formulation of liquidation rules and other rules on the premise of recognising that enterprises have corporate capacity is helpful for preventing debt suspension. The Supreme People's Court acknowledges that business corporations going out of business with revoked licenses have corporate capacity in its judicial interpretations. In its reply No. (2000)24, the Supreme People's Court provides that:

...a business corporation, after having its business license revoked, shall carry out liquidation in accordance with the law, and will not be eliminated until the liquidation proceeding is completed and the business registration is cancelled. As a result, a business corporation shall still be regarded as a going concern after having its business license revoked until its registration is cancelled and may carry out the proceedings activities in its own name.

After going out of business and the revocation of its business license, the enterprise continues to maintain corporate capacity, with its rights and powers restricted to the extent of liquidation. It can engage in civil activities only to the extent of liquidation. In principle, the enterprise shall not have legal relations as before winding up, but still have a direct repayment liability. The liquidators, at the time of performing the liquidation liability, shall assume the repayment liability for debts, but only subject to the liquidated properties of the enterprises. Since these enterprises have corporate capacity, they also have bankruptcy competency. When their properties are insufficient to repay their debts, enterprises may apply for bankruptcy liquidation proceedings. The bankruptcy petition of these enterprises can be submitted in the liquidation process, or submitted without a liquidation process. Creditors may also submit bankruptcy applications directly.

3. Branches of foreign companies

Transnational bankruptcy cases are increasing with increasing globalisation and the development of transnational corporations and overseas investments. A number of issues arise with cross-border bankruptcies.

China has adopted the “doctrine of territoriality” in cross-border bankruptcies, that is, the force of the home country’s bankruptcy declaration is limited to the home country, and does not extend to the debtor’s properties abroad. At the same time, a foreign country’s bankruptcy declaration only comes into force in the foreign country, and has no force on the debtor’s properties in other countries. In judicial practice, China does not acknowledge that foreign parent companies have recourse to their properties within the borders of China after being declared bankrupt abroad. It holds that branches of foreign companies in China have an independent bankruptcy ability, and are not directly subject to the influence of their foreign parent companies.

In recent judicial practice, this doctrine of territoriality has been refined further. Article 73(4) of the regulations provides that “any bankrupt enterprise’s properties abroad shall be reclaimed by the liquidation group”. China’s legislation and judicial practices thus try to assure the maximisation of Chinese creditors’ interests.

c) The applicability of the corporate personality disclaim principle in the acceptance of bankruptcy cases

Although the corporate personality disclaim principle has taken a place in the two main legal systems, China's phased market development meant that the corporate personality disclaim principle developed late in China and is still in its early days. It meets with difficulties in practice, especially in bankruptcy cases, since definitive laws and regulations are still lacking.

i) Related regulations and judicial interpretations

On the legislative horizon, the Bankruptcy Law (Trial) does not have related laws and regulations on personality disclaim, nor does the Company Law have an exception clause for the corporate limited liability principle. But, on 27 October 2005, the 18th Session of the 10th Standing Committee of the National People's Congress amended the Company Law. Article XX of the new Company Law provides that any company's shareholders shall not abuse their shareholder rights to impair the interests of the company or other shareholders, or abuse the company's independent corporate status and the shareholders' limited liability to impair the interests of the company's creditors. If the company's shareholders abuse their rights and inflict losses upon the company or other shareholders, they become liable for compensation under the law. And, if the company's shareholders abuse the company's independent corporate status and the shareholders' limited liability to evade debts and impair the interests of creditors, they assume joint and several liability with the company. It is the first time that Chinese authorities develop a regulation deriving from the principle of corporate personality disclaim.

In judicial practice there are widely divergent attitudes towards the corporate personality disclaim principle. On the one hand, it is provided for in Article IV of the Notice on Settlement and Rectification of the Torts and Debts of Companies Which are Terminated and/or Merged issued by the State Council on 12 December 1990 (hereafter referred to as the State Council's Notice) that for any company that was registered and incorporated at the administration for industry and commerce, that does not actually have any self-owned capital, or has paid-up capital out of line with the registered capital (except otherwise provided by the state), the governing authority directly approving the establishment of the company, or the applicant for the establishment of the company, or its investors shall assume the repayment liability for the company's debts to the extent of the registered capital. Any party providing a guarantee for the registered capital shall assume joint and several liability to the extent of the guaranteed capital.

It is also provided for in Article V that registered capital is a currency representation for any business corporation's properties under operation and management, or any business corporation's self-owned properties granted by the state. The capital contributed by each level of institution and organisation to the company can never be reclaimed. If the company's governing authority or sponsor organisation withdraws or transfers capital, conceals properties or evades debts, it shall refund all the withdrawn or transferred capital or the concealed properties, and repay the company's debts due. If there is something left, then anything falling under the investments of the Party and government organisations shall be taken as state-owned assets, and directly reclaimed by the investment organisations. Anything falling under the investments of collective enterprises shall be returned to the original investment organisations.

The provisions above are special regulations on the settlement issue of the terminated companies' credits and debts and, obviously, break the principle of shareholder limited liability (that shareholders are not liable to company creditors, and are liable only to the extent of their investment.) This is mainly shown in: 1) investors are required to repay the company's debts; and 2) investors are required under some regulations to assume the repayment liability of the company's debts to the extent of the amount of profit-making or to the extent of the company's misappropriated properties, but not subject to the limit of the amount of investment.

It is provided under Article (II) of the Reply on the Assumption of Civil Liability for an Enterprise Established by Enterprises after Being Terminated or Going out of Business made by the Supreme People's Court on 30 March 1994 (hereafter referred to as the Supreme Court's Reply) that any other enterprise sponsored by enterprises obtaining a corporate business license, having a paid-up self-owned capital in the amount provided under Article XV(7) of the Implementation Rules for the Registration Management Regulations of Business Corporations of China or other relevant regulations, (though out of line with the registered capital, and meeting other conditions for a business corporation) shall be recognised as having corporate capacity and shall independently assume a civil liability to the extent of its properties. But, if this enterprise does not have sufficient property to repay the debts after being terminated or going out of business, the sponsor enterprises shall assume a civil liability to the extent of the difference between the paid-up self-owned capital and the registered capital.

It can be seen from this clause that this reply acknowledges the following two principles in the case that the investment of a business corporation fails to reach its registered capital: 1) that when the enterprise's assets are insufficient to repay the debts, the investors assume a joint and several liability with the enterprise; and 2) that the joint and several liability

assumed by the investors has the nature of a supplementary liability and is subject to the extent of the difference between the self-owned capital and the registered capital that occurred as a result of underinvestment.

It is also provided in Article 3 that any other enterprise sponsored by enterprises obtaining a corporate business license, (but having no paid-up self-owned capital or having a paid-up self-owned capital lower than the amount as provided under Article XV(7) of the Implementation Rules for the Registration Management Regulations of Business Corporations of China or other relevant regulations), and not meeting other conditions for a business corporation, shall be recognised as not having corporate capacity, and have its civil liability assumed by the business corporations sponsoring this enterprise. This clause provides that investors failing to contribute or fully contribute the registered capital shall assume an obligation of unlimited repayment liability to balance the creditors' interests.

This document represents the spirit of the corporate personality disclaim principle to a certain extent, and makes certain regulations on the abuse of corporate personality, underinvestment, failure to contribute or fully contribute, the registered capital and other acts.

In contrast, it is provided under Article I of the Guiding Opinion of Guangdong Senior People's Court on Several Issues Concerning the Trial of Bankruptcy Cases of June 2003, that for any business corporation applying for, or being applied for bankruptcy, the court shall not reject the bankruptcy application because the debtor's shareholders or investment organisations owe or withdraw the registered capital. After the court declares it bankrupt, any person liable for owing or withdrawing the registered capital shall supplement or return the owed or withdrawn registered capital, which shall be taken as part of the bankrupt enterprise's bankruptcy properties.

This local senior court's judicial guiding document is vindication for the corporate limited liability principle. The opinion emphasises that in any bankruptcy case, if a company's shareholders owe or withdraw the registered capital, this will not affect the independence of corporate personality, and the company will still assume the debt service liability to the extent of the registered capital, while any person liable for owing or withdrawing the registered capital only needs to supplement or return the owed or withdrawn registered capital. In other words, shareholders still assume a limited liability to the extent of the amount of their investment.

ii) *Problems faced by courts at the time of applying the corporate personality disclaim principle*

Since there are no definitive regulations on the corporate personality disclaim principle under Chinese law, several documents provide specific operating bases for applying the corporate personality disclaim principle to the enterprises' registered capital deficiency in Chinese judicial practice, and also make instructive explorations for the establishment of the principle. These documents make regulations similar to the corporate personality disclaim principle in particular cases, and have the following common points: 1) all of them take the lawful and valid establishment of corporate legal personality as a premise; 2) the investors' false investment is taken as one of the constitutive requirements for liability assumption; and 3) the investors directly assume the enterprises' debts.¹

These standards not only show the direction for the local courts' judicial trials, but also provide legal bases for the local courts to "pierce the corporate veil", and safeguard creditors' interests. This is also represented in Article XLVIII of the Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Dispute Cases (I) (Exposure Draft), which provides that:

...the people's courts shall strictly follow the corporate independent personality and shareholder limited liability principle specified in the Company Law, and only order the controlling shareholder to directly assume a civil liability for the company's creditors if there exist particular causes for abusing corporate personality in specific legal relations provided in these regulations.

Articles 50 and 51 of these regulations of the Supreme Court also have specific provisions on the corporate personality disclaim under the circumstance that the company has ill-defined accounts or funds merged with its shareholder, or the company's business is confused with that of its shareholders or dominated by its controlling shareholder, or the company has in nature only one shareholder, etc.²

However, in the trial of bankruptcy cases, (since there is no regulation on the corporate personality disclaim principle in the Chinese Bankruptcy Law and its judicial interpretations), according to law applicability rules, any court, at the time of hearing any bankruptcy case, shall in principle apply the provisions of notice and reply once finding that the bankrupt debtor has a false registration, withdrawn capital or committed any other act abusing the independence of the corporate legal person. Although this is true in theory, problems may occur in judicial practice.

First, according to the provisions of the Guangdong Senior People’s Court’s Guiding Opinions, a court shall not reject a bankruptcy application at the time of hearing the application for the reason that the debtor’s shareholders or investment organisations owe or withdraw the registered capital, but shall require any person liable for the owed or withdrawn registered capital to supplement or return the owed or withdrawn part after the bankruptcy declaration and put it into the bankruptcy properties. That is, when the debtor submits an application for bankruptcy, the court shall not reject corporate personality by reason that the shareholders owe or withdraw the registered capital, but shall still follow the corporate independent personality and shareholder limited liability principle, and have it assume the repayment liability to the extent of the amount of the investment. This is inconsistent with the State Council’s notice and the Supreme Court’s reply.

Guangdong Senior Court’s Guiding Opinion is not legally binding, however, its influence and significance should not be underestimated. One is a judicial interpretation with legally binding force, and the other is a guiding opinion of a superior court on the inferior courts. The contradiction makes regulations more ambiguous and renders the work of the courts more difficult when applying the laws. On the one hand, judges will be exposed to the awkward situation of balancing the judicial interpretation against the guiding opinion in the trial of individual cases and, on the other hand, the confusion will allow some parties and their attorneys to pursue vested interests and evade the laws.

The ambiguity of the prevailing legislation also facilitates the abuse of the corporate personality independence principle, the evasion of the laws, and the impairment of creditors’ interests. Since the corporate personality disclaim principle is still at the phase of judicial practice in China, judges have adequate discretion. In specific cases, if the courts find that investors withdraw capital or fail to fully contribute the capital when hearing bankruptcy cases, in terms of legal applicability, creditors and investors will make different choices to safeguard their own interests. If the investors apply the Guangdong Senior Court’s Guiding Opinion, then the investors only need to make up for the capital fund without assuming an unlimited liability to the creditors. Creditors will persist in applying the Supreme Court’s notice, whereby investors still need to assume an unlimited repayment liability for outstanding debts as well as liability for the amount of underinvestment.

If judges are partial to investors when exercising discretion, false investors will evade liability, and creditors will be unable to get relief. This facilitates phenomena such as multiform “briefcase companies” or “government bodies turned companies”. As far as the creditors are concerned, if they are unable to predict the economic outcome of activities,

or have their interests reasonably safeguarded or their impaired interests relieved, they will distrust the law and lose confidence in the existing economic order. This will reduce confidence in the credit markets and affect overall social and economic development.

In bankruptcy practice, the courts may also meet with inconsistent standards for accepting bankruptcy applications. Since the standards for accepting bankruptcy cases in legislation lack operability, there is no consistent standard for whether the debtor has bankruptcy competency in practice. The Civil Procedural Law and the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases both provide that³ “any bankrupt debtor shall have a corporate capacity, and any enterprise without corporate capacity, small industrial or commercial business, partnership organisation, or lease holding rural household does not have the competency to be the subject of bankruptcy.”

However, there are neither definitive regulations nor consistent trial practices to determine whether an enterprise with a business license (but failing to meet the essential conditions for a business corporation), is able to apply for bankruptcy or be applied for bankruptcy. Under one opinion, the judgment on whether an enterprise has corporate capacity can only be based on the enterprise's registration. Any registered enterprise can be subject to bankruptcy, even if the registered capital has not been contributed or is only partially contributed. This then becomes a problem of ordering the enterprise's investors or sponsors to supplement or make up the registered capital.

For instance, the Guangdong Senior People's Court emphasises that the competency for being subject to bankruptcy shall be acknowledged for any enterprise with a corporate business license (even if the registered capital fails to reach the minimum required), as long as its corporate capacity is not revoked by the administration for industry or business.⁴

Another opinion holds that the judgment should be based on whether the enterprise meets essential conditions for a business corporation at the time of establishment. For any licensed enterprise, (with unpaid or insufficient registered capital), the court should reject its competency as a subject of bankruptcy in accordance with the provisions of the Supreme Court's Reply. This is the opinion of the authors for three reasons:

First, as far as Guangdong Senior Court's guiding opinion is concerned, its goal is to: strike a balance between the interests of bankrupt debtors and creditors; close obviously insolvent enterprises in a timely fashion, and exit the market through bankruptcy liquidation; and maintain the stability and safety of the social and economic order. This will, however: indirectly

protect some malicious investors in the market; facilitate abuse of the independence of corporate personality; impair the independence of corporate personality, and the authority and rationality of the limited liability principle; and lead to distrust of the market order and market credit.

Second, it goes against notions of fairness and justice if interests gained through unlawful acts are protected by law, while the losses caused by unlawful acts cannot be relieved.

Third, as far as current judicial practice is concerned, when creditors find that the debtor lacks assets to repay debts (or has no assets at all when proceeding against the debtor or applying for forcible execution), the creditors' attorney will first consider the condition of the contributions of the debtor's shareholders. If it is found that the shareholders underinvested or withdrew an investment, they will suggest that creditors join shareholders as co-defendants, and have them assume a joint and several repayment liability. In practice, this is the last and also the best legal relief for creditors.

In December 2002, the vice president of the Supreme Court, Mr. Li Guoguang, made a speech at the National Court Civil and Commercial Trial Working Conference and pointed out that:

...when a company's creditors proceed against the company's shareholders because the company's shareholders have any unfaithful act abusing corporate personality and thus making the company unable to perform or fully perform the repayment obligation, the people's courts shall accept. ...and when hearing this type of case, shall decide the shareholders' liabilities according to the specific circumstances, and have the shareholders assume a joint and several repayment liability for the company's debts to the extent of the amount of underinvestment if the shareholders have any underinvestment; have the shareholders assume an unlimited joint and several liability for the company's debts if their underinvestment makes the company's registered capital lower than the minimum standard provided in the Company Law, and the company's legal personality unable to be lawfully created; or have the shareholders assume a joint and several liability for the company's debts to the extent of the company's withdrawn assets if the shareholders withdraw the company's assets and thus result in the company's insufficient performance capacity. If the shareholders' assets are merged with the company's assets, or the shareholders' business is merged with the company's business, the company's personality will be absorbed by the shareholders' personality and become not independent, the shareholder shall

*assume an unlimited joint and several liability for the company's debts.*⁵

In conclusion, defects in the corporate limited liability system have emerged with the development of the Chinese market economy. These include false investment by shareholders, withdrawal of investment, and underinvestment, along with acts such as nominal parent and subsidiary companies, and the application of the corporate limited liability principle to deceitfully impair creditor interests. This damages the relationship between the company's shareholders and its creditors, and other stakeholders, and impairs the authority and predictability of law. The improvement of the Chinese corporate personality disclaim principle and the further development of the corporate limited liability system are urgent.

In the authors' opinion, it is necessary for judicial authorities to conduct further study in order to draw on the corporate personality disclaim principle in the company laws of other countries. It is even more necessary for legislative authorities to increase the force of standard documents, and improve the corporate personality disclaim principle on the horizon of legislation. The reason for the current disorder in China with respect to the application of the corporate personality disclaim principle is slow and confusing legislation. There are no laws or rules to go by due to the lack of detail and the roughness of prevailing legislation. In addition, there are inconsistent voices in judicial practice.

The most important step is, therefore, to build the authority and the integrity of the present laws. On the one hand, one should insist on the good faith principle of the General Principles of the Civil Law in the market economy, and prevent fraudulent acts and abuses of rights. On the other hand, legislative authorities may consider supplementing the exception clause for corporate limited liability to specify the corporate personality disclaim principle in the amendment to the Company Law. At the same time, corresponding supporting provisions should be made in the Bankruptcy Law, and the Civil Procedural Law.

First, it is necessary to specify the competency for the subject of bankrupt legal persons. Once the court finds that an enterprise applying (or being applied) for bankruptcy has a personality defect, the court should reject the application. Second, in the case of the debtor's applying for bankruptcy, it should be provided that creditors have the right to oppose the corporate personality disclaim in the process of the court's acceptance of the bankruptcy case, and that the court has an obligation to hear and give a verdict on such an opposition.

2) Essentials of bankruptcy

The essentials of bankruptcy describe the conditions under which the debtor with bankruptcy ability (a business corporation) can apply for (or be applied for) bankruptcy, and start the bankruptcy proceedings. It also describes the essential conditions for the court to accept the bankruptcy case. In other countries, these matters are grouped by scholars into the essentials of bankruptcy. These include: the debtor has reasons for bankruptcy; there is no barrier to bankruptcy; and a majority of creditors exists; etc. On the problem of which matters fall under the essentials of bankruptcy, since all countries have different legislative backgrounds, social and national situations, there are also differences between laws and the opinions of scholars.

According to Chinese bankruptcy legislation, any business corporation entering bankruptcy proceedings shall meet the following conditions:

a) The debtor reaches the bankruptcy limits

The bankruptcy limits (also called bankruptcy reason), are the legal factual basis for the parties concerned to submit a bankruptcy application, and for the court to start bankruptcy proceedings, and declare the debtor bankrupt.

It is provided under Article III of the Chinese Enterprise Bankruptcy Law (Trial) that any enterprise that suffers heavy losses due to poor operations and management, and is unable to repay its due debts may be declared bankrupt in accordance with the provisions of this law. It is provided under Article 199 of the Civil Procedural Law that (for any business corporation unable to repay its debts due to heavy losses), either the creditors or the debtor may apply to the people's courts to declare the debtor bankrupt for liquidation.

This is provided for in both the Enterprise Bankruptcy Law (Trial) and the Civil Procedural Law under the conditions of “inability to repay the debts due”, and “incapacity to repay the debts due”. Under these laws a “heavy loss” means insolvency. The focus of inability to repay the debts due is on whether the debt relationship can be maintained as normal. The insolvency focuses on asset/liability ratios and the repayment risk incurred, studies the debtor's repayment ability (only subject to the limit of physical properties but without consideration of credit, capability and other possible repayment factors), and calculates the amount of debts without consideration of whether they fall due, and includes all of them into the gross amount. The debtor usually has become insolvent by the time it is unable to repay the debts due. But, even if the book value of assets still exceeds the liabilities,

the debtor may also be unable to realise unreasonably structured assets, or may be unable to repay debts because of poor operations and management.

On the other hand, if the debtor is able to repay debts using properties, loans and other credit means at the time of becoming insolvent, it is not sure to lose the ability to repay debts. There are, therefore, not only conceptual differences between insolvency and inability to repay, but also differences in the definition of bankruptcy limits in practice. Accordingly, taking the inability to repay the debts due as the bankruptcy reason is called a cash flow standard, while taking insolvency as the bankruptcy reason is called an assets/liabilities standard. Taking the inability to repay as the bankruptcy reason is mainly to maintain the existing economic order and debt relationships, while taking insolvency as the bankruptcy reason emphasises safeguarding creditor interests from the angle of property repayment ability.

According to other countries' and Chinese bankruptcy liquidation practices, we shall focus the enterprise bankruptcy reason on "inability to repay the debts due", and "incapability to repay the debts due". The Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Bankruptcy Cases provides a clearer definition of an enterprise's inability to repay the debts due in Article XXXI. The "inability to repay the debts due", and "incapability to repay the debts due" are again emphasised as the focus of bankruptcy reasons. This is because Chinese bankruptcy law was still in the era of the planned economy, and "heavy loss" was taken as the reason for bankruptcy with a view to the condition of people's enterprises.

This gives rise to problems as follows: 1) creditors will find it hard to lodge a proof when submitting a bankruptcy application. There is no way for the creditors to know whether the debtor is insolvent or demonstrate proof. Taking this as the bankruptcy reason, if strictly implemented, is sure to restrict or even deprive creditors of the bankruptcy application right. However, if the creditors are not required to provide proof, it may also occur that a bankruptcy application could be submitted without proof of the bankruptcy reason; 2) the court will have no way to conduct a timely investigation and ascertain at the time of checking whether to accept a case. Firstly, the debtor's financial accounts cannot be taken as a basis for the decision. Debtors on the verge of bankruptcy always have chaotic bookkeeping, and asset records are inconsistent with reality. They fail to book and settle various properties, (such as impairments of commodity stocks, raw materials, doubtful accounts receivable, etc.). As a consequence, there is no way to prove whether the debtor is insolvent by book assets. Even the existence of worthless unfinished buildings may become a reason for the debtor to defend itself against a bankruptcy application. Second, in order to prove whether the debtor is insolvent, it is necessary to make an

asset appraisal and financial audit, which takes time, or is impractical during the period provided by the law for the court to decide whether to accept the case. Third, when the inability to repay is taken as the only bankruptcy reason, suspended payments of debts due in a continuous state may be inferred and judged as inability to repay. The suspended payment can be proved at the time of bankruptcy application as *prima facie* evidence and can be investigated and ascertained on a timely basis when the court examines and accepts the case. But, the court can not ascertain insolvency without material proceedings. Furthermore, legislation can not find a solution by means of presumption.

The inability to repay debts due should focus on whether the debt relationship can be maintained as normal. We think it should be grasped in the following aspects: 1) the debtor loses the ability to repay, that is, the ability to repay debts through property, credit, capacity or any other means. Repaying debts by means of credit refers mainly to the conversion or extension of debts, and repaying debts by capacity refers mainly to repayment of debts by labour, services, etc.; 2) what the debtor is not able to repay are debts that fall due, and are claimed, undisputable or determined in name. If before the maturity of the debts, the creditors believe that the debtor will be unable to repay them after maturity, or the debtor files a request for extension of debts undue, it will not be taken as inability to repay, because the repayment obligation has not come into existence at that time. If the creditors fail to claim the debts due, it will be taken as an implied consent to extension. Even if the debtor is already incapable of repaying these debts, it cannot be taken as a reason for bankruptcy because the condition of inability to repay did not actually occur. If, for a claimed debt, both parties dispute whether it exists or dispute the amount, etc., it comes to the question of whether the debtor shall (and is able to repay) if a court or an arbitral authority give an effective verdict, acknowledge the right and obligation, and determine the debt in legal name; 3) the debts are not limited to objects payable by money, but must be valuable in monetary terms, or else declaring bankrupt will become meaningless because debt cannot be repaid in the bankruptcy proceedings; and 4) it means the debtor's continuous inability to repay all or most debts during a certain or a predictable period, but not suspension of payment for temporary fund turnover problems. Here the debtor's long-term continuous inability to repay the debts will not be taken as a necessary condition: only if there are other facts proving that the debtor will be continuously unable to repay the debts during a predictable period.

b) Absence of barriers to bankruptcy

If a bankruptcy proceeding is not started, or is terminated for a legal cause that prevents the starting or continuation of bankruptcy proceedings, the legal cause is referred to as a bankruptcy barrier. According to regulations in different countries, bankruptcy barriers are classified into: barriers that prevent the start of bankruptcy proceedings; and barriers that prevent bankruptcy declarations. Only the barriers preventing the start of proceedings are discussed below:

i) Legal barriers

A legal barrier means that the court has the right to reject the bankruptcy case for certain reasons in law and regulation. According to the provisions of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases, legal bankruptcy barriers include:

(1) The claimant fails to pay the court a case acceptance fee

Any debtor or its creditors, when submitting a bankruptcy application, shall pay the court a bankruptcy case acceptance fee. If the fee is not paid, the court may not accept the bankruptcy application.

(2) The debtor's bankruptcy application fails to get approved by the competent authority

It is provided under Article V of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases that any state-owned enterprise applying to a people's court for bankruptcy shall submit a document from the superior governing authority approving its bankruptcy. Any other enterprise shall provide a document of its sponsors' or shareholders' resolution on the enterprise's bankruptcy.

(3) The claimant submits a hostile application

Article XII of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases provides that:

...if the people's courts finds any of the following circumstances upon examination, the bankruptcy application will not be accepted: (I) the debtor has such acts as concealment or transfer of properties etc., and applies for bankruptcy in order to evade the debts; (II) The

creditors use the bankruptcy application to deface the debtor's business reputation, and intend to impair fair competition.

According to these regulations, the court (if finding that the purpose of the debtor's bankruptcy application is to evade its debts or the purpose of the creditors' bankruptcy application is to defame the debtor, or impair fair competition) shall reject the bankruptcy application. As a result, if the claimant submits a hostile application, it will also constitute a bankruptcy barrier.

(4) The debtor's objection to the claimant's credits is tenable

It is provided under Article IX of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases that if the debtor lodges an objection to the creditors' rights when the creditors apply for the debtor to go into bankruptcy, the court, if considering that the objection is tenable, shall advise the creditors to lodge civil proceedings first, and reject the bankruptcy application.

ii) De facto bankruptcy barriers

De facto bankruptcy barriers mean that some de facto reasons exist for making it inadvisable or impossible to start a bankruptcy proceeding. These de facto bankruptcy barriers include:

(1) Whereabouts unknown

The whereabouts of the debtor's staff or properties are unknown, in which case the debtor is of de facto inexistence, and no bankruptcy proceedings can be carried out;

(2) Serious disorder

The debtor's financial and property are seriously disordered, and most business materials are lost and cannot be investigated and ascertained; and

(3) Social turbulence

For certain reasons, the debtor's bankruptcy may give rise to serious social turbulence, making it inadvisable to accept the bankruptcy case for the moment.

As regards "having a majority of creditors" as a pre-requisite for bankruptcy, there is no definite regulation in Chinese bankruptcy legislation

and judicial interpretations. Considering that the function of the bankruptcy proceedings is to fairly distribute the debtor's properties to a majority of creditors, if multiple creditors do not exist, then bankruptcy proceedings have no practical meanings, and bankruptcy proceedings cannot be organised (since it is not possible to organise a creditors' meeting).

3) The jurisdiction and acceptance of bankruptcy cases

a) The jurisdiction of bankruptcy cases

Jurisdiction means the right and power to interpret and apply bankruptcy law and regulation, that is, the division of authority among different courts.

i) Territorial jurisdiction

Both Article V of the Enterprise Bankruptcy Law (Trial) and Article I of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases provide that enterprise bankruptcy cases shall be under the jurisdiction of the people's court in the debtor's place of residence. The debtor's residence means the location of its main office. If the debtor has no office, the people's court at its place of registration has jurisdiction. In practice, the location of an enterprise's main office is generally determined according to the following rules: 1) the head office is the location of the main office (such as the location of the president and the financial staff); and 2) if the head office has several locations, the main office is determined by the number of executives, business volume, length of office time, and other factors. If the location of the main office cannot be determined, then multiple territories can be the location of the main office, and all relevant local courts will have jurisdiction.

ii) Hierarchical jurisdiction

Jurisdiction by hierarchy means that the scope for accepting bankruptcy cases between superior and inferior people's courts is divided according to certain standards. Jurisdiction by hierarchy is provided under Article II of the Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Bankruptcy Cases. The article states that the grassroots people's courts generally have jurisdiction over the bankruptcy cases of enterprises authorised and registered by the county, or county-level city or district administration for industry and commerce. The intermediate people's courts generally have jurisdiction over bankruptcy

cases of enterprises authorised and registered by the district (or district level or above) administration for industry and commerce. Bankruptcy cases of enterprises included in the national plan for regulation are subject to the jurisdiction of an intermediate people's court. According to this judicial interpretation, bankruptcy cases are generally subject to the jurisdiction of the grassroots and intermediate people's courts. The senior people's courts and the Supreme People's Court do not directly handle bankruptcy cases.

iii) Central jurisdiction in practice

In Shanghai, Shenzhen and other cities with concentrated bankruptcy cases, the people's courts generally take a mode of central jurisdiction, which means to say that all bankruptcy cases in the region are subject to the uniform jurisdiction of the intermediate people's court. For instance, it is provided under Article V of the Shenzhen intermediate people's court's Procedures for Hearing Enterprise Bankruptcy Cases, that the bankruptcy of any corporation registered in Shenzhen shall be heard by the Shenzhen intermediate people's court.

Specialised proceedings for bankruptcy cases have become a universal trend. In the United States, France and other countries, bankruptcy cases are accepted by special courts. For instance, in the United States, bankruptcy cases are accepted by the federal district bankruptcy courts, the federal bankruptcy appeals courts, or the Federal Supreme Court. In France, bankruptcy cases are accepted by commercial courts. In countries without special courts, bankruptcy cases are also heard in a specialised way.

There is a limited number of judges who are specialised to hear bankruptcy cases. Since bankruptcy laws are different from general civil laws, there are many special arrangements in judicial proceedings. Bankruptcy affairs demand considerable knowledge and professional experience in law, business management, etc. and judges need to expend considerable time and effort to supervise and guide liquidation. Bankruptcy trials are, therefore, characterised by their degree of specialisation, and also the need for judges to pay attention to their whole course from acceptance to termination. The jurisdiction and trial of bankruptcy cases is decided by the particular details of the proceeding.

b) The acceptance of bankruptcy cases

After the people's court accepts a case, the debtor will be put into protection, and the execution proceedings on the debtor's properties will be suspended. It also means that the debtor starts to be terminated as a business corporation. The people's courts take special care in examining and

accepting cases in which the interests of creditors, the rights and interests of investors, the interests of employees, social stability and other factors are involved.

i) Case acceptance and hearing proceedings

The acceptance and hearing proceedings are provided in the judicial practice of many cities and districts. Whether to accept a bankruptcy application is determined by giving full public audience to each party's positions. First, the provisions on hearing proceedings itemise the written materials to be submitted by the bankruptcy claimants. This helps the people's courts conduct the examination of materials. Next, all bankruptcy hearing proceedings provide for public summons of the concerned parties to make statements in the courts and respond to inquiries. Article V of the Rules of Shenzhen Intermediate People's Courts on Accepting and Hearing Bankruptcy Cases provides that the participants in bankruptcy hearing proceedings shall include the bankruptcy claimant, known creditors with a large amount of credits, the enterprise's legal representative, financial staff and employee representatives, the enterprise's top governing authority, intermediary institutions issuing the enterprise's assets appraisal and audit reports etc. Last, the hearing proceedings generally require that: the bankruptcy claimant state the cause for the bankruptcy application and present relevant proofs; the proposed bankrupt enterprise's legal representative or person in charge state the condition of the enterprise or raise a plea; the intermediary institutions comment on the audit and appraisal reports; the collegial panel make a survey; concerned persons make inquiries, etc. Accepting the case based on full information makes the court better acquainted with the relevant issues and lays a solid foundation for progress. It also helps reveal hostile bankruptcy acts and prevent ethical risks in the examination and hearing process.

ii) Examining bankruptcy cases for acceptance

In practice, the people's courts examines bankruptcy applications in the following aspects:

(1) Whether the debtor is unable to repay due debts

The debtor's inability to repay debts is a legal bankruptcy limit. In practice it is generally shown by the facts that debtors are not able to perform on a large number of verdicts because its main assets have been seized by the people's court upon application of the creditors, or it has broken faith for an extended time.

(2) Whether the debtor continues to exist

Whether the debtor continues to exist, and whether its principal assets, financial accounts, or staff still exist. It will not meet the conditions for bankruptcy proceedings if nothing is left. In addition, the debtor's asset condition shall also be taken into account. If it is insufficient for payment of bankruptcy expenses, bankruptcy proceedings will not be started.

(3) Whether the debtor is a special enterprises

It is provided under Article III(2) of the Enterprise Bankruptcy Law (Trial) that no bankruptcy declaration will be made for: any utility or any enterprise materially impacting the national economy and the people's livelihood; or an enterprise given supports by governmental authorities to repay debts or by other measures. A utility or an enterprise impacting the national economy and the people's livelihood (such as traffic, energy, infrastructure enterprises), have a direct impact on the macro economy and the people's livelihood. Since such an enterprise's bankruptcy affects the economy of some regions or even the country, it is necessary for laws to protect them. This does not mean that these enterprises cannot be declared bankrupt, or that these enterprises do not have a bankruptcy ability (bankruptcy competency), but that the courts shall take care in examining and deciding to accept bankruptcy cases, and shall consider whether governmental authorities give support to these enterprises or could take other measures to help them repay their debts. If the government supports the enterprise or takes other measures to help it repay debts, bankruptcy cases shall not be accepted.

(4) Social security

A basic condition that makes China different from developed western countries is that China does not have a social security system. Neither the rural nor the urban population is covered by social security. In addition, the vested social security obtained by urban residents is limited. The incomplete social security system and the low level of security constrain the normal operation of bankruptcy proceedings.

Bankruptcies put pressure on social stability due to the cancellation of labour contracts and the unemployment of workers without adequate security. As a result, it is necessary to examine the conditions of employees, and whether a bankruptcy gives rise to social problems. If a case falls under those included in the enterprise bankruptcy plan of the State Council, employee placement expenses will be paid to employees from the transfer fees of land use rights.

If a bankruptcy case is a general bankruptcy case (not included in the bankruptcy cases planned and regulated by the State Council), it will not apply the employee placement policy. Legal provisions and related judicial interpretations state that the wages of employees and compensation for the cancellation of labour contracts shall be repaid in the first order of bankruptcy distribution, and that employee medical and living expenses may be firstly appropriated from the bankruptcy properties during the liquidation period. In these cases, the court shall take care to examine the impact of bankruptcy on employees, since the amount of compensation obtained by employees is less than that obtained from bankruptcy cases within the plan. If the enterprise has many employees, bankruptcy will have a significant impact on their lives, and the court will accept the case on the condition that the relevant government departments give support.

(5) Trading before the enterprise's bankruptcy application

Article IIIV of the Enterprise Bankruptcy Law (Trial) provides that during the six months before the court accepts the bankruptcy case to the day of the bankruptcy declaration, the enterprise's concealment, partition without permission or free transfer of properties, abnormal underselling of properties, provision of property security for debts, advance repayment of debts, abandonment of own credits and other acts are of no effect. When examining and accepting bankruptcy cases, the court shall focus on material trading acts within the six months before the bankruptcy application and, if it finds any of the above acts, shall correct them immediately.

In addition, the court shall examine whether the debtor has concealed or transferred assets, or if the purpose of the bankruptcy application is to evade debt repayment. The Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases provide that people's courts shall not accept bankruptcy applications under these circumstances. Hostile bankruptcy applications (in order to evade debt repayment) are a bankruptcy barrier for the debtor. The people's court shall exclude the claimant's hostile action and take care to examine transfers of material properties and material investments at the time of examination.

(6) Impact on the social and economic order

There are two broad considerations. One is the impact of bankruptcy on financial stability, and the other is its impact on social stability.

Bankrupt enterprises may have enormous debts. If numerous debtors enter bankruptcy proceedings concurrently, the non-performing bank loans

may impact the banking system. The court should, therefore, take care to examine the impact of enterprise bankruptcy on systemic stability.

Bankruptcy may also damage social stability. In addition to labour creditor's rights and social security issues, bankruptcy may impact the repayment of raised funds, the personal injury insurance and housing purchases of consumers, small creditors with limited risk tolerance, equity investors, the stability of the securities markets, etc. The court should make an informed evaluation and consider the trade-offs when accepting applications.

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- ¹ Zhu, Ciyun (1998), "Study on the Corporate Personality Disclaim Principle", Law Press, 1st Issue, November 1998, pp. 356-357.
- ² Peoples Court (2003), *Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Dispute Cases (I) (Exposure Draft) (N)*, People's Court Daily, 5 November 2003.
- ³ See Article of Civil Procedural Law, and Article IV of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases.
- ⁴ The Task Force of the Second Civil Tribunal of the Provincial Senior Court (2005), "Survey Report on Regulating the Bankruptcy Trial Work and Improving the Bankruptcy Trial Mechanism", excerpted from *Tribunal*, 4th Issue, 2005, p.56.
- ⁵ Wang Yan, "Corporate Liquidation System and its Value Study", *Journal of the University of Yunnan*, law edition, 5th Issue, p.83.