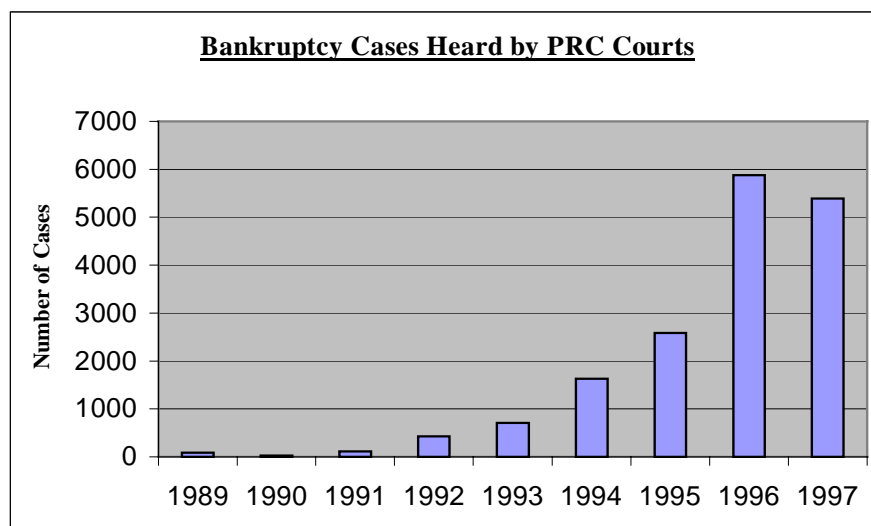


STRENGTHENING JUDICIAL EXPERTISE IN BANKRUPTCY PROCEEDINGS IN CHINA

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The Function of Judges in Bankruptcy Proceedings

China had no bankruptcy law for a long period of time until the Enterprise Bankruptcy Law promulgated in 1986. After the Law became effective in November 1998 the number of bankruptcy cases increased rapidly. Bankruptcies of all forms of enterprises together rose from 277 per annum in 1989-93 to 2,100 p.a. in 1994-95, and further to 5,640 per year in 1996-97.¹



From 1998 to 2000 the figure has become stable at the level of around 5,000 per year, partly due to the control of the Central Government on the scale of bankruptcies in order to keep social stability and avoid financial crisis.²

The judges dealing with bankruptcy cases have long been those at the “economic trial courts” (recently renamed “second civil courts”) of the people’s courts in different levels. Approximately, China has 30,000 judges working in economic trial courts and dealing with totally 1.5 million economic cases per year.³ It can be therefore seen that the 5,000 bankruptcy cases occupy only 0.3% of the total.⁴ Under such circumstances it is understandable that PRC has almost no specialized bankruptcy court except one in Shenzhen, a young city in

¹ The data and the chart are quoted from the World Bank report “Bankruptcy of State Enterprises in China”, Draft September 2000, Washington, DC.

² The figures in this paragraph are provided by a chief judge at the Supreme People’s Court.

³ Most of the economic cases are those of disputes on commercial contracts. This figure is also provided by the above-mentioned chief judge at the Supreme People’s Court.

⁴ Additionally, according to official data, China has approximately 157,000 enterprises including 54,000 SOEs (State-owned enterprises) in 2000. Therefore the 5,000 bankruptcies come to 3 % of the total enterprises. Furthermore, 1.5% of the total SOEs went into bankruptcy proceedings in 1999-2000. In comparison, around 35% of the total SOEs are deficit in the same period.

south China that is well known as a pioneer in China's economic reform. Therefore it is difficult to estimate the number of qualified "bankruptcy judges".

According to the existing Enterprise Bankruptcy Law, judges play an important role in bankruptcy proceedings. They are empowered to decide a lot of matters, either procedural or substantial, among which the following are remarkable:

- To accept or deny a petition for a bankruptcy case;
- To summon the first creditors' meeting and appoint a chairman of the meeting;
- To summon the subsequent meeting(s) when the court deems necessary;
- To adjudicate a resolution of the creditors' meeting to be null and void by reason that it violates the law;
- To accept or deny the application for composition proceeding;
- To confirm or revoke a composition agreement reached between the debtor and the creditors' meeting;
- To adjudicate the debtor to be bankrupt;
- To appoint a liquidation team to take over the debtor's assets and deal with the liquidation affairs;
- To decide a pre-bankruptcy transaction made by the debtor and third party to be null and void, and order to recover the property transferred thereby;
- To decide the disputes concerning the debtor's property and claims;
- To confirm a scheme for assets distribution prepared by the liquidation team and approved by the creditors' meeting;
- To decide to close the bankruptcy proceeding when distribution scheme is executed.

It is fair to say that the implementation of China's bankruptcy law relies very much upon judges. The more their powers, the more their accountabilities. Since China is a country in the process of institutional transition, the social environment is complicated and "rule of law" is a long time goal that have not been achieved, it seems too early to expect we have a mature bankruptcy "expertise" in the judicial rank.

Judges' Predicaments in Bankruptcy Proceedings

Based on 12 years' practice, China has established a considerable scale of judicial profession in bankruptcy law. Among the more than 30 thousands bankruptcy case dealt with in the past years, most of them have been fairly well appraised. However, since the bankruptcy legislation has not been perfected, the social environment in such a transitional period is complicated and the professional rank needs to become experienced in general, there are some predicaments that the judges are confronted with.

The Multiplicity of Bankruptcy Systems. The existing Enterprise Bankruptcy Law is only applicable to SOE (State-owned enterprises) bankruptcies. Besides there are various regulations and circulars issued by the Central Government that are applied to SOE bankruptcies *de facto* in priority over the Law. The most prominent example for this situation is the practice under the Capital Structure Optimization Program for industrial SOEs in a number of pilot cities since 1994. This Program addressed social constraints by earmarking land use rights of the liquidated debtor to pay for the "rehabilitation" of its workers. The SOEs for this Program have been selected quite administratively and the process, although involving the courts, has largely been handled by local government. The task of judges in this process is in fact no more than carrying out the schedules prepared by the local government beforehand. On the other hand, non-SOE bankruptcies involving mainly firms with collective, private, and mixed ownership fall under some rudimentary provisions in the Civil Procedures Law and Company Law, and Opinions of the Supreme Court. The deficiencies of this sketchy framework have shown in many bankruptcy cases involving large listed debtors or foreign creditors. Frankly, we can understand how hard the judges work when coping with so many gaps and flaws of the bankruptcy regimes.

Hardship in Keeping Equitable Treatment to Creditors. Due to some complex social factors, including courts' lack of entire independence from the government authorities, judicial justice has become a serious topic in China today. As far as bankruptcy proceeding is concerned, equitable treatment to creditors is most concerned with. It can be seen in many cases that the treatment of creditors has been inconsistent within classes of creditors, across municipalities, and case-by-case. For instance, there is often inconsistency in how creditor claims are addressed. There were cases where the assets were distributed to local creditors while claims from other jurisdictions were disregarded. Sometimes major creditors such as commercial banks had strong voice in the proceeding but trade creditors were virtually ignored and were even not necessarily notified of the bankruptcy in writing. Creditors often appeal that the proceeding lacks transparency in some important matters

such as the information of assets and claims, pre-bankruptcy transactions, liquidation fees and expenses, asset valuation and disposition.

Pressure of Workers' Rehabilitation. In case of SOE bankruptcy, the payment of employee rehabilitation fees is a big problem puzzling both the government and judges. In some cases, the bankruptcy proceedings were hard to push forward because the workers were not satisfied with the arrangement for their rehabilitation. It seems common practice that where assets of an insolvent SOE does not suffice to cover the entire rehabilitation expenses and the government does not work out a satisfactory arrangement, the court would refuse to accept the bankruptcy case. The reason for this refusal is quite simple: like other state authorities, courts are also politically responsible to the social stability.

Limited Capacity of Some Judges. Limited capacity of judges in dealing with bankruptcy cases has been another source of irregularities and inefficiencies. While groups of judges in large cities have accumulated considerable bankruptcy experience, courts in small cities and undeveloped regions have not. Since they are often asked to transfer their case to higher courts, the opportunity for judges to build up experience is very limited there. Moreover, bankruptcy has not got enough attention in the education of judges. Many of the judges have not got systematic knowledge in bankruptcy law and relative commercial laws such as real property law, contract law, security law and company law, and few of them are able to fully understand accounting reports.

Want of Outside Expertise. Up to the date liquidation teams (liquidators) in bankruptcy cases in many cities have been mainly composed of government officers. However, it seems a common trend that more and more practitioners such as lawyers, accountants and auditors take part in this job. In some metropolises, for instance Wuhan and Tianjin, there have appeared specialized liquidation firms. Generally speaking, however, the number of bankruptcy practitioners today is far smaller than needed.

Supposed Role in Reorganization

A drafting work for new bankruptcy law of PRC was started in 1994. The Draft Law on Enterprise Bankruptcy and Reorganization has become ready to be submitted to the National People's Congress (the parliament). It would apply to state and non-state enterprises, and cover also natural person enterprises. The draft largely resembles the bankruptcy laws of market economies. For example, it envisages a proper function of administrator (trustee), strengthens the role of creditors' meeting, and provides an elaborate option of court-supervised reorganization that can be initiated by debtors, creditors or shareholders.

According to the Draft judges dealing with insolvency cases are empowered to, as far as reorganization proceeding is concerned, (1) decide to accept, or not to accept, an insolvency case with application for reorganization; (2) appoint administrator; (3) make a decision on opening of reorganization proceeding when a bankruptcy case has been initiated; (4) approve the application for extension of the period of reorganization; (5) make decision on discontinuation of part or entire business operation by request of interested parties; (6) summon creditors' meeting for vote on plan; (7) make decision on confirmation of plan which has been, or has not been, adopted by creditors' meeting; (8) decide to terminate the reorganization proceeding ahead of schedule; (9) make a decision to close the insolvency case when the plan has been fully performed. It can be therefore seen that reorganization proceeding is, like other civil proceedings, supposed to be handled by judges at every step.

Obviously, reorganization is much more complicated than liquidation. It is more likely in reorganization proceeding that the negligence of judges leads to huge damages to creditors. A competence of a judge dealing with reorganization requires more knowledge and skill in law and business operation.

Specialized Bankruptcy Judges

The only specialized bankruptcy trial court was established by the Shenzhen Intermediate People's Court in December 1993. Until the end of 2000 it accepted 486 cases and closed 373, or averagely 69 accepted and 53 closed per year. These figures tower above all other intermediate courts nation-wide. The specialized bankruptcy judges in the court are 8 ~ 10 in recent years. Up to now it has formulated a series of professional instructions, such as the Operating Rules of Bankruptcy Court, the Instructions on Time Limit in Bankruptcy Cases and the Operating Rules of Liquidation Teams.⁵ It has kept a list of bankruptcy practitioners, which is

⁵ Furthermore, the judges of this court wrote collectively a book *The Trial Procedure for Bankruptcy Case*, which is published by the People's Court Press in June 1997.

mainly composed of experienced lawyers, for appointment of liquidation teams. These measure are proved to be successful for efficiency and lawfulness in bankruptcy practice. It is expectable that when the new bankruptcy legislation comes into force, China needs thousands of ad hoc judges to deal with increasing bankruptcy and reorganization cases.

Future Education of Judges

When drafting the new PRC bankruptcy law, we realize that court pays a very important role in the future legal framework of our bankruptcy and reorganization regimes. In the meantime, we also understand that the role of judges in bankruptcy proceedings must be kept within two reasonable borderlines. First, any absolute power including judicial one is harmful so that the function of bankruptcy judges must be checked and balanced by some other functions, for instance creditors' meeting, administrator and procurators. Second, if we say that an orderly and effective proceeding is the basic objective of bankruptcy law, the main function of bankruptcy judges lies more on legal order than efficiency. As bankruptcy proceeding is becoming more commercial and technological, we cannot expect judges to be knowledgeable in every aspect of corporate liquidation and even reorganization. Anyhow, it is not to be denied that a qualified rank of judges is a key element in the future development of bankruptcy law.

To response the coming new bankruptcy law, China has to think about the future steps for a qualified rank of bankruptcy judges. What this paper is willing to suggest may focus on the following aspects.

First, the Supreme People's Court should formulate elaborate rules for operating bankruptcy proceedings. Actually this work has started for years although on the basis of the existing bankruptcy legislation and supposed to be revised after the new law's promulgation. The Court should also have a perennial expert team in order to answer the difficult questions put forward by local judges from time to time. Furthermore, it may entrust senior judges and law professors to compile textbooks and casebooks for guiding bankruptcy judges.

Second, the Supreme People's Court should establish a long-term training program for bankruptcy judges. We need intellectual and financial resources to support this program. The State Judge Institute, an adult school for judge training run by the Supreme People's Court, has shown its interest to do that. The law schools of ordinary universities in and out of Beijing may also be involved. In the meantime bankruptcy law should become one of the major courses for university students.

Third, some institutional measures should be taken to address the shortage of experience with bankruptcy in courts of small cities or undeveloped regions, for instance revisiting rules about the transfer of cases to higher courts, rotating individual judges more actively among courts so as to impart experience in bankruptcy and related matters, and establish specialized bankruptcy courts in large cities and comparatively developed regions.