

A LENGTHY STAY? THE IMPACT OF THE PRC ENTERPRISE BANKRUPTCY LAW ON THE RIGHTS OF SECURED CREDITORS

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I INTRODUCTION

As China has transitioned from a centrally planned economy to a ‘socialist market economy’, the availability of credit and the ease with which creditors can recover debts and enforce their rights, particularly rights to enforce security over assets, have become increasingly important. A critical issue that arises in any credit economy is how to balance the rights of secured creditors with the goals of bankruptcy law,¹ a process that inevitably involves an adjustment between the following competing interests: (i) the interest of secured creditors in enforcing security and recovering debts without delay or impediment; (ii) the interest of unsecured creditors (including employees) in recovering outstanding payments in a fair and equitable manner (the so-called ‘*pari passu*’ principle); and (iii) the interest of the debtor in reviving its fortunes and avoiding liquidation to the extent possible (the so-called ‘corporate rescue’ option).

Invariably, the process requires breathing space at the start of the bankruptcy proceedings so that a thorough investigation can be conducted into the assets and liabilities of the debtor and the interested parties have an opportunity to decide on the most appropriate course of action. In general, this involves a choice between, on the one hand, liquidating the assets of the debtor and satisfying the claims of creditors out of the liquidation proceeds to the extent possible, and, on the other

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1 In China, the term for ‘bankruptcy’ (*pochan*) is used in relation to both corporate and personal insolvency. Chinese has an adjective to describe the situation where a company’s assets are insufficient to offset its debts (*zi bu di zhai*); however, there is no single-word equivalent to ‘insolvency’ in terms of describing the inability of a debtor to pay its debts when they fall due. The translations of the relevant provisions of the Enterprise Bankruptcy Law in this article were prepared by the author. Enterprise Bankruptcy Law of the People’s Republic of China, adopted at the 23rd Session of the Standing Committee of the Tenth National People’s Congress; promulgated by Order No 54 of the President of the People’s Republic of China on 27 August 2006, effective from 1 June 2007, (‘EBL’).

hand, giving the debtor a chance to restructure its debt obligations so that it can trade its way out of its financial problems and return itself to a state of solvency.

The most effective way to create breathing space for the above purposes is to impose a postponement (or stay) on enforcement action against the debtor; namely, action by creditors to recover outstanding debts from the assets of the debtor. There are several important questions that need to be considered in this regard. One question is whether the stay should apply to enforcement action by both unsecured and secured creditors, bearing in mind that secured creditors have priority over the assets that are subject to the security and are therefore in a special position. Another question is when a stay against action by secured creditors should be imposed. Should it be imposed right at the start (ie from the date on which the court accepts bankruptcy jurisdiction)? Or should it be imposed only after the commencement – and only for the duration – of a formal debt-restructuring plan that is agreed by all creditors?

All of these competing interests and questions vied for the attention of the drafters of the new PRC Enterprise Bankruptcy Law ('EBL') and were required to be balanced and accommodated in the EBL as enacted. The drafting process for the EBL commenced in 1994 and involved several hotly debated drafts.² It was finally promulgated on 27 August 2006 and came into effect on 1 June 2007.

This article considers the impact of the EBL on the rights of secured creditors in the following areas:

- the extent and nature of the stay on enforcement action by secured creditors during bankruptcy proceedings;
- the enforcement of security rights by secured creditors during bankruptcy proceedings;
- the duties, responsibilities and powers of the administrator in respect of secured assets; and
- the priority that secured creditors enjoy to recover payment from secured assets.

Part II of this article provides a brief overview of the EBL, highlighting innovations that are relevant to the issues discussed below and providing the context for an analysis of the rights of secured creditors. Part III analyses the impact of the EBL on the rights of secured creditors in the areas set out above and suggests issues that require clarification, either in regulations or judicial interpretations. Part IV concludes by outlining the general impact of the EBL on the development of bankruptcy law in China and identifying two key concerns for secured creditors.

2 Copies of the final two drafts are on file with the author.

II OVERVIEW OF THE EBL

A Evolution

Although embracing concepts that are consistent with mainstream insolvency practice, the EBL is not based on a legislative template from any other jurisdiction or on any Model Law. Like most legislation in China, it is indigenous in terms of its structure, emphasis and approach. Its conceptual universe has been described as being ‘essentially framed’ by the insolvency systems of Germany, Australia and the United States:

Germany, because it is a civil law country, the progenitor of some earlier East Asian legal systems, and a country that emphasizes the rights and influence of banks in corporate reorganization; Australia, because it is a common law system that emphasizes the voluntary nature of bankruptcy and has strong provisions for employees; and the United States, because it is a common law system that emphasizes the rights of debtors and manages and champions the role of management in corporate reorganization.³

Given the indigenous nature of the EBL, it is difficult to determine how various concepts and provisions will be interpreted and implemented. As a fundamental law in China, the EBL is a basic building block for China’s evolving bankruptcy law and will need to be supplemented by implementing regulations and judicial interpretations in line with the normal law-making process in China. At the time of writing, it is expected that the Supreme People’s Court will issue an interpretation of the EBL before the end of 2007.

B Application

The EBL repeals the 1986 PRC Enterprise Bankruptcy Law (Trial Implementation) (‘1986 Law’). The 1986 Law applied only to State-owned enterprises; namely, enterprises ‘owned by the whole people’.⁴ Prior to the promulgation of the EBL, matters concerning the bankruptcy and liquidation of other enterprises, including foreign-invested enterprises, were governed by a handful of laws and regulations, including the PRC Civil Procedure Law⁵ and, in the case of foreign-invested enterprises, various liquidation procedures. There were also interpretations and provisions issued by the Supreme People’s Court, including the 1991 Opinion on Certain Issues concerning the Thorough Implementation of the PRC Enterprise Bankruptcy Law (Trial Implementation)

3 Bruce G Carruthers and Terence C Halliday, ‘Negotiating Globalization: Global Scripts and Intermediation in the Construction of Asian Insolvency Regimes’ (2006) 31(3) *Law & Social Inquiry* 521, 564. Carruthers and Halliday provide an insightful analysis of the interaction between global and local ‘scripts’ in the evolution of China’s bankruptcy law and the role of institutions and intermediaries, including foreign experts, in the drafting process.

4 Enterprise Bankruptcy Law (Trial Implementation), adopted at the Eighteenth Session of the Standing Committee of the Sixth National People’s Congress; promulgated by Order No 45 of the President of the People’s Republic of China on 2 December 1986 (‘1986 Law’), art 2.

5 Civil Procedure Law, adopted at the Fourth Session of the Seventh National People’s Congress on 9 April 1991; promulgated by Order No 44 of the President of the People’s Republic of China on 9 April 1991, ch 19, arts 199-206.

(‘1991 SPC Opinion’) and the 2002 Provisions on Certain Issues concerning the Trial of Enterprise Bankruptcy Cases (‘2002 SPC Provisions’).

The EBL applies to ‘enterprise legal persons’,⁶ a term that embraces foreign-invested enterprises and other companies established under the PRC Company Law. Contrary to the position reflected in drafts distributed for public comment before the EBL was promulgated,⁷ it does not apply to partnerships, individually owned businesses or other entities established for profit-making purposes. However, article 135 of the EBL applies the procedures in the EBL to the liquidation of entities other than enterprise legal persons where such liquidation falls within the category of bankruptcy liquidation under the laws and regulations applicable to those entities. China does not yet have a law on individual bankruptcy and there is an ongoing debate in both the popular press and academic circles as to when such a law should be introduced.

The EBL recognises two exceptions to its scope of application: State-owned Enterprises (‘SOEs’) and financial institutions. In respect of SOEs, article 133 of the EBL provides that special matters concerning the bankruptcy of enterprises that came within the scope of the applicable State Council regulations before the implementation of the EBL will continue to be handled in accordance with those regulations. This catches those SOEs that have been earmarked for administrative reorganisation or ‘policy bankruptcy’.⁸

In respect of financial institutions such as banks, securities companies and insurance companies, article 134 of the EBL provides that the relevant regulatory authority of the State Council may apply to a people’s court for the restructuring or bankruptcy liquidation of such an institution or for a stay on any civil action or enforcement proceeding against the institution. In addition, if a financial institution enters bankruptcy proceedings, the State Council may formulate implementing measures in accordance with the EBL and other laws.⁹

6 General Principles of Civil Law, adopted at the Fourth Session of the Sixth National People’s Congress; promulgated by Order No 37 of the President of the People’s Republic of China on 12 April 1986, art 36 defines a ‘legal person’ as ‘an organisation that has capacity for civil rights and capacity for civil conduct and independently enjoys civil rights and assumes civil obligations in accordance with the law’.

7 The latest public draft was circulated on 21 June 2004 (‘June 2004 Draft’).

8 This is also known as ‘administrative bankruptcy’. For background information on these enterprises, the reasons why they are considered to be in a special position and the measures that have been adopted to deal with their bankruptcy, see Charles D Booth, ‘Drafting Bankruptcy Laws in Socialist Market Economies: Recent Developments in China and Vietnam’ (2004) 18(1) *Columbia Journal of Asian Law* 93; Wang Weiguo, *The Order of Payment of Workers’ Claims and Security Interests under China’s New Bankruptcy Law* (Report written after the Fifth Forum for Asian Insolvency Reform, Beijing, 27-28 April 2006) <<http://www.oecd.org/dataoecd/41/40/38182499.pdf>> at 6 October 2007. The measures include State Council notices that require the proceeds from the disposal of land-use rights to be applied towards the costs of resettling employees in priority to the claims of mortgagee creditors, most of which have traditionally been state-owned banks.

9 See Booth, above n 8, 110-111 for a discussion of the position concerning financial institutions.

C Innovations

The EBL introduces a number of innovations to the previous position under the 1986 Law. An outline of those innovations that are relevant to the issues discussed in this paper is set out below.

1 *Greater Autonomy to the Debtor and Creditors*

Under the 1986 Law, an insolvent SOE could only apply for bankruptcy with the approval of its responsible government department.¹⁰ Creditors could apply for bankruptcy where a debtor was unable to repay its debts when they fell due.¹¹ However, neither the debtor nor any creditor could initiate a reorganisation, which was a limited form of corporate rescue, and application for reorganisation could only be made by the responsible government department,¹² which was also responsible for supervising the reorganisation.¹³

Under the EBL, either the debtor or creditor may file a bankruptcy application with a people's court. Three bankruptcy procedures are recognised: restructuring, settlement and bankruptcy liquidation. The application is required to specify the objective of the application, which is presumably a reference to one of these three procedures.¹⁴ For the purpose of the analysis in Part III below, it is important to note that a period of time will pass between the date on which a people's court accepts a bankruptcy application and the commencement of one of these procedures.

A debtor may file an application for restructuring, settlement or bankruptcy liquidation where (i) it is unable to pay its debts when they fall due *and* its assets are insufficient to pay all of its debts;¹⁵ or (ii) it clearly lacks the ability to pay its debts.¹⁶ There is an additional ground on which a debtor may apply for restructuring: 'if there is a clear possibility that the debtor will lose the ability to pay its debts'.¹⁷ In effect, this enables the debtor to apply for restructuring before it defaults on its debt obligations.

A creditor, on the other hand, may file an application simply on the ground that the debtor is unable to pay its debts when they fall due.¹⁸ An application may be filed for either restructuring or bankruptcy liquidation but not for settlement, which can only be initiated by the debtor.¹⁹

Where a creditor has applied for bankruptcy liquidation, the debtor or investors whose capital contributions represent 10 per cent or more of the debtor's registered capital may apply to the people's court for restructuring at any time between the acceptance of the bankruptcy application by the people's

10 1986 Law, art 8.

11 1986 Law, art 7.

12 1986 Law, art 17.

13 1986 Law, art 20.

14 EBL, art 8.

15 This is a combination of the cash flow and balance sheet tests of insolvency.

16 EBL, art 7.

17 EBL, art 2.

18 EBL, art 7.

19 EBL, art 95.

court and the declaration of bankruptcy.²⁰ In the case of settlement, the debtor may apply directly for settlement as part of the initial bankruptcy application or at any time between the acceptance of the bankruptcy application by the people's court and the declaration of bankruptcy.²¹ Accordingly, there is considerable scope for a debtor to initiate a restructuring or settlement procedure during the bankruptcy proceedings and it is important for creditors to be aware of the possible impact of this in terms of delay and uncertainty.²²

In the case of restructuring, article 79 of the EBL grants the debtor or the administrator six months from the date on which the court issued a restructuring ruling to submit a draft restructuring plan to the people's court and the creditors' meeting.²³

2 *Appointment of an Administrator*

In line with mainstream insolvency practice, the EBL introduces the role of an administrator, whose responsibilities include taking over the debtor's assets, managing the debtor's assets and business and representing the debtor in legal proceedings.²⁴

The administrator is also responsible for liquidating the assets of the debtor in the event that the debtor is declared bankrupt,²⁵ a responsibility that was previously assumed by the liquidation committee under the 1986 Law.²⁶ The administrator is appointed by the court when it accepts the bankruptcy application²⁷ and the role may be performed by intermediaries such as law firms, accounting firms and bankruptcy liquidation firms.²⁸ A framework has therefore been established for the administrator to act in a more professional and independent capacity than the liquidation committee, whose members were 'designated and appointed by relevant government departments' and involved few professionals.²⁹ Provisions have been issued by the Supreme People's Court

20 EBL, art 70.

21 EBL, art 95.

22 One writer has noted in respect of settlement that 'there appears to be nothing [in the EBL] preventing the court from giving the debtor multiple chances. The potential for tactical filings is obvious.' See Eu Jin Chua, 'China's New Bankruptcy Law: A Legislative Innovation' (October 2006) *China Law and Practice* 17.

23 Article 79 further provides that this period may be extended by three months upon request to the people's court if there are 'proper reasons'.

24 EBL, art 25.

25 EBL, art 111.

26 Under the 1986 Law, a liquidation committee was appointed only after a declaration of bankruptcy by the people's court. It did not perform any role prior to bankruptcy liquidation.

27 EBL, art 13.

28 EBL, art 24.

29 Li Shuguang, 'The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law' (Paper presented at the Forum on Asian Insolvency Reform, New Delhi, 3-5 November 2004) 10.

<<http://www.oecd.org/dataoecd/1/45/33930345.pdf>> at 6 October 2007.

in relation to the appointment of administrators³⁰ and the remuneration of administrators.³¹

The adoption of an administrator system is a welcome innovation in the EBL. However, it remains to be seen how effective this system will be in practice and many issues require clarification, including the powers of the administrator in respect of secured assets – an issue that will be considered in Part III below.

3 *Enhanced Corporate Rescue Procedures*

As noted above, the 1986 Law recognised a limited form of corporate rescue procedure, initiated by the responsible government department of the SOE, called reorganisation. A reorganisation involved the preparation of a settlement agreement, which was required to specify the term for the repayment of debts and to be approved by the people's court after agreement was reached with the creditors.³² The settlement agreement was an integral part of reorganisation and did not form part of a separate settlement procedure as is now the case under the EBL.

The EBL now establishes two formal, court-supervised corporate rescue procedures: restructuring and settlement.³³ It also recognises that the debtor and its creditors may reach agreement through an informal workout outside the context of formal court proceedings.³⁴

(a) *Restructuring*

Restructuring under the EBL has many of the features of a formal corporate reorganisation as found in other jurisdictions. It applies to all creditors, including secured creditors, and imposes a stay on enforcement action by secured creditors under article 75.³⁵ Although a restructuring is required to be supervised by the administrator,³⁶ there is provision for the debtor to manage its assets and business itself in place of the administrator by application to the people's court under article 73.

All creditors of the debtor, including secured creditors, are divided into separate voting classes for the purpose of approving a restructuring plan and the approval of each voting class is necessary for it to be passed.³⁷ However, the people's court has authority, subject to the satisfaction of certain conditions, to approve a restructuring plan even if a voting class fails to give approval.³⁸ For example, if secured creditors fail to approve a draft restructuring plan, the court

30 Supreme People's Court Provisions concerning the Appointment of Administrators in the Trial of Bankruptcy Cases (approved on 4 April 2007 and effective from 1 June 2007).

31 Supreme People's Court Provisions concerning the Remuneration of Administrators in the Trial of Bankruptcy Cases (approved on 4 April 2007 and effective from 1 June 2007).

32 1986 Law, arts 18, 19.

33 The English translations for these terms are not uniform. Restructuring (*chongzheng*) is also translated as 'reorganisation' and settlement (*hejie*) is also translated as 'reconciliation' or 'composition'.

34 See EBL, art 105.

35 See further in Part III below.

36 EBL, art 90.

37 EBL, art 86.

38 EBL, art 87.

may still approve the plan if secured claims will be satisfied in full out of the secured assets, any losses incurred by secured creditors as a result of the delay in receiving payment will be fairly compensated and their security rights will not be materially damaged.

If a restructuring plan is approved but the debtor is unable or fails to implement the plan, then, upon a request by the administrator or an interested party, the people's court will terminate the restructuring plan and declare the debtor bankrupt.³⁹

(b) Settlement

Like restructuring, settlement is a formal court-supervised process that is designed to increase the debtor's chances of reaching agreement on a debt repayment plan with creditors and avoid bankruptcy liquidation. Settlement differs from a restructuring in that it is managed exclusively by the debtor – it is not supervised by the administrator and does not bind secured creditors. Secured creditors are free to enforce their security outside the settlement process, as confirmed by the second paragraph of article 96 of the EBL:

Rights holders that enjoy security rights over specific property of the debtor may exercise their rights from the date on which the people's court issues a ruling in favour of settlement.

There is no express distinction in the EBL between restructuring and settlement in terms of the nature of the arrangements with creditors that each may involve. However, settlement appears to be designed to operate as a faster and less costly alternative to restructuring and is likely to be relevant in the context of insolvencies where the support of secured creditors is either more readily available or less critical to the success of the rescue.

The procedure has been described as originating from the composition procedure as first adopted in Belgium in 1886 and later introduced in other European jurisdictions such as Austria and France, and is an interesting example of a concept that China has borrowed from the civil law tradition.⁴⁰

If a settlement agreement is agreed but the debtor is unable or fails to perform the settlement agreement, then, upon a request by a creditor, the people's court will terminate the settlement agreement and declare the debtor bankrupt.⁴¹

39 EBL, art 93.

40 Wu Gaosheng (ed), *Zhonghua renmin gongheguo qiye pochang fa tiaowen shiyi yu shiyong* [PRC Enterprise Bankruptcy Law Explanation and Application of Provisions] (2006) 200-201. The procedure was also adopted in Japan in its 1922 Composition Law. The composition procedure in Japan has now been superseded by civil rehabilitation under the Civil Rehabilitation Law, which establishes a debtor-in-possession system where secured creditors are able to enforce their security outside the civil rehabilitation proceeding, subject to a discretionary stay. For details of the switch from composition to civil rehabilitation in Japan, see Stacey Steele, 'Too Hot to Handle: Extinguishing Secured Creditors' Interests in Insolvency under Japan's Civil Rehabilitation Law' (2003) 8 *Journal of Japanese Law* 223, 228-230.

41 EBL, art 104.

4 *The Inclusion of Secured Assets in the Scope of the EBL*

One of the major changes in the EBL is to bring all of the assets of the debtor, including secured assets, within its scope.⁴²

The position under the 1986 Law was different. Secured assets were not included in the scope of ‘bankruptcy assets’ and were not relevant for the purposes of the law except to the extent that the proceeds from the sale of secured assets exceeded the amount of the secured debt and were therefore available for distribution to other creditors.⁴³ This position was confirmed in the 2002 SPC Provisions, which excluded secured debt from the definition of ‘bankruptcy claims’⁴⁴ and provided expressly that assets subject to a mortgage, lien or pledge did not constitute ‘bankruptcy assets’.

The above position reflected the fact that the 1986 Law primarily focused on bankruptcy liquidation. Because the concept of a corporate rescue was not well developed, the 1986 Law did not make express provision for the treatment of secured assets other than in the context of bankruptcy liquidation. The expectation was that the liquidation committee would limit its attention to dealing with and disposing of unsecured assets and that secured assets would be dealt with separately by secured creditors, subject only to a stay on civil enforcement proceedings in the period between the acceptance of a bankruptcy application⁴⁵ and a declaration of bankruptcy.⁴⁶

Article 30 of the EBL provides:

All assets belonging to the debtor when the bankruptcy application is accepted and assets obtained by the debtor in the period between acceptance of the bankruptcy application and the completion of the bankruptcy proceedings are assets of the debtor.

It has been suggested that the purpose behind this change is to ensure that, after the people’s court has accepted a bankruptcy application, ‘the debtor’s assets can be better identified and managed, a fair settlement of claims and debts can be achieved and the lawful interests of the creditors and the debtor can be protected.’⁴⁷

It appears that the effect of this change is that, except in circumstances where a secured creditor is not subject to a stay and is able to enforce its security rights

42 In international insolvency parlance, this is referred to as bringing all of the debtor’s assets within the ‘insolvency estate’. See UNCITRAL, *Legislative Guide on Insolvency Law* (2005) UNCITRAL <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> at 8 October 2007, [7]-[8]. The introduction to this guide notes that it ‘is intended to be used as a reference by national and legislative bodies when preparing new laws and regulations or reviewing the adequacy of existing laws and regulations.’ It contains guidelines and recommendations on the design of insolvency law based on concepts and issues recognised in many legal systems and is therefore a useful benchmark for assessing the EBL.

43 1986 Law, art 28.

44 2002 SPC Provisions, art 55.

45 1986 Law, art 11.

46 Under the 1991 SPC Opinion, art 39, court approval was required if a secured creditor wished to enforce its security in the period between the acceptance of the bankruptcy application and the declaration of bankruptcy.

47 Wu, above n 40, 79.

independently of the bankruptcy proceedings,⁴⁸ secured assets will be treated in the same way as unsecured assets for the relevant purposes, including the management and use of assets by the debtor or the administrator.

The terminology changes in the event that a bankruptcy declaration is made by the people's court and the debtor proceeds to bankruptcy liquidation. The second paragraph of article 107 of the EBL provides:

After the debtor has been declared bankrupt, the debtor shall be known as the bankrupt person, the assets of the debtor shall be known as the bankruptcy assets and the claims enjoyed against the debtor when the people's court accepted the bankruptcy application shall be known as bankruptcy claims.

Once again, the terminology appears to encompass secured assets and secured claims.

III IMPACT OF THE EBL ON THE RIGHTS OF SECURED CREDITORS

A Stay on Enforcement Action by Secured Creditors During Bankruptcy Proceedings

The discussion below outlines the circumstances in which secured creditors will be subject to a stay on enforcement action.

1 *Upon Acceptance of a Bankruptcy Application by a People's Court*

The EBL adopts an automatic stay on enforcement proceedings in respect of the assets of the debtor from the date on which a people's court accepts a bankruptcy application.

Article 19 of the EBL provides as follows:

After the people's court accepts a bankruptcy application, preservation measures in respect of the debtor's assets and enforcement proceedings shall be stayed.

Article 19 does not refer specifically to enforcement action by secured creditors and, to this extent, the position might be considered to be equivocal. However, such action appears to be caught by the general reference to 'enforcement proceedings'.

The adoption of an automatic stay on action by secured creditors upon acceptance of a bankruptcy application was not universally supported during the drafting process. Professor Wang Xinxin,⁴⁹ for example, argued that this was inconsistent with international practice and that the rights of secured creditors should only be stayed during a restructuring. In his view, a stay on enforcement action by secured creditors upon the acceptance of a bankruptcy application could not be justified on the basis that it would facilitate a settlement or restructuring. If the debtor wished to avoid a situation where enforcement action by secured creditors might jeopardise the success of a settlement or restructuring, the debtor should enter into a settlement agreement with each secured creditor

48 See further in Part III below.

49 Wang Xinxin is professor of law at People's University in Beijing and was a member of the drafting committee for the EBL.

individually. Further, although a stay on action by secured creditors would be appropriate in the context of a restructuring, the stay should only apply from the commencement of the restructuring proceeding and not before. Whilst enforcement action by secured creditors prior to an application for restructuring might jeopardise a restructuring, it would be incumbent on the debtor to apply for restructuring as soon as possible to minimise this risk.⁵⁰

This view is persuasive, particularly in view of the ability of a debtor to apply for a restructuring before it defaults on its debt obligations and thereby forestall any adverse enforcement action by secured creditors.⁵¹

The potential detriment suffered by a secured creditor as a result of the automatic stay on acceptance by the court of the bankruptcy application is significant. The EBL does not provide a timeline as to when the court will make a decision in respect of a specific proceeding (ie restructuring, settlement or bankruptcy liquidation) and, consequently, when the relevant proceeding will commence. In addition, a debtor may apply for restructuring or settlement at any time prior to a declaration of bankruptcy. As a result, a secured creditor may be subject to a stay on enforcement action for a substantial length of time before a specific proceeding commences.

The potential detriment is exacerbated by the absence of a basis on which a secured creditor can apply for relief from the automatic stay. It remains to be seen whether such relief will be available and, if so, in what circumstances.⁵²

2 During Restructuring

Encouragingly, the EBL does allow secured creditors to apply for relief from the stay during the restructuring process. Article 75 of the EBL provides as follows:

During the restructuring period, security rights enjoyed in respect of specific assets of the debtor shall be temporarily suspended. However, if there is a possibility that the secured assets will be damaged or suffer an obvious reduction in value, with the result that the interests of the person with security rights are harmed, the person with security rights may apply to the people's court to resume the exercise of security rights.

The effect of this provision is that if a restructuring plan is passed by creditors and approved by the court, the stay on enforcement proceedings by secured creditors will remain in place during restructuring, except where the secured

50 Wang Xinxin, *Biechu quan quhui quan dixiao quan (shang)* [Rights of Separation, Rights of Retrieval and Rights of Set-off (Part 1, 2003) *Zhongguo minshang falü wang* [China civil and commercial law website] <<http://www.civillaw.com.cn/article/default.asp?id=13116>> at 8 October 2007. Wang also rejects the view that action by secured creditors should be restricted on the basis that China does not yet have a developed system for enforcing security, arguing that if there were concerns about this, the law could provide for secured creditors to enforce their security through the court, but without the need to obtain the consent of the court before the security rights are exercised.

51 As noted in Part II above, the EBL, art 2, enables the debtor to apply for restructuring before it defaults on its debt obligations.

52 UNCITRAL, above n 42, 90 [45], suggests that where a stay becomes effective upon the making of an application for commencement of a bankruptcy proceeding (as distinct from the commencement of the bankruptcy proceeding itself), 'it is desirable... that clear procedures for seeking relief from the stay on an expedited basis be included in the insolvency law'.

creditor successfully applies to the people's court for relief from the stay on the ground set out in article 75.

Except as provided in article 75, the EBL does not make specific provision for when the 'temporary suspension' during restructuring will be lifted. Logically, it would be superseded by any arrangements agreed to by secured creditors under the restructuring plan. In addition, as noted above, if the restructuring fails, the debtor will be declared bankrupt and secured creditors should then be able to exercise their rights in accordance with article 109.⁵³

B Enforcement of Security Rights by Secured Creditors

As noted at the start of this article, a key concern for secured creditors in a bankruptcy proceeding is whether they can enforce their security over the relevant assets of the debtor and recover debts owing to them without delay or impediment.

There are three circumstances in which the EBL makes express provision for the exercise of security rights by secured creditors:

- where the people's court permits a secured creditor to 'resume the exercise of its security rights' during restructuring;⁵⁴
- after a ruling by the people's court in favour of settlement;⁵⁵
- after the debtor has been declared bankrupt.⁵⁶

In the event that the debtor is declared bankrupt, article 109 of the EBL provides as follows:

The holders of security rights in respect of specific assets of the debtor enjoy the right to receive payment in priority from those specific assets.

Article 109 does not expressly provide that secured creditors may exercise their security rights independently of the bankruptcy liquidation proceeding in order to 'receive payment in priority'. However, this conclusion should follow logically when article 109 is read with articles 110 and 113. Article 110 of the EBL provides that if a secured creditor fails to receive payment in full after 'exercising its priority payment rights', the unpaid claim shall be regarded as a common claim in bankruptcy. Article 113 of the EBL sets out the order in which proceeds from the liquidation of 'bankruptcy assets' are to be distributed to satisfy creditor claims, ending with common bankruptcy claims. This does not deal with claims of secured creditors and it is logical to suppose that this is because such claims are to be realised through the exercise of security rights by secured creditors under article 109.

The right of a creditor to recover payment in priority to other creditors from a secured asset independently of bankruptcy or settlement proceedings is known in civil law jurisdictions as the 'right of separation'⁵⁷. Traditionally the rights that

53 See further in Section B below.

54 EBL, art 75.

55 EBL, art 96.

56 EBL, art 109.

57 In Chinese, the relevant terminology is '*biechu quan*'.

have supported a right of separation have been pledge rights, mortgage rights, lien rights and other preferred rights.⁵⁸

Although recognised in theory, the concept of a right of separation is not expressly referred to in the EBL. The June 2004 Draft provided that creditors enjoyed rights of separation in respect of mortgages, pledges and liens. The final version dispensed with this terminology and referred simply to ‘security rights in respect of the specific assets of the bankrupt person’ in articles 96 and 109 of the EBL.⁵⁹

C The Duties, Responsibilities and Powers of the Administrator in Respect of Secured Assets

As noted above, a significant period of time may pass between the acceptance of the bankruptcy application by a people’s court and the commencement of a specific bankruptcy proceeding. If secured creditors are subject to a stay from the acceptance of the bankruptcy application, as appears to be the case, a critical question will be the extent of the administrator’s powers to use and dispose of secured assets during this period.

The question is critical because it goes to the heart of proprietary rights in China and the extent to which pre-existing rights of secured creditors are respected or compromised in the event of bankruptcy.

The position in relation to possessory security (ie a pledge or lien) is clearer than non-possessory security (ie a mortgage). Article 37 of the EBL provides that ‘after the people’s court has accepted a bankruptcy application, the administrator may recover the assets subject to a pledge or a lien by repaying the debt or providing [replacement] security that is acceptable to the creditor.’⁶⁰ This indicates that an administrator cannot extinguish a pledge or a lien except where the secured debt has been repaid or where replacement security satisfactory to the secured creditor has been provided.

In the case of a mortgage, it is not clear whether the administrator has the power to extinguish the mortgage and sell the mortgaged assets and, if so, whether the secured creditor has any influence or control over the sale and, in

58 The Securities Law, adopted at the Sixth Session of the Standing Committee of the Ninth National People’s Congress; promulgated by Order No 12 of the President of the People’s Republic of China on 29 December 1998, recognises four types of ‘asset security’: mortgages, pledges, liens and a deposits. Of these, three types of asset security are considered to be of a proprietary nature: mortgages, pledges and liens. A deposit security, which occurs where one party transfers funds to another party as security for an obligation, does not take the form of a security over any proprietary rights and simply constitutes a personal claim. As a result, a deposit does not fall within the category of a proprietary right and is therefore not included in Section 4 of the Property Rights Law, which regulates security over proprietary rights. See Wang, above n 50 for an explanation of the characterisation of security under PRC law.

59 The reference to ‘specific assets’ in the EBL, arts 96 and 109 appears to exclude deposits from the scope of rights of separation. This is consistent with the characterisation of a deposit as a personal claim instead of an asset security: see Wang, above n 50.

60 An outstanding issue, however, is what should happen if the administrator does not wish, or is unable to repay the debt and the secured creditor refuses to accept the replacement security offered by the administrator. Does this give the secured creditor an effective veto over any replacement security, or does the people’s court have the authority to intervene and rule on what security should be acceptable in the circumstances? A further issue is the basis on which the assets will be valued for this purpose.

particular, the timing and manner of the sale. This issue will be critical where the mortgage debt is greater than the value of the mortgaged asset and the mortgagee and the administrator have differing views as to when the mortgaged asset should be offered for sale and the conditions applicable to the sale. In such circumstances, the main priority of the mortgagee will be to maximise the sale proceeds and minimise any unpaid portion that will be treated as a common bankruptcy claim. Such a concern may not be the highest priority for the administrator, who may be more concerned about ensuring a sale of the secured asset without undue delay.

A similar concern applies in respect of the use of mortgaged assets by the administrator and what protection a secured creditor will have against diminution in the value of mortgaged assets prior to the commencement of a specific bankruptcy proceeding.⁶¹

What does the EBL say about this issue? The question will be discussed by considering the interplay between the duties, responsibilities and powers of the administrator and the functions and powers of the creditors' meeting.

Under article 25 of the EBL, the duties and responsibilities of the administrator include taking control of the debtor's assets,⁶² investigating the status of the debtor's assets and managing and disposing of the debtor's assets.⁶³ In performing such duties the administrator is required to act diligently and in good faith.⁶⁴

The administrator is required to provide work reports to the people's court and is subject to the supervision of the creditors' meeting and, if established, the creditors' committee.⁶⁵

In any liquidation proceedings, it is important to distinguish between the powers of the administrator that can be exercised independently of the creditors (even though they may be subject to the requirement to obtain court approval in certain circumstances) and those acts that can only be undertaken by the administrator with the consent of the creditors.

Article 61 of the EBL sets out the functions and powers of the creditors' meeting, including the following:

61 UNCITRAL, above n 42, 103, recommends that upon application to the court, a secured creditor should be entitled to protection of the value of the asset in which it has a security interest and that appropriate measures that may be granted by the court include cash payments by the estate and provision of additional security interests.

62 EBL, art 25(1).

63 EBL, arts 25(2) and 25(6) respectively.

64 EBL, art 27.

65 A creditors' committee may be established by the creditors under the EBL, art 67. Its role is mainly supervisory in nature.

- deciding whether to continue or terminate the operations of the debtor;⁶⁶
- passing plans for managing the debtor's assets;⁶⁷
- passing plans to sell the bankruptcy assets.⁶⁸

Under article 26 of the EBL, the approval of the court is required if the administrator decides to continue or terminate the operations of the debtor or engages in any of the acts specified in article 69 of the EBL before the first creditors' meeting is convened. The acts specified in article 69 include transferring rights in immovable property such as land and buildings, transferring property rights such as exploration rights, mining rights and intellectual property rights, and the disposal of other property that has a major impact on the interests of creditors. The administrator is required to report to the creditors' committee or, if a creditors' committee has not been established, to the people's court if any of the acts specified in article 69 are undertaken.

It is interesting to note that unlike the duty of the administrator to 'manage and dispose' of the debtor's assets under article 25(6) of the EBL, article 61 of the EBL simply refers to the powers of the creditors' meeting to pass plans to 'manage' the debtor's assets (ie not 'manage and dispose of' the debtor's assets),⁶⁹ to sell the bankruptcy assets⁷⁰ and to distribute the bankruptcy assets.⁷¹ In other words, the EBL does not expressly confer powers on the creditors' meeting to decide on plans for the disposal of the debtor's assets prior to the commencement of a specific bankruptcy proceeding; the only specific reference to the power to decide on the disposal of assets is in respect of 'bankruptcy assets', and this will only occur after the people's court has made a declaration of bankruptcy.⁷²

This begs the question as to whether the administrator is free to dispose of secured assets without the consent of the secured creditors (and, if so, how the interests of secured creditors will be protected), or whether the administrator is subject to the pre-existing rights of secured creditors that applied to the debtor prior to the acceptance of the bankruptcy application by the people's court.

The need to balance the interests of secured creditors and the interests of the administrator, the debtor company and the creditors as a whole is a key issue in any insolvency regime and requires insolvency law to reconcile the need to

66 EBL, art 61(5).

67 EBL, art 61(8).

68 EBL, art 61(9).

69 EBL art 61(8).

70 EBL art 61(9).

71 EBL art 61(10).

72 Interestingly, EBL art 68(1) provides that the functions and powers of the creditors' committee, if established, include 'supervising the management *and disposal* of the debtor's assets'.

respect pre-existing proprietary rights to the extent possible with the wider objectives of insolvency proceedings.⁷³

The EBL does not make express provision in respect of the powers of the administrator to use and dispose of secured assets in the period prior to the commencement of a specific bankruptcy proceeding. If the law is to permit an administrator to use or dispose of secured assets during this period, it will be necessary to clarify the circumstances in which this may occur and the conditions to which any use or disposal is subject. For example, if the value of the secured asset is less than the secured debt is the administrator required to repay the debt in full by making up the shortfall in cash or by providing substitute security before the asset can be sold? Can the administrator require a secured creditor to accept substitute security in place of cash repayment altogether? What are the powers of the court in such circumstances? It is hoped that clarification of these issues will be provided by the Supreme People's Court in its forthcoming judicial interpretation of the EBL.

An insight into how this issue might be treated may be gleaned from article 13 of the Supreme People's Court Provisions concerning the Remuneration of Administrators in the Trial of Bankruptcy Cases.⁷⁴ This provides as follows:

Where the administrator has expended reasonable labour on the management of secured assets, such as their preservation, disposal or delivery, [the administrator] may receive appropriate remuneration from the secured creditor. Where the administrator and the secured creditor are unable to reach agreement on the amount of remuneration, the people's court must make a determination based on the method provided in Article 2 of these provisions, but the remuneration may not exceed 10 per cent of the capped amounts as provided in that Article.⁷⁵

The above provision recognises that the administrator may deal with and dispose of secured assets in the performance of its duties. However, it is not clear whether this is required to be with the consent of, or in consultation with, the secured creditor. On one interpretation at least, it is possible that remuneration will be agreed or determined after the event (ie after unilateral action has been undertaken by the administrator).

Such issues will be of critical importance in the context of what has been described as a 'floating mortgage', a new type of security that is recognised by the PRC Property Rights Law.⁷⁶ This enables a debtor to mortgage existing and future production equipment, raw materials, semi-finished products and finished products on terms that if the debtor defaults, the mortgagee will be able to

73 UNCITRAL, above n 42, 104 [74], states that '[i]t is desirable that an insolvency law include provisions on the use or disposal of assets of the insolvency estate (including encumbered assets), and third-party-owned assets, addressing the conditions upon which those assets may be used or disposed of and the provision of protection for the interests of third-party owners and secured creditors.' See also recommendation 58 in relation to the ability of an insolvency representative to sell encumbered assets.

74 See Supreme People's Court Provisions concerning the Remuneration of Administrators in the Trial of Bankruptcy Cases (approved on 4 April 2007 and effective from 1 June 2007).

75 Article 2 of the provisions states that the amount of the administrator's remuneration is subject to caps expressed as a percentage of the total value of the unsecured asset.

76 PRC Property Rights Law, adopted at the Fifth Session of the Tenth National People's Congress of the People's Republic of China; promulgated by Order No 62 of the President of the People's Republic of China on 16 March 2007, effective from 1 October 2007, arts 181, 189 and 196.

recover the debt from the assets in existence at the time the mortgage is enforced. If a floating mortgage has been granted over key production assets of the debtor, the debtor's operations may be subject to extensive restrictions under the security agreement and it will be critical for the law to strike a balance between the rights of the mortgagee and the wider objectives of bankruptcy law.

D The Priority that Secured Creditors Enjoy to Recover Payment from Secured Assets

As noted above, article 109 of the EBL provides that holders of security rights in respect of specific assets of the debtor enjoy the right to receive payment in priority from those specific assets.

Article 132 of the EBL establishes a limited exception to this right of priority by providing that if the assets of a bankrupt company are insufficient to pay workers' claims⁷⁷ incurred before the date on which the EBL was promulgated (ie 27 August 2006), these claims will be paid from secured assets in priority to secured creditors. This provision is the result of a compromise between those who favoured granting absolute priority to workers' claims over secured claims and those who argued that such an outcome would undermine the objectives of the EBL and discourage banks from lending.⁷⁸

Although, at first glance, article 132 is an unwelcome exception to the priority that secured creditors normally enjoy, the exception is limited to workers' claims incurred before 27 August 2006 and it should therefore be possible to mitigate the risks through due diligence of existing claims and liabilities by prospective lenders and other creditors.⁷⁹

IV CONCLUSION

The EBL has established a general framework for corporate bankruptcy in China. With limited exceptions, it applies to all companies in China and plugs many of the gaps that previously existed, such as the specific procedures and arrangements for the bankruptcy or formal debt restructuring of foreign-invested enterprises. In establishing a unified approach to corporate bankruptcy, the EBL should increase the transparency and predictability of credit relationships between debtors and creditors.

The exceptions to the application of the EBL, namely SOEs that fall within the scope of policy bankruptcy and financial institutions, are likely to have less of an impact than one might expect at first glance. The special treatment of SOEs is the product of historical circumstances and should become less significant as time

77 The workers' claims referred to in the EBL, art 132 are 'wages, medical and disability subsidies, bereavement fees that are owed to staff and workers, the basic old-age insurance, basic medical insurance fees payable into the individual accounts of the staff and workers, and compensation payable to staff and workers in accordance with laws and administrative regulations'.

78 For a detailed discussion of this issue, see Booth, above n 8, 138-141 and Wang, above n 50, 9-12. A provision granting absolute priority to workers' claims was included in a late draft of the Enterprise Bankruptcy Law and provoked a heated debate in China.

79 See Chua, above n 22, 20.

passes. And in the case of financial institutions, the existence of special arrangements for their bankruptcy is in line with the approach adopted in many other jurisdictions.

From a conceptual perspective, the EBL follows mainstream insolvency practice by introducing innovations such as the role of an administrator and enhanced corporate rescue procedures. These innovations are consistent with the demands of a credit economy and will accelerate the development of a professional body of insolvency practitioners in China. In addition, these innovations are underpinned by mainstream insolvency principles, such as the priority of secured creditors (subject to the limited exception under article 132) and the *pari passu* treatment of ordinary creditors.

It remains to be seen, however, how effectively the EBL will be implemented in practice and, in particular, the extent to which implementation will be impeded by the inexperience of PRC courts in dealing with bankruptcy cases and the conflicting priorities of governments and local interests.

For secured creditors, two key concerns can be identified: (i) the impact of the automatic stay after a people's court accepts a bankruptcy application; and (ii) the nature and extent of the administrator's powers in relation to secured assets before a specific bankruptcy proceeding commences.

As noted in Part III of this article, secured creditors face considerable delay and uncertainty as a result of the automatic stay. The potential detriment is most acute in the period between the acceptance of a bankruptcy declaration and the commencement of a specific bankruptcy proceeding (ie restructuring, settlement or bankruptcy liquidation). The concern is heightened by the absence of an express basis on which secured creditors can apply for relief from the stay if their interests are unfairly prejudiced by the delay.

After a specific bankruptcy proceeding commences, there are safeguards in place to protect the interests of secured creditors. For example, a restructuring plan requires the approval of secured creditors and, in the absence of such approval, can only proceed if the people's court is satisfied that the interests of secured creditors will be protected as provided in article 75 of the EBL. Further, article 75 provides a basis for a secured creditor to apply for relief from the stay during restructuring. And, in the case of settlement, the EBL provides expressly that a secured creditor may exercise its security rights after the people's court rules in favour of settlement.

These safeguards are encouraging. However, the key question will be the integrity and efficiency of the procedures in the period between the acceptance of a bankruptcy declaration and the commencement of a specific bankruptcy proceeding.

In regards to the second concern, the EBL is silent on the nature and extent of the administrator's powers to extinguish mortgage security and dispose of mortgaged assets in the period before a specific bankruptcy proceeding commences. As a result, it is uncertain whether mortgagees will have any influence or control over the disposal of such assets by the administrator and the manner and terms of the disposal. The EBL is also silent on the use of mortgaged assets by the administrator and whether mortgagees will be protected

against diminution in their value during this period. A related issue is the interplay between the rights of a secured creditor under a floating mortgage and the powers of the administrator to manage and dispose of assets.

Finally, it remains to be seen how effectively Chinese courts will adjudicate conflicts involving the rights of secured creditors, and where a balance will be struck between the competing interests of secured creditors, unsecured creditors and debtors.