

# **The Establishment of the Principle of Limited priority of Workers' Claims in the Enterprise Bankruptcy Law**

Mr. LI Guoqiang<sup>1</sup>

Researcher of the Development Research Centre of the State Council

**Abstract:** 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" refers to that limitations on scope, time and amount of preferential payments of Workers' Claims are imposed. Besides, the State Council may, in accordance with the basic principles and conditions of the *Enterprise Bankruptcy Law*, separately work out specific measures for implementation of the *Enterprise Bankruptcy Law*.

China is formulating an *Enterprise Bankruptcy Law* corresponding to the market economy system, and in the Law, the order of payments of Workers' Claims and security interests is a relatively important issue. Through surveys and discussions with scholars and enterprises, and after consulting and analyzing some relevant international legal writings, I hereby give some opinions and suggestions:

## **I. 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 the payment of Workers' Claims, such as wages in arrears and social security premiums in arrears, over the payment of the payment of security interests in the event of enterprise bankruptcy.

The reasons for approval: the priority complies with the people-oriented principle, conforms to the spirits of the Constitution; failure to pay wages and social security premiums due violates laws such as the Labor Law; the priority does not overturn the Security Law; the priority is beneficial to social stability; banks are more capable of identifying and bearing risks than workers.

The reasons for objection: wages and social security premiums in arrears shall be regulated in accordance with the Labor Law; the Bankruptcy Law can not violate the principle of priority of security interests; some enterprises thereby are more likely to infringe upon the rights and interests of workers; banks will be forced to increase the interest rates and to be reluctant to lend, and the workers will lose the employment opportunities; the priority will cause the increase of bad loans and the increase of financial risks.

The essence of the controversies on order of payments 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 fiducial economic order. Why the controversies are so huge is mainly because China is in the period of system

---

<sup>1</sup> Chen Xiaohong, Director of the Institute of Enterprise Research of the Development Research Centre of the State Council, and 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 participate in the surveys for this topic.

transformation and many people consider the system design mainly for the purpose of solving short-term practical questions. We hold that the design of the Enterprise Bankruptcy Law shall deal with the current interests and actual difficulties of worker-creditors well, consider the long-term interests of worker-creditors and enterprises, and be linked with the establishment of the basic property system for market economy. We agree with the provisions concerning the “priority of Workers’ Claims”, and hold that priority shall be given to Workers’ Claims only if conditions are satisfied, so only limited priority feasible. For this purpose, we make suggestions as follows:

1. The *Enterprise Bankruptcy Law* shall deal with relevant issues according to the principle of “Limited priority of Workers’ Claims”, that is, permit Workers’ Claims satisfying certain conditions to be preferentially paid through specific provisions concerning the scope, time, and amount for preferential payments of Workers’ Claims, which not only help tackle the problems related to wages and social security premiums in arrears, but also can maintain the establishment and perfection of priority system of security interests to promote social harmony.

2. In consideration of the complexity of “Limited priority of Workers’ Claims”, some problems require further surveys, so it may be provided that the State Council shall formulate specific measures for implementation according to basic principles and conditions specified in the Enterprise Bankruptcy Law.

3. Measures for fundamental solutions shall be adopted to tackle the problems related to due wages and social security premiums unpaid by bankrupt enterprises, and the following guidelines shall be clarified simultaneously with the promulgation of the Enterprise Bankruptcy Law: (1) to unceasingly perfect the Labor Law, social security system, etc., to strengthen the law enforcement concerning labor security supervision, to fully establish a wage pay monitoring system, to establish an early-warning mechanism for wage disputes, which will radically correct the problems related to wages and social security premiums in arrears at the earliest opportunity. (2) to establish enterprise wage protection funds or similar systems. (3) to provide government relief for those who live hard due to the wages and social security premiums in arrears payable by bankrupt enterprises. It is worth drawing on the experience of France, Korea and other countries in withdrawing 0.2%~0.25% of wages to establish wage protection funds in the event of enterprise bankruptcy. The core of the three measures is that governments must bear the responsibilities for social stability and establishing social security system.

## **II. Necessity and Probability of Limited priority of Workers’ Claims □**

1. It embodies people-oriented spirits. It is beneficial to meeting the daily needs of workers of bankrupt enterprises, and embodies in the form of a law the provisions of the Constitution concerning the protection of laborer’s rights of labor and laborers’ rights to enjoy social security benefits.

2. It is a practical choice based on the national conditions of China, and is beneficial to maintaining social stability. The Enterprise Bankruptcy Law shall resolve both procedural problems and practical problems, and shall be operable. Where the relief system for workers whose wages are in arrears is imperfect, so that limited priority is not given to the payment of wages and social security premiums in arrears, courts will become the focus of contradictions, and it will be hard to make judgments; it is reflected in some regions that, in such cases, banks dare

not take back loans before all. □

3. It is linked to other relevant laws, and meets the requirements for establishing a sound and steady property system and a social transaction system of China. Limited priority of Workers' Claims is linked to the Civil Procedure Law, the Security Law, the Law on Commercial Banks, the Contract Law, and other laws, and is beneficial to establishing a property right system and a credit system as soon as possible. With respect to preferential payment of ordinary claims, the security interests system constitutes the basic principle recognized by the property system under market economy conditions, and reflects the function of the property system to basically support the credit system. Security interests system is a social transaction system which has been effectively practiced at home and abroad over several thousand years, and the denial and damage to the system will cause systematically harmful consequences. □

4. It complies with the legal practice that priority is actually given to the Workers' Claims in China. The Bankruptcy Law and the Civil Procedure Law of China provide that secured claims shall be preferentially paid. 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 proper priority of Workers' Claims has been accepted by the society to some extent. Over ten years as at 2003, in China, the total number of bankrupt enterprises including law-based bankrupt enterprises is 62 thousand, of which about a half are State-owned enterprises and 3300 go into policy-based bankruptcy. Based on the estimates by the parties concerned, on the whole, not only State-owned enterprises who go into non-policy-based bankruptcy but also non-State-owned enterprises who go into bankruptcy according to law constitute the riders on policy-based bankruptcy. □

5. Practices prove that the Limited priority of Workers' Claims is feasible. The emergent investigations on the claims of the industrial and commercial bank have reflected that, in fact, not all Workers' Claims under policy-based bankruptcy are paid in full. For policy-based bankrupt enterprises, the proportions of payments of wages in arrears and social security premiums in arrears in 2004 are respectively 76% and 87%; for law-based bankrupt enterprises, the proportions are respectively 63% and 61%. In our opinion, failure to pay up is acceptable because it has relations with the changes of ideas of enterprise workers and the relief arrangements by governments.

6. The absolute priority of Workers' Claims might force financial institutions to increase their interest rates and to be reluctant to lend. The difference between the interest rate for secured loans and the interest rate for unsecured loans is a few percentage points. The amount of loans granted by financial institutions of China exceeds 15 thousand billion RMB, more than one thirds of which is secured loans, so the interest difference resulting from the percentage points will increase the enterprises' financial costs by tens of billions RMB, which will have greater effects on enterprises facing business difficulties and affect, directly or indirectly, the long-term interests of workers.

7. It may prevent minority enterprises from maliciously defaulting or forging Workers' Claims, dodging, or gaining by cheating secured claims. It is not a sort of theoretic hypothesis, but a practical problem. Through our surveys, such a fact has been found that some credit cooperative of Foshan City used to lend to two bankrupt enterprises who respectively forged labor affiliations and dodged a great deal of debts to the credit cooperative. A US scholar and a HK employer happened to hold the same point of view that should absolute priority be given to Workers' Claims,

labor costs would be saved in case of running enterprises in China. It is obvious that with the launching of the new bankruptcy mechanism, many potentially bankrupt enterprises will definitely break surface, and gaining secured claims by forging Workers' Claims maliciously and cheating will become a new hotbed of bad debts in financial system.

8. It complies with principles and provisions recognized by bankruptcy laws of majority countries. The comparative study of the order of payments against insolvent property under enterprise bankruptcy laws of twenty-seven countries has shown that the priority of secured claims is a basic characteristic of the bankruptcy laws of majority countries. In sixteen countries including the US, England, Germany, Australia, Austria, Canada, Singapore, Bermuda, Czech, Poland, Romania, South Africa, Finland, Israel, Norway, and Malaysia, the payment of secured claims (including fixed charges and floating charges) rank first; the payment of a part of Workers' Claims ranks first in France (the wages in arrears which the absolute priority is given to is only limited to the wages for the two months immediately before the bankruptcy proceedings start), Brazil (Workers' Claims has priority over floating claims, and relevant provisions are under revision), Russia (the priority is only limited to personal injuries and relevant claims), Columbia, and Indonesia (taxes and workers' claims); taxes rank first in Japan and Indonesia; the wages payable to administrator rank first in New Zealand. The data above have shown that security interests rank first in a majority of foreign bankruptcy laws, and that Workers' Claims rank first in minority bankruptcy laws under time and amount limitations.

### **III. The Significance of "Limited priority of Workers' Claims"**

1. Workers may be trained to identify market risks, to improve the awareness, and to tackle the problems as soon as possible by various means in case of defaulting wages and social security premiums. □

2. It may urge local governments to strengthen the enforcement concerning labor security, urge governments to pay much attention to and tackle the problems related to wages in arrears and social security premiums in arrears, which is a guiding issue. □

3. It may balance bank interests, help reduce overall financial risks and 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, such ratios for law-based bankrupt enterprises were 20% and 21.8%, respectively.

4. It urges financial institutions to prevent and avoid risks of Workers' Claims. Banks can play a certain role in preventing enterprises from defaulting wages and social security premiums; banks may be cautioned to strengthen loan risk control by drawing a certain proportion of secured claims to subsidize workers. Currently, banks do not evaluate enterprises' risks of defaulting wages and social security premiums when lending, and only a few banks prohibit lending to enterprises who have defaulted more than a certain amount of wages. Of course, the provisions concerning "limited priority" can go too far, because banks are not labor supervisors and it cannot replace workers' and trade unions' counteracts towards such acts.

### **IV. The Limits for "Limited priority of Workers' Claims"**

1. Scope Limitation as to Preferential Payments. Almost all countries make clear provisions

concerning the scope of Workers' Claims which shall be preferentially paid. A majority of countries listed wages, medical expenses, pensions and limited severance pay as items which shall be preferentially paid. Some countries provide that holiday subsidies, labor protection pay, and sick leave pay may be prudentially paid. The scope of preferential payments in case of enterprise bankruptcy in China includes: wages, medical expenses, subsidies for disabled, consolation money, basic pension insurance and basic medical insurance premiums in arrears which shall be transferred to individual accounts of workers, and compensation payable to workers according to law. Such items cover the daily needs of workers, and such coverage is wider than that provided by a majority of countries, which reflects the socialist nature of China and complies with national conditions and actual situations of China.

Different opinions are still held towards whether worker compensation should be preferentially paid. In our opinion, at least, it is inadvisable to preferentially pay all the worker compensation in arrears. Because the current worker compensation is provided with various meanings, which may be regarded as severance pay or "Identity Transfer Fee" 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 the 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 categorized into commercial laws, so it is advisable to preferentially pay only severance pay of general nature which, generally, is equivalent to one-two months' wages.

2. Time limitation as to preferential payment. Different countries make different provisions in connection with it, but almost all countries provide for time limitation. As for wages in arrears payable to wages, developed countries generally provide that one-six months' wages in arrears may be preferentially paid. For France who provides the absolute priority of payment of wages in arrears, the time limitation is two months. For wages in arrears, China may provide a longer time 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 in arrears, disability subsidies in arrears, and consolation money in arrears which should be preferential paid may be extended to (by) 18 months.

3. Amount Limitation as to preferential payment. A majority of countries only provide a limitation on the total amount of Workers' Claims which should be preferentially paid. The bankruptcy of an enterprise means that the enterprise fails in business operation, and Workers' Claims are paid only for the purpose of guaranteeing the basic needs of worker to some extent. In our opinion, the amount of wages in arrears which should be preferentially paid may be determined according to the local monthly average wages in the same industry. Currently, in practice, the local average "floating wages" in the same industry may be followed as determined by related parties through consultation. It is important to define and differentiate the standards for, meanings of, scope of, and amount of wages, which may avoid the infringement upon other creditors' interests.

## **V. Some Other Issues and Situations**

1. The provisions concerning the preferential payment of expenses of bankruptcy proceedings should be adjusted or restricted. Through surveys, we have found that the expenses for enterprises'

administrators (especially agencies) are too high to affect the effective protection of Workers' Claims. Competent authorities of Foshan reflected that, such high expenses of bankruptcy proceedings had become the way for some institutions to become wealthy. Through surveys of literature from 27 countries, the payment of expenses of bankruptcy proceedings ranks first in China Hong Kong, Belgium, Latvia, and Mexico only. Therefore, we suggest that in the expenses of bankruptcy proceedings, only the payment of wages to administrators and routine administration expenses should be ranked first, and the other expenses of bankruptcy proceedings (especially all of the expenses charged in the proportion of assets or the excess over a certain amount) may be paid after the payment of security interests.

2. The solution of the Workers' Claims issue mainly depends on the labor law and social security regulations and the effective implementation thereof. The Enterprise Bankruptcy Law shall cooperate with, be linked to, and correspond to the labor law and other laws, to help solve the Workers' Claims issue. However, the basic functions of different laws cannot be misplaced, and different laws have their respective responsibilities and may give consideration to two or more things. The key to tackle the Workers' Claims issue is still the effective implementation of the labor law and social security regulations.

3. The relation between Workers' Claims and market economy status. In the order of payments against insolvent properties, whether priority should be given to the payment of Workers' Claims does not vary depending on whether the bankruptcy law is under market economy or under non-market economy, so this issue is completely provided in domestic laws of various countries, and does not involve the market economy status issue. China should use the meanings and actual effects of some foreign clauses for reference, and whether priority is given to the payment of Workers' Claims should be based on national conditions, and on this condition, efforts should be made to near the practices in general market economy countries, for the purpose of reducing probable and unnecessary international frictions. □

4. Limited priority of Workers' Claims have few impacts on social stability. It is necessary to make Socioeconomic analysis of the issue of defaulting wages and social insurance premiums. Under market economy conditions, the circumstances where people work without pay for a long period and do not resign will be special. The issue of defaulting wages and social insurance premiums have two characteristics: I. State-owned enterprises' "institutionally defaulting wages and social security premiums". This issue mainly involves some enterprises who operate improperly for a long period and should but fail to go into bankruptcy, and in such enterprises, workers are unwilling to leave such enterprises with wages in arrears because policies are not clear, and the number of such enterprises is decreasing. For the viewpoint of the whole society, the estimated proportion of wages in arrears to the total amount of wages does not exceed 2%, and China has the ability and responsibility to tackle this issue, and the Enterprise Bankruptcy Law has separately provided the bankruptcy of State-owned enterprises and may tackle this issue. II. Farmer workers' wage arrears issue, mainly farmer workers' wage arrears in construction industry. This issue cannot be tackled according to the absolute priority of Workers' Claims. Because farmer workers provide labor services mainly through "trust-worthy fellow-villager" heads of labor contractors, but a majority of heads of labor contractors usually have no valuable assets to mortgage for borrowing loans, so it can only depend on the enhancement of labor wage regulatory measures to tackle the Farmer Workers' Wage Arrears issue.

5. The provisions in international conventions concerning the priority relation between the Workers' Claims and Secured Claims. Through examinations, European Convention on Insolvency Proceedings and No. 95 Protection of Wages Convention do not clearly provide for the priority of Workers' Claims, and each member state may, at its discretion, make such provisions in its domestic law. The 28<sup>th</sup> paragraph of Preambles of 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 No. 95 Convention 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 recognize the priority of secured creditors in their collateral, but the Guidelines do not directly refer to the relation with Workers' Claims.