Insolvency Law and Reform in the People's Republic of China

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INSOLVENCY LAW AND REFORM IN THE PEOPLE’S REPUBLIC OF CHINA

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INTRODUCTION

THE People’s Republic of China is seeking to reform its insolvency law system. This may well occur in 1996. This contribution to the Fordham Colloquium on International Insolvencies endeavors to identify the major problems confronting China’s potential adoption of a modern traditional form of insolvency law, particularly with respect to the vital but troublesome state-owned enterprise sector of its economy. This sector reigned paramount for over the thirty years in which China employed a command economic regime. Today, that sector remains vital to China’s socialist market economy and is critically related to the proposal for insolvency law reform.

Ultimately, China may selectively employ traditional contemporary insolvency law to the benefit of many state-owned enterprises. For the many hopelessly debt-ridden state enterprises whose financial condition is attributable to historical systemic problems, however, such an approach is artificial, wasteful, and unnecessary. These insolvent state enterprises would best be served by a law empowering an administrative body to take extraordinary measures to shut down, conglomerate, or liquidate the businesses and their assets. There is precedent for this approach. For example, the Board for Industrial and Financial Reconstruction under the Sick Industrial (Companies Special Provisions) Act 1985 of India and the Treuhandanstalt legislation, enacted in 1990 for the purpose of dealing with the state enterprise system of the former East Germany.

Three dimensions exist with respect to Chinese insolvency law reform: legal, social welfare, and financial and accounting. These dimensions are discussed below.

A. The Legal Dimensions

Until early this century, the law that had been decreed in China over centuries through successive dynasties had little or no concern with the maintenance of private rights in civil affairs. The laws dealt only with the authority of government and criminal behavior. As best one can gather, mercantile or commercial affairs, including debt responsibility, were left to custom and administered by prominent merchants, guilds, or village elders. Regarding individuals in heavy
debt, creditors found solace in the ethic that the "son pays for the debts of the father." Thus, it seems incongruous that China enacted bankruptcy laws in 1906. Several reasons have been suggested for the appearance of such laws at that time.

While the reasons for its approval are far from clear, some suggest that China's generally weak and exhausted economy, coupled with its weak and ineffective administration, had produced a growing fluctuation and disparity in market prices of commodities. This severely affected the trade of businessmen and the law may have been only a hasty and temporary expedient. There is also a sign that the Qing dynasty, fated to be the last of the dynastic regimes, was seriously affected by foreign intrusion. In an attempt to somehow come to terms with the "foreign devils," the dynasty may have been persuaded to create a body of law more aligned with "Western" traditions. This suggestion is supported further by the enactment of a reformed criminal code at around the same time. A third possibility is that the movement toward legal reform generally may have resulted from the urgings of Chinese intellectuals and others to follow something similar to societal legal reform that is attributed to the Meiji Restoration in Japan. Regardless of the motives for its enactment, these first bankruptcy laws had a short life. Emperor Guang Xu approved the laws on 1906, but annulled them in 1908. Little is known about their real application.

Nonetheless, bankruptcy seems to have been regarded as important for, in the year following the annulment of that first bankruptcy law, a Japanese legal scholar was commissioned to draft a new bankruptcy law. The collapse of the Qing dynasty in 1912 prevented completion of the commission. Between then and 1935, there seem to have been some attempts to reintroduce a bankruptcy law. This could not have been an easy task. Indeed, law making generally must have been sporadic and ineffective because of the disunity, if not chaos, in government. In 1915, however, the legislative agency of the "Northern" government published a draft bankruptcy law, modeled after German and Japanese law. That draft was incorporated into a tentative or provisional operation in 1926. It was known as the Provisional Statute Governing Liquidation of Merchants' Debt. Again, little is known of the application or effect of this law.

Some time later, the Kuomingtang Government published another lengthy draft bankruptcy law, ultimately forming the foundation for a Bankruptcy Law of the then Republic of China in 1935. Like much of the law enacted by the Kuomingtang Government in China, it was preserved in Taiwan following the defeat of the Kuomingtang in mainland China and the removal of its government to Taiwan in 1949. It remains the substance of the bankruptcy law of Taiwan. But, again, the record of the application and effect of this insolvency law in mainland China is vague and incomplete.
The declaration of the official foundation of the Chinese People's Republic on October 1, 1949 resulted in the abolition of all the laws enacted by previous regimes. This, of course, included the 1935 bankruptcy law.

In the 1950s, after the establishment of the new Republic, the People's Supreme Court adopted some temporary procedures, likened to bankruptcy, to deal with the decline of the remnants of private enterprise in the new Republic. But once that task was completed, bankruptcy procedures were not required in a society that embraced a command economy and a state owned system of production. China did not have another bankruptcy law until 1986, when the Law of State Enterprise Bankruptcy was approved. Even then, however, that law did not become effective until 1988 and it was not seriously applied until 1992.

Thus, for the forty-year period after 1949, there was virtually no knowledge, and certainly no experience nor practical application, of a bankruptcy law in China. Indeed, except for the recent exposure of the last seven years, it can be said that China has never experienced active application of bankruptcy law.

B. The Social Welfare Dimensions

The major related factor confronting the employment of a traditional form of insolvency law in China is the problem of social welfare, particularly in the context of insolvent state-owned enterprises. The history of social welfare in China over the last forty years or so discloses reasons for their problems. In the immediate years following the establishment of the new Republic in 1949, an initial legal and economic framework for "labor" insurance was established, covering, among other things, retirement provisions, compensation for work related injury and permanent disability, and medical cover. This scheme, however, never included any provision for "unemployment." One reason for this omission was that Article 42 of the Constitution of the People's Republic of China contained a basic right (and, presumably, a correlative duty) to work for every citizen. The possibility that there might be no work for the people was, consequently, not even entertained. More importantly though, following the initial passage of the "Cultural Revolution" in 1966 and 1967, the limited social welfare framework that had been initiated was abandoned. The full burden and responsibility for the total social welfare needs of workers was shifted to state and collective enterprises. It was only from experimental reforms in 1984 that a new government funded framework for a social insurance system began to emerge again. It is still in its developmental infancy.

China's lack of a developed social insurance system impacts very heavily on state enterprises experiencing financial difficulties and faced with liquidation or, at best, reorganization. Under these circum-
stances, unemployment and lack of funding to provide for retrenched and retired workers, and a multitude of other social services threaten social order.

C. The Financial and Accounting Dimensions

All insolvency laws relate to the financial position of an enterprise, be it state or private. Only with the assistance of a modern accounting system may the financial position of an enterprise fairly be ascertained. The early identification of the financial state of an enterprise is vital to the implementation of modern insolvency techniques of reorganization or reconstruction. Also, the maintenance of full and proper accounts avoids time and costs in a liquidation process. Any reform of the insolvency law system of China therefore depends upon reform, knowledge, and experience in the financial and accounting areas.

The history of financial accounting in China shows, once again, a significant lack of knowledge and experience. Even by the time of the new Republic in 1949, accounting theory and practice in China was, at best, rudimentary and certainly lacking in the basic concepts of profit/loss and balance sheet accounting. Under the new Republic, national production was "ordered" through a system of state enterprises and collectives. Because of these circumstances and the practice of the economics that are fundamental to a command economy, accounting mechanisms were geared to provide basic cost and production information. There was no increase in accounting knowledge and experience. Instead, accounting mechanisms that provided not much more than production measurements became the model of accounting practice and reporting.

The transition from command economics to market economics in China in the mid-1980s required a revolution in accounting theory and practice. It was not until mid-1993, however, that China began to adopt recognized and accepted international accounting techniques and standards.

I. The Historical Development and Summary of the Present Bankruptcy System

Although the observation has been made that the history of insolvency law in China presents difficulties, a more detailed survey of the nature of those laws provides a deeper understanding of the problems that confront the development and application of a modern insolvency law. Some of this analysis may seem to only be of academic historical relevance. But the absence of a continuity of an evolved system, coupled with the failure to define basic concepts such as insolvency and the nonadversarial nature of the laws, creates an inheritance of difficulty.
A. The Qing Dynasty Bankruptcy Law 1906

As mentioned, the bankruptcy law of the Qing dynasty was approved in April 1906 and it is said to have commenced operation in July of that year. The law applied primarily to merchants (natural person traders), although it also extended to joint stock companies who had suffered losses in trade or in an unexpected situation. The law provided primarily for a voluntary mechanism through an administrative, nonjudicial procedure. The merchant who had suffered losses could file papers with the local authority and the local chamber of commerce (or guild) declaring his financial difficulty.

After the administrative procedure and the necessary filings, a case was then "administered" by the Chamber of Commerce. The property of the merchant was taken in and sealed. The Chamber selected a "strong" and "fair" man from the same trade or industry as the merchant to serve as "trustee." With the assistance of the Chamber, the trustee administered the case. The property was turned over to him. He was empowered to sell it, collect debts and other assets, determine the claims of creditors, and then make a distribution to the creditors. The trustee was accorded fees as approved by the creditors.

Some of the traditional provisions of a bankruptcy law were present in this law: creditors were required to establish their claims; no creditors could receive favorable treatment; creditors holding security over property might realize the property and account for the excess to the trustee; distribution to creditors was pro rata; and there were various provisions for the punishment of fraud and misappropriation. There were, however, some particularly notable features of this law. For example:

- if as a result of distribution of the property of the debtor to the creditors there would be no assets left, the trustee might, with the permission of creditors, take enough assets for two years for the family to live on in order to show sympathy and care;
- government debts were not accorded priority and were ranked with the debts owed to other creditors;
- there was a special chapter on debt payment extension arrangements. If a merchant was short of working capital in a pressing market or held outstanding accounts receivable so that he is not able to discharge matured debts, he could apply to the Chamber of Commerce for an extension of up to one year in which to meet his debts to avoid bankruptcy and to maintain the business. The Chamber then convened a meeting of creditors to decide on the extension. If the debts were not paid within that time, application for bankruptcy had to follow; and
- there were provisions for discharge which provided that if the circumstances of the bankruptcy were "excusable" (the law prescribed circumstances which were not excusable, including "playing the market which leads to money shortage that leads to bankruptcy") and the dividend to creditors was fifty percent or
more, the merchant could be exempted from the remainder of the unpaid debts.

Although this law was abandoned in 1908, some aspects of its philosophy were to reemerge in the Kuomingtang law of 1935.

B. The Kuomingtang Bankruptcy Law of 1935

The 1935 bankruptcy law was passed on July 17, 1935 and implemented on May 1, 1937. It revived the involvement of the Chamber of Commerce in cases concerning merchants (a feature of the 1906 law), but only as a source for engineering a possible compromise or composition. A judicially managed process also facilitated compries and additionally provided for bankruptcy proceedings through a judicial process. The law was directed principally at individual traders but also extended to companies, partnerships, and deceased debtors (although, in respect of the latter category, it somewhat predictably fixed the heir with the obligation to pay from which the heir might only escape through the mechanism of bankrupting the estate).

Jurisdiction was triggered when a debtor was unable to discharge liability. This was probably intended to mirror the continental European notion of "cessation of payments."

The local Chamber of Commerce was involved significantly in providing people to serve in an administrative/quasi-trustee capacity in bankruptcy or conciliation cases.

The 1935 law was in force until the foundation of the new Republic in 1949. Thirty six years elapsed before "bankruptcy" was once again mentioned in a Chinese law.

C. The "Bankruptcy" Regulations of Shenyang In Liaoning Province in 1985

The first mention of the word "bankruptcy" in a post-1949 law appears in municipal, rather than national regulations. Enacted by the Shenyang City Municipal Government on February 9, 1985, the regulations were collectively known as "Bankruptcy of Urban Collective Industrial Enterprises." The method by which these regulations were promulgated is quite peculiar. One must question the competence of a municipal authority to make bankruptcy regulations. It has been explained that the regulations were made in response to a pressing need for insolvency measures in Shenyang City. The local authority apparently could not wait for the enactment of a national law. Accordingly, it implemented "trial measures" to deal with a number of collective industrial enterprises which were known severely and financially to be deficient.

It seems that the initial idea for this "experiment" was to involve the People's Court in the city. The Court declined to become involved, however, because it doubted the local authority's power to
enact such legislation. The regulations as published therefore provided only for administrative handling of bankruptcy cases through the local industrial and commercial bureau.

The regulations applied only to "collective industrial enterprises." They provided that if such an enterprise had "incurred debts in excess of the value of its assets" (a balance sheet test), the enterprise would be regarded as insolvent. An enterprise would also be regarded as having reached "the line of bankruptcy" if it had incurred losses for two years (for reasons other than the result of the dictates of government policy) and its debts exceeded eighty percent of its assets. If an enterprise reached that "line," the regulations dictated that the enterprise would have one year to adjust its financial difficulties.

The local industrial and commercial bureau was empowered to arrange meetings with the management of a "bankrupt" enterprise. Banks and creditors would be invited to discuss the formation of a special supervisory committee to investigate and oversee the property and assets of the enterprise.

Particular provisions ensured that employees were reasonably protected. Shenyang might justly be credited with the first attempt in China to establish a "bankruptcy fund" (other than by sole recourse to the assets of the enterprise) to be used to provide living allowances to employees of bankrupt enterprises.

D. The Civil Law 1986

"Bankruptcy" was first mentioned in a national law in the General Principles of the Civil Law approved on April 12, 1986. Article 45 of that law provided that the legal person status of a "corporation" may be terminated by, among other events, a "legal declaration of bankruptcy." It was undoubtedly anticipatory and ahead of its time, for there was no law at that time under which such a declaration might be made.

E. The Law of Enterprise Bankruptcy of 1986

The national Law of Enterprise Bankruptcy ("Bankruptcy Law") was approved on December 2, 1986. It was to apply only to state enterprises with separate legal personality. It was a quite remarkable law for many reasons, particularly because it commenced life in a vacuum. It lacked a legal subject. The substantive legal reform of the state enterprise sector (which would eventually accord a state enterprise the status of a separate legal personality) was still two years off. Until it was enacted, the Bankruptcy Law was of academic curiosity only. For this reason, the Bankruptcy Law did not operate until three months after the law on state-owned enterprises became effective. That law was not approved until April 13, 1988. It was implemented
on August 1, 1988. Accordingly, the Bankruptcy Law did not become effective until November 1, 1988.

F. Informal Merger Procedures of 1989

Although it falls short of a law, another reference to bankruptcy appeared when some tentative “Procedures” regarding “enterprise merger” were informally issued in February 1989 on the initiative of four central government agencies. These “Procedures,” which did not have the force of law, envisaged circumstances in which an enterprise “on the verge of bankruptcy might be merged” with another. To encourage such mergers, the People’s Bank of China and the State Economic Commission promoted the possibility of deferring, reducing, or even canceling interest on the outstanding loans of such enterprises to banks.


On April 9, 1991 the Civil Procedure Law was approved. It contains a specific chapter (Chapter 19) on bankruptcy of legal person enterprises. The chapter, however, is comprised of only seven short articles. It applies to “an enterprise with legal person status.” The law permits application for a declaration of bankruptcy if, “due to serious losses,” such an enterprise “is unable to settle mature debts.” It expressly does not apply to “enterprises owned by the whole people” (state enterprises) because, presumably, only the Bankruptcy Law would apply to these. Some state enterprises, however, have subsequently been converted into companies with varying degrees of state ownership. This raises the issue of whether the Civil Procedure Law or the Bankruptcy Law should govern the insolvency of such an enterprise.

H. People’s Supreme Court Opinion of 1991

On November 7, 1991 the People’s Supreme Court published an opinion on the operation of the Bankruptcy Law. It was concerned primarily with procedural rules in relation to that law. By then it had been recognized that the “skeleton” nature of the Bankruptcy Law required some considerable detail regarding practice and procedure. The “opinion” sought to provide this detail.

In addition, the opinion provided some matters of substance. The most important concerned the troublesome definition of insolvency in Article 3 of the Bankruptcy Law. It read:

Article 3. Enterprises which have incurred serious losses due to poor management and administration and are unable to discharge matured liabilities will declare bankruptcy in accordance with the provisions of this Law.
The opinion of the People's Supreme Court stated that an inability to discharge matured liabilities meant that the time for discharge or payment of such debt (or debts) had expired, a creditor had demanded payment; and/or (it is not clear which) the debtor was obviously deficient in liquidity. The opinion thus sought to state that Article 3 was capable of being read or interpreted as providing for alternative tests of insolvency, including the "cashflow" test.

I. Regulations in Special Economic Zones

As part of its "open door" economic policy, China marked out a number of "special economic zones." These areas each have their own local congress and, within limits, are permitted to enact their own regulatory laws. The laws apply only with the special zone. Regulations concerning bankruptcy were made for the Shenzhen Special Economic Zone on November 10, 1993.

The 1993 Shenzhen Bankruptcy Rules contain a number of important features. First, access to the bankruptcy procedures is premised on the debtor enterprise being "unable to discharge debt which has fallen due" (Article 3). This rule is a clear "cashflow" test and is in considerable contrast to the vague concept of insolvency contained in the Bankruptcy Law. Secondly, these regulations provide for "conciliation." This is, in effect, a provision for a "composition" of debts, either in terms of extended time for payment, a reduction in debt, or a combination of the two. This somewhat mirrors the provisions for conciliation or compromise contained in the 1906 and 1935 bankruptcy laws. Thirdly, if a state enterprise is the debtor and it seeks reorganization, the provisions of the Law of Enterprise Bankruptcy are applicable. Finally, the rules provide for the appointment of a "Liquidation Committee" (Article 45) and for a "Conciliation Supervisory Group" (Article 30). It is notable that accountants and lawyers may be members of the liquidation committee or supervisory group.

II. Company Law 1993

Article 189 of the Company Law, approved in December 1993 and operative July 1, 1994, makes a fleeting reference to "bankruptcy law." This Article provides for the appointment of a special liquidation committee for an insolvent company which has been declared bankrupt. The special liquidation committee may apply to have the company declared bankrupt under the Bankruptcy Law. This is odd

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1. Curiously, in Article five of the rules of Guangdong province on company bankruptcy, which were enacted in May 1993, before the Shenzhen rules, insolvency occurs when "the total assets of the debtor are insufficient to discharge its matured liabilities." This is a "balance sheet" insolvency test. It is curious because Shenzhen Economic Zone is located in Guangdong province.
because the Bankruptcy Law is supposed to only apply to state enterprises.


On October 25, 1994 the State Council issued a "notice" regarding certain practices for carrying out the Bankruptcy Law, known as "Document Number 59." This notice is concerned primarily with the position of employees of an insolvent state enterprise. It was no doubt a political statement, for it requires that the first priority in a case of enterprise bankruptcy is to "resettle the employees in order to maintain order and stability in the society."

Additionally, Document Number 59 requires that any land use rights of the enterprise (private ownership of land, even by a state enterprise, is not permitted in China—instead both public and private enterprises are given a right to use land, although they "own" any buildings on the land) be sold and proceeds from the sale be used to fund the resettlement of the employees. Any surplus proceeds from the sale of land use rights can then be applied to pay off creditors, but if proceeds from the disposal of the land use right are insufficient to care for the employees, then any deficiency can be covered by proceeds from the sale of other assets.

Document Number 59 requires the relevant local government to take appropriate measures for the retraining of employees, endeavoring to obtain other work for them and providing them with a basic living allowance in the meantime. To encourage a sense of worker responsibility for his or her future, Document Number 59 tacitly authorizes the payment of lump sums to employees (calculated on the basis of three times the annual income for the last year of employment) which might be used by the employee to fund his or her own livelihood. This grant would, in turn, relieve the government of an obligation to support them.

The notice also provides that housing, schools, nurseries, hospitals, and other welfare facilities of the bankrupt enterprise will no longer be the property of the bankrupt enterprise, but rather will be administered by the relevant government department. Finally, it requires greater emphasis be given to reorganization, including the formation of a working department to "organise, regulate and solve problems encountered during the implementation of the bankruptcy law."

L. The Commercial Bank Law of 1995

A further bankruptcy provision appears in the Commercial Bank Law, approved in May 1995. Article 71 of the law provides that if a commercial bank cannot meet its debts it may be declared bankrupt by the People’s Court. It then articulates a procedure for liquidation
of the bank. It does not link the procedure to either the Bankruptcy Law, the Civil Procedure Law, or the Company Law.


This important law deals with the legal requirements, rights, and obligations concerning security (mortgages, pledges, liens) over property and guarantees of debt. It was approved on June 30, 1995 and became effective on October 1, 1995. It makes only one reference to bankruptcy, however, by providing that if a debtor becomes bankrupt, a guarantor may only participate in the bankruptcy proceeding if the creditor fails to enforce claims.

N. Other Miscellaneous Laws

The law on Sino-Foreign Joint Equity Enterprises (July 1979) is silent about bankruptcy, although it mentions termination of a “joint enterprise incurring heavy losses” (Article 13).

The law on Sole Foreign Investment Enterprises (April 1986) is also silent on insolvency, although it talks of “liquidation carried out in accordance with legally stipulated procedures” if the enterprise is terminated (Article 21).

The Chinese law on Sino-Foreign Co-Operative Enterprises (April 1988) is also silent on the issue of bankruptcy, although it mentions “liquidating” a co-operative enterprise upon termination.

There are also bankruptcy regulations in Shanghai (August 1991), Beijing (June 1992), and some other cities that primarily apply to legal person enterprises with foreign participation or ownership. These regulations provide for a form of solvent liquidation and, in a case where liabilities exceed assets, for a form of “special liquidation.” A case of special liquidation can be converted to a bankruptcy under the Code of Civil Procedure.

II. Assessment of the Existing Bankruptcy System

Thus exposed, the existing Chinese bankruptcy system emerges as one with several features: a primary law, the Law of Enterprise Bankruptcy, which is directed only at the state enterprise sector; opinions and policy documents that seek to direct and regulate the application of this law; a minor law, the Code of Civil Procedure, directed at most other forms of legal person; and a number of other laws and regulations, most of which are confined to special types of legal person and some of which have a limited geographical application.

There is a clear need for consolidation of this quilt of laws, regulations, and directives. The existing system is too diverse. It is a largely unconnected system that breeds complication and conflict. True, it is of recent origin and proper account must be taken of China's need to establish some threshold regulation in this area. While faults attribu-
table to the comparative youth of the law can be excused, the diversity cannot.

Viewed from an economic perspective, it may fairly be said that many of these laws, particularly the 1986 Bankruptcy Law, were designed only to meet the conditions of the then emerging planned market economy. Criticisms of the principal and other laws some ten years later should be tempered accordingly. But there can be no doubt that the passage of those years has resulted in substantial change to, and a continued transformation of, the Chinese economy.

A number of economic indicia evidence that change and transformation. First, in sheer numbers it is estimated that there are now more private enterprises (including those with collective ownership) than state enterprises in China. And while the state enterprise sector may still predominate in terms of production and contribution of taxes and the like to the fiscal economy, the very presence of such a large number of private enterprises (and the almost certain prospect that their number will continue to grow) requires that there be a more adequate law than the existing brief chapter in the Civil Procedure Law to deal with the inevitable increase in the number of private enterprise insolvencies. Second, the market created by the economic reforms in China has become increasingly competitive. This has and will continue to impact very significantly on the state enterprise sector. It will also impact on other enterprise sectors. Third, there has been a significant increase in foreign investment in China and a proliferation of “sino/foreign” joint venture enterprises. It is essential that foreign investment be both encouraged and protected. When an enterprise in which foreign investment has been made becomes insolvent, it is necessary to have an adequate law to deal with the problem. Fourth, production levels have substantially increased in China as a result of the economic activity in enterprises of all descriptions.

So, while it may still be correct to describe the Chinese economy as one which is in transition, the extent of development and transition has been such that there is a need for a bankruptcy law system that is better equipped to reflect that transition and the changes that have occurred because of it.

III. PARTICULAR DEFICIENCIES OF THE ENTERPRISE BANKRUPTCY IN RELATION TO STATE-OWNED ENTERPRISES

The law that governs the insolvency of state owned enterprises, the only substantive bankruptcy law in China, had a controversial beginning. At the time of its enactment, there was a strongly held view that a state enterprise, no matter how constructed or administered, is but an agency or branch of the state. Therefore, under this view, the state would be obligated to ensure that all the debts and liabilities of a state enterprise are met in full. Hence, a state enterprise could not, and should not, become bankrupt. Its existence might be terminated by
the state, for whatever reason, but the state must meet its outstanding obligations. Accordingly, the possibility of bankruptcy for a state enterprise should not even be remotely suggested. This view may still exist in the Chinese community. Practically, however, state enterprises have increasingly been exposed to the competition of a market economy. If that economy is truly to be competitive, state enterprises should be subject to the same market rules as other participants. One of those rules is that insolvent traders should not be permitted to continue to participate in the market.

At this time, there was also a distinct lack of confidence in the law. The law's title included the words "for trial implementation." Implementing a law on a trial basis is a unique occurrence in Chinese legislative history. Further, the vague and uninformative manner in which the law is written suggests a lack of knowledge, experience, and severe doubt about the law's application. Despite its troubled inception, the bankruptcy law has been employed to declare state enterprises bankrupt. That it has worked at all must seem remarkable to some. The basic issue of whether there should be such a law, however, should not continue to be overshadowed by the controversial and doubtful beginnings of this particular law. That aside, there are a number of reasons which explain why it has had problems. The problems may be grouped together, as follows:

- **Internal Defects.** These are quite major. It is a very short and very general bankruptcy law. The key definition of "insolvency" is unclear, vague, and open to disagreement. On its face, it requires proof of "bad management and the incurring of heavy losses" leading to an inability "to discharge matured liabilities" (although this has since been clarified by the People's Supreme Court Opinion of 1991). The procedures are not sufficiently detailed. The powers and functions of the creditors are extremely limited. There are no adequate provisions in relation to bankruptcy offenses.

- **Absence of Restructuring/Reorganization Techniques.** The Law does not emphasize restructuring or reorganization and provides no protective measures to encourage those techniques (there are only six articles that deal with reorganization in the law). Rather, it is heavily centered on liquidation.

- **Failure to Address Worker Unemployment.** Apart from a proclamation in Article 4 that the State should bear the responsibility for workers who become unemployed because of enterprise insolvency, the law fails to deal with the known and seriously apparent social welfare consequences that are destined to emerge.

- **Government and Judicial Roles.** On its face, the law provides for a judicial mechanism to administer the law. It also provides (in Article 8), however, for the bureaucracy of government to have a role in the law by requiring government approval before a state enterprise may take steps under the law. This, as will be seen, introduces an element of considerable complexity. The judicial
mechanism becomes subservient to the involvement of government administration.

IV. PARTICULAR FACTORS INHIBITING BANKRUPTCY LAW REFORM IN THE STATE ENTERPRISE AREA

Thus far, it has been suggested that there are three major reasons why a new bankruptcy law is required. These reasons are:

- the diverse and largely disconnected existing bankruptcy law system;
- the changes in, and development of, economic conditions and policy; and
- the particular deficiencies of the primary Bankruptcy Law and its attendant regulations.

The next issue concerns the possible application of a new law to state enterprises. In this section, ignoring the internal deficiencies of the existing law, an endeavor is made to identify and assess the major obstacles in applying any traditional/contemporary bankruptcy law, no matter its composition or quality, to the state enterprise sector.

A. General Reform in the State Enterprise Sector

The reform process in the state enterprise sector began in earnest in 1984 with a regulation on “ten points of autonomy.” Reformers have sought to lessen the differentiation between the state enterprise sector and the private sector and to further expose the state enterprise sector to the competitive forces of a market economy. For enterprises which have a sound financial base, a good performance record, and good management, this exposure does not present any great problem. The real problem lies, however, in state enterprises (particularly the medium and small size) which struggle to survive in the unprotected environment of a market economy. Particular problems that these enterprises have include excess employees, social welfare burdens, a high adverse asset to liability ratio (estimated to be at least 75% and possibly much higher within many enterprises), obsolete equipment, non-existent marketing and research and development, backward technology, out of date products or products for which there is no market, artificially high price structure for products, poor management, and inefficiency. Some of these enterprises have been subjected to the existing bankruptcy law. A small number of them have been liquidated; a few have been merged; and others have been “recreated” through an informal transfer of assets procedure. Although the extent of state enterprise insolvency appears from the figures to be geared to the health of the economy (evidenced by some initial economic “heat” of 1988 and 1989, a slowdown in the economy and a rectification process between 1989 and 1991, and the relative surge of numbers of insolvent enterprises following the “opening up” speeches of Deng
Xiaopeng in 1992), the number of enterprises that have been subjected to the bankruptcy law is surprisingly small, given the known financial and other difficulties under which many of them operate.

The small number of state enterprise bankruptcies implies that because of various related problems (such as unemployment, the extent of enterprise debt owed to the banking sector, and the extent of debt between enterprises) bankruptcy in the state enterprise sector has been subject to government intervention and control. There are two aspects to this intervention. First, on a macro scale, because the economy has been tightly controlled. The usual forces of a typical market economy have not been allowed free reign. If they had, there would undoubtedly have been a much larger number of state enterprise bankruptcies. Second, as a result of these broad market controls, local industry, commercial bureaus, and local government departments have similarly exerted influence over state enterprises. This has often resulted in strong enterprises being required to take over hopeless, struggling, and insolvent smaller enterprises (which should have been declared bankrupt), often at considerable cost to, and adverse effect upon, the stronger enterprise.

None of this should come as any surprise. A socialist market economy is being developed in China. Emphasis is placed on promoting and maintaining public ownership in all areas of production. This is achieved and consolidated through both state-owned and collective enterprise sectors. Because government has much at stake within these sectors, government regulation of those sectors necessarily follows.

An inevitable conflict arises from this. On one hand there is a strong desire to see a bankruptcy law promoted and to have it recognized as an integral part of a market economy that deals with these casualties in a civilized manner. On the other hand, there is a need for government intervention. This conflict results in manipulation not only to the extent to which a bankruptcy law might have to operate but, also, as will now be seen, the manner in which it operates in the state enterprise sector.

B. The Government Control Factor

Reforms in the state enterprise sector have established a state enterprise as a separate legal entity. Many state enterprises have been corporatized. A state enterprise and its management have clear lines of autonomy in operating and managing the enterprise. All of this is consistent with the aim of making the state enterprise part of the market society. It also forces the individual enterprise to regulate its affairs accordingly and holds the management of an enterprise responsible for its performance and survival. Despite these reforms, government approval is still required to terminate, declare bankrupt, merge, or reorganize the enterprise.
Dealing with insolvent state enterprises under the existing bankruptcy law entails an extensive amount of government involvement, particularly at the local government level. It is impossible for an enterprise to submit to bankruptcy (or for any creditor of an insolvent enterprise to file an application for bankruptcy and have that application duly processed through the judicial system) unless the enterprise has been cleared or licensed to do so by a number of government departments and agencies.

This, of course, illustrates the great dividing line between the state enterprise and private enterprise sectors. Government approval is required if a state enterprise is to become subject to the bankruptcy law. This is consistent with the earlier observation that the government regulates the extent of enterprise bankruptcy.

Again, this is understandable because the government has much at stake in the state enterprise sector. It is the government’s responsibility to be concerned about the fate and position of workers of an insolvent state enterprise. The government must protect the public ownership of state enterprises because the people are the ultimate owners of the worth of the enterprise. Although this is consistent with the “socialist market economy” road along which China has been traveling, however, it underscores the inevitable conflict between a socialist and market economy.

Unfortunately, the socialist market economy prevents equal involvement of all sectors in the market economy. If an enterprise cannot be declared bankrupt, even on the application of a legitimate and deserving creditor, unless the government consents or approves, an element of control is exercised which would not occur in the private sector. One effect of this is to shelter state enterprises from the normal forces that act upon the private sector in a market economy.

The other problem with the government control is that it requires the involvement of a number of government departments and agencies. In addition to the usual difficulties associated with multiple decision makers, it also results, in many cases, in a lengthy decision-making process. An insolvency law that is proactive cannot be expected to provide benefits unless the process is permitted to operate quickly and efficiently, before the financial difficulties become acute and critical.

C. Irrecoverable Debt and the Banking Sector

The next area of inhibition to insolvency law reform comes from a combination of what might best be termed “old debt” and the Chinese commercial banking sector. Traditional “financing” of the needs of the state enterprises originally came from the government in the form of direct funding. This was, in effect, a contribution of capital or equity from the nominal owner of the enterprise. Some years ago, a change in policy was fashioned. Direct government funding of state
enterprises ceased and state enterprises were forced to seek their financial requirements from the commercial banking sector.

Thus, commercial banks became instruments of economic change and reform in the state enterprise sector along the lines of "user pays." The intention and the logic may have been sound, but not the results. The banks were used, in essence, as "policy" banks. They were required, by central or local government, to fund the requirements of the state enterprise sector (sometimes on an industry basis) under policies dictated by those same authorities. Consequently, commercial banks made many loans to the state enterprise sector that aggregated in substantial sums.

Although these loans were made on "commercial" terms, in that interest was payable on them, they were far from being commercial. Although the nominal lending rate was around ten percent, the real rate, at most times since 1990 has been a negative rate caused by the upward curve of inflation which, at least for the past three years, has run at a higher rate than the nominal rate of interest. This has meant that the "return," even from performing loans, has been less than profitable to the banks. When the loans become nonperforming (such that the enterprise cannot pay even the nominal interest), the loss to the banks is significant.

Worse problems follow when it becomes apparent that many enterprises will never be able to repay the principal of the loans, or even a part of them. A considerable proportion of the loans were made in pursuit of policies or initiatives that have either missed the mark or were wrong. Many loans were made in a highly protected set of market conditions that have since evaporated. They were poorly assessed, if at all, and they were highly subsidized.

The balance sheets and profit and loss accounts of some of these banks are now affected as a result of their policy loan funding. This raises two major problems. The first is that the banks oppose bankruptcy or liquidation of an enterprise because the loan then will become plainly irrecoverable and must be written off in time. The irrecoverability of the loan becomes certain in a case of liquidation. As an adjunct to that, the banks will rarely, if ever, become the prime force in directing an enterprise into bankruptcy, even though the banks are as aware as the enterprise that the loan is nonperforming and the enterprise cannot now and probably will never be able to pay, in many cases, even part of it. The banks also become unwilling and sometimes strongly adverse participants in reorganization or compromise proposals because, again, they know they will face an inevitable write-off of debt which will follow from a reorganization or compromise.

Although the banks are by far the major creditors of these enterprises, they cannot solely be blamed for their essentially negative and, at times, critical attitude toward the application of the Bankruptcy
Law. Although their balance sheets are affected, the application of any insolvency law under those conditions is made that much more difficult and strained.

The second problem that arises is that there is nothing that an insolvency law can do to change this problem. It is a problem that the central government and central bank will have to deal with through appropriate measures. The observation must be made, however, that this is a festering problem that will not go away. If it is not dealt with soon it will be carried over to the advent of a new bankruptcy law and it will become infected by the same problem from the beginning. But what of the future? Will this scenario continue?

It is encouraging that earlier this year steps were taken to reform the Chinese banking system. Relevant to this discussion is the new Commercial Banking Law (effective July 1, 1995) and other measures seeking to achieve the following results:

- to establish (or re-establish) the effectiveness of commercial banks and to remove them from any connection with policy funding;
- to establish three new policy banks in place of the commercial banks;
- to draw a clear line of demarcation between the newly reformed commercial banks and the new policy banks (in particular, the banking law provides that the commercial banks are required to make only commercial loans; all policy funding will be the province of the new policy banks; and none of the commercial banks can be directed or required to make policy loans or funding, no matter at whose request or direction);
- to require the commercial banks to employ an appropriate system for assessment of loan applications, particularly, no doubt, those involving state enterprises, before a loan is granted. Hopefully this will result in the commercial banks requesting information and determining loan applications by reference to quality criteria such as financial position, profitability, performance, management, purpose of loan, projections, monitoring, and so forth. This, of course, will depend on the ability of commercial banks to exercise and discharge that obligation and responsibility. The new law should also require enterprises to produce authenticated financial and other relevant information that is reliable and complete.

If all this occurs, the existing problem of nonperforming loans, subsidized interest rates, and government influence and control will greatly lessen. The resulting situation should contrast markedly with a previously weak and pliable commercial bank sector. Thus, although there is a full and proper reckoning yet to be made of the position that has been reached in respect of past practices, for the future there are sufficient signs to indicate greater stability and a more open and competitive market for loan funding. The market should develop in two
ways—a supply market amongst the banks themselves (particularly if they are faced with competition from other domestic and foreign banks) and a consumption market, particularly within the state enterprise sector, such that only those with proven past and future financial and performance records will be able to borrow on competitive and commercial terms. This will also help to strengthen the need for adequate financial and accounting systems and records within the state enterprise sector.

D. Social Welfare

This quite extensive problem is largely confined to the state enterprise sector. It seriously impacts on the application of an insolvency law to that sector. Simply stated, substantial unemployment would result if the state enterprise sector were subjected to the rigorous application of an insolvency law regime. It is neither politically nor socially desirable to treat the prospect of extensive unemployment arising from the insolvency of state enterprises as simply the necessary or inevitable product of a transition process towards a market economy.

Within the state enterprise sector the biggest problem is the absence of a sufficiently established and funded social insurance scheme. If one of the major effects of the application of market forces to the state enterprise sector is that many of them will not survive, the result must be unemployment for many people and inadequate provision for the retired. This result leads to the responsibility and obligation to retrain the unemployed, resettle them in suitable work positions, provide for retired and the aged and those suffering from permanent and temporary work disabilities, and to provide health care and so forth. Other social obligations for which SOE's have been responsible, at least from the mid-1960s, and which may yet emerge as major problems in themselves, include housing, education, transportation, subsidized food, and other benefits.

Until a well established and adequately funded social insurance system is the reality, insolvent state enterprises will continue to bear the massive burden of employee “settlement” and monetary assistance. But it will be a considerable period of time before the state enterprise sector can fairly be said to have been relieved from those and other burdens. So the question is what is to be done in the meantime?

The problem is exacerbated by well or moderately performing state enterprises having to continue to employ workers who are, in reality, unnecessary, to continue their obligations for the support of the retired, and to maintain other employee benefits. These burdens affect profit and loss and have an impact on balance sheets. A state enterprise, thrust into the demands and pursuits of a commercial market economy, is ill-equipped to bear the burdens. The argument that these burdens are “evened out” because of the comparatively lower
wages that have been, and continue to be, paid to state enterprise employees in return for these extra benefits is no longer relevant. Hidden but nevertheless factual redundancy is severely affecting the state owned enterprise sector.

The present "methodology" for dealing with the problem of unemployed workers of an insolvent state enterprise largely follows the dictates of State Council Document Number 59, mentioned earlier. The real crux of the problem, in a bankruptcy situation, is that the mandates of State Council Document Number 59 have been interpreted as meaning that unless and until a settlement plan in respect to workers of a putative bankrupt enterprise has been agreed upon and determined to be in accordance with the guidelines in that policy, the enterprise is not eligible to apply for bankruptcy. This is the main reason for the previously mentioned requirement for government "approval" or "license" before an enterprise can volunteer for bankruptcy under the existing law.

Two results follow from this. First, a considerable amount of time elapses before such a settlement plan can be fashioned and approved. Another, and probably more damaging, result is that if a settlement plan cannot be made (often because there are simply no assets to enable a settlement plan to be formulated), bankruptcy is not considered to be a suitable solution and so the enterprise is left without any resolution. Both of these factors impact the workers and create uncertainty, insecurity, and general workforce instability.

Of course, the answers to these difficulties lie outside the application of an insolvency law. They may only be resolved, in the long term, by the provision of a full social insurance system. In the short term there is no real solution. The existing scheme that requires land use rights be devoted exclusively to worker settlement appears to be the only viable short term method. This solution should not be limited to the short term method and the practice of supplementing any deficiency out of other enterprise assets for worker settlement should cease.

E. The Domino Effect Factor of Triangular Debt

There is a considerable amount of debt owed between different state enterprises. This is because they have traditionally traded on credit within their fraternity and, in more recent years, because of their inability to raise finance, have resorted to credit among themselves for survival. The result is an extensive amount of debt and credit between enterprises. Little of the debt and credit is common or "mutual" between the same enterprises, thus creating the "triangular" nature of the problem. This produces a fear of a "domino" effect, namely that the bankruptcy of one enterprise might, because of debits and credits, lead to the bankruptcy of a number of other enterprises.
A bankruptcy law is incapable of solving this problem. Although a bankruptcy law should contain the usual type of provision permitting “set off” of mutual debt and credit between a bankrupt enterprise and debtors or creditors of the enterprise, it is not applicable in the circumstance of triangular debt because there is generally no mutuality between the parties involved.

F. Assessment

The overall assessment of the five problems mentioned in this part suggests that there are distinct problems in the employment of a traditional insolvency law in the adverse conditions that these factors produce. In particular, the overhang of bank debt, the social welfare issues, and the triangular debt problem has produced a systemic difficulty of considerable magnitude. No reform of the insolvency law will cure or provide a solution to these difficulties.

Indeed, it may strongly be argued that the use of a bankruptcy law to deal with enterprises under these conditions is wasteful because resources are expended throughout many areas of government to agonize over the fate of these types of enterprises. Moreover, under the existing bankruptcy law, if there is no ready and apparent convenient solution (particularly to the problem of worker settlement), more often than not, nothing is done for a considerable period of time. This, of course, only aggravates the existing problems. If, for example, there are outstanding loans which are impossible to repay, interest continues to be debited and the liabilities of the enterprise simply swell. At the same time, assets of the enterprise (particularly assets such as inventory, raw materials, and debtors) either dissipate in value or are regarded as lost. Thus, the financial position of the enterprise deteriorates because of the inability of decision makers to perform promptly the task that is required. This results in a wasting of assets, an increase in liabilities and, ultimately, a worse result.

It may also be submitted that it is unnecessary to deal with these enterprises by the application of a bankruptcy law and that many of them are best suited by a pure liquidation or merger process. It strains credibility to apply those processes through a bankruptcy law that features a judicial mechanism at its center. These enterprises may better be dealt with under an entirely separated administrative law even though it may mirror some aspects of bankruptcy. It may be submitted that precedent exists for this in both India and Germany.

G. The Possibility of an Administrative “Insolvency” Law

Like many countries, India inherited much of its basic law from England. The treatment of insolvent companies in India has largely been dealt with under the 1955 Companies Act of India, which was modeled on the English company legislation of 1948. There has been
little or no change to it. Yet, early in the 1980s it was recognized in India that laws like this were not meant, and were not able, to deal with the systemic problems of financial disability, particularly in the industrial sector. In the absence of anything else, enterprises in financial difficulty struggled until they were eventually forced to cease production, close business, and be liquidated. In the industrial sector of India, this had a number of repercussions. It could have led to a shortage of supplies in important or critical economic areas, had a concertina effect on other enterprises, and led to extensive unemployment. None of this should appear as anything remarkable, for these type of ‘flow on’ effects of insolvency are now well recognized. It is remarkable, however, that this was the subject of much public concern in India at a time when some of these economic dimensions, although known, were only barely recognized in more fully developed economies. In 1981, the Reserve Bank of India appointed a special committee (it became known as the Tiwari Committee, after the name of its chairman) to examine the difficulties encountered in the rehabilitation of enterprises in financial difficulty and to suggest remedial measures, including changes in the law.

The work of the committee was largely focused on industrial enterprises whose financial affairs might be (and were) aptly described, as "sick." The definition adopted for such a “sick” industrial enterprise was one that had incurred losses in consecutive years and whose asset to liability ratio had deteriorated to below a minimum nominal standard of one to one.

In its report, the committee correctly observed that special legislation was needed to enable speedy and effective action to be taken to rehabilitate “sick units” by creating a specialized body devoted to their revitalization. The special committee subsequently recommended such action.

As a result, in 1985, the Sick Industrial (Companies Special Provisions) Act was enacted. Under that legislation, a Board for Industrial and Financial Reconstruction was established and given powerful administrative powers. The Act mandated that a “sick” company report its condition to the Board within sixty days of finalizing its audited accounts. In addition, a financial institution to which such a company was indebted had the power to make a report to the Board.

The Board was required to conduct an inquiry into the financial position of a reported company and determine whether the company might, within a reasonable time, recover or whether a scheme of rehabilitation should be proposed. Once a company was reported, a “moratorium” took effect, preventing the institution of civil proceedings or other action against the company or its assets without the consent of the Board.
The economic purpose of the legislation was made clear in the case of Navanit R. Kamani v RR Kamani. The court observed that the primary purpose of the special legislation was "to promote a speedy and efficient machinery so that a sick industry could be revived with utmost expedition, production could be started, locked up funds could be utilized for furthering socio-economic development." This, together with the 'regulatory' nature of the legislation, suggests that it was very much in conformity with a somewhat interventionist economic approach (Fabian socialism is one description that has been applied), of the Indian government. It also suggests that this branch of Indian insolvency law was very much "pro-debtor," another way to judge the economic influences that tend to shape an insolvency law.

Although this legislation was initially enacted with reference to the private sector, it was amended in December 1991 to enable public sector enterprises to be referred to the Board. Under the amendment, it became compulsory for a public sector enterprise to report its position to the Board once the minimum standard asset to liability ratio was triggered.

It appears that the Board has been reasonably active and successful in rehabilitating public sector enterprises. This success has more likely been the result of the establishment of a special fund in February 1992, helped by a $300 million loan from the World Bank, to assist with the problems of redundant employees in these enterprises. The fund has been used by the Board to promote early retirement and retraining schemes for redundant and displaced workers from the sick state enterprises.

At the central level, some fifty-five sick central enterprises had been referred to the Board by the end of 1994. They had aggregate accumulated losses of $3 billion U.S. dollars and over 250,000 employees. The special fund was used to pay off about 25% of these employees with early retirement schemes. Some of the enterprises were then fully restored to profitability, but the prospect of restoring many of them has been difficult. Despite the prescription to report a "sick" financial position, many of them did not publish accounts and were terminally ill before the Board became involved. The result has often been the write-off of government investment and/or loan funding in the enterprise to enable it to start afresh.

Despite these failures, the legislation is regarded as effective because it does expose, in a public way, under-performing state sector enterprises and ensures that the administrative law is applied.

The institution of the Regulatory Board in India might be compared to the policies and processes that were quickly developed to deal with the financially troubled state enterprise sector of the former East Germany, immediately prior to and following the reunification of Ger-

many. Enterprises that were in a hopeless financial and production position were subjected to a concentrated, nonjudicial, administration that had only one aim—the possible conglomeration of a number of enterprises and the termination and disposal of the remainder as quickly and efficiently as possible.

This goal was achieved through specific legislation enacted in 1990 that set out the policies to be adopted. A powerful specialized administrative body (the Treuhandanstalt) was established to give effect to the legislation and its policies.

The main responsibility of the Treuhandanstalt was to restructure state enterprises and either sell (privatize), merge, conglomerate, or liquidate them if restructuring and privatization did not appear possible.

The restructuring and privatization process followed this pattern:

- the first step was to incorporate all state enterprises by transforming them into companies in which the Treuhandanstalt was the sole shareholder. The Treuhandanstalt then installed supervisory boards of directors to each enterprise that reorganized the management structure. In addition, legal ownership of assets was transferred to the newly formed companies;
- the second step was to provide some limited temporary financial restructuring. About seventy percent of state enterprises required this temporary financial assistance. The techniques employed by the Treuhandanstalt included assuming continued interest liability on all debts, imposing a short term moratorium on old debt repayment, and making available new bank loans that were guaranteed by the Treuhandanstalt to give the enterprises much needed liquidity;
- the third step was to rewrite the balance sheets in accordance with standard international accounting requirements so they reflected true and reliable values of assets and liabilities, and exposed any economic weaknesses or risks of the enterprise;
- the fourth step was to require business plans from the enterprises that helped to facilitate further loans and to identify loss-making units within the enterprise which were then closed down;
- the fifth step was to recapitalize the enterprises. The recapitalization did not require the injection of fresh capital, but was accomplished by the Treuhandanstalt assuming liability for old debt;
- the sixth step was to breakdown enterprises which comprised a number of different production units. As a result more than 5000 new enterprises were created;
- the final step was to require the sale of excess or unused assets under the supervision of the Treuhandanstalt.

The process was, of course, inhibited by the need to reduce the excess workforces that were characteristic of the state enterprise system of the former East Germany. Among other things, this reduction required intensive job creation programs. Thus refreshed, the newly formed companies became marketable and were sold. All together
some 14,500 enterprises have been privatized, either through partial privatization of a going concern business (about 50%), outright sale (about 30%), or partial sale.

For enterprises that could not immediately be restructured and privatized by the above techniques, three alternatives existed. These were:

- for enterprises whose privatization might still be a longer term possibility, a "management holding company" was created that resulted in enterprises being variously grouped under the one holding. A manager was appointed to manage the group and to determine a possible restructuring process and sale;
- the second alternative was "liquidation" or divestiture. This option required the gradual and orderly disposal of assets of the affected enterprises and, in most cases, a "consultative bargaining" process with creditors to reduce their claims, but not as low as that which might be paid if the enterprise was made bankrupt. In this "liquidation" process, the debts, whether reduced or not, had to be paid in full. This was, in effect, a state administrative process, no doubt costly for the state but arguably providing in the long term some social and economic benefits and a better result than bankruptcy;
- the third alternative was bankruptcy under the relevant law through the judicial process. This appears to have been a "last resort" option in the East German experiment.

As at the end of 1994, approximately 3500 enterprises were in liquidation or bankruptcy with some ninety percent being liquidated and only ten percent in bankruptcy. This demonstrates the predominate use of the liquidation administrative process by the Treuhandanstalt.

The advantages of such an administrative procedure or technique of "liquidation" are the continuation of the enterprises until, hopefully, sold; some employment can be maintained and preserved; asset sales can be better managed through the government agency (in this case the Treuhandanstalt); and more general economic (both macro and micro) control is possible. On the other hand, there is a significant cost involved with the administrative procedure because of the need to continue servicing the existing debt and to maintain the assets (including a business) in an adequate state for sale or transfer.

A final observation should be made on the record of the work of the Treuhandanstalt with respect to employment. In 1991, there were approximately three million employees in state enterprises that were undergoing restructure, liquidation, or both. At the end of 1994, approximately fifty percent of these were enjoying continued employment in privatized firms; about seventeen percent were unemployed; about twenty-seven percent had been retired; and the remaining six percent were employed in temporary labor schemes.
H. Discussion about the Administrative “Insolvency” Law Approach

There are, of course, arguments for and against the administrative insolvency law approach. Possibly the strongest argument against it is that if a state enterprise sector is to be truly part of the market economy, it should be subject to exactly the same regulatory environment as any other sector. Thus, regulating the financial difficulties and insolvencies of state enterprises under different laws and by different rules discriminates against the general policy. Another strong argument is that if state enterprises are truly subject to the same economic forces and the effects which follow from those, appropriate obligations and responsibilities are imposed on enterprise governance and management that can only improve the general standards and performance in the state enterprise sector.

Despite the obvious strengths of these arguments, however, the most compelling reason in favor of the administrative insolvency law approach comes from the systemic nature of the present difficulties confronting a large element of the state enterprise sector in China that are historical and inherited problems. The difficulties faced by the average state enterprise, even now (and despite the ten years or so of economic and structural change) cannot be individualized (as, for example, being a fault of management) nor attributed to economic cycles that from time to time afflict a market economy system. The difficulties, plainly, are the product of the previous system. Put simply, the welfare burdens came in return for relatively cheap labor; subsidies and policy loans came from central planning; unmarketable products came from command economy planning; general inefficiency has resulted from a noncompetitive environment; obsolete equipment was the product of a fusion of some of those factors; and the internalized fraternity system within the state enterprise sector produced triangular debt. This inheritance cannot be conveniently nor successfully addressed by a traditional form of insolvency law.

When comparing an alternative approach utilized by China to the administrative precedents used by India and Germany, it may fairly be said that the application of the Indian legislation has not been a dramatic success, while the German model, which was the product of a crisis, would not be suited to the gradualist approach of state enterprise reform in China.

If there is a political will and energy, however, the administrative approach can succeed. Although it would have to be something considerably more than that which has been evidenced in India, the energy and effectiveness of the merger, conglomeration, and liquidation administrative processes carried out by the Treuhandanstalt provide a very instructive model for possible adoption in China.
The biggest difficulty that might arise against the adoption of this type of administrative measure in China is that it may be seen as a return to the direct administrative control of the now time-distanced command economy. But the proposal would involve much more than a bare set of administrative directives that changed from time to time under the command economy regime. It would require the enactment of a comprehensive law that would give appropriate power to an independent administrative unit to deal with a specified section of the state enterprise sector, a section that was clearly incapable of surviving in a competitive economy. This would give credence to the "government by laws" ideology that is most important for the reform process in China.

Finally, it may be suggested that this type of law is not an insolvency law. The Indian and German laws are rarely mentioned as "insolvency" laws. They are not even referred to in the context of insolvency, but are more likely to be categorized as an extreme form of economic interventionist law, peculiar to time and place. The author, however, disagrees with that assessment. There are just as many examples of insolvency law as there are of the more traditional type. Even fully developed market economies have experienced the phenomenon of the extraordinary type of administrative moratorium or rehabilitation legislation that has sometimes resulted from particular economic circumstances (similar to what most countries experienced during the Great Depression and at other times in various economic sectors, such as agriculture and other industries). These administrative procedures can all be categorized, at least, as laws relating to insolvency, if not insolvency laws per se.

There can be no "conclusions" to these Remarks, at least as to China. We must wait to see what the Chinese government decides.