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WORKERS' CLAIMS IN THE ENTERPRISE
BANKRUPTCY LAW OF CHINA**

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**Meeting held on
27-28 April 2006**

This document reproduces a report by Mr. Li Guoqiang written after the Fifth Forum for Asian Insolvency Reform (FAIR) which was held on 27-28 April 2006 in Beijing, China. It will form part of the forthcoming publication "Legal & Institutional Reforms of Asian Insolvency Systems".

CORPORATE AFFAIRS DIVISION, DIRECTORATE FOR FINANCIAL AND ENTERPRISE
AFFAIRS
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
2 RUE ANDRÉ-PASCAL, PARIS 75116, FRANCE
[HTTP://WWW.OECD.ORG/DAF/CORPORATE-AFFAIRS/](http://www.oecd.org/DAF/corporate-affairs/)

THE ESTABLISHMENT OF LIMITED PRIORITY OF WORKERS' CLAIMS IN THE ENTERPRISE BANKRUPTCY LAW OF CHINA

*by Li Guoqiang**

The order of payments against all property (including secured property, owned by an enterprise when its bankruptcy is declared), is a major issue in the Enterprise Bankruptcy Law. This paper makes a relatively thorough analysis of relevant situations, and proposes that the principle of limited priority of workers' claims should be established in the Enterprise Bankruptcy Law to fully and correctly deal with the relation between the payment of workers' claims and the payment of security interests. "Limited priority" means that limitations on scope, time and the amount of preferential payments of workers' claims are imposed. Furthermore, the State Council may, in accordance with the basic principles and conditions of the Enterprise Bankruptcy Law, separately work out specific measures for implementing the Enterprise Bankruptcy Law.

China is formulating an Enterprise Bankruptcy Law that is consistent with a market economy. In the law, the order of payments of workers' claims and security interests is a relatively important issue. The observations and recommendations found in this paper were developed based upon the assessment of surveys, discussions with scholars and enterprises, and after consulting and analysing relevant international legal writings.

* Li Guoqiang is a Researcher of the Development Research Centre of the State Council. Chen Xiaohong, Director of the Institute of Enterprise Research of the Development Research Centre of the State Council, Dr. Wang Huaiyu, Dr. Qi Changdong, and other experts from the Institute of Enterprise Research of the Development Research Centre of the State Council also participated in the surveys undertaken for this topic.

1) The principle of limited priority of workers' claims should be established in the Enterprise Bankruptcy Law

Currently, two different opinions are held towards the priority of workers' claims (such as wages in arrears and social security premiums in arrears) over the payment of security interests in the event of enterprise bankruptcy.

There are a number of arguments that support the priority of workers' claims: it is people oriented; it conforms to the spirit of the Constitution; failure to pay wages and social security premiums due violates laws such as the Labour Law; it does not conflict with Security Law; it supports social stability; and banks are more capable of identifying and bearing risks than workers.

At the same time, there are arguments against the priority of workers' claims: wages and social security premiums in arrears should be regulated in accordance with the Labour Law; the Bankruptcy Law can not violate the principle of priority of security interests; some enterprises are more likely to infringe upon the rights and interests of workers; banks will be forced to increase interest rates and will be reluctant to lend, resulting in an eventual loss of employment opportunities; and workers' priority will cause an increase in bad loans and, in turn, increase financial risks.

The essence of the controversy is how to balance the interest relation among creditors based on the national conditions of China in order to properly protect the rights and interests of creditors, and to establish and develop an efficient and fiduciary economic order. Why this question is so controversial is mainly because China is in a period of systemic transformation, and many people view the system design mainly from the perspective of solving practical short-term issues.

This paper argues that the design of the Enterprise Bankruptcy Law should deal with the current interests and difficulties of worker/creditors, consider the long-term interests of worker/creditors and enterprises, and be linked to the establishment of the basic property system of a market economy. Workers' claims should be given priority only if certain conditions are satisfied (*e.g.* limited priority), in accordance with the following suggestions:

1. The Enterprise Bankruptcy Law should deal with relevant issues according to the principle of limited priority of workers' claims. It should permit workers' claims satisfying certain conditions to be preferentially paid through specific provisions concerning scope, time, and amount. Limited priority workers' claims should maintain

the priority of security, and help address problems related to wages and social security premiums in arrears, thereby promoting social harmony.

2. In consideration of the complexity of limited priority workers' claims, some problems require further study so that the State Council can formulate specific measures according to the basic principles and conditions specified in the Enterprise Bankruptcy Law.
3. Measures should be adopted to address problems related to wages and social security premiums unpaid by bankrupt enterprises at the same time as the promulgation of the Enterprise Bankruptcy Law. Such measures should include: a) perfecting the Labour Law and the social security system, strengthening enforcement of labour security supervision, establishing a wage monitoring system, and establishing an early warning mechanism for wage disputes that will correct problems related to wage and social security premium arrears at the earliest opportunity; b) establishing enterprise wage protection funds or similar systems; and c) providing government relief to those suffering hardship due to lost wages and social security premiums owed by bankrupt enterprises. In this respect, it is worth drawing on the experience of France, Korea and other countries who withhold 0.2% to 0.25% of wages to maintain wage protection funds that are used in the event of bankruptcy.

The core of these three measures is that governments must bear the responsibility for social stability and for establishing a social security system.

2) The need for and feasibility of the limited priority of workers' claims

Limited priority workers' claims embody people-oriented values. It is a good thing to meet the daily needs of workers in bankrupt enterprises. They embody, in the form of a law, the provisions of the Constitution concerning the protection of labour rights, including the right to enjoy social security benefits.

Limited priority workers' claims are a practical choice in response to current conditions in China. They help maintain social stability. The Enterprise Bankruptcy Law should resolve both procedural problems and practical problems, and should be operable. Where the relief system for

workers whose wages are in arrears is imperfect, courts will become the focus of conflict, and it will be hard to make judgments.

The limited priority of workers' claims is linked to the Civil Procedure Law, the Security Law, the Law on Commercial Banks, Contract Law and other laws. Limited priority is beneficial to establishing a property rights system and a credit system. With respect to preferential payment of ordinary claims, the security interests system constitutes the basic principle recognised by the property system in a market economy, and reflects the function of the property system to support the credit system. The security interests system is a social transaction system which has functioned effectively at home and abroad for thousands of years. Denial of, and damage to the system will have harmful consequences.

Limited priority workers' claims comply with actual legal practice in China that gives priority to workers' claims. The Bankruptcy Law and the Civil Procedure Law of China provide that secured claims be paid preferentially. However, in practice, in most cases priority is given to the payment of a part of wages and social security premiums in arrears. In fact, the principle of priority of workers' claims has, to some extent, already been accepted by society.

Practice proves that the limited priority of workers' claims is feasible. Emerging investigations on the claims of industrial and commercial banks show that, in fact, not all workers' claims under policy-based bankruptcy are paid in full. For policy-based bankrupt enterprises, the proportion of payments of wages and social security premiums in arrears in 2004 was 76% and 87% respectively. For law-based bankrupt enterprises, the proportion was 63% and 61% respectively. In our opinion, failure to pay is acceptable because it reflects the changes in ideas of enterprise workers and the relief arrangements by governments.

The absolute priority of workers' claims, on the other hand, might force financial institutions to increase their interest rates and to withhold lending. The difference between the interest rate on secured versus unsecured loans is a few percentage points. The amount of loans granted by financial institutions in China exceeds CNY (Chinese Yuan renminbi) 15 thousand billion, more than one-third of which is secured loans. The difference resulting from a small percentage point increase will raise enterprise costs by tens of billions of Yuan. This will hurt struggling enterprises, and affect, directly or indirectly, the long-term interests of workers.

It may prevent minority enterprises from maliciously defaulting or forging workers' claims, dodging repayments, or gaining by cheating on secured claims. This is not a theoretical, but a practical problem. Surveys have found that credit co-operatives in Foshan City have lent to bankrupt

enterprises who forged labour affiliations and dodged their debts to a credit co-operative. A US scholar and a Hong Kong, China employer both happened to hold the same point of view that should absolute priority be given to workers' claims, labour costs would be reduced by enterprises. It is obvious that with the launch of the new bankruptcy mechanism, additional potentially bankrupt enterprises will arise; gaining secured claims by forging workers' claims maliciously and cheating will become a new hotbed for bad debts.

Limited priority workers' claims comply with principles and provisions recognised in the bankruptcy laws of a majority of other countries. A comparative study of the order of payments under the enterprise bankruptcy laws of twenty-seven countries has shown that the priority of secured claims is a basic characteristic of bankruptcy law. In sixteen countries, including Australia, Austria, Bermuda, Canada, the Czech Republic, Finland, Germany, Israel, Malaysia, Norway, Poland, Romania, Singapore, South Africa, the UK and the US, the payment of secured claims, (including fixed and floating charges) ranked first.

The payment of a part of workers' claims ranks first in France where wages in arrears (to which absolute priority is given) is limited to the wages for the two months immediately before the bankruptcy proceedings start. In Brazil, workers' claims have priority over floating claims, and relevant provisions are under revision. In Russia the priority is only limited to personal injuries and relevant claims. In Columbia and Indonesia taxes and workers' claims. Taxes rank first in Indonesia and Japan. Wages payable to the administrator rank first in New Zealand. These examples show that security interests rank first in a majority of foreign bankruptcy laws and that workers' claims rank first in a minority of bankruptcy laws with certain limitations based on time and amount.

3) The significance of the limited priority of workers' claims

Workers may be trained to identify market risks, to improve awareness, and to tackle problems as soon as possible in case of default on their wages and social security premiums.

Local governments need to strengthen the enforcement of labour security, and urge governments to pay more attention to and tackle problems related to wages in arrears and social security premiums in arrears.

Limited priority workers' claims may balance bank interests, and help reduce overall financial risk and the level of bad debts in financial institutions. For example, ICBC's ratios of payment of secured claims of policy-based bankrupt enterprises in 2003 and in 2004 were 0.5% and 0.8%,

respectively. However, the ratios for law-based bankrupt enterprises were 20% and 21.8%, respectively.

Financial institutions need to prevent and avoid the risk of workers' claims. Banks can play a role in preventing enterprises from defaulting on wages and social security premiums. They may be cautioned to strengthen loan risk controls by drawing a certain proportion of secured claims to subsidise workers. Currently, banks do not evaluate the enterprises' risk of wage default and social security premiums when lending. And, only a few banks prohibit lending to enterprises who have defaulted on more than a certain amount of wages. Of course, the provisions concerning limited priority can go too far, because banks are not labour supervisors and cannot replace workers and trade unions.

4) The limits

Scope limitations

Almost all countries have provisions concerning the scope of workers' claims that shall be paid preferentially. A majority of countries list wages, medical expenses, pensions and limited severance pay as items that receive preferential treatment. Some countries find it prudent to compensate for holiday bonuses, labour protection pay, and sick leave. The scope of preferential payments in case of enterprise bankruptcy in China includes: wages; medical expenses; support for the disabled; consolation money; basic pension and medical insurance premiums in arrears; and compensation payable to workers according to the law. These items cover the daily needs of workers. This coverage is wider than that provided by a majority of countries, which reflects the socialist nature of China and corresponds to current national circumstances.

Different opinions are still held regarding whether worker compensation should be paid preferentially. In the opinion of the authors, it is inadvisable to pay all worker compensation in arrears preferentially because worker compensation has various meanings (it may be regarded as severance pay or as an "identity transfer fee"), as specified by eight ministries and commissions (including the former State Economic and Trade Commission). In the case of the latter, for ordinary enterprises, it is difficult to determine whether worker compensation should be paid preferentially because not all enterprises are owned by the state, and many major policies are involved. The Enterprise Bankruptcy Law is a commercial law, so it is advisable to pay only severance pay of a general nature which, generally, is equivalent to one to two months' wages.

Time limitations

Different countries have different provisions, but almost all countries provide for some sort of time limitation. As for wages in arrears, developed countries generally provide for the payment of one to six months' wages. In France, which gives absolute priority to the payment of wages in arrears, the time limitation is two months. For wages in arrears, China may provide a longer period for preferential payment, *e.g.* 6-12 months' wages in arrears immediately before the enterprise bankruptcy. China may provide that the time limitation for social insurance premiums, disability compensation, and consolation money in arrears may be extended up to 18 months.

Amount limitations

A majority of countries limit the total amount of workers' claims that can be paid preferentially. The bankruptcy of an enterprise means that the enterprise's business operations fail, and workers' claims are paid only for the purpose of guaranteeing their basic needs. In the authors' view, the amount of wages in arrears that should be preferentially paid may be determined according to the local monthly average wages in the same industry. In practice, the local average "floating wages" in the same industry may be determined through consultation. It is important to define and differentiate the standards for, meanings of, scope of, and amount of wages, in order to avoid infringing upon other creditors' interests.

5) Other issues

Provisions concerning the preferential payment of expenses of bankruptcy proceedings should be adjusted or restricted. Surveys show that the expenses of enterprise administrators are too high to protect workers' claims. Authorities in Foshan found that the high cost of bankruptcy proceedings had become a way for some institutions to enrich themselves. A literature surveys of 27 countries shows that the payment of the expenses of bankruptcy proceedings ranks first only in: Belgium; China; Hong Kong, China; Latvia; and Mexico. It is, therefore, suggested that only the payment of wages to administrators and routine administrative expenses be ranked first, and that the other expenses of bankruptcy proceedings, (especially expenses charged as a proportion of assets or the excess over a certain amount) be paid after the payment of security interests.

The solution of the workers' claims issue depends mainly on labour law and social security regulations, and the effective implementation thereof. The Enterprise Bankruptcy Law should complement, be linked to, and

correspond to the labour law and other laws to help solve the workers' claims issue. However, the basic functions of different laws cannot be altered. Different laws have their respective responsibilities and may give consideration to two or more things. The key to the workers' claims issue is the effective implementation of the labour law and social security regulations.

In the order of payments against insolvent properties, whether priority is given to the payment of workers' claims does not vary from market to non-market economies. China should base its policies on national conditions after considering foreign practices. It should near its practices to those of market economies in order to reduce unnecessary international frictions.

The limited priority of workers' claims has a limited impact on social stability. It is necessary to conduct a socioeconomic analysis of the issue of wage and social insurance premium defaults. Under market economy conditions, a situation where people work without pay for a long period (and do not resign) is unusual. The issue of default on wages and social insurance premiums has two characteristics.

First, is the issue of state-owned enterprises. This issue involves enterprises who operate improperly for a long period and should (but fail) to go into bankruptcy. In such enterprises, workers are unwilling to leave because policies are not clear. The number of such enterprises is decreasing. From the viewpoint of society, the estimated proportion of wages in arrears to the total amount of wages does not exceed 2%. The Enterprise Bankruptcy Law has provided for the bankruptcy of state-owned enterprises and may tackle this issue.

Second, is the issue of farm workers' wage arrears. This issue cannot be tackled according to the absolute priority of workers' claims. Farm workers provide labour services mainly through a "trustworthy fellow villager" who acts as a labour contractor. But the majority of such labour contractors have no valuable assets to mortgage for borrowing loans. So the farm workers' wage arrears issue can only be tackled by improving labour wage regulatory measures.

The provisions in international conventions concerning the priority relation between workers' claims and secured claims are illustrative. The European Convention on Insolvency Proceedings and the Protection of Wages Convention No. 95 do not clearly provide for the priority of workers' claims. Each member state may, at its discretion, make such provisions in its domestic law. The 28th paragraph of the preamble of the European Convention on Insolvency Proceedings provides that "Any other insolvency law questions, such as whether the employees' claims are protected by preferential rights and what status such preferential rights may have, should

be determined by the law of the opening State.” The third paragraph of Article 11 of Convention No. 95 provides that “...the relative priority of wages constituting a privileged debt and other privileged debts shall be determined by national laws or regulations.” Paragraph B of Article 16 of the World Bank’s Principles and Guidelines for Effective Insolvency and Creditor Rights Systems provides that the bankruptcy law should recognise the priority of secured creditors in their collateral, but the guidelines do not directly refer to the relation with workers’ claims.