CHAPTER 1

DIRECTORS

Authored and updated by Mr. Stefan Lo

I. EFFECT OF WINDING-UP AND RECEIVERSHIPS ON DIRECTORS

Compulsory Winding-up

Powers of Directors

General

1.001 The presentation of a petition for the winding-up of the company by the court does not in itself affect the powers or position of the directors who may continue to operate the business of the company.[1] However, the directors would need to ensure that they do not engage in fraudulent trading,[2] and in addition, should be aware that if a winding-up order is made, any disposition of the company's property and any alteration in the status of the members of the company after the date of the petition would be void unless validated by the court.[3] Where a provisional liquidator is appointed before the hearing of the petition, the directors' powers would cease.[4] The board has some residuary powers though, such as opposing the petition on behalf of the company or in appealing against the order for the appointment of the provisional liquidator.[5] The scope of the board's residuary powers can generally be tested by considering whether the power the board is said to have lost is one which can be said to have been assumed by the liquidator; if it has not been assumed, then the board would still retain the power.[6] In addition, there may be some powers which can be exercised by both the provisional liquidator and the directors, such as the right of inspection of the company's accounting records under new Companies Ordinance (Cap. 622), s.374(1)(b). In *Re Gold Pleasure Industrial Co Ltd.*,[7] the court held that there is no inconsistency for both the directors and provisional liquidators to exercise this right of inspection, so long as the directors do not exercise the right in such a way as to jeopardise or adversely affect the provisional liquidators' functions. Where a provisional liquidator had not been appointed before the winding-up order, the directors' management powers and control over the company would cease upon the making of the winding-up whereupon the Official Receiver becomes the provisional liquidator in accordance with predecessor

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1 *Re Oriental Bank Corp, ex p Guillemin* (1884) 28 Ch D 634; *Mersey Steel and Iron Co v Naylor Benzon & Co* (1882) 9 QBD 648.

2 Companies (Winding up and Miscellaneous Provisions) Ordinance (Cap. 32), s.275: see "Fraudulent trading" at paras 1.032 ff, below.

3 Cap. 32, ss.182, 184.

4 *Re Oriental Bank Corp, ex p Guillemin* (1884) 28 Ch D 634; *Fowler v Broad's Patent Night Light Co* [1893] 1 Ch 724; *Gosling v Gaskell* [1897] AC 575; *Re Mawcon Ltd.* [1969] 1 All ER 188, at 192; [1969] 1 WLR 78, at 82; *Re Union Accident Insurance Co Ltd.* [1972] 1 All ER 1105, at 1113; [1972] 1 WLR 640; [1972] 1 Lloyd's Rep 297, *per* Plowman J.

5 *Re Perak Pioneer Ltd. (No. 3)* [1984] HKC 505; *Re Union Accident Insurance Co Ltd.* [1972] 1 All ER 1105, at 1113; [1972] 1 WLR 640; [1972] 1 Lloyd's Rep 297, *per* Plowman J.

6 *Re Union Accident Insurance Co Ltd.* [1972] 1 All ER 1105, at 1113; [1972] 1 WLR 640; [1972] 1 Lloyd's Rep 297, *per* Plowman J.

7 [2006] 4 HKC 398. On the directors' rights of inspection generally, see: *Re Alvarez & Marsal Asia Ltd.* [2009] 4 HKLRD 727; *Re Fook Lam Moon Restaurant Ltd.* [2011] 1 HKLRD 964; *Lam Sit King v Chungshan Commercial Association Hong Kong* [2011] 3 HKLRD 323.

Companies (Winding up and Miscellaneous Provisions) Ordinance (Cap. 32), s.194.[8] However, the directors could act for the company to appeal the winding-up order.[9] A director might also be appointed as a special manager with such powers as determined by the court on application by the Official Receiver where the Official Receiver is liquidator of the company.[10]

Effect of Acting Outside of Powers

1.002 Where the directors act outside of their powers, the act will not be binding on the company.[11] There may be a possibility that a third party who deals with the company without knowledge of the appointment of the provisional liquidator or the winding-up could rely on the directors' ostensible authority,[12] although ostensible authority would not be applicable where notice of the order for the appointment of the provisional liquidator or for the winding-up has been advertised in accordance with Companies (Winding-up) Rules, r 36.[13] The liquidator could, however, adopt and ratify the acts of the directors.[14]

Directors Engaged as Employees

1.003 Employees are dismissed from the date of publication of the order for winding-up, and accordingly a director employed under a service contract[15] would be dismissed from his position as employee.[16] The liquidator may however allow the employment of some or all the company's employees to continue if the liquidator carries on the business of the company.[17]

Whether Directors Cease to Hold Office

1.004 Although the directors may lose their powers and executive directors are dismissed as employees, it is not entirely clear whether the directors actually cease to hold office as directors. There are indications in the English Court of Appeal decision of *Measures Brothers Ltd v Measures*[18] that the office of director is vacated automatically upon

[8] *Madrid Bank v Bayley* (1866) LR 2 QB 37, at 40; *Re Oriental Inland Steam Co* (1874) 9 Ch App 557, at 560; *Re Ebsworth & Tidy's Contract* (1889) 42 Ch D 23, at 43; *Fowler v Broad's Patent Night Light Co* [1893] 1 Ch 724; *Measure Bros Ltd. v Measures* [1910] 2 Ch 248; *Re Farrow's Bank Ltd.* [1921] 2 Ch 164, at 174; *Re Mawcon Ltd.* [1969] 1 All ER 188; [1969] 1 WLR 78; *Re Union Accident Insurance Co Ltd.* [1972] 1 All ER 1105; [1972] 1 WLR 640; [1972] 1 Lloyd's Rep 297.

[9] *Re Diamond Fuel Co* (1879) 13 Ch D 400, at 404–405; *Re Union Accident Insurance Co Ltd.* [1972] 1 WLR 640; *Re Reprographic Exports (Euromat) Ltd.* (1978) 122 SJ 400.

[10] Cap. 32, s.216.

[11] *Bolognesi's Case* (1870) 5 Ch App 567.

[12] *Cf, Re a company (No. 006341 of 1992), ex p B Ltd.* [1994] 1 BCLC 225, at 230.

[13] *Re Mawcon Ltd.* [1969] 1 All ER 188; [1969] 1 WLR 78.

[14] *Re Mawcon Ltd.* [1969] 1 All ER 188; [1969] 1 WLR 78.

[15] See *Re Beeton & Co Ltd.* [1913] 2 Ch 279.

[16] *Re General Rolling Stock Co* (1866) LR 1 Eq 346; *Re Oriental Bank Corp, ex p Guillemin* (1884) 28 Ch D 634; *Golsing v Gaskell* [1897] AC 575, HL; *Fowler v Commercial Timber Co* [1930] 2 KB 1; *Re Standard Salt & Alkali Ltd.* [1934] SASR 168; *Re Mawcon Ltd.* [1969] 1 All ER 188; [1969] 1 WLR 78; *Re Peck Winch & Tod Ltd.* (1979) 130 NLJ 116.

[17] *Re English Joint Stock Bank, ex p Harding* (1867) 3 Eq 341; *Re Herald Newspaper of Otago* (1889) 7 NZLR 484; *Re Associated Dominions Assurance Society Ltd.* (1962) 109 CLR 516; *Re Oriental Bank Corp* (1886) 32 Ch D 366; *Reid v Explosives Ltd.* (1887) 19 QBD 265.

[18] [1910] 2 Ch 248. See also *McAteer v Mullen* [2008] NI Ch 12.

the winding-up, although it does not appear that the decision actually turned on that issue.[19] That approach however was accepted in a South African decision,[20] and in addition, Canadian cases have held that, following the appointment of the liquidator, the directors are not under fiduciary duties so that they are free to purchase the company's property from the liquidator.[21] However, in the earlier case of *Madrid Bank Ltd. v Bayley*,[22] Blackburn J (with whom Shee J agreed) had held that on a winding-up, although the directors no longer have control over the management of the company, nothing in the companies legislation required the directors to cease to be officers of the company, and accordingly the directors in that case were required to answer interrogatories under relevant statutory provisions requiring "officers" of a body corporate to answer interrogatories in an action to which the body corporate is a party. Australian courts have, upon reviewing the various English and overseas decisions, subsequently held that the weight of authority supports the view that the directors are not automatically removed from office upon a winding-up, but simply have their powers suspended.[23] In *Austral Brick Co Pty Ltd. v Falgat Constructions Pty Ltd.*,[24] Young J stated that the Canadian cases do not proceed on the basis that the directors have ceased to hold office, and can be explained on the basis that, because the company is adequately protected by an independent liquidator on a winding-up, it is not necessary to impose on the directors all the usual fiduciary obligations when dealing with the liquidator. In *McAusland v Deputy Commissioner of Taxation*,[25] French J had also held that the legislative scheme (in relevant respects comparable to the Hong Kong legislation) requires nothing more than a cessation of the powers of the directors on a winding-up, and further that the legislation, in allowing for a stay or termination of the winding-up, would be consistent with a mere suspension of power rather than an automatic vacation of office, as this militates against the unnecessary inconvenience of having to reappoint the directors should the winding-up proceedings be stayed or terminated.

[19] The issue before the Court of Appeal was whether the company in liquidation could by injunction enforce a restraint of trade covenant against the director, in circumstances where the employment of the director ceased upon winding-up. Buckley LJ, in dissent, had held that as the director vacated office upon the winding-up, then in accordance with the contract, the director would be restrained from competing against the company for a seven-year period following vacation from office (see especially [1910] 2 Ch 248 at 256). The majority had held against the company, but the ratio of the majority was simply that the company would be denied equitable relief because it was unable to perform its side of the bargain by continuing the employment of the director. Of the majority judges, Cozens-Hardy MR did not comment on whether the director vacated office, but Kennedy LJ did state that the director was displaced from his office. Whether the director actually ceased office was not an issue though (as noted by Joyce J in the first instance decision in *Measures Brothers v Measures* [1910] 1 Ch 336 at 345) and it appears that the analysis in the Court of Appeal judgments would not have depended on whether the winding-up automatically led to the office of director being vacated or simply led to the director's employment under the contract being automatically terminated.

[20] *Attorney General v Blumenthal* [1961] 4 Sth Af LR 313.

[21] *Re Mabou Coal and Gypsum Co* [1894] 27 NSR 305, affirmed *Chatam National Bank v McKeen* (1895) 24 SCR 348; *Holmstead v Annable* (1914) 18 DLR 3.

[22] (1866) LR 2 QB 37.

[23] *Austral Brick Co Pty Ltd. v Falgat Constructions Pty Ltd.* (1990) 8 ACLC 1011; 2 ACSR 766; *Lord Corporation Pty Ltd. v Green* (1991) 22 NSWLR 532 at 541–3; *McAusland v Deputy Commissioner of Taxation* (1994) 12 ACLC 78; 12 ACSR 432.

[24] *Austral Brick Co Pty Ltd. v Falgat Constructions Pty Ltd.* (1990) 8 ACLC 1011; 2 ACSR 766 at 768.

[25] *McAusland v Deputy Commissioner of Taxation* (1994) 12 ACLC 78; 12 ACSR 432 at 449. Gummow J (with whom Sheppard J agreed on this issue) decided the relevant issue on a different basis, but was willing to assume that the "suspension of powers" approach to be correct for the purposes of that case.

Assistance in the Liquidation and Examination of Directors

Assistance in the Liquidation

1.005 Upon a provisional liquidator being appointed or upon a winding-up order being made, the directors must allow the provisional liquidator or liquidator to take custody and control of all the property of the company.[26] Directors or former directors, if required by the provisional liquidator or liquidator, must within 28 days of the appointment of the provisional liquidator or the date of the winding-up order (as the case may be) submit to the provisional liquidator or liquidator a verified statement of the company's affairs in accordance with Cap. 32, s.190. After a winding-up order is made, the liquidator may order officers of the company to deliver, convey, surrender or transfer any money, property or books and papers in their hands to which the company is *prima facie* entitled.[27] The directors may also need to attend on the Official Receiver, provisional liquidator or liquidator to answer questions and to give information both before and after the submission of the statement of affairs.[28] Where required, the directors might also be summoned before the court under s.221 to be examined in relation to the promotion, formation, trade, dealings, affairs or property of the company, or to produce any books and papers in their custody or power relating to the company.[29] Failure to deliver the company's property and books to the liquidator or for concealing or providing false information about the company may lead to criminal liability.[30]

Public Examinations

1.006 Directors might also be required to be publicly examined before the court under s.222, where the Official Receiver or liquidator has made a report under s.191 stating that in his opinion the director has committed a fraud in the promotion or formation of the company or in relation to the company since its formation. In addition, under s.188IA, where the Official Receiver has made a report that in his opinion a *prima facie* case exists against a director that would render him liable to a disqualification order under Part IVA,[31] the court may, on application by the Official Receiver, require the director to attend before the court to be publicly examined as to the conduct of the business of the company or as to his conduct and dealings as a director.

Fiduciary Duties

Scope of Application of Duties: Effect of Winding-up

1.007 As discussed above, it is not entirely clear whether directors vacate office upon a winding-up or merely have their powers suspended. However, even if the directors have not vacated office, it is clear that the directors would not be subject to any duties

[26] Cap. 32, s.197.

[27] The liquidator is delegated with the court's power to require delivery of property under Cap. 32, s.211: see Cap. 32, s 226(c) and Companies (Winding-up) Rules, r 67.

[28] Companies (winding-up) Rules, rr 39(2), 41.

[29] Section 221 is discussed in more detail in chapter 6.

[30] Under Cap. 32, ss.271, 272: see "Falsification of books: s.272" and "Other offences: s.71" at paras 1.063 ff, below.

[31] See "Disqualification of directors" at paras 1.065 ff, below.

to act bona fide in the interests of the company or to act for proper purposes or to act with due care, skill and diligence, for the reason that the directors can no longer exercise powers on behalf of the company. In addition, the directors may purchase the company's assets from the liquidator without being subject to restrictions arising from any fiduciary duties.[32] But it is also clear that, whether or not the directors are treated as having vacated office, they would not be able to use information properly regarded as trade secrets belonging to the company, since such a restriction applies even after a director has left office.[33] So, for example, in *Measures Brothers Ltd. v Measures*,[34] where, at a time when winding-up of the company was imminent, the director had made copies of lists of the company's customers for later use in his own business after the winding-up order was made, Joyce J held that the director's actions in taking the lists amounted to a breach of duty to the company and ordered the director to deliver back those lists to the company.[35]

In non-winding-up cases, the courts have accepted that the corporate opportunity doctrine still applies where a director has resigned from the company, where the resignation may fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company or where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired.[36] It is not clear how far this principle applies in the winding-up situation though. There is a New Zealand authority which indicates that a company cannot prevent a director from exploiting a corporate opportunity where the company had terminated the director's employment.[37] On this analysis, and if the winding-up has led to the director vacating office, then it could be said that the company has terminated the director's position and thus the directors are entitled to exploit the corporate opportunity and it matters not whether the company had acted voluntarily or involuntarily in the termination.[38] In any event, the continuing fiduciary obligations of directors who have left office do not go so far as to prevent a director from using his own accumulated knowledge, skill and experience for his own profit, nor from preventing the director from cultivating his own commercial relationships with the company's suppliers and customers,[39] provided that the use of the company's contacts does not involve taking away confidential customer lists or committing to memory of such information.[40]

[32] *Re Mabou Coal and Gypsum Co* [1894] 27 NSR 305, affirmed *Chatam National Bank v McKeen* (1895) 24 SCR 348; *Holmested v Annable* (1914) 18 DLR 3; *Lord Corporation Pty Ltd. v Green* (1991) 22 NSWLR 532.

[33] See *Kishimoto Sangyo Co Ltd. v Akihiro Oba* [1996] 2 HKC 260, CA; *Measure Bros Ltd. v Measures* [1910] 1 Ch 336; *Lord Corporation Pty Ltd. v Green* (1991) 22 NSWLR 532.

[34] *Measure Bros Ltd. v Measures* [1910] 1 Ch 336. See also *Austral Brick Co Pty Ltd. v Falgat Constructions Pty Ltd.* (1990) 8 ACLC 1011; 2 ACSR 766, at 768.

[35] This aspect of the decision of Joyce J at first instance was not challenged on appeal.

[36] *Canadian Aero Service Ltd. v O'Malley* (1973) 40 DLR (3d) 371; *Industrial Development Consultants Ltd. v Cooley* [1972] 2 All ER 162; *Kishimoto Sangyo Co Ltd. v Akihiro Oba* [1996] 2 HKC 260, CA.

[37] *Plateau Equipment Ltd. v Marsden* (1991) 5 NZCLC 67,096.

[38] See *Measure Bros Ltd. v Measures* [1910] 2 Ch 248. But *cf Lord Corporation Pty Ltd. v Green* (1991) 22 NSWLR 532, at 543–544.

[39] *Kishimoto Sangyo Co Ltd. v Akihiro Oba* [1996] 2 HKC 260, CA; *Kao Lee and Yip v Koo Hoi Yan Donald* [2003] 2 HKC 113.

[40] *Measure Bros Ltd. v Measures* [1910] 1 Ch 336; *Robb v Green* [1895] 2 QB 315, CA (Eng); *Sanders v Parry* [1967] 2 All ER 803; [1967] 1 WLR 753; *Roger Bullivant Ltd. v Ellis* [1987] ICR 464; [1987] IRLR 491, CA (Eng).

CHAPTER 5

MEMBERS' VOLUNTARY WINDING-UP

Authored and updated by Messrs. Johnson Tan and Rex So

I. INTRODUCTION

5.001 Where a company is solvent and its members wish to put it into liquidation, they may do so by way of a members' voluntary winding-up.

As the company is solvent, the creditors will be paid in full and therefore they have no financial interest in the outcome of the liquidation. The members will therefore have control of the conduct of the winding-up of the company. Accordingly, the members will appoint the liquidator, determine his remuneration and exercise a general power of supervision over the performance of his duties.

II. PREREQUISITE FOR MEMBERS VOLUNTARY WINDING-UP CERTIFICATE OF SOLVENCY

5.002 Before a company can be placed in members' voluntary winding-up, the directors of the company (or if there are more than two, the majority of the directors) must issue a certificate of solvency.[1] The certificate of solvency is normally issued at a directors' meeting. However, it may be issued other than at a directors' meeting if, but only if, before such certificate is issued, the directors have passed a resolution authorising the certificate to be issued.[2]

In the case of a private company having only one director, the sole director may issue a certificate of solvency by recording the certificate and signing the record of it in the minute book of the company.[3]

The certificate of solvency must be in the specified form.[4] It must state that:

(a) The directors have made full enquiry into the company's affairs; and

(b) They have formed the opinion that the company will be able to pay its debts in full within such period not exceeding 12 months from the commencement of the winding-up as may be specified in the certificate of solvency.[5]

The certificate of solvency must also fulfill the following requirements to be effective:

(1) It must be issued within five weeks immediately preceding the date of the passing of the resolution for winding-up or on that date but before the passing of the resolution;

(2) It must be filed with the Registrar of Companies not later than the date of the filing with the Registrar a copy of the resolution for voluntary winding-up[6] (ie within 15 days of the making of the resolution for voluntary winding-up).[7]

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1 Section 233 of Companies Ordinance (Cap 32) (herein referred to as "CO") to be renamed as the Companies (Winding Up and Miscellaneous Provisions) Ordinance (**"CWMPO"**) upon enactment of the new Companies Ordinance (the **"New CO"**) expected to be in the first quarter of 2014.

2 Section 233(1A) of CO. See Appendix 8 for draft Minutes of Directors' Meeting.

3 Section 233(6) of CO.

4 See Form W1 of the Companies Registry Specified Forms (see Appendix 9).

5 Section 233(1) of CO.

6 Section 233(2)(a) of CO.

7 Section 117 of CO *Cf* Section 622 of New CO.

The certificate of solvency must contain a statement of the company's assets and liabilities at the latest practicable date before the issuing of the certificate.[8]

Most members' voluntary liquidations are used to wind up inactive or dormant companies which have minimal assets and liabilities. Provided the company is solvent, issuing a certificate of solvency under such circumstances should be a straightforward matter.

More care should be exercised for active companies with significant assets and liabilities. In such circumstances, the directors of the company may wish to seek advice from a reputable firm of accountants and request such firm to provide written advice on whether the company is indeed solvent and able to discharge all its liabilities within a period of 12 months or less. They may also wish to discuss the proposed certificate of solvency with the proposed liquidator. In considering whether a certificate of insolvency may be issued, the directors should also bear in mind future or contingent liabilities under contracts, guarantees and other instruments and circumstances.

The proper issuance and filing of the certificate of solvency will result in the winding-up being a members' voluntary winding-up. Otherwise it will be a creditors' voluntary winding-up.[9]

A director who signs a certificate of solvency without reasonable grounds for the opinion that the company will be able to pay its debts in full within the period specified in the certificate may be convicted and be liable to a fine[10] and imprisonment for six months.[11]

If the company is unable to pay or provide for its debts in full within the period of five weeks after the issuing of the certificate, the directors are presumed not to have had reasonable grounds for their belief in the solvency of the company until the contrary is shown.[12]

III. PROCEDURE

Passing of Special Resolution

5.003 A members' voluntary winding-up is deemed to commence at the time of passing by the members of the company of a resolution placing the company into voluntary liquidation.[13]

Generally, a special resolution is required.[14] However, in rare circumstances where there is a period fixed for the duration of the company by the articles and this has expired or where the event on the occurrence of which the memorandum of articles provide that the company is to be dissolved has happened, an ordinary resolution will suffice.[15]

[8] Section 233(2)(b) of CO.
[9] Section 233(4) of CO.
[10] The maximum punishment is a fine at level 5 (currently HK$50,000).
[11] Section 351, Twelfth Schedule of CO.
[12] Section 233(3) of CO.
[13] Section 230 of CO.
[14] Section 228(1)(b) of CO.
[15] Section 228(1)(a) of CO.

For a special resolution, the following requirements must be satisfied:[16]

(a) Not less than 21 clear days notice[17] must be given of the meeting at which a special resolution is proposed. This requirement may be waived by 95% in nominal value of those shareholders having the right to attend and vote.

(b) Notice of the meeting must specify the special resolution in full.[18]

(c) 75% of those attending and voting must vote in favour of the special resolution.

(d) Voting can occur in person or by proxy.

(e) Voting is initially on a show of hands although a poll vote may be demanded.

A chairman's declaration that the resolution is carried shall, unless a poll is demanded, be conclusive evidence of the fact without proof of the number or proportion of the votes recorded in favour of or against the resolution.[19]

The need for 21 days' notice[20] of the proposed resolution may be dispensed with where there is a resolution in writing signed by or on behalf of all members who, at the date of the resolution, would be entitled to attend and vote at the meeting.[21] Under the proposed new Companies Ordinance (the "New CO") which is expected to come into effect in the first quarter of 2014, there will be new provisions for proposing, passing and circulating written resolutions.[22]

The date of the resolution should be the date on which the last member or representative signs the written resolution.[23]

A copy of the special resolution must be filed with the Registrar of Companies within 15 days after the passing thereof.[24] If the company fails to register the special resolution within 15 days, the company and every officer of the company

[16] Section 116 of CO *Cf* Sections 562 and 564 of New CO.
[17] *Securities and Futures Commission v Stock Exchange of Hong Kong Ltd.* [1992] 1 HKLR 135, HC where it was held that the words "not less than 21 days' notice" meant at least 21 clear days excluding the day of giving the notice, the day of deemed receipt and the day of the meeting itself. Under Section 571(1)(b) of the New CO, the minimum notice period for all general meetings (regardless whether it is an ordinary resolution or a special resolution) may be reduced to 14 clear days (for a limited liability company) and 7 days (for unlimited liability company).
[18] *See Re Moorgate Mercantile Holdings Ltd.* [1980] 1 All ER 40, [1980] 1 WLR 227 and applied in *Re Hong Kong Pharmaceutical Holdings Ltd.* [2006] HKCU 1931 and in *Re Peninsular and Oriental Steam Navigator Co.* [2006] All ER (D) 36. See Appendix 10 for draft Notice of Extraordinary General Meeting and Section 564(4) of the New CO.
[19] Section 116(2) of CO *Cf* Section 590 of New CO. See *Re Hadliegh Castle Gold Mines* [1900] 2 Ch 419.
[20] see n 17, above.
[21] Sections 116B(1) and 116B(6) of CO.
[22] For example, the New CO provides that (a) either the directors or a member of a company may propose a written resolution [s.549 New CO]; (b) member(s) of the company who proposed the written resolution may require the company to circulate with the resolution a statement of not more than 1,000 words on the subject matter of the resolution [s.551(2) New CO]; (c) the company must circulate the written resolution if it was proposed by the directors or by members of a company representing not less than 5% or a lower percentage specified for that purpose in the company's articles [ss.550 & 552(2) New CO]; and (d) the proposed written resolution may be circulated, and member(s) may signify their agreement to it, by electronic means [ss.553(2)(a) & 556(3)(a) New CO].
[23] Section 116B(3) of CO *Cf* Section 548(4) and 556 of New CO.
[24] Section 117(1) and (4) of CO *Cf* Section 622(1) and (2) of New CO. See Appendix 11 for draft Notice of Ordinary and Special Resolutions and Section 564(4) of New CO.

who is in default[25] shall be liable to a fine and, for a continued default, to a daily default fine.[26]

Within 14 days[27] after the passing of the special resolution for voluntary winding-up, the company must give notice of the passing of the resolution by advertisement in the Gazette. Otherwise, the company and its officers who are in default[28] will become liable to a fine and, for a continued default, to a daily default fine.[29]

Appointment of Liquidator

5.004 In addition to passing a special resolution, the company will, in practice, pass one or more of the following resolutions[30] as appropriate:

(a) an ordinary resolution to appoint a liquidator;[31]

(b) an ordinary resolution to fix the remuneration of the liquidator;[32]

(c) a special resolution to authorise the liquidator to exercise particular powers set out in s.199 of the CO including the following:

(1) to pay any class of creditors in full;

(2) to make compromises or arrangements with creditors or persons claiming to be creditors, or having or alleging themselves to have any claim against the company; and

(3) to compromise claims by the company against debtors, potential debtors and contributories;[33]

[25] "Officer who is in default" means any officer or shadow director of the company who knowingly and wilfully authorises or permits the default, refusal or contravention: see s.351(2) of CO. The New CO introduces a new formulation of "responsible person" to replace "Officer who is in default". "Responsible person" includes an officer or a shadow director of a company as well as an officer or a shadow director of a corporate officer of the company see s.3 of the New CO. The threshold for committing an offence under the New CO will be lowered by removing the element of "knowingly and willfully" from the provision to cover, *inter alia*, reckless acts or omissions.

[26] Section 117(5) of CO *Cf* Section 622(7) of the New CO. The maximum punishment is a fine at level 3 (currently HK$10,000) and a daily default fine of HK$300: see s.351(1A) and Twelfth Schedule to CO *Cf* Section 622(7) of the New CO.

[27] Section 229(1) of CO. Balancing the need for the notice to be given promptly and the practical difficulty faced by a company under the present requirement for publication in the Gazette, it is proposed in the Improvement of Corporate Insolvency Law Legislative Proposals Consultation Document published in April 2013 by the Financial Services and the Treasury Bureau (the "Consultation Document") to extend the time limit from 14 days to 15 days. Presumably, this is also to align the notice period with the period within which a copy of the special resolution for voluntary winding up must be filed with the Registrar of Companies under section 117(1) and (4) of CO *Cf* Section 622 (1) and (2) of New CO.

[28] See n 29, below.

[29] Section 229(2) of CO. The maximum punishment is fine at level 3 (currently HK$10,000) and a daily default fine of HK$300: see s.351(1A) & Twelfth Schedule of CO.

[30] See Smart and Booth (Eds), *Hong Kong Corporate Insolvency Manual* (2002), at p 16.

[31] Section 235(1) of CO.

[32] Section 235(1) of CO.

[33] These powers may be exercised if sanction is obtained in a members' voluntary winding-up by special resolution of the company in a general meeting: s.251(1)(a) of CO.

(d) an ordinary resolution to dispense with the requirement to audit the liquidators' statement of receipt and payment;[34]

(e) an ordinary/special resolution to authorize the liquidator to divide amongst the members of the company *in specie* or in kind the whole or any part of the assets of the company[35].

The appointment of the liquidator is made,[36] in practice, at the same meeting at which the resolution to wind up the company voluntarily is passed.[37]

The Liquidator must file notice of his appointment with the Registrar of Companies and also publish the same in the Gazette within 21 days of his appointment.[38] Any person in default will be liable to a fine and, for continued default, to a daily fine.[39]

In the event that the members of the company are unable to agree on the identity of the liquidator, the court may appoint a liquidator.[40]

IV. IF COMPANY IS FOUND TO BE INSOLVENT

5.005 If, at any time, the liquidator is of the opinion that the company will not be able to pay its debts in full within the period specified in the certificate of solvency, he shall immediately summon a meeting of the creditors.[41] If the liquidator fails to do so, he shall be liable to a fine.[42]

At this meeting convened by the liquidator, the liquidator shall lay before the creditors a statement of the assets and liabilities of the company.[43] The creditors may decide either to proceed as a creditors' voluntary winding-up or one or more of them may petition for the compulsory winding-up of the company. The creditors may appoint another liquidator and fix the remuneration of the liquidator so appointed. In addition, the creditors may also appoint a committee of inspection.[44]

[34] Section 255A of CO.

[35] Special resolution is required by CO, First Schedule, Table A, Part I, Art 136 *Cf* Schedule 1, Article 105 (for public companies) and Schedule 2, Article 84 (for private companies) of the model articles made by the Financial Secretary under section 78(1) of the New CO.

[36] An ordinary resolution would suffice. See s.235(1) of CO.

[37] Section 235(1) of CO. See Appendix 12 for draft Minutes of Meeting.

[38] Section 253(1) of CO. It is proposed in the Consultation Document that the notice period be shortened to 15 days to align with (i) the requirement of section 117(1) of CO *Cf* section 622(2) of New CO and (ii) proposed changes to section 229 of the CO referred to in n 27 above. See Appendix 13 for draft Notice of Appointment of Liquidators.

[39] The maximum punishment is a level 3 fine and a daily default fine of HK$300: see s.351(1A) & Twelfth Schedule of CO.

[40] Section 252 of CO.

[41] See n 43, below.

[42] Section 237A(3) of CO.

[43] Section 237A(1) of CO. However, this section does not specify (a) the time limit for the liquidator to summon the meeting of creditors, (b) the manner in which notice should be given to the creditors, or (c) the details of the statement of assets and liabilities. The Consultation Document proposes inclusion of new provisions to address these issues so that when the winding up is to proceed as a creditors' voluntary winding-up, the creditors would be involved and duly informed at the earliest possible instance, and the obligations of the liquidator to engage the creditors would be clearly set out, see Para. 3 in Annex C to the Consultation Document at pp 73–74.

[44] Section 237A(2) of CO.

V. STAY/RESCISSION OF MEMBERS' VOLUNTARY WINDING-UP

Stay of the Winding-up Proceedings

5.006 In a members' voluntary winding-up, the court may stay the winding-up proceedings either altogether or for a limited period of time, and on such terms and conditions as the court thinks fit, upon the application of the liquidator, the Official Receiver or any creditor or contributory.[45] The company itself has no right to apply for a stay.[46]

The court has a discretion whether to grant a stay of the winding-up proceedings. The burden is on the applicant to make out a sufficient case for a stay that carries conviction[47] so that it is not merely sufficient for the applicant to establish that a stay is reasonable in the circumstances.[48] The court has to be satisfied that it is right to stay the winding-up proceedings, and, if there be matters as to which the court has doubts, it should not order a stay.[49] The factors that a court would take into account in exercising such discretion will include:[50]

(a) whether there are sufficient assets to pay the creditors and the expenses of the liquidation;

(b) whether the stay is in the interest of the creditors, the liquidator and the members and whether they consent to the stay;

(c) whether there is a genuine commercial reason for the stay;

(d) whether the stay is conducive or detrimental to commercial morality and to public at large including whether there is any irregularity in the affairs of the company.

Once a permanent stay of the winding-up procedure is granted, the liquidation is for all practical purposes at an end. The liquidator may be discharged, control of the company reverts to the directors and the company may resume its business.[51]

Rescission of Members' Voluntary Winding-up

5.007 It has been held in Hong Kong that the members of a company may, by special resolution, rescind the earlier special resolution placing the company in Members' Voluntary Liquidation.[52]

[45] Section 209 and 255 of CO.
[46] See *King Pacific International Holdings Ltd.* [2002] 3 HKLRD 474.
[47] Re *Calgary and Edmonton Land Co Ltd. (in liquidation)* [1975] 1 WLR 355, at 358–359 cited in *Re Outboard Marine Corp Asia Ltd.* [2003] 1 HKLRD 585, at 588, CFI.
[48] *Re Outboard Marine Corp*, *ibid*.
[49] *Re Lowston Ltd.* [1991] BCLC 570.
[50] See *Outboard Marine Corp* and *Re Calgary and Edmonton Land*, *ibid*.
[51] *Palmer's Company Law*, para 15.164.
[52] See *Re Keon Trading Co Ltd.* (unrep, 6 Feb 1998, HCMP 3674 of 1997).

The above decision has been the subject of criticism,[53] as being contrary to dicta of Megarry J in *Re Calgary and Edmonton Land Co Ltd.*[54] to the effect that a voluntary liquidation may not be terminated by the members of the company passing a resolution to that effect. It has also been argued, *inter alia*, that if such rescission were to be allowed, there would be no necessity to apply to court to permanently stay a members' voluntary winding-up.[55]

Conversion from Voluntary Winding-up to Compulsory Winding-up

A members' voluntary winding-up of a company shall not bar the right of any creditor or contributory to apply to have the company wound up by the court, but in the case of an application by a contributory, the court must be satisfied that the rights of the contributories will be prejudiced by a voluntary winding-up[56]. 5.008

In *Re Goldcone Properties Ltd. (in creditors' voluntary winding-up)*[57] Ribeiro J laid down, *inter alia*, the following principles relevant to determining whether the court should order a compulsory winding-up where the company is already in voluntary liquidation:

(a) The court has unfettered discretion to be exercised judicially taking into account all material factors, including whether the class remedy of liquidation would be better satisfied by the continuation of the voluntary liquidation or better served by being superseded by a compulsory liquidation.

(b) The court should consider whether the majority of the creditors in value supported the petition. If so, unless there are contrary reasons, the court would be inclined towards making a compulsory order.

(c) In weighing the views of creditors a qualitative as opposed to a purely quantitative approach should be used. In this regard, it would be relevant if the creditors opposing the petition had a personal interest in the opposition.

(d) Where the petitioner required the issues concerning the company's liquidation to be further investigated, the question was whether there was prima facie evidence that the matters which the petitioner required investigation were questions which rational creditors could think of that required investigation and further action and the outcome of which might be financially favorable to them.

(e) Whether the liquidators are acting and seen to be acting independently and impartially particularly where possible wrongdoing by the directors had to be investigated and possibly pursued in litigation.

[53] See *Smart and Booth, op cit*, at pp 11 and 12.
[54] *Ibid*.
[55] *Ibid*.
[56] Section 257 of CO.
[57] [2000] 2 HKLRD 16. This was applied in *Re Fullbright Co Ltd* [2009] 2 HKLRD 584.

In considering whether it should exercise its discretion to grant an order that the company be wound up by the court in circumstances where the company is already being wound up voluntarily, the court should consider whether there are transactions which require investigation or whether the circumstances call for the exercise of powers which the court has in a compulsory winding-up.

The Official Receiver may also petition for a compulsory winding-up where a company is being wound up voluntarily. If the court is to make an order for compulsory winding-up, it must be satisfied that the voluntary winding-up cannot be continued with due regard to the interests of the creditors and contributories.[58]

Where a voluntary winding-up is converted to a compulsory winding-up, the winding-up of the company shall be deemed to have commenced at the time of the passing of the resolution and all proceedings taken in the voluntary winding-up are deemed to have been validly taken unless the court, on proof of fraud or mistake, thinks fit otherwise to direct.[59]

VI. CONSEQUENCES OF A MEMBERS VOLUNTARY WINDING-UP

5.009 Upon the commencement of the winding-up, the company shall cease to carry on its business except so far as may be required for the beneficial winding-up thereof.[60]

On the appointment of a liquidator, all the powers of the directors of the company shall cease except so far as sanctioned by the company in general meeting or by the liquidator.[61] It appears, however, that directors and employees are not automatically dismissed upon the voluntary winding-up.[62]

VII. THE LIQUIDATORS: DUTIES, POWERS, VACANCY IN OFFICE, REMOVAL BY THE COURT, REMOVAL OF LIQUIDATOR BY THE COMPANY AND CREDITORS, RESIGNATION AND VACATION OF OFFICE

Duties

5.010 In the event of the members' voluntary winding-up continuing for more than one year, the liquidator must summon a general meeting of the company at the end of the first year from the commencement of the winding-up, and of each succeeding year, or the first convenient date within three months from the end of the year or such longer period as the Official Receiver may allow. The liquidator must lay before the meeting

[58] Section 179(2) of CO.
[59] Section 184(1) of CO.
[60] Section 231 of CO.
[61] Section 235(2) of CO.
[62] See *Fowler v Commercial Timber Co Ltd.* [1930] 2 KB 1.

an account of his acts and dealings and of the conduct of the winding-up during the preceding year.[63] Failure to comply with this provision results in a summary conviction or a fine.[64] The duty of the liquidator to call a general meeting is to ensure that he accounts to the members of the company in relation to the liquidation.

The liquidator must pay the debts of the company and must adjust the rights of contributories amongst themselves.[65]

Although there is no formal requirement to do so, the liquidator will often advertise for creditors to provide the liquidator with full particulars of their debts and claims.

The liquidator or any contributory or creditor may apply to the court to determine any question in the winding-up of a company, or to exercise all or any powers which the court might exercise if the company were being wound up by the court as respects the enforcing of calls, or any other matter.[66] If the court is satisfied that the determination of the question or the required exercise of power will be just and beneficial, it may accede wholly or partially to the application on such terms and conditions as it thinks fit and may make such other order on application as it thinks just.[67] Generally, the application will be made by the liquidator. For example, the liquidator may rely on this power to apply for an order for public examination under s.222 of the CO[68] (which would not otherwise have been available to a liquidator in a voluntary winding-up)

The liquidator may also apply for other orders and directions, for example, those relating to the sale of assets or other operational matters of the company.

In the case of every voluntary winding-up, as soon as the affairs of the company are fully wound up, the liquidator shall prepare an account of the winding-up showing how it has been conducted and how the company's property has been disposed of. He must then convene a general meeting of the company for the purpose of laying before it the account and giving an explanation of the same.[69] The meeting must be called by advertisement in the Gazette at least one month before holding it.[70]

Within one week after the general meeting, the liquidator must send a copy of the account and a return as to the holding of the meeting and its date to the Registrar of Companies. If a copy is not sent or return is not made, he is liable on summary conviction to a fine and, for continued default, to a daily default fine.[71]

However, if a quorum was not present at the meeting, the return should state that a meeting was duly summoned and that no quorum was present at the meeting.[72]

[63] Section 238(1) of CO.
[64] Section 238(2) of CO. The maximum punishment is a fine at level 3: see s.351(1A) & Twelfth Schedule of CO.
[65] Section 251(2) of CO. 66 Section 255(1) of CO.
[66] Section 255(2) of CO.
[67] Section 255(2) of CO.
[68] It is proposed in the Consultation Document that: (a) the existing requirement under section 222 of the CO that the Official Receiver or the liquidator must have alleged in his "further report" that fraud has been committed in order to initiate the public examination procedure be removed; (b) further categories of persons that may be subject to public examination be added. See Chapter 6 of the Consu provides that in a members' voluntary winding-up, the company may ltation Document at pp 63–64. See also Sections 191 (1) and (2) of CO.
[69] Section 239(1) of CO.
[70] Section 239(2) of CO.
[71] Section 239(3) of CO. The maximum penalty is a level 3 fine and a daily default fine of HK300. See section 351(1A) and Twelfth Schedule of CO.
[72] Section 239(3) of CO.

delay and probably would be less advantageous for the unsecured creditors than an exercise of s.199(1)(e) power;[122] (d) where most, if not all, creditors are financial or otherwise sophisticated investors;[123] (e) where there has been substantial consultation with the creditors who had been given an opportunity to express their views on a fully informed basis;[124] (f) where there is an overwhelming majority in support of the proposal, and (g) where, as in a group companies liquidation situation, there otherwise would have to be separate schemes of arrangement for each of the companies in liquidation, involving separate applications, which would be costly and time-consuming.[125]

The availability of the SOA procedure exemption device helps increase the flexibility of Hong Kong's SOA-based reorganisation system. Where the problems that a decision-making procedure seeks to address, such as creditor opportunism, do not exist, as in most of the situations enumerated above, there is no need to force such a procedure on the stakeholders of the company. Doing so would only increase the cost for and prolong the process of reorganisation unnecessarily.

[122] *Re Hong Kong Pharmaceutical Holdings Ltd.* [2005] HKEC 1593.
[123] *Re Hong Kong Pharmaceutical Holdings Ltd.* [2005] HKEC 1593.
[124] *Re Moulin Global Eyecare Holdings Ltd.* [2007] HKEC 409.
[125] *Re Moulin Global Eyecare Holdings Ltd.* [2007] HKEC 409.

Chapter 14

BANKRUPTCY LAW IN THE PRC

Originally authored by Mr. Melvin Sng; updated by Prof. Xianchu Zhang

I. AN INTRODUCTION[1]

In comparison to the legal systems of its major trading partners, the legal system that exists in the People's Republic of China ("PRC") is still in its developing stages. During the Cultural Revolution, the entire legal institutions and systems were attacked and dismantled. In the third plenary session of the Eleventh Central Committee of the CPC in December 1978 the country's reorientation with economic reform and opening policy was made. Since then a legislative campaign and legal construction have been vigorously promoted.[2] In October 2011 the government declared that a socialist legal system with Chinese characteristics had been established, which included the Constitution, 240 laws, 706 administrative regulations and 8600 local provisions.[3] **14.001**

The rapid pace at which the various state organs and authorities have introduced laws and regulations to match China's economic and social development presents one of the main challenges for many practitioners whose work requires familiarity with PRC laws. It is therefore useful to first understand the sources of legal rules and regulations in the PRC.

The body of laws and regulations in the PRC is perhaps most easily understood as existing within a hierarchical system with the Constitution as the supreme law of the country.[4] Under the Constitution, the National People's Congress ("NPC") acts as the primary legislative organ of the country. It has the power to enact and amend basic laws (基本法律) such as the criminal and civil law.[5] The Standing Committee of the NPC also possesses legislative powers to pass and amend laws save in relation to those matters which are reserved to the NPC.[6] When the NPC is not in session, the Standing Committee also has power to pass supplements and amendments to laws enacted by the NPC provided that such legislation is consistent with the basic principles of the relevant laws. Article 89 of the Constitution also designates the State Council as another body with authority to enact administrative regulations (行政法規)) in accordance with the Constitution and laws.

Below this upper echelon of legislative bodies noted above, the Constitution also empowers the people's congresses at the provincial level and their standing committees to enact local regulations (地方性法規) provided that such regulations do not contravene the Constitution and the laws and administrative regulations promulgated by the NPC, the NPC Standing Committee and/or the State Council.[7] The Constitution also delegates to the people's congresses of national autonomous regions the power to enact autonomy regulations (自治條例) and specific regulations (單行條例).[8]

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[1] This section is partially adapted from the chapter entitled Insolvency in the PRC of the previous edition authored by Melvin Sng.

[2] Information Office of the State Council, White Paper on China's Efforts and Achievements in Promoting the Rule of Law, 28 February 2008; available at http://www.china.org.cn/government/whitepaper/node_7041733.htm.

[3] Information Office of the State Council, White Paper on the Socialist Systems of Laws with Chinese Characteristics, 27 October 2011, available at http://news.xinhuanet.com/english2010/china/2011-10/27/c_131215899.htm.

[4] Art.

[5] Aers 58 and 62, PRC Consitution.

[6] Art 67, PRC Constitution.

[7] Art 100, PRC Constitution.

[8] Art 116, PRC Constitution.

The *Law on Legislation* which was passed by the NPC in 2000 was an attempt to address this problem by reserving to the NPC and its Standing Committee exclusive legislative authority in respect of 10 matters, namely:

(1) matters concerning national sovereignty;

(2) the formation, organisation and powers of people's congresses, people's governments, courts and procuratorates at various levels;

(3) systems of regional national autonomy, special administrative regions and basic-level autonomous associations of the people;

(4) crime and punishment;

(5) deprivation of citizen's political rights and coercive measures and penalties involving the restriction of personal liberty;

(6) requisition of non state-owned property;

(7) the basic system of the civil law;

(8) the basic economic system and the basic systems of finance, taxation, customs, monetary affairs and foreign trade;

(9) the systems of litigation and arbitration; and

(10) "other matters that must be regulated by laws enacted by the NPC or its Standing Committee".[9]

Where the NPC or its Standing Committee have not enacted any laws regulating any of these restricted matters, the State Council may be delegated the power to enact administrative regulations relating to such matters.[10] However, that is perhaps an understatement since there are at least three other types of legislative enactments which may be passed by the State Council or its ministries and commissions.

First, the State Council may enact administrative regulations relating to matters within its jurisdiction of administrative management or for the purposes of implementing laws which have been passed by the NPC or its Standing Committee.[11] Secondly, rules (規章) may be passed by the ministries or commissions of the State Council.[12] In addition, the State Council or its ministries and commissions may, under certain laws, be delegated the authority to enact implementing rules.[13]

At the local level, the *Law on Legislation* directs that local regulations may be enacted by the local authorities (ie the people's congresses or standing committees of the province or municipality) for the purpose of implementing laws or administrative regulations in their region or to regulate "local affairs". In addition, Article 64 of the *Law on Legislation* also empowers the local authorities to enact local regulations on

[9] Art 8, PRC Law on Legislation.
[10] Art 9, PRC Law on Legislation.
[11] Art 89, PRC Constitution and Art 56, PRC Law on Legislation.
[12] Art 90, PRC Constitution and Art 71, PRC Law on Legislation.
[13] Arts 56 and 71, PRC Law on Legislation.

any matter other than those which are within the exclusive jurisdiction of the NPC or its Standing Committee on which no law or administrative regulation already exists.

Unlike common law systems, the judiciary in China does not have power to interpret the law except the Supreme People's Court (SPC). As such the SPC has developed a practice to issue judicial circulars as binging legal authority to guide the lower court's case handlings. The SPC promulgated the Provisions Concerning Judicial Interpretations (司法解釋) on 23 March 2007. Art 5 explicitly stipulates that judicial interpretations adopted by the SPC shall have the effect of the law, which may be in forms of interpretations, provisions, replies and decisions of the SPC. In addition, the SPC has promoted guiding cases practice as part of its efforts to streamline the local practice and deal to with issues and concerns newly raised. According to the Provisions Concerning Case Guidance (案例指導) of SPC dated 26 November 2010, the local People's Court shall make reference to the guiding cases while dealing with the similar cases. By October 2013, the SPC has issued 16 guiding cases (指導性案例) in four batch issuing and none of them concerns with bankruptcy practice yet.

Besides various enactments as legal resources, the state and judicial policy have also played an important role in legal practice. For instance, during the worldwide financial crisis, the government and the SPC promulgated a series of policies in the worldwide financial crisis in order to stabilize the economic conditions of the country and avoid massive bankruptcy of enterprises. For instance, the SPC issued its Opinions on Certain Issues Concerning Correctly Handling Enterprises Bankruptcy Cases to Provide Market Economic Order with Judicial Protection on 12 June 2009. According to the Opinions, the People's Court shall actively coordinate with the government and the Communist Party to deal with various problems in the crisis period for maintaining social stability and sensibly apply the bankruptcy rules. Even some enterprises were already insolvent and apparently lack of capacity of repaying debts, the People's Court were required to take active rescue measures to avoid bankruptcy as long as these firms were in line with the national industrial policy with prospects.[14]

II. DEVELOPMENT OF BANKRUPTCY LAW & PRACTICE IN CHINA

The first bankruptcy law in the PRC history was adopted on 2 December 1986 which was applicable only to state-owned enterprises (SOEs). The so-called SOE Bankruptcy Law had just 43 short and general articles. It was considered a milestone for economic reform and an important political and ideological breakthrough in socialist China – bankruptcy as a market institution had not been heard of since the institution of the planned economy in 1949.[15] 14.002

[14] For a discussion in this regard, see Zhang Xianchu, "Too Big to Fail with Chinese Characteristics", in Rebecca Parry (ed.), *Too Big to Fail? Large National and International Failure under the Spotlight*, (INSOL Europe, 2013), at 133–148.
[15] Ta-kuang Chang, "The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process", 28 Harvard International Law Journal (1987), at 333–372; Peng Xiaohua, "Characteristics of China's First Bankruptcy Law", 28 Harvard International Law Journal (1987), at 373–384. For a brief review of bankruptcy law development in China since the Qing Dynasty in 1906, see Ronald Winston Harmer, "Insolvency Law and Reform in the People's Republic of China", 64 Fordham Law Review (1996), at 2567–2574.

The enactment of the SOE Bankruptcy Law, however, was highly controversial due to its political implications on the sensitive issue of public ownership. Thus, it faced a lot of uncertainties in the transition from the planned economy to a market-oriented economy, and was adopted merely on a trial basis.[16] Moreover, the SOE Bankruptcy Law suffered from some serious congenital deficiencies. Among them, two issues were most fundamental: (1) the lack of a social welfare system and the corresponding potential for financial crisis, and (2) the lack of a uniform bankruptcy law applicable to all market players.

Social Welfare & Potential for Financial Crisis

In 1980s China was not prepared with a social welfare system that could effectively support bankruptcy as a market institution. As a result, Art. 4 of the SOE Bankruptcy Law stipulates that "The state shall adopt various measures to duly arrange employment for workers of bankrupt enterprises and assure their basic living needs before their reemployment." Without any established social welfare and insurance system, a large extent of the operation of the bankruptcy regime would inevitably rely on relief measures from different levels of the government.

The Lack of Uniform Bankruptcy Laws

For a long time bankruptcy practice in China was governed by different laws and regulations according to different ownership and status of different enterprises. At the national law level, the SOE Bankruptcy Law was applicable only to state-owned enterprises.[17] No bankruptcy regime for non-SOE enterprises, including foreign investment enterprises, existed until the 1991 enactment of Chapter 19 of the Civil Procedure Law, entitled, Bankruptcy and Debt Repayment Procedures of Enterprise Legal Persons.[18] The Company Law of 1993 in turn added provisions dealing with corporate insolvency.[19] In addition, the Ministry of Foreign Economics and Trade issued Measures of Foreign Investment Enterprises Liquidation in 1996 (1996 Measures), applicable only to foreign investment enterprises.

However, the different laws set out inconsistent rules applicable to different subjects. For SOEs, a bankruptcy declaration could not be made without proof that 1) the SOE had suffered serious loss due to mismanagement, 2) the SOE was unable to repay the debts due, and 3) the government department in charge had failed to provide financial assistance or other support measures.[20] By comparison, under Chapter 19 of the Civil Procedure Law of 1991 (*i.e.*, the non-SOE bankruptcy law), proof of insolvency only required proof of the debtor's serious loss and inability to repay the debt due.[21] Finally, and least demanding, the Company Law allowed a corporation to be declared bankrupt as long as it could not repay the debt due.[22] These disparate requirements created an uneven playing field and lead to chaotic judicial practice.

[16] The full title of the law is The Enterprise Bankruptcy Law of PRC (Trial).

[17] Art 2 of the SOE Bankruptcy Law provides that "This Law applies to state owned enterprises."

[18] Art 206 of the Civil Procedure Law provides that "Bankruptcy procedures of state owned enterprises shall be governed by the SOE Bankruptcy Law of PRC."

[19] Chapter 8 of the Company Law was entitled Corporate Bankruptcy, Dissolution and Liquidation. The Law was superseded by the Company Law 2005.

[20] Art 3 of the SOE Bankruptcy Law.

[21] Art 199 of the Civil Procedure Law.

[22] Art 189 of the Company Law 1993.

Such inconsistent and defective legislative framework put tremendous pressure on the People's Courts and created strong demand for judicial innovation to address the challenges of rapid market development. Since the early 1990s, the Supreme People's Court has issued numerous judicial guidelines for bankruptcy cases to the lower courts in the form of judicial interpretations, instructions, circulars, replies and notices.[23] The most comprehensive of the judicial guidelines are the 106 articles comprising the Provisions on Certain Issues Concerning Enterprise Bankruptcy Trials, which the SPC promulgated on July 30, 2002 (the Provisions). The Provisions attempt to unify the legal rules of various laws,[24] setting out rules to deal with newly emergent issues,[25] and rewriting some old rules of the SOE Bankruptcy Law.[26]

In the early years of the SOE Bankruptcy Law and SOE reform, the government's intention was to use the SOE Bankruptcy Law as "a preventive shot" or "yellow warning card" to urge SOEs and state departments to improve management, motivation, and vitality. The government did not intend immediate, strict enforcement of the law.[27] Official statistical data showed that in 1991, 36% of SOEs were in the red; yet, from 1989 through 1992, the People's Court received less than 700 cases, most of them, if not all, were SOE bankruptcies.[28]

The year 1993 marked China's ground-breaking Constitutional Amendment that set "the socialist market economy" as the basic economic system of the country.[29] Not only did this forcefully accelerate the SOE reform, it also propelled the expansion and transformation of the bankruptcy practice. The number of bankruptcy cases jumped from 428 in 1992 to 5,396 in 1997, of which 3,735 involved an SOE bankruptcy.[30] However, the social turmoil arising from mass unemployment and potential financial crisis imposed tremendous pressure on the government at all the levels. Accordingly, the central government issued a number of documents concerning SOE bankruptcy. In 1994, the so-called policy bankruptcy scheme was officially introduced on a pilot basis in eighteen cities, and later expanded to 111 cities. The policy bankruptcy scheme was eventually made applicable in all cities, and became the dominant form of bankruptcy practice.

The policy bankruptcy scheme had four major pillars. First, resettlement of workers should be the top priority in SOE bankruptcy in order to ensure social stability. To this end, the central government ordered local governments to finance the settlement

[23] Most of these judicial rules of the Supreme People's Court are collected in Judicial Interpretations on Enterprise Bankruptcy Trials and Related Provisions (Beijing, Legal System Publishing House of China, 2002, in Chinese).

[24] The preface to the Provisions stated that the purpose of the Provisions is to streamline the bankruptcy practice under the SOE Bankruptcy Law and Civil Procedure Law. An English translation can be found in China Law & Practice, Oct. 2002, at 41–67.

[25] For example, in order to deal with lack of legal rules on debtors' asset administration in practice, the Provisions assigned the bankruptcy supervisory group the duty to manage the debtor's assets during the bankruptcy proceedings. See Art 18 of the Provisions.

[26] For example, the SOE Bankruptcy Law countenanced settlement between the debtor and its creditors made before but not after the bankruptcy declaration - see Art. Chapter 4 of the SOE Bankruptcy Law - but the SPC Provisions (Art. 25) allow the debtor and the creditor to reach settlement even after the bankruptcy declaration.

[27] Speech of Mr. Peng Chong, Vice Chairman of the Standing Committee of the National People's Congress on the legislative deliberation; quoted in Cao Siyuan, "The Storm over Bankruptcy (II)", Chinese Law & Government, March–April 1998, at 83.

[28] Cai Siyuan, *Pochan Fengyuan* (The Storm over Bankruptcy), (Beijing, Central Compilation and Translation Publishing House, 1996), at 288–291.

[29] Art 7 of the Constitutional Amendment dated March 29, 1993.

[30] Li Shuguang, "Bankruptcy Law in China: Lessons of the Past Twelve Years" (English translation), Harvard Asia Quarterly, Winter (2001), available at http://www.fas.harvard.edu/-asiactr/haq/200101/0101a006.htm.

of workers' claims by using proceeds of the SOEs' rights in land if the bankrupt's assets proved insufficient to meet these claims.[31] In 1997, the government pushed the policy further to mandate that proceeds from rights in land were to be used first for settling workers claims, even if the land right was subject to security interests.[32] Despite criticism regarding the arbitrary change of the distribution priority in bankruptcy in violation of the SOE Bankruptcy Law, the central government has insisted on the practice over the past decade.[33] Second, the state adopted and vigorously promoted a policy "to prefer mergers and acquisitions rather than bankruptcy," that was, to avoid SOE bankruptcy by encouraging healthy SOEs to take over ailing ones.[34]

Third, the central government allocated funds to help the state-owned banks write off their unrecoverable loans. This policy measure has effectively brought SOE bankruptcy under the control of the central government. Without the central government's support and approval, the SOE bankruptcy could not be carried out unless the local governments were able to deal with the bad debts and settle the claims with their own means.[35] Fourth, the Central Government instigated annual SOE bankruptcy planning with the participation of state ministries and provincial governments. On the national level, various state organs, including the SPC and Legislative Affairs Committee under the Standing Committee of the National People's Congress, established a coordinating group in charge of the implementation of the national plan.[36]

The policy bankruptcy scheme was accepted and practiced by the People's Courts since 1994. The SPC clearly instructed the lower courts (via a judicial circular) to apply the state policy in SOE bankruptcy proceedings.[37] In practice, the government policy and the circular have been closely followed by the local People's Courts.

China's bankruptcy regime also faced challenges on other fronts in the rapid development of its market economy. Since the late 1980s, cross-border insolvency has raised concerns for both mainland China and its main trading partners, including Hong Kong, Italy, and Japan.[38] In addition, bankruptcy of financial institutions is not covered by the SOE Bankruptcy Law and has troubled the People's Courts and government regulators. For instance, the Hainan Development Bank failed in the Asian financial crisis in 1998. However, at the time of this writing (2013) its liquidation has not been completed due to the lack of clear rules applicable to financial institutions.[39]

A brief review of legislative and practice developments since the institution of market-oriented economic reform in China makes clear that despite China's historical

[31] Arts 1and 2 of The Notice of the State Council on Certain Issues to Implement Pilot Scheme of State Owned Enterprise Bankruptcy dated October 25, 1994 ("1994 Notice").

[32] Art 5 of the Supplementary Notice on Issues Concerning the Pilot Scheme in Certain Cities to Implement Mergers and Acquisitions and Resettlement of Workers of State Owned Enterprises by the State Council dated March 2, 1997 ("1997 Notice").

[33] Art 32 of the SOE Bankruptcy Law explicitly provides for the priority of secured creditors in bankruptcy distribution.

[34] Art 9 of the 1997 Notice.

[35] Art 6 of the 1994 Notice and Art. 6 of the 1997 Notice.

[36] Art 1 of the 1997 Notice.

[37] The Notice on Several Issues That the People's Courts Should Pay Their Attention to in Enterprise Bankruptcy Trials dated March 6, 1997, particularly Art. 12.

[38] Jingxia Shi, "Chinese Cross-Border Insolvency: Current Issues and Future Developments", 10 International Insolvency Review (2001), at 33–57.

[39] See the report, "Hainan Development Bank: The Fist Bank Bankruptcy Case in China", Shanxi Financial Website, 26 June 2013, available at http://www.sxjr.cn/plus/view.php?aid=68824 (in Chinese).

breakthrough in introducing a bankruptcy regime, the legislation has become outdated in the course of rapid market development. Additionally, the underdeveloped legal infrastructure has required reliance on government policy and judicial measures. As such, development of bankruptcy law and practice has been challenged by political ideology, administrative intervention, and the defective condition of market institutions.[40]

In 1994, a drafting group was formed to modernize the bankruptcy law through new legislation. The drafters experienced complications and policy debates due to lack of sufficient support of market mechanisms and the legal infrastructure, but steady progress was eventually made through extensive studies and drawing upon the experiences of developed jurisdictions.[41] Judicial interpretations from the SPC and domestic research outputs in the past decade have been well incorporated into the new law. Meanwhile, the World Bank, the Asia Development Bank, the German Federal Ministry of Economic Cooperation and Development, and the American Bar Association as well as many other foreign experts have also provided valuable technical aid and professional advice.[42] The new Bankruptcy Law has therefore developed based on both the experiences of other developed jurisdictions and the internal experience and research in China's own market development.

III. ENTERPRISES BANKRUPTCY LAW OF 2006

The long-awaited Enterprise Bankruptcy Law (EBL) of the People's Republic China (PRC) was adopted by the Standing Committee of the National People's Congress on August 27, 2006[43] and came into force on June 1, 2007.[44] 14.003

The new Enterprise Bankruptcy Law has completely reformed and unified the previous bankruptcy enactments. As a result, the EBL now governs all enterprises with legal person status and supersedes previous bankruptcy laws.[45] Thus, the playing field has been leveled to some extent. The EBL is organized into 136 articles in twelve chapters – a marked increase from the 43 articles under the original SOE Bankruptcy Law. Of particular importance, the new law introduced five key areas of bankruptcy reform: a uniform insolvency test, a new mechanism of bankruptcy administration, a new reorganization system, enhanced employee protection, and cross-border insolvency provisions. After the adoption of the EBL both the Civil Procedure Law and the Company Law were amended where the separate rules applicable to different types of enterprises were deleted. The Ministry of Commerce issued its Guiding Opinions on Well Handling Dissolution and Liquidation of Foreign Investment Enterprises in

[40] For some analysis in this regard, see Harmer, *supra note* 4, at 2576–2589; Neal Stevens, "Confronting the Crisis of Insolvency in China's State-Owned Enterprises: Can the Proposed Bankruptcy Law Erase the Red Ink?", 16 Wisconsin International Law Journal (1998), at 551–572; Carsten A. Holz, "Economic Reform and State Sector Bankruptcy in China", The China Quarterly, 2001, at 342–367.

[41] For a recent comment on the developments in this period, see Roman Tomasic and Margaret Wang, "Reforming China's Corporate Bankruptcy Laws", 18 Australian Journal of Corporate Law (2005), at 220–232; and Chua Eu Jin, "The Reform of PRC Corporate Bankruptcy Law: Slowly but Surely", China Law & Practice, Oct. 2002, at 19–23.

[42] Most of these contributions are reflected in Zhu Shaoping and Ge Yi (ed.), *The Bankruptcy Law of the People's Republic of China: Materials of the Drafting Process 2000*, (Beijing: CITIC Publishing House, 2004, bilingual).

[43] An English translation of the EBL can be found in China Law & Practice, Oct. 2006, at 39–90.

[44] Art 136 of the EBL.

[45] Art 136 of the EBL.

Accordance with the Law dated 5 May 2008 to replace the 1996 Measures, which subject the foreign related liquidation to the provisions of the Company Law and the EBL.[46] These enactments have generally been well received by commentators for its innovative measures to reform and modernize China's bankruptcy law regime.[47]

IV. JUDICIAL INTERPRETATIONS AND CIRCULARS

14.004 In order to implement the EBL and deal with new issues in the course of bankruptcy practice the SPC has promulgated several judicial interpretations and circulars to provide the lower courts with policy guidance and further detailed rules. These judicial authorities include:

- Provisions on Certain Issues Concerning Application of the PRC Enterprises Bankruptcy Law (1) dated 9 September 2011 ("EBL Provisions (1)");
- Provisions on Certain Issues Concerning Application of the PRC Enterprises Bankruptcy Law (2) dated 5 September 2013 (EBL Provisions (2));
- Provisions on Appointment of Administrators in Bankruptcy Trials dated 12 April 2007; and
- Provisions on Determination of Administrator Remunerations in Bankruptcy Trials dated 12 April 2007

V. A UNIFORM INSOLVENCY TEST

14.005 The new law provides a uniform standardized test for bankruptcy in Article 2. It stipulates that an enterprise may enter into liquidation if its assets are insufficient or incapable of satisfying its debts. An enterprise in this condition or apparently lacking of ability of repayment may be reorganized in accordance with the law. Thus, the SOE Bankruptcy Law's ideological hurdle of proving "serious loss caused by mismanagement"[48] has been removed and both state-owned and non-state-owned enterprises are subject to the same insolvency test.

The SPC, however, in its EBL Provisions (1) further elaborates the test to mean either the condition where the debtor's assets prove by its balance sheet, auditing reports or other appraisal reports insufficient to repay all the debts,[49] or the situations where the debtor apparently lacks of ability to repay all the debts. According to the SPC, a debtor may be deemed lacking of ability of repayment where its assets is seriously insufficient or cannot be liquidated for repayment, the whereabouts of the debtor's legal representative is unknown and nobody is in charge for repayment, the judicial execution cannot be made due to lack of assets, inability to repay debts as a result of loss suffering for a long time, or other situations leading to inability of repayment.[50] As such, the interpretation obviously allows the People's Court to have more discretion in dealing with bankruptcy cases with both objective and subjective determinations.

46 James M. Zimmerman, *China Law Deskbook: A Legal Guide for Foreign-Investment Enterprises*, vol 1 (3rd. ed.), American Bar Association, 2010, at 935–950.

47 See, e.g., Wang Pei, "Bankruptcy Legislation Passed", China International Business, Nov. 2006, at 26; Deryck A. Palmer and John J. Rapisadi, *The PRC Enterprise Bankruptcy Law: The People's Work in Progress*, (Beard Books, 2009); and Eu Jin, "China's New Bankruptcy Law: A Legislative Innovation", China Law & Practice, Oct. 2006, at 17–20.

48 Art 3, SOE Bankruptcy Law.

49 Arts 1 and 3, SPC EBL Provisions (1).

VI. PETITION AND ACCEPTANCE

14.006 Both the debtor and creditors may file petition to the People's Court at the debtor's domicile to start the bankruptcy or reorganization proceedings.[51] The petition needs to be supported by relevant evidence to prove the condition of inability to repay the debts due.[52] The People's Court shall make its decision on whether to accept the petition within 10–15 days, depending on the debtor's agreement to start the proceedings.[53] A party may appeal the court's decision to refuse to accept its petition within 10 days to the upper level court.[54]

Once a petition is accepted by the People's Court, a notice will be given to the parties concerned and the public with the basic information of the proceeding and instructions on claim registration.[55] At the same time judicial acceptance of the case will subject the management of the debtor to the legal duties up to the end of the proceeding of duly safekeeping property, account books, stamps and documents, cooperating with the court and the administrator, truthfully responding to inquiries, attending creditors' meeting and truthfully answer questions, not leaving their domicile without permission of the court and not taking any senior management position in other enterprises.[56]

VII. BANKRUPTCY ADMINISTRATION

14.007 The EBL mandates the People's Court to appoint an administrator at the time of its acceptance of the case.[57] The administrator may be selected from professional firms or the liquidation group established by the government departments in consultation with market intermediary institutions on special knowledge and professional qualification of the candidates. The law prohibits certain individuals from becoming administrators, including those with a criminal history, those who have lost professional qualifications,

50 Arts 1 and 4, SPC EBL Provisions (1).

51 Arts 3 and 7 EBL.

52 Art 8, EBL and Arts 6 and 7, SPC EBL Provisions (1).

53 Art 10, EBL.

54 Art 12, EBL.

55 Art 14, EBL.

56 Art 15, EBL.

57 Art 13, EBL.