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Continuing Economic Reform in the People's Republic of China: Bankruptcy Legislation Leads the Way

By SHIRLEY S. CHO*

I. Introduction

Critics view the 1986 Enterprise Bankruptcy Law (the "Bankruptcy Law") of the People's Republic of China (P.R.C.) as an ineffective piece of legislation passed more for symbolic ends than as a means to deal with systemic economic problems plaguing China. However, the Bankruptcy Law has proven to be one of the most pivotal pieces of legislation in modern Chinese history.

The Bankruptcy Law has served as the main impetus for wide-reaching reform in all major sectors of the Chinese economy. New regulations have ranged from the implementation of a national social unemployment insurance system to a contract employment system, which fundamentally alters the structure of employer-employee relations in China. In addition, the government has responded to criticisms of the Bankruptcy Law itself by revising the existing law. The new bankruptcy law, which conforms substantially with international precepts of bankruptcy, is expected to be passed in the near future.

This Note will examine the debate surrounding the Bankruptcy Law from its inception, its controversial substantive provisions, its un-

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5. See infra part IV.A.
successful implementation, and finally its positive repercussions in the form of the expected passage of the drastically improved bankruptcy law and labor reform.

II. The 1986 Enterprise Bankruptcy Law

A. Motivations for a Bankruptcy Law in the People's Republic of China

The state-owned enterprises (SOEs) are "the backbone" of China's "political, economic, and social life." The SOEs provide forty percent of the industrial output for the country, supply goods for the non-state sector, and employ at least one hundred million workers. However, of the estimated one hundred thousand SOEs in the P.R.C., an official government report estimated that between twenty and twenty-five percent of SOEs were running at heavy losses in the early 1980s.

The inefficiency of SOEs poses a serious threat to the very existence of the Chinese state in that government subsidies to the financially troubled SOEs are a tremendous strain on the national budget. In 1993, subsidies to SOEs totaled three percent of the gross domestic product, while accounting for sixty percent of the budget deficit.

In an effort to combat the lagging Chinese economy, the government implemented a series of economic reforms in the early 1980s aimed at improving the overall state of the nation. The goal of these reforms was the marketization of the economy with a corresponding decline in state planning. Because some enterprises were able to improve their profit margins under these reforms, the disparity between successful enterprises and those continually running in the red

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8. Id.
15. Zheng, supra note 2, at 685.
highlighted the need for a better method to weed out failing enterprises.\(^ {17} \)

Bankruptcy, as a solution, came to the forefront of national debate after Cao Siyuan, widely regarded as the father of Chinese bankruptcy,\(^ {18} \) published a study entitled “Proposals Concerning Various Questions on Striving for Scientific Technological Progress and Promoting Economic Development.”\(^ {19} \) According to the study, a bankruptcy law would be the most effective means of eliminating inefficient SOEs.\(^ {20} \)

To further support the bankruptcy solution, proponents proclaimed that a bankruptcy law would break the “iron rice bowl”\(^ {21} \) dependence of China’s ailing SOE sector on government bailouts.\(^ {22} \) As the concepts of autonomy and responsibility for economic losses are absent from a socialist system,\(^ {23} \) SOEs have been immune to the market-force consideration that profits are linked to the enterprise’s survivability.\(^ {24} \) SOEs have operated under a “soft budget constraint.”\(^ {25} \) In essence, they have not needed to be concerned with high costs as individual employees and managers have never suffered from the consequences of an inefficient allocation of business assets. A bankruptcy law was viewed as the necessary incentive for reform in that profitability of the enterprise would finally be linked to productivity and quality\(^ {26} \) as the SOEs would finally be held accountable to market forces.\(^ {27} \)

\(^ {17} \) Zheng, supra note 2, at 685.

\(^ {18} \) Nicholas C. Howson, Cao Siyuan: A “Responsible Reformer” Silenced, 8 UCLA PAC. BASIN L.J. 267, 269 (1990).


\(^ {20} \) \( \textit{Id.} \)

\(^ {21} \) \textit{See infra} part II.B.3 for a discussion of the “iron rice bowl” policy. The term generally refers to the fact that the worker is guaranteed employment for life by the state.


\(^ {23} \) Zheng, supra note 2, at 685-86.

\(^ {24} \) Clarke, supra note 16, at 293.

\(^ {25} \) \( \textit{Id.} \)

\(^ {26} \) Toronto, supra note 22, at 292.

\(^ {27} \) Clarke, supra note 16, at 284.
B. Obstacles to Adoption of the Bankruptcy Law

The Bankruptcy Law was one of the most widely debated and publicized pieces of legislation in Chinese history.\textsuperscript{28} The amount of free debate and public access to legislative debates was unprecedented.\textsuperscript{29} Congressional debates were televised to the Chinese public.\textsuperscript{30} The proposed draft of the law was published in a popular magazine.\textsuperscript{31} Public opinion polls were taken, and foreign academics and legislators were invited to a conference on bankruptcy.\textsuperscript{32}

Significantly, the focus of the debates was largely political and economic in nature and had little to do with the legal substance of the draft law itself.\textsuperscript{33} The most heated arguments involved fundamental problems of implementing a bankruptcy law in a socialist economy.\textsuperscript{34}

1. Macroeconomic Factors

Several features of the Chinese economy seem anomalous with a bankruptcy law. Macroeconomic difficulties arise from the fact that the state’s fixed price system often does not accurately reflect market prices.\textsuperscript{35} For instance, the coal industry has always posted losses because the price for raw materials has steadily increased while the coal price to the Chinese consumer has remained artificially low.\textsuperscript{36} Consequently, some argued that the SOEs’ profit or loss margin is determined by the state and is not a real measure of the enterprise’s profitability.\textsuperscript{37} Additionally, government interference occurs at every level of decision-making from production to management.\textsuperscript{38} Opponents argued that it would be inherently unfair to hold individual SOEs or their managers responsible for losses because they have no control over major aspects of their business related to profits or losses.\textsuperscript{39}

\begin{thebibliography}{99}
\bibitem{28}Toronto, \textit{supra} note 22, at 290.
\bibitem{29}\textit{Id.} at 290; Chang, \textit{supra} note 19, at 334.
\bibitem{30}Chang, \textit{supra} note 19, at 333.
\bibitem{31}\textit{Id.} at 338.
\bibitem{32}\textit{Id.} at 342-44.
\bibitem{33}Toronto, \textit{supra} note 22, at 291.
\bibitem{34}Zheng, \textit{supra} note 2, at 689-97.
\bibitem{37}Peng, \textit{supra} note 35, at 374.
\bibitem{38}Chang, \textit{supra} note 19, at 355-56.
\bibitem{39}Peng, \textit{supra} note 35, at 375.
\end{thebibliography}
Reflecting these concerns, the bankruptcy law became a body of compromise. It acknowledged that the lack of true market indicators was a pressing concern for the implementation of bankruptcy in China. The government also assuaged opponents by promising that it would pass supplemental reforms to grant SOEs and managers greater autonomy as well as to restructure the fixed-price system.

2. Bankruptcy as Incongruous with Socialist Precepts

Socialist ideology depicts bankruptcy as an inherently capitalist feature. The fact that a SOE theoretically could not be bankrupt was socialism's claim to superiority over capitalism. Therefore, accepting a bankruptcy law was viewed by some as a tacit admission of the flaws of the socialist system.

Scholars were the first to minimize ideological inconsistencies between the concepts of bankruptcy and socialism. One theorist reasoned that since socialism encourages healthy competition, bankruptcy was simply a means to foster a competitive atmosphere among SOEs. Another proponent argued that in order for socialism to progress, eliminating unhealthy SOEs was essential. A third theorist proposed that socialist systems should be able to utilize aspects of capitalism to their own socialistic ends. These theories coincided with the willingness of legislators to associate the failure of an enterprise with the individual and not with the socialist structure as a whole.

3. Threat to the “Iron Rice Bowl”

The “iron rice bowl” policy is considered by the government to be the cornerstone of socialism. It is written in the Chinese Constitu-

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40. Id. at 376-77.
41. Chang, supra note 19, at 356.
42. Zheng, supra note 2, at 691.
43. Toronto, supra note 22, at 290.
44. Zheng, supra note 2, at 659.
47. Id.
48. Id. at 690.
49. Id.
51. Toronto, supra note 22, at 291.
tion that workers are guaranteed the right to employment. The state’s aim has always been to provide “full employment” for all workers. Unemployment, in theory, has been nonexistent. If a person is jobless, he is classified as “waiting for a job” and not as unemployed.

The premise of the iron rice bowl policy is that the worker and the state are mutually bound to each other; the government provides for all necessities in the worker’s life in exchange for the worker’s service to the state. Often, each SOE resembles a small company town in that all aspects of the worker’s life are accommodated. Not only are basic amenities such as housing, food, education, day care, and medical care provided, but entertainment, barber shops, and recreational facilities also are provided.

As job security has been a trademark feature of socialist systems, adopting a bankruptcy law was seen as undermining this basic promise of economic security. As will be discussed in Part V.A. of this Note, proponents of the Bankruptcy Law were all too aware of the need to maintain the social equilibrium by providing greater guarantees to displaced workers. Thus, not only was a provision that provided for displaced workers adopted, corollary social insurance measures were passed and continue to be passed by the National People’s Congress (NPC).

C. Legislative Goals

The Bankruptcy Law was passed on December 2, 1986, after it was substantially revised three times and heatedly debated by the

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52. Id.
54. Id. at 490.
55. Id.
56. Stevenson-Yang, supra note 3.
57. Id.
58. Id.
59. Josephs, supra note 4, at 204.
60. Toronto, supra note 22, at 291.
61. See infra part V.A.
62. See infra part II.D.9.
63. See infra part V.
The Bankruptcy Law was expressly tailored for China's unique transitional economy. In general, the typical function of legal enactments in China is to serve as a moral guideline. The effectiveness of the laws lies in the instructive messages conveyed and the ability to mold behavior to conform to the goals of the law. Therefore, the Bankruptcy Law, rather than being a substantive body of legal work, is considered to be more of a political statement. The Bankruptcy Law was only intended as a proverbial stick to motivate SOEs to become more efficient and thus help revitalize the economy in general. Accordingly, the effectiveness of the Bankruptcy Law was said to be in the mere threat of bankruptcy.

D. Notable Provisions of the 1986 Enterprise Bankruptcy Law

1. Preamble

The Law has a distinctly socialist flair, as is evident from the preamble. The preamble contains language that is hortatory in nature and carries greater significance in terms of the legal and moral meaning attached to it than would be true of a U.S. law. As enacted, the preamble of the Bankruptcy Law states:

This law is enacted to meet the need for development of the planned socialist commodity economy and for economic reform, to promote the independence of business management of the enterprises under the ownership by the whole people, to strengthen the system of economic responsibility and democratic management, to improve business management and economic performance, and to protect the lawful rights and interests of debtors and creditors.

The goals of the Bankruptcy Law are listed in descending order of importance. Whereas an efficient reorganization of the debtor's es-

66. Id. at 360. For a detailed overview of the legislative process of the passage of this law, see Chang, supra note 19, at 366.
67. Goosen, supra note 50, at 8.
68. Id.
69. Toronto, supra note 22, at 291.
70. Id. at 292.
71. Id.
72. Chang, supra note 19, at 365.
73. 1986 Bankruptcy Law art. 1, translated in Zheng, supra note 64, at 733.
74. Chang, supra note 19, at 365.
tate and protection of creditors’ and debtors’ rights is one of the foremost concerns in the United States Bankruptcy Code; China’s Bankruptcy Law places minimal significance on these factors.\textsuperscript{75}

2. **Applicability**

Whether or not the Bankruptcy Law would encompass foreign enterprises was debated at length.\textsuperscript{76} The Law was held ultimately to apply only to SOEs, and not to foreign investment Enterprises.\textsuperscript{77} As foreign investment enterprises are governed under different laws than SOEs, many of the proposed Bankruptcy Law provisions, such as punishment of management, would be difficult to apply uniformly.\textsuperscript{78}

To a large extent, foreign investment enterprises in China operate under normal market forces where there are no ideological difficulties in allowing enterprises to go bankrupt.\textsuperscript{79} As foreign investment enterprises were already subject to more market-based bankruptcy provisions,\textsuperscript{80} it seemed superfluous to include them in the Bankruptcy Law.

3. **Definition of a Bankrupt Enterprise**

Any commonly accepted market definition of bankruptcy would have proved disastrous in the Chinese context.\textsuperscript{81} The result would have been the bankruptcy of at least one quarter of the SOEs.\textsuperscript{82} Therefore, the standard for determining bankruptcy could not be based on the enterprise’s ratio of assets to liabilities, but had to be based on a more amorphous concept.\textsuperscript{83} Article 3 of the Bankruptcy Law states, “Enterprises that sustain serious loss due to inappropriate management and that are unable to pay off debts that mature will be declared bankrupt in accordance with the provisions of this law.”\textsuperscript{84}

\textsuperscript{76} Chang, supra note 19, at 361.
\textsuperscript{77} 1986 Bankruptcy Law art. 2, translated in Zheng, supra note 64, at 733. “The law applies to enterprises under the ownership of the whole people.” Id. The “whole people” refers to the State-owned enterprises. Id. at n.1.
\textsuperscript{78} Chang, supra note 19, at 361-62.
\textsuperscript{79} Zheng, supra note 2, at 697.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} Id. at 359.
\textsuperscript{83} Id. at 359-60.
\textsuperscript{84} 1986 Bankruptcy Law art. 3, translated in Zheng, supra note 64, at 733-34.
Thus, the gauge for determining bankruptcy in China is whether or not timely payment of debts can be made.\textsuperscript{85}

However, two significant exceptions to the general definition of bankruptcy were carved out to accommodate concerns by the opposition.\textsuperscript{86} Businesses that fail through no fault of their own due to external forces are not eligible to declare bankruptcy.\textsuperscript{87} Furthermore, if the enterprise will be able to pay off its debts within six months after declaring bankruptcy because it has found a guarantor or if it is one that is deemed to have an important impact on the economy, such as a public utility, it is not eligible to declare bankruptcy.\textsuperscript{88} Under this exception, the government has leeway to continue to subsidize the SOE so that the enterprise can cover its operating costs and avoid bankruptcy.\textsuperscript{89}

4. Filing for Bankruptcy and Government Retention of Control

The government essentially determines when bankruptcies will be allowed by retaining direct control over the filing process.\textsuperscript{90} Voluntary petitioners must first obtain consent from their governing department before the petition will be approved.\textsuperscript{91} The debtor’s governing department may also petition the court on its own for the bankruptcy of the enterprise.\textsuperscript{92} As mentioned previously, the government is free to thwart the bankruptcy through other means, such as by subsidizing or guaranteeing the enterprise’s losses.\textsuperscript{93}

5. Reorganization, Reconciliation, and Liquidation

While either debtor or creditor may file for liquidation, reorganization is possible only when the governmental authority in charge of the debtor requests a reorganization and both the creditors and the court agree.\textsuperscript{94} As reorganization is only discussed in the context of the involuntary petition brought by the state, voluntary petitioners may

\textsuperscript{85} Chang, \textit{supra} note 19, at 359-60.
\textsuperscript{86} \textit{Id.}
\textsuperscript{87} \textit{Id.}
\textsuperscript{88} 1986 Bankruptcy Law art. 3, \textit{translated in} Zheng, \textit{supra} note 64, at 733-34.
\textsuperscript{89} Chang, \textit{supra} note 19, at 360.
\textsuperscript{91} \textit{Id.}; 1986 Bankruptcy Law art. 8, \textit{translated in} Zheng, \textit{supra} note 64, at 734.
\textsuperscript{92} 1986 Bankruptcy Law art. 17, \textit{translated in} Zheng, \textit{supra} note 64, at 736.
\textsuperscript{93} Boshkoff & Song, \textit{supra} note 90, at 361.
\textsuperscript{94} 1986 Bankruptcy Law arts. 17-19, \textit{translated in} Zheng, \textit{supra} note 64, at 736.
not request reorganization themselves.\textsuperscript{95} Significantly, the Bankruptcy Law does not state the grounds by which creditors may oppose the government's request for reorganization nor does it specifically authorize the People's Court to reject the state's request for reorganization.\textsuperscript{96}

At the same time, the Bankruptcy Law encourages the debtor to file a "conciliation" proposal after the petition for reorganization has been filed.\textsuperscript{97} The conciliation agreement, if agreed upon by the creditors and approved by the court, terminates the bankruptcy.\textsuperscript{98} However, should the parties fail to reach reconciliation, the Bankruptcy Law is unclear as to how the court shall proceed.\textsuperscript{99}

In general, reconciliation between the parties is highly encouraged and the role of the judiciary has been greatly de-emphasized.\textsuperscript{100} Should the debtor fail to comply with the conciliation agreement before the two year time limit for reorganization, the debtor will be declared bankrupt, and within fifteen days, the court will form a liquidation group comprised of various government officials to distribute the estate's assets.\textsuperscript{101}

6. Punishment of Corporate Management for Business Failure

Drafters of the 1986 Bankruptcy Law were disappointed to learn that Western bankruptcy laws do not typically contain provisions for punishing mismanagement.\textsuperscript{102} In capitalist systems, however, this is unnecessary as managers are held accountable by market forces in the form of dismissal by the board of directors or refusal of banks to provide loans for future capital.\textsuperscript{103} In China, managers have been immune to market forces as they have been able to rely on government bail-outs. Therefore, accountability of corporate management was seen as essential to economic reform.\textsuperscript{104} Thus, one of the major goals

\textsuperscript{95} 1986 Bankruptcy Law art. 17, translated in Zheng, supra note 64, at 736. See also Henry R. Zheng, China's Civil and Commercial Law 178 (1988).
\textsuperscript{96} Zheng, supra note 95, at 178.
\textsuperscript{97} 1986 Bankruptcy Law art. 18, translated in Zheng, supra note 64, at 736.
\textsuperscript{98} Id., art. 19, at 736.
\textsuperscript{99} Zheng, supra note 95, at 178.
\textsuperscript{100} Toronto, supra note 22, at 289.
\textsuperscript{101} 1986 Bankruptcy Law arts. 22, 24, translated in Zheng, supra note 64, at 736-37.
\textsuperscript{102} Chang, supra note 19, at 366.
\textsuperscript{103} Id.
\textsuperscript{104} Id. See also Alpe, supra note 65.
of the Bankruptcy Law was to force managers to take greater responsibility for business failures.  

Under Chapter 5 of the Bankruptcy Law, entitled "Declaration of Bankruptcy and Liquidation," Article 42 subjects managers and supervising government officials to "administrative penalties" if the investigating auditing state agency determines that the managers bear the responsibility for the business failure. In addition, state managers can be held criminally liable if their negligence leads to serious loss of state property. Again, the underlying premise for enacting this provision was not actually to punish the managers but to provide sufficient incentive to improve their organizations.  

7. State Protection for Displaced Workers  

Finally, in an attempt to make the Bankruptcy Law more amenable to the workers' needs, the Law contains a provision that provides workers protection against displacement. Article 4 states that the government will provide new employment to displaced workers of bankrupt enterprises and will "ensure" that "basic living necessities" are provided during the period of displacement. In addition, far-reaching labor reform measures were passed prior to the enactment of the Bankruptcy Law on July 12, 1986 by the State Council.  

E. Implementation  

As is the case with most new Chinese laws, the government used extreme caution before implementing the Bankruptcy Law on a national level. Prior to adoption, the Law was implemented on a trial-run basis in select localities. In addition, the Law was enforced for a period of three months after the enactment. As a precursor to implementation, laws granting greater autonomy to the SOEs required passage. Therefore, the Bankruptcy Law did not become officially enacted until November 1, 1988 after the Law Governing  

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105. Chang, supra note 19, at 366. See also Alpe, supra note 65, at 9.  
107. Id.  
109. Chang, supra note 19, at 368-70.  
110. 1986 Bankruptcy Law art. 4, translated in Zheng, supra note 64, at 734.  
111. Id.  
112. See infra part V.  
113. Goosen, supra note 50, at 8.  
114. Id.  
115. Id.
Industrial Enterprises Owned by the Whole People (the "Industrial Enterprise Law") was passed.116

III. Aftermath: Criticisms Abound


Critics of the Bankruptcy Law charge it with being vague on several points. First, the standard for bankruptcy is vague.117 For instance, there is no criteria to establish what constitutes "heavy debts."118

Second, the Bankruptcy Law has no provisions dealing with preferences among creditors119 since most assets are state-owned and therefore are nontransferable to creditors.120 Also, secured property is excluded from the estate’s assets.121 While this may be beneficial to secured creditors, it will usually have the effect of depriving unsecured creditors of any value in the debtor’s estate.122

In addition, there is a dual standard regarding when creditors, as opposed to debtors, may petition for bankruptcy. While a creditor may file whenever the debtor cannot pay its mature debts,123 the debtor may only file if the heavy debts result from mismanagement.124 Furthermore, the two year deadline by which the estate must complete a reorganization may be unnecessarily rigid and force debtors into liquidation merely because they are unable to comply with the deadline.125

Other criticisms arise from the attempted implementation of the Bankruptcy Law itself. Because of the time lag between the declaration of bankruptcy and any action toward reorganization or liquidation, fraudulent transfers have occurred.126 There also have been reports of difficulties in relocating workers, conflicts of interest be-

116. Id.
118. Id. The Law Governing Industrial Enterprises Owned by the Whole People [hereinafter Industrial Enterprise Law] was to afford the SOEs autonomy vis-a-vis the state. See id.
119. Id.
120. Id.
121. Id.
122. Id.
123. 1986 Bankruptcy Law art. 7, Zheng, supra note 64, at 734.
124. Id., arts. 3, 8, at 733-34.
125. Qi, supra note 117, at 44.
tween claimants to the liquidation, and collusion between the debtors and governmental departments who transfer assets before declaring bankruptcy.\textsuperscript{127}

\textbf{B. Reluctant Use of the Bankruptcy Law}

The bulk of the criticisms, however, lie not with the substance of the Law, but rather with the government's reluctance to use the Law. As many as forty-five percent of the SOEs still run at a heavy loss.\textsuperscript{128} In 1991, SOEs reported the highest recorded losses, an estimated thirty-one billion yuan (US$5.7 billion) since the founding of the P.R.C. in 1949.\textsuperscript{129} Chinese economists estimate that ten percent of SOE production has come to a complete standstill.\textsuperscript{130}

Government subsidy of the SOEs has been cited as the largest roadblock to China's economic competitiveness in the world market as well as the largest drain on the government's budget.\textsuperscript{131} In 1992 alone, state subsidies amounted to US$90 billion.\textsuperscript{132} In 1988, subsidies to SOEs constituted thirteen to fifteen percent of the national budget allocation.\textsuperscript{133} It is estimated that only one-third of the SOEs now operating would be able to survive without the aid of government subsidies.\textsuperscript{134} In addition, government bail-out of SOE debt is cited as the cause\textsuperscript{135} of rampant double-digit inflation in China.\textsuperscript{136}

Although at least one-third of the SOEs (approximately thirty thousand) are acknowledged by Chinese government officials as being


\textsuperscript{130} Rajiv Chandra, \textit{Real Estate Deals to Save Sick State Units}, \textit{Inter-Presse Serv.}, Sept. 13, 1994, \textit{available in WESTLAW}, 1994 WL 259312. Those sectors which have come to a stand-still are primarily the heavy industrial industries such as coal, textile, and defense industries. \textit{Id.} In sharp contrast, the non-state-owned sector economy is booming. \textit{Id.}


\textsuperscript{132} \textit{China Stirs Its Sleeping Giants}, \textit{ supra} note 10, at 53.

\textsuperscript{133} Macartney, \textit{ supra} note 1.

\textsuperscript{134} Chandra, \textit{ supra} note 130.

\textsuperscript{135} \textit{China's Ailing State Firms Need Dose of Bankruptcy}, \textit{Asian Wall St. J.}, Sept. 15, 1994, at 5.

\textsuperscript{136} \textit{China Will Soon Let Failing Public Firms Go Bankrupt}, \textit{ supra} note 128.
bankrupt, only two thousand companies have been permitted to file for bankruptcy since the passage of the Bankruptcy Law.137 This has led to criticism that bankruptcy legislation in China is "more bark than bite."138 The Bankruptcy Law is viewed as an ineffective warning by the government to SOEs and workers.139 Thus, even though the Bankruptcy Law was passed in 1986, the concept of bankruptcy is still a relatively new one in China.140

Understandably, state-owned banks, currently the major creditors of the SOEs, have also been opponents of the Bankruptcy Law.141 Cao Siyuan has even cited banks as the "biggest obstacle to bankruptcy."142 State-owned bank loans comprise as much as ninety-five percent of the working capital for some SOEs.143 SOEs and the state banks, upon which they are heavily dependent, are engaged in a "triangular debt" whereby the SOEs, state banks, and the state are linked together in a cycle of debt exchange.144 One economist estimates that twenty percent of China's bank assets would be destroyed if all failing SOEs were declared bankrupt.145 In addition, banks fear not being able to recover full loan amounts from liquidation proceedings.146

The small number of successful bankruptcies has also been attributed to excessive interference from governmental agencies.147 However, the government has had good reason to use the Bankruptcy Law sparingly for fear of potential social unrest caused by worker layoffs.148 To prevent that end, the state has discouraged bankruptcies by providing economic incentives in the form of lenient grace periods on interest charges for those profitable SOEs that agree to merge with

139. Id. See also Kristof, supra note 1, at D6.
141. Id.
145. China's Ailing State Firms Need Dose of Bankruptcy, supra note 135, at 5.
146. Bankruptcies Soar as China Faces up to Reality, supra note 142.
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failing SOEs. Alternatively, the state has simply merged the failing SOE with a successful SOE without such incentives. Needless to say, this practice has merely masked the underlying inefficiency of the failing SOE and imposed an additional burden on the healthy SOE.

IV. China’s New Bankruptcy Law

A. Ideological Acceptance of Bankruptcy

Amidst these criticisms, it is not surprising that the government undertook to revise the Bankruptcy Law. The nature of the revisions represents a hallmark in Chinese governmental ideology in that the government has recognized and attempted to synchronize the Chinese economy with international standards of commerce and bankruptcy. In addition, an increased number of SOEs have simultaneously been allowed to successfully file for bankruptcy.

However, the primary focus of the government’s reform efforts still remains the revitalization, not the elimination, of the state-owned sector. The new emerging mentality is that it is acceptable to sacrifice a few unprofitable SOEs for the betterment of the national economy as a whole.

There has also been a change in the general public perception. Bankruptcy, as a solution to political and financial woes, is now seen as a “politically correct solution.” Cao Siyuan stated: “[P]eople accept bankruptcy now, although they have mixed feelings about it. ... There is no alternative. Leftist critics have no solution to offer.”

150. Kristof, supra note 1, at D6.
151. Id.
153. Bankruptcies Soar As China Faces Up to Reality, supra note 142.
155. City of Beijing to Let State-Owned Firms Fail, supra note 148, at 8.
157. Bankruptcies Soar As China Faces Up to Reality, supra note 142.
B. Congressional Delays

The new bankruptcy law, to be called the “Bankruptcy Law of the People’s Republic of China” (the “New Law”) is heralded as “one of the most important pieces of Chinese legislation in years.” The New Law is on the forefront of Congress’ agenda for 1996. Lawmakers stated that the old Bankruptcy Law is not able to keep pace with the transforming economy. Unlike the Bankruptcy Law, the New Law will be premised on China’s status as a market economy and will not be a law geared toward supplementing a planned economy.

The Financial and Economic Committee of the NPC began revising the New Law in March 1994. Although the New Law was expected to be released earlier this year, publication of the New Law has been postponed due to fierce debates in the NPC. While reports earlier in the year were hopeful that the draft might be submitted for approval in March 1996, recent reports are skeptical that the passage of the New Law will occur before the year’s end. One point of contention in the NPC is whether the passage of the New Law should be postponed until a more substantial social insurance law is passed.

As is the case with most Chinese laws, including the 1986 Bankruptcy Law, revision of the New Law was approved only after a successful trial implementation of the proposed bankruptcy provisions. The New Law was first implemented in eighteen major industrial cities. City governments were rewarded with cash infusions if they designated a list of factories for immediate bankruptcy.

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159. Brooks, supra note 152, at 5.
162. Drafting of New Bankruptcy Law Almost Finished, supra note 158.
163. Ma, supra note 6, at 12.
165. Id.; see also Solvency Law Falters on Bankrupt Ideas, S. CHINA MORNING POST, May 5, 1996, at 5.
166. Ma, supra note 164, at 3.
168. Kahn, supra note 144, at 1.
169. Id.
ernment backed the experiment with US$813 million in funding to compensate displaced workers and to cover bank losses.\textsuperscript{170}

\section*{C. Substantial Changes Expected in the New Bankruptcy Law}

The Bankruptcy Law is expected to be substantially changed.\textsuperscript{171} Modified provisions are said to be drawn directly from foreign bankruptcy laws, including the United States Bankruptcy Code, in an attempt to bring China's bankruptcy law in line with international standards.\textsuperscript{172} Members of the International Conference on Bankruptcy Law who examined the third draft of the New Law stated that the revised Law is “fundamentally sound, comprehensive, and fits well within the parameters of current bankruptcy systems in other countries.”\textsuperscript{173}

The New Law will have a much greater scope. Not only will it apply to SOEs, it will also apply to all enterprises including state, private, and foreign enterprises.\textsuperscript{174} “Non-legal person enterprises,” which include privately owned companies and partnerships, now comprise more than fifty percent of the businesses registered in China with the State Administration for Industry and Commerce.\textsuperscript{175} Therefore, the broader scope of the New Law is in step with the government's promise to reform according to changing market needs.

One drafter stated that the New Law will provide that the government “should not intervene” in the bankruptcy case.\textsuperscript{176} Debtors will be able to apply to the courts directly for bankruptcy, rather than through their superior governmental departments.\textsuperscript{177} The effect of this will be to provide greater flexibility to the individual SOEs and their creditors to resolve all claims without government interference.\textsuperscript{178}

\begin{itemize}
  \item \textsuperscript{170} Id. For details of an actual experimental implementation, see \textit{Chinese Bankruptcy Sends Shock Waves}, \textsc{Calgary Herald}, Sept. 7, 1994, at D8.
  \item \textsuperscript{171} \textit{China to Revise Bankruptcy Law}, supra note 160, at 22.
  \item \textsuperscript{172} Vivien Pik-Kwan Chan, \textit{NPC Date for Bankruptcy Legislation}, \textsc{S. China Morning Post}, Oct. 11, 1995, at 10.
  \item \textsuperscript{173} Brooks, \textit{supra} note 152, at 5.
  \item \textsuperscript{174} Rowena Tsang, \textit{New Bankruptcy Law by Year-End}, \textsc{S. China Morning Post}, Mar. 10, 1995, at 4.
  \item \textsuperscript{175} Chan, \textit{supra} note 172, at 10.
  \item \textsuperscript{176} Id.
  \item \textsuperscript{177} Id. “Enterprises which cannot pay due liabilities can apply to courts for insolvency.” \textit{Id}.
  \item \textsuperscript{178} Id.
\end{itemize}
The New Law will also provide more detailed provisions regarding restructuring and liquidation procedures. An entire chapter on corporate reorganization is to be added to the New Law. Provisions regarding the order of debtor's claimants will be more clearly defined. There will also be a guarantee of creditors' rights to assets. In addition, the time frame between filing bankruptcy and reorganizing or liquidating the estate will be minimized in an effort to prevent fraudulent transfers.

Despite these advances, the New Law will not entirely abandon its old premises. The New Law will continue to discourage "the negative effects of bankruptcies" by encouraging mediation and enterprise restructuring as opposed to declaring the enterprise bankrupt. In addition, the New Law will devote a separate section to the SOEs to tailor the New Law toward China's "special needs." Also, in practice, merger is still a popular state remedy as redundant industries are encouraged to consolidate.

D. Changed Attitude of the State Toward SOEs

Drastic reform of the Bankruptcy Law is possible largely because the government has taken the attitude that it will no longer tolerate SOEs that chronically post losses. Prime Minister Li Peng has even predicted that fully one-third of SOEs will soon be converted into private companies or forced into bankruptcy in order to quicken the pace of default, and, in turn, bring the Chinese economy up to par with internationally competitive economies.

179. Id.
180. Ma, supra note 164, at 12.
181. See Chan, supra note 172, at 10. Debtor must first pay outstanding claims and taxes, followed by money owed to banks and other businesses. Id.
185. Id.
188. Under the Corporate Law passed in 1994, which also has provisions dealing with bankruptcy and mergers, a legal basis is provided to allow SOEs to convert into privately-run companies. Gao Jin'an, Corporate Law Guides Economy, CHINA DAILY, June 28, 1994, at 13.
189. Tefft, supra note 156, at 7.
Of the one thousand SOEs targeted for reform, Vice-Prime Min-
ister Wu stated that three hundred enterprises will be allowed to run
independently without government intervention. Also, the govern-
ment continues to simultaneously promote and praise profitable SOEs
while castigating the unprofitable ones. For example, the govern-
ment recently announced a highly public plan aimed primarily at hu-
miliating 156 targeted SOEs by liquidating the enterprises in a public
auction.

As government supervision eases, SOEs have been given the op-
portunity to seek help elsewhere. For instance, SOE managers have
tried to lure foreign investors with little success. More promising
alternatives have included raising capital in the public market or form-
ing partnerships with foreign entities.

V. The Necessary Precursor: Implementation of Labor
Insurance Laws

A. Fear of Worker Unrest

Under the iron rice bowl labor system, SOEs bear a tremendous
burden to provide for the welfare of their workers, dramatically in-
creasing their operating costs. The resulting “catch-22” situation is
that workers cannot, for fear of losing their benefits, move to better
employment opportunities; meanwhile, employers are bound by a so-
cial duty to provide for the workers even if the workers are not neces-
sary to the business. In effect, the employee and employer are
chained together.

The result is that SOEs support a large, redundant labor force. An
estimated twenty million workers, or seventeen percent of the
work force, employed by SOEs are said to be redundant or surplus
labor. Inefficiency is compounded because the guarantee of work
and benefits eliminates any incentive for workers with respect to the
quality or quantity of their work product.

192. Ibison, supra note 187, at 12.
193. Chandra, supra note 130.
195. Stevenson-Yang, supra note 3.
196. Id.
197. Id.
198. Chan, supra note 172, at 10.
199. Henry R. Zheng, An Introduction to the Labor Law of the People's Republic of
Chinese workers have not been pleased by the threat of termination to their iron rice bowl existence.\textsuperscript{200} As economic reforms progress, there have been reports of increased worker activism in the form of strikes, work actions,\textsuperscript{201} and attempts to form unauthorized trade unions.\textsuperscript{202}

It is widely acknowledged that the social security system requires improvement before the newly revised provisions can take effect\textsuperscript{203} and that a major problem with enforcing the Bankruptcy Law has been the "absence of a unified social welfare package."\textsuperscript{204} Without the protection of a support system, bankruptcy may lead to social instability.\textsuperscript{205} Support services for employment relocation must be improved.\textsuperscript{206} Otherwise, as Chinese Vice Premier Zhu Rongji stated "the consequences would be unthinkable."\textsuperscript{207} The Central Committee of the NPC stated that maintaining social equilibrium while implementing marketization is its primary goal for the 1990s.\textsuperscript{208} Therefore, any progress that is made in the bankruptcy arena will most likely be slow as government officials tread lightly due to fears of urban unrest.\textsuperscript{209}

\textbf{B. Nationalization Efforts}

Fear of displaced worker backlash led some SOEs to make settlement offers to its workers before declaring bankruptcy as a way of minimizing the impact of joblessness.\textsuperscript{210} Although this method proved successful in some instances, a broader solution was clearly needed.

To that end, the government has started reform that will shift the burden of social welfare from the individual SOEs to the national level.\textsuperscript{211} The first phase entails turning over operation of facilities pre-
viously run by the bankrupt SOE, such as schools, housing and hospitals to the local government. In effect, the SOEs will no longer be responsible for caring for employees "from cradle to grave."

C. The Social Safety Net

1. Protections for Workers in the New Bankruptcy Law

The New Law will require that proceeds from the sale of state-granted land in liquidation be distributed to workers either in the form of a direct compensation in a lump sum or a fund to be used for retraining and relocating displaced workers. United States Bankruptcy Judge Sid Brooks sees two benefits to such a scheme: (1) it will ease the government's financial burden from the bankruptcy of the SOE and (2) it will alleviate the fear of bankruptcy and the courts’ reluctance to declare bankruptcies.

Under the current system, employees are barely given enough unemployment wages for subsistence, making it all the more difficult to find new employment. Thus, the concept of an unemployment fund would serve as more of a settlement to tide the workers over until alternative employment can be found.

2. The July 12, 1986 Labor Reform Regulations

The state passed the most significant regulations in the area of labor reform on July 12, 1986. The July 12, 1986 regulations encompassed four areas: contract employment, hiring of workers, termination of workers and unemployment insurance. The regulations codified what had already existed for six years in many local cities on an experimental basis. Among other problems, the government hoped to address through the labor reforms the inefficient allocation

212. Chan, supra note 172, at 10.
214. Chan, supra note 172, at 10.
217. Id.
218. Id. at 229.
219. Id. at 229. The four regulations passed on July 12, 1986 are: (1) Provisional Regulations on the Implementation of the Contract Employment System in State Enterprises, (2) Provisional Regulations on the Hiring of Workers in State Enterprises, (3) Provisional Regulations on the Dismissal of Workers and Staff for Work Violation in State Enterprises, and (4) Provisional Regulations on Unemployment Insurance for Workers. Id.
220. Id. at 230.
of labor supply, poorly trained work force, and favoritism of status-based employees.221

3. Introduction of the Contract Employment System

The government’s first step in its labor reform efforts was to alter the structure of the relationship between employer and employee by mandating a contract system222 of employment.223 As foreign investment enterprises in China had long been operating under a contract employment system,224 the government’s introduction of contract employment served to validate its efforts to bring China’s overall economy in line with modern market economies as well as to further erode the iron rice bowl mentality.225

The contract employment system was approved for mandatory implementation only after experimentation in select cities showed that contract employment resulted in higher worker productivity and decreased rates of absenteeism.226 Implementation was also facilitated by academic critics who quickly distinguished the contract employment system from the “wage labor system,” considered a hallmark of capitalist societies.227 Contract employment was said to merely formalize the existing relationship between the employer and employee in accordance with the socialist labor system.228

One of the goals of the contract employment system was to create a mobile labor force that could better accommodate industry demand.229 Under the 1986 Regulations, employers and employees have greater freedom to enter into and terminate employment relationships.230 The benefit to workers is that they are encouraged to bargain and resign while managers have incentive to negotiate terms of employment rather than forcing terms through administrative means.231 Workers are free to leave employers at the end of the contractual term...

221. Id. at 209-19.
222. See id. at 264-70 for a text of the contract employment system.
224. Id. at 385.
225. Id. at 391.
226. Id. at 391-92.
227. Id. at 393.
228. Id.
229. Id. at 391.
231. Zheng, supra note 199, at 430.
and find employment where there may be a demand, thus hopefully alleviating the redundant-worker problem.

4. Unemployment Insurance

The 1995 Labor Law is another hallmark in the arena of labor reform. The new labor law establishes five mandatory funds so that both employer and employee must contribute. One of these is an unemployment insurance fund. Unemployment Insurance, like the contract labor system, serves a dual purpose. Not only does it appease displaced workers and thereby ensure social stability, but it also serves to encourage businesses to layoff redundant workers. In addition, the 1995 Labor Law applies to both foreign and state-owned enterprises.

It is important to note that social insurance and social welfare are two distinct categories of social aid in China. Social insurance is comprised of the five mandatory funds under the 1995 Labor Law while social welfare consists of government subsidies and emergency relief. Social welfare in China has been intact since 1954 and is commonly associated with the iron rice bowl system of the SOEs.

Although implementation of the mandatory funds is still in the preliminary stages, the Unemployment Insurance Fund gives the most significant worker protection yet. Under the Unemployment Insurance Fund, unemployed workers are entitled to compensation without distinction as to their status or reason for unemployment. The worker is entitled to compensation for two years based on a fixed percentage of the worker's wage. Workers who have been employed

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232. Josephs, supra note 4, at 209.
233. Id.
234. Stevenson-Yang, supra note 3.
235. Id.
236. Id. Other mandatory funds include: pension, medical, accident or disability, and maternity. Id.
237. Williams & Woo, supra note 53, at 493.
238. Id.
239. Chan Wai-Fong, Social Security Bill Nears Completion, S. CHINA MORNING POST, Nov. 26, 1994, at 9. However, the Labor Law does not apply to China's large rural workforce sector, self-employed workers or individual business owners. Id. The self-employed workers or individual business owners may participate in the program voluntarily. Id.
240. Stevenson-Yang, supra note 3.
241. Id.
242. Id.
243. Id.
244. Josephs, supra note 4, at 248.
245. Id. at 248-49.
with the employer for less than five years receive compensation for only one year.\footnote{246} Employee contributions are based on a percentage of their yearly wages.\footnote{247} Although starting at two percent, the government plans to increase the total contribution to eight percent over the next six years.\footnote{248} Corporate employers are expected to contribute a minimum of fourteen percent of their income.\footnote{249}

**VI. Conclusion**

Bankruptcy in China has had a tenuous existence. To a large extent, bankruptcy legislation has reflected political difficulties in China's economic transition to a market economy. Initially, the government acted conservatively and authorized a minimal amount of bankruptcies for fear of political and social opposition. However, as the government has become increasingly determined to make the Chinese economy competitive on an international scale, it has become adamant in its attempts to transform the inefficient state-owned sector.

Both the 1986 and the New Bankruptcy Law have been instrumental in the government's reform efforts. When applied seriously, the New Law will force out inefficient SOEs, reduce the redundant worker problem and better allocate the labor supply. Before this can occur, the government has correctly surmised that several aspects of Chinese law need to be addressed. While this Note has emphasized the progress in labor reform, the government has also been forced to examine other areas dealing with asset ownership and governance of SOEs, among other things.

The New Bankruptcy Law embodies the government's firm resolve to implement market reforms, as many of the provisions espoused in the New Law will be based on market principles. As China continues on a path toward economic reform and marketization, fundamental precepts of the socialist system will continue to be challenged and bankruptcy legislation will be at the forefront of the change.

\footnote{246} Id. at 249.
\footnote{247} Stevenson-Yang, supra note 3.
\footnote{248} Id.
\footnote{249} Id.