

Enterprise Bankruptcy Law of China: Changes Based on Reform Process

—Take Example by the Relationship between Workers' Claims and Security Interests

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I. Enterprise Bankruptcy Law of China: Changes and Controversies

1. Overview of the Enterprise Bankruptcy Law of China and relevant regulations

1986 Enterprise Bankruptcy Law,

1988 Enterprise owned by the whole people,

1990 Civil Procedure Law (Chapter 19),

1994 Company Law

1994 The "Notice of Several Issues Concerning the Trial Implementation of Bankruptcy of State-Owned Enterprises in Several Cities" issued by the State Council (Guo-Fa [94] No. 59)

1996 The "Notice of Several Issues Concerning the Trial Implementation of Merger and Bankruptcy of State-Owned Enterprises" issued by the State Economic and Trade Commission, etc. (Document No. 492)

Recently The Enterprise Bankruptcy Law under revision.

2. Brief Summary

- Attention is paid to the legislation and revision of the Bankruptcy Law.
- Because the reform of State-owned enterprises is important, the documents issued by the State Council have great effects.

3. An Important Controversy: the relationship between workers' claims and security interests

1) Regulations

- The Law (1986) provided that the payment of security interests had priority over the payment of workers' claims.
- The relevant provisions of the Notice (Guo-Fa [94] No. 59) issued by the State Council in 1994 were the same as those provided in the Law (1986).
- In 1996, the State Economic and Trade Commission provided in the SETC Document No. 492 that the payment of workers' claims had priority over the payment of security interests.

2) Points of Disagreement

Approval of the preferential payment of workers' claims:

- Beneficial to the payment of unpaid wages and social security premiums.
- Enabling banks to identify risks,
- Beneficial to social stability.

Objection to the preferential payment of workers' claims:

- Failing to resolve the imperfection in the labor law and social security programs,
- Violating basic principles of civil and commercial laws,
- Hard Financing, and employers are more likely to infringe upon the rights and interests of

employees.

3) Essence of Controversies:

- Not only in the understanding of the Bankruptcy Law:
 - in most countries (16/27), priority is given to the secured claims,
 - in minority countries, priority is given to the workers' claims, provided that, generally, certain conditions are satisfied;
- How to evaluate the effects of laws;
- How to evaluate the current status of the economic system of China and the roles and capabilities thereof in various aspects.

II. Important Reasons for Controversies: Changes in the Goals and State System

1. Development, reform and social stability are major factors that affect the promulgation of the Bankruptcy Law

Development and Reform

- To facilitate the reform of State-owned enterprises, to allow the competition and bankruptcy, and to formulate the Bankruptcy Law.
- The development of non-State-owned and foreign-funded enterprises, the formulation of the Civil Procedure Law in 1990.
- Changes of Economic Structure, and the decrease in the proportion of State-owned enterprises.

Ratio of State-Owned Enterprises to the Industrial Output Value (%)

	1978	1990	1995	2000	2003
State-Owned and State-Controlled	77.6	54.6	34.0	44.4	37.5

Note: Changes occur to the statistical methods before and after 1995.

Data Source: based on China Statistical Yearbook.

The goal of social stability starts to change

- For urban residents, the policy that their employment is fully guaranteed by the State is changed to the policy that their unemployment is permitted while the State offers a minimum living standard (unemployment relief, etc.).
- “Rural Labor Migration”: Over more than 20 years, more than one hundred million rural residents work in urban area.

2. Many factors allow the priority of workers' claims in China

at the beginning of 1990s, the structure change makes the demand for bankruptcy (including obligation reorganization) of State-owned enterprises expand, but it is hard to proceed with bankruptcy:

- In the first half year of 1995, only 4% of insolvent enterprises in 18 major cities went into bankruptcy (based on the report by the former State Economic and Trade Commission);
- Only 0.01% of State-owned enterprises in China went into bankruptcy.

The number of enterprise bankruptcy cases accepted by courts in China

1988-1992	1993	1994	First half year of 1995
About scores of cases per year*	163	395	478

Data Source: Survey by Mr. Chen Xiaohong

* refers to the evaluated number of interviewees, from Page 256 of “China Development Review (1996 Edition)” published by China Development Publishing House.

Main Reasons for Difficulties in Bankruptcy of State-Owned Enterprises:

- Consciousness.
- The number of enterprises that are likely to go into bankruptcy is small.
- The arrangement of workers from bankrupt enterprises is still in the hands of governments.
- The fiscal responsibility system has been implemented for a long term, and the central government has limited financial resources, and a relatively complete social security system has not been established yet.

For the purpose of social stability, China decides to give priority to the payment of workers’ claims in bankrupt State-owned enterprises in pilot cities.

- To promote the reform of State-owned enterprises;
- Both the enterprises and main creditors (banks) are owned by the State;
- Scholars’ viewpoints: the bankruptcy of State-owned enterprises at that time belongs to “structural bankruptcy”, and is not general business bankruptcy;
- Only limited to “policy-based bankruptcy”.

3. Conditions after 1996

The application of the principle of preferential payment of workers’ claims in bankrupt enterprises actually expands to the “market-guiding bankruptcy” of State-owned enterprises and the bankruptcy of non-State-owned enterprises.

Through the survey in 2004, quite a few enterprises were found to owe wages and premiums, especially the wages payable to “rural immigrant workers” in construction industry, so there is a very high voice of demanding the continuous implementation of the priority of workers’ claims during the revision of the Bankruptcy Law.

The voice of objecting to the preferential payment of workers’ claims in bankrupt enterprises becomes higher on the important grounds as follows:

- The original State-owned banks and enterprises are not wholly owned by the State now.
- A time limitation shall be imposed on the policy of special treatments for State-owned enterprises.
- The perfection of social system and legal system shall be taken into considered.

III. Recommendations

1. The guiding ideology for legislation shall be adjusted based on the development and reform process

The tasks of law-making are changed from the launch and promotion of reform into the establishment economic and legal systems corresponding to socialist market economy system.

The development of non-State-owned economy and mixed public-private economy requires the establishment of a Bankruptcy Law.

The increase in financial resources of China and enterprises provides economic base for harmonizing the economic relations concerning bankruptcy.

Special arrangements may be made for the problems concerning bankruptcy of State-owned enterprises, which are left over by history.

2. The solution of problems concerning bankruptcy of enterprises requires systematic engineering

The difficulties in dealing with bankruptcy of enterprises of China are rooted in the changes of economic system of China, and the solution of contradictions in enterprise bankruptcy requires systematic engineering in consideration of the characteristics of China, such as

- To clarify goals: the issues concerning Enterprise Bankruptcy Law shall be dealt with by means of market approaches, and the legislative principles shall be compatible with the international practices.
- From a legal point of view, the solution of problems concerning the workers' wage and social security premium arrears mainly depends on the implementation of and regulation according to the labor law, and proper special policies may be made for the solution of problems left over by history concerning State-owned enterprises.
- Full performance of functions of special agencies.
- The State shall bear corresponding liabilities for the establishment of Worker Relief Fund on Enterprise Insolvency.

3. Recommendations concerning dealing with the Relations between workers' claims and security interests under the Bankruptcy Law

- Under certain conditions, the payment of workers' claims is permitted to have priority over the payment of security interests (limited priority of workers' claims),
- The workers' claims preferentially paid include the unpaid wages and allowances, social security premiums that shall be transferred to individual accounts of workers, and compensations payable to workers according to law.
- A strict time limitation shall be imposed on the items and amounts under preferential payment.