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**Applicability of the World Bank Reports on Doing Business for the
case of bankruptcy in China**

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¹ The findings, interpretations, and conclusions expressed here are those of the author and do not necessarily reflect the views of the “Attractivité économique du Droit- Economic Attractiveness of Law” program, or his partners.

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1. Introduction

The World Bank's Reports on Doing Business in 2004, in 2005 and in 2006 (the Reports) are aimed at providing business indicators for governments in formulating appropriate economic policy and designing reform. The indicators are measured by a hypothetical limited liability company emphasis more on small and medium sized enterprises². As the 2004 Report admits, the data generated from this simplistic model have limitations, for example, political economy of reform is not included in the study³. The author acknowledges the valuable observations and several advantages as offered by the model, but readers should study the report with a caution as to their degree of generalisation and bear in mind the simplicity of the model when employing the data in developing their own country's policy. Based on the indicators, the Reports have put forwarded various recommendations to improve a country's business environment.

China is popularly recognised as a potential huge market. Since China began its economic reform in 1978, it has achieved a steady and rapid growth with an average of 9 % GDP in the past two and half decades⁴. It was recently announced by the Chinese National Bureau of Statistics⁵ that the Chinese economy has expanded by 10.9% in the first half of 2006. Therefore, the Reports' proposals in relation to the successful story of the China economy should be closely

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² Report 2004, p 1.

³ Report 2004, p x.

⁴ Editor, 'Economic goals for 2006 outlined', Chinadaily Online, 2 December 2005, www.chinadaily.com.cn (visited on 4 December 2005)

⁵ Editor, 'Economy grows 10.9% in first half', Asia Times Online, www.atimes.com (visited on 22 July 2006)

examined. While the Reports are designed to encompass a broad discussion of doing business in all countries, the objective of this paper is to extend the discussion to a specific country, i.e. China. For analysis purposes, the 2004 Report is comprised of five topics: doing business, including starting a business; hiring and firing workers; enforcing a contract; getting credit; and closing a business, with an expansion to two more topics on 'removing obstacle to growth'⁶ and creating jobs⁷ in the later editions. The extended topics are still within the overall scope of the fundamental aspect of a firm's life cycle and this paper is focused on the last phase of a business cycle, i.e. closing a business.

To advance the business environment in a country, the Reports make proposals as to what needs to be reformed for an efficient closure of business. Since common proposals are made amongst the three reports, they are consolidated for the purposes of discussion. Broadly speaking, the Reports' propositions can be grouped into four main areas: choosing appropriate institutions; provision of expertise; involving stakeholders; and various bankruptcy mechanisms. In order to test the applicability of the 'one size fits all' approach⁸ as proposed by the Reports, these four areas of propositions are examined for their relevance and accuracy in relation to the recent bankruptcy reform in China, particularly from a legal perspective.

2. Why reform and what to reform?

The 2006 Report claims that 'easy exit means easy entry'⁹. By referring to one study, the 2006 Report concludes that 'reforms to encourage a fresh start have

⁶ The 2005 Report

⁷ The 2006 Report

⁸ The Report 2004, p. xvi.

⁹ The Report 2006, p71.

raised rates of entrepreneurship by 8-9%¹⁰. In order to reallocate capital to its full potential, the 2006 Report advocates that there be business freedom to fail and that exist from the market be effected through an efficient process. To achieve this aim, the Reports suggest various methods for transformation to an economically efficient bankruptcy system.

2.1. Appropriate institutions

2.1.1. Time, cost and recovery rate

It is generally believed that if the transaction costs are kept low and the system is quick, then the recovery will be as well¹¹. The Reports discussed the close correlation between the costs and time required for bankruptcy with the willingness of the business entity to utilize the bankruptcy system. They argue that 'if bankruptcy is expensive and drawn out, both the distressed companies and their creditors will avoid it'.¹² Data regarding the cost and length of time that a company needs in order to go through an insolvency process in various countries are found in the three Reports. As indicated in the 2004 Report, the duration for a bankruptcy process in China was 2.6 years¹³, and was 2.4 years in the 2005 and the 2006 Reports¹⁴. While the cost to go through insolvency rose from 18 % of the estate value¹⁵ to 22 %¹⁶, the recovery rate dropped from 35.2 %¹⁷ to 31.5 %¹⁸ (no data is available in 2004 Report). If the data in the three reports are accepted, the bankruptcy procedure in China takes much longer in practice than

¹⁰ Ibid.

¹¹ William B. Gamble, 'China, Bankruptcy, and the Dollar', International Assessment and Strategy Centre, 18 April 2005, http://www.strategycenter.net/research/pubID.70/pub_detail.asp (visited on 16 April 2006)

¹² The 2004 Report, p72.

¹³ The 2004 Report - 2.6 years, p141.

¹⁴ The 2005 Report, p 95 and the 2006 Report p107 - 2.4 years.

¹⁵ The 2004 Report, p 141; The 2005 Report, p 95.

¹⁶ The 2006 Report, p 107.

¹⁷ The 2005 Report, p95.

¹⁸ The 2006 Report, p107.

the timeframe prescribed in the legislation, i.e. approximately 9 months and 10 days from the time the court ruling accepting a bankruptcy petition is given¹⁹. Furthermore, the bankruptcy procedure is becoming more expensive, but less successful in recovery of assets. Nevertheless, such an unfavourable bankruptcy situation does not appear to be an obstacle, or at least not a major obstacle as the Reports alleged, for the economic growth in China. In 2004-2006, the GDP of China has increased from 10.1% to 10.9%, although one could comment that such an economic development may well be explained by many contributing factors.

2.1.2. Good regulatory environment

The 2004 Report argues that cumbersome regulation causes lower productivity, forcing business activity to grow in the informal rather than formal sector and increasing corruption²⁰. It claims that poor countries legislate the most and that the origin of a legal system also determines whether that country is heavily legislated. It alleges that 'common law countries regulated the least. Countries in the French civil law tradition the most'²¹. Such a claim may well be inconsistent with the reality in some common law countries. For example, Australia has often been criticised for her arduous business regulations²². The Australian Productivity Commission noted for example that there were 2380 federal regulations introduced in 2004-2005 and the federal government passed 172 bills in 2004 which was almost 13% more than previous year²³. Furthermore, in theory, the fact that those common law countries could have court precedent

¹⁹ Industry Watch, 'China's Proposed New Bankruptcy Law: The Practical Implications', PricewaterhouseCoopers, Hong Kong December 2004, p4, www.pwchk.com (visited on 5 May 2006)

²⁰ The 2004 Report, pxii.

²¹ The 2004 Report, pxiv.

²² Editor, 'Fed: Costello unveils changes to slash business red tape', CCH online, 15 August 2006. www.cch.com.au (visited on 17 August 2006)

²³ Editor, 'Fed: Canberra drowning the nation in regulations', CCH online, 31 October 2005. www.cch.com.au (visited on 2 November 2005)

as a major source of law should enable their Parliaments to legislate less. Civil law countries where legislation is their major source of law do not enjoy the same privilege. In addition, the conclusion that ‘cumbersome regulation is associated with lower productivity’²⁴ is questionable in the case of China. China has many layers of legislation, its enforcement system is notoriously recognized as inefficient and the degree of corruption is still the country’s major concern. Yet China economic growth has maintained a skyrocketing increase in the last few decades. Perhaps one could argue that had China have better quality law and enforcement institutions, its economic growth could exceed what it has achieved so far.

Though the 2004 Report criticises cumbersome regulation as a detriment to economic growth, it does not suggest zero regulation²⁵. Instead, the 2004 Report considers ‘the quality of business regulation and the institutions that enforce it are a major determinant of prosperity’²⁶. The 2005 Report has cited 9 countries which have successfully improved the recovery rate from bankruptcy through simplifying their existing laws²⁷. The legal reform includes reducing statutory deadlines on the duration of procedures, cutting routes for appeal, and flexible access of various proceedings²⁸. The 2004 and 2005 Reports suggestions coincide with the revisions recently made by the Chinese bankruptcy law (the New Bankruptcy Law)²⁹.

²⁴ The 2004 Report, pxii.

²⁵ The 2004 Report, pxv.

²⁶ The 2004 Report, pviii.

²⁷ The 2005 Report, p70.

²⁸ Ibid.

²⁹ Law of the People’s Republic of China on Enterprise Bankruptcy, adopted at the 23rd Meeting of the Standing Committee of the 10th National People’s Congress on 27th August 2006, and promulgated by Order No of 54 of the President of the People’s Republic of China on the 27th August 2006, effective 1 June 2007.

On 28 August 2006, China repealed current bankruptcy law which was passed in 1986³⁰. The New Bankruptcy Law will take effect on 1 June 2007. The new law has shortened the statutory timeframe and simplified the process. For example, instead of 10days³¹ as stipulated under the current law, a limitation period of 5 days has been prescribed for notification of a court's ruling in case of a successful bankruptcy petition by applicant³². The public announcement of a court's ruling is generally necessary³³, but the obligation is impliedly exempted for a court's ruling in rejecting a bankruptcy application by virtue of Art 12. In addition, an administrator appointment can be an individual³⁴ rather than a team as currently required. No doubt these provisions are to save costs, which could preserve more assets for repayment. The 2006 Report points out that the right of appeal has been misused as a common tactics for delaying a bankruptcy process³⁵. The current Chinese bankruptcy law is silent on the issue of appeal but the New Bankruptcy Law has filled the gap. In accordance with Art 12, appeal against the People's Court ruling refusing a bankruptcy petition must be lodged within 10 days after the ruling is notified. Setting a time constraint of 10 days, instead of 15 days as proposed in the draft legislation, the new legislation has demonstrated its effort to address the issue of sham appeals. Art 65 authorises a court to make decision on debtor's property management, bankruptcy property appraisal or bankruptcy assets distribution when creditors' meeting fail to pass resolution on the matters. Such judicial decision can be reviewed upon creditors' request³⁶. However, creditors must lodge their application within 15 days after receiving

³⁰ Law of the People's Republic of China on Enterprise Bankruptcy (For Trial Implementation) 1986, adopted at the 18th Meeting of the Standing Committee of the Sixth national People's Congress and promulgated by Order No of 45 of the President of the People's Republic of China on 2 December 1986, for trial implementation three full months after the Law on Industrial enterprises with Ownership by the Whole People comes into effect. (hereafter cited as The Trial Bankruptcy Law)

³¹ The Trial Bankruptcy Law, Article 9.

³² Article 11.

³³ For example, Article 14.

³⁴ Article 29.

³⁵ The 2006 Report, p 68.

³⁶ Article 66.

notification of the court's ruling, and the application would not stay the execution of the court decision. These two restrictive measures clearly indicate the New Bankruptcy Law is designed to ensure the efficient progression of the bankruptcy process. In addition, a variety of bankruptcy proceedings are also available in the New Bankruptcy Law including liquidation, conciliation and reorganisation. A new feature of the proceedings in the New Bankruptcy Law is the separation of conciliation³⁷ and reorganisation³⁸ mechanisms. The separate system is to address the sketchy provisions of the combined conciliation and reorganisation proceedings under Chapter IV of the current legislation.

The 2004 Report argues that the best method to evaluate the quality of a country's bankruptcy law is whether the stakeholders use it³⁹. The said Report cites as examples a number of countries which have high and low applications rates and conclude that this should be taken as a reflection of the efficiency of that country's insolvency legislation. While the 2004 Report's assertion might be correct in other countries, it is not an appropriate measure indicator for China. The current bankruptcy legislation in China was passed in 1986 and applicable to state-owned enterprises only. Bankruptcy of non-state-owned enterprises is governed by the brief provisions of Chapter 19 of the Civil Procedure Law of the People's Republic of China. Bankruptcy application for Chinese state-owned enterprises requires government approval. Such an application has not been easy to obtain because state-owned enterprises were the dominant business entities in the economy. There is a concern of the domino effect which might result to connected business in the case of bankruptcy of state-owned enterprises. The detrimental effect could extend further to the financial system when banks are the major creditors for the state-owned enterprises under government

³⁷ Chapter 9.

³⁸ Chapter 8.

³⁹ The 2004 Report, p 78.

instruction. Hence the low rate of usage of the bankruptcy legislation in China is⁴⁰ due to policy reason rather than the quality of the law itself.

The Chinese government has been aware of the need for a new bankruptcy law for the present changed economic structure, and this has led to the recent enactment of the current legislation. Whether the quality of the new Chinese bankruptcy law can be measured by its popularity of application, it is too early to say. But an increase in bankruptcy petitions from state-owned enterprises is predictable. It is because of this that around 2000 state-owned enterprises which have been scheduled by the State Council to undergo bankruptcy would be exempted till 2008 from the application of the new legislation⁴¹. In other words, those planned bankrupt state-owned enterprises will continue to receive government financial assistance⁴² and on bankruptcy will pay off workers first under old system. Other state-owned enterprises which announce bankruptcy before the new law go into operation in June 2007 will also be subject to the old legislation⁴³. Naturally, financial distressed state-owned enterprises will race to close down their business before they lose their aid of government bail out. This illustrates the fact that the quality of the bankruptcy law in China is not measured by the frequency of its application as the 2004 Report has alleged,

⁴⁰ 98 cases in 1989, 32 cases in 1990, 117 cases in 1991, 428 cases in 1992, and 478 cases in 1993. Sourced from Booth, Charles, 'Drafting Bankruptcy Laws in Socialist Market Economies: Recent Developments in China and Vietnam', Columbia Journal of Asian Law, Vol 18, Issue 1, 2004, pp93-147, at p 95.

⁴¹ Article 133. Setting an exemption period for the 2116 state-owned enterprises is because the State Council had planned for their closing down before the passage of the new legislation. (Sourced from Zhou, Scott, 'Foreign credit crack China's 'iron rice bowl'', AsiaTimes Online, 2 September 2006. http://www.atime.com/atimes/China_Business?H102Cb02.html (visited on 3 September 2006)

⁴² In 2006, the State Council has set aside Rmb 33.8 billion to assist bankrupt state-owned enterprises to settle with their workers' claims. Sourced from Editor, 'China's legislature adopts corporate bankruptcy law', People's Daily Online, 28 August 2006, http://english.people.com.cn/200608/27/eng20060827_297276.html (visited on 3 September 2006)

⁴³ Dexter, Roberts, 'China's New Mantra: Creditors First', BusinessWeek Online, 31 August 2006, http://news.yahoo.com/s/bw20060831/bs_bw/gb20060830421789&printer=1 (visited on 3 September 2006)

because policy reasons are the controlling factor behind bankruptcy petitions in the country.

No doubt, an efficient legislation will enhance recovery rate of bankruptcy. It is difficult to comment on the success of the New Bankruptcy Law in achieving this objective before the legislation takes effect. Nevertheless, an issue worth noting is assessment of recovery rate is often based on the value of the bankrupt's estate. However, obtaining an accurate evaluation of the bankrupt's asset is difficult in China. The unsound accounting system and the common practice of keeping two account books are the two main culprits. Furthermore, under the current law, workers have the priority right to repayments which consequently has a negative impact on the recovery rate of creditors. Because of the serious social repercussion of bankruptcy, outstanding wages and salaries used to have the first claim over assets although this superior priority has been changed under the New Bankruptcy Law⁴⁴. In addition, the property rights in bankrupt assets remain ambiguous and this is partly due to the fact that the property law system is still in its development stage.

2.2. Provision of expertise

2.2.1. Judiciary

In addition to legislative developments, the 2004 Report comments that the necessary expertise is a prerequisite for an efficient bankruptcy regime⁴⁵. The same report claims that experienced judges would improve court procedure and that is the reason why widespread judicial training in commercial litigation is conducted around the world⁴⁶. The training includes accounting and business

⁴⁴ Article 109 - creditors with guarantee credit will take priority over workers entitlement.

⁴⁵ The 2004 Report, p 72.

⁴⁶ The 2004 Report, p 81.

courses⁴⁷. The 2005 Report also cites some countries which have strengthened their judicial expertise by appointing judges with business experience acquired through training as in Germany, working in-house with corporations as in the United States, or running their own firms as in France⁴⁸. The Report further claims that countries that value judges' business experience have a 10% higher recovery rate⁴⁹. A brief review of the biography⁵⁰ of judiciary at the Federal Court⁵¹ in Australia indicates that most of them have impressively strong legal background but, with respect, are thin on actual business experience apart from the acknowledge that they acquired through legal practice. However, the Report⁵² illustrates that the recovery rate of bankruptcy in Australia (79.7%) is ahead of the United States (77.0%), Germany (53.1%) and France (48.0%). Thus, the contradicting finding on Australian judges' business experience in relation to bankruptcy recovery rate evident another unsubstantiated comment which has weakened the creditability of the Reports.

While the Report's recommendation in improving bankruptcy judge proficiency is generally relevant to China, China may not be able to adopt it straight away. Due to political turbulences in the country from 1966 to 1976, laws and legal profession were almost non-existing in China⁵³. Legal profession only returns to China in 1979⁵⁴. This means that there is a limited number of qualify lawyers or

⁴⁷ The 2004 Report, p 81.

⁴⁸ The 2005 Report, p 72.

⁴⁹ The 2005 Report, p 72.

⁵⁰ Comment is based on the data available on the Federal court websites. www.federalcourt.gov.au (visited on 28 September 2006)

⁵¹ Federal court is the court vested with bankruptcy jurisdiction in Australia.

⁵² Doing Business benchmarking business regulations <http://www.doingbusiness.org/ExploreTopics/ClosingBusiness/Default.aspx?direction=asc&sort=3> (visited on 29 September 2006)

⁵³ The Congressional-Executive Commission on China <http://www.cecc.gov/pages/virtualAcad/rol/legalprof.php>

⁵⁴ Xiao, Hongming, 'Legal Profession in China: Past, Present and Future', Perspectives, online edition, vol 1, no. 4, 2000, http://www.oycf.org/perspectives/4_022900/legal_profession_in_china.htm (visited on 1 October 2006)

judges, let alone the attribute of strong commercial experience. In addition, civil servants in China are prohibited from engaging in commercial activities. Therefore, recruiting judges with business knowledge or expecting judges to acquire commercial experience through running their own firms as in France is very difficult. Furthermore, the Reports recommendation may help China to build up the quantity of its judicial expertise but not necessary increase the efficiency in bankruptcy proceedings. The impediment in China is not only the shortage of relevant judicial expertise but also lack of entire judicial independence. Though Chinese judges are required to play a major role in the substantial and procedural parts of a bankruptcy proceeding, their roles are often hampered by potential government interference. Government intervention in execution of court order is not an uncommon phenomenon in China. Art 313 of the Criminal Law of the People's Republic of China⁵⁵ responses to the issue by imposing jail term, detention and fine on people who are capable but refuses to execute a court's ruling if the circumstance is serious. 'Serious circumstance' is interpreted by the Standing Committee of the National People's Congress, as included conspiracy between respondent, guarantor, or executor's assistant with government officers who misuse their positions in obstructing execution of court's ruling and consequently cause the court's ruling fails to implement⁵⁶. The absence of entire judicial independence in China is firstly due to court reliance on the financial support from local government. Therefore, Chinese judges hesitate to discount local government concerns for the sake of justice if the decision may give rise to such interests. Furthermore, Art 128 of the Constitution⁵⁷ obliges

⁵⁵ Criminal Law of the People's Republic of China. Adopted at the Second Session of the Fifth National People's Congress on 1 July 1979, revised at the Fifth Session of the Eight National People's Congress on 14 March 1997, and promulgated by Order No. 83 of the President of the People's Republic of China on 14 March 1997.

⁵⁶ Interpretation by the Standing Committee of the National People's Congress Regarding Article 313 of the Criminal Law of the People's Republic of China. Adopted at the Twenty-nine meeting of the Ninth Standing Committee of the National People's Congress on 29 August 2002.

⁵⁷ Constitution of the People's Republic of China. Adopted at the Fifth Session of the Fifth National People's Congress and promulgated for implementation by the Announcement of the

local courts to be responsible to local governments which created them. Thus, when creditors are coming from different municipalities, giving a fair treatment to all of them could be a challenge for the court. Secondly, cooperation and assistance are required from local government in executing a bankruptcy case. For instance, local government help is often sought in determining land use rights or deciding on workers' settlement in a bankruptcy case⁵⁸. Finally, due to the dominant⁵⁹ position of State-owned enterprises in Chinese economy, government authorities traditionally took control in bankruptcy matters. Apart from that, the supervisory function of a court has limited judicial autonomy in China. Chinese judges are obliged to get advice from a superior court with respect to complicated legal issues⁶⁰, which often means cases which are politically difficult to handle. The proposition that 'issues not covered sufficiently in the law are decided swiftly in the (judicial) profession'⁶¹ is not applicable in the case of China. Besides, some Chinese judges may be daunted by the personal responsibility arising from a controversial decision and are consequently more inclined to look for the advice of a superior. Thus, simply strengthening the judicial expertise alone without freeing judges from political and administrative

National People's Congress on December 4, 1982. Amended in accordance with the Amendments to the Constitution of the People's Republic of China adopted respectively at the First Session of the Seventh National People's Congress on April 12, 1988, the First Session of the Eighth National People's Congress on March 29, 1993, the Second Session of the Ninth National People's Congress on March 15, 1999 and the Second Session of the Tenth National People's Congress on March 14, 2004. Article 128 states that the Supreme People's Court is responsible to the National People's Congress and its Standing Committee. Local people's courts at various levels are responsible to the organs of state power which created them.

⁵⁸ Booth, Charles and Zhang, Xian Chu, 'Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience', *Columbia Journal of Asian Law*, vol. 15, no. 1, fall 2001, pp1-33, at p11. (hereafter cited as Booth and Zhang)

⁵⁹ The dominant position has changed since the state owned enterprises reform begins in 1980's.

⁶⁰ Chinese judges are subjected to multiple layers of supervision by virtue of Article 6 of the Constitution, Chapter V of the Criminal Procedure Law of the People's Republic of China 1980, and Chapter XVI of the Civil Procedure Law of the People's Republic of China 1991. For detail discussion of the supervision of Chinese judiciary, see Xin, Chun Ying, 'What kind of judicial power does China need?', *International Journal of Constitutional Law*, New York University, vol. 1, no. 1, 2003 pp58-78.

⁶¹ The 2004 Report, p 81.

interference would not achieve the efficiency of bankruptcy proceedings as the Reports allege⁶².

2.2.2. Specialised courts

In enhancing bankruptcy efficiency the 2004 Report advocates the establishment of specialized courts. The 2005 Report further suggests that a specialized court could be a specific section within a general court whose personnel are devoted entirely to bankruptcy cases⁶³. In 1993 China established a specialized bankruptcy court in Shenzhen. To some extent, the Shenzhen bankruptcy court has endorsed the 2004 Report's claim that a specialty court is a vehicle for growing expertise. However, due to a number of unresolved issues⁶⁴ embedded in Chinese bankruptcy regime, the said court does not improve bankruptcy efficiency noticeably. From 1995 to 1998, only 316 cases⁶⁵ were accepted by the Shenzhen bankruptcy court and the average recovery rate was less than 10%⁶⁶. Thus, setting up a specialized court without the support of necessary institutions would not be a panacea for achieving an effective bankruptcy regime, at least in the case of China⁶⁷.

2.2.3. Administrator

The reference to bankruptcy expertises in the 2004 Report applies to both judges and administrators. Administrators are regarded as major manager of a

⁶² Wang, Weiguo, 'Strengthening Judicial Expertise in Bankruptcy Proceedings in China', Forum for Asian Insolvency Reform, *Insolvency Reform in Asia: An Assessment of the Recent Developments and the Role of Judiciary*, Bail – Indonesia, 7-8 February 2001, OECD 2001, p 1-4, at p 2. www.oecd.org/dataoecd/8/24/1874188.pdf (hereafter cited as Wang 2001)

⁶³ The 2005 Report, p 72

⁶⁴ For detail discussion, see Booth and Zhang.

⁶⁵ Booth and Zhang, p 9.

⁶⁶ Booth and Zhang, p 10.

⁶⁷ *Ibid*, p 32.

distressed business and therefore, it is necessary to assure their basic qualifications and competency through a system of some kind, such as a license system⁶⁸. The 2005 Report notes the shortage of relevant professions and suggests extending the eligibility list to individual experts as well as legal entities⁶⁹ for the administering of bankrupt estate. Art 24 of the New Bankruptcy Law concurs with this suggestion and allows administrator to be appointed from a collection of insolvency practitioners ranging from intermediary institutions, like accounting firms, law firms or auditing firms, to individuals who are qualified to practice in their professions. Furthermore, an individual who accepts the position of administrator is required to take out insurance for professional liability. Art 24 demonstrates China's awareness of the growing demand for insolvency professions in the new bankruptcy era and an administrator's significant responsibility in managing bankruptcy property.

2.3. Involving stakeholders

2.3.1. Creditors

With respect to management of the bankruptcy proceedings, the 2004 Report is heavily weighted in the creditor's favour. It suggests that creditors should take control of the process rather than letting the court to make business decisions⁷⁰. It regards expanding court power as counter-productive for bankruptcy efficiency since court power is associated with a level of corruption⁷¹. This conclusion is questionable as the data⁷² provided in the Report does not seem relating to the

⁶⁸ The 2004 Report, p 82.

⁶⁹ The 2005 Report, p 72.

⁷⁰ The 2004 Report, p 81.

⁷¹ The 2004 Report, p 78.

⁷² Figure 2 of the 2004 Report relates heavy regulation with informality and corruption; whereas Figure 6.5 of the same Report links court power with the goals of insolvency.

issue of court power and corruption. Besides, court power can be checked and balanced by the doctrine of separation of power, which was formulated by the French philosopher Montesquieu. The Report also proposes that creditors should be empowered to remove judicial appointed administrators because ‘countries where creditors have a say in appointment and replacement have bankruptcy procedures that are significantly cheaper and more efficient in achieving the right outcome’⁷³. It further suggests administrators should report on their work to creditors only. The importance of the active involvement of creditor in the preparation and adoption of bankruptcy plan is evident throughout the 2004 Report. In addition, the 2006 Report recommends the setting up of creditors’ committees to advise administrators and concludes that increasing the influence of creditors would raise the recovery rate as this would align the actions of administrators with creditors’ incentive to rescues viable businesses and close down unviable businesses⁷⁴. Essentially, the 2004 and 2006 Reports advocate giving creditors almost complete power and control over the bankruptcy process. Since there are different stakeholders’ interests in a bankruptcy, the Reports then again fail to explain how the various interests could be safeguarded and why increasing creditors’ power would not lead to corruption like court.

In relation to the question of control of the bankruptcy process, Chinese legislators do not agree with what the Reports have proposed. Under the New Bankruptcy Law, the court still plays a dominant role in bankruptcy proceedings. The court is given exclusive power to appoint an administrator⁷⁵ and to accept its resignation⁷⁶. If an administrator fails in its duty, the creditors’ committee has to apply to court for a replacement⁷⁷. Though the administrator is subject to the

⁷³ The 2004 Report, p 81.

⁷⁴ The 2006 Report, p 70.

⁷⁵ Article 22

⁷⁶ Article 29

⁷⁷ Article 22 and Article 61(2)

supervision of a creditors' committee, it has to report its work to the court as well as to the creditors' committee⁷⁸. The duties and functions of an administrator are specified in Art 25 and a list of activities of which the administrator is obliged to inform the creditors' committee is found in Art 69. Professor Wang, a renowned scholar in Chinese bankruptcy law, explains that the underdeveloped professional expertise in the country is the main reason why administrator has not been given discretionary power while entrusted with great deal of administration task⁷⁹.

Professor Booth takes the view that an active creditors' committee would enhance the proficiency and legal compliance of administrators⁸⁰. Professor Booth's assertion is absolutely correct in principle, but in China an administrator does require court support in dealing with the complex bankruptcy situation. The elements which contribute to the complexity include the possibility of political interference⁸¹, administrative meddling and the tricky issue of local protectionism⁸². As noted above, even the Chinese courts may find it difficult to deal adequately with some of these issues. Furthermore, potential conflict between creditors does need court intervention to resolve the deadlock⁸³.

⁷⁸ Article 23

⁷⁹ Wang Weiguo, 'Institutional Reasoning in New Bankruptcy Law of China', Asian Institute of Financial Law, Hong Kong University, Chinese Insolvency Symposium 17-18 November, 2000, pp1-21, at p 4. <http://law.hku.hk/aiifl/events/symposium/papers/wang%20weiguo.doc>. (hereafter cited as Wang)

⁸⁰ Booth, Charles, 'New Bankruptcy Laws in Socialist Market Economics: Recent Developments in China and Vietnam', Columbia Journal of Asian Law, Vol 18, Issue 1, 2004, pp 93-147, at p 119.

⁸¹ Cheng, Mu Long, 'Report in relation to the investigation of incomplete bankruptcy cases', Chinalawinfo website, 20 May 2006 http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=32884 (visited on 14 July 2006)

⁸² In the Explanatory note of 'the Draft Interpretation by the Standing Committee of the National People's Congress Regarding Article 313 of the Criminal Law of the People's Republic of China', Wu Hong Sang, the deputy director of the Legal Committee of National People's Congress Standing Committee, commented that Art 313 should stipulate legal liability for government officials who abused their authority for the purpose of local protectionism and obstructed the execution of court order. <http://www.npc.gov.cn>

⁸³ Article 65.

Therefore, extensive court involvement in bankruptcy process does not necessarily block the bankruptcy process (at a minimum) and perhaps accelerates it.

In view of the fact that Chinese courts are restricted by their lack of business experience and knowledge from playing an exclusive part in supervision, the New Bankruptcy Law has left the daily management of a bankruptcy process to an administrator, entrusted supervision to the creditors' committee, and empowered the court to step in for any major dispute. Therefore, a collective approach rather than a creditor-oriented method as suggested by the Reports seems best suited to fill the requirements of an efficient bankruptcy management in China.

The 2004 Report links positively the power of creditors with the rate of recovery and publishes statistical evidence in the 2006 Report⁸⁴ to substantiate its claims. A breakthrough of the New Bankruptcy Law is to lift creditors' status in a bankruptcy procedure. Secured creditors under the new law will have a better prospect of recovery. Instead of ranking after workers' entitlements as at present, secured creditors will be paid first when the new law comes into effect on 1 June 2007⁸⁵.

The New Bankruptcy Law has also introduced a system of creditors' committee to strengthen creditors' rights. The introduction of creditors' committee has been applauded as China's recognition of creditors' contribution in bankruptcy proceedings. Art 68 of the New Bankruptcy Law stipulates the jurisdiction of a creditors' committee. It includes supervising the management and disposal of debtor assets; supervising the distribution of bankrupt assets; initiate

⁸⁴ The 2006 Report, p 70.

⁸⁵ Articles 132, 113 and 109.

summoning the creditors meeting; and performing other duty as entrusted by the creditors' meeting. As mentioned above, Art 69 imposes on the administrator an obligation to report to the creditors' committee when it engages in any activity specified by the provision. Such an obligation should reinforce the protection of creditors' interests in the bankrupt property. Indisputably, giving more power to creditors or its committee, who have great vested interests in the bankruptcy process, would improve the recovery amount. However, a successful recovery rate of bankruptcy in China is affected by the many factors, in addition to those which have previously discussed.

Firstly, a comprehensive registration system for property⁸⁶ is not yet available in China. This lack will pose difficulties for an administrator in working out the distressed loans, collecting the assets of the bankrupt estate, and redistributing them. Bankrupt properties may be subjected to multiple pledges or may be partly State-owned, especially when the assets include land use rights, State assets or assets transferred from the State sector at some time in the past. Secondly, the absence of a standard appraisal system for bankrupt assets and its associate stigma may make the property not easy to realise⁸⁷. Thirdly, local protectionism is still likely to create impediments for administrators trying to execute their duty of repayment smoothly. It is not difficult to find cases where dismayed creditors are left with considerable losses even though they have gone through the proper bankruptcy process⁸⁸ because of protection activities by local

⁸⁶ Editor, 'New Bankruptcy Law has tabled in legislative agenda', National People's Congress Website, 21 June 2004, pp 1-3. <http://www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXZLK&id=330988&pdmc=110106>

⁸⁷ Li, Shuguang, 'Bankruptcy Law in China: Lessons for the Past Twelve Years', Harvard Asia Quarterly, Vol 1, No 1, Winter 2001, pp 1-23, at p 10. <http://www.asiaquarterly.com/content/view/95/40> (visited on 16 April 2006)

Qi, DuoJun, 'Studies of Bankruptcy Law in Mainland China', <http://www.rjmacau.com/english/rjm1996n3/bank-jin.html> (visited on 23 March 2006)

⁸⁸ The Guangdong International Trust and Investment Corporation 1999. Case reported by Hilken, Daniel, 'Rotten system will still persist, say lawyer', The Standard, 14 February 2005. <http://www.thestandard.com.hk/stdn/std/others/print.htm> (visited on 29 July 2006)

government. Fourthly, fraudulent bankruptcy is commonly used by some unethical enterprises to evade debts. To counter sham bankruptcy or attempt defeat of creditors' claims, the New Bankruptcy Law has extended the relation back date from 6 months under the current law to 12 months. By virtue of Art 31, the administrator is allowed to petition the court for rescission of irregular transfers or transactions in debtor's property that take place in the 12 months immediately preceding the court's acceptance of the bankruptcy petition. Art 33(1) has explicitly voided against the administrator any transfer or hidden of debtor's property for the purpose of debt evasion. Art 34 further empowers the administrator to trace debtor's property from people who obtain those properties through the irregular activities proscribed by preceding provisions. Chinese government has made corresponding change in the Criminal Law to combat fraudulent bankruptcy. Art 162(2) of the Amended Criminal Law⁸⁹ imposes a fixed term imprisonment of not more than 5 years or criminal detention, and/or fine for not less than Rmb 20,000 but not more than Rmb 200,000 on person who are directly or indirectly in charge of a company or legal entity, which through concealment of property, approval of fabricate debt, transference or disposition of assets for the purpose of fraudulent bankruptcy, has caused severely damage to the interests of creditors or other people. Finally, as previously mentioned, Chinese employees have preferred rights over the assets of the bankruptcy estate. In China, employee's entitlements include wage or salary as well as other fringe benefits such as medical expenses, disability supplementary benefit, insurance, housing, nursery, education, pension etc, especially if the employees come from a state-owned enterprise. Under the current law, employees have the first priority of claim in bankruptcy proceedings. Though this order of priority is going to change next year, currently, recovery rate in China is not on a par with the power

⁸⁹ Amendment VI to the Criminal Law of the People's Republic of China, adopted at the 22nd Meeting of the Standing Committee of the Tenth National People's Congress on 29 June 2006 and promulgated by Order No. 51 of the President of the People's Republic of China on 29 June 2006.

of creditors but rather depends on what is remain for distribution after the preferential debt owed to workers and other debts such as administration fee, cost and tax, are fully discharged. Therefore, a cursory assertion that a high level of involvement of creditors could in and of itself increase a successful recovery rate is clearly not appropriate to the intricacy of bankruptcy situations in China.

2.3.2. Employees

The 2004 Report has acknowledged the importance of involving creditors and other stakeholders in the bankruptcy process⁹⁰, but the subsequent discussion in the report focuses solely on creditors⁹¹ with no mention of other stakeholders, such as workers. Employees are major stakeholders in the bankruptcy of an enterprise, particularly in China where social and welfare payments have traditionally been provided by the enterprise. In line with the norms of a market economy, the New Bankruptcy Law has put secured creditors' claim ahead of workers'⁹². Certainly, secured creditors will be in a better position to recover their loans. While removing worker's superior preference to repayment, the New Bankruptcy Law emphasises⁹³ court's obligation in safeguarding workers' rights in bankruptcy. The new legislation also gives workers the right to have a representative participating in the creditors' meeting, to comment on relevant matters⁹⁴, and to be a member of the creditors' committee⁹⁵. These workers' privileges substantiate Jia Zhijie's⁹⁶ comment that the new law is designed to protect all stakeholders in a bankruptcy, including both creditors and workers. They also endorse the 2004 Report's recognition of the value in involving

⁹⁰ The 2004 Report, p 78.

⁹¹ The 2004 Report, p 81, and The 2006 Report, p 70.

⁹² Article 109, 113 and 132.

⁹³ Article 6.

⁹⁴ Article 59.

⁹⁵ Article 67.

⁹⁶ Member of National Peoples' Congress Standing Committee.

stakeholders, although they extend workers' role in the operation of bankruptcy proceedings which is necessary in China.

2.4. Various bankruptcy mechanisms

The 2006 Report claims that an inefficient bankruptcy approach is detrimental to viable business. It considered that reorganisation as a method of dealing with corporate collapse is a failure whereas foreclosures and liquidations can save viable firms⁹⁷. The Report cites a number of countries where it considers that reorganization has been failed and goes on to praise the success of the practice of foreclosures and liquidations in other countries⁹⁸. The reasoning and methodology behind this rather sweeping conclusion are not made clear in the Report.

2.4.1. Reorganisation

China has taken a very different view of reorganisation mechanism as the country has many financially unhealthy enterprises and the government appears to feel that it cannot afford to let them all go bankrupt⁹⁹. Thus, reorganisation is a powerful mechanism in preventing the Chinese enterprises from bankruptcy. Chinese scholars regard the process of reorganisation as consistent with the international trend of shifting the focus of bankruptcy law from debt liquidation to business rehabilitation¹⁰⁰.

⁹⁷ The 2006 Report, pp 69-70.

⁹⁸ The 2006 Report, p 70.

⁹⁹ Wang, at p 9.

¹⁰⁰ Ibid

Reorganisation procedure is new in the New Bankruptcy Law. It is because under the current law, reorganisation is combined with the process of conciliation and has little as well as fragmentary governing provisions. In acknowledging the decision to retain a reorganisation procedure in the Chinese bankruptcy system, the New Bankruptcy Law separates reorganisation mechanism from conciliation and instituted a separate chapter for each of them. Chapter VIII, which is comprised of 25 Articles, set out the application for reorganisation, formulation of reorganisation plan and approval, and execution of reorganisation plan. In order to encourage financially distressed enterprises in using reorganisation as a means of corporate rescue, Art 2 lay down broad criteria upon which insolvent enterprises could apply for reorganisation. At the same time creditors, debtors and investors are all eligible to apply by virtue of Art 70. Various ballot procedures are introduced to facilitate the adoption of a reorganisation plan¹⁰¹. If the procedures fail, administrator or debtor can apply for judicial approval of the reorganisation plan provided the court is satisfied with the fulfillment of the conditions specified in Art 87. Nevertheless the new reorganisation provisions are not without ambiguity. In addition to the broad prerequisite for reorganisation application which needs to be elaborated, the circumstances pursuant to which the court's permission would be given to a debtor in continuing its management under reorganisation are not made clear under Art 73.

Despite some ambiguity of reorganisation provisions for reorganisation, the reorganisation mechanism still has an important role to play in Chinese bankruptcy. One major concern of bankruptcy aftermath in China is the possibility of social unrest due to the widespread lay off of workers, loss of national and local revenue, and a similar effect on connected business entities.

¹⁰¹ Articles 82, 84, 85,86, and 87.

These undesirable social repercussions¹⁰² stem from the facts that social welfare system in China is still at its stage of infancy and that there is often still a close business relation between companies and state-owned enterprises. As An Jian¹⁰³ comments 'This (reorganisation) will help to avoid social ramifications as result of liquidation such as unemployment and loss of social wealth'¹⁰⁴.

Furthermore, Chinese scholars identify three important values for corporate rescues¹⁰⁵. They believe that a company's assets will be worth more as a going concern than through realisation. They also believe there is a mutual benefit for creditors and debtors if they revive an enterprise through reorganisation, and they consider that creditors could recover more of their loss from a reorganisation scheme than by letting the financial distressed enterprise go into liquidation. Chinese scholars appreciate the value of taking a fair and equitable approach for all stakeholders instead of appeasing some creditors by liquidation. In view of China's positive attitude toward reorganisation, a simple statement that reorganisation approach does not work in any circumstances and other mechanisms do without taking into account of the specific country's situation is debatable, at least in the case of China.

2.4.2. Conciliation

China is in favour of corporate rehabilitation than exist. Chapter IX of the New Bankruptcy Law endeavours to help poorly performing enterprises to redeem

¹⁰² Jingzhou, Tao, 'China is Ready for a New Bankruptcy Law', Hong Kong Lawyer, April 2005, p 39.

¹⁰³ The vice chairman of the legislative affairs committee of the Standing Committee of the National People's Congress.

¹⁰⁴ Wu, J.R. and Winning, D. 'Update: China Bankruptcy Law Takes Effect June 1 Next Year', Dow Jones Revisedwires, www.morningstar.com/Revised/DJ/M08/D27/200608270743DOWJONES (visited on 3 September 2006).

¹⁰⁵ Wang, at p 9.

themselves from financial difficulty. By means of agreement reached between creditors, the conciliation seeks to preserve the enterprise. Measure for unsecured creditors is included in Chapter IX in order to prevent fraudulent conciliation or failure in execution of a conciliation agreement. Art 103 requires a court to void a conciliation agreement which is reached by deception or illegal conduct of debtors. Repayments to unsecured creditors, however, would survive the annulled agreement and restoration is not required. When a debtor fails or refuses to carry out a conciliation agreement, upon the application of the unsecured creditors the court could stay its execution and declare the debtor bankrupt. The termination would nullify the unsecured creditors' undertakings relating to the adjustment of their rights. Any repayment received during the execution of the agreement would remain valid, and outstanding conciliation rights would be converted to rights under liquidation¹⁰⁶. It is clear from the safeguard provisions in Chapter IX that as a matter of policy Chinese legislators are seeking to persuade creditors to opt for corporate rehabilitation before seeking bankruptcy.

3. Conclusion

The 2004, 2005 and 2006 Reports have provided informative data for countries which would like to consider restructuring their bankruptcy regime. No doubt, the Reports are 'collaborative effort' of a pool of leading experts from the academic and profession communities and public sector¹⁰⁷. It is generally known that any model designed for measuring various outcomes does have its limitations and there is no exception in terms of the model employed in the Reports – i.e. a model based on hypothetical, domestic, small and medium sized

¹⁰⁶ Article 104.

¹⁰⁷ The 2004 Report, p ix.

companies. While the author is not in the position to comment on the appropriateness of this empirical study¹⁰⁸, the author is not comfortable with the generalization of the hypothesis where a limited liability company¹⁰⁹ is assumed to be the appropriate model in all circumstances and suggested it to be the point of reference for measuring other types of business structures¹¹⁰. The Reports have also made a number of relatively sweeping recommendations for all the countries on the basis of the data. However, while the data and the use of it made by the Reports might be useful for one country, it might not be applicable in another. Countries have varied and distinctive circumstances, thus the 'one size fits all' model advocated by the Reports is not suitable in all circumstances and this has been proved in the case of China.

China's legal reform is based on the 'yang wei zhong yong' approach (adapting Western ideas into a Chinese framework). This is strongly evident in the New Bankruptcy Law where foreign experience has been considered¹¹¹ and international standards¹¹² have to some extent been adopted. For example, reorganisation mechanism in the New Bankruptcy Law which is similar to Chapter 11 of the US Bankruptcy Code¹¹³ is praised as 'filling a gap in the China's market economy legal infrastructure'¹¹⁴. Nevertheless, the adoption has been modified to tie in with the complex situation in China. The modification approach was recorded in the legislative transcript for the passage of the new

¹⁰⁸ Comprehensive analysis of the empirical approach adopted in the Reports can be found in Working Paper AED-2006-1 Version 4 "Methodological limits of 'Doing Business' Reports" by Bertrand du Marais.

¹⁰⁹ Report 2004, p 3.

¹¹⁰ Ibid.

¹¹¹ Wang, at p 18.

¹¹² Ibid

¹¹³ Sourced from Kevin Fisher, 'Bankruptcy Reform: China a Safer Bet', White & Case, www.whitecase.com/publications/detail.aspx?publication=420 (visited on 16 April 2006)

¹¹⁴ Fuxiang, Wang, 'The Structure of the New Enterprise Bankruptcy Law after the Second deliberation and the Relevant Controversial Issues', King & Wood China Bulletin, October 2005, p3. www.kingandwood.com

bankruptcy law. As noted in the transcript dated 21 June 2004¹¹⁵, the underlying directives for the draft bankruptcy law were to meet the requirement of establishing a socialist market economy, to fulfill the accession obligation under the World Trade Organization agreements, to match the international experience with the overall circumstance of the country, and to reflect the current need of the country as well as to address the real issues. Professor Wang cites¹¹⁶ further examples of employing ‘yang wei zhong yong’ approach in dealing with managers’ business ethics of the bankrupt enterprises in China. Professor Wang explains how the new legislation customized on but distinguished from the American model in addressing the issue. The new law has added a supervisory mechanism into the process of reorganization and allowed administrators to monitor debtors’ property when the debtors are permitted to continue with the management of their own business¹¹⁷. In addition, the administrator’s power of tracing has extended it reaches to irregular income and encroaching property which obtained by managerial staff through abuse of their authority¹¹⁸. Professor Wang comments that this power of property tracing does possess special Chinese characteristic because misuse of managerial position and misappropriation of enterprise fund by directors, managers and other senior staff are common phenomenon in the country.

Undoubtedly, the new legislation, which is responsive to the calls from commercial sectors in strengthening creditors’ right, is a ‘Great Leap Forward’ for the bankruptcy legal regime in the Chinese socialist market economy. Though it is too early to comment on the efficiency of the new legislation before its

¹¹⁵ Interpretation by the Standing Committee of the National People’s Congress Regarding the Law of the People’s Republic of China on Enterprise Bankruptcy (Draft), for the Tenth Session of the Standing Committee of the Tenth National People’s Congress, 21 June 2004.

¹¹⁶ Wang, Weiguo, ‘The Draft New Bankruptcy Law and Corporate Governance’, Civillaw website, 29 October 2005. www.civillaw.com.cn/weizhang/default.asp?id=22929 (visited on 25 September 2006)

¹¹⁷ Articles 73 and 74.

¹¹⁸ Article 36.

implementation, the New Chinese Bankruptcy Law provides this paper a timely example to test the applicability of the Reports in regarding bankruptcy reform. The above discussion has validated the author's concern of the generalization the Reports. For instance, the Reports' sweeping statement that cumbersome regulation is associated with lower productivity does not consistent with the rapid economic growth in China. Another comment on the application rate of a country's insolvency legislation as a reflection of the efficiency the legislation has failed to take into account of the restriction in Chinese insolvency legislation which only applies to state owed enterprises because of government's policy on bankruptcy. Further remark that some countries, especially the French-legal-origin jurisdictions in Africa, which expanded court powers in bankruptcy proceedings did not achieve the desired goals¹¹⁹ has proved to be a contrary situation in China. Chinese courts still have to play a significant role in bankruptcy proceedings owing to its unique domestic circumstances. With respect to the criticism of reorganisation as a bad bankruptcy mechanism, the opposite is true in China. By reason of the potential economy displacement associated with bankruptcies, China strongly prefer continuous operation of viable business. Finally, the comment on judges' business experience links with recovery rate in bankruptcy is conflicted to the case not only in China but also in Australia.

Perfecting Chinese bankruptcy regime requires more than amending the law. Corresponding changes in legal, social and economic infrastructures are of equal importance. China has been very responsive in addressing the issues. For instance, in strengthening judicial competency to deal with cases of corporate insolvency, there is a need for Chinese judges to acquire a wider knowledge and appreciation of commercial and corporate affairs. Learning from their peers in other countries has been part of the Chinese judiciary on-going education and

¹¹⁹ The 2004 Report, p 78.

training. In July 2006, a delegation from the Shenzhen Intermediate court, where the sole special court for bankruptcy is located, visited the District court of New South Wales, in Sydney, Australia. The delegation underwent a three-days training program focusing on Australian property law and guarantee law. Furthermore, in early July this year, a mutual understanding for a joint legal professional development program was signed between China and Australia under which up to four Chinese lawyers will come for a 23-week of study tour in Australia of the Australian legal professional regulation and policy development. These demonstrate some of the Chinese government's effort in strengthening the judiciary for the new legal environment of business.

In addition, reform of pension system is undergoing major change. Restructuring the pension system is of particular necessary when Chinese economy is becoming more market oriented. The old feature of planned economy which requires work unit to provide its employees with accommodation, education, medical care and annuity will soon become part of the Chinese employment history. Hence, a new system of pension is required to take over the role of safeguarding role workers' welfare after their retirement. In order to fortify the property rights system, a draft property right law has been tabled in the legislative agenda of 2006¹²⁰, and it is anticipated that the draft will receive approval from the National People's Congress in this forthcoming round of discussions.

Adaptation of other country's experience and practice is more than a simple transplantation process. Relevant modification is mandatory to suit the special needs of the adopting country. And that is the approach of 'yang wei zhong yong' which China has been applying for her reform. Promulgation of a new

¹²⁰ Editor, 'The property law will enter into its fifth parliamentary debate', Singtao Online, 17 August 2006, http://www.singtao.com/china/news_detail.asp?sid=173695 (visited on 17 August 2006)

bankruptcy law is just part of the overall bankruptcy reform in China. Corresponding changes in economic and social infrastructure are required and undergoing. It is going to be a 'Long March' for China to achieve an effective bankruptcy system in a market oriented economy. Nevertheless, the country is marching at the right direction.

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