

China Moves to Improve Bankruptcy Laws

The Beijing Siyuan Merger and Bankruptcy Consulting Company (SMB) has been a key group exploring ways to improve bankruptcy law implementation and diversification of property ownership in China. Its work has proved far-reaching: providing policy recommendations for amending the bankruptcy law launching a discussion forum on public policy regarding these issues and creating a model of judicial reform to increase public awareness of the benefits of a more transparent legal system. Cao Siyuan, SMB's director, is one of China's leading advocates for improving bankruptcy procedures, reforming the judicial system and diversifying ownership of the country's state-run companies as China's economy moves to a market economy.

ERT: *Why is effective bankruptcy legislation so important to China?*

MR. CAO: Restructuring of assets is pivotal to the development of countries in the process of moving from a planned economy to a market economy. Mergers and bankruptcies are important ways of restructuring assets. The Bankruptcy Law of the People's Republic of China, which was enacted in November 1988, is the cornerstone of the country's move toward a competitive economy.

ERT: *You have discussed what you consider to be the two major obstacles to implementation of the bankruptcy law: reform of the banking system and of the judicial system. What are the realistic prospects of diversifying the ownership of commercial banks?*

MR. CAO: One of the major obstacles to implementation of the bankruptcy

law has been opposition by the banking system; yet, banking reform is critical to the entire process. I believe that diversification of ownership and operation of the banking system is likely in the medium term—between three and ten years. Diversification of commercial banking is unlikely to happen in the short term because of the Asian banking crisis, which still poses many concerns.

Currently, China has four huge banks that monopolize different sectors of the economy. This is clearly a major problem. I have recommended that each of the four major specialized bank—the Industrial and Commercial Bank, the Agricultural Bank, the Construction Bank and the Bank of China—be divided into three. These twelve commercial banks should be established as limited share companies. More diversified ownership will enable China's financial institutions

to support the market economy and will promote the standardization and modernization of the country's financial markets.

China has passed a commercial banking law that requires banks to be organized under a shareholder system. That law is not new. However, it has been applied only to banks created after the law's passage not to those established previously. No one has said that the law is not applicable to the existing state-owned large banks, but no one has acted to reorganize the existing state banks. As soon as you reorganize into a new bank under the shareholder system, enterprises from other sectors will become involved in the financial market because they can purchase shares. That is how the ownership structure of the banks will be changed from sole government ownership to other forms of ownership.

While diversification of the ownership of the banks created prior to the law's enactment hasn't occurred yet, it should not be a very difficult step.

ERT: What is the status of judicial reform?

MR. CAO: In the short term, reform of the judicial system is more likely—in fact, this process has already begun. I have written a proposal that China adopt a federal court system. Premier Zhu Rongji has reviewed the proposal and already instructed the National People's Congress (NPC) and the State Council to consider it.

Both of these important bodies have been studying how to reform the judicial system. This is a complex issue, of course, particularly because of local opposition from entrenched interests that impede the fair administration of justice.

Without judicial reform, community courts are unlikely to act independently. Many cases of bankruptcy fraud involve protec-

tionism of local interests. This occurs because the local people's courts are under the control of local government officials.

ERT: You have referred to the "dual-track" operation of bankruptcy stating that "one track implements bankruptcy in conformity with the law and the other according to administrative regulation." Could you explain what this means and how it is a problem?

MR. CAO: The NPC time had had little experience with the subject of bankruptcy when it enacted the law in 1998. As a result, the bankruptcy law it approved was in a simplified form. A lot of provisions in the original draft actually were dropped because they were controversial. The law states that if an enterprise or a company cannot meet its debt obligations, the court may take the case and start the bankruptcy proceedings.

Under this rule, of course, there would be many bankruptcy cases because so many state enterprises could not meet their debt obligations. Banks were horrified by the dramatic increase in bankruptcy cases and thus were opposed to the law.

The primary reason the banks opposed bankruptcy proceedings is because they would have exposed the bad loans that many of them held on their books. Many of these were made, primarily at the local level, and in violation of government policy. Say, for example, that an enterprise with no capability of repaying a loan needed \$10 million. The bankers would nevertheless lend it the money—in exchange for a \$100,000 kickback. But were that loan to be exposed, the bankers would be in big trouble. On the other hand, if the enterprise does not go into bankruptcy, the bad loan remains "hidden" behind the regular loans.

Of course, the bankers claimed

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CENTER FOR INTERNATIONAL PRIVATE ENTERPRISE

1155 15th Street NW, Suite 700
Washington, DC 20005, USA
tel.: (202) 721-9200 fax: (202) 721-9250
email: cipe@cipe.org
World-Wide Web site: www.cipe.org

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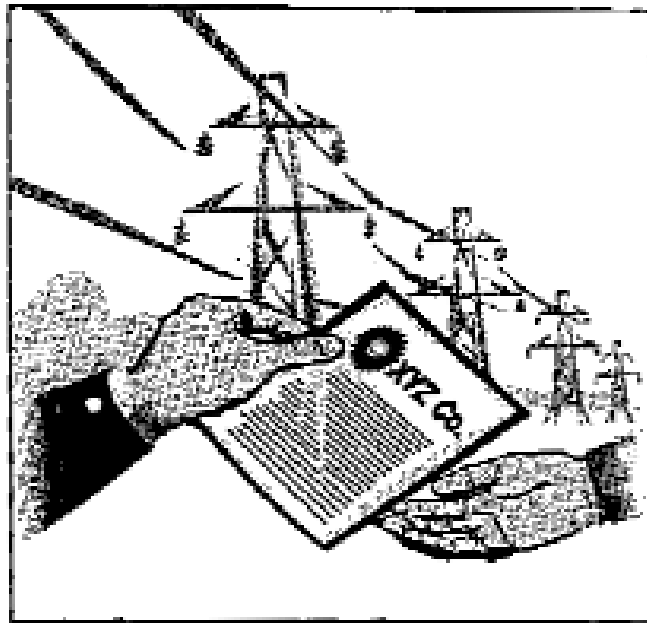
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that the bankruptcy process itself was a fraud and, at first, Premier Zhu believed them. He instructed the State Council to promulgate Document 10 of the State Council regulations, which gives the banks veto power over bankruptcy proceedings. In practice that has meant that if you wanted to declare bankruptcy, you would need the bank's approval before the courts could take your case.

In summary, the key distinction between the 1998 Bankruptcy Law and

can still be beneficial if it is achieved incrementally. If we don't advocate, maybe it would take ten years to achieve reform of all three systems. But if we do, then maybe it will take only three years to implement these essential reforms. A Chinese proverb says that success depends on people. That's what I mean: we *can* make a difference. Even for things that are possible, the process of achieving them will take longer if we don't make an effort.



State Council Document 10 is the following: the law says that when you cannot meet a debt obligation, you may go through bankruptcy, whereas the State Council regulation requires bank approval before you can elect to go through bankruptcy proceedings. That is why we proposed an amendment, and we hope it will reconcile this conflict.

ERT: Will amending the bankruptcy law—in the absence of substantive change in the banking and judicial systems—make a difference?

MR. CAO: Of course amending the bankruptcy law is just one of the things we need to do to improve bankruptcy procedures. For example, banking reform and judicial reform would both supplement the process. But the change

ERT: What are the realistic prospects for amending the bankruptcy law given that, as you have stated, legislative action on this topic has been practically nonexistent since 1994?

MR. CAO: I believe that amending the bankruptcy law is very likely. Last year we had two conferences in China. We emphasized the urgent need of amending the law to the PNC. Although the amendment itself has yet to happen, we have done a lot of preparatory work. The bankruptcy law amendment was not formally on the PNC's legislative agenda but as a result of the work we have carried out, it is now officially on the agenda. It is very likely that the PNC will do what we recommend—probably within two to three years.

ERT: Is the Chinese government actu-

ally committed to privatizing the state-owned industries? If not, how can improved bankruptcy legislation make any difference?

MR. CAO: The government is committed to giving the private sector and new companies starting up in that sector full protection, as reflected in the recent constitutional amendment that recognizes private property rights. However, the government's commitment is much more limited as far as transforming the state-owned enterprises into private-owned enterprises. The government is playing a passive role in terms of privatizing the state-owned enterprises.

You have to push and force those changes. That's where we can make a difference. We need to appeal to the government and advocate the advantages of privatization, so that the leadership can understand why we need privatization. Enforcement of the bankruptcy law promotes the deepening of reform of the state-owned enterprises in two respects. First, it exposes the inner contradictions of the old economic system. Secondly, it provides a realistic pathway toward reform of these enterprises by gradually reducing the ratio of state ownership and diversifying the structure of property rights.

ERT: *If China's government is not committed to privatizing state enterprises, what role can the bankruptcy law play? What difference can it make?*

MR. CAO: I think that the bankruptcy law will still make a difference, just less so. If the government is committed to privatization, the bankruptcy law will be more effective. But even if it is not committed to privatization, the bankruptcy law will still be important. Even without privatization, the state enterprises will have to take responsibility as individual legal entities, and the financial obligations among state enterprises will become much clearer. If a state enterprise cannot meet its debt obliga-

tions, it will still go through bankruptcy instead of being financed by the government.

ERT: *Will the bankruptcy laws, in general, have more of an impact on smaller and medium-size companies?*

MR. CAO: Yes, the bankruptcy law will have the most impact on small and medium-size companies. But in principle, and sometimes in reality, the big state-owned enterprises can also go bankrupt. Just last year, Guangdong International Trust and Investment Company was forced to declare bankruptcy. It is a huge state enterprise with about \$4 billion in debts. GITIC was the first nonbanking financial institution to request bankruptcy protection in China since 1949.

ERT: *The constitution was recently amended to recognize the role of the private sector in China. Could you describe the impact this will have on the privatization process?*

MR. CAO: That provision will make a difference for those people who actually are private-enterprise owners. It enables them rightfully to demand equal treatment for the private economy. Before this constitutional amendment, they were branded as a lower class and did not have a sound legal foundation on which to defend their rights.

Second, this constitutional amendment will have an effect on those who work for the government and regulate the economy, including those who dislike the private sector. Now, it will be much more difficult for them to discriminate against private property owners because the constitution manifestly protects the private economy. The demands of private property owners will be given more serious consideration. In this way, the amendment will improve the political environment for the development of a private economy in China. ☺☺