



**THE ORDER OF PAYMENT OF WORKERS' CLAIMS AND
SECURITY INTERESTS UNDER CHINA'S NEW
BANKRUPTCY LAW**

by Wang Weiguo

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1) Current legal provisions

Article 32 of the Enterprise Bankruptcy Law for Trial Implementation provides that:

With respect to claims secured with property that are established before bankruptcy is declared, the creditors enjoy the right to receive repayment with priority with respect to such security. With respect to claims that are secured with property whose amount exceeds the value of the security collateral, the part that is not repaid constitutes a bankruptcy claim, and will be repaid in accordance with the bankruptcy proceedings.

Article 37 of the Enterprise Bankruptcy Law for Trial Implementation provides that:

After the prior deduction of bankruptcy expenses from the bankruptcy property, repayment shall be made in the following order: 1) wages of staff and workers and labour insurance expenses that are owed by the bankrupt enterprise; 2) taxes that are owed by the bankrupt enterprise; and 3) bankruptcy claims.

Article 203 of the Civil Procedure Law provides that:

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With respect to the property mortgaged or otherwise used as security for bank loans or other obligations, the bank and other creditors shall have priority in the repayment of debts as regards the property mortgaged or used as security for other kinds of obligations.

Article 204 of the Civil Procedure Law provides that:

After the prior deduction of bankruptcy expenses from the bankruptcy property, repayment shall be made in the following order: 1) wages of staff and workers and labour insurance expenses that are owed by the bankrupt enterprise; 2) taxes that are owed by the bankrupt enterprise; and 3) bankruptcy claims.

In accordance with these provisions, among all the properties of a debtor, secured claims enjoy the status of being paid with first priority with respect to the security. Unsecured properties and remaining properties shall be paid after secured claims and expenses associated with the bankruptcy proceedings. As for bankruptcy distribution, workers' wages, labour insurance premiums and other workers' claims shall be paid with first priority.

2) Provisions of the International Convention

Article 5 of the Convention Concerning the Protection of Workers' Claims in the Event of the Insolvency of their Employer (passed at the International Labour Conference in 1992) provides that "In the event of an employer's insolvency, workers' claims arising out of their employment shall be protected by a privilege so that they are paid out of the assets of the insolvent employer before non-privileged creditors can be paid their share." Article 8 thereof provides that "National laws or regulations shall give workers' claims a higher rank of privilege than most other privileged claims, and in particular those of the [s]tate and the social security system." That is to say, the convention requires that workers' claims be paid prior to "non-privileged creditors", "privileged claims of the [s]tate and the social security system" and most other privileged claims. The provisions of the current bankruptcy legislation of China give priority to workers' claims over ordinary claims and tax claims, which satisfies the level of protection required by the convention.

3) Provisions concerning policy-based bankruptcy

As for the “policy-based bankruptcy” implemented since 1994, the worker arrangement issue for bankrupt enterprises has a prominent status. With respect to the status of secured claims, the Notice of Several Issues Concerning the Trial Implementation of Bankruptcy of State-owned Enterprises in Several Cities Document No. 59, issued by the State Council in 1994, also recognised the priority of secured creditors. However, Article 5 of the Notice of Several Issues Concerning the Trial Implementation of Merger and Bankruptcy of State-owned Enterprises Document No. 492, issued by SETC and the People’s Bank of China in 1996, made a new provision that:

...during the implementation of enterprise bankruptcy, firstly, workers of bankrupt enterprises shall be properly arranged, for the purpose of maintaining social stability. Where an enterprise offers the land use right as a collateral, the revenues from the transfer of the land use right shall be first used for arrangement of workers of bankrupt enterprises, and the mortgagees shall enjoy the right to be paid with priority out of the remaining revenues if the revenues from the disposal of the land use right are insufficient for the arrangement of workers, the insufficient amount shall be paid successively out of the revenues from disposal of unsecured property or other secured property. The portion which fails to be preferentially paid to the mortgagees shall be paid as general claims.

This provision was reaffirmed in the Supplementary Notice of Several Issues Concerning the Implementation of Merger and Bankruptcy of State-owned Enterprises and Workers’ Reemployment in Several Cities Document No. 10, by the State Council in 1997. However, it is generally understood that this provision is only an expedient measure adopted during a special period in connection with special issues.

By the end of April 2004, the number of enterprise closings and bankruptcy projects arranged in China was 3 377. The total amount of bad accounts in state-owned banks and claim losses of financial asset management corporations that was cancelled after verification was CNY 224 billion (Chinese Yuan renminbi). The amount of eliminated source of losses was CNY 134 billion. Central Finance accumulatively appropriated CNY 49 billion as bankruptcy subsidies.¹ To some extent, the claim losses of banks were borne directly or indirectly by Central Finance, and were made up by financial resources saved due to the elimination of the source of losses. Generally speaking, this measure is a strategic arrangement for the

distribution of reform costs within the state-owned economy, instead of a systematic arrangement for establishing a market-based economic order.

4) Provisions of the draft new Bankruptcy Law

Provisions on secured claims

In the course of drafting the new Bankruptcy Law, NPC-FEC continues the current legislative plan regarding the payment of workers' claims and secured claims. The draft submitted by FEC to the standing committee in June of 2004, provided the right of exclusion status of secured claims. Article 121 of the draft provides that:

...the right of mortgage, the right of pledge, and the lien enjoyed on the property or rights of a bankrupt belongs to the rights of exclusion, and the holders of such rights of exclusion are referred to as exclusion right holders. An exclusion right holder shall enjoy the right to be paid with priority with respect to the subject matter of the right of exclusion.

The right of exclusion refers to the “right to receive payment from special property of a bankrupt corporation with preference over creditors in the bankruptcy.”² Specifically, the right of exclusion refers to the:

...right to receive payment separately from special property of a bankrupt corporation with priority. Such a right comes from the security interests existing on special property of a bankrupt prior to the bankruptcy declaration, and is not created due to bankruptcy proceedings.³ A creditor who enjoys the right of exclusion shall not exercise its right according to liquidation proceedings. Not exercising “its right according to liquidation proceedings” means a creditor who enjoys the right of exclusion shall exercise its right out of bankruptcy proceedings according to the type of its right of exclusion and based on the force of its right of exclusion.⁴

For example, Japanese Bankruptcy Law provides that, “those who have a special pre-emption, a right of pledge or a right of mortgage on the property belonging to a bankrupt corporation shall enjoy the right of exclusion with respect to the subject property.” Under Article 92, the “right of exclusion shall not be exercised according to the bankruptcy proceedings.” Article 95 of the US Bankruptcy Act states that claims in bankruptcy are divided into secured claims and unsecured claims: “A secured claim is a claim secured by special property, and an unsecured claim does not involve any special property and is paid from any other property of

the debtor other than the collateral.”⁵ In accordance with the US Bankruptcy Act, workers’ claims belong to unsecured claims, but have relative priority status among a series of unsecured claims.⁶

In a market economy the largest creditors of enterprises are banks and other financial institutions. With the credit of banks, enterprises produce, improve technology, introduce talent and smooth logistics for the purpose of exploiting markets, developing themselves and promoting economic prosperity for the whole society. In order to reduce their lending risks, banks typically grant loans to applicants with good credit standing. An important means for an enterprise to create comfort for the bank is to reinforce the enterprise’s credit standing by offering a security. In this way, banks become major creditors of enterprises in the form of secured loans.⁷

It is definitely not viewed positively to give the right of exclusion status to secured claims. One reason is that the existence of a great deal of rights of exclusion causes the reduction of unsecured property, and the decrease of the ratio of payment of unsecured claims (including workers’ claims) and, at the same time, results in the frustration of the collective payment principle of the Bankruptcy Law.

Provisions on workers’ claims

Based on the observations of foreign scholars, there are four types of attitudes toward security in the legal systems of various countries: 1) very sympathetic countries such as Sweden and the UK; 2) sympathetic countries such as Germany, Japan, the Netherlands, Switzerland and the US; 3) ill-disposed countries such as Belgium, Spain, and the majority of countries in Latin America; and 4) very ill-disposed countries such as Austria, France, and Italy.⁸

The convention concerning the Protection of Workers’ Claims in the Event of the Insolvency of their Employer provides for workers’ claims. In 2004, the FEC’s draft adopted the concept of workers’ claims.⁹ Workers’ claims refers to the claims for payment enjoyed by workers against their employers based on their labour affiliations, that are embodied in Item 1 of the first paragraph of Article 137 of the draft, that is, “the wages owed to workers by and social insurance premiums in arrears payable by a bankrupt, and the compensation and other expenses payable by the bankrupt to workers in accordance with laws and administrative regulations.” The first paragraph of the article provides that insolvent properties, after preferential payment of expenses of bankruptcy proceedings and common debts, shall be used first to pay workers’ claims, then to pay the taxes in arrears and, finally, to pay general claims. This provision is consistent with current legislation.

The UNCITRAL draft Legislative Guide on Insolvency Law 2004 points out that:

In a majority of countries, workers' claims including claims for wages, leave or holiday pay, allowances for other paid absence, and severance pay constitute a class of priority claims, which in a number of cases ranks above tax and social security claims. This approach is generally consistent with the special protection that is afforded to employees in other areas of insolvency law (see chapter III.D.6), as well as with the approach of some international conventions. In some insolvency laws, the importance of maintaining continuity of employment in priority to other objectives of the insolvency process, such as maximisation of value of the estate for the benefit of all creditors, is evidenced by a focus on sale of the business as a going concern with the transfer of existing employment obligations, as opposed to liquidation or reorganisation where these obligations may be altered or terminated.¹⁰

Following are the situations of several developed countries:

The United States

The US Bankruptcy Act provides that, workers' claims belong to unsecured claims and the portion below USD 2 000 (United States dollars) shall be protected with the third/fourth priority. Wages of no more than USD 2 000 earned within 90 days before the filing of the bankruptcy petition shall be regarded as wages with third priority. The welfare with fourth priority must be the welfare enjoyed by employees with respect to the work within 180 days before the bankruptcy petition is filed. The total amount of the two priorities above may not exceed USD 2 000. For example, if an employee has been paid USD 2 000 with third priority, he may not be paid with fourth priority. If workers' claims exceed USD 2 000, the excess can only be paid as general unsecured claims.

The US provides that the priority of the payment of workers' claims is inferior to that of the payment of secured claims, mainly for the following reasons. First, maintaining economic growth is more important than relief to individual worker creditors. The secured creditors (mainly banks) can safely anticipate that claims will be effected within the framework of the Security Law, so that industrial and commercial enterprises may continue to obtain the bank funding they need for business operations. In a strong economic environment, even if an enterprise goes bankrupt, workers can find employment quickly, and the potential for civil strife is reduced. Second, the US Bankruptcy Act, to a great extent, reflects the interests of financial

creditors, so secured claims are fully protected. Third, in the US, wages are usually paid once every two weeks. It is rare to see wages in arrears for three months; employees would probably quit before this point. As a result, there appears to be little probability of an employer defaulting on a large part of employee wages.

France

In order to keep workers from losing their claims due to a failure to declare them in a timely fashion, the law on the Judicial Rehabilitation and Liquidation of Enterprises of 1985 provides that the payment of workers' claims, (including all remuneration within the past 60 days and leave pay payable to employees and apprentices) established according to the Labour Code, are given first priority over secured claims. Such remuneration and compensation payable to employees and apprentices should be paid within 10 days after proceedings are declared.

The implementation of this system in France is based not only on political considerations, but also on special conditions in France. First, a wage protection system was established by law in 1973, whereby enterprises and employers pay the Association for Employment in Trade and Industry 0.25% of total wages as a guarantee for wages payable to employees in the event of a bankruptcy.¹¹ The impact of workers' claims on secured claims can, thus, be abated to some extent.

Second, in 1974, the government, in accordance with a decree passed by the congress, established an Inter-ministerial Committee for the Reorganisation of Industrial Structures. The fifteen members of the committee are the heads of ministries under the French government and are led by the Minister of Finance. The committee has a secretariat and is governed by the Ministry of Finance. Its main function is to help large private enterprises with more than 400 employees out of insolvency through co-ordination and proper financing. As for small private enterprises with less than 400 employees, regional and provincial governments carry out co-ordination and assistance. As for state-owned enterprises, the competent government ministries are responsible for handling their problems. As a result, when an enterprise falls into trouble, even if banks are unwilling to lend, the enterprise may be salvaged by resorting to the government.¹²

Japan

As for the secured claims mentioned above, the Japanese Bankruptcy Law has provided the right of exclusion as a guarantee. With respect to claims, the law provides that only the unpaid wage claims for the six months

immediately before the bankruptcy declaration are recognised as general pre-emptions and priority claims in bankruptcy. However, all of the wage claims unpaid by a limited joint-stock company, limited company or mutual insurance company prior to the bankruptcy declaration become general pre-emptions. Some scholars have criticised this differential treatment.¹³ The claims after the bankruptcy declaration may be paid with priority as corporate common claims. In addition, it is generally understood that pension claims should apply the provisions concerning wage claims.

Although the Japanese Bankruptcy Law grants different priority to workers' claims, it still abides strictly by the civil theory that "property rights have priority over claims". Workers' claims do not encroach on secured claims as they do under French law.

Korea

Workers' claims refer to the claims on all pecuniary goods as defined under Article 18 Wages of the Labour Standards Law, including claims on basic wages, claims on various incomes, claims on severance pay, claims on savings, etc. As for the order of payments, the priority of workers' claims is inferior to the priority of claims secured by a pledge or mortgage, but the wages for the last three months and the pensions and disaster compensation for the last three years shall be paid with first priority over claims secured by a pledge or mortgage.

When an enterprise goes into bankruptcy, the order of payments against the property of the enterprise is as the follows: 1) the wages payable to workers for the last three months, and the pensions and disaster compensation payable to workers for the last three years; 2) land taxes and other levies and fees surcharged by public organs having priority over right of pledge and right of mortgage; 3) claims secured by a pledge or mortgage; 4) other claims based on labour affiliations other than the wages for the last three months; and 5) general claims.

In addition, the Korean government has realised that if an employer is insolvent, the priority of workers' claims is nothing but a theoretical right. In 1998, the Wage Claims Protection Law was formulated, and Korea decided to establish a wage claims protection fund for the purpose of guaranteeing the payment of wage claims in the event of the insolvency of the employer. The wage claims protection fund is funded by employers, and the contribution made is no more than 2‰ of the wages of workers for the current year. The amount of the contribution is determined by the Review Committee for Wage Claims Protection Fund. The ratio (as specified by the Minister of Labour) multiplied by this amount is the total.¹⁴

The relation between workers' and secured claims, and legal provisions in Korea are similar to those of France. However, Korea offers a fuller protection of workers than France does. Practices in Korea seem to be more socially orientated.

Chinese Taipei

Chinese Taipei's laws follow the civil law tradition. As for the issue of workers' and secured claims, the civil theory that property rights have priority over claims is followed:

The claims provided for in Article 38 of the Trade Union Law (in the event of bankruptcy of its debtor, a trade union has the right to be paid with priority against the debtor's property) Article 15 of the Law on Ore Yards (a mining right holder shall pay miners all wages in arrears with priority in the event of business discontinuance or bankruptcy) and the third item of Article 11 of this Law (the remunerations payable to administrators, as determined by courts, have the right to be paid with priority) shall get paid prior to general claims in bankruptcy... the priority of such priority claims is with respect to bankrupt corporations instead of special property, so such priority claims do not belong to rights of exclusion.¹⁵

In Chinese Taipei, special laws, including the Trade Union Law and the Law on Ore Yards, still give the payment of workers' claims against general property of debtors a priority over other claims, although the priority of workers' claims is inferior to that of secured claims.

5) The revised draft by the Law Committee

After the draft was submitted to the NPC standing committee for review, the Law Committee made major changes to the provisions of the draft concerning the status of the payment of secured claims and the priority of the payment of workers' claims. The basic intent of the changes is to give first priority to outstanding workers' claims. The second paragraph of Article 127 of the revised draft by the Law Committee provides that:

...the workers' wages and basic social insurance premiums payable by a bankrupt and the compensation payable to workers by the bankrupt according to laws and administrative regulations, which are not paid according to the previous paragraph, shall be paid with priority against the special property provided for in Article 113 hereof.

In practice, a major change occurs in this provision. The capitalisation of the collateral must be implemented by the administrator and the secured creditors can be paid only after the workers' claims are paid in full. During general bankruptcy liquidation proceedings, creditors with security rights on property shall have the right of exclusion. That is, after the bankruptcy declaration, the collateral shall be disposed of directly, and in a timely manner, in a usual way to realise the security right. In accordance with the Security Law, the pledge and lien of movable assets shall be subject to the handover of possession of the property. As a result, in the event of bankruptcy, the pledge or lien has actually been in the possession of the creditor.

The following questions arise: will all of the property be handed over to the administrator? How is it handed over? If the possessor refuses to hand it over, what is done? In case of the inability to hand over, the administrator can only use the income from the realisation of the collateral to arrange workers, which causes an unfair burden on mortgagees and pledges/lienors.

More important is that the priority of workers' claims over secured claims as provided for in the Bankruptcy Law will have a significant effect on the relationship between banks and enterprises, which can be deduced as follows:

1. The direct aftermath of this institutional arrangement is a decrease in public trust in security rights and the reduction of the expected payment ratio of secured claims. In the event of civil execution, a debtor may file a bankruptcy petition to keep creditors from exercising the security because, in the event of bankruptcy, collateral may be reserved through the priority of workers' claims.
2. Where the expected payment ratio decreases, a bank may adopt the following countermeasures: 1) to refuse to grant loans to enterprises that default on workers' wages and social insurance premiums, and who fail to participate in social insurance programmes. This means that such enterprises may go bankrupt or close due to lack of funding with the eventual result that their workers become unemployed; and 2) in consideration of the reduction of the payment ratio of bank claims due to workers' claims, banks will increase the rebate rate for collateral when accepting enterprise collateral for loans. This means that the financing ability of the fixed assets of enterprises will decrease, which will cause a decrease in the volume of financial transactions and aggravate the financial difficulties of enterprises.

3. Under this system, banks will incorporate the payment of workers' wages and social insurance premiums by enterprises into the enterprise credit evaluation system. A solvent enterprise will make its best efforts to reduce workers' claims in arrears for the purpose of receiving loans.
4. A bank may insert articles into loan agreements that provide that if the enterprise is found to have workers' claims in arrears, the bank shall have the right to demand repayment in advance. If the enterprise is unable to repay loans, the bank will tend to start bankruptcy procedures. In this case, the probable results are: 1) through restructuring or conciliation, the enterprise and its workers make a compromise to provide a favourable guarantee for bank claims; and 2) the enterprise goes into liquidation and is closed, and its workers become unemployed.
5. The improvement in the priority of workers' claims will probably become another way for enterprises to evade paying debts through bankruptcy. Especially state-owned enterprises that have not been transformed may adopt the following sequence of actions in order to evade paying debts through bankruptcy: increasing workers' claims; filing of a bankruptcy petition; workers obtain the main assets of the enterprise based on priority; workers use such assets for funding; the enterprise is revived after a change of ownership; and the enterprise's debts to banks are cancelled. The results are as follows: 1) worsening bank assets; 2) deteriorating the bank-enterprise relation; and 3) worsening credit markets. The concurrent occurrence of the three means the worsening of China's business environment.

It appears that worker interests are not merely limited to the payment of claims. The following two points are worth consideration:

1. Employment is the fundamental long-term interest of workers. If the institutional arrangements under the Bankruptcy Law cause the deterioration of the existing business environment, the deterioration will necessarily result in a great deal of unemployment. This is not in workers' interests.
2. A nation's economic development is in the long-term interest of society as a whole. If the institutional arrangements under the Bankruptcy Law cause a deterioration in the Chinese economy, the final result will be a decrease in social welfare, including a decrease in workers' welfare. Nor is this in the interest of workers.

6) Recommendations

The following recommendations are made to tackle the problems above:

1. With respect to the institutional design of the priority of payment of secured claims and the priority of payment of workers' claims, the plan in the FEC Draft should be adopted. The priority of secured claims should be recognised and, in the liquidation and distribution of unsecured property, first priority is given to workers' claims.

If there are sufficient reasons for the reinforcement of the protection of workers' claims, special limited priority may be given to workers' claims. That is to say, it may be provided that workers' wages owed by a bankrupt for a half year or one year, shall be paid with the same priority as that of the expenses of bankruptcy proceedings.

Limited priority means satisfying workers' basic needs during the bankruptcy procedures, thus showing basic concern for human needs. As for the workers' other claims, the current legislation and the plan in the FEC draft should be abided by. Workers' claims should be paid with first priority out of the income from the realisation of unsecured property. This arrangement has the advantage that the risk of losing secured claims are limited and easily grasped, and that it maintains the credit of the commercial banks of China in the world.

2. Provide for joint and several liability borne by enterprise operators and investors for workers' claims. This helps urge enterprises to reduce the amount of workers' claims in arrears and keeps enterprises from evading debts through bankruptcy.
3. Establish a compulsory liability insurance system for payment of workers' claims, whereby the premiums are collected at an agreed ratio of enterprise profits and dividends paid to shareholders, and handed over to a social insurance institution for trust administration.
4. Establish a worker security fund that will provide for the basic needs of workers in the event of an enterprise bankruptcy.

¹ Source: Basic Situations on Policy-based Bankruptcy of State-owned Enterprises, 10 June 2004, issued by SASAC under the State Council, in Document (Ren-Cai-Wen (2004) No. 6) of NPC-FEC.

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- ² New Law Dictionary (1991), edited by Wagatsuma, Sakae, Chinese translation, China University of Political Science and Law Press, p. 855.
- ³ Chen Jinan (2002), *Bankruptcy Law*, Taiwan Sanmin Book, p. 196.
- ⁴ *Id.*, p. 200.
- ⁵ Pan Qi (1999), *US Bankruptcy Act*, Law Press, p. 128.
- ⁶ The US Bankruptcy Act provides that eight types of unsecured creditors belong to unsecured priority creditors, and all others who do not have priority are referred to as general unsecured creditors. Among the nine types of creditors, creditors at a lower level may be paid only after creditors at the next higher level are fully paid. The priority of workers' claims is inferior to that of the first priority unsecured claims of administrative expenses during the trial of the bankruptcy case, and is also inferior to that of the second priority unsecured claims formed by debtors during normal business operation from the time when the involuntary liquidation petition is filed to the time when the debtors are declared bankrupt. The "wages and other labour remunerations owed by debtors to their employees" in the workers' claims belong to third priority unsecured claims. The welfare funds, pension funds, medical insurance premiums, life insurance premiums, and other welfare items payable by employers belong to the fourth priority unsecured claims.
- ⁷ It was reported by relevant agencies that in 1982, 80% of the loans granted by US banks to large and small enterprises were secured claims. By 2001, the secured loans granted by US commercial banks to enterprises against real estate had reached USD 1 652 billion. See, Bebchuk, Lucian Arye and Jesse M. Fried (2001), "A New Approach to Valuing Secured Claims in Bankruptcy", 114 *Harvard Law Review*.
- ⁸ Wood, P.R. (1995), *Principles of International Insolvency*, p. 189.
- ⁹ Articles 46, 81, and 86 of the draft.
- ¹⁰ UNCITRAL Working Group V (Insolvency Law), Draft Legislative Guide on Insolvency Law, March 29-April 2, 2004, New York, paragraph 633.
- ¹¹ Wang Yiyug ed. (2001), *Foreign Labor Laws and Social Security Laws*, China Renmin University Press, pp. 233-234.
- ¹² Wang Weiguo (1996), "Legislation and Practice on Regulation of Enterprise Plights in France", *CASS Journal of Foreign Law*.
- ¹³ 石川明 and translated by He Qinhua and Zhou Guiqiu (2001), *Japanese Bankruptcy Law*, China Legal Publishing House, p. 105.
- ¹⁴ Wang Yiyug ed. (2001), *Foreign Labor Laws and Social Security Laws*, China Renmin University Press, pp. 545-546.
- ¹⁵ Chen Jinan, *Bankruptcy Law*, Taiwan Sanmin Book, p. 170.