COMMENCEMENT OF BANKRUPTCY PROCEEDINGS IN CHINA: KEY ISSUES IN THE PROPOSED NEW ENTERPRISE BANKRUPTCY AND REORGANISATION LAW

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Recent events and developments in China's economic reform have exposed the inadequacy of China's bankruptcy infrastructure. In this context, a new People's Republic of China (PRC) bankruptcy law has been proposed. This essay examines the problems in the most recent draft pertaining to the initiation of bankruptcy proceedings. In contrast with the bankruptcy laws of the United States and France, China's draft presents ambiguities and imperfections in the threshold requirement. Accordingly, further improvements have been proposed to facilitate the commencement of bankruptcy proceedings in the PRC.

L'actualité et développements récents en matière de réformes économiques que connaît aujourd'hui Chine, ont aussi mis en évidence les limites des règles qui encadrent le droit de la faillite en vigueur dans ce pays. Le gouvernement de la République Populaire de Chine parfaitement conscient de cet état de fait, a entrepris une reforme d'envergure dans ce domaine. Cet article examine les principaux problèmes induits par ce nouveau dispositif légal et plus particulièrement sur les situations qui devraient à l'avenir justifier le recours aux procédures collectives. L'auteur se livre par ailleurs à une comparaison entre le droit de la faillite en vigueur aux Etats Unis et en France avec celui qui sera dorénavant appliqué en Chine. Ainsi seront mis en lumière les nombreuses ambiguïtés et des imperfections qui demeurent. Fort ce constat, l'auteur suggère quelques améliorations qui, selon lui, devraient avoir pour effet de faciliter la mise en œuvre des nouvelles règles du droit de la faillite en la République Populaire de Chine.

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I INTRODUCTION

Since 1978, the People's Republic of China (PRC) has embarked on a steadfast and unprecedented reform from a command economy to a market one.[1] Those years have witnessed many solid and measurable achievements.

Bankruptcy law is indispensable in the market economy infrastructure. It provides for liquidation proceedings to remove uncompetitive or loss making enterprises from the market, and reorganisation proceedings to maximise the value of the enterprise.[2] However, the slow development of bankruptcy law in the PRC is surprising. The first national bankruptcy law, The Enterprise Bankruptcy Law of the PRC (For Trial Implementation) ("1986 Bankruptcy Law"), was only passed by the National People's Congress (NPC) on 2 December 1986, and it was 1 November 1988 before that law came into effect.[3]

The current bankruptcy regulations in China have been underutilised and have proved to be outmoded. Now the need is more pressing than ever for the establishment of a bankruptcy mechanism which is efficient and compatible with steady Chinese economic development. Recognising this reality, the PRC has been drafting a new bankruptcy law since 1994.[4] In January 2001, the latest version of the proposed Enterprise Bankruptcy and Reorganisation Law of the PRC ("the proposed law") was submitted to the Fiscal and Economic Committee of the NPC for consideration.[5]

This article will discuss the latest attempt to reform bankruptcy legislation in the PRC. The focus will be on whether, and if so to what extent, the proposed law makes bankruptcy proceedings more accessible by reducing the threshold for both liquidation and reorganisation proceedings.

The article first outlines China's current statutory framework for bankruptcy, then addresses the institutional obstacles that make commencement of bankruptcy proceedings difficult. It then analyses the provisions that have been significantly revised in the proposed law as regards threshold issues. In the overall assessment, problems which need to be addressed further in the proposed law are highlighted. To illustrate the strengths and weaknesses of threshold issues in the proposed law, a comparison is made between Chinese, United States and French bankruptcy regimes in light of insolvency tests, procedural requirements for voluntary petitions, eligibility of petitioning creditors,

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1 David Eu "Financial Reforms and Corporate Governance In China" (1996) 34 Colum J Transnat'l L 469.

2 World Bank "Building Effective Insolvency Systems – Rehabilitation" (Washington (DC), 14-15 September 1999) 13 <http://www.worldbank.org/legal/insolvency_ini/wg6-paper1.htm> (last accessed 20 June 2004).

3 Ron W Harmer "Insolvency Law and Reform in the People's Republic of China" (1996) 64 Fordham L Rev 2563, 2568-70.

4 Wang Weiguo "Institutional Reasoning in Drafting New Bankruptcy Law of China" (Chinese Insolvency Law Symposium: Developing an Insolvency Infrastructure, Hong Kong, 17-18 November 2000) <http://law.hku.hk/aiifl/events/symposium/papers/wang%20weiguo.doc> (last accessed 20 June 2004).

5 See Draft Enterprises Bankruptcy and Reorganisation Law of the People's Republic of China 2001 ["The proposed law"].

early screening of reorganisation cases, and termination of inappropriate reorganisation and conversion into liquidation. In the overall comparison, experiences are drawn from the United States and French systems to benefit the emerging Chinese one. Finally, a conclusion is drawn predicting the future of instituting bankruptcy proceedings in the PRC.

II BACKGROUND

A Current Statutory Framework[6]

China's current bankruptcy statutory framework is characterised by its diverse and inconsistent approaches to different categories of debtors. There is no unified bankruptcy law applying to all business entities at all levels in the PRC. Instead, there are several parallel bankruptcy regimes categorised by the different legal nature of debtors, and their geographical applications. The most important one is the 1986 Bankruptcy Law with its accompanying judicial opinion,[7] applying nationally to state owned enterprises (SOEs) only. Chapter 19 of the 1991 Civil Procedure Law of the PRC and its accompanying judicial opinion[8] contain rudimentary provisions on bankruptcy applying nationally to non-SOEs with legal personality.[9] There are some regional bankruptcy regulations with limited territorial application that apply to both domestic investment enterprises and foreign investment enterprises (FIEs), such as the Guangdong Province Company Bankruptcy Regulations ("Guangdong Regulations") and the Shenzhen Special Economic Zone Enterprises Bankruptcy Regulations ("Shenzhen Regulations").

The existing framework needs reform and unification. First, the various and unconnected regulations have created conflict, inconsistency, "complication, difficulty and uncertainty"[10] in practice. Second, these regulations are too brief and superficial to provide real guidance on handling bankruptcy cases.[11] The deficiencies of the current bankruptcy regulations have been exposed in recent bankruptcy cases, in particular the bankruptcy of the Guangdong International Trust and

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6 Harmer, above n 3, 2572-2573.

7 People's Supreme Court, Opinions on Several Issues in the Implementation of the Enterprise Bankruptcy Law of the PRC (For Trial Implementation), 7 November 1991.

8 People's Supreme Court, Opinions on the Civil Procedure Law of the PRC, 14 July 1992.

9 Civil Procedure Law, art 206.

10 Ron W Harmer "Evaluation of a Draft for a New PRC Insolvency Law", (Chinese Insolvency Law Symposium: Developing an Insolvency Infrastructure, Hong Kong, 17-18 November 2000) 5.

11 Immanual Gebhardt and Kerstin Olbrich "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 AJCL 110.

Investment Corporation in 1999-2003.[12] The present Chinese bankruptcy regulations constitute a legal obstacle to commencing bankruptcy proceedings in the PRC.

B Institutional Obstacles

1 Obstacles to commencing bankruptcy proceedings involving SOEs

SOEs, once the backbone of the socialist economy, have turned out to be the most thorny problem in the economic reform.[13] It has long been suggested that the number of SOEs entering into bankruptcy proceedings is extremely small compared with the number of SOEs actually insolvent.[14] Though a number of industrial SOEs have been liquidated since 1994, the process has mainly been handled by local administrative governments instead of adhering to bankruptcy legislation.[15]

There were a total of 277 bankruptcies annually in 1989-93, 2,100 in 1994-95, and 5,640 in 1996-97.[16] More than half of all bankruptcies were SOEs.[17] In 1998-2000, about 1.5 per cent of all SOEs entered bankruptcy proceedings. That was only a portion of SOEs that were actually in the red.[18] Though a proliferation of SOE bankruptcy cases has been witnessed during these years, it is still difficult for SOEs to commence bankruptcy proceedings.

2 Political policy

The first bankruptcy law in the PRC was adopted after the most furious debate in Chinese legislative history.[19] Before that, the PRC boasted of being without bankruptcy law, which indicated

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12 Gordon G Chang "Bankruptcy Law in China: Too Much or Too Little?" (1999) 5 China L & Prac 22-23; (2003) *Gazette of the Supreme People's Court of the PRC* 3.

13 World Bank "Reform of China's State-Owned Enterprises: A Progress Report of Oxford Analytica" <http://www.worldbank.org/html/prddr/trans/n&d95/china.htm> (last accessed 20 June 2004).

14 See Lan Cao "The Cat that Catches Mice: China's Challenge to the Dominant Privatization Model" 21 Brooklyn J Int'l L 172-173; Leslie Burton "An Overview of Insolvency Proceedings In Asia" (2000) 6 Ann Surv Int'l & Comp L 113, footnotes 39-41 and accompanying text.

15 World Bank "Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System " (2001) <http://www.worldbank.org.cn/English/Content/485a6232469.shtml> (last accessed 20 June 2004) ["World Bank"].

16 World Bank, above n 15.

17 World Bank, above n 15.

18 World Bank, above n 15.

19 Donald C Clarke "What's Law got to do with It? Legal Institutions and Economic Reform in China" (1991) 10 UCLA PAC Basin LJ 51.

that no enterprise became bankrupt. This had been "regarded as an attribute that made a socialist economy superior to its capitalist counterpart".[20]

Recognising that the command economy needed reform, the PRC adopted its first bankruptcy law but only enforced it on a very selective basis.[21] The 1986 Bankruptcy Law aims mainly to function as a threat to urge SOEs to improve their management.[22] It was passed more for symbolic reasons than for its effect to deal with economic or legal problems.[23] Governments have little incentive to embark on regulating bankruptcy of insolvent SOEs, because bankruptcy might lead to a loss of control over the SOEs through liquidation and thus reduce the area of authority.[24]

3 Fear of social unrest

As frequently quoted in Chinese political life, "social stability overwhelms everything else". Social stability is one of the biggest concerns in handling SOE bankruptcy. SOEs have a large number of employees.[25] For a long time, all the social welfare needs of these workers have been borne by the SOEs. Without the adequate protection of a mature social welfare system, a substantial percentage of the labour force would be unemployed and unprotected if SOEs went bankrupt.[26] This might lead to strong political opposition.[27]

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20 Henry R Zheng "Bankruptcy Law of the People's Republic of China: Principles, Procedure and Practice" (1986) 19 Vand J Transnat' L 683, 738.

21 Steven L Toronto "Bankruptcy of Foreign Enterprises in the PRC: an Interpretation of the 'Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone"' (1990) 4 J Chinese L 292.

22 Sherry Miller "Institutional Impediments to the Enforcement of China's Bankruptcy Laws" (1996) 8 Int'l Legal Persp 187, 189.

23 Shirley S Cho "Continuing Economic Reform in the People's Republic of China; Bankruptcy Legislation Leads the Way" (1994) 19 Hastings Int'l & Comp L Rev, 739.

24 World Bank "Building Effective Insolvency Systems – State-Owned Enterprise Insolvency" (Washington (DC), 20 September 2000) <http://www.worldbank.org.cn/English/content/bankruptcy.pdf > (last accessed 20 June 2004).

25 See Deborah Kay John "Reforming the State-Enterprise Property Relationship in the People's Republic of China: Corporatization of State-Owned Enterprises" (1999) 16 Mich J Int'l L 911, 915.

26 World Bank, above n 15.

27 World Bank, above n 15.

4 Tsunami domino effect in economic development

Routine SOE bankruptcy would trigger chain bankruptcies of other SOEs that are entangled in a web of interim and triangular debts.[28] That would be disastrous to Chinese economic development.[29] As the major creditors of SOEs, state-owned banks fear that loans will become irrecoverable. The write-off of debts is inevitable when SOEs go bankrupt. The non-recoverability of non-performing loans would greatly cut down the assets of the banks.[30] It is estimated that 20 per cent of China's bank assets would be destroyed if all failing SOEs were declared bankrupt.[31]

5 Judicial weakness

Chinese courts are heavily dependent both financially and politically on the administrative governments.[32] Consequently, under pressure from governments that are closely related to SOEs, the courts may, out of political or administrative considerations, refuse to accept a bankruptcy petition or to declare SOEs bankrupt.[33]

6 Obstacles to commencing bankruptcy proceedings involving non-SOEs[34]

Not all non-SOEs are eligible to resort to bankruptcy legislation, nor is a non-SOE able to be rescued through formal reorganisation proceedings.[35] The court might refuse a voluntary petition to prevent bad faith debtors evading debts through bankruptcy proceedings. Moreover, out of fear that the creditor might use bankruptcy as a threat to accelerate the debt, the court will reject an involuntary liquidation petition to prevent the abuse of the bankruptcy mechanism as a debt-collecting machine.

When it comes to FIEs, the widespread bankruptcy of non-SOEs with foreign investment is unwanted. First, the problem of social stability is of the same importance as anywhere else in the PRC,

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28 Triangular debts mean non-mutual debts between different SOEs. The discharge of an insolvent SOE's debt will cause its creditor SOE to become insolvent. See Ron N Harmer "Insolvency Law and Reform in the People's Republic of China (1996) 64 Fordham L Rev 2582, 2583.

29 Neal Stevens "Confronting the Crisis of Insolvency in China's State-Owned Enterprises: Can the Proposed Bankruptcy Law Erase the Red Ink?" (1998) 16 Wi S Int'l LJ 551, footnote 108 and accompanying text.

30 Ron N Harmer "Insolvency Law and Reform in the People's Republic of China" (1996) 64 Fordham L Rev 2563, 2578-2581.

31 Shirley S Cho "Continuing Economic Reform in the People's Republic of China: Bankruptcy Legislation Leads the Way" (1994) 19 Hastings Int'l & Comp L Rev 789, 752.

32 Sherry Miller "Institutional Impediments to the Enforcement of China's Bankruptcy Laws" (1996) 8 Int'l Legal Persp 189, footnote 126 and accompanying text.

33 Steven L Seebach "Bankruptcy Behind the Great Wall: Should US Business Seeking to Invest in the Emerging Chinese Market be Wary?" (1995) 8 The Transnat' Lawyer, 357.

34 Here, non-SOEs include collective, private, and mixed owned business entities, and even individuals.

35 For more details, see Part II Background.

and any bankruptcy proceedings taken in China must consider the economic, political, social and administrative factors besides the legal issues. Second, widespread bankruptcies are avoided to maintain a favourable and prosperous investment environment.[36] Third, though the Guangdong Regulations and the Shenzhen Regulations bear more resemblance to modern bankruptcy laws than the awkward 1986 Bankruptcy Law, they are still far from being effective regimes.

III FUNDAMENTAL CHANGES REGARDING COMMENCEMENT OF BANKRUPTCY PROCEEDINGS CONTAINED IN THE PROPOSED LAW

Since 1994, attempts to reform Chinese bankruptcy legislation have been undertaken and many drafts have been presented.[37] The latest draft dated January 2001 is the subject of the following analysis.

Under the proposed law, "liquidation", "reorganisation" and "composition"[38] are available to business entities in financial distress.

A Bankruptcy Liquidation

1 Commencement of voluntary liquidation

(a) Eligibility of debtors

Under current regulations, eligibility for bankruptcy proceedings is very limited. All the current bankruptcy regulations apply only to business entities with legal personality. To date, various existing forms of business entities without legal personality in the PRC, including sole proprietors, individual businesses, lease-holding farm households, partnerships, and individuals (either traders or consumers), have not been allowed to enter formal bankruptcy proceedings.

One of the most striking features of the proposed law is the provision to greatly extend the capacity of bankruptcy liquidation. First, the proposed law would apply not only to legal person enterprises, but also to non-legal person enterprises including partnership enterprises, sole proprietorships, and all other profitable economic organisations.[39] All business entities, of whatever

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36 Steven L Toronto "Bankruptcy of Foreign Enterprises in the PRC: an Interpretation of the 'Rules Concerning Bankruptcy of Foreign Related Companies in the Shemzen Economic Zone'" (1990) 4 J Chinese L 292, 294.

37 Wang Weiguo "Institutional Reasoning in Drafting New Bankruptcy Law of China" (Chinese Insolvency Law Symposium: Developing an Insolvency Infrastructure, Hong Kong, 17-18 November 2000) <http://law.hku.hk/aiifl/events/symposium/papers/wang%20weiguo.doc> (last accessed 20 June 2004).

38 Under the 1986 Bankruptcy Law, "composition" and "reorganisation" are combined into one joint proceeding. This proceeding has turned out to be a failure because it has been applied to hardly any cases. In drafting the proposed law, some scholars suggest abolishing the chapter entitled "composition". One of the convincing arguments is that a simplified reorganisation can also serve as composition. Since the proposed law is still under review, the final fate of composition is as yet unclear. For the purpose of this article, composition is, however, relatively unimportant.

39 The proposed law, art 2.

legal nature, would be eligible to have liquidation proceedings commenced against them. Also the FIEs are included in the proposed law and are subject to the same bankruptcy liquidation proceedings as those of domestic investment enterprises. Second, the proposed law would, by implication, apply to bankruptcy liquidation of partners or investors due to the bankruptcy of partnership enterprises or sole proprietorships. Consequently, by expanding the law to cover partnerships and sole proprietorships, the proposed law inevitably applies to the partners of partnership enterprise and to investors in sole proprietorships. Hence, for the first time in China's legislative history, trader-individuals can be declared bankrupt.

However, certain limitations remain. First, the application to trader-individuals is a limited one and it fails to apply to traders generally. This differentiates it from personal bankruptcy proceedings in some jurisdictions in which it is:[40]

> possible for bankruptcy proceedings to take place against one of the partners in his individual capacity and, if so, the adjudication of him as an individual [does] not bring about the collective bankruptcy of the partnership.

Under article 2, in contrast, it is impossible for bankruptcy liquidation proceedings to be commenced against only one of the partners rather than the whole partnership. Instead, bankruptcy liquidation proceedings can only be commenced against the partnership in its own name, and the individual bankruptcy of each member of the partnership is the mere outcome of the collective bankruptcy of the partnership as a whole, when neither the partnership nor any of the members can pay the debt falling due.

Second, the proposed law remains silent on the problem of consumer bankruptcy. However, measures regarding consumers will sooner or later be addressed, as a result of the development of consumer credit in China.[41]

(b) Procedural requirements for voluntary petitions

Under the 1986 Bankruptcy Law, SOE bankruptcies are subject to extensive government control.[42] Only after obtaining the prior consent from the government in charge, can the SOE debtor file a voluntary liquidation petition.[43] Under the proposed law, there is no such requirement. However, article 168 provides that, with respect to SOEs established before the Company Law of the PRC took effect on 1 July 1994, the State Council is empowered to make special provisions. There are still arguments that, since the government still has much at stake in SOEs, and because of the dramatic

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40 Ian F Fletcher *The Law of Insolvency* (2 ed, Sweet & Maxwell, London, 1996) 77-78.

41 Hon Lloyd D George "Chinese Insolvency Law Strains to Keep Pace with Economic Development" <www.abiworld.org> (last accessed 15 September 2002).

42 Ron W Harmer "Insolvency Law and Reform in the People's Republic of China" (1996) 64 Fordham L Rev 2563, 2577-2578.

43 1986 Bankruptcy Law, art 8.

social and economic problems unleashed by SOE bankruptcies, the government in charge should be entitled to approve the bankruptcy petition.[44]

At first glance this argument sounds reasonable, but it is untenable. First, with the economic reform in China SOEs began to sever their connection with government and became increasingly autonomous in making business decisions.[45] Second, the demarcation between SOEs and non-SOEs has blurred as the ownership interest of SOEs has been distributed and some stakes in SOEs have even been sold in public markets.[46] Third, the requirement of prior governmental approval inevitably results in a "lengthy decision making process".[47] Abolishing this requirement will speed up the process. In principle, SOEs should be subject to the usual market forces and the same legal and commercial procedures as non-SOEs.

2 Commencement of involuntary liquidation

Liquidation can be commenced involuntarily upon a petition by an eligible creditor. The court examines both the petitioner's eligibility to file and the grounds for liquidating the debtor.

(a) Eligibility of petitioning creditors

The proposed law imposes no explicit limitation on the eligibility of creditors.[48] The problems that arise are as follows: are creditors holding prospective and contingent claims eligible? Or should the creditor hold claims that are due and non-contingent at the date of filing? If the debtor argues that the claim held by the creditor is disputed, either regarding the existence or the amount of the debt, is such a creditor eligible? There is no real guidance on the answers to these problems in the proposed law.

(b) Grounds for liquidation

Both the existing regulations in Article 7 of the Bankruptcy Law 1986 and the proposed law require the petitioning creditors to prove that the grounds for liquidation exist at the day of filing, though the grounds for liquidation are differently defined.

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44 Yongjun Li *Bankruptcy Legal System* (Legal Publisher, China, 2000) 30 (in Chinese).

45 Asian Development Bank *Guide to Restructuring in Asia 2001* 18 <http://www.adb.org/Documents/Reports/Restructuring_Asia/default.asp> (last accessed 20 June 2004).

46 Gordon G Chang "Bankruptcy Law in China: Too Much or Too Little?" (1999) 5 China L & Prac 22; (2003) *Gazette of the Supreme People's Court of the PRC* 3.

47 Ron W Harmer, "Insolvency Law and Reform in the People's Republic of China" (1996) 64 Fordham L Rev 2563, 2578.

48 The proposed law, art 10.

3 The existing regulations: outdated, complex, and conflicting approaches

The 1986 Bankruptcy Law prescribes a bewilderingly and complex test for threshold proof of insolvency. Article 7 simply states that when the debtor cannot pay the debts when they fall due, the creditor can petition for bankruptcy. However, this article must not be read in isolation. Instead, it must be looked at together with article 3 (one of the most criticised articles in the 1986 Bankruptcy Law)[49]which states, "[e]nterprises that sustain *serious loss* due to *inappropriate management* and are unable to pay off the debts that fall due, will be declared bankrupt" (emphasis added). The opinion on the 1986 Bankruptcy Law also requires the court to take article 3 into consideration when deciding whether or not to accept the petition.[50] Therefore, the mere fact of the SOE debtor's inability to pay due debts does not warrant the bankruptcy petition. The court must review two additional factors: whether the loss of the debtor is serious and whether the loss is due to inappropriate management.

These provisions are full of ambiguities. How should the courts determine whether the "loss" is "serious"? What constitutes "inappropriate management"? How should the courts decide whether there is causation between the "serious loss" and "inappropriate management"? The high threshold requirement effectively discourages any creditors who intend to make a bankruptcy petition, as well as any debtors. This characteristic concept in the 1986 Bankruptcy Law does not accord with the present day commercial reality.[51]

For non-SOE enterprises with legal personality, as provided in article 199 of the 1991 Civil Procedure Law, the court is also required to review whether the debtor has suffered "serious loss". Again, what constitutes "serious loss" is not clearly defined.

In contrast, both the Shenzhen Regulations and the Guangdong Regulations adopt simpler insolvency tests, without imposing ambiguous requirements of "serious loss" or "inappropriate management". But they are inconsistent with each other. In the Shenzhen Regulations, the insolvency test is a simple cash flow test. However, in the Guangdong Regulations, the insolvency test is a balance sheet one.

4 The proposed law: inability to pay debts when they fall due

It is time to abandon these confusing and conflicting insolvency tests. Under article 3 of the proposed law, "when a debtor is unable to pay its debts when they fall due", a bankruptcy petition can be made. The article further provides that the "cessation of payment of due debts by a debtor shall be

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49 See Weigno Wang "Institutional Reasoning in Drafting New Bankruptcy Law of China" (Chinese Insolvency Law Symposium: Developing an Insolvency Infrastructure, Hong Kong, 17-18 November 2000); and Yongjun Li *Bankruptcy Legal System* (Legal Publisher, China, 2000) 50 (in Chinese).

50 People's Supreme Court, Opinions on Several Issues in the Implementation of the Enterprise Bankruptcy Law of the PRC (For Trial Implementation), 7 November 1991.

51 Peng Xiaohua "Characteristics of China's First Bankruptcy Law" (1987) 28 Harvard Int'l LJ 377-378.

presumed to be evidence that he is unable to pay, unless otherwise proved". Compared with the existing legislation, this "inability to pay due debts" test makes it easier to judge whether the debtor is insolvent or not. In addition, since cessation of payment by a debtor warrants involuntary bankruptcy petition, it is easier for creditors to file the petition.

However, this "inability to pay" test is deceptive in its simplicity. A number of problems arise. First, does "cessation of payment" have to be general or is the single default of payment to a single creditor sufficient? What factors should be taken into account when the court decides whether the debtor is unable to pay?

Secondly, is the test a cash flow or a balance sheet one? If it is a cash flow test, a company is not necessarily insolvent merely because of insufficient liquid assets to meet debts. A debtor can raise additional funds to meet the debts when they fall due, by borrowing or disposing of its assets.[52] Should the relevant conduct of the debtor be taken into account by the court when deciding the overall financial circumstances of the debtor?

These likely problems are not only technical. They present problems to both petitioners and courts. Under the ill-defined "inability to pay" test in the proposed law, a creditor who knows little about the debtor's overall financial situation may find the onus of proof too heavy. More importantly, a certain, predictable, and coherent approach in interpreting the "inability to pay" test will be necessary for courts to make decisions.

B Reorganisation

The formal rescue culture in the current bankruptcy regulations is poor. Among all the existing regulations, only the 1986 Bankruptcy Law contains some rudimentary provisions on reorganisation. There have been no known cases of any formal reorganisation proceedings under any relevant bankruptcy legislation since 1988.[53]

One of the proposed law's most dramatic changes from the existing bankruptcy regulations is the well-developed chapter 10, entitled "Reorganisation". As indicated by the name of the proposed law (Enterprise Bankruptcy and Reorganisation Law), reorganisation is highly valued as an alternative to bankruptcy liquidation. The emphasis on reorganisation is consistent with prevailing international practice;[54] it also helps to alleviate fear when mentioning bankruptcy law – a commercial death

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52 R M Goode *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London, 1990) 81.

53 Asian Development Bank *Guide to Restructuring in Asia 2001* 15 <http://www.adb.org/Documents/Reports/Restructuring_Asia/default.asp> (last accessed 20 June 2004).

54 Weigno Wang "Institutional Reasoning in Drafting New Bankruptcy Law of China" (Chinese Insolvency Law Symposium: Developing an Insolvency Infrastructure, Hong Kong, 17-18 November 2000).

penalty law.[55] The proposed law makes reorganisation a more readily available alternative to more business entities through simple procedures and easy entry criteria.

1 Eligibility of debtors

Under the proposed law, reorganisation applies to enterprises with legal personality.[56] Compared with the current regulations, the proposed law expands access to reorganisation not only to SOEs, but also to other non-SOE enterprises with legal personality, including certain FIEs. Note too that reorganisation is not yet available to those business entities without legal person status.

2 Commencement and initial screening of reorganisation

The proposed law provides two easy criteria upon which the petition for reorganisation can be made: when a debtor is insolvent but with hope of rescue; or when a debtor is likely to be insolvent.[57] The insolvency test is the same as that which applies in initiating liquidation proceedings.

The proposed law encourages debtors to address their financial difficulties at an early stage, namely when they are only potentially insolvent. At the same time, in order to prevent the debtor abusing the reorganisation proceedings, if the debtor has already been insolvent, foreseeability should be shown in order to gain access to reorganisation.

Meanwhile, to prevent the premature dismissal of reorganisation petitions, the proposed law tends to permit quick and easy access to reorganisation. The early screening is not aggressive. Though it is required that petitioners submit "relevant evidence and preliminary scheme"[58] along with the filing, there are no mandatory rules about the content of the "preliminary scheme". Further, under article 121, "if the court, after review, considers that the petition conforms to the provisions of the law, it can approve the petition and then the debtor enters into a period of reorganisation protection".[59] Hence, the court has an independent right in determining the start of reorganisation. Such review is ex parte; the court is not required to immediately summon creditors after the debtor's filing nor to hold a hearing to listen to creditors' opinions. At this stage, creditors are not entitled to challenge the debtor's eligibility to reorganise.

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55 Mark E Monfort "Reform of the State-Owned Enterprise and the Bankruptcy Law in the People's Republic of China" (1999) 22 Okla City U L Rev 1077.

56 The proposed law, art 118.

57 The proposed law, art 3.

58 The proposed law, art 121.

59 The proposed law, art 121. A period of reorganisation protection refers to the period from the commencement of reorganisation proceedings to the court's decision on whether to approve the reorganisation plan or not.

3 Termination of reorganisation and conversion into liquidation

Under the proposed law, inappropriate reorganisation can be terminated. If the debtor is insolvent at that time, the proceeding will be converted into a liquidation.

The proposed law provides a mechanism to convert reorganisation into liquidation. After the debtor enters into the period of reorganisation protection, interested parties can ask the court to terminate the reorganisation proceedings if one of the specified events occurs.[60] The period of reorganisation protection shall not exceed 12 months.[61] If no reorganisation plan is submitted for confirmation one month before the expiration of that period, the court can decide ex officio to terminate the reorganisation proceedings.[62]

Under the proposed law, the failure of a reorganisation plan to be confirmed by the court[63] or the non-performance of a reorganisation plan[64] will terminate a reorganisation. However, the failure of a reorganisation plan to be approved by the creditors' meeting does not lead to immediate termination of reorganisation, for the court can decide to confirm the reorganisation plan if it is satisfied that the plan conforms to certain mandatory requirements, despite the dissent of some creditors. These criteria include, inter alia, that the unsecured creditor will receive not less than what they would be likely to receive if the debtor were liquidated, and that the reorganisation plan is feasible.[65]

However, the proposed law fails to explicitly list the mandatory requirements in confirming a reorganisation plan. While article 140 sets out certain criteria for the court to confirm a plan even when the plan has been rejected by some creditors, it is unclear whether the court *must* consider these criteria.

C Overall Assessment

The proposed law embodies many significant changes toward a more effective and credible bankruptcy regime and is consistent with international practice. Under the proposed law, the threshold to liquidation and reorganisation is reduced so that more business entities can gain access to these

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60 The proposed law, art 130 provides, inter alia, that if any of the following circumstances occur, namely: (i) the debtor's business continues to deteriorate, showing little or no hope of rehabilitation; (ii) the debtor cheats, or disposes of the debtor's property in bad faith, or delays payments unreasonably, or acts in ways obviously harmful to the interests of the creditors; or (iii) it is impossible for the administrator to perform the duties because of the debtor's conduct, then upon the application of interested parties, the people's Court, after review, may make a decision to terminate reorganisation.

61 The proposed law, art 121.

62 The proposed law, art 130.

63 The proposed law, art 144.

64 The proposed law, art 148.

65 The proposed law, art 140.

proceedings, the insolvency test is more clearly and reasonably defined, and an effective mechanism for conversion between liquidation and reorganisation is well established.

However, some provisions in the proposed law do need further interpretation; the need for certainty, clarity and predictability in the law is still pressing. In particular, in terms of commencing liquidation and reorganisation proceedings, the following issues should be highlighted:

(1) The test of "inability to pay debts when they fall due" needs to be further clarified;

(2) More transparent procedural requirements for voluntary petitions are needed;

(3) Whether there should be any requirements on petitioning creditors should be addressed;

(4) Should the early screening of a reorganisation case be rigid or loose? What standard governs the acceptance or dismissal of a reorganisation petition?

(5) On what grounds should the court terminate reorganisation proceedings and convert them into liquidation proceedings? Guidance on the criteria for confirming the reorganisation plan should also be included.

Lack of clearly defined statutory provisions on these issues will no doubt hinder the commencement of bankruptcy proceedings. Tangible guidelines should be provided on these key issues to guide the courts as well as participants in future bankruptcy proceedings. Experiences of other jurisdictions will be helpful in interpreting and developing these provisions in the proposed law.

IV COMPARATIVE BANKRUPTCY THRESHOLDS

A United States

In the United States, bankruptcy law is federal statutory law and mainly contained in Title 11 of the United States Code ("11 USC" or "the United States bankruptcy code").[66] Debtors can liquidate under Chapter 7[67] or reorganise under Chapter 11[68] of the United States bankruptcy code.

1 "Generally not paying its debts when they become due": experience of the United States

Since the enactment of the current United States bankruptcy code in 1978, the predominant[69] insolvency test has been that "the debtor is generally not paying its debts when they become due".[70] "Generally not paying" is an equitable test of insolvency instead of a balance sheet one.

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66 "Bankruptcy: An Overview" < http://www.law.cornell.edu/topics/bankruptcy.html> (last accessed 20 June 2004).

67 11 USC, s 109(b).

68 11 USC, s 109(d).

The debtor's failure to pay must be a general one. Although the term "generally" is not defined in the bankruptcy code, "in order to avoid a result suggested by the mechanical test put forth by the alleged debtors and to give the bankruptcy courts enough leeway to be able to deal with the variety of situations that will arise",[71] most United States courts have utilised a set of common factors to make "generally not paying" a workable and coherent judicial standard.[72]

A "totality of the debtor's financial circumstance" test has been adopted by the United States courts to determine whether the default is "general".[73] Most courts consider the following four factors on a case-by-case basis:[74]

The first two factors, namely the number of the debts and the amount due:[75]

> … require a consideration of the number of debts not paid compared to the number paid. The amount of the debts, separately and in the aggregate, must be examined and these should be viewed in the context of the debtor's liquidity.

"Generally not paying" includes "regularly missing a significant number of payments to creditors or regularly missing payments which are significant in amount in relation to the size of the debtor's operation".[76] The amount of unpaid claims in relation to the debtor's business is an important standard in determining the general default. If the amount of non-payment is not substantial in relation to the magnitude of the debtor's business, the court will not grant the involuntary relief.[77]

The third factor to be determined is the materiality of non-payment. "Default of short duration should be viewed differently than one which is longer".[78] In addition, debts subject to bona fide dispute are statutorily excluded from the "generally not paying" determination.[79]

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69 The other ground for involuntary petition is rarely used. See Susan Block-Lie "Why Creditors File so Few Involuntary Petitions and Why the Number is not Too Few" (1999) 57 Brooklyn L Rev 825.

70 11 USC, s 303(h)(1).

71 *Re All Media Properties* (1980) 5 Bankr 126, 142 (Bankr SD Tex) affirmed (1980) 626 F 2d 193 (5th Cir).

72 *Re Smith* (1999) 243 BR 169; (1999) Bankr Lexis 1664.

73 *Re Vortex Fishing Systems Inc* (2001) US App Lexis 27846.

74 Arlene E Katz "Recent Development in Bankruptcy Law: Commencement of a Case" 1 Bank Dev J 226. Also see *Re Goldsmith* (1983) 30 BR 956; (1983) Bankr Lexis 5946; *Re Vortex Fishing Systems*, above n 73.

75 *Re Larry Tarletz* (1983) 27 BR 787; (1983) Bankr LEXIS 6752; (1983) 10 Bankr Ct Dec 911.

76 Michale J Herbert *Understanding Bankruptcy* (Matthew Bender, New York, 1999) 95.

77 Herbert, above n 76.

78 *Re Larry Tarletz*, above 75.

79 For more discussions on bona fide disputed debt, see Part III A 2 (a) Eligibility of petitioning creditors.

Fourthly, the court will also look at the way in which the debtor conducts its financial affairs.[80] The court may examine the debtor's "overall contemporaneous handling of its affairs".[81] "If the debtor is conducting his financial affairs in a manner inconsistent with good faith and outside the ordinary course of business, it may affect the court's determination".[82] This would be the case if: the debtor's assets declined dramatically and the reduction in debt was due to the sale of the debtor's assets rather than the generation of profits;[83] the debtor involuntarily closed down;[84] insiders deferred payment on account of loans payable to them;[85] or serious allegations existed concerning irregularities in the conduct of the debtor's business.[86]

Finally, on the problem of a single default, in the absence of two exceptional circumstances developed by the courts,[87] the vast majority of the United States courts have held that non-payment to a single creditor does not constitute "generally not paying", even if there is only one creditor.[88]

2 Procedural requirements for voluntary liquidation petitions

In the United States, most liquidation cases are filed voluntarily by debtors.[89] The United States bankruptcy code has wide coverage: bankruptcy relief is open to almost every business entity and individual.[90] One of the most notable features of the United States bankruptcy code is the swift and easy access to voluntary liquidation.[91]

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80 Arlene E Katz "Recent Development in Bankruptcy Law: Commencement of a Case" 1 Bank Dev J 226.

81 *Re Reed* (1981) 11 Bankr 755, 760 (Bankr SDW Va).

82 *Re Reed*, above n 81.

83 Susan Block-Lie "Why Creditors File so Few Insolvency Petititons and Why the Number is Not Too Few" (1999) 57 Brooklyn L Rev 822, 822.

84 *Re Covey* (1981) 650 F 2d 877 (7th Cir).

85 Block-Lie, above n 83, 822.

86 Block-Lie, above n 83.

87 Either where the single creditor lacks an adequate state remedy or where there have been special circumstances such as frauds, tricks, or scams which allow the debtor to pay his other creditors: see *Re RN Salem Corporation* (1982) 23 BR 452; (1982) Bankr Lexis 3164.

88 Michele J Herbert *Understanding Bankruptcy* (Matthew Bender, New York, 1999) 89; and Block-Lie, above n 83, 823.

89 Richard I Aaron *Bankruptcy Law Fundamentals* S 1.03: "Overview of Chapter 7 Bankruptcy" <http://uk.westlaw.com> (last accessed 20 June 2004).

90 11 USC, s 109.

91 Randal C Picker "Voluntary Petitions and the Creditors' Bargain" (1992) 61 U Cin L Rev 519.

(a) Eligibility of petitioning creditors

To be "eligible creditors", two requirements, namely number of creditors and amounts of unsecured debts, must be met.[92]

Moreover, the United States bankruptcy code imposes a restriction on non-contingent and non-disputed claims. When counting the debts generally defaulted by the debtor, the court is required to exclude contingent and bona fide disputed claims.[93] Non-contingent claims are defined as a legal obligation to pay which arose at the time of the original relationship, though subject to being avoided by some future event or occurrence.[94] The claim is not contingent merely because the time for payment has not yet come. When the time does not come, the debt is immature, but not contingent. On the other hand, a contingent claim is one "when the debtor's duty to pay arises only upon occurrence of a future event that was contemplated by parties at time of contract".[95]

Since 1984, the United States bankruptcy code has excluded creditors holding "bona fide disputed" claims from filing petitions.[96] The United States courts have adopted the Lough/Busick standard in interpreting the phrase "subject to a bona fide dispute".[97] Under this criterion, ″if there is either a genuine issue of material fact that bears upon the debtor's liability, or a meritorious contention as to the application of law to undisputed facts, then the petition must be dismissed".[98] What the court must determine is "whether there is an objective basis for either a factual or a legal dispute as to the validity of debt".[99] This standard does not require the court to resolve the dispute, only its existence or absence.[100]

As discussed above, the United States bankruptcy code imposes complex requirements on the eligibility of petitioning creditors. These restrictions might prevent the creditor from attempting to

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92 11 USC, s 303. Involuntary liquidation should be filed by three or more creditors. Each creditor must hold a claim that is neither contingent nor subject of a bona fide dispute, and at least $10,775 of such aggregated claims should be unsecured (the threshold was raised from $10,000 to $10,750 on April 1988: see *Re Smith* (1999) 243 BR 169; (1999) Banker Lexis 1664. If the number of such creditors is less than 12, a single creditor can also file the petition but that creditor must hold an unsecured claim valued at least $10,755).

93 11 USC, s 303(h)(1).

94 *Re All Media Propeties* (1980) 5 Bankr 126, 142.

95 *Re Seko Inv Inc* (1998) 156 F 3d 1005, 1008 (9th Cir).

96 Lawrence Ponoroff "Involuntary Bankruptcy and Bona Fides of a Bona Fide Dispute" (1990) 65 Ind LJ 315, 316.

97 *Re Smith* (1999) 243 BR 169; (1999) Bankr Lexis 1664.

98 *Re Smith*, above n 97.

99 *Re Smith*, above n 97.

100 *Re Smith*, above n 97.

force the debtor to pay with threats of bankruptcy. What bankruptcy law intends to afford to creditors is a remedy against defaulting debtors to ensure an orderly disposition of debtors' assets, but not a mere debt-collection machine.

3 Early screening of reorganisation

Reorganisation is highly favoured by chapter 11 of the United States bankruptcy code, as a way to preserve the going concern value of the debtor. Reorganisation applies to almost all debtors against whom liquidation proceedings are eligible to be commenced.[101] Every eligible debtor has wide freedom to commence reorganisation.

Arguing that rescue is more likely to be achieved when the debtor seeks it early before there is too little economic strength to recover, the United States bankruptcy code encourages early filing by the debtor. Chapter 11 is widely conceived to be the most pro-debtor reorganisation system in the world.[102] Under chapter 11, no statutory requirement of actual or potential insolvency, or feasibility, must be proved in early filing. What the debtor needs to do is simply deliver to the court a petition, a list of names and addresses of creditors and the filing fee.[103] This statutory lacuna on threshold and the strong incentive of debtor-controlled reorganisation has effectively encouraged early voluntary filings. At the same time, however, these procedures also create a serious risk of abuse of reorganisation by debtors.

The United States bankruptcy code does not afford creditors the opportunity to challenge the debtor's eligibility until the reorganisation has commenced. Creditors are given notice and they can apply for dismissal or conversion of the case to liquidation, and secured creditors may de facto terminate reorganisation – they are entitled to enforce their security so that not much property will be left for reorganisation.[104] However, unless the debtor is obviously guilty of some serious abuse, the United States courts tend to give the debtor breathing space and the opportunity to reorganise.[105] Early in the reorganisation, the standards for conversion or dismissal of proceedings are stringent: the creditor must show that the debtor filed in bad faith or that the prospects of rescue are hopeless.[106] Some United States courts have terminated the process very shortly after its inception on the creditor's

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101 11 USC, s 109(d).

102 Theodore Eisenberg and Stefan Sundgren "Is Chapter 11 Too Favorable to Debtors? Evidence From Abroad" (1997) 82 Cornell L Rev 1532.

103 Lynn M Lopucki and George G Triantis "A System Approach to Comparing US and Canadian Reorganisation of Financially Distressed Companies" (1994) 35 Harv Int'l LJ 286.

104 11 USC, s 362 (d).

105 Lopucki and Triantis, above n 103, 287.

106 Eisenberg and Sundgren, above n 102, 1538.

motion that the petition was filed in bad faith[107] or without reasonable hope of success.[108] These criteria are not easy to satisfy. Under the bad faith test, the United States courts must be satisfied that the debtor filed for reorganisation knowing that there is no realistic chance to reorganise the business and hoped merely to prevent the creditor taking control of the business.[109] Some "single-asset" cases have been dismissed for bad faith. In such special cases the debtor has only one business, one substantial asset, and few unsecured creditors or employees to benefit from the debtor's reorganisation.[110]

4 Dismissal of reorganisation and conversion to liquidation

The United States bankruptcy code explicitly lists the substantive grounds for dismissal or conversion of reorganisation.[111] Reorganisation proceedings can be dismissed on similar grounds to those in China's proposed law: the deterioration of the debtor's financial circumstances without hope of rehabilitation;[112] unreasonable delay by the debtor that is prejudicial to creditors;[113] failure to propose a plan within a fixed time;[114] denial of confirmation of the proposed plan;[115] inability to effect a confirmed plan;[116] or non-performance of a confirmed plan.[117] Attention is drawn to the fact that the United States bankruptcy code imposes restrictions on certain grounds for dismissal: with regard to the debtor's inability to effect a confirmed plan, it must be an inability to effectuate the "substantial consummation"[118]of the plan; and the failure by the debtor to implement a confirmed plan should be a "material" one. These restrictions in the United States bankruptcy code are practicable and reasonable.

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107 Carols J Cuevas "Good Faith and Chapter 11: Standard that Should be Employed to Dismiss Bad Faith Chapter 11 Cases" (1993) 60 Tenn L Rev 525, 526.

108 Jay Lawrence Westbrook "Chapter 11 Reorganisation in the United States" in Harry Rajak (Ed) *Insolvency Law: Theory & Practice* (Sweet & Maxwell, London, 1993) 353.

109 Douglas G Baird and Thomas H Jackson *Cases, Problems and Materials on Bankruptcy* (Little Brown, Boston, 1985) 129 (Supp L 1994).

110 Westbrook, above n 108, 354.

111 11 USC, s 1112(b) provides 10 such grounds.

112 11 USC, s 1112(b)(1); the proposed law, art 130.

113 11 USC, s 1112(b)(3); the proposed law, art 130.

114 11 USC, s 1112(b)(4); the proposed law, art 130.

115 11 USC, s 1112(b)(5); the proposed law, art 114.

116 11 USC, s 1112(b)(7); the proposed law, art 148.

117 11 USC, s 1112(b)(8); the proposed law, art 148.

118 11 USC, s 1101(2).

The United States bankruptcy code also explicitly lists the mandatory confirmation criteria of the reorganisation plan in section 1129(a). The court shall confirm a plan only if all of those listed requirements are met.[119] The mandatory requirements include, inter alia, that the plan and the proponent of the plan have complied with the provisions of chapter 11 and have proposed the plan in good faith and not by any means forbidden by law;[120] that the court must have approved payments made by the proponent, the debtor, and certain other parties, if those payments are for services or for costs and expenses in connection with the plan or the case;[121] that the "best interest of creditors" test is met;[122] that if there are any impaired classes, at least one impaired class has accepted the plan;[123] and that the plan is "feasible".[124] If the classes have voted to approve, and the criteria in section 1129(a) have been met, the plan will be confirmed by the United States bankruptcy courts.[125]

B France

The commencement of French bankruptcy proceedings is governed by Law No 85-98 of 25 January 1985 ("Law 1985"),[126] as amended by Law No 94-475 of 10 June 1994 ("Law 1994").[127] Law 1985 provides a unified procedure applicable to companies, merchants, artisans and farmers.[128] The court that deals with bankruptcy proceedings is the Commerce Tribunal ("the Tribunal").[129] The court-driven feature of French bankruptcy proceedings makes them different in many aspects from proceedings in the United States.

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119 11 USC, s 1129(a).

120 11 USC, s 1129(a)(1)-(3).

121 11 USC, s 1139(4).

122 11 USC, s 1129(a)(7).

123 11 USC, s 1129(a)(10).

124 11 USC, s 1129(a)(11).

125 11 USC, s 1129(a)(8) provides that each class of claims or interests must either (i) accept the plan by required statutory majority or (ii) be unimpaired under the plan. Although this is listed as a mandatory provision, it is not in fact mandatory. If the plan has not been accepted by all of the impaired classes, a plan can still be confirmed through "cramdown" as provided in section 1129(b).

126 Anker Sorensen and Paul Jomar *Corporate Rescue Procedures in France* (Kluwer, Boston, 1996) 27.

127 Sorensen and Jomar, above n 126.

128 Law 1985, art 2. Unless specified otherwise, hereinafter the articles of French bankruptcy law are drawn from the translated version in Philip Wood and Peter G Totty *Butterworths International Insolvency Law* (Butterworth, London, 1993) 48-168.

129 Sorensen and Jomar, above n 126, 64.

1 "Cessation of payments" (cessation des paiements)*: experience of France*

To commence bankruptcy proceedings under Law 1985, the French debtor must be in a state of "cessation of payments", which is defined as being ″unable to meet its current liabilities from its liquid assets".[130] This concept has been further interpreted by French courts. Liabilities mean due debts, and "due debts are those for which the amount is certain and outstanding";[131] liquid assets are available assets, ″for example, loans extended to the enterprise are considered as an available asset".[132] However, the Commerce Tribunal has stated that "a guarantee issued by a parent company in favour of its subsidiary's creditors could not be considered to be an asset belonging to the debtor company and [is] therefore irrelevant when determining the 'available assets' which can be used to meet due debts".[133]

"Cessation of payments" is recognised as a condition or "state" of grave financial difficulty.[134] The following factors are considered by French courts in determining whether the state of "cessation of payments" exists.

One is the materiality of default.[135] The Commerce Tribunal will not look at the debtor's default in isolation. The focus of the Tribunal is on the overall financial situation of the debtor. Thus, it not only looks at both the amount and the nature of the default ″as an indicator of the gravity of the financial embarrassment of the debtor",[136] but also "the extent to which a debtor's ability to obtain credit has been weakened".[137] Only a material default that is an important indicator of the debtor's financial situation will be considered. Cessation of payment "does not include the situation where a business, for whatever reason, refuses to pay a particular debt, and is a legal concept distinct from an accounting one".[138]

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130 Law 1985, art 3.

131 Andre Moquet *Collier International Business Insolvency Guide* (looseleaf, published by Matthew Bender & Co, New York) 22-23 para 22.05(3).

132 Moquet, above n 131.

133 Anker Sorensen (ed) *Directors' Liabilities in Case of Insolvency* (Kluwer International, The Hague, 1999) 232.

134 John Honsberger "Failure to Pay One's Debts Generally as they Become Due: The Experience of France and Canada" (1980) 54 Am Bankr LJ 157.

135 Honsberger, above n 134.

136 Honsberger, above n 134.

137 Honsberger, above n 134.

138 Sorensen, above n 133, 63.

Another consideration is the number of defaults.[139] With regard to the problem of whether a single default to a creditor is sufficient or not, the French court says:[140]

> The question as to the number of payments that a debtor has failed to pay in itself means little in that it is only a purely arithmetical approach to the cessation of payments. It is important only as one criterion in determining the gravity of the debtor's financial embarrassment and the degree that his ability to obtain credit has been impaired.

Thirdly, conduct of the debtor will also be considered.[141] French courts might "go behind the conduct of the debtor to ascertain his true financial circumstances".[142] If the creditor pays its debts by "ruinous borrowings, sales of inventory at prices substantially below normal cost"[143] or similar conduct, and such conduct leads to the amelioration of the debtor's financial circumstances, it might be considered as evidence of cessation of payment.[144]

2 Procedural requirements for voluntary petitions

One of the striking features of French bankruptcy law is that, under Law 1985, the debtor must file a petition for bankruptcy at the latest within 15 days after cessation of payment.[145] Any delay will result in sanctions against the manager of the debtor.

3 Eligibility of petitioning creditors

Unlike the United States, French bankruptcy law does not impose complex mandatory requirements on the eligibility of petitioning creditors. One creditor holding a claim that is liquidated, non-contingent and due (*certain, liquide et exigible*) can commence proceedings,[146] regardless of the nature (either a business or non-business claim) or size of the debt.[147]

In contrast to the United States, there is no requirement as to the number of petitioning creditors, nor on the amount of the claim the creditor is holding. This relatively loose control on the eligibility of petitioning creditors, however, does not necessarily mean abuse of the bankruptcy petition by

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139 Honsberger, above n 134, 158.

140 Honsberger, above n 134.

141 Honsberger, above n 134, 159.

142 Honsberger, above n 134.

143 Honsberger, above n 134.

144 Sorensen and Jomar, above n 126, 65.

145 Law 1985, art 3.

146 Richard L Koral and Marie-Christine Sordino "The New Bankruptcy Reorganisation Law in France: Ten Years Later" (1996) 70 Am Bankr LJ 437, 448.

147 Sorensen and Jomar, above n 126, 68.

creditors. While petitioning, the creditor is required to specify the amount of the debt as well as the proceedings formerly taken by the creditor which have failed to recover the debt.[148] It is required that the creditor's petition relates to the initiation of bankruptcy proceedings only.[149] The use of a petition as a method of imposing pressure on the debtor to pay is severely sanctioned by French courts and thus effectively deters bad faith petitions.[150] As in the United States,[151] a debtor in France may recover damages for an unwarranted suit.[152]

4 Early screening of reorganisation

French bankruptcy law puts great emphasis on rehabilitating the insolvent company via the rescue proceeding of *redressement judiciaire*.[153] Reorganisation proceedings apply to individual merchants, craftsmen and farmers and to all private legal entities (including state banks and insurance companies), excluding non-trader individual or state entities subject to public law.[154]

In contrast with those in the PRC or the United States, the French reorganisation proceedings are divided into two distinct components:[155] the prevention and intervention proceedings under Law 84-148 dated 1 March 1984 ("Law 1984") and the formal reorganisation proceedings (*redressement adjudiciare*) under Law 1985.[156] Law 1984 provides a conciliation proceeding (*reglement amiable*) for debtors with financial difficulties before they reach the state of "cessation of payment". Formal rescue proceedings under Law 1985 do not start until the efforts under Law 1984 have failed and the company is already in "cessation of payment".

Before the reform of Law 1994, after receiving the petition, the Tribunal would hold a hearing to see whether the prerequisites, namely the eligibility of debtor and petitioner, and the fact of cessation of payments,[157] are satisfied. If so, the Tribunal would permit the debtor to enter the observation period. There was no need of proof of the hope of rescue at this stage. No immediate liquidation

148 Sorensen and Jomar, above n 126, 68.

149 Sorensen and Jomar, above n 126, 68.

150 Sorensen and Jomar, above n 126, 68.

151 11 USC, s 303(i)(2).

152 Sorensen and Jomar, above n 126, 68.

153 It is called "judicial reconstruction" in Wood and Totty, above n 128.

154 Philip R Wood *Principles of International Insolvency* (Sweet & Maxwell, London, 1995) 186.

155 Koral and Sordino, above n 146, 456.

156 Koral and Sordino, above n 146.

157 Another ground is the non-performance of binding financial obligations in the out-of-court-agreement under Law 1984. See Law 1985, art 5.

proceedings could be commenced without a prior observation period.[158] In practice, most cases were quickly converted to liquidation,[159] and statistics reveal that after the observation period, "more than 90 percent of the cases [went] into final liquidation",[160] thus the observation period was redundant for most insolvent debtors.

Recognising the reality, Law 1994 simplified liquidation proceedings by allowing immediate liquidation to be commenced without a prior observation period. According to Law 1994, access to reorganisation is denied and immediate liquidation is appropriate if the debtor has ceased to make payments, all business activities have ceased and rescue is manifestly impossible.[161] Here, the "manifestly hopeless" test is a relatively high threshold to warrant immediate liquidation. Therefore, debtors who have some hope of rescue can still gain access to reorganisation. It is suggested that the purpose of the French Tribunal's early screening is not only to winnow out the debtor who is manifestly hopeless, but also to discover as many debtors as possible that are not entirely hopeless and can be salvaged.[162]

5 Termination of redressement judiciaire *(reorganisation) and conversion into liquidation*

If neither survival nor sale of the business appears possible after the observation period, French courts will terminate reorganisation and order compulsory liquidation.[163]

In the order of commencing reorganisation, the court will limit the reorganisation period to six months.[164] The period is renewable once and if necessary it may be further extended by up to eight months.[165] The administrator (*Administrateur Judiciaire*) will submit a report suggesting either survival of the business, sale of the business, or liquidation. After hearing or duly summoning the debtor, the administrator, the creditor's representative and the representative of the works council, and after taking into account the report of the administrator, the court will give its ruling either approving a plan or ordering liquidation.[166]

Reorganisation might be terminated upon the debtor's non-performance of a reorganisation plan under French bankruptcy law. The procedure is clearly provided as follows: if the debtor fails to

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158 Wood, above n 154, 188.

159 Sorensen and Jomar, above n 126, 30.

160 Sorenson and Jomar, above n 126, 28.

161 Law 1984, art 148.

162 Koral and Sordino, above n 146, 448.

163 Law 1985, art 8.

164 Law 1985, art 8.

165 Law 1985, art 8.

166 Law 1985, art 61.

perform its financial undertakings within the time limits set out in the plan, a creditor or group of creditors representing at least 15 per cent of the total amount claimed may, after informing the supervisor, apply to the court for termination of the plan and commencement of proceedings for judicial reconstruction with the sole object of sale or compulsory liquidation.[167]

Except for this, unlike in the United States, French bankruptcy law does not explicitly list grounds on which reorganisation might be terminated, nor does it entitle creditors or interested parties to ask for termination of reorganisation during the observation period. French reorganisation proceedings operate more speedily than those in the United States by imposing stricter time limits for, and removing interruption from creditors during, the observation period.

Additionally, the French bankruptcy law does not explicitly list the criteria for confirming the reorganisation plan. There is no mathematical statutory standard such as the "best interests of creditors" test in the United States bankruptcy code. In fact, the Tribunal, whose judges are lay business people selected for their many years of successful business experience, has a broad discretion to confirm a plan based upon the practical experience of its judges.[168] In addition, the Tribunal strongly relies on the expertise and impartiality of the administrator.[169] Appointed by the court, the administrator is responsible for submitting a report that frankly assesses the debtor's financial condition and prospects, and for helping to structure a plan that gives the courts greater confidence to approve.[170] Here, creditors' participation in voting on a reorganisation plan is removed. The Tribunal is given the independent power to adopt a plan even if the creditor's representative objects. Only when neither survival of the business nor sale is possible might the court order compulsory liquidation.

C Overall Comparison

Compared with the United States bankruptcy code and French bankruptcy law, China's proposed law is still in its embryonic form. There is much valuable experience for China to draw from these two mature jurisdictions.

1 Insolvency test

The cash flow test has become the prevailing insolvency test in many jurisdictions,[171] including France and the United States. Both the United States' "generally fail to pay" and the French "cessation

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167 Law 1985, art 80.

168 Koral and Sordino, above n 146, 443-444, 457.

169 Koral and Sordino, above n 146.

170 Koral and Sordino, above n 146.

171 Legal Department, International Monetary Fund "Orderly & Effective Insolvency Procedures – Key Issues" (1999) 16-17 <http://www.imf.org/external/pubs/ft/orderly/index.htm> (last accessed 20 June 2004) ["International Monetary Fund"].

of payment" take into account the totality of the debtor's financial situation. Both of these tests are recognised as requiring a state of grave financial difficulties. In these jurisdictions, an elaborate doctrine has been created as to what circumstances characterise the state of grave financial difficulties. It is submitted that "inability to pay" in China's proposed law should be interpreted as a cash flow test. An exhaustive definition of "inability to pay", as well as "generally fail to pay" or "cessation of payment", is impossible to draw. However, Chinese courts should establish a coherent system to interpret and develop this provision in the proposed law. Chinese courts should take into account the amount of the defaulting debts, the debtor's liquidity, the materiality of default, and the conduct of the debtor, to decide the overall financial circumstances of the debtor.

2 Procedural requirements

Since debtors know their financial situation best, they should be encouraged to file the petition at the right time. Unlike the law in France, China's proposed law chooses not to impose penalties on a debtor who delays filing, to encourage debtors to commence proceedings early. Therefore the law should encourage debtors to file at the right time by other incentives. The procedural requirements in China's proposed law should be as transparent and explicit as that of French bankruptcy law and the United States bankruptcy code. To SOE debtors, it is suggested that they should be entitled to file the petition on their own motion.

3 Eligibility of petitioning creditors

China's proposed law should also be designed to be utilised as a remedy by creditors to protect their own interests. On the other hand, to avoid the bankruptcy regime being used as a debt-collecting mechanism, necessary restrictions should be imposed on the eligibility of petitioning creditors.

Unlike that of the United States or France, China's proposed law does not explicitly impose requirements on the number of petitioning creditors, nor does it impose explicit restrictions on the nature, (contingent or disputed), of the claim. To prevent unqualified creditors using bankruptcy proceedings as a threat to the debtor to pay contingent or disputed debts, it is suggested that China's courts should determine whether the petitioning creditor holds a debt that is due, non-contingent or even undisputed. The petitioning creditor should be required to specify the amount of the debt at the time of filing. In defining the non-contingency and undisputed nature of the debt, the United States' experience can be used as a reference.

4 Early screening of reorganisation cases for eligibility

The overall economic objective of the reorganisation procedures is to enable the enterprise to overcome financial distress and return to being competitive and viable.[172] To achieve this aim, reorganisation proceedings should create enough incentives for interested parties to commence

172 International Monetary Fund, above n 171, 36.

proceedings at an early stage and thus enhance the possibility of rehabilitation. On the other hand, reorganisation proceedings must be designed so they are not used "merely as a device by a nonviable enterprise to delay liquidation, during which time the value of their claims will deteriorate".[173]

The United States' chapter 11 has been criticised as being too easy to enter since it has no requirement of insolvency or prospect for voluntary filing,[174] and some obviously unworthy candidates have created confusion in the picture of reorganisation proceedings. Unlike the United States, China is more pragmatic in restricting the threshold into reorganisation to ensure that viable and prosperous enterprises can reorganise. Consequently, the proposed law allows only enterprises with legal personality to be reorganised, while those business entities without legal person status often have few employees and creditors to benefit from reorganisation. In addition, the debtor must be in financial difficulty, either factual or potential, and be capable of reorganising. Thus, China's reorganisation system tends to be more selectively employed, and to be less likely to waste time and energy on hopeless debtors.

China imposes a slightly stricter requirement on eligibility for reorganisation than the United States. However, China's proposed law does not aggressively screen cases early in the reorganisation process. In China, the court holds an ex parte hearing upon filing, makes a preliminary determination of the debtor's eligibility for reorganisation, and, if satisfied, allows the debtor to enter a period of reorganisation protection.[175] Reorganisation systems in China and the United States afford creditors the opportunity to challenge the eligibility of the debtor. They do so after reorganisation has commenced. In China and the United States, although creditors are allowed to seek dismissal or conversion into liquidation, it is difficult to convert cases early in the proceedings. Creditors wishing to terminate a case because they believe the debtor has no hope of rescue face a considerable burden of proof. Likewise, in the court-driven French bankruptcy law, creditors' chance to ask for dismissal or termination shortly after the debtor's entry into reorganisation is even more remote.

5 Terminating inappropriate reorganisation and conversion into liquidation

Both the United States bankruptcy code and China's proposed law list circumstances under which reorganisation proceedings might be dismissed and converted into liquidation. French bankruptcy law has no such provisions. What French bankruptcy law contains are some rules to expedite cases: the length of the observation period is limited by statute, and the administrator must propose a plan within a fixed time limit. In contrast, the United States' chapter 11 gives the court discretion to control the length of proceedings, but few courts fix a deadline for the debtor to file a plan and dismiss the case or

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173 International Monetary Fund, above n 171.

174 Lawrence Westbrook "Chapter 11 Reorganisation in the United States" *Insolvency Law: Theory & Practice* (Sweet & Maxwell, London, 1993) 348.

175 The proposed law, art 120.

convert it into liquidation if the debtor fails to meet the deadline.[176] Hence, the United States bankruptcy code provides an array of mechanisms under which the creditor can seek dismissal or conversion.

In China, there are double mechanisms to warrant the termination of inappropriate reorganisation: first, the period of reorganisation protection is fixed, and the administrator should submit the plan within a statutorily-fixed period of time. Second, the proposed law lists the circumstances under which the creditor can seek dismissal during the period of reorganisation protection. China intends to have a strict screening of reorganisation during the period of reorganisation protection. Such strict screening will reduce the time elapsing between filing and termination of unsuccessful reorganisation cases which never confirm a plan. Therefore, like France, China's reorganisation proceedings might progress more quickly than proceedings in the United States.

Neither French bankruptcy law nor China's proposed law explicitly lists mandatory mathematical criteria for confirming the reorganisation plan. The French system relies heavily on the judges and administrators. It is submitted that the common sense approach applied by experienced lay judges in the French Commerce Tribunal achieves roughly the same result as the highly analytic process required by the mandatory criteria, such as "feasibility" of the United States bankruptcy code.[177] In contrast, the lack of explicit mandatory requirements on confirming the reorganisation plan in China's proposed law places considerable emphasis on the exercise of discretion by the judiciary. Such reliance might not prove to be effective, particularly when Chinese judges lack the practical business experience as applied by professional lay judges in French courts, and the bankruptcy practitioners including administrators are also building their experience.[178] It is therefore suggested that like the United States, China's proposed law should encourage the creditors' participation to give the court more practical and real guidance on confirming or rejecting a plan.

In all three jurisdictions, reorganisation proceedings will be terminated on the debtor's non-performance of the reorganisation plan. However, there are more details on how to proceed in the United States and French laws: the United States defines the nonperformance or default to be a "material" one; French bankruptcy law regulates the eligibility of the creditor to seek termination. Comparatively, China's proposed law imposes no explicit restriction. Therefore, it is suggested that China's proposed law impose similar limitations on the creditor's motion for termination.

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176 Lynn M Lopucki and George G Triantis "A System Approach to Comparing US and Canadian Reorganisation of Financially Diverse Companies" (1994) 35 Harv Int'l LJ 286, 338.

177 Koral and Sordino, above n 146, 448.

178 Bahrin (Kam) Kamarul "The Role of Bankruptcy Practitioners and the Draft Law of the People's Republic of China: an Empirical Perspective" (1998) 9 AJCL 272-282.

6 Summary of overall comparisons

Delaying access would allow insolvent debtors, who should be liquidated, to dispose of their assets at their discretion, thereby cutting down the final payment to creditors, and even dragging their creditors into insolvency. The domino principle will then take effect, unleashing a default crisis affecting China's economy. Restricted access to reorganisation can also be harmful to the success of rescue. Hence, it is suggested that in China's proposed law, access to bankruptcy proceedings, both liquidation and reorganisation, should be convenient, inexpensive and quick.[179] Incentives and facilities should be provided accordingly. The procedural requirements for a debtor's voluntary petition should be transparent and predictable. A creditor's commencement is also encouraged by non-rigid restriction on capacity, though any possible undermining is undesirable. Reliance on the relatively easily proved "general cessation of payments" test can activate the proceedings sufficiently early in the debtor's financial distress. Incentives to encourage the debtor's early filing can also be effectively incorporated into the reorganisation proceedings, encouraging eligible business entities to file at an early stage of financial distress by non-aggressive early screening. To ensure that reorganisation is not abused by the debtor, liquidation can be commenced through conversion from inappropriate reorganisation, particularly when the proposed reorganisation plan does not meet the mandatory criteria for confirmation. Meanwhile, to ensure that the viable debtor is not liquidated, reorganisation proceedings should not be terminated unless there is material default by the debtor in performing the confirmed plan.

V CONCLUSION: THE WAY AHEAD

It seems too early to draw any conclusion.[180] Chinese bankruptcy law is definitely on the right track to reform, and this needs to be a continuous process. The ambiguities in the proposed law may present some pragmatic concern and compromise between reform and actuality. But, academically and practically, the ambiguities may create trouble for the future and need to be further clarified. It is submitted that the reform must be an ongoing process, not only in terms of initiating bankruptcy proceedings – the first step in bankruptcy regimes – but for other areas of bankrupcy law, including the enforcement mechanism[181] and the overall institutional framework, including compatible development in economic, judicial and social welfare system reform.

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179 Asian Development Bank *Law and Policy Reform at the Asian Development Bank* (Vol I, 2000) 31 <http://www.adb.org/Documents/Others/Law_ADB/lpr_2000_1.asp?p=lawdevt> (last accessed 20 June 2004).

180 On 20 July 2002, the PRC Supreme People's Courts promulgated "the Regulations on Several Problems in Trying Enterprises Bankruptcy Cases", effective as of September 2002. Such Regulations provide some non-material complements to the current bankruptcy regulations, and may be a symbol that the government favours non-drastic reform in the bankruptcy regime.

181 Ron W Harmer "Evaluation of a Draft for a new PRC Insolvency Law" (Chinese Insolvency Law Symposium: Developing an Insolvency Infrastructure, Hong Kong, 17-18 November 2000) 20.

Bankruptcy law cannot function as a lonely island. While it is important to construct a credible and effective bankruptcy mechanism, bankruptcy law is not the panacea itself. If the government continues to interfere heavily in the proceedings of SOE bankruptcy, it is more likely that the threat of bankruptcy will be ineffective as regards SOEs who have powerful state backing. However, more restructuring of SOEs and non-SOE business entities will be inevitable as they face greater foreign competition with China's accession to the World Trade Organisation at the Doha Summit in November 2001.[182]

By all indications, the necessary prerequisites for the commencement mechanism are almost all in place in China's proposed law. Whether it has more bite or bark is still to be seen. The law is not only what is written on paper, but more importantly, what is performed in reality. Given the proposed law, there remain many unresolved problems, even after bankruptcy proceedings have been commenced. Gaining access to the proceedings, though vital, is only the first step.

182 "WTO Ministerial Conference Approves China's Accession" (10 November 2001) <http://www.wto.org/english/news_e/pres01_e/pr252_e.htm> (last accessed 20 June 2004).