

Bailouts and Bankruptcy law in China: A Confusion of Law and Policy*

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Abstract:

It is not uncommon for large companies in China, especially SOEs, to be bailed out with government funds or bank loans. This article explores the bailouts of non-financial companies in the country with empirical and theoretical analysis. It finds that the government, especially the local governments are keen to bail out large companies in order to prevent social instability. Also, bailouts in China are still erratic and unprincipled. When bailouts are carried out under the bankruptcy law, legal principles are frequently undermined to the detriment of the creditors. This article argues that bailouts and governmental intervention in general must be constrained with legal principles so that inefficient companies can be closed down and resource can be allocated more efficiently.

Key Words: Bailout, Chinese Bankruptcy Law, Economic Reform

1. INTRODUCTION

The Palgrave Dictionary of Economics defines a bailout as 'the rescue of an economic entity from potential or actual insolvency', usually carried out by a national government, a central bank or an international organisation.¹ The 2008 financial crisis has provided ample examples of bailouts as many financial institutions collapsed. Non-financial companies can also be bailed out by the government, for example, utility and airline companies, if they are considered 'too-big-to-fail'.²

In the EU, bailouts are regulated by the regime of rescue and restructuring aid (R&R aid), which is an exception to the state aids rule that prohibits the Member States from giving subsidies or other aid to businesses.³ Under the regime, R&R aid for a firm in difficulty may be considered compatible with the common market at the discretion of the European Commission.⁴

In the US, bailouts are not regulated through a formal legal regime. Although the US Bankruptcy Code (BC) already contains a reorganisation procedure (Chapter 11) that aims to revive a distressed company rather than put it into liquidation, some financial institutions were bailed out on an ad-hoc basis during the 2008 financial crisis.⁵ This has led to controversies over the government's decisions on bailouts vs. bankruptcy, which are criticised as erratic and arbitrary. It has been argued that the bankruptcy is a more effective alternative to bailouts if carried out in a transparent way.⁶

In China, the economic reform in the past decades is transforming the country into a market-oriented economy. In the old days of planned economy, the government could command the allocation of resources and inject funds directly into State-Owned-Enterprises (SOEs), which were equivalent to governmental affiliations. In contrast, today's China features a fast-growing private sector and SOEs that have a shareholder system. In theory, the government can only intervene as a neutral regulator or as the dominating shareholder in an SOE. However, the government shows path dependent tendencies to inject funds into SOEs as well as private

¹ 'The New Palgrave Dictionary of Economics Online' (*dictionaryofeconomics.com*) <<http://www.dictionaryofeconomics.com/resources/default/bailout>> accessed July 2017.

² S Azgad-Tromer, 'Too Important to Fail: Bankruptcy Versus Bailout of Socially Important Non-Financial Institutions' (2015) <<http://www.hblr.org/wp-content/uploads/2017/06/Too-Important-to-Fail-Bankruptcy-Versus-Bailout-of-Socially-Important-Non-Financial-Institutions.pdf>> accessed July 2017.

³ Treaty on the Functioning of the European Union, as adopted by the Treaty of Lisbon, [2010] OJ C83/49, article 107: "Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."

⁴ Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty, [2014] OJ C 249/01, p.1

⁵ For example, Bear Sterns and ALG were bailed out, while Lehman applied for Chapter 11 reorganisation. See S Ben-Ishai and SJ Lubben, 'A Comparative Study of Bankruptcy as Bailout' (2011) 6 *Brook. J. Corp. Fin. & Com. L.* 79.

⁶ *ibid.*

companies, in order to prevent social repercussions caused by the demise of large companies. Also, 'too-big-to-fail' companies are often fostered by the government in the first place.

This article will focus on the bailouts of non-financial companies in China⁷ and argue that the unprincipled bailouts in the country has created market distortions and undermined the legal principles. It begins with a historical account of the restructuring of SOEs from the 1990s to the early 2000s, during which bailouts were frequent and the bankruptcy was often used to bail out local SOEs, which could escape bank debts through bankruptcy under the support of local governments. Then it will discuss the current bankruptcy law in China and use case analysis to demonstrate that legal principles and creditors' interests are still often disregarded when bailouts are carried out under the bankruptcy law. After depicting the problems of bailouts in China, the article will make a theoretical discussion of bailouts and propose for policy changes in the future. The final section will conclude the article.

2. BAILOUTS IN CHINA: A HISTORICAL REVIEW

2.1 Bailouts and the Restructuring of SOEs

After Deng expressed his support for 'shareholding system (gufen zhi)' in his famous 1992 speech, the 14th third-plenary meeting of the party set the goal of establishing a 'modern enterprise system' in 1993, which marks the start of the restructuring of SOEs.⁸ The same year saw the enactment of the Company Law, which is the first modern company law in post-1949 China. Company Law 1993 has established the basic features for modern companies—legal personality, transferable shares, limited liability for shareholders and centralised management.⁹ With transferable shares, SOEs could transfer shares to private and foreign parties and thus obtain capital injections. The reform of the SOEs was driven by the lack of funds in SOEs and focused on rescuing unprofitable enterprises rather than fostering those relatively well performed.¹⁰

In the 1990s, bank loans replaced the direct grants from the government as the main source of funding for SOEs and State-Owned-Banks (SOBs) were tasked with bailing out the SOEs. As SOEs' financial circumstances deteriorated, the bank system was saddled with bad debt.¹¹ To solve this problem, the State Council launched the Capital Structure Optimisation Program

⁷ There are no detailed rules for the bankruptcy of financial institutions in China although they are permitted to apply for bankruptcy under the Enterprise Bankruptcy Law 2006 (EBL).

⁸ B Naughton, *The Chinese Economy: Transitions and Growth* (MIT Press 2007), p 301. Also see D Xiao, 'The Road of Reform for SOEs [国有企业改革之路]' [2014] Research on Party History [中共党史研究] 9.

⁹ A business corporation has five defining characteristics: (1) legal personality; (2) limited liability; (3) transferable shares; (4) centralised management; (5) ownership shared by equity investors. See Reinier Kraakman, Paul Davies, and Henry Hansmann, *The Anatomy of Corporate Law: a Comparative and Functional Approach*, (Oxford University Press, 2009), p 5.

¹⁰ Xiao, "The Road of Reform for SOEs".

¹¹ G Yi, *The Monetisation in China [中国的货币化进程]* (Commercial Press[商务印书馆] 2003), p 350.

(CSOP) in 1994 which assigned ‘debt write off quota’ to SOE bankruptcies and mergers.¹² SOBs would use funds provided by the state to write off the debts owed by SOEs based on the quotas assigned to them. It was mandated that proceeds of selling land use rights be used first to pay workers and retirees and housing and other social assets be excluded from the bankruptcy estate.¹³ Further, under the programme, the merger was the main restructuring alternative to bankruptcy for SOEs.

In 1995, the government stated that it would ‘keep the large and let the small go’ (*zhuada fangxiao*), namely, to retain the control of the largest SOEs owned by the central government and privatise collective enterprises and small SOEs owned by the local governments. This decision was justified by the poor performance of local SOEs and the crucial role of central SOEs.¹⁴

However, these measures did not improve the balance sheets of SOEs significantly and the eruption of the Asian financial crisis had aggravated the situation. In 1998, industrial SOEs incurred losses estimated at RMB 80 billion with profits only at RMB 120 billion.¹⁵ In 1999, the average debt-for-equity ratio in Chinese SOEs reached as high as 75%.¹⁶ It was estimated that the level of NPLs in SOBs reached 25% or higher and the banks were technically bankrupt.¹⁷ To deal with the problems, the government announced the objective to reduce the number of loss-making SOEs within three years (1999–2001). During this period, the bankruptcy took priority over the merger and the number of bankruptcy cases surged. In 1999, 133 major bankruptcy cases were approved and acquired an average write-off quota of RMB 135 million or a total of 18 billion.¹⁸

¹² State Council, ‘Notice of the State Council on the Relevant Issues Concerning the Pilot Implementation of Bankruptcy of a State-Owned Enterprise in Some Cities [关于在若干城市试行国有企业破产有关问题的通知] (Guofa No. 1994/59)’ ([lawinfochina.com](http://www.lawinfochina.com), 1994) <<http://www.lawinfochina.com/>> accessed April 2017.

¹³ State Council, ‘Supplementary Notice of the State Council on the Relevant Issues About the Pilot Implementation of the Merger and Bankruptcy of State-Owned Enterprises in Some Cities and the Reemployment of Workers [关于在若干城市试行国有企业兼并破产和职工再就业有关问题的补充通知] (Guofa No. 1997/10)’ ([lawinfochina.com](http://www.lawinfochina.com), 1997) <<http://www.lawinfochina.com/>> accessed April 2017.

¹⁴ IMF, ‘Resolving China’s Corporate Debt Problem’ (*imf.org*, October 2016) <<https://www.imf.org/external/pubs/ft/wp/2016/wp16203.pdf>> accessed March 2017, p 29.

¹⁵ World Bank, ‘Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System’ (documents.worldbank.org, 20 September 2000) <<http://documents.worldbank.org/curated/en/2000/09/14451105/bankruptcy-state-enterprises-china-case-agenda-reforming-insolvency-system>> accessed 1 September 2013.

¹⁶ Q Guan, ‘Does Debt-for-Swap Mean Opportunity for Banks and Rescue for Enterprises [债转股是银行的契机企业的救赎?]’ (finance.ifeng.com, April 2016) <http://finance.ifeng.com/a/20160407/14311026_0.shtml> accessed 19 January 2017.

¹⁷ Yi, *The Monetisation in China*, p 346.

¹⁸ World Bank, ‘Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System’.

In the same year, the government established four Asset Management Companies (AMC) in 1999, to carry out bailouts of SOEs and SOBs through a debt-for-equity swap scheme.¹⁹ The four AMCs—Huarong, Cinda, Great Wall and Dongfang—were respectively paired up with the big four commercial banks—Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB) and the Agricultural Bank of China (ABC). AMCs were funded by initial capital injections from the Ministry of Finance (MoF)(RMB1 hundred billion), 10-year bonds issued to the four big banks (RMB 8.2 hundred billion), as well as borrowings from the PBC under the guarantee of the MoF (RMB 5.8 hundred billion).²⁰ AMCs purchased the NPLs from the four big commercial banks and had completed their tasks of disposing the NPLs taken from the banks at the end of 2006, which amounts to RMB 1.4 trillion in total. The debt recovery rate is slightly below 20% on average.²¹

On appearance, the AMCs had successfully achieved the goals set by the government. First, the balance sheets of four big banks were significantly improved after transferring NPLs to AMCs, paving the way for their IPOs.²² Second, the AMCs replaced the banks as the creditors of indebted SOEs and became shareholders through the debt-for-equity swap. There were 580 SOEs chosen by the government to be restructured in the debt-for-equity scheme, through which their average debt/asset ratio was reduced from 73% to below 50%.²³

However, the overall effects of the debt-for-equity swap are debatable. First, the swap was costly at the expense of taxpayers. By estimation in 2006, it had cost more than RMB 2.5 trillion of fiscal resources (equivalent to near one-third of 1998 GDP).²⁴ Also, with a thin equity base, the AMCs were mainly funded by the borrowings from the PBC and the bonds issued to the 'big four banks' at an interest lower than market rates. The borrowings from the PBC were never repaid. AMCs were also unable to repay the bonds after they came due in 2009, which were rolled over for another 10 years with the guarantee provided by the MoF.²⁵ The main explanation is that the AMCs were unable to gain much from the NPLs after paying the full price for them.²⁶

Second, the swap carried out by AMCs did not 'harden' the budget of SOEs but instead fulfilled the expectations that SOEs would be bailed out and thereby aggravated the moral hazard within

¹⁹ PBC, 'Opinions on Implementing Debt-to-Equity Conversion [关于实施债权转股权若干问题的意见]' (hk.lexiscn.com, July 1999) <<https://hk.lexiscn.com/law/law-chinese-3-204001199911-T.html>> accessed 21 December 2016.

²⁰ Guonan Ma and Ben SC Fung, 'China's asset management corporations' (Bank for International Settlements 2002); Guonan Ma, 'Sharing China's Bank Restructuring Bill' (2006) 14 *China & World Economy* 19–37

²¹ G Yi, *Reflections on the Financial Reform in China* [中国金融改革思考录] (Commercial Press[商务印书馆] 2009), p 291.

²² Ma and Fung, 'China's Asset Management Corporations'; Ma, 'Sharing China's Bank Restructuring Bill'.

²³ *ibid.*

²⁴ *ibid.*

²⁵ IMF, 'Resolving China's Corporate Debt Problem', p 29.

²⁶ S Breslin, 'Financial Transitions in the PRC: Banking on the State?' (2014) 35 *Third World Quarterly* 996.

SOEs and banks.²⁷ This is because the shareholder role of the AMCs is largely illusory and they did not impose much disciplinary effect on the management. In fact, directors of SOEs and the local government were enthusiastic about the swap because the capital injected by the AMCs was ‘cheaper’ than the bank loans, contrary to the corporate finance theory that equity is more costly than debts as it requires more returns.²⁸ Also, as the management of the loss-making management usually would continue to be in charge, they viewed the swap as a debt write-off without significant negative consequences.²⁹ Since the swap did not strengthen the financial discipline of SOEs or transform their corporate governance structure, it was actually a bailout that only gave short-term boosts in the balance sheet without improving the long-term performance of the troubled SOEs. As the economic growth slowed down in recent years, many of these SOEs once again become heavily indebted and are potential targets for the current debt-for-equity scheme.³⁰

Third, although the plan was that AMCs only acted as shareholders provisionally and would exit within 10 years, in fact, AMCs are still stuck with massive shareholdings converted from debts and unable to gain profits from selling these shares.³¹ This has contributed to the default of AMCs in the bonds issued to the banks. In cases where AMCs had successfully exited, the government usually shouldered the burden. For example, Liaoning SASAC became the major shareholder of Dongbei Special Steel by purchasing shares from Huarong, one of the four major AMCs. In 2016, Special Steel became mired in debt once again and requested for another round of debt-for-equity swap.³²

In summary, the above discussion has briefly discussed the restructuring of Chinese SOEs from the 1990s to the early 2000s. Bailouts were frequent during this period because the SOEs were highly inefficient and most of them were making huge losses. The next section will focus on the

²⁷ SOEs actually have a ‘soft budget’ that enables them to continue to receive financing and make investments regardless of failures. This is in contrast with ‘hard budget’ under which a company has to pay for its failures with its own income. The lack of hard budget constrains creates perverse incentives of managers, who are prone to overlook the need for cash as they assume they can always maintain liquidity by governmental subsidies or bank loans. See J Kornai, ‘The Soft Budget Constraint’ (1986) 39 *Kyklos* 3.

²⁸ Chinese companies’ inclination for the equity market over the bond market is at variance with the pecking order theory that companies proceed from debt to equity in raising funds.

²⁹ Yi, *Reflections on the Financial Reform in China*, p 355.

³⁰ For example, during the last swap, Cinda has taken over bad debts in many SOEs of the coal industry and became the major shareholder by converting debts into equity, however, it was excluded from the management by the local governments. In recent years, Chinese coal companies once again slipped into the quandary of whether to reduce overcapacity and make millions of workers redundant. See ‘Reducing Overcapacity in Coal and Steel [煤钢艰难去产能]’ (magazine.caijing.com.cn, February 2016) <<http://magazine.caijing.com.cn/20160223/4072826.shtml>> accessed 19 January 2017.

³¹ ‘Reply of State Council to Cinda: the Finance Pays for Soured Assets Estimated at Two Hundred Billion [国务院批复信达转型 2000 亿问题资产财政兜底]’ (finance.sina.com.cn, June 2016) <<http://finance.sina.com.cn/roll/20160620/23368142940.shtml>> accessed 18 January 2017.

³² ‘The Deadlock for Dongbei Special Steel [东北特钢债务陷入僵局]’ (news.xinhuanet.com, 2016) <http://news.xinhuanet.com/fortune/2016-07/26/c_129178715.htm> accessed 21 January 2017. The bankruptcy case of Dongbei Special Steel will be further discussed.

bankruptcy of SOEs at the time, which was often used as a means of bailout as SOEs could escape their bank debts through bankruptcy under the support of local governments.

2.2 Policy Bankruptcies and Debt Evasion

As discussed above, the bankruptcy procedure was used to close down loss-making SOEs from the 1990s to 2000s, with funds provided by the central government to compensate employees and write off bank debts. In addition, the Interim Bankruptcy Law 1986, the bankruptcy law applicable at the time, only provides for the bankruptcy of SOEs and ranks employees in priority to secured creditors.³³ Directed by the governmental policies, the bankruptcy during this time is called ‘policy bankruptcy’³⁴ with little regard to creditors’ interests.³⁵

In fact, the bankruptcy was an administrative procedure dominated by local governments and the courts only played a rubber-stamp role.³⁶ With the support of the local governments, many local SOEs applied for bankruptcy voluntarily in order to evade debts.³⁷ After they filed for bankruptcy, they would continue to operate on the same site with the same management after they filed for bankruptcy.³⁸

³³ Interim Bankruptcy Law 1986, article 37

³⁴ As the restructuring of SOEs completed, policy bankruptcy was put to an end in 2008. See R Li, ‘Report on Supervision of State Assets and SOE Reform [关于国有资产监管和国有企业改革情况的报告]’ (npc.gov.cn, 26 April 2005) <http://www.npc.gov.cn/wxzl/gongbao/2005-05/30/content_5341707.htm> accessed 2 November 2016.

³⁵ Banks clearly had incurred substantial losses during the restructuring of SOEs as they could only recover only 3-10% of their claims while laid off employees of large SOEs were usually entitled to a substantial amount of compensation. See World Bank, ‘Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System’.

³⁶ *ibid.*

³⁷ S Cao, ‘Legislation and Implementation of Chinese Bankruptcy Law in a Decade [十年来中国破产法的立法与实施]’ (*modernchinastudies.org*, 1997) <<http://www.modernchinastudies.org/cn/issues/past-issues/57-mcs-1997-issue-2/400-2011-12-29-17-45-11.html>> accessed 28 November 2016.

³⁸ There were various means of escaping bank debts through bankruptcy. For example, an enterprise could merge with others to form a new company, transferred its assets to the new company, and then went into bankruptcy. It could also distribute the proceeds of the sale of assets regardless of the bank’s claim as a secured creditor. At the same time, the enterprise would tamper with the asset/debt ratio, inflate the bankruptcy fees, and reduce the value of the bankruptcy estate. See State Council, ‘Notice on Evading Bank Debts by PBC(Forwarded by State Council) [国务院办公厅转发人民银行关于企业逃废金融债务有关情况报告的通知]’ (*chinaacc.com*, 2001) <<http://www.chinaacc.com/new/63/69/110/2001/4/ad98071930111214100221060.htm>> accessed 15 November 2016.

The number of bankruptcies reached a peak in 2001³⁹ and many cases involved debt evasion supported by local governments.⁴⁰ Both local officials⁴¹ and the managers of SOEs believed that the bankruptcy was a means to relieve the SOEs of debts. A survey has found that 90% CEOs of SOEs reckoned bankruptcy could be used to resolve debt problems.⁴² Also, the debts owed to state banks were believed to be owed to the central government and could be written off.⁴³

Employees' priority in the bankruptcy procedure was used to facilitate debt escape. The management would increase the employees' claims before filing for bankruptcy. Then the assets were transferred to the employees, nullifying the debts owed to the banks. The assets were only held by the employees in the name and then could be used to obtain new funding for the company.⁴⁴

To summarise, debt evasion through bankruptcy can be viewed as bailouts of local SOEs at the cost of state banks. The bankruptcy during the SOE restructuring was far from a collective mechanism for creditors to enforce their debts. The following sections will discuss the ramifications of the SOE restructuring that will lock the bankruptcy law in the old path.

2.3 Ramifications of the SOE Restructuring

2.3.1 Dismantling of Social Security System

The restructuring of SOEs from the 1990s to the early 2000s led to more than 20 million SOE workers being laid-off.⁴⁵ They received some compensation from the state, however, as the life-long job in SOEs was bundled with housing, health care and social security, most of them became disadvantaged in the absence of a sound social welfare system.

During this time, the government also started to dismantle the social security system that is attached to SOEs and established a new system under which both individuals and their employees

³⁹ Also see 21 Century News, 'SPC Report Claims That SOEs Account for 80% of the 40,000 Bankruptcy Cases [最高法院报告称 4 万起破产案中国企业集体企业占 8 成]' (finance.sina.com.cn, 2014) <<http://finance.sina.com.cn/china/20140904/030720206424.shtml>> accessed 15 November 2016.

⁴⁰ As of the end of 2000, 51.29 % of all the restructured (gaizhi) enterprises had evaded bank debts, according to the survey on those that had bank accounts with the major SOEs. The bad debts they incurred amounted to 31.96% of the entire bank loans (plus interests) allotted to restructured enterprises. It was commercial banks owned by the state that had suffered most from the wave of debt defaults. See State Council, 'Notice on Evading Bank Debts by PBC(Forwarded by State Council)'.

⁴¹ For example, the officials of Pinggu, a county in Beijing, even proclaimed, 'By getting rid of debts through bankruptcy, enterprises could continue to operate with the existing factory and equipment.' As a result, some enterprises in the county, which had relatively good performance, went into bankruptcy to escape bank debts. They changed their name and continue their operations in the old site. It had been found that 88.51% of the restructured enterprises in the county had escaped bank debts, resulting in bad debts comprising 78.19% of the bank loans extended to the local restructured enterprises. See *ibid*.

⁴² BM Fleisher, *Policy Reform and Chinese Markets: Progress and Challenges* (Edward Elgar 2008), p 54.

⁴³ *ibid*.

⁴⁴ W Weiguo, 'The Order of Payment of Workers' Claims and Security Interests Under China's New Bankruptcy Law' (*search.oecd.org*, 2006) <<http://search.oecd.org/china/38182499.pdf>> accessed June 2017.

⁴⁵ K Ngok and CK Chan, *China's Social Policy: Transformation and Challenges* (Taylor & Francis 2015), p 67.

were required to share the cost of social security with the state.⁴⁶ This means that laid-off workers were excluded from the social safety net without a new job. In order to maintain social stability, the government established re-employment centres to help workers find new jobs and offered them an 'unemployment insurance' that ensured basic livelihood. However, many laid-off workers still could not find new jobs and became the main source of urban poor with no basic social protections.⁴⁷ Further, the widening income and the managerial corruption during the restructuring led to growing anger among former SOE employees whose living standards continued to deteriorate.⁴⁸

All these factors contributed to a rising number of 'mass accidents' by laid-off workers, namely collective protests in the public arena. Many protests were spurred by the restructuring schemes that involved collective layoffs in order to 'improve industrial efficiency'. It has been estimated that from 1993 to 2003, the number of mass accidents rose from 10,000 to 60,000 and it continued to increase to 74,000 in 2004 and then to 87,000 in 2005.⁴⁹ Faced with increasing challenges caused by massive laid-offs, the government proposed the vision of a 'harmonious society' to promote social stability in 2005.⁵⁰ The stress on social stability and employment is one of the factors that led local governments to protect local enterprises. This will be further discussed in the following.

2.3.2 Perverse Incentives of Local Governments

Local governments in China have strong incentives to protect local companies because they derive financial benefits from doing so. To begin with, local governments are still the shareholders of many local companies after the privatisation and this fosters widespread local protectionism in China.⁵¹ Further, local enterprises produce tax revenues for local governments under the tax sharing system established in 1994. Under the system, taxes were divided into the central tax, local taxes and taxes shared between local governments and the central government. Also, parallel systems for collecting local and central taxes were established. The tax sharing system has motivated local governments to promote the local economy and generate revenues.⁵²

In addition to financial benefits, local officials also have strong political incentives to promote local companies. First, the GDP is the main indicator for their performance in promoting

⁴⁶ Y Sha, 'China's Social Security System: Present Status and Issues' (2007) <http://open_jicareport.jica.go.jp/pdf/11850484.pdf#page=49> accessed June 2017.

⁴⁷ Ngok and Chan, *China's Social Policy: Transformation and Challenges*, p 36.

⁴⁸ J Fewsmith, 'Assessing Social Stability on the Eve of the 17th Party Congress' (2007) 20 *China Leadership Monitor* 1.

⁴⁹ *ibid.*

⁵⁰ K-M Chan, 'Harmonious Society' (www.cuhk.edu.hk, 2010) <http://www.cuhk.edu.hk/centre/ccss/publications/km_chan/CKM_14.pdf> accessed June 2017.

⁵¹ P Keller, *Law and the Market Economy in China* (Taylor & Francis 2017), p 429.

⁵² Q Zhang and S Li, 'Key Issues of Central and Local Government Finance in the People's Republic of China' (2016) <<http://www.ssrn.com/abstract=2893347>> accessed July 2017.

economic growth.⁵³ The central government would set GDP targets for local officials. If they achieved the target or even better, they could be promoted to a higher rank.

Second, social stability is also an important benchmark for local officials and the collapse of large companies would cause social instability. The central government has reiterated that political stability is essential for the economy and made it an essential assessment criterion for local officials.⁵⁴ As is discussed above, the reform of SOEs has led to the dismantling of the old welfare system based on SOEs and a structural undersupply of public goods.⁵⁵ After the closing of SOEs, former SOE workers became severely deprived losing their pension and healthcare. With rising social inequality, it is increasingly difficult for local governments to suppress 'mass incidents' and maintain social stability. Nevertheless, the central government requires local governments to ensure "no small incidents out of village, no big incidents out of town, no conflicts transferred to the superior".⁵⁶ Faced with such pressure, local officials often have to meet all the demands by the 'instability groups', including laid-off workers that ask the government to pay instead of their employer.⁵⁷

To summarise, local governments in China are strongly motivated, both by economic and political reasons to protect local enterprises. In order to maintain local revenues and employment, local governments would prevent local enterprises from going into bankruptcy liquidation, or attempt to bend the bankruptcy law to the benefits of the debtor. As in the SOE restructuring period, bankruptcy has been frequently used as a means to bail out companies. This will be discussed in details in the following sections.

3. BAILOUTS AND BANKRUPTCY LAW IN CHINA

3.1 Overview of Enterprise Bankruptcy Law 2006

The current bankruptcy law in China, the Enterprise Bankruptcy Law (EBL), was promulgated in 2006. It applies to all enterprises and replaces the Interim Bankruptcy Law 1986 that only applied to SOEs. The EBL 2006 provides for three bankruptcy procedures—liquidation, reorganisation and conciliation. The provisions on liquidation and reorganisation are analogous

⁵³ H Li and L-A Zhou, 'Political Turnover and Economic Performance: the Incentive Role of Personnel Control in China' (2005) 89 *Journal of Public Economics* 1743.

⁵⁴ Y He and G Wang, 'Order in Chaos: Re-Understand Social Instability in China' (2016) 1 *Journal of Chinese Governance* 228.

⁵⁵ Sha, 'China's Social Security System: Present Status and Issues' (2007).

⁵⁶ He and Wang, 'Order in Chaos: Re-Understand Social Instability in China'.

⁵⁷ For example, the local government of the Changshu city, as well as the government on the provincial level, played a critical role in maintaining social stability when the subsidiaries of FerroChina Lt went into financial difficulty and their directors fled. This is one of the largest bankruptcy cases in China with more than 1400 creditors and the debt claimed by creditors amounting to 11 billion. The local government established an ad hoc team to handle the case and took immediate actions to preserve the corporate assets and pacify the angry creditors. It also paid for part of workers' salaries. See W Dinya, 'The Largest Bankruptcy Case That Spanned Five Years and Involved 11 Billion Debts [最大破产重整案历时 5 年终结 债务记录达 110 亿]' (*lawfirm.com.cn*, 2014) <http://www.lawfirm.com.cn/Article/Article_Info.asp?Id=1317> accessed August 2015.

to those in Chapter 7 and Chapter 11 of the US Bankruptcy Code (BC) 1978. In general, the EBL resembles closely to the US BC in basic principles, however, a closer examination will reveal that Chinese bankruptcy law is still subject to political and historical factors that have undermined its development.

To begin with, the initiation of bankruptcy cases in China is being controlled by the local governments. In order to enter into the bankruptcy procedure, SOEs have to apply for the approval by the State-owned Assets Supervision and Administration Commission (SASAC). In addition, the courts require companies to submit plans for workers resettlement in addition to financial documents when applying for bankruptcy. Even all the requirements are met, the courts may still reject bankruptcy cases due to the opposition of the local government.⁵⁸ This has made it very difficult for Chinese companies to go into the bankruptcy procedure. It has been found that court-based bankruptcy cases account for a very small proportion of all company dissolutions in China.

Second, the priority rule under the Chinese bankruptcy law is shaped by the concerns for unemployment. As in the US, secured creditors rank highest in the repayment under the EBL 2006, followed by holders of priority claims including administrative expenses, employees' compensation and tax claims (from high to low). The rest of the bankruptcy assets will go to the unsecured creditors. However, it has made an exceptional rule that the employees' claims that occurred before 2006 rank above secured creditors. This is a transitional provision to replace the rule that employees are paid before creditors under Interim Bankruptcy Law 1986, the predecessor of the EBL 2006. It reflects the government's concern for the social instability caused by unemployment that follows bankruptcy.

Third, although the EBL 2006 introduces court-appointed administrators to oversee the bankruptcy procedures, in practice the role of the administrator is often assumed by government officials. The EBL 2006 provides that administrators can be liquidation teams, law firms, accountancy firms, bankruptcy firms, or any other public intermediary agency that may serve as an administrator. Liquidation teams consist mostly of governmental officials as courts are required to choose members of the liquidation team from the 'interim emergency team', which is established by local governments to deal with distressed companies in the region before formal bankruptcy. The fact that local governments are the controlling shareholders of local SOEs casts doubt on the independence of the liquidation team acting as the administrator in bankruptcy.

Fourth, the reorganisation procedure provided by the EBL 2006 is often used by the local governments to 'bail out' large companies at the cost of creditors. The purpose of reorganisation procedure is to enhance creditors' value and give the debtor a 'second chance'. However, under the governmental intervention, the reorganisation procedure in China has been used to prolong the life of unprofitable companies. It has been found that it is relatively common for Chinese

⁵⁸ Z Zhang and R Tomasic, 'Corporate Reorganization Reform in China: Findings From an Empirical Study in Zhejiang' (2016) 11 *Asian Journal of Comparative Law* 55.

courts to ‘cram down’ reorganisation plans, namely to force creditors to accept reorganisation plans despite their opposition.

The wide use of cramming down reorganisation plans by the courts has given rise to the criticism that the courts have disregarded two basic principles in the reorganisation—the absolute priority rule and the best interest rule. Under the US BC, the absolute priority rule must be satisfied for the reorganisation plan to be crammed down by the court. To be specific, first, if creditors rank in seniority oppose the reorganisation plan, they must be paid before junior creditors. Second, shareholders can receive no distributions from the bankruptcy estate under the reorganisation plan if it is opposed by the unsecured creditors.⁵⁹ It has been argued that there is an absolute priority rule in the EBL,⁶⁰ which provides that a reorganisation plan can only be crammed down without the approval of secured creditors and priority creditors (employees, tax claimants) if these groups are fully paid. However, the adoption of the absolute priority rule is only partial as the EBL fails to assert the priority of unsecured creditors over shareholders. The EBL also contains a statement of the ‘best interest rule’,⁶¹ which requires that creditors receive at least as much value as the creditor would receive in the liquidation if the court crams down the reorganisation plan despite their opposition.

An empirical research has found that the best interest rule has usually been complied with, at least superficially. However, the absolute priority rule is routinely contravened in the reorganisations of Chinese listed companies and social stability is prioritised over creditors’ interests. Particularly, unsecured creditors have a low recovery rate in the reorganisations.⁶²

Creditors’ interests are further undermined by the lack of provision on the absence of provisions on refinancing under Chinese bankruptcy law. In contrast, the US BC provides that new borrowings incurred by the DIP⁶³ are superior to existing debts.⁶⁴ The unclear status of new funds given to the debtor increases the risks for creditors and creditors often suffer more losses as a result of offering new funds.

In summary, the problem of governmental intervention still looms large in the bankruptcy procedure and has undermined the basic principles of the bankruptcy law. To further illustrate this point, the following section will provide an analysis of typical cases in which the government has assumed a dominant role.

⁵⁹ CJ Tabb and R Brubaker, *Bankruptcy Law: Principles, Policies, and Practice* (LexisNexis 2010), p 703.

⁶⁰ X Wang, ‘New Arguments on Reorganisation Theories and Practice[重整制度理论与实务新论]’ (*aisixiang.com*, February 2013) <<http://www.aisixiang.com/data/61298.html>> accessed June 2017.

⁶¹ Tabb and Brubaker, *Bankruptcy Law: Principles, Policies, and Practice*, p 709.

⁶² Zhang and Tomasic, ‘Corporate Reorganization Reform in China: Findings From an Empirical Study in Zhejiang’.

⁶³ During the reorganisation process provided by the Chapter 11 of the US BC, directors will remain in control and the firm will be referred to as the debtor-in-possession (DIP).

⁶⁴ BC § 364 (c)(1).

3.2 Case Studies

In response to the slowed economic growth and massive corporate debt, the Chinese government has launched a 'supply-side reform' to reduce debt and cut overcapacity. The bankruptcy law has come into the fore as a principal measure to close down inefficient companies.⁶⁵ Consequently, the number of bankruptcy cases has risen sharply since 2016 (see Table I and Figure I). Many recent bankruptcy cases involve large industrial and manufacturing enterprises that received massive state subsidies and had overproduced. Some high-tech industries, such as the solar industry, have also received substantial governmental funds and now are in predicament. The following subsections will use examples of steel companies and solar companies to demonstrate the governmental role in creating the problem of overproduction and bailing out the failed companies.

3.2.1 Steel Companies

The steel industry in China is one of the most overproduced industries in the country. As part of the efforts of the supply-side reform, the government has started to eliminate the capacity of the steel industry and reduce the number of steel companies by mergers, as well as bankruptcies. The government also launched a new round of debt-for-equity swaps to save viable companies.⁶⁶ As stated by the government, the latest swap is 'market-based' as it will be led by banks (major creditors in China) and exclude the 'zombie companies'.⁶⁷

The closing down of inefficient companies is bound to create a new wave of massive unemployment. The China International Capital Corp (CICC) estimates that from 2016 to 2017, overproduced industries in China, including coal and steel, would slash 30% of their 10 million workers.⁶⁸ Compared with more than twenty million laid-off workers in the last round of reform, three million laid-off workers are much more manageable as they would only amount to 0.3% of the country's urban population.⁶⁹

However, some regions would be hit particularly hard by the supply-side reform due to the concentration of heavy industries and the lack of alternative employment opportunities. For example, the Northeast region, the old industrial base in the country with the highest proportion

⁶⁵ 'Government Report' (*mofcom.gov.cn*, March 2016)
<<http://www.mofcom.gov.cn/article/i/jyj/1/201603/20160301282908.shtml>> accessed March 2017.

⁶⁶ 'State Council's Opinions on Lowering the Leverage of Enterprises [国务院关于积极稳妥降低企业杠杆率的意见]' (*gov.cn*, October 2016) <http://www.gov.cn/zhengce/content/2016-10/10/content_5116835.htm> accessed 27 November 2016.

⁶⁷ *ibid.*

⁶⁸ European Chamber, 'Overcapacity in China: an Impediment to the Party's Reform Agenda' (*static1.squarespace.com*, 2016)
<http://static1.squarespace.com/static/5537b2f8e49a1e30c01c/t/56cc3017cf80a1fc057c84e4/145622242257/Overcapacity_in_China_An_Impedim.pdf> accessed June 2017.

⁶⁹ *ibid.*

of zombie companies, will be shaken severely.⁷⁰ During the SOE restructuring period, the Northeast region had already seen the devastating effects of massive unemployment. From 1995 to 2002, the total number of workers being laid off amounted to 7.3 million.⁷¹

The Northeast region remains to be the ‘rust belt’ of the country since then and the economic downturns in recent years have brought many companies in the region into financial difficulty. For example, Dongbei Special Steel, a local SOE based in the northeastern city of Dalian, had defaulted on bonds ten times in the interbank bond market since March 2016. To forestall the bankruptcy proceedings, its controlling shareholder, the Liaoning SASAC proposed to creditors to convert most of their debts into equity and then creditors could exit through the equity market after the company was listed. The proposal had met fierce opposition from creditors who requested the National Association of Financial Market Institutional Investors (NAFMII), a self-regulatory body of institutional investors that oversees the interbank bond market, to suspend bond issues of companies from Liaoning province and publicly denounce Special Steel. Creditors also requested state regulators to issue a blanket ban on the fundraising by companies from the region and suggested financial institutions avoid purchasing bonds issued by both Liaoning government and companies in the province. In the creditors’ eyes, the debt-for-equity swap proposed by Liaoning SASAC was a disguise for debt evasion. Accordingly, the NAFMII issued a serious reprimand and suspended Special Steel from issuing bonds. It was one of the factors that prompted Dalian Intermediate Court to finally accept reorganisation application filed by creditors on October 10, 2016. A document from Liaoning government revealed that in May 2016, the company's debt-to-assets ratio had reached to 120% with its liabilities totalled at RMB 55.6 billion. The banks' total credit exposure to the company is more than RMB 44 billion, half of which is contributed by local banks in Dalian.⁷² The Dalian court had permitted the submission of the plan to be postponed until May 10, 2017, exceeding the six months limit imposed by law.⁷³ The latest report on the case is that the company finally submitted its reorganisation plan to the court in July 2017.⁷⁴

The predicament of Special Steel has often been contrasted with Sinosteel, whose controlling shareholder is the national SASAC and therefore supposedly has the support of the central government. In October 2015, Sinosteel became the first Chinese steel company to default in the

⁷⁰ Y Tan, Y Huang and WT Woo, ‘Zombie Firms and the Crowding-Out of Private Investment in China’ [2016] Asian Economic Papers.

⁷¹ H He and others, ‘Breaking the “Iron Rice Bowl:” Evidence of Precautionary Savings From Chinese State-Owned Enterprises Reform’ (*frbsf.org*, 2017) <<http://www.frbsf.org/economic-research/publications/working-papers/2014/04/>> accessed June 2017.

⁷² W Xiaomeng and D Tongjian, ‘Hopes Corroding for 44 Billion Yuan Owed to Banks by Insolvent Dalian Steelmaker’ (*caixinglobal.com*, May 2017) <<http://www.caixinglobal.com/2017-05-05/101086693.html>> accessed July 2017.

⁷³ EBL 2006, article 79.

⁷⁴ ‘Dongbei Special Steel Group Co Files Restructuring Plan’ (*globaltimes.cn*, July 2017) <<http://www.globaltimes.cn/content/1055792.shtml>> accessed July 2017.

interbank bond market with a debt-to-asset ratio of around 90%. This debt-to-asset ratio is much higher than the industry average, which is around 65%. Despite its financial difficulties, the company was able to reach a debt-for-equity swap agreement with its creditors. According to the agreement, around half of the debts owed to banks and other institutions, which totalled at 60 billion RMB, would be replaced by convertible bonds.⁷⁵ Then the convertible bonds would be gradually converted into equity within six years. As the first debt-for-equity swap for an SOE in 17 years, it casts doubt on whether the swap is still a bailout rather than a 'market-based' restructuring as claimed by the government.

3.2.2 Solar Companies

It should be noted that large private companies in China actually resemble SOEs in terms of market access, access to finance, governmental subsidies and governmental intervention. Strongly motivated to foster economic growth, both the state and local governments give generous support to private companies with growth potential and has the tendency to protect the incumbent firms.⁷⁶ For fear of the social instability caused by massive unemployment, the state and the local governments also provide the implicit guarantee for large enterprises. This is especially true in regions that are dominated by a local champion.⁷⁷

The flourishing of the solar industry in China can largely be contributed to governmental subsidies and the competition of local governments to create local champions. When solar companies went into financial difficulties, local governments tried to forestall them from going into bankruptcy and then bail them out through the reorganisation procedure. Two leading solar companies, Suntech in Jiangsu province and LDK Solar in Jiangxi province, are good examples for this point.

Both companies were established by entrepreneurs and then successfully listed on the New York Stock Exchange (NYSE). Their fast growth can be attributed to the support of the local governments to a large extent. The government of Wuxi city, where Suntech is located, had invested 6 million US dollars in the company through local SOEs and government funds.⁷⁸ It had also helped the company secure national subsidies, business opportunities and additional investments. When Suntech met financial difficulty, the mayor of Wuxi even expressed the government's support for the company in September 2012 and helped it get a new loan from Bank of China.⁷⁹

⁷⁵ Y Jin, 'Debt-for-Equity Swap of Sinosteel [中钢千亿负债破冰债转股]' (*epaper.21jingji.com*, August 2016) <http://epaper.21jingji.com/html/2016-08/17/content_45212.htm> accessed 10 January 2017.

⁷⁶ CJ Milhaupt and W Zheng, 'Beyond Ownership: State Capitalism and the Chinese Firm' (2014) 103 *Geo. LJ* 665.

⁷⁷ IMF, 'Resolving China's Corporate Debt Problem', p 29.

⁷⁸ L Xia, 'Conflicts Between Suntech CEO and Wuxi Government Coming to the Surface[尚德施正荣与无锡政府矛盾公开化]' (*finance.sina.com.cn*, October 2012) <<http://finance.sina.com.cn/chanjing/gsnews/20121020/000413424294.shtml>> accessed 19 July 2017.

⁷⁹ *ibid.*

A similar story happened in Xinyu city of Jiangxi province, the home to LDK solar. The city government decided to invest two hundred million RMB into the company, an amount that exceeded the maximum loans of local banks authorised to issue. In order to make the investment, the mayor of the city helped the company get a loan from Jiangxi Provincial International Trust and Investment Corporation, guaranteed by the fiscal revenues of Xinyu city. The rest of the funds came from the city's fiscal reserve and a grant from the provincial government. The company also enjoyed tax discounts and subsidies for electricity.⁸⁰ In addition to financial support, the city government allotted 15,000 acres land to the company and carried out land expropriation and relocation with great efficiency. When the financial situation of LDK solar deteriorated, the government of Jiangxi province provided 2 billion RMB to the company in May 2012 and the Xinyu government injected about 1 billion RMB into the company.⁸¹

Before these companies entered into the formal bankruptcy procedure, local governments had tried to negotiate with the bank creditors and persuade them to provide new loans. Such efforts had failed in Suntech, whose bank debts amounted to 7.1 billion when it entered into the reorganisation procedure in March 2013. As for LDK, Jiangxi government was able to facilitate the establishment of a bank syndicate to provide 2 billion loans to the company with an interest discount at 10%. However, the company's collapse was inevitable and finally, it entered into the reorganisation procedure.

The reorganisation of Suntech is relatively successful as its core assets were acquired by Shunfeng Photovoltaic International Ltd and the repayment rate for creditors reached 31.55%, higher than that in a hypothetical liquidation (10%-15%).⁸² The same thing cannot be said of the reorganisation of LDK solar, which resulted in a repayment rate of 6.62%. Banks had voted against the reorganisation plan proposed by the company, however, it was crammed-down by the local court in the end. It should be noted that in both cases, not only domestic banks, the main creditors, have suffered great losses. Foreign investors of the dollar-denominated bonds were excluded from the domestic insolvency procedures and had received almost nothing after the main assets were distributed to domestic creditors.⁸³

So why local governments tried so hard to save the solar companies? A brief answer is that local governments have the dual objectives of promoting economic growth and maintaining social stability. The solar companies had made a great contribution to both of these objectives and their failure would be devastating. Solar companies contributed a large proportion of taxes to the local

⁸⁰ 'The Special Treatment of LDK Solar [赛维 LDK 的神奇优待]' (*guangfu.bjx.com.cn*, July 2012) <<http://guangfu.bjx.com.cn/news/20120719/374319.shtml>> accessed July 2017.

⁸¹ *ibid.*

⁸² 'Shunfeng Photovoltaic Takes Over Suntech [顺风光电接盘尚德三折清偿债务]' (*finance.sina.com.cn*, March 2013) <<http://finance.sina.com.cn/chanjing/gsnews/20131130/013817484881.shtml>> accessed July 2017.

⁸³ A Wang and C Yi, 'Suntech Power: Challenges Under PRC Bankruptcy' (*business-finance-restructuring.weil.com*, April 2013) <<https://business-finance-restructuring.weil.com/international/suntech-power-challenges-under-prc-bankruptcy/>> accessed March 2017.

governments. For example, LDK solar was the largest taxpayer in Xinyu city, accounting for 96% of total local tax revenues. In addition, solar companies had driven the fast growth of local GDP, leading to the promotion of local officials. The GDP of Xinyu city had increased at an annual rate of 15% since LDK solar was established.⁸⁴ Although Wuxi city has more diversified industries than Xinyu, Suntech had also been an important force for the city's economic growth. The stellar performance of the solar companies led to the promotion of the local officials.⁸⁵

Furthermore, the solar companies were the major employers of these cities and are deeply embedded in the local society. After the solar companies became financially distressed, local governments were worried that their collapse would undermine social stability and therefore unwilling for them to go to the bankruptcy procedure. For example, with about 12,000 employees, Suntech Power had employed 0.3% of the city's population. The number was even higher for LDK Solar, with 16,000 employees that amounted to 1.9% of the total population of Xinyu.⁸⁶ The bankruptcy of the solar companies would also have disastrous effects on their affiliated enterprises and suppliers, which were also important employers. For example, Suntech's affiliated companies and suppliers had more than 200,000 employees in total.⁸⁷

The case analysis above shows that bailouts are still frequent, and unprincipled in China. When large companies went into financial difficulties, the government would first try to bail them out rather than let them go into bankruptcy. Bailouts can be carried outside the bankruptcy law, through debt-to-equity swaps or direct capital injections. Bailouts can also be carried out through the reorganisation procedure, as provided by the bankruptcy law. In this way, the companies are often revived at the cost of creditors, undermining the basic principles of the bankruptcy law. For both political and economic reasons, bailouts are not only carried out for SOEs, but also for private companies that can cause severe social repercussions. The following section will further discuss this problem and propose a 'law-based' model for bailouts in China.

4. A DISCUSSION ON BAILOUTS IN CHINA

4.1 Bailouts: for and against

The above discussions have argued that the Chinese government, especially local governments bail out large non-financial companies for both political and financial reasons, particularly on the account of social stability. The question naturally follows as to whether social stability can be the justification for bailouts, and governmental intervention in general.

⁸⁴ X Xuehui, 'The Debt Predicament of LDK Solar[赛维 250 亿债务危局]' (*finance.sina.com.cn*, January 2013) <<http://finance.sina.com.cn/chanjing/gsnews/20130105/094914190774.shtml>> accessed July 2017.

⁸⁵ *ibid.*

⁸⁶ Y Xia, 'The Role and Incentives of Chinese Local Governments in Solar PV Overinvestment' (*repositories.lib.utexas.edu*, 2013) <<https://repositories.lib.utexas.edu/bitstream/handle/2152/21769/XIA-THESIS-2013.pdf?sequence=1>> accessed July 2017.

⁸⁷ *ibid.*

From the perspective of political theories, the government has a duty to maintain social order, a 'sacred right which is the basis of all other rights' as put by Rousseau.⁸⁸ According to social contract theories, people surrender part of their natural rights and accede to a social contract in order to create a government that can impose law and order. Therefore, under the social contract, the government has a primary duty to maintain social order. Without a powerful government, human beings would live in a state of disorder and violence.⁸⁹ In the 'state of nature' described by Hobbes, people would be constantly engaged in the 'war of all against all'.⁹⁰ Since maintaining social order is implicit in the social contract, the government should intervene when socially important institutions fall apart and threaten stability.

Further, governmental intervention is also justified on the economic ground that the government should correct a market failure, a situation in which the market fails to allocate resources efficiently. One major cause of market failure is an externality, which refers to the effects on a person's well-being caused by the actions of another.⁹¹ Systemic risk, the risk that poses threats to financial stability, can also be viewed as a negative externality as it is an effect on other parties and the whole society caused by the actions of a firm. The 2008 financial crisis has provided ample evidence to the devastating and wide-reaching effects of systemic risk. One firm's risk-taking behaviours and financial distress will have spillover effects on other parties in the financial market, which is increasingly interdependent and interconnected. In order to correct the market failure and prevent financial and social instability, governments had to bail out institutions that are too-big-to fail. Despite controversies on the use of taxpayer's money to bail out financial institutions, a consensus has emerged as to the need for the government to step in to prevent systemic risk caused by the failure of sizeable institutions.⁹²

Analogous to large financial institutions, some non-financial institutions are also socially important as they produce social goods and may even be monopolists providing essential services such as railways, hospitals, utility companies.⁹³ The failure of such institutions will result in negative externalities on the society and cause social instability. The social repercussions will be more serious if the failed institutions are major employers. For example, failures of SOEs in the Northeast of China, the old industrial base, would have disastrous effects on millions of workers

⁸⁸ J-J Rousseau, *Rousseau: 'the Social Contract' and Other Later Political Writings* (Cambridge University Press 1997), p 3.

⁸⁹ R Hardin, 'Hobbesian Political Order' (1991) 19 *Political Theory* 156.

⁹⁰ 'Hobbes's Moral and Political Philosophy', 'Hobbes's Moral and Political Philosophy' (February 2014) <<https://plato.stanford.edu/entries/hobbes-moral/>> accessed July 2017.

⁹¹ N Mankiw, *Principles of Economics* (6 edn, Cengage Learning 2011), p 206.

⁹² MG De Nicoló, G Favara and L Ratnovski, *Externalities and Macropprudential Policy* (International Monetary Fund 2012).

⁹³ IR Segal, 'Monopoly and Soft Budget Constraint' [1998] *The RAND Journal of Economics* 596; E Głowicka, 'State Aid and Competition Policy: the Case of Bailouts in the European Union' (*d-nb.info*, 2008) <<http://d-nb.info/99039753X/34>> accessed July 2017.

and their families, as these SOEs are the dominant employers in the region and the workers' skills are industry-specific.

However, there is no guarantee that governmental intervention can correct market failures and it is prone to inefficiencies. Expectations for bailouts engender a moral hazard on companies to over-expand and take excessive risks as the government provides the implicit guarantee for their debt.⁹⁴ The problem of moral hazard will also arise on the part of creditors, who are willing to offer loans to large companies with lower interest rates and fewer restrictions as they are presumed to be guaranteed by the government.⁹⁵ This is especially true in SOEs, where the government often fails to impose hard-budget constraints and the creditors are not independent from the state.⁹⁶

Moreover, bailouts will create distortions and undermine the market efficiency, resulting in misallocation of resources. This is because bailouts often aim at saving weak firms rather than promoting the strong ones and politically connected firms are more likely to be bailed out.⁹⁷ This means bailout often involves a shifting of resources into inefficient sectors. Bailouts also transfer resources from the taxpayers to the inefficient companies, thereby shifting losses to the general public that should be born by the shareholders, managers and creditors.

Given the problems, some have argued that ad hoc bailouts can only be used in limited circumstances and bankruptcy law can provide an effective alternative to bailouts. For example, it has been proposed that the liquidity problems of a financial institution can be solved by the automatic stay and DIP financing under the Chapter 11 of the US BC.⁹⁸ To be specific, the debtor can obtain new financing by issuing new senior debts according to DIP financing rules. On the other hand, the automatic stay will prevent a run on the debtor's assets. Moreover, the Chapter 11 reorganisation and bailouts are not mutually exclusive. The reorganisation procedure can be used to implement the government's decision to provide rescue loans to the financial institution when the systemic risk is great.

Compared with ad hoc bailouts, bankruptcy law provides for a collective mechanism for creditors to claim their debts under the supervision of the judiciary. It can ameliorate the problem of collective action,⁹⁹ reduce dissipation and improve returns for creditors. In addition, bankruptcy law produces more predictable and consistent results, in contrast to ad hoc bailouts that usually

⁹⁴ Azgad-Tromer, 'Too Important to Fail: Bankruptcy Versus Bailout of Socially Important Non-Financial Institutions'.

⁹⁵ VV Acharya and AV Thakor, 'The Dark Side of Liquidity Creation: Leverage and Systemic Risk' (2016) 28 *Journal of Financial Intermediation* 4.

⁹⁶ JY Lin, F Cai and Z Li, 'Competition, Policy Burdens, and State-Owned Enterprise Reform' (1998) 88 *The American Economic Review* 422.

⁹⁷ M Faccio, RW Masulis and J McConnell, 'Political Connections and Corporate Bailouts' (2006) 61 *The journal of finance* 2597.

⁹⁸ K Ayotte and DA Skeel Jr, 'Bankruptcy or Bailouts' (2009) 35 *J. Corp. L.* 469.

⁹⁹ TH Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 *Yale LJ* 857.

deviate from the contractual arrangements.¹⁰⁰ However, bankruptcy can only be a better option than bailout if it is implemented in a transparent way.¹⁰¹

4.2 Bailouts and Market Distortions

As discussed above, bailouts in China are sometimes carried out within the framework of the bankruptcy law, particularly through the reorganisation procedure. However, the bankruptcy procedure lacks transparency and the returns for creditors are inconsistent. The basic principles of the bankruptcy law are often undermined. This has also undermined the ‘rule of law’ in general. Without sufficient legal constraints, local governments are able to use the bankruptcy law for their own economic and political interests.

Moreover, bailouts have reinforced governmental policies that have distorted the market. To be specific, the subsidies given to SOEs and private companies, including governmental funds, low interest rates and monopoly rights,¹⁰² have created overcapacity and ‘zombie companies’ in the first place. Then the government uses public resources to bail them out. The essence of the problem is that the government in China, both at the local and national level, still plays a pivotal role in allocating resources and has great command over the private sector despite years of market-oriented reform.

As the insight of Hayek shows, the ultimate decision of allocating resources should be left to those familiar with the particular circumstances and can respond quickly to the changes. He argues forcibly that it is impossible for a central authority to possess all the knowledge that is necessary for making top-down planning, as such knowledge is dispersed among different individuals and cannot be conveyed to the central authority in the form of statistical information.¹⁰³ To quote Hayek, ‘to assume all the knowledge to be given to a single mind... is to disregard everything that is important and significant in the real world’.¹⁰⁴ Therefore, planning or control over resources should be decentralised, namely, ‘ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them’.¹⁰⁵

The past decades of reform in China is essentially a process of ‘decentralisation’, namely to relinquish the power over resources from the government to the market participants. The country’s miraculous economic growth since the reform stands in stark contrast to the

¹⁰⁰ LJ M, ‘Rethinking the Unthinkable: Bankruptcy for Large Financial Institutions (Speech) Jeffrey M. Lacker,’ (*richmondfed.org*, 2014)
<https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2014/lacker_speech_20141010>
accessed July 2017.

¹⁰¹ Ben-Ishai and Lubben, ‘A Comparative Study of Bankruptcy as Bailout’.

¹⁰² Lin, Cai and Li, ‘Competition, Policy Burdens, and State-Owned Enterprise Reform’.

¹⁰³ FA Hayek, ‘The Use of Knowledge in Society’ [1945] *The American Economic Review* 519.

¹⁰⁴ G Gilder, ‘Knowledge and Power: the Information Theory of Capitalism and How It Is Revolutionizing Our World’, p 4.

¹⁰⁵ Hayek, ‘The Use of Knowledge in Society’.

catastrophic failure of the planned economy in the past. This has provided strong evidence to Hayek's theory that decentralisation is necessary as only those familiar can respond promptly when a society is experiencing rapid changes. However, the problems of bailouts in the country demonstrate that its transformation from a highly concentrated planned-economy to a competitive market economy is far from complete.

In summary, the governmental intervention, both at the central and local level should be constrained as it poses impediments to the function of a competitive market economy. To achieve this, it is essential to implement a plethora of legal rules that ensure companies enter and exit the market in a fair and efficient way. This will be further discussed in the following section.

4.3 Towards Law-based Bailouts

The governmental practice of promoting local champions and bailing them out in the event of insolvency can be viewed as a manifestation of 'administrative monopoly' in China, which refers to using administrative power to promote or prevent economic activities.¹⁰⁶ The Anti-Monopoly Law (AML) in China, which came into effect in 2008, contains a chapter on administrative monopoly that prohibits local governments from favouring local enterprises and imposing discriminatory measures on non-local enterprises.¹⁰⁷

The latest effort to constrain administrative monopoly is the Fair Competition Review System (FCRS) established by the State Council.¹⁰⁸ The FCRS is complementary to the AML as it is an ex-ante control mechanism while the AML only imposes an ex-post control that requires the superior authorities of the violator to order the rectification. The FCRS requires government bodies to conduct a self-review before issuance of business-related regulations, which can only be implemented if they have no anti-competitive effects.¹⁰⁹ Government bodies are also required to eradicate existing regulations that have anti-competitive effects.¹¹⁰ This means a comprehensive overhaul of regulations will be carried out. Further, it encourages authorities to recruit third parties to conduct the evaluation of regulations and the results of the review should

¹⁰⁶ M Williams, *Competition Policy and Law in China, Hong Kong and Taiwan* (Cambridge University Press 2005), p 138.

¹⁰⁷ See AML 2008, Chapter V. Administrative monopolies under the chapter include: (1) force enterprises or individuals to purchase commodities designated by government authorities (2) setting barriers on the inter-region trade (3) exclude or restrict non-local enterprises from participating in tendering and bidding (4) exclude or restrict non-local enterprises from investing or establishing branches in a region (5) force enterprises to engage in monopolistic activities (6) formulate regulations that eliminate or restrict competition. Also see EM Fox, 'An Anti-Monopoly Law for China—Scaling the Walls of Government Restraints' (2008) 75 *Antitrust Law Journal* 173.

¹⁰⁸ State Council, 'Opinions of the State Council on Establishing a Fair Competition Review System During the Development of Market-Oriented Systems [国务院关于在市场体系建设中建立公平竞争审查制度的意见](Guofa No. 2016/32)' (*gov.cn*, June 2016) <http://www.gov.cn/zhengce/content/2016-06/14/content_5082066.htm> accessed October 2016.

¹⁰⁹ *ibid.*, at para 3.2.

¹¹⁰ *ibid.*, at para 4.

be made public. The antitrust authorities¹¹¹ and State Council's Law Affairs Office (LAO) are required to promulgate specific rules for implementing the self-review.

According to the State Council, the aim of the FCRS is to 'prevent the introduction of anti-competitive regulations and gradually eradicate the regulations and activities that hinder fair competition and the establishment of a unified national market'.¹¹² The State Council emphasises that the core of the economic reform is to let the market play a decisive role in allocating resources and thereby excessive and inappropriate governmental intervention should be prevented.¹¹³

Even though both the AML and FCRS lack effective sanctions and will not interfere with central government decisions and national industrial policies, they have established a legal regime that aims to constrain local protectionism and level the playground for companies in the domestic market. In this regard, the legal rules in the AML and FCRS are comparable to the EU state aids regime. However, focusing on eradicating the barriers to market entry, they fail to address the governmental intervention in the market exit, particularly the issue of bailouts.

The rescue and restructuring aid (R&R aid) rule under the EU state aids law can be a reference in point for China. For example, the test of Market Economy Operator Principle (MEOP) can be introduced under which saving a bankrupt business cannot justify injecting funds into a company unless a private investor would have done the same under normal market conditions.¹¹⁴ To apply the test into the Chinese context, when banks write off debts or carry out a debt-for-equity swap in a particular company, it should be satisfied that rational private parties would have carried out comparable transactions.

If rescue loans are provided in the bankruptcy procedure, the principles of the bankruptcy law should be respected and the process should be fair and transparent. To be specific, the contractual positions of creditors should be protected and any adjustment of their interests should comply with the 'absolute priority rule' and the 'best interest rule'. This will enable creditors to predict their repayments based on the contractual arrangements. This will also prevent the local governments forcing creditors to accept unfair arrangements for financial or political reasons. In addition, market participants, rather than the government, should make the ultimate decisions on critical issues such as the evaluation of the bankruptcy estate. As discussed above, the market forces can drive toward efficiency, but governmental interventions usually create distortions. The government's role should be limited to fostering a sound social security system and facilitating the implementation of the bankruptcy law. Saving inefficient companies can only

¹¹¹ Antitrust authorities in China refer to National Development and Reform Commission (NDRC), Ministry of Commerce (MoFCOM) and State Administration for Industry and Commerce (SAIC).

¹¹² State Council, Opinions of the State Council on Establishing a Fair Competition Review System During the Development of Market-Oriented Systems

¹¹³ *ibid.*

¹¹⁴ JJP López, *The Concept of State Aid Under EU Law: From Internal Market to Competition and Beyond* (Oxford University Press 2015), p 53.

help employment in the short term; it cannot improve the industrial output and generate new job opportunities. If inefficient companies are closed down, resources will be transferred to more efficient sectors, which will produce more employment.

In a word, bankruptcy law can be combined with principles of the state aids law to facilitate market efficiency and reduce the distortions caused by governmental intervention. The state aids law constrains subsidies to market participants that distort the market competition. Bankruptcy law can ensure an orderly market exit and thus reallocate assets from inefficient industries to more productive uses. If bailouts in China are carried out strictly in accordance with the principles of the bankruptcy law and state aids law, the distorting effects on the market could be minimised.

However, the effectiveness of legal institutions ultimately depends on the progress of political reform in the country. The future political reform should aim at providing for a strong social security system, changing the perverse incentives of local governments, and constraining governmental intervention with the rule of law. Only in this way can the distortions in the market be corrected and resources, including labour and capital, can be allocated more efficiently.

5. CONCLUSION

This article has discussed the bailouts of non-financial companies in China. It has found that despite years of reform, the government still uses an unprincipled, erratic approach to bailing out large companies. When bailouts are carried out in the framework of bankruptcy law, the procedure is opaque and dominated by local governments. Legal principles are often given way to the political and economic interests of the local governments, whose major concern is the social repercussions caused by the demise of large companies. This has distorted the market and undermined the rule of law. This article argues that although bailout or governmental intervention in general is necessary for maintaining social stability, it must be constrained by legal principles. Also, 'too-big-to-fail' companies in China are often created by governmental policies. In order to reduce the number of companies that need to be bailed out, it is imperative to curb governmental intervention that causes overcapacity and misallocation of resources. In the long term, the government must take on the daunting task of a deep political reform without causing severe social instability.

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