

**Bankruptcy and Intellectual Property**  
**in the**  
**People's Republic of China**

By Ubbo Neelen

## **Preface**

This thesis reflects the draft version of the proposed Enterprise Bankruptcy Law of the People's Republic of China as of 30 January 2006. A revised version of the law was subsequently enacted on 27 August 2006, and will be effective 1 June 2007. An English translation of the enacted law is available through the Internet site of the Ministry of Commerce of the People's Republic of China at:

[http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/GeneralLawsandRegulations/  
BasicLaws/P020070118609950781519.pdf](http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/BasicLaws/P020070118609950781519.pdf)

## **Abstract**

This thesis examines the new system of bankruptcy law in the People's Republic of China.

A major issue of the thesis is the analysis of the possible links and side effects of the upcoming bankruptcy law on intellectual property rights in China.

The fact that the People's Republic of China is one of the fastest growing economies with the intention of becoming accepted as a market economy has various influences upon the political decisions and legal developments in China and the rest of the world.

All changes of the legal environment in China aim at increasing the faith of foreign investors and the growth of foreign investment in China.

China continuously allows foreigners to invest in more and more business areas and there is a wide variety of different types of investment in China.

On the one hand, companies have the possibility to invest their capital. On the other hand, companies have the option to invest their technical knowledge. Technical knowledge is of particular interest to Chinese partners. Because of this strong interest, western companies are in great danger of losing their intellectual property.

The Chinese legal system meanwhile offers western companies a range of different corporate forms. The corporate forms "Wholly Foreign Owned Enterprise" and "joint venture" in particular are very attractive to

foreign investors. Due to the large variety of corporate forms, this thesis focuses on the involvement of foreign investors in a joint venture.

Usually, western companies choose to invest intellectual property in the form of a “joint venture”. This generates a special need for the foreign company to receive a guarantee for their property. Foreign companies fear that a third party might use their intellectual property and, in order to reduce this risk, they have to be very careful as to how they invest their intellectual property in China.

The new bankruptcy law can create a new form of this well-known threat to foreign companies who invest in the People’s Republic of China. The aim of this thesis is to identify some of these new risks and to attempt to find solutions to help foreign investors reduce potential risks for their investments.

Globalisation and international investors are currently focusing on the Chinese market. In order to understand the contemporary situation in China, it is important to understand Chinese history and culture. Taking this into account, this thesis summarises the historical and cultural aspects in the initial chapters.

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## A Introduction

In the current world economic situation, China seems to be one of the few countries whose economy is booming.<sup>1</sup> As a result, many international companies are willing to invest financial and technological values in China. These international companies are allowed to invest in most of the different economic areas and the investment of intellectual property is quite popular. China is of great interest to the investing companies as human labour in China is currently cheap. These companies are looking to exploit this.

The idea that a booming economy like the Chinese one might be facing negative growth and that ultimately companies may have to file for insolvency or bankruptcy is not very popular.<sup>2</sup> Neither politicians nor businessmen like these “negative” views and tend to refer to those who breach the subject as “alarmists”. If, finally, a collapse occurs, it is most likely that everybody will point at these “alarmists” and accuse them of provoking the downfall by creating a “negative” climate. This is happening although bankruptcies and insolvencies are part of the normal economic life in every market economy. As in many other countries, the topic of negative economic growth is very unpopular in China. This attitude is probably related to the reservations concerning

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<sup>1</sup> Gärtner, M, "Zwischen Turbo-Kapitalismus und Planwirtschaft - Die Schwächen des Standorts liegen vor allem in der Machtfülle des Staates" (2004) <<http://www.nrw-export.de/export/2113.asp>> (07 April 2005).

<sup>2</sup> Gärtner, M, "Zwischen Turbo-Kapitalismus und Planwirtschaft - Die Schwächen des Standorts liegen vor allem in der Machtfülle des Staates" (2004) <<http://www.nrw-export.de/export/2113.asp>> (07 April 2005)

the latest economic changes in the country and the “new” idea that companies which are not performing well have to be removed from the market.

In Chinese newspapers, the development of the new bankruptcy law is widely criticised. Besides these newspapers, it is quite difficult to find relevant information on the drafting of the new bankruptcy law. This may be due to the fact that the legislation process for the new bankruptcy law is in its final stage but not yet complete. Several institutions have been assisting the Chinese lawmakers to develop and evaluate the different drafts of the new law. These institutions have refused to provide the author with any current information. This reservation is based upon the fact that the Chinese did not authorise any publication beforehand. In addition to this barrier, Chinese authorities do not seem interested in providing information. The author has sent several requests to Chinese ministries to gain access to current information, laws, regulations and catalogues related to laws or regulations. These requests either remained unanswered until the submission date or, if answered, the response was incomplete. In the context of this thesis, the information policy of the People’s Republic of China caused some difficulties. English versions of Chinese newspapers are sometimes the most recent source of information that is provided by mainland China. Some academic articles or papers related to the topic of bankruptcy have been released which discuss the 2002 draft of the new bankruptcy law. The 2002 draft is the latest version that seems to have been published. The fact that no current

academic information on the bankruptcy law is available makes it quite difficult to evaluate the latest and most recent steps in the development of that law.

The aim of this thesis is to alert international investors to problems which could be caused by the new bankruptcy law. The focus of this thesis will fall upon the effects the new bankruptcy law could have on the intellectual property rights. This thesis is extremely challenging as there is very little academic literature dealing with the topics of Chinese bankruptcy law and intellectual property. In the end, it is useful to approach some of the legal issues from an economic point of view, which is appropriate to point out a link between the two different legal areas. In order to understand the Chinese approach to legal questions, it is necessary to provide a short overview of Chinese legal philosophy and its connection to the legislative process.

## **1. Chinese Legal Philosophy**

The Chinese legal philosophy is very difficult to understand for western-educated individuals. Although Chinese philosophy seems difficult to comprehend, the importance of understanding this philosophy is indisputable for doing business in China. Confucius is one of the most famous and well-known Chinese philosophers and he started a philosophical approach to legal issues.

In the early stages of Chinese legal theory, two different theories are apparent.

The first source of legal development is “fazhi”. “Fazhi” is traditionally translated as “law” and approaches the legal issue from the legal order.<sup>3</sup>

The second source of legal development is “lizhi”. “Lizhi” approaches the legal issue from the rites or rituals.<sup>4</sup> The “lizhi” is often described as a kind of natural law.<sup>5</sup>

Confucius based his philosophy on the “li” and described order as a policy of harmony that requires the voluntary participation of the individuals who collectively comprise a society. According to his ideas, the ability to resolve a conflict relies on the willingness of each person involved to reach a mutual solution.<sup>6</sup> In Confucian philosophy, a ruler had to bring harmony to the arguing parties. Consequently, this Confucian system was extremely personalised.

The legalists based their system of law on the “fazhi”. This means they tried to establish codified laws. The advantage of codified laws is the objective and simple way in which the rules can be understood. A legal system like this made it easy to establish and maintain political control and social order. The idea of codified public laws was very simple and clear. Everybody was aware of the published laws and the consequences of violating them.<sup>7</sup>

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<sup>3</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 29 ff.

<sup>4</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 29 f.

<sup>5</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 31.

<sup>6</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 30;

Wong, B K Y, "Traditional Chinese Philosophy and Dispute Resolution" (2000) 30 Hong Kong Law Journal 304, 307 Electronic Westlaw (29 June 2005).

<sup>7</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 33 f.;

Wong, B K Y, "Traditional Chinese Philosophy and Dispute Resolution" (2000) 30 Hong Kong Law Journal 304, 311 Electronic Westlaw (29 June 2005).

In China, both systems existed in parallel. In the Han period, the power of the rulers of Confucian ideology was limited. The idea of the Huang-Lao school was to reduce the power of the Confucian rulers. The intention of Huang-Lao was that the “rulers” should only interpret the laws as opposed to creating them. This means the written laws set up standards that had to be used by the “rulers” to solve the problems of disputing parties. Huang-Lao’s idea was to have judges who only decided what was right or wrong on the basis of codified laws.<sup>8</sup>

During the Chinese Imperial Era, the legal system was well-developed and detailed regulations were established to organise the legal system. The laws basically remained the same and their implementation was supported by official commentaries. Nevertheless, the imperial legal system was still under the influence of the legalists and the Confucian philosophy.<sup>9</sup> The content of the laws generally continued although the dynasties changed. Usually the change of a dynasty led to a change in the names or the characters of the laws. In the early stages of the imperial system, the magistrates had a strong, classic, Confucian influence. In the later dynasties, they were trained in the laws and supported by clerks who had studied the law.<sup>10</sup> Although there was a well-developed legal system, it mostly covered criminal law.

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<sup>8</sup> Peerenboom, R, *China’s Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 34 f.

<sup>9</sup> Peerenboom, R, *China’s Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 38.

<sup>10</sup> Peerenboom, R, *China’s Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 36 f.;

Wong, B K Y, "Traditional Chinese Philosophy and Dispute Resolution" (2000) 30 *Hong Kong Law Journal* 304, 316 *Electronic Westlaw* (29 June 2005);

Wang C, "Introduction: An Emerging Legal System" in Wang C and Zhang, X (ed) *Introduction to Chinese Law*, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.04.

Commercial and civil cases were still solved in a more informal fashion. In the end, the imperial system did not achieve the reduction of the rulers influence and the “lizhi” and “fazhi” traditions remained until the end of the dynasty system.<sup>11</sup>

As a result of the inability of the Quing dynasty to protect China against Great Britain and Japan, several different political and legal changes were recommended by radical groups. Some of these groups were influenced by western ideas and some remained in the tradition of Confucius. In the era of the Chinese Republic, China adopted the legal code systems from Germany and Japan. These changes were carried out in the early 1900s. However, these changes had little impact on the Chinese attitude towards the laws due to the fact that the Republic did not last very long.<sup>12</sup>

The Chinese Republic was ended by the Communist Revolution. Communist ideology and thoughts became relevant to everything in public life. The attitude towards the bourgeois laws in particular was quite clear. The ideal communist society does not need laws established by the overthrown political system which only protect the privileged positions. The legal system under Mao varied according to the various periods of the Mao era. Effectively, this means that there were only a few written laws and the laws could be altered at any time to suit the attitude of the Communist Party leaders. In most cases, the

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<sup>11</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 41.

<sup>12</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 43;  
Wang C, “Introduction: An Emerging Legal System” in Wang C and Zhang, X (ed) *Introduction to Chinese Law*, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.07.

idea was that the laws should serve the proletariat.<sup>13</sup> This could only be achieved if the laws the Communists established were simple and easy to understand for everybody in the country. The ideology of Marxism-Leninism and the ideology of Confucius had different approaches towards the understanding of legal issues but both ideas lead to similar solutions. One example of how both ideologies converge is the issue related to intellectual property.<sup>14</sup> This could lead to the idea that the influence of traditional Chinese culture on the legal system continued after the foundation of the People's Republic of China.<sup>15</sup> During the Mao era, the legal system and the legislative process had its ups and downs. The Cultural Revolution terminated the attempt to introduce legal reform of the 1960s. The Chinese Communist Party influenced specific legal cases which were of any interest to the political leaders. Eventually, the written law was effectively futile because the Party cadres interpreted the laws in favour of the Communist Party.<sup>16</sup>

The Cultural Revolution caused serious damage to Chinese legislative development and, in the follow-up to the Mao era, this problem became quite apparent.<sup>17</sup> The open-door policy of the 1970s needed legal

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<sup>13</sup> Wang C, "Introduction: An Emerging Legal System" in Wang C and Zhang, X (ed) Introduction to Chinese Law, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.08 f.

<sup>14</sup> Alford, W P, To Steal a Book is an Elegant Offense: Intellectual Property Law in Chinese Civilization (Stanford: Stanford University Press 1995) Page 57.

<sup>15</sup> Wong, B K Y, "Traditional Chinese Philosophy and Dispute Resolution" (2000) 30 Hong Kong Law Journal 304, 306 Electronic Westlaw (29 June 2005).

<sup>16</sup> Peerenboom, R, China's Long March Toward Rule of Law (Cambridge, New York: Cambridge University Press, 2002) Page 43 ff;

Wang C, "Introduction: An Emerging Legal System" in Wang C and Zhang, X (ed) Introduction to Chinese Law, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.09.

<sup>17</sup> Peerenboom, R, China's Long March Toward Rule of Law (Cambridge, New York: Cambridge University Press, 2002) Page 49;

modification or, better still, total modernisation. In the debate over creating a legal system for China, some scholars introduced a shift in rhetoric. The expression “fazhi” could be written in different Chinese characters and carry a different meaning. One of the meanings could be the “Socialist Rule of Law”. This particular interpretation became popular again in that period.<sup>18</sup> Several modernisations were carried out in the late 1970s and 1980s. These modernisations created a legal system that, in the end, was dominated by the idea of a government of law and not man.<sup>19</sup>

An escalation of the domestic political situation in China was the reason why the changes to the legislation stalled. The Tiananmen incident in 1989 was the reason the Chinese authorities suspended any further legal reforms. The reluctance of the Communist leaders towards further legal reforms lasted until 1992. That year marked the greater independence of the legal profession and the launch of different experiments in the economic field. Laws were passed and introduced which especially ruled lawyers and judges or other arms of the legal system.<sup>20</sup>

Under the current situation of constitutional laws, the Communist Party still has a considerable influence over, for example, the National

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Wang C, “Introduction: An Emerging Legal System” in Wang C and Zhang, X (ed) Introduction to Chinese Law, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.08 f.

<sup>18</sup> Peerenboom, R, China’s Long March Toward Rule of Law (Cambridge, New York: Cambridge University Press, 2002) Page 63;

Wang C, “Introduction: An Emerging Legal System” in Wang C and Zhang, X (ed) Introduction to Chinese Law, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.12.

<sup>19</sup> Peerenboom, R, China’s Long March Toward Rule of Law (Cambridge, New York: Cambridge University Press, 2002) Page 56 ff.

<sup>20</sup> Peerenboom, R, China’s Long March Toward Rule of Law (Cambridge, New York: Cambridge University Press, 2002) Page 58.

People's Congress, courts, and governmental organs. Consequently, the party ideology can still be implemented throughout the various governmental levels.<sup>21</sup>

Although the Chinese constitution states that the Chinese courts shall be independent of any influence from the government or governmental organisations, there is always a possibility to influence the courts today.<sup>22</sup> Local authorities in particular have the potential to influence the courts. This influence is based upon the fact that the courts are financed by the local government. Consequently, the strong financial dependence of the local courts on the local governments is one of the potential opportunities for the authorities to exert their influence.<sup>23</sup>

In addition, the organs of the Communist Party have different possibilities to manipulate the legal system. There are a variety of alternatives for the Communist Party to influence the courts in general, and the Party has the ability to influence the court's decision directly in specific cases. These manipulations could, on the one hand, be carried out from outside the legal system by the Party committee, the Politico-

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<sup>21</sup> Halliday, T C & Carruthers, B G, "How (Not) to Implement Effective Insolvency Risk Management Systems: Lessons From Asia - and Elsewhere" *Insolvency Systems and Risk Management in Asia*; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 8  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005);

Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 189.

<sup>22</sup> Wang C, "Introduction: An Emerging Legal System" in Wang C and Zhang, X (ed) *Introduction to Chinese Law*, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.19.

<sup>23</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 280 f.;

Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 *Victoria University of Wellington Law Review* 239, 242 *Electronic LexisNexis* (03 April 2005); Wang C, "Introduction: An Emerging Legal System" in Wang C and Zhang, X (ed) *Introduction to Chinese Law*, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.19.

Legal Committee and the Organisation Departments. On the other hand, manipulations could be carried out internally by the Party Group, Party Institutional Organ, Party cells, Political Departments or by the adjudicative department within the legislation system.<sup>24</sup>

One of the possibilities the Party has to influence the judge is, for example, its ability to exert moral pressure on the judge by reminding him to follow socialist ideology.<sup>25</sup> Socialist ideology in China is established by the Communist Party and is still dominant in Chinese society. This means that if the Party supports an idea, there is a lot of pressure on the judge to follow the idea of the Communist Party. For Chinese people, social standing is very important.<sup>26</sup> The Chinese characters for “guanxi” (or the personal network) and “renqing” (or human feelings or empathy) describe a social understanding that should not be underestimated. As social standing in Chinese society is very important, a judge might be forced into a situation where he is in danger of losing his “guanxi”. Due to the risk of losing his social position, a judge might rule in favour of the social ideology of the Communist Party instead of adhering to the written laws.<sup>27</sup>

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<sup>24</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 302;

Wang C, “Introduction: An Emerging Legal System” in Wang C and Zhang, X (ed) *Introduction to Chinese Law*, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.19.

<sup>25</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 302.

<sup>26</sup> Wilson, J & Brennan R, "Market Entry Methods for Western Firms in China" (2003) 15: 4 *Asia Pacific Journal of Marketing and Logistics* 3, 8 f. *Electronic Proquest* (27 June 2005)

<sup>27</sup> Halverson, K, “China's WTO Accession: Economic, Legal, and Political Implications” (2004) 27 *Boston College International and Comparative Law Review* 319, 358 *Electronic LexisNexis* (04 April 2005);

Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 315 f.

Another possibility to influence the judges is based on the power of the Communist Party to influence personal matters of the courts<sup>28</sup>, namely the ability of the Communist Party to influence a judge's career.<sup>29</sup> For the judges, it is very clear that there is little chance of furthering their career, if their decisions do not comply with the Communist Party.

Probably another less obvious but effective technique in the manipulation of the legal system is the influence on the legislation process. The political leaders have the possibility to influence the legislative process and have the ability to limit the changes to an extent that is appropriate for them. Their influence on the legal system and the courts is effectively a question of power. In China, the most powerful organisation is the Communist Party. As long as the Communist Party does not give away the power, the changing ideology or philosophy of the Communist Party will be the governing factor in the development of Chinese legislation.<sup>30</sup> It is easy to assume that the Communist Party will not allow the legal system to become fully independent as long as the political leaders can see disadvantages in the idea of having a fully independent legal system. As a result, a reduction in the influence of the Communist Party is not foreseeable for the near future. Even if the central authorities thought that a change were advantageous, the local

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<sup>28</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 302.

<sup>29</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years.“ (2001) 5:1 *Harvard Asia Quarterly*  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005);  
Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 305;  
Wang C, "Introduction: An Emerging Legal System" in Wang C and Zhang, X (ed) *Introduction to Chinese Law*, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.17.

<sup>30</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 217 f.

authorities would lose their influence and hamper these improvements.<sup>31</sup> In fact, the influence of local governments on the courts is described as the most common form of external influence on the courts. The government officials are able to exert pressure on the courts in order to generate a judgement that favours the local administration.<sup>32</sup> Currently, the central government is introducing changes to reduce the power of local authorities over the courts.<sup>33</sup> Therefore, it is highly likely that the legal system will become independent in distant future.

A further problem of the current Chinese legal system is corruption.<sup>34</sup> In the near future, it will be important for China to minimise the possibility of corruption in the legal system. At present, there are not any significant statistics on the topic of corruption in the Chinese legal system but the rare figures that are published give the general impression that the level of corruption is quite high. This is emphasised by the fact that the authorities have introduced several laws to prevent corruption within the legal system.<sup>35</sup>

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<sup>31</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 220 f.

<sup>32</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 311.

<sup>33</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 312.

<sup>34</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 295;  
Wang C, "Introduction: An Emerging Legal System" in Wang C and Zhang, X (ed) *Introduction to Chinese Law*, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.19.

<sup>35</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 296 f.;  
Wang C, "Introduction: An Emerging Legal System" in Wang C and Zhang, X (ed) *Introduction to Chinese Law*, Hong Kong, Singapore: Sweet & Maxwell Asia, 2002), 1.19.

It is remarkable that the legal system in China, in certain cases, still requires the approval of the division chief, division committee, court president or adjudicative committee for a judge to make a valid decision. This issue is very important for international foreign investors due to the fact that politically sensitive cases, bankruptcy cases or decisions on significant cases with foreign investments belong to the group of legal cases that are subject to this approval.<sup>36</sup>

The fact that legal cases dealing with foreign investment are treated differently to other cases in China may trigger concerns in these investors, especially after the Chinese restrictions on foreign investments have been relaxed. There are now several opportunities for foreign investors to start or expand business in China. The next section provides a brief overview of some of the different company forms in China.

## **2. Company Forms of the People's Republic of China**

Under the current laws, Chinese authorities distinguish companies by the structure of the different financial investment. Generally, they can be divided into two different forms of companies, the State-Owned Enterprises on the one hand and the companies with foreign investment on the other. Companies with foreign investment can be subdivided

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<sup>36</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 286.

according to the amount of foreign investment.<sup>37</sup> The company form “State-Owned Enterprises” is the first company form described in the following section.

## 2.1. State-Owned Enterprises

Before the People’s Republic of China allowed foreigners to invest in China, the dominant company form known in the country was the so-called State Owned Enterprise.<sup>38</sup>

State Owned Enterprises are companies whose main shareholder is the state of China. As the main shareholder, the state controls the performance of the company and the manager.<sup>39</sup> The State-Owned Enterprises have been performing very poorly in recent years. The People’s Republic of China introduced modern corporation laws in order to clarify the property rights and separate the ownership from the management.<sup>40</sup>

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<sup>37</sup> Chan, V, "China: Cross-Border Mergers and Acquisitions in the PRC" (2001) *International Financial Law Review* 43 *Electronic Proquest* (27 March 2005); Moser, M J & Chong, S, "How Private Equity Investors Can Avoid Directors' Liability" (2003) *International Financial Law Review* 1 *Electronic Proquest* (27 March 2005).

<sup>38</sup> Ng, C Y M, ""One Country, Two Systems" - Insolvency Administration in the People's Republic of China" (2002) 17:7 *Managerial Auditing Journal* 363, 364 *Electronic Proquest* (27 June 2005); Zhang, X C, „A Same Game With Different Rules: Cross-Border Mergers and Acquisitions in the People’s Republic of China“ in Horn, N (ed) *Mergers and Acquisitions and the Law* (The Hague, London: Kluwer Law International 2001) Page 279.

<sup>39</sup> Peerenboom, R, *China’s Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 489; Zhang, X C, „A Same Game With Different Rules: Cross-Border Mergers and Acquisitions in the People’s Republic of China“ in Horn, N (ed) *Mergers and Acquisitions and the Law* (The Hague, London: Kluwer Law International 2001) Page 279.

<sup>40</sup> Peerenboom, R, *China’s Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 490.

There have been various contributory factors in the poor performance of these enterprises. Generally speaking, the influence of the government on the daily management is one of the reasons that could be claimed a key issue. A second factor is the performance of the company managers. As long as a manager has an interest in increasing his personal bonuses or using company resources for personal reasons, hardly any profit can be expected and the financial problems of these companies are predestinated.<sup>41</sup>

In the past, the authorities tried to solve these financial problems in different ways.

The first attempt to solve this dilemma was to get a foreign investor to take over some of the companies' shares.<sup>42</sup> The investments by these foreign investors did not prove to be as successful as the authorities had expected and the authorities had to change their policy. Chinese authorities even established the option that State-Owned Enterprises can be turned into a stock company and listed on the Chinese stock market. For political and economic reasons, the Chinese government keeps the majority of the shares in order to prevent the privatisation of certain companies.<sup>43</sup>

The next attempt to solve this dilemma was to allow the State-Owned Enterprises to file for bankruptcy. In order to avoid massive

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<sup>41</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 490 f.

<sup>42</sup> Zhang, X C, „A Same Game With Different Rules: Cross-Border Mergers and Acquisitions in the People's Republic of China“ in Horn, N (ed) *Mergers and Acquisitions and the Law* (The Hague, London: Kluwer Law International 2001) Page 280.

<sup>43</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 490 f.

unemployment and social unrest, the number of companies that were allowed to apply for bankruptcy was restricted.<sup>44</sup>

The lack of transparent accounting records of State-Owned Enterprises obstructed nearly all possible alternatives the failing enterprises had under the current bankruptcy laws. Mergers, acquisitions or reconstructions turned out to be very difficult due to problems with accounting standards, the various transfers of assets, the foundation of subsidiaries or the change of company names. These business activities caused problems because these operations did not always abide by the Chinese laws.<sup>45</sup>

The People's Republic of China is currently changing the economic system from a planned economy to a market economy. In order to fulfil the WTO criteria, China has to make several changes to the legal and the economic system. As a result of these changes, the company form of State-Owned Enterprises will soon be abolished. A larger scale of privatisation will replace the system of State-Owned Enterprises but, for this, more precise laws and regulations have to be introduced.

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<sup>44</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 491;  
Ng, C Y M, "One Country, Two Systems" - Insolvency Administration in the People's Republic of China" (2002) 17:7 *Managerial Auditing Journal* 363, 370 Electronic Proquest (27 June 2005);  
Zhang, X C, „A Same Game With Different Rules: Cross-Border Mergers and Acquisitions in the People's Republic of China“ in Horn, N (ed) *Mergers and Acquisitions and the Law* (The Hague, London: Kluwer Law International 2001) Page 289.

<sup>45</sup> Peerenboom, R, *China's Long March Toward Rule of Law* (Cambridge, New York: Cambridge University Press, 2002) Page 490 f.

## 2.2. Foreign Investment Enterprises

In the 1970s, China's policy towards foreign investment changed. Certain special areas in China were entitled to have company forms with foreign investment.<sup>46</sup>

One of the first forms of foreign investment to be allowed in China was the company form joint venture. Today, there are varieties of different foreign investments possible in China.<sup>47</sup> The most important company forms are the Wholly Foreign-Owned Enterprise and the different forms of joint ventures. China offers two different types of joint ventures, on the one hand the so called Equity Joint Venture and the so-called Cooperative (or Contractual) Joint Venture on the other.<sup>48</sup> The following paragraph will provide a general overview of joint ventures.

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<sup>46</sup> Huck, W, "Rahmenbedingungen für den Technologietransfer von Deutschland nach China" (2005) Page 16 f. <[http://www.law-and-business.com/content/e7/e149/index\\_ger.html?nummer=e268](http://www.law-and-business.com/content/e7/e149/index_ger.html?nummer=e268)> (06 March 2005); Wilson, J & Brennan R, "Market Entry Methods for Western Firms in China" (2003) 15: 4 Asia Pacific Journal of Marketing and Logistics 3, 11 Electronic Proquest (27 June 2005)

Kirby, D A & Kaiser, S, "Joint Ventures as an Internationalisation Strategy for SMEs" (2003) 21:3 Small Business Economics 229 Electronic Proquest (27 June 2005).

<sup>47</sup> Devonshire-Ellis, C, "Setting up Your Company in China" (2004) 47:07 Beijing Review 39 <<http://www.bjreview.com.cn>> (14 April 2005);

Moser, M J & Chong, S, "How Private Equity Investors Can Avoid Directors' Liability" (2003) International Financial Law Review 1 Electronic Proquest (27 March 2005).

<sup>48</sup> Devonshire-Ellis, C, "Equity & Cooperative Joint Ventures" (2004) 47:01 Beijing Review 43 <<http://www.bjreview.com.cn>> (14 April 2005);

Moser, M J & Chong, S, "How Private Equity Investors Can Avoid Directors' Liability" (2003) International Financial Law Review 1 Electronic Proquest (27 March 2005).

### 2.3. Joint Ventures

Joint venture in the Chinese sense meant that the foreign investors were allowed to invest technology or capital in a State-Owned Enterprise. Initially, the amount of investment was limited. The Chinese companies mainly demanded the investment of modern technology in the form of machinery.<sup>49</sup> The form of foreign investment in these foreign investment companies changed over the years. The restrictions on the minimum and the maximum amount of foreign investment were changed by the authorities. The restrictions on special regions were abolished recently. Abolishing restrictions and a booming economy are creating a positive climate for the investment of intangible technology like patents or other intellectual properties and financial capital.<sup>50</sup> As a result of this positive climate, foreign investors are transferring cash and a high amount of valuable intangible assets into China. Joint ventures used to be the only vehicle foreign investors were given by the authorities to enter the Chinese market.<sup>51</sup> Foreign investors are using

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<sup>49</sup> Tetz, S, „Technology Transfer in the People's Republic of China – A Foreign Investor's Perspective“ in Heath, C & Liu, K-C (ed) *Legal Rules of Technology Transfer in Asia* (The Hague, London, New York: Kluwer Law International 2002), 55 Page 56;

Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 *Management Research News* 1 Electronic Proquest (26 April 2005) Page 7;

Chan, V, "China: Cross-Border Mergers and Acquisitions in the PRC" (2001) *International Financial Law Review* 43 Electronic Proquest (27 March 2005).

<sup>50</sup> Huck, W, "Rahmenbedingungen für den Technologietransfer von Deutschland nach China" (2005) Page 15 <[http://www.law-and-business.com/content/e7/e149/index\\_ger.html?nummer=e268](http://www.law-and-business.com/content/e7/e149/index_ger.html?nummer=e268)> (06 March 2005).

<sup>51</sup> Parnell, M F, "Doing business in China--the modern German experience" (2002) 14:5 *European Business Review* 351, 353 Electronic Proquest (27 June 2005)

joint ventures, although some legal advisors indicate that there is a potential risk for intellectual property rights.<sup>52</sup> In the beginning, the joint ventures were not allowed to have a foreign investor as the majority shareholder. Like other restrictions, this was abolished. As the next step in the development of foreign investment, Chinese authorities offered foreign investors the opportunity to set up so-called “Wholly Foreign-Owned Enterprises”.

#### **2.4. Wholly Foreign-Owned Enterprises**

The introduction of a broader form of foreign investment than the joint venture enterprises allowed non-Chinese investors to hold more than a few shares or even the majority of the shares. This change in investment policy was a consequent step towards the enlargement of foreign investment in China. Chinese authorities introduced the company form “Wholly Foreign-Owned Enterprises”. These companies, as the name implies, allow foreign investors to hold one hundred percent of the company’s shares.<sup>53</sup> However, in the early stages, the

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Chong, W S & Naganuma, S, "Insurers Find Strategic Path for China Investment" (2003) September International Financial Law Review 1 Electronic Proquest (27 March 2005).

Chang, T K, “Foreign Technology Transfer” in Cohen, M A, Bang, A E, Mitchell, S J (ed), Chinese Intellectual Property Law and Practice, (The Hague, London, Boston: Kluwer Law International 1999), 63 Page 63;

Chan, V, "China: Cross-Border Mergers and Acquisitions in the PRC" (2001) International Financial Law Review 43 Electronic Proquest (27 March 2005).

<sup>52</sup> Devonshire-Ellis, C, "JV vs WFOE" (2004) 5:2 China Briefing 4, 5 <<http://www.china-briefing.com>> (27 March 2005).

<sup>53</sup> Devonshire-Ellis, C, "Setting up Your Company in China" (2004) 47:09 Beijing Review 37 <<http://www.bjreview.com.cn>> (14 April 2005);

Chan, V, "China: Cross-Border Mergers and Acquisitions in the PRC" (2001) International Financial Law Review 43 Electronic Proquest (27 March 2005).

owners of “Wholly Foreign-Owned Enterprises” were subject to strict regulations. In the beginning, these companies were restricted, for example, in the location in which the business could be established or the business areas these companies could operate in.<sup>54</sup> Several of these regulations have now been abolished and the Wholly Foreign-Owned Enterprises are allowed to be based outside the former exclusive special economic zones.<sup>55</sup> Nevertheless, some restrictions still remain and are hampering the development of foreign investment in China.<sup>56</sup>

### **3. Restrictions for Foreign Investment**

Most of the restrictions set by the Chinese government have been abolished in recent years. Nevertheless, there are still restrictions on the import and the export of technology. In some cases, the transfer is restricted and in others the transfer is banned.<sup>57</sup> For example, the restriction of foreign investment in the special economic zones and the

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<sup>54</sup> Vettoretti, A, "Outsourcing Manufacturing Operations to China" (2004) 5:10 China Briefing 7, 10 <<http://www.china-briefing.com>> (27 March 2005); Devonshire-Ellis, C, "Small-Medium Enterprise Guide to Business in China" (2004) 47:39 Beijing Review 42 <<http://www.bjreview.com.cn>> (13 April 2005); Devonshire-Ellis, C, "Setting up Your Company in China" (2004) 47:07 Beijing Review 39 <<http://www.bjreview.com.cn>> (14 April 2005).

<sup>55</sup> Devonshire-Ellis, C, "Wider Access to Business Sector" (2004) 47:33 Beijing Review 40 <<http://www.bjreview.com.cn>> (13 April 2005).

<sup>56</sup> Huck, W, "Rahmenbedingungen für den Technologietransfer von Deutschland nach China" (2005) Page 17 <[http://www.law-and-business.com/content/e7/e149/index\\_ger.html?nummer=e268](http://www.law-and-business.com/content/e7/e149/index_ger.html?nummer=e268)> (06 March 2005).

<sup>57</sup> Zhang, X C, „A Same Game With Different Rules: Cross-Border Mergers and Acquisitions in the People’s Republic of China“ in Horn, N (ed) Mergers and Acquisitions and the Law (The Hague, London: Kluwer Law International 2001) Page 287;

Xue, H & Zheng, C, Chinese Intellectual Property Law in the 21st Century (Hong Kong, Singapore, Malaysia: Sweet & Maxwell Asia, 2002) 5.35 ff.

restrictions on the import of goods produced by Wholly Foreign-Owned Enterprises have been abolished. However, there are still several restrictions in China that are related to foreign investments.<sup>58</sup> For example, certain economic fields or certain technology that are used by certain companies are either limited in the amount of foreign investment or strictly forbidden for any foreign investment.<sup>59</sup>

This restriction for certain technology has effects on the different forms of investment in China. Several non-Chinese investors are willing to meet the demands for the transfer of high technology to China and use intangible assets as a part of their paid-in stock capital. Although Chinese authorities are very eager to improve the amount of technology flowing into China and the authorities are luring foreign investors with advantages such as low taxes or cheap labour, China has other restrictions besides these for the foreign investments. Remarkable for foreign investors are the restrictions which are related to the foundation or investment of companies. In this field, there are further restrictions which easily could effect a foreign investment negatively.

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<sup>58</sup> Vettoretti, A, "Outsourcing Manufacturing Operations to China" (2004) 5:10 China Briefing 7, 10 f. <<http://www.china-briefing.com>> (27 March 2005)  
Devonshire-Ellis, C, "Setting up Your Company in China" (2004) 47:09 Beijing Review 37 <<http://www.bjreview.com.cn>> (14 April 2005); Devonshire-Ellis, C, "Opportunities and Strategies into Chinese M&A Market" (2004) 47:43 Beijing Review 40 <<http://www.bjreview.com.cn>> (13 April 2005);  
Devonshire-Ellis, C, "Opportunities and Strategies in Chinese M&A Market" (2004) 47:48 Beijing Review 40 <<http://www.bjreview.com.cn>> (13 April 2005).

<sup>59</sup> Devonshire-Ellis, C, "Setting up Your Company in China" (2004) 47:09 Beijing Review 37 <<http://www.bjreview.com.cn>> (14 April 2005).

#### **4. Restrictions as a Result of Company Laws and Regulations**

Besides the restrictions on foreign investment in China that are subject to the different investment laws, foreign investment in China is regulated by the company laws and regulations.

Although the People's Republic of China is looking to attract foreign investors to transfer as much modern technology and capital as possible into China, there is still a concern that the foreign investors may fleece the Chinese partners or the Chinese authorities.

For example, the company laws of China include regulations which prescribe how the evaluation of assets is to be carried out. Article 24 of the Regulations for the Implementation of the Law on Sino-Foreign Equity Joint Ventures revised 22 July 2001 states that:

The price of the machinery, equipment and other materials referred (to) in the proceeding paragraph shall not be higher than the current international market price for similar equipment or materials.

A similar regulation is included in the regulations restricting investment for a wholly foreign investment company. Article 26 of the Detailed Rules for The Implementation of The Law on Wholly Foreign-Owned Enterprises re-promulgated 12 April 2001 states:

The capitalized value of such machinery or equipment shall not exceed the current normal price for the same type of items on the international market.

In addition to this restriction, there are several other regulations which affect the investment of foreign investors in different types of companies. These regulations do not only prescribe how the machinery, intellectual property or other assets have to be evaluated. For example, Article 27 of the Detailed Rules for The Implementation of The Law on Wholly Foreign-Owned Enterprises states that the amount of industrial property rights or proprietary technology which is invested in a Wholly Foreign Owned Enterprise is restricted to a maximum of 20% of the companies' registered capital. A comparable regulation was established for joint venture enterprises in Article 5 of the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures amended by the 4th Session of the Standing Committee of the 9th National People's Congress on 15 March 2000. Article 5 of that law states in the last sentence:

The various investments mentioned above shall be specified in the contract and articles of association of the equity joint venture and the value of each contribution (except for the site) shall be appraised and determined through discussions between the parties to the venture.

Any agreement has to be submitted for registration to the department which is in charge of foreign relations and trade.<sup>60</sup> There is a good chance that the authorities are using similar measurements for foreign investment,<sup>61</sup> although this regulation does not state how intangible assets could be part of the foreign investment or how much foreign investment could be contributed as an intangible asset.

On the one hand, the restrictions in the company laws and the particular regulation governing how the assets have to be evaluated protect the Chinese economy; on the other hand, foreign investors are forced to invest capital in addition to these assets. The foreign investors face the problem of how to protect their investment.

Losing a financial investment is always a problem for the investor. Nevertheless, if the investor is losing high advanced technology or other valuable intangible assets in addition to the financial investment, this loss could easily prove even greater.

The bankruptcy laws in China have faced changes throughout the history of China. Over the decades, bankruptcy laws have faced different phases of development. The next chapter gives an overview of the development of Chinese bankruptcy laws and regulations.

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<sup>60</sup> Tetz, S, „Technology Transfer in the People's Republic of China – A Foreign Investor's Perspective“ in Heath, C & Liu, K-C (ed) Legal Rules of Technology Transfer in Asia (The Hague, London, New York: Kluwer Law International 2002), 55 Page 56.

<sup>61</sup> Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26, 1 The China Business Review 20, 21 Electronic Proquest (07 March 2005).

## **B Development of Bankruptcy Laws and Regulation in China**

The development of a national bankruptcy law system in China seems to be strongly related to the different political system of power. Over the last few centuries, China has seen several attempts to establish a bankruptcy law system.

In contrast to China, Germany has established a bankruptcy law system, which has been valid for over a hundred years. Although Germany, like China, had several different political systems during this period, the legal system itself has not changed greatly. The German “Konkursordnung” was established in 1877 and replaced on 1 January 1999 by the “Insolvenzordnung”. Germany’s bankruptcy system survived the transition to democracy, several lost wars and a dictatorship. In evaluating the history of both countries, it should be kept in mind that the history of national bankruptcy regulation in Germany dates back a little further.

### **1. The Historical Changes in Chinese Bankruptcy Laws**

The conviction of the Chinese authorities for the requirement of a bankruptcy law can be traced back to the Quing dynasty. Before the “Quing dynasty”, the concept of bankruptcy was unknown to the people of China. Because of the country’s legal and ethical background, children had to pay their father’s debts. In 1906, the Chinese emperor

introduced the first bankruptcy law. This first attempt was only valid for two years. The bankruptcy law was annulled by the next emperor of China due to problems in its implementation. For the next thirty years, China effectively did not have a bankruptcy law. Some of the Chinese warlords in northern China drafted a bankruptcy law but it was not implemented for the whole nation. This changed in 1935 under the regime of the National Government and a general bankruptcy law was introduced. This second attempt at a nationwide bankruptcy law system only lasted until the communist revolution as a result of the political circumstances. After the communists founded the People's Republic of China in 1949, the laws implemented by the National Government were abolished by the newly-formed government. Due to the separation of Taiwan, the communist government has no authority on the island, where the bankruptcy law developed by the National Government is still in force today.<sup>62</sup>

In mainland China, officially there was no need for a bankruptcy law for another thirty years. State-Owned Enterprises could not go bankrupt under the ideology of the communist leaders.<sup>63</sup> The fact that Chinese

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<sup>62</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005);  
Chang, T K, "The East is in the Red" (1999) 18:3 International Financial Law Review  
43 Electronic Proquest (27 March 2005).

<sup>63</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 242 Electronic LexisNexis (03 April 2005);  
Ng, C Y M, ""One Country, Two Systems" - Insolvency Administration in the People's Republic of China" (2002) 17:7 Managerial Auditing Journal 363, 364 Electronic Proquest (27 June 2005).

enterprises suffered heavy losses and could technically have been declared bankrupt, was a well-kept secret.<sup>64</sup>

During the 1980s, several Chinese experts from different branches of study recognised that changes to the economic system and dealing with the heavy losses of the State-Owned Enterprises were necessary.<sup>65</sup>

Before the trial bankruptcy law could be introduced, there were furious debates related to the legislative process. During this drafting process, the fact that State-Owned Enterprises guaranteed the social stability of the country was one of the main arguments against its implementation.<sup>66</sup> Another argument concerned social stability as well but picked up that thread from a different direction. It considered that one bankrupt State-Owned Enterprise could trigger a chain reaction of bankruptcies in China. The high percentage of non-performing loans given to State-Owned Enterprises by the state owned financial institutions supported this argument in particular.<sup>67</sup> As a result of the realisation of the need for urgent changes, Chinese authorities introduced the People's Republic of China's Law on Enterprise Bankruptcy in 1986. This bankruptcy law was introduced on a trial basis

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<sup>64</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

<sup>65</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005);  
Tjoa, L, "International Style Laws on Bankruptcy" China Daily HK Edition 06 August 2003 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005);  
Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 2 Electronic LexisNexis (31 March 2005).

<sup>66</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 243 Electronic LexisNexis (03 April 2005) .

<sup>67</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 244 Electronic LexisNexis (03 April 2005).

and was only applicable to State-Owned Enterprises, so it was only a framework that had a great number of holes. Given the thirty years without any bankruptcy law before this trial implementation, Chinese authorities soon recognised these discrepancies. As a second step, chapter 19 of the Code of Civil Procedure was added on 9 April 1991. This chapter of the Civil Procedure Law was intended to establish the basic rules for handling bankruptcy in China. The implementation of Chapter 19 in the Civil Procedure Law greatly changed the bankruptcy culture in China. The proceedings under Chapter 19 have not been combined with a certain type of enterprise. Consequently, Chapter 19 is generally applicable to all forms of entities with a legal person status. Several bankruptcies of State-Owned Enterprises and various other company forms, e.g. those with foreign investment, followed these proceedings.<sup>68</sup>

In addition to the changes in the Civil Procedure Law, a further juristic matter concerning the bankruptcy laws arose in 1991. The Supreme People's Court issued the first interpretation of the bankruptcy law on

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<sup>68</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly <<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005); Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 241 Electronic LexisNexis (03 April 2005); Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Riskmanagement in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development, Page 2 <[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005); Wong, R, "The New Face of Bankruptcy" (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005); Zhu, S, "Discussion of Several Issues Related to the Draft Law" papers from the 2000 Symposium on Bankruptcy Law, Pages 2 ff. <[http://www.gtz-legal-reform.org.cn/english/projects/fec/papers\\_2000bl.htm](http://www.gtz-legal-reform.org.cn/english/projects/fec/papers_2000bl.htm)> (27 June 2005).

7 November 1991.<sup>69</sup> The fact that the Supreme People's Court had to give an interpretation is a first indicator that the bankruptcy system contained certain inconsistencies and needed some revision.

The process of adjusting the bankruptcy legislation led to the addition of some articles to the People's Republic of China Company Law in 1993.<sup>70</sup>

As the bankruptcy law of the central government did not cover all of the different company forms, was unclear and complicated on certain points, some provinces introduced regulations that addressed the bankruptcy topic in 1993. The provincial governments of the special economic zones of the Guangdong and Shenzhen provinces released their regulations on company bankruptcies.<sup>71</sup>

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<sup>69</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005);  
Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Riskmanagement in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development, Page 2  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

<sup>70</sup> Wong, R, „The New Face of Bankruptcy“ (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005)  
Zhang, X & Booth, C D, "Beijing's Initiative on Cross-Border Insolvency" (2002) 10 American Bankruptcy Institute Law Review 29, 33 Electronic LexisNexis (30 March 2005).

<sup>71</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005);  
Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Riskmanagement in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 2  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005);

Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 241 Electronic LexisNexis (03 April 2005).

In order to control the bankruptcy policy, the State Council has published several policy documents concerning the bankruptcy of State-Owned Enterprises since 1994.<sup>72</sup>

In addition to the laws and regulations, measures on liquidation procedures for foreign investment enterprises were introduced in 1996.<sup>73</sup>

In 1997, the Supreme People's Court published another notice dealing with the bankruptcy law. The Supreme People's Court tried to clarify some contradictions in the wording of the bankruptcy laws.<sup>74</sup>

The latest decision by the Supreme People's Court, dated 18 July 2002, issued a notice in relation to court proceedings in bankruptcy cases.<sup>75</sup>

Currently, there are different regulations and laws applicable to the different forms of companies in China. Even the area in which the company is located can have a different influence on the laws and regulations which apply. Some of the rules that are applicable turned out to be very complex or even contradictory. There were concerns that the confused system of bankruptcy laws had been kept alive in order to

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<sup>72</sup> Wong, R, „The New Face of Bankruptcy“ (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005); Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Riskmanagement in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development, Page 3 <[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

<sup>73</sup> Wong, R, „The New Face of Bankruptcy“ (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>74</sup> Wong, R, „The New Face of Bankruptcy“ (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>75</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Riskmanagement in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development, Page 2 <[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005);

Wong, R, „The New Face of Bankruptcy“ (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

have a certain amount of flexibility in the case of a state owned company going bankrupt. Since 2001, China has been a member of the WTO and is striving to be considered as a market economy. In order to achieve the aim of being declared a market economy, China still has to address several issues. One of these issues is the implementation of a structured bankruptcy law system. The EU will not consider China as a market economy without a well-developed and transparent bankruptcy law. The equal treatment of the different company forms during the bankruptcy procedure will be one of the measures for a fair and equal trade system in particular.<sup>76</sup> Even researchers in China consider the current bankruptcy law to be inappropriate and have called for changes to the current law.<sup>77</sup> As China authorities became aware of these demands for a transparent bankruptcy system, the drafting process for a new bankruptcy law became increasingly necessary.<sup>78</sup> Several drafts have been discussed and many changes have been made to create a modern bankruptcy law that might bring stability and legal certainty.<sup>79</sup> This drafting process for the new Chinese bankruptcy law started more than ten years ago. Several authors expected the new bankruptcy law to take effect by the spring of 2005 but the legislation process was not

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<sup>76</sup> Yan, M, "China Set To Clarify Bankruptcy Protection" China Daily 24 June 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (07 April 2005);

Wong, R, „The New Face of Bankruptcy“ (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>77</sup> Yan, M, "China Set To Clarify Bankruptcy Protection" China Daily 24 June 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (07 April 2005).

<sup>78</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Riskmanagement in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 4 f. <[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

<sup>79</sup> Lan, X, „Outdated Bankruptcy Law Upgraded“ (2004) 47:30 Beijing Review 38.

completed until mid 2005.<sup>80</sup> There is still a good chance that these laws will be passed this year and could be effective by early 2006.

The urgency of changes to the bankruptcy law system seemed to return to the focus of the authority's minds after a massive bankruptcy case shocked the international and Chinese public and the international call for a clear provision grew louder.

The next paragraph provides a brief overview of the bankruptcy cases of the People's Republic of China.

## **2. Statistics of Cases of Bankruptcy in the People's Republic of China**

Prior to 1986, when the first bankruptcy law was established in the People's Republic of China, the authorities tried to conceal the fact that a state-owned company went bankrupt. Because of Chinese governmental policy, there is hardly any documentation on bankruptcies or companies with serious financial problems before that time. Even after the Bankruptcy law became effective, the number of documented bankruptcy cases was very small. During the first few years, the different governments seemed to avoid bankruptcy if possible. A very common way of achieving this was to turn the company from a state-

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<sup>80</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 34 Electronic LexisNexis (29 March 2005).

owned company into a Foreign Joint Venture Company.<sup>81</sup> As foreign investment was limited to certain provinces, this solution was only applicable to provinces that enjoyed the status of a special economic zone.

Since the early 1990s, the People's Republic of China has developed the experiment of avoiding bankruptcies through mergers and acquisitions.<sup>82</sup> The appointed number of cities taking part in this model experiment increased from 18 in 1994 to 111 cities by 1997. Within the first year of that experiment, the number of State-Owned Enterprises filing for bankruptcy hardly changed. In the second year, twice as many companies merged as had to file for bankruptcy.<sup>83</sup> During the experiment, the Chinese authorities discovered that this attempt to solve the financial problems of State-Owned Enterprises through mergers was not proving successful. Finally, in 2000, the central government changed its policy and became dedicated to the idea "more bankruptcies less mergers".<sup>84</sup>

Under these circumstances, no statistics can accurately express the actual evolution of bankruptcy in China.

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<sup>81</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly

<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

<sup>82</sup> Zhang, X C, „A Same Game With Different Rules: Cross-Border Mergers and Acquisitions in the People's Republic of China“ in Horn, N (ed) Mergers and Acquisitions and the Law (The Hague, London: Kluwer Law International 2001) Page 278;

Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly

<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

<sup>83</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly

<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

<sup>84</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly

<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

Nevertheless, some articles refer to official statistics and attempt to demonstrate that the number of bankruptcies is generally increasing in China. Although the total number of bankruptcies has been increasing through the years, these figures do not illustrate the real situation in China due to the governmental policy. Li Shuguang reports the figures documented by the Supreme Court Annual Work Report. This report shows how the number of bankruptcy cases increased in the initial years of Chinese bankruptcy legislation.<sup>85</sup>

| Year | Bankruptcies per Year |
|------|-----------------------|
| 1989 | 98                    |
| 1990 | 32                    |
| 1991 | 117                   |
| 1992 | 428                   |
| 1993 | 710                   |
| 1994 | 1,625                 |
| 1995 | 2,583                 |
| 1996 | 5,875                 |
| 1997 | 5,396                 |

There do not seem to be any other figures available as these specific figures from the Supreme Court Annual Work Report can be found in

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<sup>85</sup> Li, S., „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

various publications.<sup>86</sup> The current statistics for cases of bankruptcy in China are not given in detail. Wu's suggestion for the increase in bankruptcy in State-Owned Enterprises is an approximate rise of 1.5% between 1998 and 2000.<sup>87</sup> Regardless of these figures, a huge number of Chinese companies are technically bankrupt but cannot be declared bankrupt, due to the government authorities' refusal to agree to the bankruptcy petition.<sup>88</sup> The reason for this discrepancy lies in the current law and the interaction of authorities and courts. Another reason for incorrect statistics is evident in the problems authorities have with statistics in general.<sup>89</sup> The current bankruptcy policy states that the decision as to whether a bankruptcy petition is authorised or not can only be made by the government.<sup>90</sup> Because of the necessary governmental approval, a system of understanding and converting the bankruptcy law has been created. The Chinese authorities seemed to recognize their approval of a bankruptcy petition more as a political

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<sup>86</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005);  
Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 34 Electronic LexisNexis (29 March 2005);  
Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 242 Electronic LexisNexis (03 April 2005).

<sup>87</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 242 Electronic LexisNexis (03 April 2005).

<sup>88</sup> Imai, K-i, "Dynamics of Ownership Transformation: Privatisation of Small and Medium Scale Enterprises" in Imai, K-i (ed), Beyond Market Socialism Privatization of State-owned and Collective Enterprises in China (IDE Spot Survey March 2003) 9, 15 <[www.asia-studies.com](http://www.asia-studies.com)> (18 April 2005);

Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

<sup>89</sup> Sun, S, "All Eyes on Overseas State Assets" China Daily 27 April 2005  
<<http://www.chinadaily.com.cn/english/home/index.html>> (06 June 2005)

<sup>90</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 8 Electronic LexisNexis (01 April 2005).

question than an economical one.<sup>91</sup> After this political decision is made, the bankruptcy petition concerning a State-Owned Enterprise is forwarded to the court. A judge then has to decide whether the requirements of the current law have been met. In Article 7, the current bankruptcy law states the reason why a creditor can apply to declare a company bankrupt.

According to the first sentence of Article 7 of the current bankruptcy law:

“Where a debtor is unable to discharge a matured liability, a creditor may apply for the debtor to be declared bankrupt(cy).”

In addition to Article 7, Article 2 of the current law also has to be considered.

The first sentence of Article 3 of the current bankruptcy law states:

“Enterprises which have incurred serious losses due to poor management and administration and are unable to discharge matured liabilities will declare bankruptcy in accordance with the provisions of this Law.”

In order to declare a company bankrupt, the judge has to answer the following questions.

Firstly, can the company repay the debts?

Secondly, is the company suffering “serious losses due to poor management”?

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<sup>91</sup> Li, S., „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

The question as to whether a company is able to pay back its debts might be relatively easy to answer. Generally speaking, the question can be answered by any judge if the relevant company records are valid and traceable. The traceability of a company's records is an important factor in finding an answer to that question. Nevertheless, the issue of the traceability of a company records is not unique to the bankruptcy law and will not be discussed in this thesis.

The second question deals with a known legal issue. Article 3 of the current bankruptcy law states two requirements that contain indefinite legal terms. To declare a company bankrupt, a judge has to decide what he considers as "serious losses" and whether these losses are related to "poor management". Both terms "serious losses" and "poor management" are not defined by the law and there is a wide scope for the judges' decision-making.<sup>92</sup>

Considering these legal questions, it is unlikely that a judge will declare a company bankrupt. As the judges are appointed by the government, the decision made by the judges does not usually vary from that of the government.<sup>93</sup> In the worst case scenario, this could even mean that the court decision contradicts the bankruptcy law.<sup>94</sup>

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<sup>92</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 248 Electronic LexisNexis (03 April 2005).

<sup>93</sup> Peerenboom, R, China's Long March Toward Rule of Law (Cambridge, New York: Cambridge University Press, 2002) Page 305;

Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly

<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

<sup>94</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly

<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

The combination of the legal questions and the governmental authorisation of a bankruptcy petition is another reason why the official statistics cannot provide a reliable picture of bankruptcy in China.

Some analysts forecast that the new bankruptcy law will apply to nearly 118 million companies. According to their speculation under the new law, approximately eight million companies will have to file for bankruptcy in the near future. The government made an exception for some 2000 companies, especially in the military and mining business, in order to protect these companies for the next three to five years.<sup>95</sup>

The following paragraphs will examine examples of so-called policy-oriented bankruptcy and provide examples of how bankruptcy procedures have been manipulated under the current bankruptcy laws. The cases of bankruptcy chosen illustrate how manipulations are carried out before and after the companies have been declared bankrupt.

The first example shows how a company has been forced into bankruptcy by direct governmental manipulation. The second example describes the different methods of manipulation by a liquidation committee to systematically disadvantage creditors.

The bankruptcy of the Zhongjiang Silk Company serves as a prime example of how a fraudulent bankruptcy can be arranged by government officials.

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<sup>95</sup> Li, J, "NPC Weighs Momentous New Bankruptcy Law" China Daily 22 June 2004 <<http://www.chinadaily.com.cn>> (23 March 2005); Business Weekly, "SOE Bankruptcies Planned" Business Weekly 03 August 2003 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 April 2005).

### **3. Examples**

In order to give an insight into bankruptcy practice in China, the following paragraphs describe the bankruptcy cases of the Zhongjiang Silk Company and the Guangdong International Trust and Investment Company. These examples show the different effects which might occur.

#### **3.1. The Zhongjiang Silk Company Case**

In 1982, Zhongjiang Silk Company was founded as a state-owned commercial and trade enterprise. The company's main business was sale and purchase of pod and raw silk. Zhongjiang County granted the Zhongjiang Silk Company the exclusive right to operate in the business and the company apparently performed very well. As a result of its good performance, several financial institutions rated Zhongjiang Silk Company as an "AA credit enterprise" or a "superfine and first-class credit enterprise". In fact, the company had to pay Zhongjiang County more taxes between 1995 and 1999 than Zhongjiang County expected. In spite of this, officials created a plan to force the company into bankruptcy. Different departments and even the courts were involved in the plan, which finally ended with the bankruptcy of the Zhongjiang Silk Company. In order to achieve this, Zhongjiang County authorities arranged that several different companies linked to the Zhongjiang Silk

Company filed for bankruptcy. As a direct consequence of these bankruptcies, the claims against these companies held by the Zhongjiang Silk Company disappeared. In addition to the manipulation of debts, the Zhongjiang financial bureau claimed the immediate recovery of debts. The culmination of these coincidences meant that the Zhongjiang Silk Company could be declared bankrupt. To make things even worse, the Zhongjiang authorities advised the Zhongjiang Silk Company to withdraw its capital, as well as submit the balance sheets and accounts in such a way that it could be assumed that the company was insolvent. The court responsible accepted the bankruptcy petition without any serious examination and appointed the liquidation committee. The liquidation committee was established the same day the Zhongjiang Silk Company was declared bankrupt and a vice-secretary of the Zhongjiang County Commission was appointed head of the committee. A newly founded company acquired the assets of the Zhongjiang Silk Company at auction. Generally speaking, if something is sold at auction the procedure is fair. However, in this particular case, the government had designated who would be allowed to acquire the company's assets in advance. Coincidentally, this particular company had been founded by the Zhongjiang County shortly before the auction. In the end, the Zhongjiang County authorities were able to retain control over the relevant assets and reduced the debts owed to the different creditors.<sup>96</sup>

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<sup>96</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" *Insolvency Systems and Risk Management in Asia*; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development

This case is a prime example of how different provincial authorities, courts and creditors could cooperate under the current law in order to abolish debts and retain control over the relevant assets of a company. There is no doubt that this way of escaping debts is fraud under Chinese legislation. It could even be suggested that local governments use the bankruptcy law to achieve the new system of market economy. The fact that those responsible for the manipulation in the case of the Zhongjiang Silk Company have been punished shows that there is a general understanding of how business should be carried out and how bankruptcy law should be used.

The case of the Zhongjiang Silk Company illustrates how bankruptcy has been used under the current law to reduce debts. Even if a company is not forced by the authorities to file for bankruptcy, the following example shows that there are nevertheless other opportunities to manipulate the bankruptcy proceedings in order to minimise the financial damage.

In the documentation of the bankruptcy case of the Guangdong International Trust and Investment Company, manipulation by the authorities, which could have forced the company into bankruptcy, is mentioned. However, the following section will illustrate how subtle the influence under the current law can be.

## **3.2. The Guangdong International Trust and Investment Company Case**

The Guangdong International Trust and Investment Company (GITIC) was one of the larger financial companies in Chinese history that had to file for bankruptcy. In addition, the GITIC bankruptcy case is one of the rare examples that describe a recent bankruptcy which could be observed by the public in and out of China.

The court responsible declared GITIC bankrupt on 16 January 1999.<sup>97</sup> A short summary of the bankruptcy case will highlight the most interesting details, especially as these particulars occurred before the court declared the company bankrupt.

GITIC was one of the leading financial companies with several subsidiaries within and outside China. The creditors of GITIC had been informed of the closure of the company by the People's Bank of China on 6 October 1998. This public announcement did not contain any hint that the company had to file for bankruptcy. Instead of this, the announcement contained other information on the creditors. One issue that was mentioned in the announcement was the invitation to all creditors to register their debts within a three-month period. There was no reason for the creditors to become suspicious as a result of this information or the information that an asset transfer of GITIC's securities trading business to one of the company's competitors would be carried out. Experience with Chinese bankruptcy proceedings gave

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<sup>97</sup> Chang, T K, "The East is in the Red" (1999) 18:3 International Financial Law Review 43 Electronic Proquest (27 March 2005).

no reason for the foreign creditors to worry as the proceedings announced appeared to be normal.<sup>98</sup>

As it turned out, this announcement was one of several different things which happened throughout the downfall of GITIC that should have made foreign investors question Chinese bankruptcy practice. Right at the beginning of the winding-up process, the creditors were surprised by the fact that the number of subsidiaries had doubled and the amount of assets halved. Besides the aforementioned asset transfer of the securities trading business, a further asset transfer had been arranged by the liquidation committee. GITIC's assets included some stakes in China's largest nuclear power plant. These assets could not be sold on the open market due to the fact that their transfer to a foreign party was not permitted.<sup>99</sup> After the transfer of valuable assets, the creditors complained that these assets had been sold at a suspiciously low price. However, the complaints and arguments brought up by the creditors had no effect on the decision of the liquidation committee.<sup>100</sup>

China Daily quotes a Hong Kong lawyer who was of the opinion that GITIC's bankruptcy "...was an unusual case, born of unusual

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<sup>98</sup> Chang, T K, "The East is in the Red" (1999) 18:3 International Financial Law Review 43 Electronic Proquest (27 March 2005); Farkas, P P, "Discipline in the Marketplace" (1999) CAmagazine <[http://www.camagazine.com/index.cfm/ci\\_id/5926/la\\_id/1/camagazine/1/print/true.htm](http://www.camagazine.com/index.cfm/ci_id/5926/la_id/1/camagazine/1/print/true.htm)> (06 March 2005).

<sup>99</sup> Farkas, P P, "Discipline in the Marketplace" (1999) CAmagazine <[http://www.camagazine.com/index.cfm/ci\\_id/5926/la\\_id/1/camagazine/1/print/true.htm](http://www.camagazine.com/index.cfm/ci_id/5926/la_id/1/camagazine/1/print/true.htm)> (06 March 2005); Shi, J, "Chinese Cross-Border Insolvencies: Current Issues and Future Developments" (2001) 10:1 International Insolvency Review 33, 47 Electronic Proquest (22 March 2005).

<sup>100</sup> Farkas, P P, "Discipline in the Marketplace" (1999) CAmagazine <[http://www.camagazine.com/index.cfm/ci\\_id/5926/la\\_id/1/camagazine/1/print/true.htm](http://www.camagazine.com/index.cfm/ci_id/5926/la_id/1/camagazine/1/print/true.htm)> (06 March 2005); Chang, T K, "The East is in the Red" (1999) 18:3 International Financial Law Review 43 Electronic Proquest (27 March 2005).

circumstances".<sup>101</sup> As the article by Zhao examines the potential failures of financial institutions becoming bankrupt, this statement could only refer to the business developments of GITIC before the company had to file for bankruptcy.

A further article discusses suspicion regarding the behaviour of the Chinese authorities. In this article, Shi assumes that the Chinese authorities realised the full extent of GITIC's financial dilemma after the announcement by the People's Bank of China. As the authorities discovered that there was no way of saving GITIC, the authorities seemed to try their best to minimise the financial damage. As a reaction to that perception, the Chinese authorities seemed to change their mind and allowed the company to file for bankruptcy. As the next step, some members of the provincial government and larger Chinese creditors were announced as members of the liquidation committee.<sup>102</sup> As some of the creditors were appointed, it comes as no surprise that some assets were valued and sold to those companies at a low price.

On the one hand, this could explain the fact that assets were sold at a very low price to the organisations of some members of the liquidation committee. On the other hand, it must be taken in consideration that some of GITIC's assets were shares, like the stakes in the nuclear power plant, which could not be transferred to foreign parties.<sup>103</sup> As these assets had to be sold to a Chinese company it is very likely that it

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<sup>101</sup> Zhao, R, "Law to Allow Financial Firms to go Bankrupt" China Daily 16 August 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>102</sup> Shi, J, "Chinese Cross-Border Insolvencies: Current Issues and Future Developments" (2001) 10:1 International Insolvency Review 33, 47 Electronic Proquest (22 March 2005).

<sup>103</sup> Chang, T K, "The East is in the Red" (1999) 18:3 International Financial Law Review 43 Electronic Proquest (27 March 2005).

was in the interests of the members of the provincial government to sell those assets at a low price. Considering these circumstances, it is quite reasonable to save the valuable assets by transferring them to different state companies.

Some foreign creditors wondered if it was a coincidence that some of the acquiring companies had a seat on the liquidation committee. The question might be raised as to whether there was a conflict of interest in the disposal of these assets. One example of conflicting interest is the fact that these assets were sold to some creditors at a low price. These creditors were given a huge advantage in the struggle for the recovery of outstanding debts. An additional example of conflicting interests could be the fact that the liquidation committee decided that local Chinese creditors would be satisfied before their foreign counterparts. In the end, the members of the liquidation committee did their organisations a second favour because their organisations were also local Chinese creditors. This meant these Chinese creditors would be satisfied before the foreign creditors in the case of any repayment and would gain a further advantage. The main financial damage was suffered by the foreign creditors who had been relying on the Chinese bankruptcy system.

The example given by the GITIC bankruptcy case shows how the Chinese authorities can strategically benefit from the bankruptcy of a State-Owned Enterprise. It is not necessary to plan a bankruptcy like that described in the Zhongjiang Silk Company case.

These examples illustrate how Chinese authorities can influence the bankruptcy of a State-Owned Enterprise. Unfortunately, no example

could be found of how the authorities could influence the bankruptcy of a foreign investment company. However, the general consensus of the Chinese authorities seems to be that the bankruptcy of a foreign investment enterprise is not desirable.<sup>104</sup> China's authorities seem to remain silent on anything that is related to the bankruptcy of a foreign investment company. Most articles published in China merely mention that there have been bankruptcy cases of foreign investment companies but hardly any of the articles provide any detailed documentation.<sup>105</sup>

Nevertheless, both of the examples given here show that the current bankruptcy law contains loopholes and is in urgent need of attention by the Chinese central government. As, amongst others, the European Union is demanding a unified Chinese bankruptcy law, the Chinese authorities have been forced to accelerate the drafting process for the new bankruptcy law. In addition to the demands of the European Union, several economic reasons made it reasonable for the People's Republic of China to revise the bankruptcy law.

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<sup>104</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 244 Electronic LexisNexis (03 April 2005).

<sup>105</sup> Li, S, „Bankruptcy Law in China: Lessons of the Past Twelve Years“ (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

## **4. The Economic Effects of the Current Chinese Bankruptcy Laws**

As any nation's economy, the Chinese economy is subject to the market forces. This is a fact that Chinese leaders have to deal with and cannot ignore if they want to transform China into a market economy.

One of the issues that has been addressed is the bankruptcy law system. As every national economy requires regulations on the different ways in which a company can be founded, there have to be clear regulations on how a company can be closed. If a country only has regulations and laws that structure the foundation of companies, an essential part of the economic cycle is missing.<sup>106</sup> Various authors have pointed out that inefficient bankruptcy laws could severely damage or even ruin the entire economy.<sup>107</sup>

China has to change its current bankruptcy law system. The current system contains loopholes, is inconsistent and lacks structure. By eliminating the multiple inadequacies in the different bankruptcy regulations, the climate for foreign investment could become much better. Although foreign investors are withholding some of their potential

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<sup>106</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 240 Electronic LexisNexis (03 April 2005).

<sup>107</sup> Farkas, P P, “Discipline in the Marketplace” (1999) CAmagazine <[http://www.camagazine.com/index.cfm/ci\\_id/5926/la\\_id/1/camagazine/1/print/true.htm](http://www.camagazine.com/index.cfm/ci_id/5926/la_id/1/camagazine/1/print/true.htm)> (06 March 2005);

Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 240 Electronic LexisNexis (03 April 2005).

investments, the Chinese economy is currently booming. As the total amount of foreign investments in China is still increasing<sup>108</sup>, the current Chinese policy of avoiding widespread bankruptcies seems to be working. However, if a reliable bankruptcy law system were in place, foreign investment in China could be much higher. Foreign investors are still looking at examples like the GITIC case and are not willing to take similar risks again.

One effect on the economy is evident in the delay of bankruptcy proceedings. China's current system provides the possibility of disposing of a company's assets prior to bankruptcy.<sup>109</sup> The avoidance of repaying the creditors' debts will damage the creditors' interests. The reduction of debts to be recovered could lead to a surge of bankruptcies amongst the creditors of that company. This possibility has threatened Chinese authorities since the 1980s when the current law was under discussion.<sup>110</sup> In fact, if the Chinese authorities do not manage the bankruptcy petitions of weak State-Owned Enterprises, there may be the risk of a surge of bankruptcies that could shake China's economy.

China is currently trying to convince the members of the WTO that it has a market economy. Several countries are still refusing this request

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<sup>108</sup> Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005).

<sup>109</sup> Wang, W, "Notes and Current Developments: Corporate governance and the draft Bankruptcy Law of China" (2004) 17 Australian Journal of Corporate Law 1, 14 Electronic LexisNexis (30 March 2005);

China Daily, "Bankruptcy Laws Need Review" China Daily 17 March 2003 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 April 2005).

<sup>110</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 244 Electronic LexisNexis (03 April 2005).

by Chinese authorities and are unwilling to grant China the status of a market economy. However, most of the countries denying China this status are willing to change their decision in exchange for a variety of changes in the country.

The European Union, for example, is one of the most significant partners refusing to accept that China is a market economy. The changes to the Chinese bankruptcy laws are one of the European Union's demands.<sup>111</sup> Besides the bankruptcy law, there are three other topics that have to be addressed before the European Union will change its decision. One of the other areas the European Union is demanding changes in is strongly related to the bankruptcy law.<sup>112</sup>

Without a well-organised accounting system, it is impossible to answer the question as to whether a company is bankrupt.

The examples given show that there is a wide variety of possibilities for the authorities to influence the bankruptcy system.

For China, the status of a market economy is not only a quest for prestige. The WTO has different regulations for members with a market economy and those who do not. Consequently, recognition as a market economy is a vital issue for China.

Besides the effects on trade, there may be further consequences. If the discussion on Basel II regulations for ranking of financial investment becomes operative, China will suffer additional negative effects. In the

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<sup>111</sup> Qi, H & Dai, Y, "EU Ruling on China's Market Status 'Unfair'" (2004) China Daily 30 June 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005); Gärtner, M, "Zwischen Turbo-Kapitalismus und Planwirtschaft - Die Schwächen des Standorts liegen vor allem in der Machtfülle des Staates" (2004) <<http://www.nrw-export.de/export/2113.asp>> (07 April 2005).

<sup>112</sup> Qi, H & Dai, Y, "EU Ruling on China's Market Status 'Unfair'" (2004) China Daily 30 June 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

worst case scenario, any investment in China will be rated as a much higher risk than a comparable investment in a country that has a more structured bankruptcy law system.<sup>113</sup> This does not mean that the investment is any safer in the other country, but the chances of recovering the money invested is a risk factor that will have to be taken into consideration by the financing companies. As stated in the Basel II stipulations, the interest rates for investments with a higher risk factor have to be higher. Therefore, China will have to pay higher interest rates for foreign capital.

If China wants to be recognised as a market economy and become eligible for the Basel II regulations, the Chinese bankruptcy laws have to meet international standards.

During the last decade, a drafting committee tried to establish a modern bankruptcy law. Currently, the Standing Committee of the National People's Congress is discussing the draft for the second time. The next section will highlight certain elements of the final draft.

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<sup>113</sup> Zhao, R, "Law to Allow Financial Firms to go Bankrupt" China Daily 16 August 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005); Barker, M & Purser, R, "Bankruptcy Reform in China" (2004) Freshfields Bruckhaus Deringer Page 3 <<http://www.freshfields.com/practice/finance/publications/pdfs/9710.pdf>> (07 March 2005).

## C The new Bankruptcy Law of China

The Standing Committee of the National People's Congress has been discussing the latest draft of the New Bankruptcy Law since June 2004.<sup>114</sup> At this stage, it is not clear whether the name of the law will be changed by the committee or not. During the drafting process, most of the authors simply referred to the draft of the new law as the "bankruptcy law".<sup>115</sup> Although there is still a chance that the new law will carry a different name in the final stage of the legislation process, the change should not make any substantial alterations to the content.

In 2004, legal experts forecasted that the legislation process could be completed by the end of 2004 and the law could be effective by early 2005.<sup>116</sup> In fact, the legislation process was not completed until June 2005, thus reducing the chances for the adoption of this law by 2006. For some reason, the discussion within the Standing Committee has taken an astonishingly long time. Most of the arguments were

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<sup>114</sup> Wang, W, "Notes and Current Developments: Corporate governance and the draft Bankruptcy Law of China" (2004) 17 Australian Journal of Corporate Law 1, 6 Electronic LexisNexis (30 March 2005);

Lan, X, "Outdated Bankruptcy Law Upgraded" (2004) 47:30 Beijing Review 38 <<http://www.bjreview.com.cn>> (13 April 2005).

<sup>115</sup> Zhu, S, "Discussion of Several Issues Related to the Draft Law" papers from the 2000 Symposium on Bankruptcy Law Page 6 <[http://www.gtz-legal-reform.org.cn/english/projects/fec/papers\\_2000bl.htm](http://www.gtz-legal-reform.org.cn/english/projects/fec/papers_2000bl.htm)> (27 June 2005)

<sup>116</sup> Korff, C & Chua, E J, "China Sets Short Timetable for Bankruptcy Law Reform" (2004) China Law & Practice 1 Electronic Proquest (27 June 2005); Barker, M & Purser, R, "Bankruptcy Reform in China" (2004) Freshfields Bruckhaus Deringer Page 2 <<http://www.freshfields.com/practice/finance/publications/pdfs/9710.pdf>> (07 March 2005).

discussed during the ten year drafting process and, in light of this, it is strange that the Standing Committee needs such a long time.<sup>117</sup>

From the drafting process, some financial experts forecasted economic consequences, if the introduction of the drafts to the public were delayed.<sup>118</sup> Consequently, it is highly likely that the delay in very important changes to the current bankruptcy law system is causing damage to the Chinese economy.

Several points were on the agenda during the drafting process. The new law should, for example, pay respect to the current status of changes in the processes of economic development and should consider the needs of a bankrupt company's employees. The threat of a massive increase in unemployment and political instability as a result of the new bankruptcy law were some of the major issues discussed during the drafting process.<sup>119</sup> Due to these concerns, the resettlement of laid-off workers became one of the important arguments in the discussion throughout the different levels of government.<sup>120</sup>

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<sup>117</sup> Wu, W, "Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law" (2004) 35 Victoria University of Wellington Law Review 239, 244 Electronic LexisNexis (03 April 2005).

<sup>118</sup> Wang, Y, "New Bankruptcy Law Drafted" (2002) Business Weekly 30 April 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>119</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 3 Electronic LexisNexis (01 April 2005);

Zhang, X C, „A Same Game With Different Rules: Cross-Border Mergers and Acquisitions in the People's Republic of China“ in Horn, N (ed) Mergers and Acquisitions and the Law (The Hague, London: Kluwer Law International 2001) Page 289;

Wang, Y, "New Bankruptcy Law Drafted" (2002) Business Weekly 30 April 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>120</sup> Yan, M, "China Set To Clarify Bankruptcy Protection" China Daily 24 June 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (07 April 2005);

Wang, Y, "New Bankruptcy Law Drafted" (2002) Business Weekly 30 April 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

Besides these social and political points, the new bankruptcy law is expected to apply to all company forms in China and should protect the rights of every party involved in the bankruptcy proceedings.<sup>121</sup>

During the discussion on how the different parties could be protected, some emotional statements were made. One example is a comment in the China Daily, dated on 16 August 2004, claiming that the "...government departments in China have generally overprotected investors."<sup>122</sup> Although the author explains his comment on "governmental overprotection" as a "byproduct" of the former planned economy<sup>123</sup>, this argument can be considered as "ironic", especially after the GITIC bankruptcy case showed that foreign investors suffered the largest losses. Cao, a member of the agency that drafted the current bankruptcy law, admitted that he thinks the protection of interests and rights of creditors is a weakness of the current bankruptcy law.<sup>124</sup>

In theory, the protection of secured rights and interests is a driving force towards the stability of the growing Chinese economy.<sup>125</sup> In order to achieve the changes in the Chinese economy, the draft pays tribute to

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<sup>121</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) China Law Developments January 2005, Page 2 f. <[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16 April 2005).

<sup>122</sup> Zhao, R, "Law to Allow Financial Firms to go Bankrupt" China Daily 16 August 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>123</sup> Zhao, R, „Law to Allow Financial Firms to go Bankrupt“ China Daily 16 August 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>124</sup> Cao, S, "Comments on the Draft" papers from the 2000 Symposium on Bankruptcy Law Page 3 <[http://www.gtz-legal-reform.org.cn/english/projects/fec/papers\\_2000bl.htm](http://www.gtz-legal-reform.org.cn/english/projects/fec/papers_2000bl.htm)> (26 March 2005).

<sup>125</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 8 <[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

this theory and creates a system of protection for secured rights and interests. This system is guided by the idea that secured assets will not become part of the bankruptcy assets. Once these changes have been implemented, the interests of foreign and Chinese investors will be protected. Generally speaking, there will be no guarantee that the secured debts are safe and can be recovered in the end. This insecurity arises because in some cases one asset is securing two debts and both debtors cannot be one hundred percent sure of recovering their debts in full.

Retaining the creditors meeting was supposed to protect the rights of creditors and secured creditors in particular.<sup>126</sup> In theory, this creditors' meeting is supposed to have the power to guide and supervise all proceedings within the bankruptcy process. One of the following sections will provide an overview of the advantages the creditors meeting will bring under the new law and try to explain what potential problems the creditors may face.

According to the 2002 draft, the new bankruptcy law will be applicable to most corporate forms. Some of the lawmakers did not accept the idea of a general bankruptcy law that would be applicable to all corporate forms in all economic areas. An intense discussion was necessary to convince most of the critics. Although the new bankruptcy law will be applicable generally, some exceptions will be made for

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<sup>126</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 11  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

certain companies, such as financial institutions, or some special economic sectors.<sup>127</sup> The fact that some of China's financial institutions are already facing enormous problems due to mismanagement or a high number of so-called "non-performing loans" supports this very sensitive discussion. Some authors estimate that the total amount of "non-performing loans" given to state-owned companies from state-owned banks in 2000 represented 25-50 % of the state-owned banks' total lending.<sup>128</sup> During this discussion, some of the lawmakers predicted the threat of a general financial crisis should State-Owned Enterprises go bankrupt, which could in turn lead to multiple losses and affect other larger creditors.<sup>129</sup> Various different approaches have been considered to find a suitable way of regulating financial institutions which have to file for bankruptcy. The alternatives discussed ranged from the introduction of separate legislation for the bankruptcy of financial institutions to an unsophisticated inclusion in a general bankruptcy law.<sup>130</sup> Finally, it was widely accepted that it is necessary to have a

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<sup>127</sup> China Daily, "China Ends Support for Insolvent Companies" China Daily 13 May 2005 <<http://www.chinadaily.com.cn/english/home/index.html>> (06 June 2005); Sprayregen, J H M, Friedland J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005); Korff, C & Chua, E J, "China Sets Short Timetable for Bankruptcy Law Reform" (2004) China Law & Practice 1 Electronic Proquest (27 June 2005); Barker, M & Purser, R, "Bankruptcy Reform in China" (2004) Freshfields Bruckhaus Deringer Page 2 <<http://www.freshfields.com/practice/finance/publications/pdfs/9710.pdf>> (07 March 2005).

<sup>128</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 3 Electronic LexisNexis (01 April 2005); Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 267 Electronic LexisNexis (03 April 2005)..

<sup>129</sup> Wang, Y, "New Bankruptcy Law Drafted" (2002) Business Weekly 30 April 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>130</sup> Zhao, R, „Law to Allow Financial Firms to go Bankrupt“ China Daily 16 August 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

general regulation that includes the bankruptcy of financial institutions. Nevertheless, the state council will be granted the power to adopt special regulations as an addition to the new bankruptcy law.<sup>131</sup> The introduction of these special regulations could be regarded as a form of compromise to cover both extreme positions. These additional regulations will be created by the state council once the law is finally effective. Some of these special regulations will govern the bankruptcy of commercial banks and insurance companies. Chinese lawmakers took into consideration the special situation of all different forms of financial companies and recognised the necessity of introducing special regulations in order to avoid social unrest and preserve order. These special regulations in particular will primarily protect customer assets placed in trusts and assuage the fears of Chinese private investors.<sup>132</sup> In general, most of the recommended changes were transcribed in the 2002 draft and some approved regulations specified.

Therefore, liquidation is still one of the possible procedures in the new bankruptcy law, but the new law will not concentrate on the bankrupt company's process of liquidation. The main focus will fall on the question as to how liquidation can be avoided.<sup>133</sup> Accordingly, the most

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<sup>131</sup> Zhao, R, "Law to Allow Financial Firms to go Bankrupt" China Daily 16 August 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005); Sprayregen, J H M, Friedland J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005).

<sup>132</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005); Barker, M & Purser, R, "Bankruptcy Reform in China" (2004) Freshfields Bruckhaus Deringer Page 2 <<http://www.freshfields.com/practice/finance/publications/pdfs/9710.pdf>> (07 March 2005).

<sup>133</sup> Wong, R, "The New Face of Bankruptcy" (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

significant change will probably be the detailed regulations on the reconstruction or reorganization of a bankrupt company.<sup>134</sup> Although the focal point is the reconstruction of the bankrupt company, some additions will be made to the current regulations on how liquidation is to be carried out. In the context of liquidation and reorganisation, China has not solved all of its problems related to the question of property code.<sup>135</sup> This makes it difficult to answer the question as to whether a particular asset belongs to a bankrupt company.<sup>136</sup>

Another significant change is the universal treatment of most companies and the reduction of governmental influence on bankruptcy proceedings.<sup>137</sup> Generally speaking, the current laws require governmental approval by the relevant authorities if a company is filing for bankruptcy.<sup>138</sup>

The Chinese government is still trying to change the planned economy into a market economy. These changes in the economic system should minimise the influence of governmental officials. However, the surprising effect of these changes on the economic system is not a fall in governmental influence but rather the reverse. In order to accomplish

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<sup>134</sup> Lan, X, "Outdated Bankruptcy Law Upgraded" (2004) 47:30 Beijing Review 38 <<http://www.bjreview.com.cn>> (13 April 2005).

<sup>135</sup> Ho, L, "Chapter VI, Section 3 - Bankruptcy Property" papers from the 2000 Symposium on Bankruptcy Law Page 1 <[http://www.gtz-legal-reform.org.cn/english/projects/fec/papers\\_2000bl.htm](http://www.gtz-legal-reform.org.cn/english/projects/fec/papers_2000bl.htm)> (29 July 2005).

<sup>136</sup> Ho, L, "Chapter VI, Section 6 - Right of Priority and Section 7 - Appraisal and Distribution" papers from the 2000 Symposium on Bankruptcy Law Page 2 <[http://www.gtz-legal-reform.org.cn/english/projects/fec/papers\\_2000bl.htm](http://www.gtz-legal-reform.org.cn/english/projects/fec/papers_2000bl.htm)> (29 July 2005)

<sup>137</sup> Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 38 Electronic LexisNexis (31 March 2005).

<sup>138</sup> Barker, M & Purser, R, "Bankruptcy Reform in China" (2004) Freshfields Bruckhaus Deringer Page 1 <<http://www.freshfields.com/practice/finance/publications/pdfs/9710.pdf>> (07 March 2005).

these changes, several state-owned companies have turned into limited companies. The result of these transformations is that the government authorities are in the position of controlling shareholder. This position establishes new power for the authorities. They retain the influence to decide the economic future of any of these companies. This power includes the possibility to file for bankruptcy. Effectively, government officials are doubling their influence. Firstly, they are gaining this new position as the controlling shareholder and, secondly, they are not forfeiting their position as the approval authorities.<sup>139</sup>

In addition, there is another way in which the governmental organisations maintain their influence. On the one hand, it is possible under the current regulations and laws for governmental organisations to act as members of a liquidation committee. On the other hand, they are supposed to control the liquidation committee.<sup>140</sup> In addition to their dual role as executor and administrator of the proceedings, the courts also have to rely upon the information provided by the government authorities or the liquidation committee. This information is necessary for the courts to make a decision. As a result of this dependence, the

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<sup>139</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 11 Electronic LexisNexis (01 April 2005);

Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 11 Electronic LexisNexis (31 March 2005).

<sup>140</sup> Wang, W, "Notes and Current Developments: Corporate governance and the draft Bankruptcy Law of China" (2004) 17 Australian Journal of Corporate Law 1, 4 Electronic LexisNexis (30 March 2005);

Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005);

Ng, C Y M, "'One Country, Two Systems' - Insolvency Administration in the People's Republic of China" (2002) 17:7 Managerial Auditing Journal 363, 366 Electronic Proquest (27 June 2005);

Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1 Electronic LexisNexis (01 April 2005).

judges have to cooperate closely with the authorities. This situation makes it practically impossible for the judges to pass a fair and impartial judgement for all parties.<sup>141</sup> To make things worse for the judges, the government still has the general power to recall the judge if he does not make a decision in their favour.<sup>142</sup> Because of the complex status occupied by governmental authorities, it can be claimed that the authorities have the power to consider and accommodate local interests. The assurance of local interests inevitably leads to discrimination against foreign investors.

The new bankruptcy law will constitute a very important step towards a market economy, although there are still some remnants of the planned economy in the draft.<sup>143</sup> These could easily become a serious problem.

In addition to the aforementioned changes, some of the more significant changes will be emphasised in the following sections. As already mentioned, the new bankruptcy law offers a variety of different procedures and certain flexibility in the adjustment of the procedures during a bankruptcy case.<sup>144</sup>

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<sup>141</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 244 Electronic LexisNexis (03 April 2005).

<sup>142</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 12 Electronic LexisNexis (01 April 2005)

<sup>143</sup> Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 38 Electronic LexisNexis (31 March 2005).

<sup>144</sup> Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 38 Electronic LexisNexis (31 March 2005).

Several modern bankruptcy laws have already introduced detailed models for reconstruction or reorganisation in order to improve the common alternative to the liquidation of a company.

## 1. Reconstruction

The current draft version of the bankruptcy law implemented in China does not offer liquidation as the sole solution for a company facing bankruptcy.<sup>145</sup> However, the regulations are not very specific. The bankrupt company, for example, is not provided with a detailed alternative to liquidation. Most of the other modern bankruptcy laws include detailed regulations on reconstruction or reorganisation. Under the current Chinese laws, this is missing.<sup>146</sup> At present, the Chinese authorities are still trying to recover the valuable assets prior to the liquidation of an insolvent company. Generally speaking, this is not the way to deal with the problem. Unfortunately, it only benefits the individuals who receive the assets before the company is declared

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<sup>145</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 31 Electronic LexisNexis (01 April 2005);

Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005);

Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 14 Electronic LexisNexis (31 March 2005).

<sup>146</sup> Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 14 Electronic LexisNexis (31 March 2005);

Lan, X, "Outdated Bankruptcy Law Upgraded" (2004) 47:30 Beijing Review 38 <<http://www.bjreview.com.cn>> (13 April 2005);

Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) China Law Developments January 2005 Page 2 <[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16 April 2005).

bankrupt or are chosen to purchase the assets at a low price by the liquidation committee. The bankrupt company's remaining creditors have to suffer the losses and there is nothing they can do about it.

Modern bankruptcy laws introduce different forms of reconstruction in order to reallocate capital from ineffective companies to more effective ones.<sup>147</sup> In Chapter 6, the current 2002 draft contains the opportunity to reconstruct the struggling company and to settle outstanding debts with the creditors. Any form of reconstruction helps to conserve valuable capital to benefit the Chinese and worldwide economy. These assets are supposed to be transferred to those economic areas where the degree of positive effects is the highest and the secondary effect is that the economy is kept running.<sup>148</sup> The debtor and the creditor both have the opportunity to apply for reconstruction if either of them sees a chance of saving the company.

The reconstruction plan can be developed with the assistance of the management of a company when a bankruptcy case is filed. These managers should know why the company is struggling and has had to file for bankruptcy. The experience of reorganisation in other countries shows that fast and direct action is necessary to establish a reorganisation plan. In order to save as many of the assets as possible,

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<sup>147</sup> Barker, M & Purser, R, "Bankruptcy Reform in China" (2004) Freshfields Bruckhaus Deringer Page 1

<<http://www.freshfields.com/practice/finance/publications/pdfs/9710.pdf>> (07 March 2005);

Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005).

<sup>148</sup> Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005).

the management should assist in setting up the reorganisation plan.<sup>149</sup> The application for reorganisation can be made to the People's Court before or after the bankruptcy case has been declared.<sup>150</sup> In order to start reconstruction, the debtor has to develop a reconstruction plan that outlines how the turnaround is to be achieved. This plan has to be accepted by the creditor's conference and approved by the court. Other countries are well-acquainted with the possibility that there may be more than one reconstruction plan. The current draft does not provide any opportunity to offer a variety of different plans. The absence of this possibility could prove to be one of the disadvantages of the forthcoming bankruptcy law.<sup>151</sup>

Even if the creditors' meeting accepts or refuses the reconstruction plan, the decision still can be overruled by the court. The court will overrule the reconstruction plan if it is not convinced by it or the plan violates the law.<sup>152</sup> The idea of overruling the creditors' meeting could lead to the suspicion that the court is fulfilling the requirements of the

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<sup>149</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" *Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004*, New Delhi, Organisation for Economic Co-operation and Development Page 10  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

<sup>150</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) *China Law Developments* January 2005 Page 11  
<[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16 April 2005).

<sup>151</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 *American Bankruptcy Institute Journal* 34, 60 *Electronic LexisNexis* (29 March 2005).

<sup>152</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 *Victoria University of Wellington Law Review* 239, 251 *Electronic LexisNexis* (03 April 2005).

authorities. However, an overruling can only be carried out under certain circumstances, which are stated by the bankruptcy law.<sup>153</sup>

Although the law contains regulations which bind the courts, the threat will remain as long as the court system in China is not considered independent.

If the plan is accepted, there are two possibilities as to how the reconstruction can be implemented. In any case, the People's Court advises the transfer of the company's property and management affairs to the person that will be charged with carrying out the reconstruction. One way of implementing the reorganisation is under self-management and supervision of the bankruptcy administrator; the other option is the complete replacement of the management by the bankruptcy administrator.<sup>154</sup> If the debtor is trying to recover the company, he is permitted to carry out normal business during the period of reconstruction. This includes employing professional staff or deciding whether the current staff is to remain in employment or not.<sup>155</sup>

The different effects, along with the side effects of the reorganisation system, are very numerous. Besides the minimisation of financial losses and the potential risk of cascading bankruptcies, a second very important effect should be specified here. In most cases, the company

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<sup>153</sup> Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 251 Electronic LexisNexis (03 April 2005).

<sup>154</sup> Wang, W, "Notes and Current Developments: Corporate governance and the draft Bankruptcy Law of China" (2004) 17 Australian Journal of Corporate Law 1, 8 Electronic LexisNexis (30 March 2005).

<sup>155</sup> Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 34 Electronic LexisNexis (31 March 2005).

has to reduce staff. The reduction of staff causes unemployment, but if a company does not close down completely, there is a good chance of saving a large number of jobs.<sup>156</sup>

This “side” effect has to be taken into consideration at all times during the bankruptcy procedures. The chance of minimising the negative effects of a bankruptcy can be increased if the application for bankruptcy is filed as early as possible.

Compared to the current bankruptcy law, the new bankruptcy law will also bring significant changes with respect to the causes of filing for bankruptcy.

## **2. The Different Causes of Bankruptcy**

As a result of the combination of Article 7 and 3, the current bankruptcy law defines the cause of bankruptcy as where “the debtor is unable to discharge a matured liability” and the enterprise “has incurred serious losses due to poor management and administration”.<sup>157</sup> In this thesis, it

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<sup>156</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" *Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004*, New Delhi, Organisation for Economic Co-operation and Development Page 11

<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005);

Zhu, S, "Discussion of Several Issues Related to the Draft Law" papers from the 2000 Symposium on Bankruptcy Law Page 10 <[http://www.gtz-legal-reform.org.cn/english/projects/fec/papers\\_2000bl.htm](http://www.gtz-legal-reform.org.cn/english/projects/fec/papers_2000bl.htm)> (27 June 2005).

<sup>157</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) *China Law Developments* January 2005 Page 5

<[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16 April 2005),

Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 *Victoria University of Wellington Law Review* 239, 248 *Electronic LexisNexis* (03 April 2005);

has already been pointed out that these causes of bankruptcy include at least two undefined legal terms which require clarification by the judge. In contrast to this vague and undefined reason for declaring a company bankrupt, the 2002 draft provides a general but clearer definition of where to declare a company bankrupt. The first sentence of the draft Article 4 states that the company either does not have the amount of assets necessary to pay off all liabilities or is unable to repay the debts when they are due. In the last sentence of Article 4, the draft contains legal fiction. This legal fiction states that a debtor who "ceases" to repay the debts due "shall be deemed unable to pay". This legal fiction could lead to numerous litigations.<sup>158</sup> The draft does not state whether the cessation of payments has to be permanent or whether a temporary cessation fulfils this requirement. Another problem could arise from the fact that the application for bankruptcy can be filed without any proof that the company is bankrupt.<sup>159</sup> The request for bankruptcy proceedings could prove to be the very reason why a troubled company finally collapses, especially if an application for a claim is submitted by one of the creditors without any proof of insolvency.

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Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 7 Electronic LexisNexis (01 April 2005).

<sup>158</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005);

Wu, W, „Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law“ (2004) 35 Victoria University of Wellington Law Review 239, 248 Electronic LexisNexis (03 April 2005).

<sup>159</sup> Gebhardt, I & Olbrich, K, "Chapter I - General Provisions and Chapter II, Section 1 and 2 - Application and Acceptance of the Insolvency Case" papers from the 2000 Symposium on Bankruptcy Law Page 7 <[http://www.gtz-legal-reform.org.cn/english/projects/fec/papers\\_2000bl.htm](http://www.gtz-legal-reform.org.cn/english/projects/fec/papers_2000bl.htm)> (29 July 2005).

Generally speaking, the new bankruptcy law does not address the reasons for which a company is unable to pay back its debts on time or whether the delay in payment is only temporary. This simplification might prove to be a problem.<sup>160</sup>

The debtor has the possibility to arrange a reconstruction plan before the court declares the company bankrupt. Even if the parties have agreed to a reorganisation plan, this plan cannot prevent the threat of the company finally being declared bankrupt. According to Article 77 of the 2002 draft, the court still has the power to declare the company bankrupt "upon the request of an interested party". The draft is not clear as to who is considered to be "an interested party" in this context. This loophole could offer governmental authorities an opportunity to request the termination of a reconstruction plan if they so desire. In addition, according to Article 89 of the 2002 draft, a judge has the power to declare a company bankrupt if he deems that the reorganisation plan does not meet the bankruptcy law regulations. This means that the court can declare a company bankrupt without the request of any party. The court's ability to do so is contradictory to the general idea of a market economy. Should a judge exert this power and force a company into bankruptcy, the newly introduced procedures of reconstruction and conciliation are annulled.<sup>161</sup>

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<sup>160</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) China Law Developments January 2005 Page 5 <[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16. April 2005).

<sup>161</sup> Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 17 Electronic LexisNexis (31 March 2005).

The responsibilities and influences to be obtained by the People's Courts are very extensive and there probably will not be a safe way for the creditors to minimise the latent threat of conceivable manipulation by the court.

A further threat can be minimised by the creditors. Under the current bankruptcy regulations, some damage may have been caused by manipulations by the management of the liquidation committee. An administrator will substitute the personnel of the liquidation committee. This administrator will be controlled by the creditors' meeting.

### **3. Management**

According to Article 25 of the 2002 draft, the People's Court has to appoint an administrator after declaring a company bankrupt. One of the responsibilities of this administrator is, according to the first sentence of Article 25, the daily management of the debtor and the debtor's property. The current system requires that a liquidation committee has to be established under the new bankruptcy law and this committee will be replaced by the administrator.<sup>162</sup> The general idea of abolishing the liquidation committee is to reduce the influence of

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<sup>162</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) China Law Developments January 2005 Page 5 f. <[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16 April 2005);  
Lan, X, "Outdated Bankruptcy Law Upgraded" (2004) 47:30 Beijing Review 38 <<http://www.bjreview.com.cn>> (13 April 2005);  
Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 20 Electronic LexisNexis (31 March 2005);  
Wang, W, "Notes and Current Developments: Corporate governance and the draft Bankruptcy Law of China" (2004) 17 Australian Journal of Corporate Law 1, 16 ff. Electronic LexisNexis (30 March 2005).

governmental officials.<sup>163</sup> Unlike the current system with the liquidation committee, there is a good chance that the bankruptcy administrator will not be directly connected to the government. The administrator is introduced in the draft as an independent third-party. His independence is supposed to make the management of bankruptcies more convincing and transparent.<sup>164</sup> To reinforce the image of an independent third-party, Article 27 states several circumstances which disqualify an individual from becoming a bankruptcy administrator. The stipulations help create a legal environment which should generate confidence in all parties. According to the draft, it is, for example, impossible for a person with a criminal record or interests in the particular bankruptcy case to be appointed as the bankruptcy administrator.<sup>165</sup> Another improvement to the current system is the requirement of professional experience on the part of the administrator. The draft states who can be appointed as an administrator in Article 27. This means that the appointed administrator should be an individual with experience of business and legal matters.<sup>166</sup>

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<sup>163</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005).

<sup>164</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 10  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

<sup>165</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 10  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27. July 2005).

<sup>166</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) China Law Developments January 2005 Page 6<[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16. April 2005);

According to the article, the court shall appoint as administrator a lawyer, an accounting specialist, or a relevant social intermediary institution, which has the necessary experience, knowledge and has passed a qualification examination.<sup>167</sup> As the Standing Committee of the National People's Congress has not yet passed the bankruptcy law, this discussion is by no means over and will probably resurface after the law has been adopted. At this stage, it is not entirely clear how some of these qualifications can be proven. In the forthcoming discussion, the "relevant social intermediary institution", level of experience and examinations will have to be defined.<sup>168</sup>

Irrespective of what qualifications the administrator is required to have, no one will be able to carry out the administrator's duties unless the law provides power for this position. In order to safeguard the management of the administrators appointed, the new bankruptcy law contains some instruments to enable the administrator to establish his management.

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Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" *Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004*, New Delhi, Organisation for Economic Co-operation and Development Page 10 <[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27. July 2005).

<sup>167</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 *American Bankruptcy Institute Journal* 34, 60 *Electronic LexisNexis* (29 March 2005);

Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" *Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004*, New Delhi, Organisation for Economic Co-operation and Development Page 10 <[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27. July 2005).

Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) *China Law Developments* January 2005 Page 6 <[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16. April 2005)

Korff, C & Chua, E J, "China Sets Short Timetable for Bankruptcy Law Reform" (2004) *China Law & Practice* 1 *Electronic Proquest* (27 June 2005).

<sup>168</sup> Chan, T, "Accountants Lobby for a Role in Bankruptcy on Mainland" (14 January 2005) *China Daily HK Edition* <<http://www.chinadaily.com.cn/english/home/index.html>> (03 March 2005).

For example, the administrator has the option of requesting legal action from the People's Court if the debtor refuses to provide access to accounts, documents and data, or destroys evidence. Legal action can be taken against those directly responsible.<sup>169</sup>

The bankruptcy administrator has a duty to analyse any transaction made by the former management of the company prior to bankruptcy. Under the current law, there is a good opportunity for company managers to draw up a well-planned strategy to apply for bankruptcy. After a six-month period, the liquidation committee has no chance to do anything about these transactions.<sup>170</sup> Although the special economic zone of Shenzhen has one of the modified regional bankruptcy laws, some fraudulent bankruptcy cases have reportedly occurred. The general strategy in these cases was to end the companies' operations without liquidation or formal dissolution. The current bankruptcy system allows companies to transfer assets to avoid paying the creditors.<sup>171</sup> Sometimes, the managers of these companies leave nothing behind. Consequently, these companies have been referred to as "three no companies". The courts and authorities were faced with the problem that there was a bankrupt company without any assets, accounts or business location. If these procedures were carried out under the new bankruptcy law, the bankruptcy administrator would face the same problem. The change in the legal system cannot prevent such well-

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<sup>169</sup> Wang, W, "Notes and Current Developments: Corporate governance and the draft Bankruptcy Law of China" (2004) 17 Australian Journal of Corporate Law 1, 20 Electronic LexisNexis (30 March 2005).

<sup>170</sup> Wong, R, "The New Face of Bankruptcy" (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>171</sup> China Daily, "Bankruptcy Laws Need Review" China Daily 17 March 2003 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 April 2005).

planned forms of fraudulent bankruptcy. The changes in the legal system might be helpful in such cases in the brief period between the submission of the bankruptcy petition and the appointment of the liquidation committee.<sup>172</sup>

To avoid the effects of some of these fraudulent transactions, the bankruptcy administrator is entitled to rescind a variety of the transactions. The periods where these actions can be requested vary according to the different forms of transaction and can be extended by the People's Court upon the request of the administrator.<sup>173</sup> The maximum period for this request is one year prior to the submission of the bankruptcy petition. The administrator can request the repayment of money paid for undue debts, the retransfer of assets which have been transferred in a non-sensical deal or request the repayment of money paid to non-secured creditors.<sup>174</sup> In addition to this, the draft includes regulations that recommend civil, administrative and criminal liability against the former managers of companies. If there is a suspicion that the bankruptcy was arranged by the former managers or that gross

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<sup>172</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 10 f. Electronic LexisNexis (01 April 2005).

<sup>173</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 11  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

<sup>174</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005);  
Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 11  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

negligence caused the bankruptcy, further action can be taken.<sup>175</sup> If one of the parties involved believes that the bankruptcy administrator is doing a poor job, they can appeal to the People's Court for further action. This includes the threat of an administrator taking over any discriminating or fraudulent decisions. The important message in all these changes is that everybody, including the bankruptcy administrator, is responsible for his own performance.

The reduction of interdependencies between the bankruptcy management and government officials combined with the possibility of holding the bankruptcy administrator liable will hopefully change the way in which these decisions are scrutinised by the courts.<sup>176</sup>

Chinese and foreign creditors will be able to join the creditors' meetings and will have the opportunity to control the administrator or even claim back damages and losses generated by unsatisfactory work or fraudulent activities on the part of an administrator.

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<sup>175</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" *Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004*, New Delhi, Organisation for Economic Co-operation and Development Page 11  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

<sup>176</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) *China Law Developments* January 2005 Page 6  
<[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16 April 2005).

## 4. The Creditors' Meeting

Under the current law, the liquidation committee has a wide range of duties. Some of the duties and responsibilities will be adopted by the bankruptcy administrator. The liquidation committee has a duty to carry out the liquidation under the current bankruptcy laws and is basically in control of the liquidation process.<sup>177</sup> In order to create an efficient supervisory body, the new bankruptcy law will reinforce the position of the creditors' meeting. In contrast to its limited authority under the current bankruptcy law, the modified creditors' meeting will have a wider scope of authorisation under the new law.

An important part of the creditors' meeting authority is the control of the bankruptcy administrator. This function is one of the several duties which will be carried out by the creditors' meeting. Article 56 provides an enumeration of the creditors' meeting's full range of duties, responsibilities and powers. If the creditors' meeting is aware of mismanagement or fraudulent behaviour on the part of the administrator or is generally displeased with his nomination, there is the possibility of replacing the administrator. In the end, it is a question of democratic voting and the majority of creditors decide who will be the administrator of the bankrupt company.

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<sup>177</sup> Tjoa, L, "International Style Laws on Bankruptcy" China Daily HK Edition 06 August 2003 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

The creditors' meeting seems to command a very powerful position but certain loopholes in the draft demonstrate how difficulties can arise. The power of the creditors' meeting can be overruled by the People's Court, as previously pointed out in the section discussing the administrator.

Nevertheless, the new bankruptcy law has the advantage that the evaluation of the assets no longer falls under the control of the governmental officials. This is very important for the liquidation procedure as there will be a greater chance of recovering the assets' real value at a free auction. In addition, the possibility of fraudulent asset deals will be minimised by the control through the creditors' meeting. This will abolish the current practice of selling assets below their actual value after bankruptcy has been declared.<sup>178</sup>

In addition to the greater likelihood of recovering debts, creditors can always be confident that decisions are discussed by the creditors' meeting. This fact erases the current risk of fraudulent cooperation between the governmental authorities and the liquidation committees.

The creditors' meeting will become increasingly important as the non-Chinese creditors realise that a new instrument has been introduced in China that creates a better chance of recovering debts in so-called cross-border insolvencies.

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<sup>178</sup> Wong, R, "The New Face of Bankruptcy" (2002) Business Weekly 31 December 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

## 5. Cross-border Insolvencies

Generally speaking, all bankruptcy cases that have an effect upon assets outside a country can be considered as cross-border insolvency. This would, for example, include any bankruptcy case that concerns a bankrupt Chinese company which has assets abroad or a bankrupt non-Chinese company with assets in China.<sup>179</sup>

Under the current laws, there is hardly any regulation that guides the judges on how they should address the problem of cross-border insolvencies.<sup>180</sup> For example, the Beijing Municipal Government has set up cross-border regulations for Beijing that deal with this topic.<sup>181</sup> Besides this, only a few countries have signed a bilateral judicial

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<sup>179</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 24 f. Electronic LexisNexis (01 April 2005);

Lau, R, Bannister, J & Banks, J, "Asset Recovery in China-Related Restructurings" (2001) 20:7 International Financial Law Review 51 Electronic Proquest (27 June 2005);

Shi, J, "Chinese Cross-Border Insolvencies: Current Issues and Future Developments" (2001) 10:1 International Insolvency Review 33, 36 ff. Electronic Proquest (22 March 2005).

<sup>180</sup> Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005);

Gilligan, P & Bannister, J, "Recovering Assets in China" (2002) 21:6 International Financial Law Review 52 Electronic Proquest (27 July 2005);

Zhang, X & Booth, C D, "Beijing's Initiative on Cross-Border Insolvency" (2002) 10 American Bankruptcy Institute Law Review 29, 32 f. Electronic LexisNexis (30 March 2005).

<sup>181</sup> Zhang, X & Booth, C D, "Beijing's Initiative on Cross-Border Insolvency" (2002) 10 American Bankruptcy Institute Law Review 29, 30 Electronic LexisNexis (30 March 2005);

Lau, R, Bannister, J & Banks, J, "Asset Recovery in China-Related Restructurings" (2001) 20:7 International Financial Law Review 51 Electronic Proquest (27 June 2005).

assistance treaty with China so there is at least a small chance that some foreign rulings will be recognized by the Chinese courts.<sup>182</sup>

For example, if a Chinese company were declared bankrupt, the Chinese court would claim that any of the company's assets fall under the control of the Chinese liquidation committee. The court would demand control of these assets, regardless of whether that asset is abroad or not. In the latter case, Chinese courts would claim that a second bankruptcy needed to be filed in China and that all assets that were located in China needed to be liquidated under the control of the Chinese liquidation committee.<sup>183</sup>

Foreign bankruptcy administrators have to be very creative and use unconventional methods to retain control of bankrupt company's assets within China's territory.<sup>184</sup> A foreign ruling would especially not be recognised if it could affect state sovereignty, security and/or public policy.<sup>185</sup> This Chinese practise would force, for example, lawyers to advise non-Chinese bankruptcy administrators to negotiate with the board of directors of the Chinese subsidiary in question. The aim of the negotiation is to retain control of the assets and protect them from

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<sup>182</sup> Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005).

<sup>183</sup> Shi, J, "Chinese Cross-Border Insolvencies: Current Issues and Future Developments" (2001) 10:1 International Insolvency Review 33, 39 Electronic Proquest (22 March 2005).

<sup>184</sup> Shi, J, "Chinese Cross-Border Insolvencies: Current Issues and Future Developments" (2001) 10:1 International Insolvency Review 33, 38 f. Electronic Proquest (22 March 2005).

<sup>185</sup> Yuan, A A, "Enforcing and Collecting Money Judgments in China From a U.S. Judgment Creditor's Perspective" (2004) 36 George Washington International Law Review 757, 767 Electronic LexisNexis (03 April 2005);  
Shi, J, "Recent Developments In Chinese Cross-Border Insolvencies" (2002) 15 Australian Journal of Corporate Law 1, 12 Electronic LexisNexis (30 March 2005).

liquidation by the liquidation committee.<sup>186</sup> Consequently, there is still a good chance that the foreign bankruptcy administrator could keep control of the Chinese assets without involving the Chinese courts.

In addition, Chinese practise led to a system where misguided Chinese debtors would transfer their assets back to China instead of filing a bankruptcy case abroad.<sup>187</sup> This behaviour was purely driven by the idea of safeguarding these assets. In return, foreign debtors tried the same in order to protect their assets against the Chinese undeveloped bankruptcy law and the threat of a Chinese liquidation committee that is focused only on regional interests.

Cases such as that described in the China Daily on 14 March 2002 in which foreigners were not allowed to enter a "public auction" do not improve the image of the legal system.<sup>188</sup> How the bankruptcy proceedings are carried out is very important to foreign investors. The current regulations do not offer any advice on how judges should deal with cross border bankruptcies, so foreign investors feel uncomfortable with the situation.<sup>189</sup> In earlier drafts, the topic of cross-border

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<sup>186</sup> Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005); Gilligan, P & Bannister, J, "Recovering Assets in China" (2002) 21:6 International Financial Law Review 52 Electronic Proquest (27 July 2005); Lau, R, Bannister, J & Banks, J, "Asset Recovery in China-Related Restructurings" (2001) 20:7 International Financial Law Review 51 Electronic Proquest (27 June 2005).

<sup>187</sup> Gebhardt, I & Olbrich, K, "Chapter I - General Provisions and Chapter II, Section 1 and 2 - Application and Acceptance of the Insolvency Case" papers from the 2000 Symposium on Bankruptcy Law Page 5 <[http://www.gtz-legal-reform.org.cn/english/projects/fec/papers\\_2000bl.htm](http://www.gtz-legal-reform.org.cn/english/projects/fec/papers_2000bl.htm)> (29 July 2005).

<sup>188</sup> China Daily, "First Auction of a Wholly Foreign Owned Firm Fails" China Daily 14 March 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 April 2005).

<sup>189</sup> Yuan, A A, "Enforcing and Collecting Money Judgments in China From a U.S. Judgment Creditor's Perspective" (2004) 36 George Washington International Law Review 757, 781 Electronic LexisNexis (03 April 2005); Barker, M & Purser, R, "Bankruptcy Reform in China" (2004) Freshfields Bruckhaus Deringer Page 3

bankruptcies was not considered extensively. Researchers demanded changes to the bankruptcy draft in order to clarify this topic.<sup>190</sup> The 2002 draft is changing this strictly territory-related practise and now provides universal procedures that are compatible with most other modern bankruptcy laws.<sup>191</sup>

The new draft demands that a foreign ruling be submitted and approved in order to retain control of the assets. As a result, the new law has a clear regulation on how to deal with cross-border bankruptcies on the one hand but, on the other hand, there is still the possibility that the judge may refuse the submission.<sup>192</sup> As a result of this, there might still be the risk of a debtor trying to withhold the assets from the creditor by an assets transfer. The creditors have to face this risk under the current law and it will not be eradicated totally by the draft bankruptcy law. The possibility that a judge might refuse to accept a foreign court decision might lead to the unequal treatment of creditors and debtors inside and outside of China.<sup>193</sup>

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<<http://www.freshfields.com/practice/finance/publications/pdfs/9710.pdf>> (07 March 2005);

Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005).

<sup>190</sup> Shi, J, "Recent Developments In Chinese Cross-Border Insolvencies" (2002) 15 Australian Journal of Corporate Law 1, 35 Electronic LexisNexis (30 March 2005).

<sup>191</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) China Law Developments January 2005 Page 5

<[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16 April 2005).

<sup>192</sup> Korff, C & Chua, E J, "China Sets Short Timetable for Bankruptcy Law Reform" (2004) China Law & Practice 1 Electronic Proquest (27 June 2005);

Shi, J, "Chinese Cross-Border Insolvencies: Current Issues and Future Developments" (2001) 10:1 International Insolvency Review 33, 53 Electronic Proquest (22 March 2005).

<sup>193</sup> Korff, C & Liu, X, "Why China's Insolvency Regime Must Improve" (2002) 21:8 International Financial Law Review 33 Electronic Proquest (11 May 2005);

Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 36 f. Electronic LexisNexis (31 March 2005).

In an additional area, the draft improves the insufficiency of the current bankruptcy laws. The current laws do not contain a detailed regulation dealing with the possibility of contracts terminated by the bankrupt company. The 2002 draft introduces specific regulations which allow the administrator to decide whether he wants to terminate certain contracts.

## **6. Termination of Contracts**

Under the current law, the liquidation committee has the opportunity to decide whether a contract may be terminated or continued.<sup>194</sup> According to Article 127 of the 2002 draft, this power is granted to the appointed administrator. The other party will have the right to set a time limit for the manager to make a decision as to whether the contract will be fulfilled or not.<sup>195</sup> This regulation is an improvement on the current bankruptcy proceedings.

The decision as to whether a contract is terminated or not is entirely up to the appointed administrator<sup>196</sup>. The other contracting party is unable to minimise that risk without setting an ultimatum for the manager's decision. In the following chapter, this risk will be considered from the particular perspective of contracts on intellectual property rights. In this

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<sup>194</sup> Peiji, G & Kruger, P, "China Faces up to the New Challenges of Securization" (2000) 19:8 International Financial Law Review 29 Electronic Proquest (27 July 2005).

<sup>195</sup> Wang, F, "An Overview of the Draft Enterprise Bankruptcy Law of the People's Republic of China" (2005) China Law Developments January 2005 Page 13 f. <[http://www.legal500.com/devs/ch/fi/chfi\\_002.pdf](http://www.legal500.com/devs/ch/fi/chfi_002.pdf)> (16 April 2005).

<sup>196</sup> Gebhardt, I & Olbrich, K, "New Developments in the Reform of Chinese Bankruptcy Law" (2000) 12 Australian Journal of Corporate Law 1, 24 Electronic LexisNexis (31 March 2005).

context, possible solutions to this problem will be discussed, as well as how this problem can be avoided.

## **D Intellectual Property and Bankruptcy Law**

There does not seem to be a direct link between intellectual property rights and bankruptcy law at first sight. Browsing through current literature, one gets the impression that most of the experts consider this a special topic. There hardly seems to be an interdisciplinary link between these subjects and, as a result, hardly any research has been carried out on the effects of bankruptcy laws on intellectual property rights. When an author discusses the topic of a link between intellectual property law and bankruptcy laws, the contribution only deals with small aspects of this broad field and generally the focus is either the problems of intellectual property rights or the problems of bankruptcy laws.<sup>197</sup>

In order to outline a link between these two topics, the accounting aspect of intellectual property rights and licenses should be taken into consideration. Looking at Chinese accounting standards makes a possible link very obvious.

Approaching intellectual property or licences from an accounting perspective, these rights are assets. To be precise, they have to be considered as intangible assets. Under proper accountancy rules,

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<sup>197</sup> Nguyen, X-T N, "Bankrupting Trademarks" (2004) 37 U.C. Davis Law Review 1267 Electronic LexisNexis (02 April 2005),  
Gilligan, P & Bannister, J, "Recovering Assets in China" (2002) 21:6 International Financial Law Review 52 Electronic Proquest (27 July 2005).

intangible assets have to be recorded in the companies accounting documents.

As mentioned earlier in this thesis, the current Chinese accounting system does not meet the general international standard required by the countries of the European Union and elsewhere. The European Union is not willing to accept China as a market economy because of several shortfalls in the Chinese accounting standards and various other issues.<sup>198</sup> Although there are certain shortfalls in China's accounting standards, the procedure of filing intangible assets in the company books is recognised under the current Chinese accounting system and is at least established in some Chinese accounting laws. For example, Chapter 7 of the Accounting Regulations of the People's Republic of China for Enterprises with Foreign Investment deals with "Intangible and other Assets".

Article 36 of the regulation states in sentence one:

"Intangible assets of enterprises with foreign investment include patents, proprietary technology, patents and trademarks, land occupancy rights and other intangible assets, and shall be accounted for separately and separately disclosed in the balance sheet."

With this in mind, a brief examination of the different Chinese bankruptcy laws will highlight the link between the different bankruptcy

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<sup>198</sup> Qi, H & Dai, Y, "EU Ruling on China's Market Status 'Unfair'" (2004) China Daily 30 June 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

laws and intellectual property rights. Although the different bankruptcy laws are not very consistent in their definitions of the terms, the analysis of these laws will outline the connection.

In order to highlight the link, firstly the 1986 Trial Implementation of the Law of the People's Republic of China on Enterprise Bankruptcy should be examined. This law does not provide any details as to which specific assets belong to the bankrupt company.

The trial law states in Chapter VI, Article 28:

Bankruptcy property is made up of the following property:

- (1) all property managed and administered by the bankrupt enterprise at the time of the bankruptcy declaration
- (2) property obtained by the bankrupt enterprise between the time of the bankruptcy declaration and the end of bankruptcy proceedings
- (3) other property rights over which the bankrupt enterprise exercises authority

Property already classed as a security is not part of the bankruptcy property. Should the value of the security be in excess of the amount of the claim for which it is a security, the amount in excess will be taken as part of the bankruptcy property

To give an example of the regional bankruptcy laws, a second glance shall be taken at the Bankruptcy Regulations of Shenzhen Special Economic Zone on Companies with Foreign Investment. This law

declares in Chapter VI, Section 2 which assets belong to the bankrupt company. Article 31 states:

”Bankruptcy assets include:

- (1) Property belonging to the bankrupt company at the time when the company is declared bankrupt;
- (2) Other property rights that are within the purview of and shall be exercised by the bankrupt company; and
- (3) Property recovered by the bankrupt company in accordance with Article 11 of the present regulations.”

According to the trial implementation of the 1986 Bankruptcy law, only property rights belong to the bankrupt company. Examining the legal term “property rights”, there could be a loophole for claiming that licences are not property rights in a legal sense. This argument could be supported by the idea that the licensor is the owner of the patent and the licensee only has a right to use foreign property.

In the chosen example of the regional bankruptcy laws, the bankruptcy regulations of the Shenzhen special economic zone on companies with foreign investment, at least a clear definition of what comprises the bankruptcy assets is given. Even a close examination of this more specific regulation does not clarify what belongs to the bankrupt company. It could still be argued that the licences for intellectual property do not belong to the company’s property. This uncertainty will change under the new bankruptcy law. The 2002 draft of the new bankruptcy law clarifies this point. The interaction of Article 23 and 134 does not leave any room for argument. Article 23 states:

All the property and property rights that belong to the debtor at the time when the bankruptcy case is accepted and the property and property rights the debtor obtains after the acceptance of the bankruptcy case but before the termination of the bankruptcy procedures, shall be the debtor's property. Where laws stipulate special provisions on the debtor's property, the special provisions shall apply.

The clarification results from Article 134 that states:

Bankruptcy property shall be sold off through auction unless otherwise provided by resolutions of the creditors' meeting. Complete sets of equipment in the bankruptcy property shall be sold as a whole, and that which cannot be sold as a whole may be sold in parts. The bankrupt enterprise may be sold either as a whole or in parts. Intangible assets and other assets may be sold separately in the latter case.

Intangible assets are stated clearly here and, furthermore, the draft sets out a clear procedure as to what should happen to these assets. Looking back at the accounting standards, it is obvious that all the intangible assets that have to be filed in the companies balance sheets belong to the assets of the bankrupt company and consequently come under the management of the bankruptcy administrator. Tangible and intangible assets will be treated in a similar way under the new bankruptcy law. Although all assets will be treated similarly, there will

still be various different varieties and features. The next section will analyse some of the most interesting varieties.

Several changes have been made in the economic and legal systems of China. However, a variety of different features remain in the legal system. Nevertheless China is trying to create the required legal standards e.g. in the field of intellectual property laws and bankruptcy laws in order to become a market economy. But all these circumstances create a climate for investors or creditors that can easily generate multiple difficulties and financial damages.

The following sections will provide a short overview of the issues of intellectual property rights and the transfer of technology, which are necessary to demonstrate the potential risks that are created by the new bankruptcy law's application to intellectual property rights. An example of how this threat could easily become a practical problem will demonstrate the potential worldwide effects. The example will be given at the end of this chapter and will consider some additional interactions on this topic.

The protection and transfer of intellectual property rights or technology in China is a widely discussed topic. The next section will not examine this topic in great depth and will only provide some general information concerning the transfer of intellectual property rights.

## 1. Transfer of Intellectual Property Rights

From a historical point of view, Chinese legislation for the protection of intellectual property focussed on civil law and not on criminal law. After China entered the WTO, the laws for the protection of intellectual property were changed very rapidly.<sup>199</sup> These changes can be attributed to China's WTO entry and its attempt to fulfil the WTO standards. Although China has made considerable changes, the TRIPS agreement has not yet been fulfilled in its entirety.<sup>200</sup> This could especially be a problem for those investors who are willing to invest their intellectual property in China. China has to accept that time is a very important factor in the investment of intellectual property. The effects of delays become very obvious if it is taken into consideration that intellectual property is very short-lived and has to exploit the short period in which it gives the owner an advantage over competitors.<sup>201</sup>

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<sup>199</sup> Pattloch, T, "Die Neuordnung des internationalen Technologietransfers in der VR China" (2003) 8-9 GRURInt 695, 695 f. <<http://rsw.beck.de/rsw/shop/default.asp?toc=beckonline.module>> (30 April 2005); Xue, H & Zheng, C, Chinese Intellectual Property Law in the 21st Century (Hong Kong, Singapore, Malaysia: Sweet & Maxwell Asia, 2002) Page XXXIX; Snodey, S R, "Intellectual Property Security in China's Rapidly Expanding Commerce" (2004) 5:5 China Briefing 7 <<http://www.china-briefing.com>> (27 March 2005).

<sup>200</sup> Huck, W, "Rahmenbedingungen für den Technologietransfer von Deutschland nach China" (2005) Page 19 f. <[http://www.law-and-business.com/content/e7/e149/index\\_ger.html?nummer=e268](http://www.law-and-business.com/content/e7/e149/index_ger.html?nummer=e268)> (06 March 2005); Snodey, S R, "Intellectual Property Security in China's Rapidly Expanding Commerce" (2004) 5:5 China Briefing 7 <<http://www.china-briefing.com>> (27 March 2005).

<sup>201</sup> Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 Management Research News 1, 1 Electronic Proquest (26 April 2005).

The definition of “intellectual property” varies in the literature.<sup>202</sup> For the purpose of this thesis, intellectual property includes trademarks, patents, trade secrets and copyrights. The international importance of these intellectual property rights is widely recognised. However, the official recognition of intellectual property rights is one thing but the effective protection of these rights is an entirely different issue. In this context, one comment from Chin-Ning Chu - a specialist in Asian culture studies - is particularly interesting. She is of the opinion that: “It is not that they (Asians) do not recognise the intellectual property rights of others, it is just that they sometimes choose to ignore them.”<sup>203</sup> As China is an Asian country, this seems to apply to China as well.

In the past, the term “technology transfer” was associated with the transfer of equipment to China. This practice has changed in recent years.<sup>204</sup> The People’s Republic of China has improved its legal protection of intellectual property. Nevertheless, the Chinese partners of foreign companies on the one hand display the general intention of acquiring as much technology as possible but appear to ignore the legal implementation of intellectual property protection on the other.<sup>205</sup>

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<sup>202</sup> See: Nguyen, X-T N, "Bankrupting Trademarks" (2004) 37 U.C. Davis Law Review 1267, 1268 ff. Electronic LexisNexis (02 April 2005);

By defining the range of „Technology transfer“ Pattloch give a variety of example what is “Technologies are covered”: Pattloch, T, "Die Neuordnung des internationalen Technologietransfers in der VR China" (2003) 8-9 GRURInt 695, 698 <<http://rsw.beck.de/rsw/shop/default.asp?toc=beckonline.module>> (30 April 2005).

<sup>203</sup> Snodey, S R, "Intellectual Property Security in China's Rapidly Expanding Commerce" (2004) 5:5 China Briefing 7 <<http://www.china-briefing.com>> (27 March 2005).

<sup>204</sup> Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 Management Research News 1, 7 Electronic Proquest (26 April 2005).

<sup>205</sup> Snodey, S R, "Intellectual Property Security in China's Rapidly Expanding Commerce" (2004) 5:5 China Briefing 7 <<http://www.china-briefing.com>> (27 March 2005).

China's is one of the biggest and fastest growing economies in the world and its appetite for new technology is immense. Like companies in most other countries, Chinese companies have recognised the importance of intellectual property and technical know-how.<sup>206</sup> In order to obtain an increasingly high standard of technology, China is luring foreign companies with the possibility of low-cost production and other financial advantages.<sup>207</sup> In order to seize the opportunities on the Chinese market, which are offered to all kinds of companies, non-Chinese companies are more than happy to succumb to that temptation. The vehicle used by foreign companies as an effective way of investing their capital and technology in China used to be the company form joint venture.<sup>208</sup> However, recently the possibility of Wholly Foreign-Owned Enterprises has become a viable alternative to

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Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 Management Research News 1, 1 Electronic Proquest (26 April 2005).

<sup>206</sup> Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 Management Research News 1, 7 Electronic Proquest (26 April 2005);

Kirby, D A & Kaiser, S, "Joint Ventures as an Internationalisation Strategy for SMEs" (2003) 21:3 Small Business Economics 229 Electronic Proquest (27 June 2005);

Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 21 Electronic Proquest (07 March 2005).

<sup>207</sup> Kirby, D A & Kaiser, S, "Joint Ventures as an Internationalisation Strategy for SMEs" (2003) 21:3 Small Business Economics 229 Electronic Proquest (27 June 2005);

Chang, T K, "Foreign Technology Transfer" in Cohen, M A, Bang, A E, Mitchell, S J (ed), Chinese Intellectual Property Law and Practice, (The Hague, London, Boston: Kluwer Law International 1999), 63 Page 72 f.;

Lau, R, Bannister, J & Banks, J, "Asset Recovery in China-Related Restructurings" (2001) 20:7 International Financial Law Review 51 Electronic Proquest (27 June 2005);

Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 23 f. Electronic Proquest (07 March 2005).

<sup>208</sup> Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 Management Research News 1, 6 Electronic Proquest (26 April 2005).

Chang, T K, "Foreign Technology Transfer" in Cohen, M A, Bang, A E, Mitchell, S J (ed), Chinese Intellectual Property Law and Practice, (The Hague, London, Boston: Kluwer Law International 1999), 63 Page 63.

joint ventures as an increasing number of economic areas are opened to Wholly Foreign-Owned Enterprises.<sup>209</sup>

There are different ways of transferring intellectual property to China and these technology transfer agreements can take many different forms.<sup>210</sup> In the early stages of technology transfer contracts to China, it was usual to transfer intellectual property either by giving the intellectual property as a contribution to the investment in a joint venture or by a licence agreement.<sup>211</sup> In the case of joint ventures, there is the possibility of having technical exchange and cross-licensing, co-production and marketing agreements, joint product development programs, to name but a few alternatives of investment.<sup>212</sup>

The different cultural interpretations for a written agreement can become a very serious problem. Cultures like the American or European, which try to state everything of importance within the different contracts, have to understand that the Chinese culture and understanding of written agreements is different.<sup>213</sup> The Chinese

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<sup>209</sup> Huck, W, "Rahmenbedingungen für den Technologietransfer von Deutschland nach China" (2005) Page 16 <[http://www.law-and-business.com/content/e7/e149/index\\_ger.html?nummer=e268](http://www.law-and-business.com/content/e7/e149/index_ger.html?nummer=e268)> (06 March 2005).

<sup>210</sup> Tetz, S, "Technology Transfer in the People's Republic of China – A Foreign Investor's Perspective" in Heath, C & Liu, K-C (ed) *Legal Rules of Technology Transfer in Asia* (The Hague, London, New York: Kluwer Law International 2002), 55 Page 60 ff.

<sup>211</sup> Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 *The China Business Review* 20, 20 *Electronic Proquest* (07 March 2005).

Chang, T K, "Foreign Technology Transfer" in Cohen, M A, Bang, A E, Mitchell, S J (ed), *Chinese Intellectual Property Law and Practice*, (The Hague, London, Boston: Kluwer Law International 1999), 63 Page 63.

<sup>212</sup> Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 *Management Research News* 1, 7 *Electronic Proquest* (26 April 2005).

<sup>213</sup> Snodey, S R, "Intellectual Property Security in China's Rapidly Expanding Commerce" (2004) 5:5 *China Briefing* 7 <<http://www.china-briefing.com>> (27 March 2005);

Wilson, J & Brennan R, "Market Entry Methods for Western Firms in China" (2003) 15: 4 *Asia Pacific Journal of Marketing and Logistics* 3, 8 *Electronic Proquest* (27 June 2005).

understanding and philosophy of a written contract is not binding. For the Chinese, it is the beginning of an understanding. Due to Chinese interpretation, the strategy of Chinese business partners is to negotiate a contract with the aim of achieving as little transparency as possible.<sup>214</sup> Consequently, most non- Chinese managers must be aware of the risk which business in China entails.

In order to minimise the risk of disclosure, the transfer of technology should always be carried out in the form of a written agreement and the technology agreement should include a nondisclosure clause.<sup>215</sup> Signing a licence agreement with a Chinese-based joint venture has a characteristic that differs from the general western understanding of time limited use of technology. If a license agreement expired under the former Chinese regulations, the recipient was the owner of the property and the use of the intellectual property was no longer restricted.<sup>216</sup> Because of this characteristic, many foreign companies opted for the alternative of transferring the technology as a contribution to the investment.<sup>217</sup> Chinese authorities introduced regulations which limited the maximum amount of registered capital that could be contributed by foreign investors in the form of intellectual property as the foreigner's

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<sup>214</sup> Snodey, S R, "Intellectual Property Security in China's Rapidly Expanding Commerce" (2004) 5:5 China Briefing 7 <<http://www.china-briefing.com>> (27 March 2005).

<sup>215</sup> Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 Management Research News 1, 9 Electronic Proquest (26 April 2005).

<sup>216</sup> Pattloch, T, "Die Neuordnung des internationalen Technologietransfers in der VR China" (2003) 8-9 GRURInt 695, 697 <<http://rsw.beck.de/rsw/shop/default.asp?toc=beckonline.module>> (30 April 2005);

Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 20 Electronic Proquest (07 March 2005).

<sup>217</sup> Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 20 Electronic Proquest (07 March 2005).

investment in the Chinese company.<sup>218</sup> Generally speaking, blaming the foreign companies if they lose their intellectual property seems to be common practice in China. Certain lawyers advise their clients against transferring intellectual properties to Chinese joint ventures due to the fact that the risk of disclosure is very high.<sup>219</sup> Some authors argue that the foreign companies should protect their intellectual property more effectively and should ensure that the corresponding return for the intellectual property is granted.

Different strategies for the protection of the financial and technological investments have been developed.<sup>220</sup> The protection of intellectual property could be achieved, for example, if the foreign companies planned their investments more effectively. In order to plan the investment more effectively, the agreement should cover the partner company, the people and the government functionaries.<sup>221</sup> Another way of protecting the intellectual property is to transfer the technology gradually. This strategy can be carried out through different forms of technology transfer agreements which state that the transfer is to take place in different stages or time periods.<sup>222</sup> The main error outlined by

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<sup>218</sup> Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 21 Electronic Proquest (07 March 2005).

<sup>219</sup> Devonshire-Ellis, C, "JV vs WFOE" (2004) 5:2 China Briefing 4, 5 <<http://www.china-briefing.com>> (27 March 2005).

<sup>220</sup> Snodey, S R, "Intellectual Property Security in China's Rapidly Expanding Commerce" (2004) 5:5 China Briefing 7 f. <<http://www.china-briefing.com>> (27 March 2005).

<sup>221</sup> Snodey, S R, "Intellectual Property Security in China's Rapidly Expanding Commerce" (2004) 5:5 China Briefing 7 f. <<http://www.china-briefing.com>> (27 March 2005).

<sup>222</sup> Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 24 Electronic Proquest (07 March 2005); Wilson, J & Brennan R, "Market Entry Methods for Western Firms in China" (2003) 15: 4 Asia Pacific Journal of Marketing and Logistics 3, 8 Electronic Proquest (27 June 2005);

some authors is the occurrence that the protection of intellectual property is not the primary goal of the foreign investors.<sup>223</sup> In some articles, it is evident that the authors suggest the idea of considering the companies' investments of intellectual property as strategic. Strategic investment in this sense can be considered as the aim of reducing the financial investment by investing the maximum amount of intellectual property.<sup>224</sup> Some companies seemed so eager to reduce the financial investment that the risk of losing the intellectual property disappeared. These companies establish their business with a high amount of intangible assets and a high risk of losing the winning margin before the managers of the companies even realise the loss.

In addition to the fear of losing the intellectual property, the owner shall always be aware of the risk of the technology being used without any authorisation at any time.

There are different forms of agreements which can be concluded in order to transfer technology. On the one hand, there is the possibility of alienating a patent or another right and, on the other hand, there is the possibility of issuing a form of licence agreement.<sup>225</sup> Both alternatives have their advantages and disadvantages. Due to the fact that the control over intellectual property is usually lost entirely in a case where

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Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 Management Research News 1, 8 Electronic Proquest (26 April 2005).

<sup>223</sup> Wong, Y-Y, Maher, T E, Nicholson, J D & Bai, A F, "Organisational Learning and the Risks of Technology Transfers in China" (2003) 26:12 Management Research News 1, 10 Electronic Proquest (26 April 2005).

<sup>224</sup> Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 21 f. Electronic Proquest (07 March 2005).

<sup>225</sup> Tetz, S, "Technology Transfer in the People's Republic of China – A Foreign Investor's Perspective" in Heath, C & Liu, K-C (ed) Legal Rules of Technology Transfer in Asia (The Hague, London, New York: Kluwer Law International 2002), 55 Page 60 ff.

the owner of intellectual property rights sells them to a Chinese entity, this thesis will examine the possibility of license agreement more closely.

In the early stages of technology transfer to China, any agreement aimed at technology transfer had to be approved by a Chinese ministry.<sup>226</sup> This requirement has changed slightly.<sup>227</sup> The requirement of the necessary governmental approval has been replaced by a system of general permission with a few exclusions. In order to meet the requirements of these regulations, the investor has to look very closely at the requirements and bear in mind that there are three different groups of technology.<sup>228</sup>

The Regulations of the People's Republic of China on Technology Import and Export Administration adopted on 31 October 2001 state in Article 5 that the import and export of technology is permitted unless other regulations state otherwise. However, in Articles 8 and 31 of the regulations, it is stated that the technology can not be imported or exported due to the fact that they are prohibited or restricted by the

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<sup>226</sup> Pattloch, T, "Die Neuordnung des internationalen Technologietransfers in der VR China" (2003) 8-9 GRURInt 695, 695

<<http://rsw.beck.de/rsw/shop/default.asp?toc=beckonline.module>> (30 April 2005); Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 22 f. Electronic Proquest (07 March 2005);

Chang, T K, "Foreign Technology Transfer" in Cohen, M A, Bang, A E, Mitchell, S J (ed), Chinese Intellectual Property Law and Practice, (The Hague, London, Boston: Kluwer Law International 1999), 63 Page 65.

<sup>227</sup> See Article 5 Regulations of the People's Republic of China on Technology Import and Export Administration adopted 31 October 2001.

<sup>228</sup> Huck, W, "Rahmenbedingungen für den Technologietransfer von Deutschland nach China" (2005) Page 11 <[http://www.law-and-business.com/content/e7/e149/index\\_ger.html?nummer=e268](http://www.law-and-business.com/content/e7/e149/index_ger.html?nummer=e268)> (06 March 2005)

Pattloch, T, "Die Neuordnung des internationalen Technologietransfers in der VR China" (2003) 8-9 GRURInt 695, 699

<<http://rsw.beck.de/rsw/shop/default.asp?toc=beckonline.module>> (30 April 2005); Vettoretti, A, "Outsourcing Manufacturing Operations to China" (2004) 5:10 China Briefing 7, 9 <<http://www.china-briefing.com>> (27 March 2005).

catalogue of Articles 16 or 17 of the Foreign Trade Law. For example, Article 17 of the Foreign Trade Law already totally restricts some technology and goods, such as the import or export of weapons or nuclear technology. Nevertheless, several technologies and goods can only be purchased if the authorities have approved the contracts.<sup>229</sup> The major problem with the lists of transfer-restricted technology published by ministries in China is that they could be altered without any discussion or legislation process.

This restriction on technology transfer could become a problem in combination with the new bankruptcy law. In the following section, the effects of this and other regulations of the new bankruptcy law will be explained. The next section will start with the different forms of payment for technology transfer agreements. A technology transfer carried out by licence agreement can have three different forms of payment. There may be a lump-sum, a royalty stream or a combination of both forms.<sup>230</sup> The licence agreement is a contract in the context of the draft of the new bankruptcy law. According to Article 127 of the 2002 draft, the administrator will have the right to decide what happens to these agreements. In any case, the administrator's decision will have an effect on the agreement and the intellectual properties that are affected by it. The next section describes some of the effects that can occur on the licensor of intellectual property.

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<sup>229</sup> The catalogue of goods and technologies according to the Articles 16 and 17 of the Foreign Trade Law should be published by the relevant Ministry. The author requested the MOFTEC in writing to send a copy of that list or at least give the location where the catalogue is published but until the day the theses was submitted the ministry did not respond.

<sup>230</sup> Bassolino, F & Tse, J, "Leveraging Technology in the PRC" (1999) 26:1 The China Business Review 20, 23 Electronic Proquest (07 March 2005).

## 2. The Effects of Bankruptcy Laws on Intellectual Property Rights

In a case where a licensor goes bankrupt, the licensee still has the right to use that license.<sup>231</sup> In the case where a Chinese licensee has to file for bankruptcy, the appointed administrator of that company generally has the right to decide whether the licence agreement will be cancelled or severed. This fact is particularly important for the licensor and the licensee in patent, trade secret or copyright licenses that can be used continuously after the licensor has filed for bankruptcy.<sup>232</sup> For example, in the United States, legal protection is provided for a licensee in a case where the licensor files for bankruptcy. The Intellectual Property Licenses in Bankruptcy Act grants the licensee the right to use the license, even if the bankrupt licensor decides to reject the license. This act grants the same protection for trade secrets, inventions, processes, designs, plant protection, patent application, plant variety, authorship and mask work.<sup>233</sup> Judging by the existence of this US law, the general risk of bankruptcies in relation to licence agreements seems to have been recognised.

According to Article 127 of the 2002 draft, the administrator will scrutinise these contracts and decide which solution is best. The

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<sup>231</sup> Nguyen, X-T N, "Bankrupting Trademarks" (2004) 37 U.C. Davis Law Review 1267, 1286 Electronic LexisNexis (02 April 2005).

<sup>232</sup> Nguyen, X-T N, "Bankrupting Trademarks" (2004) 37 U.C. Davis Law Review 1267, 1286 f. Electronic LexisNexis (02 April 2005).

<sup>233</sup> Nguyen, X-T N, "Bankrupting Trademarks" (2004) 37 U.C. Davis Law Review 1267, 1290 Electronic LexisNexis (02 April 2005).

administrator has the right to insist on the fulfilment of the agreement or even has the possibility of transferring the contract to a third party in order to be able to pay back the debts of the company. In this case, the owner of the intellectual property is in grave danger of losing it to a competitor.

In addition, the administrator generally has the possibility of recalling any intellectual property that has been transferred to the foreign investor by an agreement. The administrator has to arraign this transfer of intellectual property. This possibility is introduced in chapter 3, section 3 of the 2002 draft due to the fact that the administrator has the right to check the contracts for any contraventions.

One reason could be a contravention of the catalogue in accordance with Articles 16 and 17 of the Foreign Trade Law; another reason might be a contravention of the catalogue of foreign investment or the fraudulent or unbalanced transfer of assets.

In order to minimise the risk of fraudulent or discriminating clauses in technology transfer agreements, they had to be double-checked by governmental authorities. Given that governmental approval is no longer compulsory for many of these agreements, the method of payment is not double-checked. The principal aim of auditing the license agreement was to make sure that the payment for the technology does not amount to more than the value of the technology.

The administrator of a bankrupt company now has the power to audit these licence agreements. The evaluation of the value of any agreement concerning intellectual property is now up to the administrator and the creditors' meeting. If a company is to be

reconstructed, there are a variety of options for the administrator in a negotiation. On the one hand, there is the threat that the administrator could sell the whole company and the licence to a competitor. This threat will raise the bid from the licensor for the termination of the agreement. On the other hand, the threat of terminating a licence agreement could easily raise the bid of a third party, who is extremely interested in purchasing the company with this particular license.

Generally, it is up to the licensor or owner of the intellectual property to decide what value a certain agreement has.<sup>234</sup> However, during negotiations in a bankruptcy case, more or less anything can happen. In order to reconstruct the company, the administrator might try to reduce the royalty fee, call for the financial support of the licensor or for a reduction in the debts the creditor has with the licensor. In the end, it is up to the licensor how much he is willing to pay in order to ensure that competitors cannot legally gain access the technology. This could prove to be very expensive for the owner of the intellectual property. For example, the bigger the technological advantage, the better the position of the administrator in the negotiation. This notion is a threat that western managers either have not yet detected or are reluctant to talk about.

Generally speaking, this problem could arise in many other countries. For example, if a German company is facing the threat of bankruptcy in Germany, the appointed bankruptcy manager ("Insolvenzverwalter") has similar powers to his Chinese equivalent. However, there are

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<sup>234</sup> Nguyen, X-T N, "Bankrupting Trademarks" (2004) 37 U.C. Davis Law Review 1267, 1287 Electronic LexisNexis (02 April 2005).

several mechanisms in German bankruptcy law that give the licensor a good chance of recovering his intellectual property or at least protecting it from a competitor.

The possibility of a company with a licence being sold to one of the owner's competitors or the owner paying more money than the potential purchaser is of great interest to the creditors of the bankrupt company. The money received from such a deal will help to reduce the financial damage resulting from the company's bankruptcy. This notion could be limited by the bankruptcy law itself. Article 134 of the 2002 draft states:

Bankruptcy property shall be sold off through auction unless otherwise provided by resolutions of the creditors' meeting.

Complete sets of equipment in the bankruptcy property shall be sold as a whole, and that which cannot be sold as a whole may be sold in parts.

The bankrupt enterprise may be sold either as a whole or in parts. Intangible assets and other assets may be sold separately in the lat(t)er case.

Bankrupt property that is not allowed to be auctioned or sold in public as provided by state laws or regulations shall be disposed of as per relevant laws or regulations.

The last two sentences of this article will have an effect in connection with the list established by the Foreign Trade Law. As a result of these sentences the court will have to evaluate every intangible asset for a possible violation of the Foreign Trade Law. In the end, the administrator has a duty to uphold the law. At worst, this means that the

administrator is only allowed to sell the intellectual property to an interested Chinese party at an unreasonable price. This regulation is accompanied by the additional danger of losing the technology on the part of the owner of the intellectual property. The only possibility of recovering the technology for the owner could then be achieved by a different Chinese company that meets the requirements of this regulation. Unless the owner already has a second company established in China that is able to recover the assets, this task may prove practically impossible to achieve.

If the Chinese authorities are eager to keep the intellectual property under Chinese control, the catalogue of technologies and goods that are forbidden or restricted from being transferred could be altered very easily.

A similar problem has already occurred under the current bankruptcy regulations. Zhang and Booth report that valuable assets like the business licence of a bankrupt company has to be returned to the state authorities. These assets cannot be sold in order to reduce the debts of the creditor.<sup>235</sup>

In the case of technology that is not allowed to be transferred to a foreign-dominated company or a foreign investment company, this could cause financial damage, not to mention the loss of control over the intellectual property. All hopes of creditors receiving a higher percentage of recovery on their debts due to the amount of money gained by the purchase of that technology could be dashed. This could

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<sup>235</sup> Zhang, X & Booth, C D, "Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience" (2001) 15 Columbia Journal of Asian Law 1, 23 Electronic LexisNexis (01 April 2005).

easily happen if these assets can only be sold to a one-hundred-percent Chinese-owned company. These companies can purchase the assets for less than the true value of the technology because no true competitor is able to place an offer. The idea that the creditors' meeting has to evaluate the value of all assets will be undermined and the chances of recovering the debts reduced in this case.

Probably the administrator's most important task is the repayment of all of the bankrupt company's creditors. In order to complete this task, he has the option of carrying out secondary tasks, such as saving jobs. As China has not completed the process of amending the social security system, there is considerable pressure on the administrator to save jobs. Saving jobs could become a bigger issue than repaying the creditors. The risk of social instability was widely discussed during the different stages of the drafting process. For example, the social security system in other countries, such as Germany, is more developed and, consequently, the attention of the administrators is more focused on the creditors than the workers. Although a German bankruptcy administrator generally tries to save as many jobs as possible, there is not such a big reliance on the existence of a company as there is in China today. The result of different social systems and backgrounds means less pressure for the German bankruptcy administrator.

The problem of unemployment in most countries is both an economic question and a political question. Social stability on the one hand and political stability on the other are both issues which politicians always bear in mind, regardless of what nationality they may be. The next section gives an example of how intellectual property can be lost due to

the financial instability of a company. This example is taken from a western country and is not related to China or any other developing country.

### 3. Practical Appearance

The threat of losing intellectual property due to the financial problems of a licensor or an affiliate is seldom mentioned in publications. One of the reasons why this problem is hardly addressed could be that the parties involved try their best to ensure that nobody is aware of the problem. One prime example of such a case happened in 2000. The parties involved were the German company “Krauss-Maffei Wegman”, the Spanish company “Santa Barbara SA” and the American Company “General Dynamics”.<sup>236</sup>

In this particular case, the German company owned patents and licences for the construction of the “Leopard 2” tank. In 1999, the Spanish company “Santa Barbara” purchased the right to build approximately 200 “Leopard 2” tanks for the Spanish army.<sup>237</sup> Unfortunately, the state-owned “Santa Barbara” company suffered serious financial problems in 2000. As the major shareholder, the

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<sup>236</sup> SIPOTEC, "Meldungen/ Kurzkomentare" (2000) <<http://www.sipotec.net/aktuell/>> (27 March 2005);

Teller, S, "Stellungskampf im Rüstungsgeschäft" 10 September 2003 <<http://ZDF.heute.de/>> (26 March 2005);

Schult, C & Szandar, A, "US-Konzern erschleicht sich deutsches Panzer-Know-how" (2001) Der Spiegel Online <<http://www.spiegel.de/>> (26 March 2005).

<sup>237</sup> SIPOTEC, "Meldungen/ Kurzkomentare" (2000) <<http://www.sipotec.net/aktuell/>> (27 March 2005);

Teller, S, "Stellungskampf im Rüstungsgeschäft" 10 September 2003 <<http://ZDF.heute.de/>> (26 March 2005).

Spanish state received an offer from “General Dynamics” to take over the struggling company. Usually, this would be considered as a “normal” business transaction. However, something made this “normal” transaction very delicate indeed. “General Dynamics” is the manufacturer of the “M1 Abrams” tank and therefore one of the major competitors of “Krauss-Maffei Wegman”. “Kraus-Maffei Wegman” was desperately trying to secure the intellectual property forwarded to that Spanish licensee. Several attempts were made to ensure that this military know-how and the licences were not accessible to “General Dynamics”. In the early stages of the German-Spanish tank deal, the German company considered taking over the Spanish company themselves. The licence agreement did not have a restrictive clause for a case where “Santa Barbara” was taken over by any other company. After “General Dynamics” offered the Spanish government the takeover deal, German politicians tried to convince the Spanish government to call off the sale and accept the German offer instead. In the end, all German attempts failed due to the fact that the offer by “General Dynamics” was more attractive than that of the German consortium.<sup>238</sup>

A similar scenario could have occurred if “Santa Barbara” had had to apply for bankruptcy and an administrator had had to make a decision.

A chance to secure 1,800 jobs made the decision very easy for the Spanish government in this case.<sup>239</sup> A bankruptcy administrator would

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<sup>238</sup> Teller, S, "Stellungskampf im Rüstungsgeschäft" 10 September 2003 <<http://ZDF.heute.de/>> (26 March 2005).

<sup>239</sup> Schult, C & Szandar, A, "US-Konzern erschleicht sich deutsches Panzer-Know-how" (2001) Der Spiegel Online <<http://www.spiegel.de/>> (26 March 2005).

have made the same decision in order to secure the company or facilitate a reconstruction.

Finally, “Santa Barbara” agreed to sign a contract that should “safeguard” the German company’s intellectual property and know-how by introducing strict contractual penalties should the American company gain access to the German technology. This agreement and the contractual penalty could only appease the concerns of the German managers. If there is a possibility of this know-how being transferred, the German company will have the problem of proving how the information reached the competitor. This ultimately poses the question: how can anybody be sure that no information is transferred? In the end, even if the information itself is not transferred, you still can transfer the individuals that have the experience or knowledge to work out a similar solution without violation of the ban on technology transfer to a different group company.

The German company was lucky in that at least the agreement was signed to protect the intellectual property. If “Santa Barbara” had had to file for bankruptcy there would basically have been no chance to sign such an agreement with a bankruptcy administrator. The administrator would only care about the creditors. If there is no contractual penalty in the licence agreement or any ban on technology transfer to a competitor, the administrator only has the option of ensuring that the creditors obtain the best return on their outstanding monetary money. Even if the administrator would like to offer a comparable agreement, as the Spanish government did, he could be held liable for the fact that the company’s value would suffer.

This example was not based on a bankruptcy case but if “Santa Barbara” had had to file for bankruptcy, the effect would have been worse for the German company.

It is easy to blame the legal advice of the German company in this case. The legal advice of the German company did not introduce a clause into the licence agreement to revoke the licenses in the case of a takeover by one of its competitors. However, if “Santa Barbara” had had to file for bankruptcy, there would have been no chance to revoke the licences. The idea of the reconstruction or recovery of any bankrupt company would be abolished by a clause that allows the owner of an intellectual property to revoke the licence. China’s new bankruptcy law is very clear on this point. Only the administrator has the right to cancel the agreements. If he has, for example, the opportunity to reconstruct the company with the financial support of any of the licensor’s competitors, the administrator might choose this option. In this case, the licensor is bound by the licence agreement and his competitor has access to all information.

The next chapter will summarise the results. This will be followed by comments on the results, which will illustrate solutions to the various problems.

## **E Summary**

The case of the Spanish company “Santa Barbara SA” and the German-Spanish tank deal with the German company “Kraus-Maffei Wegman” is a prime example of how intellectual property rights could be jeopardised by a financial crisis.

There are several stages in a financial crisis before a company has to file for bankruptcy. Usually, the chances recovering a company are better the earlier the management tries to adjust business operations. Bankruptcy is the final stage in a financial crisis prior to liquidation. However, if a company can still fashion a turnaround, it always has a chance of surviving the crisis.

### **1. The Situation in China**

As a result of China’s ambition to become a market economy, all market forces that influence the rest of the world will affect Chinese economy. Chinese authorities seem to have accepted the urgent need for a general bankruptcy law in China. The currently suggested bankruptcy law is a significant step in the right direction. As the current draft requires several changes or additions, it can only be the first step. The drafting process is a good example of how political concerns in China influence the legislation process. In addition, the connection between political development in China and legislation development is very

obvious in the bankruptcy law sector. The Chinese revolution and the introduction of the “open window policy” are two of the relevant political events that have had an influence on the positive and negative development in China. The first incident abolished the existing bankruptcy system and the second could be considered as the foundation stone of the bankruptcy laws in the People’s Republic of China. Since the bankruptcy law was revitalised in China, several amendments have been made. The most recent development in bankruptcy legislation is the drafting of the new bankruptcy law, which has lasted for more than 10 years.<sup>240</sup> Eventually, it will provide China with a modern bankruptcy law.<sup>241</sup>

## **2. A Modern Chinese Bankruptcy Law**

The current bankruptcy system, with all its confusing or inconsistent regional bankruptcy regulations and the likelihood of policy-orientated bankruptcies, will be replaced.<sup>242</sup> One of the improvements implemented by the new bankruptcy law is the change in the application of the bankruptcy laws. According to the drafted Article 3 of the new bankruptcy law, it will be applicable to all company forms. The different

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<sup>240</sup> Li, S, "Bankruptcy Law in China: Lessons of the Past Twelve Years" (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

<sup>241</sup> Zhao, R, "Law to Allow Financial Firms to go Bankrupt" China Daily 16 August 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005)  
Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005).

<sup>242</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 34 Electronic LexisNexis (29 March 2005).

treatment of foreign investment companies and State-Owned Enterprises will finally be abolished. The new law will offer a different treatment as exceptions in the military, mining and finance business areas.<sup>243</sup> The finance sector in particular is facing some problems due to so-called non-performing loans. In order to safeguard private investors, certain special regulations will be introduced after the new bankruptcy law becomes effective.<sup>244</sup> The special regulations could be used to prevent cascading effects throughout the country due to the bankruptcy of a main creditor.<sup>245</sup> Although special regulations will be implemented, this new law will offer China a possibility to improve the legal standards and help China approach its goal of recognition as a market economy. As an addition to the greater prospect of being recognised as a market economy, these changes will increase China's chances under the upcoming Basel II rating regulation and create a positive climate for international investment in China.<sup>246</sup> Resulting from the effect of the Basel II agreement, the possibility of transferring intangible assets instead of liquid assets will become very important for all parties on the different markets. If China does not address the shortfalls in several areas, such as the accounting standards, the bankruptcy laws and the intellectual property laws, the rating for any investment in China will become worse. Investors will seek a different location with a lower risk

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<sup>243</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005).

<sup>244</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005).

<sup>245</sup> Wang, Y, "New Bankruptcy Law Drafted" (2002) Business Weekly 30 April 2002 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

<sup>246</sup> Zhao, R, "Law to Allow Financial Firms to go Bankrupt" China Daily 16 August 2004 <<http://www.chinadaily.com.cn/english/home/index.html>> (23 March 2005).

for investment. Investors require information to evaluate the risk of an investment. In order to make a reasonable evaluation, there is a need for comparable data. Currently, the Chinese statistic system has certain shortfalls if it reaches the stage of providing market orientated statistic data.

### **3. Chinese Bankruptcy Statistics**

The fact that “statistically” speaking the number of bankruptcies in China is rising continuously cannot be used as an indicator that the current bankruptcy laws are working efficiently. Chinese authorities have had different approaches in dealing with the problem of bankruptcy through the years. Therefore, the fact that the number of bankruptcies is rising cannot be considered as a consequence of the efficiency of the legal system. In the early stages of the problem of financial difficulties, the authorities tried to solve this by pursuing a strategy of mergers or acquisitions. Experience proved that this alternative was not very helpful. Consequently, the authorities decided to admit more bankruptcies.<sup>247</sup> As a result of these variations in strategy, it is very difficult to obtain any detailed historical information from the Chinese bankruptcy statistics. The situation has improved, but there is still a shortfall in the statistics due to the fact that Chinese managers or regional authorities have different understandings of how the economic

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<sup>247</sup> Li, S, "Bankruptcy Law in China: Lessons of the Past Twelve Years" (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

data should be processed. Foreign investors will not obtain the necessary information from these statistics. Consequently, the information provided by them is basically not very helpful in analysing the risks of investment in China. In the forthcoming years, one of the by-products of the introduction of the new bankruptcy law will be the possibility that Chinese statistics might paint a more realistic picture of bankruptcies and insolvencies in China. If the changes in the bankruptcy law are carried out seriously, the significance of Chinese statistics will be helpful for any investment decision. An initial step towards more precise statistics will be the reduction of political influence on bankruptcy courts and procedures. An improvement in the statistics will not only help the international investors, but also the Chinese authorities will have a better overview of what is happening in China. The fact that Chinese authorities have no idea as to what is happening in the country should be one reason to improve this.<sup>248</sup> A further key issue in the current bankruptcy law system is the eradication of governmental influence.

#### **4. Government Influence**

Several bankruptcies in China that were affected by governmental influences have alerted international investors. The bankruptcy of the Guangdong International Trust and Investment Company in particular

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<sup>248</sup> Sun, S, "All Eyes on Overseas State Assets" China Daily 27 April 2005 <<http://www.chinadaily.com.cn/english/home/index.html>> (06 June 2005).

gave international and national investors a prime example of how Chinese authorities can use the current bankruptcy laws and regulations. Under the current bankruptcy laws, the courts have been influenced by the authorities.<sup>249</sup> It is still highly likely that the danger of manipulation by government authorities of bankruptcy proceedings or courts still very much exists. This should be kept in mind, even after the new bankruptcy law finally takes effect. The elimination of governmental influence on the bankruptcy system could be one of the principle objectives of the new bankruptcy law. On the one hand, some of the current manipulation potential will be eliminated by the new bankruptcy law; on the other hand, however, the new law may well contain several loopholes. These newly introduced influences will offer the authorities fresh opportunities to manipulate the bankruptcy procedures at different stages. There might be a direct manipulation of the proceedings or an indirect influence on the courts. In order to avoid the negative effects of these loopholes, the new bankruptcy law should either be amended or the judges should be aware of the potential influence the authorities could have. In view of the history of the Chinese legal system and the influence Chinese authorities have enjoyed on the courts in the past, the second alternative will not be sufficient enough and the effect of the new bankruptcy law could vanish. The possibility of governmental influence is a loophole that opens up an additional gap for fraudulent bankruptcies.

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<sup>249</sup> Li, S, "Bankruptcy Law in China: Lessons of the Past Twelve Years" (2001) 5:1 Harvard Asia Quarterly  
<<http://www.fas.harvard.edu/~asiactr/haq/200101/0101a006.htm>> (17 April 2005).

## 5. Fraudulent Bankruptcy

Nearly every bankruptcy system has to combat attempts made by individuals to benefit from a company's bankruptcy. Fraudulent bankruptcy does not necessarily imply the creation of personal benefit. In some variations, the benefit is offered to a third-party. As in other countries, fraudulent bankruptcy cases have been reported under China's current bankruptcy procedure. A prime example of fraudulent bankruptcy activities is the Zhongjiang Silk Company Case. In that particular bankruptcy case, a political decision forced the company to file for bankruptcy.<sup>250</sup> In the end, the creditors had to suffer the financial damage of politically motivated bankruptcy. Reducing the influence of governmental authorities will reduce the possibility of similar cases. A number of other regulations will be implemented under the new bankruptcy law that might help to minimise the attempts at fraudulent bankruptcies or detect criminal activity.

A prime example of such regulations could be the changes in the duties of the company's management. Under the new law, the management of a company will have an obligation to submit a bankruptcy petition if the requirements of a bankruptcy are fulfilled. This means that if the management fraudulently withholds the petition, the behaviour of the management can be detected more easily. In order to carry out this

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<sup>250</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" Insolvency Systems and Risk Management in Asia; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 5 f.  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

task, the new bankruptcy law is improving the reason for filing for bankruptcy. According to Article 11 in connection with Article 4 of the new bankruptcy law, the management of the company will have a clear requirement defining at what stage a bankruptcy petition is to be handed in. The courts will then be able to control the management and have an opportunity to take action against managers who fraudulently withhold a bankruptcy petition. Under the current bankruptcy laws, no State-Owned Enterprise can apply for bankruptcy unless the application has been approved by the governmental authorities. In addition to this, the current bankruptcy law for State-Owned Enterprises includes a very vague reason for a bankruptcy petition. Consequently, there is a wide scope for the authorities to exercise their influence.<sup>251</sup> If the influence of authorities is reduced by clarifying the reasons for bankruptcy, fraudulent bankruptcies could be reduced and several other side-effects could hopefully be registered. One side-effect could be that the investors and creditors will be able to predict the full risk of bankruptcy for a particular company more easily. Another side-effect could be that the statistics might become more precise and the investment opportunities for the future could be evaluated more effectively. In addition to these important improvements, some other adjustments have been made in the new bankruptcy law. Foreign investors will appreciate that the new bankruptcy law is more strongly focusing on

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<sup>251</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" *Insolvency Systems and Risk Management in Asia*; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 8 f.  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

protection against losses, abuses or disadvantages and changing the protection focus.

## **6. Creditor Orientation**

The intent of the new Chinese bankruptcy laws is to focus on the needs of all creditors. Creditors in this sense are not only the creditors that delivered goods to the bankrupt company. According to Article 10 of the 2002 draft, the court will safeguard the lawful rights and interests of the employees. This means that employees of the company who have not been paid by their employer are creditors as well. In this sense, the administrator has to ensure that he does not discriminate against any of the creditors.<sup>252</sup> All creditors who belong to the creditors' meeting have the right to vote on different issues in the bankruptcy proceedings unless their credits have not been confirmed. This right to make decisions on the further proceedings and how the debtor is treated is a very important step towards a modern bankruptcy law.

The power of the creditors' meeting is limited by Article 89. The possibility of limiting the power of the creditors' meeting is a loophole that grants the court and anybody who is able to influence the court immense power. This article introduces the right of the court to reject

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<sup>252</sup> Li, S, "The Significance Brought by the Drafting of the New Bankruptcy Law to China's Credit Culture and Credit Institution: A perspective of Bankruptcy Law" *Insolvency Systems and Risk Management in Asia*; Forum on Asian Insolvency Reform 2004, New Delhi, Organisation for Economic Co-operation and Development Page 10  
<[http://www.oecd.org/document/20/0,2340,en\\_2649\\_201185\\_33928916\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/20/0,2340,en_2649_201185_33928916_1_1_1_1,00.html)> (27 July 2005).

the decision of the creditors' meeting and could be considered as a remnant of the planned economy. Although this regulation specifies some vague premises in which cases the court may overrule the creditors' meeting's decision, some uncertainties remain that might have negative effects upon the bankruptcy proceeding. For example, the court could overrule the vote of the creditors' meeting if the court regarded the decision as violating a law. This regulation could eventually prove to be too broad and could halt the reconstruction of the company. This negative effect could especially occur if one of the creditors thinks he has been treated unfairly and the court could terminate the entire reconstruction process.

## **7. Reconstruction**

In Articles 17 to 21, the 1986 trial bankruptcy law introduced the possibility of reorganising a State-Owned Enterprise instead of adopting the ultimate alternative of liquidating the company.<sup>253</sup> The law does not explain how the reconstruction of the company should be carried out. Effectively, the law is not very precise. The current bankruptcy law only states that the bankrupt company could try to achieve a conciliation agreement with the creditors' meeting. As a matter of fact, the likelihood that the creditors' meeting is led by individuals who usually work as

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<sup>253</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 34 Electronic LexisNexis (29 March 2005).

government officials is very high.<sup>254</sup> This means that it is highly likely that the liquidation committee will transfer the valuable assets before the creditors' meeting has the chance to make a decision on the alternative of a reconstruction. After these assets have been transferred, there are usually no valuable assets remaining that could be used for the reconstruction of the company. Under these circumstances, a successful reconstruction becomes very unlikely. Reorganisation under the current regulation becomes even more unlikely if it is taken into consideration that the debtor is not obliged to develop an explicit reconstruction plan for the creditors' meeting. This ultimately means the creditors' meeting would be ignorant as to what happens with the creditors after the conciliation agreement has been signed.

The 2002 draft improves this situation dramatically. In Chapter VI, Section 3, the new bankruptcy law states how the reconstruction plan is to be set up. Forming a reconstruction plan basically means describing how a turnaround can be achieved for the company. The creditors' meeting should have a detailed picture and be able to make its own predictions regarding the chances of the proposed reconstruction. The aspect that will be of the greatest interest and probably the deciding issue is the creditors' meetings satisfaction with the expected recovery of debts. This method of solving the problem of bankruptcy is similar to the bankruptcy laws of other nations. Unfortunately, the Chinese model will introduce Article 89. This article has already been detected as a

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<sup>254</sup> Sprayregen, J H M, Friedland, J P & Wang, Y, "The Middle Kingdom's Chapter 11? China's New Bankruptcy Law Comes into Sight" (2004) 23:10 American Bankruptcy Institute Journal 34, 60 Electronic LexisNexis (29 March 2005).

potential risk factor for the bankruptcy procedure and the potential overruling of the creditor's meeting decision could easily prove to be the biggest loophole in the new bankruptcy law. The fact that Article 77 allows any "interested party" to request the termination of the reconstruction will make this one of the most powerful regulations for anyone who is trying to influence the bankruptcy procedures. An interested party in this sense is not clarified. In addition to the debtor and the creditors, governmental authorities or even the court itself could be considered as an "interested party". It is essential for the new bankruptcy law to clarify who is allowed to request the termination of a reconstruction plan. Social and political stability will increase if the new bankruptcy law provides a clear answer to the question as to which parties are permitted to influence the bankruptcy proceedings. The new bankruptcy law introduces many changes that will bring stability to the entire economy. One of these changes is clarification concerning intellectual property rights.

## **8. Intellectual property rights**

The connection between bankruptcy laws and intellectual property rights is not very obvious under the current law. The fact that the bankruptcy laws and regulation are not very clear about the fact that intellectual property rights are assets, which belong to the bankrupt company, supports this impression. To outline a link between both areas of law, it is necessary to examine the topic from a different angle.

A connection can be manifested if the accounting standards are taken in consideration. Looking at the current bankruptcy laws from an accounting point of view helps identify a link between the bankruptcy laws and intellectual property rights. However, the laws are so non-specific that there are still some details that might be worth discussing. A link will be clarified after the new bankruptcy law becomes effective. In Article 134 of the 2002 draft, it is very clearly stated that intangible assets belong to the company's assets. According to the accounting standards, intellectual property rights are intangible assets. This regulation includes patents, licenses or knowledge contracts. Due to this clarification, the link between both areas of law should now be very clear. This clarification of the bankruptcy law will have effects on the intellectual property rights and a significant impact on the Chinese economy. The fact that the new bankruptcy law clarifies the status of licences and patents within a bankruptcy should attract the attention of managers all over the world who are dealing with China and intellectual property rights. The penultimate sentence of Article 134 will particularly be a danger for the owner of intellectual property rights. According to this regulation, intangible assets cannot be sold in the same way as tangible assets. This different treatment seems necessary according to the last sentence of Article 134. The regulation states that all regulations prohibiting the purchase of certain property at a public auction have to be kept in mind. At least one of the relevant regulations could be the catalogue of goods and technologies which are restricted by Articles 17 and 18 of the foreign trade law. The problem with this catalogue is that the authorities could easily alter the catalogue or

regulation without any discussion or legislation process. This fact is a very high risk for a variety of individuals. One of the individuals affected is the administrator.

The administrator always has to watch very carefully to whom he is selling the intangible assets of a bankrupt company or whether he is generally entitled to sell a company to a foreign investor.

This is one of two potential scenarios that might occur in relation to bankruptcy laws and intellectual property rights. The investor of intellectual properties has to consider this regulation. He has to bear in mind the fact that he might not be allowed to take over the company in which he invested his intellectual property rights. Furthermore, he may not be allowed to repurchase the intellectual property rights.

A different scenario in this context could easily emerge if the bankrupt company is transferred to a competitor of the intellectual property rights owner. A similar scenario has been described in the examination of the example of the Spanish “Santa Barbara” company. In this context, the investor of intellectual property has to consider that a repatriation of intellectual property rights might be counter-productive to the successful reconstruction of the bankrupt company. Because of this, a court might consider this repatriation as impossible or invalid. International investors will have to clarify whether their licence agreements have to be adjusted or whether there is no chance of modifying this form of technology transfer. In the future, several other threats that have not been discussed in this thesis may arise.

## **F Conclusion**

This thesis provides an insight into problems that might occur for investors of intellectual property in China and for creditors of bankrupt Chinese companies, which hope to benefit from the fact that a bankrupt Chinese company has intangible assets. China's new bankruptcy law explicitly states that intangible assets are included in the debtor's assets. At face value, this clarification is an improvement on the current bankruptcy law. At a second glance, creditors might have several ideas in connection with development that probably will not be fulfilled. Furthermore, some of these changes will raise concerns on the part of intellectual property owners.

Intangible assets are very important for the Chinese economy and they will become increasingly important in the future. The technical development of China and the financial developments according to Basel II are two of the reasons for this trend. Companies that are willing to invest in China will have to be very careful in the way they act and deal with Chinese companies. The due diligence in contractual negotiations and the written agreement will become increasingly important. This thesis illustrates that every manager or legal advisor has to be aware of the fact that there is at least more than one way to lose intellectual property. Violation of patents or licences is a common and well-known way to lose control over intellectual property rights. For the

owner of intellectual property, the loss of that property could become even worse in the case of a bankruptcy. The possibility that a competitor could be able to gain lawful access to licensed or restricted knowledge has to be taken in consideration in any investment plans in China.

The owners of intellectual property will now have to consider the financial situation of a licensee very carefully and consider an exit strategy. This exit strategy should be able to recover the knowledge right at the beginning of a financial crisis. The fact that the reconstruction of a bankrupt company is becoming more and more likely in China makes it, amongst other things, important for the owner of intellectual property rights to monitor the companies that hold licenses.

In the end, the investors have to decide which strategy is appropriate. The example of the Spanish company “Santa Barbara” perfectly describes the problem that can arise if a considered takeover fails and a competitor places a better offer. In order to avoid this scenario, the monitoring carried out by the licensor has to be able to detect a financial crisis before the company fulfils the criteria to apply for bankruptcy. This monitoring requires a well-developed accounting standard so changes in the Chinese accounting regulation are necessary to monitor the development of a particular company. Risk management and financial forecasts will be some of the tools that will help to safeguard intellectual property.

At worst, the owners of intellectual property have to make up their mind as to which alternative to pursue. The owner of intellectual property can

always try to outbid a competitor if there is a threat that a company could be taken over by a competitor. Looking at the current situation in China, there are still a few uncertain possibilities that could frustrate this plan. In any case, there is still the possibility that the administrator will think that the competitor has the better opportunity in the case of a take over. Even if the administrator wants to transfer the company to the owner of the intellectual property rights, a further obvious possibility might occur.

If the technology is very valuable to the Chinese authorities and they decide to protect the special technology, they could, in order to achieve that goal, be tempted to change the technology transfer regulations or the catalogue of goods and technologies referring to the foreign trade law. After these changes have been implemented, no foreigner would be allowed to receive that particular technology. As these regulations or catalogues are not bound by legislative processes, the changes can be carried out quickly and unbureaucratically. Recently, the practice of protecting Chinese industry by changing regulations has already been reported in other economic areas.<sup>255</sup>

The more advanced a technology or intellectual property is to the owner, the better the supervision and risk management that needs to be taken.

China is on the right track to improving the legal framework and thus to being recognised as a market economy. Introducing the drafted bankruptcy law can only be a step in the right direction towards

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<sup>255</sup> Gärtner, M, "Zwischen Turbo-Kapitalismus und Planwirtschaft - Die Schwächen des Standorts liegen vor allem in der Machtfülle des Staates" (2004) <<http://www.nrw-export.de/export/2113.asp>> (07 April 2005).

establishing a modern bankruptcy law in China. The standard of this modern law will become comparable to most of the international bankruptcy laws. However, unless China reinforces the independence of the courts, any change in the legal framework will not have any effect and there will not be a great difference to the current system. The essence is that the influence of the Chinese authorities on the bankruptcy procedures needs to be reduced to zero in order to have an independent bankruptcy law system. An independent bankruptcy law system will have a significant effect on the Chinese economy. The 2002 draft of the bankruptcy law still contains some loopholes that might allow the authorities to influence the bankruptcy procedures. If the judges are willing and able to implement the new regulation without any influence from the authorities, this law will offer good protection to all investors. Investors of intellectual property rights have many concerns regarding the legal environment and prefer an environment that is calculable. Like any other investors, they are looking for the lowest risk. The more uncertainties investors see in a country, the higher the chance is that they will look elsewhere for their investment.

After the new bankruptcy law becomes effective, it will have to be analysed and strategies can be developed to face the new challenge.

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