A Comparative Study of the Corporate Bankruptcy Reorganization Law of the U.S. and China
A COMPARATIVE STUDY OF THE CORPORATE
BANKRUPTCY REORGANIZATION LAW
OF THE U.S. AND CHINA

Proefschrift

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Table of Contents

1 Introduction ............................................................................................................. 1

1.1 Why Bankruptcy Reorganization Law Exists ......................................................... 1

1.2 The Subject and Structure of the Book ................................................................. 2

1.2.1 The Subject of the Book ............................................................................. 2

1.2.2 The Structure of the Book ........................................................................ 4

1.3 Overview of the Development History of US and Chinese Bankruptcy Reorganization Law 5

1.3.1 Overview of the Development History of US Law ................................................. 5

1.3.2 Overview of the Development History of Chinese Law ....................................... 8

2 Bankruptcy Jurisprudence theory: Comparison and Choice ........................................ 16

2.1.1 Creditors’ Bargain Theory ........................................................................ 16

2.1.1.1 The Goal of Bankruptcy Law ....................................................................... 17

2.1.1.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors ........................................................ 20

2.1.2 Bankruptcy-policy Theory ........................................................................ 23

2.1.2.1 The Goal of Bankruptcy Law ....................................................................... 23

2.1.2.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors ........................................................ 24

2.1.3 Value-Based Theory ........................................................................... 26

2.1.3.1 Goal of Bankruptcy Law ........................................................................ 26

2.1.3.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors ........................................................ 27

2.1.4 Risk-Sharing Theory ............................................................................. 29

2.1.4.1 Goal of Bankruptcy Law ........................................................................ 29

2.1.4.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors ........................................................ 32

2.1.5 The Team Production Theory of Bankruptcy Reorganization .............................. 33

2.1.5.1 The Goal of Bankruptcy Law ....................................................................... 34

2.1.5.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors ........................................................ 35

2.1.6 Comparison and Choice ........................................................................... 36

2.1.6.1 The Decisive Role of the Economic Value among All the Values of a Corporation 37

2.1.6.2 The Problem in Taking the Protection of Non-investors as One Goal of Bankruptcy Law .................................................................................................................. 38

2.1.6.3 The Creditors’ Bargain Theory and the Wealth Redistribution Rules in the Real Bankruptcy Law ........................................................................................................ 41

2.1.6.4 Conclusion .......................................................................................... 44

3 The Plan-drafting System .................................................................................. 45

3.1 The Plan-drafting System under US Law .............................................................. 45

3.1.1 Statutory provision on the exclusivity period under U.S. law .............................. 45

3.1.2 Analysis of the exclusivity period under US law ............................................ 46

3.1.2.1 The Efficient Elements of the Exclusivity Period ........................................ 47
3.1.2.2 The Inefficient Elements of the Exclusivity Period ..............................................49
3.1.3 Measures for mitigating the inefficient elements of the exclusivity period ..........53
  3.1.3.1 The committee device ........................................................................ .................53
  3.1.3.2 Judicial Supervision over the length of the exclusivity period .................57
  3.1.3.3 The trustee device ............................................................................ .....................58
3.1.4 General comments on the US plan-drafting system ..............................................60

3.2 The Plan-drafting System under Chinese Law........................................................ ...............62
  3.2.1 Statutory provision on the exclusivity period under Chinese law ...............62
    3.2.1.1 The administrator as the sole plan proponent ....................................................62
    3.2.1.2 The DIP as the sole plan proponent ............................................................ ..........66
    3.2.1.3 The length of the exclusivity period .......................................................... ............67
  3.2.2 Analysis of the exclusivity period under Chinese Law .................................................67
    3.2.2.1 The control model of the plan-drafting process under the EBL ............67
    3.2.2.2 The efficient and inefficient elements of the exclusivity period under Chinese law 70
  3.2.3 Measures for mitigating the inefficient elements of the exclusivity period.........73
    3.2.3.1 The committee device .......................................................................... .................74
    3.2.3.2 Judicial supervision over the length of the exclusivity period ....................80
    3.2.3.3 The administrator’s control over the DIP ..................................................... ......80
  3.2.4 General comments on the Chinese Plan-drafting system ..............................................83
  3.2.5 Weighing the exclusivity period’s contribution against damage to the collective procedure and some reform suggestions for the exclusivity period......................83
    3.2.5.1 Whether the exclusivity period is necessary for the collective procedure 83
    3.2.5.2 Examining the exclusivity period’s contribution to the early filing of reorganization petition .......................................................................................... 84
    3.2.5.3 Examining the exclusivity period’s contribution to the expedition of the reorganization decision-making process .........................................................88
    3.2.5.4 Examining the conventional opinions concerning plan-competition ............90
    3.2.5.5 Conclusion .................................................................................... ........................93
  3.2.6 Reform suggestions for the Chinese plan-drafting system ............................................94
    3.2.6.1 Reform suggestions for the DIP system ......................................................... .......94
    3.2.6.2 Reform suggestions for the committee device ................................................... ...95
    3.2.6.3 Reform suggestions for the administrator’s control over the DIP ..........96
    3.2.6.4 Reform suggestions for the administrator system .................................................97

4 The plan-passing system ............................................................................. ................................102
  4.1 The plan-passing system under US law .......................................................... 102
    4.1.1 The classified voting system under US law .................................................... 102
      4.1.1.1 Overview of the classified voting ............................................................... 102
      4.1.1.2 The efficient elements of classification .....................................................104
      4.1.1.3 The inefficient elements of classification ...................................................106
      4.1.1.4 The efficient and inefficient elements of the supermajority rule .......108
    4.1.2 The confirmation system under the US law ............................................... 112
      4.1.2.1 Overview of the confirmation system ................................................................... 112
      4.1.2.2 The efficient and inefficient elements of the confirmation system ..........117
4.1.2.3 The efficient elements of cram down ........................................................... 119
4.1.2.4 The inefficient elements of cram down ......................................................... 122
4.1.2.5 The efficient elements of the absolute priority rule ............................................. 129
4.1.2.6 The inefficient elements of the absolute priority rule ......................................... 132

4.2 The plan-passing system under Chinese law ........................................................ 132
4.2.1 The Classified voting system under Chinese law ................................................ 132
4.2.1.1 Overview of the classified voting system ...................................................... 132
4.2.1.2 The efficient elements of the classified voting system ........................................ 133
4.2.1.3 The inefficient elements of the classified voting system ..................................... 134
4.2.2 The confirmation system under Chinese law ....................................................... 137
4.2.2.1 Overview of the confirmation system ........................................................... 137
4.2.2.2 The efficient elements of the confirmation system ............................................. 139
4.2.2.3 The inefficient elements of the confirmation system .......................................... 139
4.2.2.4 Reform Suggestions for the Chinese Plan-passing System ................................. 147
4.2.2.5 Reform suggestion for the classified voting system ............................................ 148
4.2.2.6 Reform Suggestions for the Confirmation system .............................................. 151

5 The reorganization-fostering system: automatic stay and post-petition financing ......... 154
5.1 The automatic stay system in the US and China ..................................................... 154
5.1.1 The US Automatic Stay System ....................................................................... 154
5.1.1.1 Overview of the US Automatic Stay System ...................................................... 154
5.1.1.2 Protection of the Secured Creditors’ Interest during the Pendency of the
Automatic Stay ............................................................................................................... 156
5.1.1.3 The Delay Compensation to Unsecured Creditors of Solvent Debtors .......... 161
5.1.1.4 The Efficient Elements of the US Automatic Stay System ................................. 164
5.1.1.5 The Inefficient Elements of the US Automatic Stay System ......................... 165
5.1.2 The Chinese Automatic Stay System ............................................................... 166
5.1.2.1 Overview of the Chinese Automatic Stay System .............................................. 166
5.1.2.2 Efficient Elements of the Chinese Automatic Stay System ............................. 167
5.1.2.3 Inefficient Elements of the Chinese Automatic Stay System ........................ 167
5.1.3 Reform Suggestions for the Chinese Automatic Stay System............................. 170
5.1.3.1 Providing Adequate Protection of the Secured Creditors’ Interest ..................... 170
5.1.3.2 Providing Time-value Compensation to Unsecured Creditors of Solvent Debtors 173
5.1.3.3 The Practical Method of Determining the Proper Interest Rate ......................... 174

5.2 The Post-Petition Financing system in the U.S. and China ......................................... 176
5.2.1 The US Post-Petition Financing System .......................................................... 176
5.2.1.1 Overview of the US Post-Petition Financing System ........................................ 176
5.2.1.2 The Efficient Elements of the US Post-petition Financing System ................. 177
5.2.1.3 The Inefficient Elements of the US Post-petition Financing System ............... 178
5.2.2 The Chinese Post-petition Financing System .................................................... 181
5.2.2.1 Overview of the Chinese Post-petition Financing System ............................... 181
5.2.2.2 The Efficient and inefficient elements of the Chinese Post-petition Financing System 182
5.2.3 Reform suggestions for the Chinese Post-Petition Financing System .................. 182
6 Overall Comparison of US and Chinese bankruptcy reorganization law and practice, Conclusion

6.1 Overview of the US and Chinese bankruptcy reorganization Law

6.2 Overview of the US and Chinese Bankruptcy Reorganization Practice

6.2.1 The Control Model in US and Chinese Bankruptcy Reorganization Practice

6.2.1.1 The Control Model in US Bankruptcy Reorganization Practice

6.2.1.2 The Control Model in the Chinese Bankruptcy Reorganization Practice

6.2.2 The Time Length to a Confirmed Plan, Confirmation Rate, Consummation Rate in US and Chinese Reorganization Practice

6.2.2.1 The Time Length to a Confirmed Plan, Confirmation Rate, Consummation Rate in US and Chinese Reorganization Practice

6.2.2.2 Exploring the factors contributing to the prominent features of Chinese reorganization practice

6.3 Conclusion

Appendix A: Study on the liquidation panel’s role in the Bankruptcy Reorganization of Listed Corporations

Appendix B: Study on the wealth distribution in the bankruptcy reorganization of 18 listed corporations

Appendix C: Statement of the Rehabilitation in the Plan of 18 Listed Corporations

Appendix D: Study on the Time used for reaching a confirmed plan and the time Used for Consummating the Confirmed Plan in the 18 listed corporations

Summary of the Book in Dutch (Nederlandse samenvatting)
1 Introduction

1.1 Why Bankruptcy Reorganization Law Exists

Bankruptcy reorganization law establishes a legal procedure in which all the interested parties are bound to make efforts towards collective rehabilitation and to produce a reorganization plan setting out how the debtor’s assets should be dealt with. Whether or not the provisions of the bankruptcy reorganization law of a specific country are good depends on whether the provisions will bind the participating parties, such as the debtor, the creditors, the shareholders, the committees, the bankruptcy trustee, and the court, to produce a desirable plan. Whether the plan emerging at the end of the bankruptcy reorganization procedure is desirable depends on whether the implementation of the plan will realize the goal of the bankruptcy. Therefore, before examining the merits and defects of the bankruptcy reorganization provisions under the law of a specific country, we need to understand why bankruptcy reorganization law exists, i.e. what function does bankruptcy reorganization serve or what is the goal of bankruptcy reorganization law.¹ The jurisprudence theories of bankruptcy law have proposed different answers to the question of why bankruptcy reorganization law exists. Generally, these theories may be divided into two groups: the group emphasizing the debtor’s economic value that sees bankruptcy as the procedure for maximizing the debtor’s economic value or creditors’ economic recovery and the group emphasizing the debtor’s diversified values that sees bankruptcy as the procedure for addressing the vast range of social problems caused by business failure.² In other words, the former argues that the goal of bankruptcy reorganization law is to enhance the debtor’s economic value,³ while the latter group believes the goal is to provide ideal protection to the parties affected or the values held by the affected parties.⁴ After comparing the representative

bankruptcy theories,\textsuperscript{5} the author adopts the creditors’ bargain theory in this book as the theoretical device for analyzing the efficient and inefficient elements of the bankruptcy reorganization law of the chosen countries.

1.2 The Subject and Structure of the Book

1.2.1 The Subject of the Book

This book makes a comparative study of the bankruptcy reorganization law of the US and China with the aim of establishing an efficient legal system for bankruptcy reorganization in China. The research question is: judged against the standard proposed by the creditors’ bargain theory and compared with US law, what are the efficient and inefficient elements of Chinese bankruptcy reorganization law and how can this law be improved? The term “efficiency” in this book refers to both the efficient and inefficient elements of a bankruptcy provision or subsystem. The term “inefficient” means the costs of implementing a provision or subsystem or the negative effects caused by a provision or subsystem that obstruct the realization of the ultimate goal of bankruptcy reorganization law, which, according to the creditors’ bargain theory, is the maximization of the debtor’s overall value. Correspondingly, “efficient” means the cost-saving effect or positive effects caused by a provision or subsystem, which fosters the realization of the ultimate goal of bankruptcy reorganization law. The costs and effects of a bankruptcy provision or subsystem include both ex ante costs and effects, such as the strategic behaviors caused by the bankruptcy legal provisions before the bankruptcy procedure is initiated, and ex post costs and effects, i.e. costs and effects caused by the bankruptcy legal provisions after the bankruptcy procedure is initiated.

The comparative law approach is used to answer to the research question. Chinese law is compared with US law in order to obtain a clearer picture of the efficient and inefficient elements of Chinese bankruptcy reorganization law.\textsuperscript{6} The main reason for choosing to

\textsuperscript{5} The analysis and comparison of the representing theories of the two groups is made in Chapter II of this book.

\textsuperscript{6} Comparative research provides an important method for acquiring useful knowledge. See Zweigert & Kötz (1998), p. 15. K. Zweigert & H. Kötz, translated by Tony Weir, An Introduction to Comparative Law (third Edition), Clarendon Press, Oxford, (1998), p. 15. “The basic methodological principle of all comparative law is that of functionality. From this basic principle stem all the other rules which determine the choice of laws to compare, the scope of the undertaking, the creation of a system of
compare US law with Chinese law is that US bankruptcy reorganization law has evolved over more than one hundred years and has been quite influential in the international trend of establishing corporate rescue law. Moreover, because Chinese bankruptcy reorganization law is quite similar to US law, the merits and defects of US law may provide useful insights for examining Chinese law.

Bankruptcy reorganization law touches upon a lot of interesting issues. In order to make a clear analysis, this book studies bankruptcy reorganization law from the perspective of the efficiency of the reorganization decision-making mechanism. Bankruptcy reorganization law is a set of legal provisions that binds the participating parties to produce a reorganization plan on how to deal with the debtor’s assets. The reorganization plan is essentially a set of decisions on how to deploy the debtor’s assets in the most efficient way and how to distribute the debtor’s value to all the interested parties. Whether the detailed provisions or systems of the bankruptcy reorganization law of a specific country are good or not depends on whether these provisions or systems establish an efficient decision-making mechanism that drives the participating parties to produce a desirable or efficient plan, the implementation of which will realize the goal of bankruptcy reorganization law. Therefore, the decision-making mechanism

comparative law, and so on. Incomparables cannot usefully be compared, and in law the only things which are comparable are those which fulfill the same function.” Id, p. 34.

7 For example, Germany amended its bankruptcy law and the new bankruptcy code (“Insolvenzordnung”) took effective from 1 January, 1999. One of the reform purposes is to eliminate the tendency of the former law to liquidate the debtor and introduce a rehabilitation procedure. The US law is a particularly influential model. “The reform process included an extensive study of existing bankruptcy regimes; in particular, the US Bankruptcy Code used as a model.” Bianca Schwehr (2003), Corporate Rehabilitation Proceedings in the United States and Germany, 12 Int. Insolv. Rev. 11, pp. 14-6. The UK introduced a major reform to its bankruptcy law, which took effective on January 1 and September 15 of 2003. One of the main aims of the reform was to emulate the spirit of enterprise and introduce the rescue culture that has been deemed as the characteristic of the US bankruptcy law. Ian F. Fletcher (2004), UK Corporate Rescue: Recent Developments - Changes to Administrative Receivership, Administration, and Company Voluntary Arrangements - The Insolvency Act 2000, The White Paper 2001, and the Enterprise Act 2002, 5 European Business Organization Law Review 119.

8 The main structure or the major systems of Chinese bankruptcy reorganization law is quite similar to that of the US. For instance, both laws include the debtor-in-possession system, the exclusivity period for the debtor-in-possession to file a plan, the classified voting system, the plan-confirmation system. Please refer to Chapter III, IV and V of this book for detailed analysis of these designs. See Rakhi I. Patel (2009), A Practical Evaluation of the People’s Republic of China’s 2007 Enterprise Bankruptcy Law, 10 U. C. Davis Bus. L. J. 109, p. 109 (commenting the new Chinese bankruptcy law is similar to Chapter 11 of the US). Hon. Samuel L. Bufford (2007), The New Chinese Bankruptcy Law Text and Limited Comparative Analysis, 16 J. Bank. L. & Prac. 5 Art. 3, (“Many of the features of the reorganization provisions are similar to provisions in Chapter 11 of the U.S. Bankruptcy Code, and are obviously from U.S. law”).
provides a useful perspective for examining the merits and defects of the detailed provisions and systems of the bankruptcy reorganization law.

From the perspective of the decision-making mechanism, the legal system for bankruptcy reorganization may be roughly divided into three major components: the plan-drafting system, the plan-passing system and the reorganization-fostering system. The plan-drafting system focuses on who may formulate a plan, how the other interested parties participate in the plan formulation and supervise the plan-proponent etc. The plan-passing system deals with how the draft plan is examined by the interested parties and the court through voting and confirmation and how it ultimately either becomes effective or fails. During the plan-drafting and –passing process, the interested parties are actually making collective rehabilitation efforts and trying to make an efficient decision on how to deal with the debtor’s assets. Some reorganization-supporting systems, such as the automatic stay and post-petition financing system, are necessary in order to provide basic preconditions and support for the collective reorganization efforts. Without these systems, it would be impossible to make the collective reorganization efforts. Therefore, in addition to the plan-drafting and –passing system, the reorganization-supporting system is another important component of the reorganization law.

To summarize, this book compares the bankruptcy reorganization law of the US and China from the perspective of the reorganization decision-making mechanism. The constituent systems or sub-systems being compared are the plan-drafting system, plan-passing system and the reorganization-supporting system.

1.2.2 The Structure of the Book

The book contains five chapters. Chapter 1 introduces the subject and structure of the book and provides a brief overview of the development history of bankruptcy reorganization law in the U.S. and China. Chapter 2 discusses and compares the representative jurisprudence theory of bankruptcy law and further analyses the reason why this book chooses the creditors’ bargain theory as the standard theory for examining the efficient and inefficient elements of the detailed provisions and subsystems of bankruptcy reorganization law in the U.S. and China; Chapter 3 compares the plan-drafting system of US and Chinese law, analyzes the
efficient and inefficient elements and provides reform suggestions for the Chinese system; Chapter 4 compares the plan-passing system of US and Chinese law, analyzes the efficient and inefficient elements and provides reform suggestions for the Chinese system; Chapter 5 compares the reorganization-supported system of US and Chinese law, analyzes the efficient and inefficient elements and provides reform suggestions for the Chinese system; Chapter 6 gives a summary of the comparison of the US and the Chinese law in Chapters 2, 3 and 4 of this book, conducts an overall comparison of the US and Chinese practice and draws a final conclusion.

1.3 Overview of the Development History of US and Chinese Bankruptcy Reorganization Law

Before going into a detailed analysis and comparison of the current bankruptcy reorganization law in the US and China, we need to obtain an overview of the development history of bankruptcy reorganization law in both countries, which is necessary for us to get a clear understanding of the current law in both countries.

1.3.1 Overview of the Development History of US Law

(1) The Equity Receivership

US bankruptcy reorganization law originated from the equity receivership of railroads that began from the late nineteenth century.\(^9\) When the railroads were trapped in financial distress there were no bankruptcy reorganization provisions in bankruptcy law and the parties were left to their own devices. What they discovered as the legal mechanism to reorganize the railroad enterprise was the equity receivership.\(^10\) “One of the powers of a judge sitting in equity is the ability to appoint a person (called a receiver) to administer assets over which there is dispute. A creditor, for example, could petition the court to appoint a receiver to gain control over the assets of its debtor and sell them. This device was reshaped to accommodate


the nineteenth-century railroads that had obligations so inconsistent with their earnings that they needed a new capital structure. The insiders who ran the railroad, typically also owners of a substantial part of the stock, would find a friendly creditor and have that creditor petition the court to place the assets in the hands of a receiver, usually the same person then managing the railroad.”  

The market parties creatively used equity receivership as the legal device available at that time to maximize the value of investment. During the equity receivership, the creditors formed a “protective committee” to represent their interests. The various protective committees of different groups of creditors further formed the reorganization committee. The reorganization committee focused on negotiating and producing a plan, which provides a new capital structure for the debtor with appropriate adjustment to the investors’ interests. The typical plan respected the investors’ pre-bankruptcy priorities. Once the reorganization committee finished drafting a plan, they had actually determined the price that they would bid (the value of the debtor) and the distribution of the value among all the claimholders. At the end of the equity receivership there was a court-supervised sale. When the court conducted the judicial sale and solicited competing bids, the reorganization committee was certain to be the top bidder, because it did not have to collect cash and was able to “credit bid”. Since the proceeds of any sale had to go to the most senior creditors, the committee could bid the amount of their claims. The only constraint upon the committee’s ability to credit bid came from its obligation to pay cash to the few senior creditors who refused to participate in the reorganization. It was commonly noticed that in the equity receivership, advisors to debtors, i.e. the investment bankers and lawyers, the debtor’s managers and creditors’ committees dominated the process.

(2) Codification of Railroad Reorganization and Corporation Reorganization in 1933 and 1934

13 Id.
The railroad reorganization was codified and added to the Bankruptcy Act of 1898\textsuperscript{16} in 1933, bringing an end to the railroad equity receivership.\textsuperscript{17} Soon after the codification of railroad reorganization, corporate reorganization was codified and added to the Bankruptcy Act of 1898 in 1934,\textsuperscript{18} which preserved the main feature of the practice in the equity receivership and allowed the investment bankers and lawyers to play a controlling role in the reorganization decision-making.\textsuperscript{19}

(3) Reform of Corporate Bankruptcy Reorganization in 1938

The corporate reorganization model that evolved from the equity receivership era was suspected of being a device used by corporate insiders, investment bankers and lawyers for enriching their self-interest at the expense of the interests of public investors.\textsuperscript{20} Corporate reorganization law changed dramatically because of the New Deal Reform efforts. The most prominent change of corporate reorganization law was the new Chapter X of the 1898 Bankruptcy Act added by the Chandler Act of 1938,\textsuperscript{21} which was to regulate the reorganization of large public corporations and protect the public investors who were usually senior bondholders.\textsuperscript{22} Chapter X required the mandatory appointment of a trustee to replace the existing managers, a judicial valuation hearing for the purpose of determining the debtor’s reorganization value, the Securities Exchange Committee (“SEC”)’s advisory report on the draft plan which was to provide the creditors and shareholders with the SEC’s evaluation of the plan, and a distribution of the debtor’s value according to the absolute priority rule etc.\textsuperscript{23}


\textsuperscript{18} Act of June 7, 1934, ch. 424, § 1, 48 Stat. 911 (codified as amended at 11 U.S.C. § 207 (1934) (repealed 1938)).


\textsuperscript{23} House Report, pp. 6184-5.
In addition to Chapter X, the Chandler Act also included a second reorganization chapter, Chapter XI. While Chapter X was designed for public corporations, Chapter XI was designed for small firms. In contrast to Chapter X’s management replacement and pervasive government oversight, Chapter XI left the management in control and did not provide for SEC intervention. Chapter XI was to provide a quick procedure for an arrangement of a business’ unsecured debts. Because Chapter XI did not permit the adjustment of a secured debt or of equity, it was not a completely effective remedy for a business undergoing financial difficulty. However, Chapter XI turned out to be the much more popular procedure, even though what can be done under Chapter XI was less than that under Chapter X.

(4) Reform of Corporate bankruptcy Reorganization in 1978

In 1978, the US Congress fundamentally reformed the corporate reorganization law, justifying this by claiming that any justification that existed in 1938 for two reorganization chapters had disappeared; Chapter X had become an unworkable procedure, while Chapter XI was unable to fill the void; Chapter X needed to be more flexible while Chapter XI needed to be expanded to permit adjustment of secured debt and equity. The Bankruptcy Reform Act of 1978 (“the 1978 Code” or “the current US bankruptcy code” or “the US Code”) contained one unified corporate reorganization procedure, which was considered to be the product of adopting much of the flexibility of Chapter XI and the essence of public protection of Chapter X. Chapter 11 of the 1978 Code, which provides a unified procedure for corporate bankruptcy reorganization, is the current US bankruptcy reorganization law that is compared with the Chinese bankruptcy reorganization law in this book.

1.3.2 Overview of the Development History of Chinese Law

(1) The 1986 Law – the Bankruptcy Law for SOEs

Bankruptcy law in China has developed hand in hand with the advancement of the reform of

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China’s economic system. Before 1978, China operated a planned economic system, under which almost all the enterprises were state-owned-enterprises (“SOE”s), owned and operated by the state, i.e. governments at different levels (the central government and local governments) and there were no private enterprises. Because the SOEs operated under the government direction to execute the government’s economic plan, they were financed by the government and their losses were also born by the government. As a result, during that period there was no bankruptcy law in China.\(^{29}\)

In 1978, China began to reform its economic system. One of the reform measures was to transfer power from the government to enterprises, giving the enterprises more managing power and allowing them more autonomy in management and to compete with each other. As SOEs gradually began to compete with each other this resulted in some enterprises going bankrupt and the government had to bear the losses. Against this background, the first bankruptcy law of China—\textit{Enterprise Bankruptcy Law of the People’s Republic of China (for Trial Implementation)} (‘the 1986 Law’) \(^{30}\) was promulgated in 1986. The 1986 Law was a breakthrough in Chinese bankruptcy legislative history in that it created the first set of bankruptcy rules in the history of the People’s Republic of China. The 1986 Law applied only to SOEs. With 43 articles, the 1986 Law was so simple and general that there was a need for detailed provisions on how to apply it. Two judicial interpretations were issued by the Supreme People’s Court in order to enhance the 1986 Law’s applicability, these were \textit{Opinions on Certain Issues in the Implementation of the Law of the People’s Republic of China on Enterprise Bankruptcy (for Trial Implementation)} (“the 1991 Judicial Interpretation”), issued on 17 November, 1991 and \textit{Provisions on Issues concerning the Trial of Enterprise Bankruptcy Cases} (“the 2002 Judicial Interpretation”), issued on July 18, 2002. Containing 106 articles, the 2002 Judicial Interpretation was a comprehensive judicial interpretation of bankruptcy law.

The 1986 law was a bankruptcy law under which the government can liquidate or

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\(^{30}\) Passed on December 2, 1986 at the 18\textsuperscript{th} Session of the Standing Committee of the Sixth People’s Congress and repealed on June 1, 2007 by the current bankruptcy law, i.e. the Enterprise Bankruptcy law of the People’s Republic of China, which was passed on August 27, 2006 at the 23\textsuperscript{rd} Session of the Standing Committee of the Tenth People’s Congress.
reorganize SOEs. Under the 1986 law, the Government Department in Charge,\textsuperscript{31} which controlled the operation of SOEs outside of bankruptcy, played a controlling role in the SOE’s bankruptcy procedure. According to the 1986 law, if a SOE wanted to file a bankruptcy petition, it must first obtain the written approval of the Government Department in Charge, which it should then submit to the court in order to get the court’s acceptance of the bankruptcy case. In the liquidation procedure, the court should appoint personnel from the Government Department in Charge, the financial department of the government and other related departments to constitute a “liquidation panel”, which was charged with the disposition of the debtor’s asset. The liquidation panel might hire some intermediary agencies, such as law firms or accounting firms, to provide professional services.\textsuperscript{32} 

Under the 1986 law the Government Department in Charge was in charge of the reorganization of the indebted enterprise.\textsuperscript{33} After the court had accepted the bankruptcy case, the Government Department in Charge (or the shareholders’ meeting if there was no Government Department in Charge) was the only party with the right to apply for reorganization to the court.\textsuperscript{34} The SOE or its creditors had no right to apply for reorganization. The reorganization procedure was initiated on the reorganization application being made by the Government Department in Charge; there was no judicial screening of the initiation of the reorganization procedure. The Government Department in Charge was responsible for preparing a reorganization scheme. During such preparations the Government Department in Charge was required to present the reorganization scheme to the workers’ representatives’ meeting for discussion and to listen to their opinions.\textsuperscript{35} Based on the reorganization scheme, the SOE would then propose a reconciliation agreement, which had to be voted on by creditors at the creditors’ meeting. The reconciliation agreement should provide the time period, the method and the source of the funds for paying the debts.\textsuperscript{36} A reconciliation agreement was deemed to be approved by the creditors’ meeting if it was

\textsuperscript{31} The Government Department in Charge is the specific department of the government that controls the management of the SOE. Normally a SOE is controlled by the department that administers the specific kind of trade or business that the SOE belongs to. For example, a coal SOE is controlled by the coal department of the government.

\textsuperscript{32} Art. 24 of the 1986 law. Art. 47, 48, 49, 50 of the 2002 Judicial Interpretation.

\textsuperscript{33} Art. 20 of the 1986 law.

\textsuperscript{34} Art. 17 of the 1986 law. Art. 28 of the 2002 Judicial Interpretation.

\textsuperscript{35} Art. 18 of the 1986 law.

\textsuperscript{36} Art. 18 of the 1986 law. Art. 33, 34 of the 1991 Judicial Interpretation.
approved by more than one-half of the creditors present at the meeting and more than two thirds of the total unsecured credit amount. After being approved by the creditors’ meeting, the reconciliation agreement should be presented to the court for approval. If the court approved the reconciliation agreement, the bankruptcy procedure was suspended. During the implementation process, the Government Department in Charge should provide periodical reports concerning the progress of the reorganization to the creditors meeting and the court. If the reorganization scheme failed to be successfully implemented and the debtor remained unable to pay according to the reconciliation agreement, the court would push the debtor into the liquidation procedure and re-register the unpaid debts.

(2) Chapter 19 Procedure—Bankruptcy Law for Non-SOEs

The bankruptcy law for non-state-owned enterprises (“non-SOEs”) was enacted 6 years after the passing of the 1986 law. The Civil Procedure Law of the People’s Republic of China, which was passed in 1992, contained a chapter entitled “Chapter 19: Procedure of Bankruptcy and Debt Repayment of Corporate Legal Persons” (“the Chapter 19 Procedure”). Containing only eight articles, the Chapter 19 Procedure provided very simple and basic rules for liquidation for non-SOEs and did not touch upon reorganization.

To summarize, before the current Chinese enterprise bankruptcy law came into force, the 1986 law and the chapter 19 procedure jointly constituted the basic bankruptcy legal system for all the corporations in China, with the former applying to SOEs and the latter to non-SOEs.

(3) Regulations for the Policy-Based Bankruptcy

In addition to the 1986 law and the Chapter 19 procedure, the policy-based bankruptcy of SOEs should be mentioned to provide a complete picture of the development of Chinese bankruptcy law. Policy-based bankruptcy deals with special problems accompanying the

During the transition from the planned economy to the market economy, the bankruptcy of a SOE is accompanied by many problems, of which the most prominent is the problem of how to help the jobless workers acquire a basic living allowance, basic medical care and reemployment. Under the planned-economy system, unemployment was not a problem for workers of SOEs since they were permanent employees of the government. Moreover, the workers of SOEs relied on the enterprise for which they worked for social security benefits. For instance, they received their pension and reimbursement of their medical care expenses etc. from the enterprise for which they worked. The transition from the planned economy to a market economy calls for the establishment of a uniform national social security system, which provides insurance for pension, unemployment, medical care etc. While developing the bankruptcy system, China made great efforts to establish a social security system that matches the market economy.44 Despite these efforts, during the transition period the great number of jobless workers that were employed by the bankrupt SOEs is problematic. Problems include how to help these workers find new jobs, how to transfer their old social security benefits to the new system, how to help them pay the unpaid social insurance contributions, how to help them claim the unpaid salaries and how to ensure they have a basic living and receive basic medical care.

33 These provisions for policy-based bankruptcy are still effective at the time the book is finished since there has been no official announcement of the complete termination of all the policy-based bankruptcy cases or official appellation of the policy-based bankruptcy rules.

The main content of the policy-based bankruptcy provisions is intended to deal with the problems posed by these jobless workers. The 1994 Circular provides that the income from selling the land-use right of the insolvent SOE should first be used to solve the unemployed workers’ problems and if it is insufficient, the income from selling other assets should first be used to solve the unemployed workers’ problems. The government will pay a lump-sum settlement fee to workers who agree to find a job by themselves. The pensions and medical care costs of retired workers of bankrupt SOEs should be afforded by the social pension and medical care insurance fund. In cases where the bankrupt enterprise did not participate in the pension and medical care insurance fund or the insurance fund could not provide sufficient funds, the income from selling the land-use right, and if not sufficient, the income from selling the other assets of the insolvent enterprise should first be used to pay for the pensions and medical care costs of retired workers. The 1997 Notice provides that even if the land-use right has been the collateral of security rights, the income from selling the land-use right of the insolvent SOE should first be used to solve the unemployed workers’ problems. Where the income from selling the land-use right is not sufficient, the costs for solving the unemployed workers’ problems should be paid firstly by the income from transferring the unsecured assets; secondly by the income from transferring the secured assets; and thirdly by the government to which the insolvent SOE belongs. The payment method of the part of the pensions and medical care costs for retired workers of the bankrupt SOEs that could not be afforded by the social insurance fund is provided in a similar way. The 2006 Notice provides that the compilation of the policy-based bankruptcy plan should end at the end of the year 2008, which implied that after the end of 2008, no SOE could apply to be included in a new plan and conduct policy-based bankruptcy. However, the plans that had been compiled before December 31, 2008 should continue to be carried out according to the policy-based bankruptcy provisions until they are completely finished. Thus, the policy-based bankruptcy cases of SOEs that had already been included in the official policy-based bankruptcy plan

45 Art. 2; 3 of the 1994 Circular.
46 Art. 5 of the 1994 Circular.
47 Art. 5 of the 1994 Circular.
48 Art. 5 of the 1997 Circular.
49 It should be noted that the 2006 Notice puts an end to the compilation of policy-based bankruptcy plan, but does not put an end to the implementation of the policy-based bankruptcy plans that have been compiled before December 31, 2006. See part (3) of Section 1.3.2.
should continue until they are finished.

What deserves special notice is that according to the policy-based bankruptcy provisions, the fee for solving the unemployed workers’ problems and paying the pensions and medial care expenses for the retired workers of the bankrupt SOEs ranked higher in priority than secured debt, which deviated from the provisions of the 1986 law and that the government should take on the obligation to make up the balance where the total income from the insolvent asset is not enough. In addition to provisions concerning how to solve the unemployed workers’ problems, the policy-based bankruptcy regulations also contain provisions on the merger and acquisition of the bankrupt SOEs, the valuation of the bankruptcy assets and the cancellation of the unpaid credit of banks.

(4) The Establishment of the New Bankruptcy Law

Through the reform of the economic system, China gradually established the market economy and the modern corporate legal system. The SOEs gradually transferred from government-controlled enterprises into market parties which make management decisions through the corporate governance mechanism established according to the law. In order to unify the administration of state-owned assets, State-owned Assets Supervision and Administration Commissions (SASAC) have been established by governments at different levels. The SASAC, as a specific government department, is charged with the duty of managing the state-owned assets on behalf of the government that owns the assets. When the SASAC exercises the shareholders’ right on behalf of the government, it should act according to the law. Meanwhile, more and more privately owned enterprises have been established and many foreign enterprises have successfully entered the Chinese market. These corporations, as equal market competitors, needed a unified bankruptcy law. However, the 1986 law and the Chapter 19 Procedure could not meet the demands of the market economy. The market economy drastically needed a new set of bankruptcy rules. After twelve years of

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50 In 1993, China passed the Corporate Law of the People’s Republic of China.
51 Art. 10 of the Regulations on the Supervision and Management of State-Owned Assets in Corporations, which was issued by the State Council in 2003, provides that the owner of the state-owned assets shall respect the autonomous management right of the corporation and shall exercise its owner’s right according to the relative laws. Art. 46 of this regulation provides that the government and the corporations, in which the government invests, shall be separated.
drafting and discussion, the current Chinese bankruptcy law, Enterprise Bankruptcy Law of the People’s Republic of China (“the EBL”) was passed on August 27, 2006 and took effect on June 1, 2007. With 136 articles, the EBL contains 12 chapters, these being General Rules, Bankruptcy Petition and Acceptance of the Case, Bankruptcy Administrator, Debtor’s Asset, Insolvency Fee and Debts Incurred for Common Benefits, Declaration of Creditors’ Claim, Creditors’ Meeting, Reorganization, Reconciliation, Liquidation, Legal Liability and Supplementary Articles. Chapter 8 of the EBL, entitled “Reorganization”, contains the rules governing the corporate bankruptcy reorganization procedure. In the following chapters of this book, the bankruptcy reorganization provisions of the EBL will be compared with the corporate bankruptcy reorganization provisions of the current US bankruptcy code.

52 Shi Jingxia (2007), Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy, 16 J. Bank. L. &Prac. 5 Art. 2.
53 Passed at the 23rd Session of the Standing Committee of the Tenth People’s Congress.
2 Bankruptcy Jurisprudence theory: Comparison and Choice

Before analyzing the bankruptcy reorganization law of a specific country in detail, we need to clarify the goal or the function of the bankruptcy reorganization law. Different bankruptcy theories have different opinions concerning the goal or function of bankruptcy reorganization law. These theories may be generally divided into two groups. The first group takes the goal of bankruptcy reorganization law as the maximization of the debtor’s economic value, while the second group considers that the goal is to protect the debtor’s diversified values or to provide ideal protection for all the parties affected or the values held by the affected parties. A brief analysis and comparison of the representing theories, i.e. the creditors’ bargain theory, the bankruptcy policy theory, the value-based theory, the risk-sharing theory, and the team production theory of bankruptcy reorganization is made below.

2.1.1 Creditors’ Bargain Theory

Thomas H. Jackson proposed the creditors’ bargain theory in the early 1980s and subsequently, Douglas G. Baird joined him as the main proponent of the creditors’ bargain theory. Ever since its publication, the creditors’ bargain theory has caused heated debate and been the focus of much attention. It became the most influential law and economics theory concerning bankruptcy law.


2.1.1.1 The Goal of Bankruptcy Law

The creditors’ bargain theory aims at providing a normative theory of what bankruptcy law should be, instead of trying to provide a normative justification of the bankruptcy law that already exists in practice. It explains the goal of bankruptcy law or why bankruptcy reorganization law exists, through the perspective of a “hypothetical bargain”. Suppose that the debtor and its creditors were rational and able to bargain among themselves ex ante, they would agree to restrain their individual collection actions and adopt a mandatory and collective bankruptcy procedure. The reasons why the debtor and creditors would choose a mandatory and collective procedure can be summarized as that the collective procedure helps to maximize the debtor’s value and minimize the costs of debt-collection. Detailed analysis is below.

1) Reduction of strategic costs

Absent cooperation among creditors, each creditor would have the incentive to pursue individual collection before the other creditors, thus creating a classic example of “common pool puzzle”. The “race to the courthouse” or the race to individual collection activities not only incurs high costs (such as costs caused by frequent checking of the collection lawsuit against the debtor by other creditors, vigilant monitoring of the debtor’s financial status and payment ability, competing with other creditors in trying to get the necessary information) for individual creditors, but may also lead to a premature termination of a debtor’s business. These strategic costs may be reduced by an ex ante agreement on a compulsory collective bankruptcy procedure.

2) Administrative efficiencies

“Issues such as the precise amount of the debtor’s assets and the nature and extent of secured claims must be solved in virtually every collection procedure.” “A single inquiry into recurring collection questions is likely to be less expensive than the multiple inquiries necessary in an individualistic remedies system,” since a single mandatory and collective

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60 Id. p. 866.
procedure may help to avoid the recurring costs and case management inefficiency under the individual collection system to the common interests of the debtor and all its creditors.  

3) Maximization of the debtor’s overall economic value

In some cases, the debtor’s assets may be worth more if kept together, whether in the form of going-concern liquidation or reorganization, than in the case of a piecemeal liquidation. Under the individual collection system, a creditor will try to be the first to collect payment from the debtor. If the debtor and its creditors could bargain ex ante, they would choose to have a compulsory collective procedure, in which they could act as if they were the one owner of the assets and try to find a way of realizing the highest economic value of the debtor’s assets, which may be piecemeal liquidation, going-concern liquidation or reorganization.

According to the creditors’ bargain theory, bankruptcy reorganization is an equal alternative to liquidation. Market pricing does not always work well. Sometimes a going-concern sale to third parties may result in a price which is lower than the price at which the existing claimholders value the bankruptcy assets. This may be because “there were no or few potential outside buyers with accurate and timely information about the true state of affairs and future prospects of the business or when the process of searching for and educating outside buyers would itself be very expensive.” In this situation, reorganization is needed in order to help the claimholders to realize the highest value from the bankruptcy assets. The principal distinction between reorganization and liquidation is not that the assets are kept together in reorganization, since the assets can be kept together in a going-concern liquidation sale to a third party. The key distinction is who the buyers are: third parties or former claimants. Under the liquidation procedure, the assets are actually sold to third parties. Under reorganization, the assets are sold as a going-concern to the existing claimholders themselves because the assets are worth more to them than to third parties. Therefore, the bankruptcy reorganization law exists simply to realize the goal of the maximization of the debtor’s overall economic value.

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61 Id, pp. 866-8.
62 Id, pp. 864-5.
64 Thomas H. Jackson (2001), The Logic and Limits of Bankruptcy Law, Bear Books, p. 211.
4) Preserving the benefits of the collective procedure: including secured creditors in the collective procedure.

Compared with unsecured creditors, secured creditors are not direct beneficiaries of the “reduction of strategic costs” or the “maximization of the value of the debtor’s assets” advantages of a collective procedure. They are less likely to view the “administrative efficiencies” as special benefits since the difficult administrative issues, such as the availability of assets and the priorities of competing claimants, may have often been previously negotiated and the cost in realizing the security is often contractually allocated to the debtor. However, if secured creditors could remove the collateral from the debtor, the going-concern value that comes from the debtor’s aggregate pool of assets cannot be preserved, which means that the advantages of the collective procedure are being diminished or lost. Therefore, under the condition that “secured creditors are left as well off as outside bankruptcy”, they have no reason to object to being included in the collective procedure.65

To summarize, because of the reasons discussed above, we would expect that the debtor and all the creditors would agree to replace the individual remedies system with a mandatory and collective bankruptcy procedure, in which the collection costs are best minimized and the value of the debtor’s assets is maximized. Although a real ex anti negotiation among all the creditors and the debtor will not happen because of problems, such as the bounded rationality of the creditors, the great difficulty and high costs in making an agreement which provides comprehensive, scientific and optimal arrangement on all the related matters, the high costs in organizing such a complex negotiation, and the fact that the creditors of a debtor are changing over time, the legislation body may solve these problems by making available a mandatory and collective procedure in bankruptcy context. In a word, bankruptcy law exists “as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an ex ante position”,66 and bankruptcy reorganization law exists just for the goal of the maximization of the debtor’s overall economic value.

2.1.1.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors

The creditors’ bargain theory posits three principles with respect to the relationship of bankruptcy law and protection of non-investors. Detailed analysis is below.

1) Bankruptcy law should respect non-bankruptcy law.

Even if a non-bankruptcy rule is substantively inefficient or inequitable and changing the rule within bankruptcy might result in overall improvement in efficiency and equity of bankruptcy procedure, this would be less preferable and the second best solution because of the following three reasons.

First, because the rule is not a bankruptcy rule, changing it into only bankruptcy will confuse the distinction between bankruptcy law and non-bankruptcy law and obscure the unique function of bankruptcy.

Second, changing the rule into only bankruptcy is an incomplete or partial solution. This incomplete solution masks the fundamental necessity of making a general rule change by the Congress, which should be the best way of finding a solution that keeps the relationship between the non-bankruptcy and bankruptcy law clear and ordered.

Third, changing the rule only within a bankruptcy context means wealth redistribution or creating a set of entitlements in bankruptcy different from those that exist outside of bankruptcy, which will cause the undesirable effect—forum shopping. The interested parties who are advantaged by the distinct bankruptcy rule will try to use the bankruptcy process to get their individual benefits even when it is not in the collective interests of all the claimholders as a whole, while the parties who are disadvantaged by the bankruptcy rules will try to prevent the use of the bankruptcy procedure even if using bankruptcy procedure is in the collective interests of all the interested parties.

The creditors’ bargain theory asserts that bankruptcy law should fully respect the interested

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67 The term “non-investors” means those who do not hold a legal claim against the bankruptcy estate according to non-bankruptcy law. These non-investors hold some value or interest that is not a non-bankruptcy right to payment or a non-bankruptcy claim, but may be affected by the business failure, such as a worker’s employment opportunity, the interest of a certain affected community that may be hurt by the failed enterprise.


69 Id, p. 730.
parties’ non-bankruptcy entitlement and the wealth distribution order established by non-bankruptcy law in order to avoid wealth redistribution in bankruptcy and forum shopping. The creditors’ bargain theory emphasizes that how to establish an appropriate wealth distribution priority order should be “a question of the law generally” instead of being a question “peculiar to the bankruptcy law”. The creditor’s bargain theory proposes that wealth distribution should be dealt with within the context of the whole legal system. Bankruptcy law should honor the wealth distribution order in bankruptcy law and set up a wealth distribution order which is the same as that in the non-bankruptcy law so that there will be no forum-shopping between non-bankruptcy and bankruptcy procedures and a value or interest will be protected in a unified way inside and outside bankruptcy. Baird stated that “[l]egal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them. Whenever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy.” Baird took the retiree health benefits claims as an example. He argued that if we intend to protect the retiree’s health benefits claims against a corporation, we should establish relevant rules in the non-bankruptcy law, which is ERISA (Employee Retirement Income Security Act) in the US. Since firms may close without defaulting to creditors or without bankruptcy petition, solving the problem only within bankruptcy law, i.e. providing retiree health benefits claims a special priority level, does not provide a complete and uniform solution while creating a forum-shopping problem.

2) Bankruptcy law interferes with non-bankruptcy rules or creditors’ non-bankruptcy rights only when fully recognizing that those rules or rights hinder the operation of the collective procedure and the extent of that interference is limited by the necessity for preserving the benefits of the collective procedure.

The collective procedure sometimes requires the interference with non-bankruptcy rights. In these situations, we must weigh the damage that keeping a non-bankruptcy right unchanged in bankruptcy would inflict upon the collective procedure against the undesirable effects created

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71 Id, p. 822.
72 Id, pp. 828-31.
by changing that right. Only if the damage to the collective procedure is higher, can bankruptcy law change the non-bankruptcy right. In some cases (such as automatic stay of security rights), inferring with the right does not require interfering with the value of the right. In other cases (such as preferences avoidance), the value of the right is disregarded by the bankruptcy law. In either case, at bottom, the preemption rule that determines whether to modify a non-bankruptcy entitlement and how to modify a non-bankruptcy entitlement is derived from the fundamental reason of bankruptcy law’s existence, i.e. the necessity of replacing an individual remedies system with a collective procedure. Therefore, preserving the benefits of the collective procedure is the only justification for interfering with non-bankruptcy rights.

3) Bankruptcy law should not take the protection of non-investors as its goal.

Starting from the point that bankruptcy law should try to respect non-bankruptcy law and avoid wealth redistribution in bankruptcy, the creditors’ bargain theory is opposed to the idea that bankruptcy law should take the responsibility of protecting the rights of non-investors, i.e. parties whose interests are affected by the business failure but who do not have a legal claim against the debtor’s assets according to non-bankruptcy law. Baird argued that: “[b]usiness ‘failure’ is not necessarily connected with default. Moreover, default itself is not necessarily connected with bankruptcy. Anytime resources are shifted from one use to another, or from one place to another, there are likely to be spill-over effects—both positive and negative.”

There is no sufficient reason why it is appropriate only to tackle the outside effect of business change within bankruptcy law. If some interests need to be protected, it is better to tackle this problem and provide protection within the whole legal system in order to provide a uniform and certain protection. To provide special non-investor protection within bankruptcy would create wealth redistribution in bankruptcy, which may cause the forum shopping problem.

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75 Id, p. 829.
76 Baird stated that “[l]egal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them. Whenever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy.” Douglas G. Baird (1987), Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 815, p. 822.
77 Id, pp. 828-9.
2.1.2 Bankruptcy-policy Theory

In response to the creditors’ bargain theory, Elizabeth Warren proposed a bankruptcy-policy theory, through which she tried to highlight the limited explaining power of the law and economics account of bankruptcy law.\(^78\)

2.1.2.1 The Goal of Bankruptcy Law

Warren criticized that the creditors’ bargain theory provides a “narrow” explanation and “negates a realistic appraisal of the bankruptcy system”.\(^79\) Warren argued that economic value enhancement is only part of the goal of bankruptcy law.\(^80\) She stated that her bankruptcy theory is to give “a comprehensive statement about the various and competing goals that underlie the bankruptcy system” so as to provide useful assistance to the legislative and judicial decision-making.\(^81\) Generally, Elizabeth Warren held that bankruptcy law is a debt collection scheme for distributing the wealth among the competing claimholders and dealing with the broad effect of business failure in the context of the debtor’s imminent collapse, or a

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\(^78\) The main content of bankruptcy policy theory is discussed in the these articles: Elizabeth Warren (1987), Bankruptcy Policy, 54 U. Chi. L. Rev. 775 and Elizabeth Warren (1993), Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336.

\(^79\) “The policies we embrace and the models we use to describe the system animate our vision of how the system operates and our conclusions about its successes and failures. If the inquiry over bankruptcy policy becomes nothing more than a debate over allocative efficiency, it will pass over crucial elements of the policy scheme that cannot be so neatly tied up in economic models. An approach that eschews any role for efficiency analysis suffers a similar fate, creating an economic versus noneconomic dichotomy that negates a realistic appraisal of the bankruptcy system.” Elizabeth Warren (1993), Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336, p. 338.

\(^80\) “[T]he value-enhancement principle is sufficiently well accepted....., however, a more complete elaboration of a bankruptcy policy may change how a problem is framed or what solutions are proposed.” Elizabeth Warren (1993), Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336, p. 373.

\(^81\) This essay is about bankruptcy policy. It attempts to articulate a comprehensive statement about the various and competing goals that underlie the bankruptcy system. The essay offers both a positive observation, drawn from the Code and its operation, and a normative evaluation, designed to outline the difficult value judgments that comprise the bankruptcy system. It also serves warning: before commentators propose any sweeping changes or policymakers take seriously any suggestions to scrap the system, they must consider the impact of such proposals on a number of competing normative goals.” Elizabeth Warren (1993), Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336, p. 338. “I begin with a historical observation about legal structures, I surmise the concerns of the drafters, and I end with tentative conclusions and more complex questions.” Elizabeth Warren (1987), Bankruptcy Policy, 54 U. Chi. L. Rev. 775, pp.777-8. “I have not offered a single-rationale policy that compels solutions in particular cases....I have only identified normative considerations that may drive legislative and judicial decisions.” Id, at 795-6. “A policy that focuses on the values to be protected in a bankruptcy distribution scheme and on the effective implementation of these values assists the decision-making process even if it does not dictate specific answers.” Id, at 796.

“Baird’s view is more chic than mine, but I believe my view is more realistic and more likely to yield useful analysis.” Id, at 811.
debt collection law for protecting the values affected in the context of business failure.\(^\text{82}\) In an attempt to make a clear articulation of the goal of bankruptcy law, Warren summarized that bankruptcy law has four principal goals: “foster[ing] substantial enhancement of the value of the debtor, so that parties receive more than they would under alternative collection systems”; “distribut[ing] those assets according to a deliberate scheme, offering protection to a number of deserving parties who would otherwise receive little”; “forc[ing] parties who deal with the debtor to bear the burden of their losses without externalizing them to others”; establish[ing] a mechanism that can “bring the [bankruptcy] system into play at the appropriate time”.\(^\text{83}\)

2.1.2.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors

According to the bankruptcy-policy theory, bankruptcy law can alter the interested parties’ non-bankruptcy right and there can be wealth redistribution in bankruptcy because bankruptcy and non-bankruptcy law deal with different kinds of default. Warren argues that bankruptcy law provides a collection scheme that operates in a unique context. She noticed that there are “two prototypes of default: first, the single default where only one creditor complains about repayment and the remaining creditors are evidently (even if only temporarily) content with their repayment prospects; and second, the debtor’s widespread default and collapse in which every creditors’ prospects for payment are sharply diminished.”\(^\text{84}\) While non-bankruptcy law provides a collection scheme that copes with the first kind of default or limited default, the bankruptcy collection scheme “concentrates on the default of the debtor’s imminent

\(^{82}\) Elizabeth Warren (1987), Bankruptcy Policy, 54 U. Chi. L. Rev. 775, pp. 785-97. “I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing-and sometimes conflicting-values in this distribution. As I see it, no one value dominates, so that bankruptcy policy becomes a composite of factors that bear on a better answer to the question, ‘How shall the losses be distributed?’” Id., p. 777. Warren listed some values affected in the business failure, such as the protection of payment to the wage claims, of the workers’ employment opportunities, of the survival opportunity to a failed business. She commented that “[t]he list offered here is preliminary at best, and any example given undoubtedly could be explained by several distributional rationales. The point of this paper, however, is not to explore every value weighed in bankruptcy's distributional scheme, but to establish that such values exist, that Congress gives them credence, and that collectively they have a significant impact on the bankruptcy process.” Id., at 793.


\(^{84}\) Elizabeth Warren (1987), Bankruptcy Policy, 54 U. Chi. L. Rev. 775, p. 781.
collapse".\textsuperscript{85} Since non-bankruptcy and bankruptcy law deal with different situations, they should adopt different distributive schemes. Under the bankruptcy-policy theory, bankruptcy law aims at providing appropriate protection to the different parties or values affected by the business failure through its specific distribution rules.\textsuperscript{86} “Distribution among creditors is not incidental to other concerns; it is the center of the bankruptcy scheme.”\textsuperscript{87} According to the bankruptcy-policy theory, the creditors’ bargain theory, by proposing bankruptcy law should adopt the distribution order established under non-bankruptcy law, actually adopts the distributional scheme under non-bankruptcy law without inquiring into its appropriateness.\textsuperscript{88} On the ground that bankruptcy and non-bankruptcy law deal with different kinds of default, the bankruptcy-policy theory claims that bankruptcy and non-bankruptcy law differ “in their central policy considerations because they rest on fundamentally different premises.”\textsuperscript{89} “To structure collection rules and priorities in the context of inextinguishable claims is to create one kind of system. To craft that set of collection rules and priorities onto a system that discharges debt is to create a very different collection system—one that should be evaluated separately and not accepted simply because some of the rules make sense in a different, state law scheme.”\textsuperscript{90} Warren listed a series of distributive rationales of bankruptcy law, such as favoring creditors whose ability to bear the cost of default is relatively weak, preventing pre-bankruptcy transactions based on perverse incentives, treating like creditors alike, forcing shareholders to bear the loss of business failure, benefiting the whole bankruptcy estate by helping the business to survive.\textsuperscript{91} However, Warren also pointed out that the distributive goals may conflict with each other and it is difficult or even impossible to provide a consistent answer to questions such as how to reallocate the resources and how to solve the conflict between the different distributive goals.\textsuperscript{92} Warren stated that although she has “identified the distributional rationale of bankruptcy”, there is still a need to explore the detailed policies or normative

\textsuperscript{85} Id, pp. 781-2.
\textsuperscript{86} Id, pp. 785-97.
\textsuperscript{87} Id, p. 785.
\textsuperscript{88} Id, pp. 789-90.
\textsuperscript{89} Id, p. 784.
\textsuperscript{90} Id, p. 785.
\textsuperscript{91} Id, pp. 790-3.
basis of an optimal bankruptcy distributional scheme. According to bankruptcy-policy theory, protection of non-investors is an element of the wealth redistribution in bankruptcy, since bankruptcy is “an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing-and sometimes conflicting-values in this distribution”. Warren asserted that “bankruptcy policy also takes into account the distributional impact of a business failure on parties who are not creditors and who have no formal legal rights to the assets of the business.” For instance, “[the] Code accounts for the rights of other parties that a business failure affects by giving a failing company an opportunity to sell itself as a going concern in Chapter 7 or to reorganize in Chapter 11.” Moreover, Warren pointed out that “[t]he protection offered to parties without formal rights may be indirect and incomplete, but that does not mean that such factors are—or should be—irrelevant to policymaking.”

2.1.3 Value-Based Theory

Donald R. Korobkin proposed the value-based theory which tries to give a rich and full explanation to the question why bankruptcy law emerged as a system with the varied contours and dimensions that it has.

2.1.3.1 Goal of Bankruptcy Law

The value-based theory objects to considering the debtor as merely a pool of assets, i.e. dead property and emphasizes that the debtor has personality and dynamic potential, and like a natural person debtor, is a moral, political and social actor. The value-based theory compares the progress of the debtor’s estate with that of a human life. Just as the decision on what is

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96 Id, at 355.
“good” for a human can not be made once and for all, there is no fixed answer as to what is the good solution to a debtor’s financial distress, since every financial distress is in a specific historical context and contains particular questions.\textsuperscript{99} Bankruptcy law is a full response to all the problems arising from the financial distress, not only economic but also moral, political, personal and social. The problems arising from financial distress are so complicated that the answer should be left to the participants representing conflicting and fundamentally incommensurable values, who will finally find the answer to the changing questions in historically situated contexts.\textsuperscript{100}

The value-based theory concluded that bankruptcy law is not merely a response to the problem of collecting debt,\textsuperscript{101} and the goal of bankruptcy law is to “address the problems of financial distress and to create conditions for a discourse in which values of participants may be rehabilitated into a coherent and informed vision of what the enterprise shall exist to do.”\textsuperscript{102} Correspondingly, bankruptcy reorganization law is to rehabilitate and redefine the values of the debtor into a “coherent new version of what the enterprise shall exist to do.”\textsuperscript{103}

What kind of value-protection scheme should be achieved? How can the bankruptcy decisions be made? “[B]ankruptcy law frames decision making in a way that allows a full response to the problem of financial distress. Historically situated participants express conflicting and fundamentally incommensurable values; they make decisions based on the possible visions of the enterprise that exist--or that may be invented--at a particular moment in the case.”\textsuperscript{104} “[W]e are free to engage in rational debate…[and] to acknowledge the diverse values that find expression in financial distress.”\textsuperscript{105} To put it concisely, the value-based theory asserts that bankruptcy involves complicated problems and the answer to these problems should be open.

\subsection*{2.1.3.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth}

\textsuperscript{99} Id, pp. 744-5; 768.
\textsuperscript{100} Id, p. 766-8.
\textsuperscript{101} Id, p. 766.
\textsuperscript{102} Id, p. 789. “[T]he success of a bankruptcy case, whether it ends in reorganization or liquidation, must be evaluated in more comprehensive, yet perhaps more problematic, terms: in what ways has the bankruptcy case caused a rehabilitation of the values of its participants, and to what extent has there emerged out of bankruptcy an informed and coherent vision of the aims of the enterprise.” Id, p. 774.
\textsuperscript{103} Id, p. 773-4.
\textsuperscript{104} Id, p. 788.
\textsuperscript{105} Id, p. 789.
Redistribution and Protection of Non-investors

Since the value-based theory takes the protection of the values affected in every specific business failure case as the goal of bankruptcy, it supports alteration of the interested parties’ non-bankruptcy rights, wealth redistribution in bankruptcy and protection of non-investors that are the result of the “rational debate” of the participating parties of a specific bankruptcy case. The value-based theory claims that “in responding to financial distress, bankruptcy law sometimes should and must alter rights recognized under substantive nonbankruptcy law. This is not a forbidden act, as the economic account suggests; it is an essential and inevitable part of a full response to the problem of financial distress.” "There may be good economic and noneconomic reasons for preserving state law entitlements, but in specific contexts, there will be compelling reasons to change them." Whether or not to change non-bankruptcy entitlements is a complicated question and requires serious discussion among all those who will be affected by the outcome. “The debate on this question is the kind of debate that bankruptcy law is uniquely structured to offer.” To summarize, under the value-based theory, bankruptcy decisions are the result of a rational debate, which may include alteration of non-bankruptcy rights and promotion of noneconomic values.

The value-based theory supports protection of non-investors in bankruptcy. The proponent of the value-based theory commented that the economic account of bankruptcy law undermines the explanation of the bankruptcy system since it only recognizes economic values involved in the financial distress of a debtor corporation. In sharp contrast to the economic account of bankruptcy law, the value-based theory recognizes all the values affected in a bankruptcy case, not only the economic value, but also the moral, political and social values. Obviously, under

106 Id, p. 789; 768.
107 Id, p. 768.
108 Id.
109 Id, p.768.
110 “The challenge facing anyone who wants to write about bankruptcy policy,’ Professor Baird has stated, ‘is to explain why a distinct bankruptcy law exists at all.’ The value-based account explains bankruptcy law as existing to address the problem of financial distress and as creating conditions for a discourse in which values of participants may be rehabilitated into a coherent and informed vision of what the enterprise shall exist to do. Because the value-based account does provide an answer, albeit a preliminary one, to Baird's question, we are free, once again, to ‘write about bankruptcy policy.’” Id, at 788-9. “We are no longer barred--as the economic account would bar us--from urging changes that alter substantive nonbankruptcy rights or that promote noneconomic outcomes as independent values. At times, we will urge such changes, at other times, we will not. In any event, we are free to engage in rational debate. For the value-based account releases us, in writing about bankruptcy policy, to acknowledge the diverse values that find expression in financial distress.” Id, p. 789.
the value-based theory, the values to be protected include values held by formal investors but also values held by non-investors.\textsuperscript{111}

2.1.4 Risk-Sharing Theory

The risk-sharing theory is proposed by Thomas H. Jackson and Robert E. Scott in an attempt to provide normative justification of the redistributive provisions in bankruptcy law. Because it is basically a modified version of the creditors’ bargain theory, the risk-sharing theory is called by the proponents as “an expanded model of the creditors’ bargain”.\textsuperscript{112}

2.1.4.1 Goal of Bankruptcy Law

Risk-sharing theorists noticed that bankruptcy law deviates from the creditors’ bargain theory in that it contains wealth redistribution or reallocation provisions. In trying to justify the wealth redistribution provisions contained in bankruptcy law, they proposed the risk-sharing theory. According to the risk-sharing theory, bankruptcy law has a central goal of maximizing the debtor’s overall value and a complementary goal of forcing all claimholders to “share (at least in part) the ‘common’ risks of business failure”.\textsuperscript{113} Risk-sharing theorists explained that all the investors of the debtor would have agreed to a commonly beneficial risk-sharing agreement to deal with the risk of loss from the debtor’s insolvency were they able to negotiate. Since the negotiation could not really happen because of the prohibitively high transaction costs, the bankruptcy wealth redistribution provisions serve as what the risk-sharing agreement would have provided.\textsuperscript{114} All the investors of a debtor would prefer a risk-sharing agreement, because of the following reasons:

1) Sharing common risks

Risk-sharing theory proposes that besides the central goal of maximizing the value of the debtor’s assets, bankruptcy law should have a complementary distributional goal, which is that “all participants should share (at least in part) in the ‘common’ risks of business failure”.

\textsuperscript{111} Id.
\textsuperscript{113} Id, p. 164.
The term “common risks” is defined in comparison with the term “particular risks”. Common risks are the risks of loss from “exogenous” sources beyond management’s control, such as the general downturn of an industry or of the overall economy. In contrast, particular risks are the risks from “endogenous” sources, i.e. the risk of loss due to managerial misbehavior, managerial preference for risk etc.\textsuperscript{115}

Risk-sharing theory holds that because some individual group is the best able to monitor or control the particular risks, the parties would bargain for bearing the particular risks individually. For example, the parties would agree that shareholders should bear the risks arising out of incompetent or dishonest management, since shareholders stand in the best position for monitoring the firm’s managers’ performance.\textsuperscript{116} In relation to common risks, the hypothetical bargain result would be different. Because no individual group can control common risks and all investors are risk averse, they would bargain to share the common risks because a risk-sharing arrangement reduces the risk and ensures that each party has a higher probability of incurring a smaller loss. “[P]arties to a creditors’ bargain would adopt a mixed strategy of bearing risk. Individualized strategies designed to reduce risk are generally preferred, but some form of risk sharing would be adopted for those common perils that are too uncertain and interactive to make individual action meaningful.”\textsuperscript{117} As a result of sharing common-risks, bankruptcy law does not absolutely respect non-bankruptcy entitlements, but contains some redistributive provisions. For instance, allowing the bankruptcy trustee to decide whether to assume or reject executory contracts, imposing delay interest on secured creditors, providing the debtor with a generous opportunity for rehabilitation, are wealth redistribution provisions contained in bankruptcy law as a result of risk sharing.\textsuperscript{118}

2) Mitigating eve-of-bankruptcy conflict and securing cooperative incentives

On the eve of bankruptcy, the parties may have perverse incentives. Firstly, an individual creditor may engage in a destructive race for debt-collection, which may cause dissipation of the debtor’s business. Moreover, those who have de facto control over a debtor’s decision-making will have an incentive to make decisions that favor themselves but are

\textsuperscript{116} Id, p.164.
\textsuperscript{117} Id, p.167.
\textsuperscript{118} Id, p.185; 189-90; 192.
harmful to the interests of the claimants as a group. For instance, creditors, who have a special relationship with the debtor’s management, may receive payment in a favored way. Wealth redistribution provisions, such as bankruptcy provisions that restrain preferred payments and fraudulent conveyance, can help to solve this kind of problems. Secondly, equity holders and their agent—the management, have the incentive of delaying the bankruptcy petition. Risk-sharing agreement and the bankruptcy’s redistribution provisions, such as providing the debtor a generous opportunity for rehabilitation, imposing delay cost on secured creditors, can help to counteract this kind of perverse incentive and secure cooperative actions. Should the shareholders still acquire part of the assets based on risk-sharing, they and their agent would try to preserve the debtor’s value, since they are dealing with the assets that are related to the interests of not only the creditors but also the shareholders.  

3) Protecting firm-specific capital investments

Some shareholders or managers make firm-specific investments that cannot be evaluated in monetary or any other objective term. For example, in some small, closely held firms, the owner-managers make substantial non-pecuniary or sentimental investments. This firm-specific investment is essentially non-diversifiable and cannot be protected by a normal insurance method. Offering the firm a more generous opportunity for rehabilitation is a device for protecting the firm-specific investments.

4) Protecting victims of business failure who have no risk-reducing alternatives

Risk-sharing theorists tried to provide a normative justification for the distribution to non-investors. “Tort claimants, retired employees, residents of the community, and other affected third parties might be considered ‘victims’ of business failure and bankruptcy.”  

“In some sense, these claimants are analogous to the victims of a common disaster, such as a flood.” They stated that the non-investors “share an important quality with the victims of true disasters that may explain why such victims are the beneficiaries of distributions when catastrophe strikes”, which is that they do not have “risk-reducing alternatives, such as insurance, security, or other bonding mechanisms.” “Because these parties do not have an

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119 Id, pp. 169-74.
120 Id, p.175.
121 Id, p. 177.
122 Id, p. 177.
opportunity to protect themselves with security, it can be argued that they ‘deserve’ a
distribution of the assets in bankruptcy in the same way that flood victims deserve
assistance.” 123

2.1.4.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth
Redistribution and Protection of Non-investors

As a theory for providing an explanation of the wealth redistribution provisions in the
bankruptcy law, the risk-sharing theory accepts that bankruptcy law can, to a limited extent,
deviate from the wealth distribution order established by non-bankruptcy law.124 Recall that
in the creditor’s bargain theory, Jackson warned that wealth redistribution invites the perverse
incentive of forum shopping. What did he say about the problem of forum shopping created
by the wealth-redistribution rules in the risk-sharing theory? Jackson said that the irreducible
cost of forum shopping is reasonable if it brings greater benefits.125 The risk-sharing theorists
pointed out that whether the benefits of wealth redistribution exceed the corresponding cost
remains to be an unsolved “empirical problem” and admitted that their theory “ultimately
leaves unresolved the ongoing normative debate concerning the proper role for bankruptcy in
the resolution of creditor claims.” 126 Risk-sharing theory is different from the creditors’
bargain theory in that it takes wealth redistribution as a complimentary goal of bankruptcy law.
Risk-sharing theory finds that four specific reasons may justify the wealth distribution
provisions contained in bankruptcy law. Those four reasons are sharing common-risks,
mitigating eve-of-bankruptcy conflict and securing cooperative actions, protecting
firm-specific capital investments and protecting victims of business failure who have no
risk-reducing alternatives.127 It should be noted that risk-sharing theorists proposed that the
wealth redistribution rules should be designed in a way that may cause less rent-seeking
behavior. They said that wealth redistribution in bankruptcy could be taken as “a bankruptcy
tax imposed on the participants in the collective procedure.”128 It is better to make the tax

123 Id.
124 Id, pp. 156-8.
125 Id, p.198.
126 Id, p. 203.
127 See section 2.1.4.1.
128 Id, p. 204.
“certain and horizontally equitable”. “The more the tax is made certain and horizontally equitable, the less individual parties will be motivated to escape their share of the distributional burden.”\textsuperscript{129} If the bankruptcy redistribution rules are ambiguous and uncertain, which means that their application depends on the ex post evaluation of the particular facts of a specific case, the uncertainty would motivate wasteful rent-seeking behavior. For instance, “the claimants have an incentive to expend resources to minimize the incidence of the bankruptcy tax on them as individuals, thus reducing the wealth of the claimants as a group.”\textsuperscript{130}

Concerning the protection of non-investors, the risk-sharing theory’s conclusion is tentative. It proposes that bankruptcy law may provide protection of non-investors since they, like the victims of a flood, do not have risk-reducing alternatives.\textsuperscript{131} However, risk-sharing theorists noticed that “it may in some sense be analytically correct to suggest that the problems that animate distribution to nonconsensual victims of common disasters are not ‘bankruptcy’ problems.”\textsuperscript{132} “[T]he individual participants in the creditors' bargain would presumably be as willing to support these claimants as they would any other charitable cause. From the perspective of the collective, however, these forms of redistribution will be seen as costs of bankruptcy that will undermine, at least in part, the primary objectives of collectivization.”\textsuperscript{133} Anyway, risk-sharing theorists provided inspiration in explaining wealth redistribution to non-investors from the perspective of risk-sharing.

2.1.5 The Team Production Theory of Bankruptcy Reorganization

The team production theory of bankruptcy reorganization was proposed by LoPucki with the aim of establishing a theory of the bankruptcy reorganization law of public corporations by applying the team production theory of corporate law in the field of bankruptcy

\textsuperscript{129} Id, pp. 202-3. In order to give a clear explanation of the legislative suggestion, which is “making bankruptcy tax certain and horizontally equitable”, the risk-sharing theorists made further illustration. “This suggests that cross-the-board redistributions, such as the Timbers denial of postpetition interest for secured creditors, are preferable to the individualized distributional policies reflected in the Eighth Circuit’s decision in Ahlers.”\textsuperscript{130} Id, at 202-4.\textsuperscript{131} Id, at 177\textsuperscript{132} Id, at 178. \textsuperscript{133} Id.
reorganization.\textsuperscript{134}

\subsection{The Goal of Bankruptcy Law}

The team production theory of bankruptcy reorganization is to provide a normative theory on bankruptcy reorganization law of public corporations by applying the team production theory of corporate law to the bankruptcy reorganization of public corporations.\textsuperscript{135} The team production theory of corporate law is based on the hypothesis that the constituent groups of public corporations, i.e. the “team”, deliberately delegate to the board of directors the ultimate authority over both the direction of the corporation and the distribution among team members of production rents and surpluses. Why would the team delegate this ultimate authority to the board of directors? The reason is that it is difficult or impossible to deal with these matters through explicit contracts in the changing and uncertain everyday business environment.\textsuperscript{136} Under the team production theory of corporate law, “the team members may include stockholders, creditors, executives, other employees, suppliers, customers, local governments, regulatory agencies, and others.”\textsuperscript{137} The team production theory of bankruptcy reorganization asserts that “the team production contract continues in force during bankruptcy reorganization. The rationale … is that the team members intended that result at the time they contracted. Preservation of the firm’s going concern value usually requires that much of the team remain in place and continue to produce during a reorganization effort, but adjustments to the team production arrangement may be necessary. For example, the team may need to fire and replace its managers--or pay them bonuses to stay. Team members are not, however, in a position to negotiate the necessary adjustments. Many are already irrevocably committed to the firm. Instead, team members long before delegated the adjustment process to the discretion of the board.” According to the team production theory of bankruptcy reorganization, the bankruptcy reorganization law of public corporations is the expression of the hypothetical team production contract and its goal is “to serve the interests of all team

\begin{itemize}
\item \textsuperscript{134} For the team production theory of corporate law, please see Margaret M. Blair and Lynn A. Stout (1999), A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247.
\item \textsuperscript{135} Lynn M. LoPucki (2004), A Team Production Theory of Bankruptcy Reorganization, 57 Vand. L. Rev. 741.
\item \textsuperscript{136} Id, pp. 749-54.
\item \textsuperscript{137} Id, p. 749.
\end{itemize}
2.1.5.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors

According to the team production theory of bankruptcy reorganization, the team production contract gives the board complete freedom in dealing with the deployment problem and non-bankruptcy law entitlements. The team production theory of bankruptcy reorganization accepts that the creditors’ and shareholders’ non-bankruptcy entitlements may be changed and the wealth may be redistributed in bankruptcy. The team production theory holds that the board, just as outside of bankruptcy, remains in control after the firm enters into bankruptcy and has the authority of deciding how to treat the creditors’ and shareholders’ entitlements that are recognized by the non-bankruptcy law and the team members’ team entitlements’ that are not recognized by the non-bankruptcy law but as part of the team contract.

“Under the Team Production Theory, the bankrupt firm should honor its obligations to all who made firm-specific investments at the invitation of the firm and could not protect them in other ways….It might justify the retention of particular long-term employees, for example, despite the fact that others were now available to work more cheaply. It might justify the payment of ‘retention bonuses’ of the type that have recently become common in reorganization cases. It might also justify continuing to operate the business in a community where costs were higher than in some alternative location. The firm-specific investments so recognized might include the expenses incurred by employees and suppliers in moving to the community to join the team, or tax concessions made by the local taxing authority to attract the debtor to the community. They might also include the investments and efforts consumers of computer products make when they buy and learn to use products. In each of these cases, the firm invited the investment and the investor placed trust in the directors to reciprocate. Meeting these obligations does no violence to the rights of team members who do have legal rights against assets, because the holders of the legal rights have contracted that the

138 Id, p. 769.
139 Id, pp. 749-64.
obligations to the team be met.”

“The members of the board of directors, acting as fiduciaries, decide which of these claims to recognize and how much to pay the claim holders.”

With respect to the protection of non-investors, the team production theory of bankruptcy reorganization asserts that it justifies “bankruptcy’s service of a broad range of interests.”

The team production theory of bankruptcy reorganization criticizes the fact that the creditors’ bargain theory, by “concluding that bankruptcy exists solely for the benefit of creditors and shareholders”, provides a statement of the objectives of bankruptcy reorganization, which is positively and normatively too narrow.

However, it should be noted that the team production theory of bankruptcy reorganization is only a theory explaining the bankruptcy reorganization of public corporations and is not a theory concerning the whole bankruptcy law. Moreover, the proponent pointed out that “Team Production is not a theory with which I feel comfortable.”

“The theory is based on a wholesale grant of unfettered power to directors. My inclination is to think that will not work. Power corrupts, and absolute power corrupts absolutely.”

“Researchers can test the Team Production Theory empirically by determining whether the actual contracts match those asserted by the Team Production theorist.”

2.1.6 Comparison and Choice

After comparing the representative theories concerning bankruptcy law, the author adopts the creditors’ bargain theory as the theoretical device for analyzing the bankruptcy reorganization law of the chosen countries in this book. The reasons for choosing the creditors’ bargain theory are discussed below.

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140 Id, pp. 766-7.
141 Id, p. 767.
142 Id, p. 766.
143 Id.
144 Id, p. 778.
145 Id.
146 Id, p. 744
2.1.6.1 The Decisive Role of the Economic Value among All the Values of a Corporation

Irrespective of any one of these theories, either outside or inside bankruptcy, the economic value is the most decisive among all the values of a corporation. A corporation comes into existence with the ultimate goal of making a profit. To put it differently, market investors invest in a corporation, as shareholders or as creditors, with the goal of making a profit. While pursuing the economic value, a corporation brings benefits to the society, such as increasing employment opportunities, enhancing community wealth and bringing convenience to the community residents’ life etc., and thus obtains moral, political and social values. Therefore, the basic logic in the operation of a corporation is that its economic value is the basis for all other non-economic values, or that its non-economic values are the byproducts or the derivatives of its profit-making activity.

When the corporation is trapped in difficulty, enters into the bankruptcy procedure in order to find a solution to the difficulty, the relationship between the economic value and the other values should not be overturned. If outside bankruptcy, a debtor is a corporation for making a profit, it should not be changed into a philanthropic organization with the protection of some non-economic values as the ultimate goal simply because it is in financial distress and has entered into the bankruptcy proceeding. Bankruptcy law should not force the investors of a corporation to change their ultimate goal of profit-making to social-value-protection upon entering the bankruptcy procedure. Since the investors are allowed by non-bankruptcy law to set up a corporation with the ultimate goal of making a profit, they should be allowed to keep the same ultimate goal when they need to solve the corporation’s financial problems in the bankruptcy proceeding. Therefore, the non-economic values should not triumph over the economic value even if a corporation has entered into bankruptcy proceeding. Inside bankruptcy, the non-economic values, as derivatives of the economic value, can only be achieved on the basis of the economic value.147 It has been commented that a business

147 Corporations may be categorized into not-for-profit corporations and for-profit corporations/business corporations. Not-for-profit corporations are often public corporations that are created by government to carry out some public functions. Stephen M. Bainbridge (2002), Corporation Law and Economics, Foundation Press, p. 2. A not-for-profit corporation comes into existence for carrying out certain public functions and protecting some non-economic values. The difference between a not-for-profit corporation and a for-profit corporation is that the government shareholder of a
corporation’s social values, such as its contribution to employment or community welfare, cannot be realized unless its income exceeds the costs of production. The fundamental flaw of the bankruptcy-policy theory, value-based theory, and risk-sharing theory is that these theories, by vindicating that bankruptcy law may allow non-economic values to triumph over the economic value, fail to recognize the decisive power of the economic value among all the values of a corporation.

2.1.6.2 The Problem in Taking the Protection of Non-investors as One Goal of Bankruptcy Law

Compared with the creditors’ bargain theory, the other theories define the goal of bankruptcy law in a more ambitious and broader way, since the other three theories, to different extents, hold that bankruptcy law should help to mitigate the negative social effects caused by business failure and protect the interests of all the parties affected by the business failure. According to the other theories, in order to achieve the function of solving the social problems caused by business failure, bankruptcy law may contain wealth redistribution provisions and provisions on the protection of non-investors. Since the provisions on wealth redistribution among the investors are analyzed in the Section 2.1.6.3, this section discusses the protection of non-investors in bankruptcy law.

First, it is problematic to force the investors to bear the cost for protecting the values held by non-investors, whom happen to be affected by the business failure and with whom they do not

not-for-profit corporation need not pursue economic value. However, the other investors, such as shareholders and creditors, invest in it for making economic profit. In its operation, a not-for-profit corporation, just like a for-profit corporation, should pay its debt according to the contract and non-bankruptcy laws. Where a not-for-profit corporation is in financial distress and enters into bankruptcy to solve its financial problem, just as outside bankruptcy, its market investors should not be forced to bear the costs for its social function and non-economic value. If the government wants to rescue it to protect social values, the government should bear the costs for protecting such social values. By using the bankruptcy law designed for for-profit corporations, the market investors of a not-for-profit corporation are protected in the same way as those investors of a for-profit corporation since bankruptcy law is designed to ensure the maximization of the debtor’s overall economic value and the maximization of the market investors’ recovery. For the convenience of analysis, this book is confined to the analysis of the bankruptcy of for-profit corporations/business corporations.


149The risk-sharing theory does not directly state that a corporation’s non-economic values could triumph over its economic values. However, by proposing that bankruptcy law should protect the shareholders’ non-pecuniary or sentimental investment and non-investors, it actually implies this idea. See 2.1.4.2 for discussions concerning the protection of non-economic values by the risk-sharing theorists.
have a direct legal relationship. If bankruptcy law forces the investors of a corporation to abandon the goal of maximizing the debtor’s economic value for the sake of other kinds of values, bankruptcy law actually forces the investors to pay for the benefits of non-investors. Under this circumstance, wealth redistribution is created, which may cause the problem of forum shopping between bankruptcy and non-bankruptcy proceedings. The risk-sharing theory argued that if the benefits of wealth redistribution exceed the cost of forum shopping, wealth redistribution can be accepted and that making this judgment needs empirical study. But it is not easy to conduct an empirical study that provides an exact calculation of the benefits and cost of a wealth redistribution provision. Some normative analysis of both sides may provide certain help. As discussed in the two paragraphs below, detailed examination of the benefits caused by bankruptcy law’s protection of non-investors reveals that the benefits are illusory because it is difficult to define the value held by non-investors that should be protected by bankruptcy law and that bankruptcy law does not seem to be the proper way for protecting non-investors’ interests.

It is problematic to use the bankruptcy law to provide protection to the non-investors affected by the business failure, because it is difficult to define the value held by non-investors that should be protected by bankruptcy law. For instance, it is difficult to define the value of the interest held by the community. It is unclear which kind of community interest should be protected. If we allow market competition, we must accept the changes in our life caused by the death of certain corporations, which releases capital and manpower that might build the basis for the birth of new corporations. Frost noticed that “[w]hile liquidation may harm the community served by the closed enterprise, it may benefit a distant community served by a competing enterprise.” When the values held by non-investors are ambiguous, it is problematic to use the bankruptcy law to provide appropriate protection to these ambiguous values.

Bankruptcy law does not seem to be the best way for protecting the interests or values held by

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150 Please refer to Section 2.1.1.2 for the forum shopping problem.
non-investors affected by business failure. Frost concluded that “the bankruptcy process is institutionally incapable of achieving redistributive goals.”\textsuperscript{153} Baird commented that if some values need to be protected, it is better to provide a clear protection system within the context of the whole legal system instead of within the bankruptcy law.\textsuperscript{154} Wealth redistribution provisions in bankruptcy law can only provide limited protection to victims of cases that enter into bankruptcy proceeding. Even if a corporation does not enter into bankruptcy, it may dispel workers, change its business from one kind into another, move from one community to another, or dissipate without going into the formal bankruptcy proceeding. All these business activities, just like bankruptcy, can negatively affect some persons and communities. However, the victims in these cases cannot receive equal protection since these situations are outside of the application scope of the bankruptcy law.\textsuperscript{155} Therefore, when we attempt to protect the non-investors in bankruptcy law, we need to think whether we could recognize this value and provide complete and consistent protection within the whole legal system, whether the coherency between bankruptcy law and non-bankruptcy law is preserved and the problem of forum shopping may be avoided. For instance, with respect to the protection of the employment opportunity of the affected workers, compared with forcing the investors of a debtor corporation in a bankruptcy case to provide unpredictable and inconsistent protection through wealth redistribution provisions in bankruptcy law, a social security system concerning protection of all the unemployed workers seems to be a more reasonable way.\textsuperscript{156}

To summarize, while it is ideal to protect all the values held by the parties affected by the business failure, it seems to be sub-optimal to use bankruptcy law to provide protection to the non-investors influenced by business failure.

\textsuperscript{153} Id, p. 75.
\textsuperscript{154} “Legal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them.” Douglas G. Baird (1987), Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 815, p. 822. “Other things being equal, one would want to transplant what good things are done in bankruptcy to ordinary avenues of rights enforcement and do away with bankruptcy law.” Id, p. 824.
\textsuperscript{156} Id, pp. 828-31.
2.1.6.3 The Creditors’ Bargain Theory and the Wealth Redistribution Rules in the Real Bankruptcy Law

The competing theories of the creditors’ bargain theory commonly point out that the wealth redistribution provisions contained in the real bankruptcy law prove the failure of the explanatory power of the creditors’ bargain theory. However, the existence of wealth redistribution provisions in the real bankruptcy law is not sufficient to fundamentally overthrow the explaining power of the creditors’ bargain theory. First, the fact that the real bankruptcy law contains wealth redistribution provisions cannot by itself prove the failure of creditors’ bargain theory. Baird pointed out “one can not derive the normative from the positive.” What the bankruptcy law is can not prove the creditors’ bargain theory completely wrong, since the creditors’ bargain theory is to provide a normative theory of what bankruptcy law should be. On the contrary, we need to check whether the real law is based on a normative theory that is better than the creditors’ bargain theory, if it is not, then how should the law be improved according to the creditors’ bargain theory.

Second, most of the wealth redistribution provisions in the real bankruptcy law can be explained by the creditors’ bargain theory. After careful examination, one may find that most of the redistribution provisions in bankruptcy law are caused by the collectivization of the disparate debt collection activities, serve the goal of minimizing the debt-collection costs and maximizing the debtor’s overall value, and thus are consistent with the creditors’ bargain theory. The redistribution provisions can be divided into four categories: (1) redistribution provisions that enhance the overall value by avoiding a race of debt-collection and minimizing debt collection costs and risks (for instance, provisions concerning equal distribution to similarly situated creditors or pro rata payment to general unsecured creditors); (2) redistribution provisions that preserve and enhance the overall value by preventing harmful strategic behaviors (for instance, provisions on preference avoidance); (3) redistribution provisions that preserve the debtor’s going-concern value and maximize the debtor’s overall value (for instance, providing the DIP or the bankruptcy trustee the power of

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deciding whether to continue or abrogate the executory contracts, automatic stay of the secured creditors’ right, the opportunity of rehabilitation; (4) redistribution provisions that enhance the protection of some specific parties (for instance, providing enhanced priority to employees and taxing authorities). The first three kinds of redistribution are caused by the collectivization of debt-collection activities, and are the devices for minimizing collection costs and maximizing the overall value, and thus can be explained by the creditors’ bargain theory. The first three kinds of redistribution provisions may damage the pre-bankruptcy entitlements of some parties, such as secured creditors, or creditors who hold preferred claims. According to the creditors’ bargain theory, the damage is justified if the damage is less than the corresponding benefits.

The problem with the creditors’ bargain theory is that it does not provide a justification for the existence of the fourth kind of redistribution provisions, i.e. the enhanced priority of some special unsecured claims. However, we need to examine whether this kind of wealth redistribution provisions is really necessary. Take the enhanced priority of employees’ claims and tax claims as an example. Should the protection of employee claims and tax claims be achieved only within formal bankruptcy proceedings or should these be achieved both inside and outside bankruptcy proceeding? The proponents of the creditors’ bargain theory have argued that if the protection of employee’s claims and tax claims is a legislative policy, it is more reasonable to implement it within the context of the whole legal system instead of implementing it through wealth redistribution provisions within bankruptcy law.\footnote{Douglas G. Baird (1987), Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 815, pp. 825-8.} For instance, in order to provide special protection to employees’ claims, labor law may provide that where the debtor defaults on more than one of its payment obligations, the employees’ claims should be paid before other unsecured claims. Default is not necessarily related to bankruptcy.\footnote{Id, p. 829.} Where a corporation is pursued by several creditors or dissipates value without entering into the formal bankruptcy proceedings, the protection of employees’ claims and tax claims is problematic if one needs to only rely on the wealth redistribution provisions in bankruptcy law to provide protection.

Indeed, after carefully reading China’s bankruptcy and non-bankruptcy law concerning the
protection of employees’ claims and tax claims, the author finds that the legislators intend to provide equal protection inside and outside bankruptcy when the debtor defaults on several obligations. For instance, Article 45 of the Law of the People’s Republic of China on the Administration of Tax Collection (“LOATC”)\textsuperscript{160} provides: “when the taxing authorities collect tax, their tax claims should be superior to other unsecured claims, unless other laws provide otherwise. If the tax occurred before the establishment of mortgage, pledge, or lien on the tax payer’s assets, the tax claim should be paid before the execution of the mortgage, pledge, or lien.” Obviously, Article 45 of LOATC intends to ensure the protection of tax claims outside bankruptcy proceedings. Another example is Article 187 and 188 of the Company Law of the People’s Republic of China (“CL”).\textsuperscript{161} Article 187 of CL provides that where the debtor dissolves, the debtor’s assets should be liquidated and the proceeds should first be used to pay all the unpaid claims. After paying all the claims, the remaining property shall be distributed to its shareholders. Article 188 of CL further provides that where the debtor’s assets are not enough to pay all the creditors, the company shall apply to the court for bankruptcy. Article 188 of Chinese company law reflects that, since bankruptcy law has come into existence and provided the priority order for all the claims in a uniform way, non-bankruptcy law has become reliant on bankruptcy law and simply refers to bankruptcy law for the priority order instead of providing the priority order directly. Article 45 of LOATC, Article 187 and 188 of CL reflect that the priority order of the Chinese bankruptcy law,\textsuperscript{162} although providing enhanced priority to employees’ claims and tax claims, is not a form of wealth redistribution, but simply a reflection of the priority order under the non-bankruptcy law. To summarize, a comprehensive reading of the distribution provisions in LOATC, CL and EBL supports the idea of the creditors’ bargain theory that the priority order in bankruptcy law should be a centralized and clear reflection of the priority order established under the non-bankruptcy law instead of being a new kind of priority order meant to be different to that under the non-bankruptcy law.

\textsuperscript{160} Passed by the Standing Committee of the Seventh People’s Congress on February 28, 1992; modified on April 28, 2001 and the modified version became effective on May 1, 2001.


\textsuperscript{162} The EBL, Art. 113.
Therefore, even if the real bankruptcy law contains the fourth kind of wealth redistribution provisions, this phenomenon cannot overthrow the explanatory power of the creditors’ bargain theory. It is suggested here that legislative reform should be conducted according to the creditors’ bargain theory to remove the fourth kind of wealth redistribution. When the priority order under bankruptcy law is different from that under non-bankruptcy law, we should first check which priority order is meant to be the correct reflection of the legislative policy and then modify the relevant provisions to ensure that the bankruptcy priority order is just a reflection of the non-bankruptcy priority order and that there is only one uniform priority order concerning debt payment inside and outside bankruptcy.

2.1.6.4 Conclusion

Based on the preceding discussions, the author considers that the creditors’ bargain theory defines the function of the bankruptcy law in a reasonable and practical way while the other theories impose an ambitious function on bankruptcy law. The creditors’ bargain theory, because of its merits in providing a convincing normative analysis on the goal of bankruptcy law, the relationship between bankruptcy and non-bankruptcy law, and the major provisions and systems of bankruptcy law, has been widely adopted as the normative bankruptcy theory for judging and analyzing the detailed bankruptcy provisions and systems. Therefore, the creditors’ bargain theory is adopted in this book as the theoretical device for examining the efficiency of the detailed provisions and sub-systems of the bankruptcy reorganization law of the chosen countries in this book.

3 The Plan-drafting System

This chapter compares the plan-drafting system under US and Chinese bankruptcy reorganization law, analyzes the efficient and inefficient elements of both systems and puts forward reform suggestions for the Chinese system. The plan-drafting system is intended to constrain the collective bargaining and plan formulation activities during the plan-drafting process. The key element of the plan-drafting system in the US and Chinese law is the exclusivity period, during which the sole plan-proponent is given substantial control over the decision-making process. Both the US and Chinese law provide for some restraining measures intended to strengthen the interested parties’ participation in the plan-drafting process and to guarantee their supervision over the sole plan-proponent. A detailed analysis of both systems is below.

3.1 The Plan-drafting System under US Law

3.1.1 Statutory provision on the exclusivity period under U.S. law

Under Chapter 11, once a bankruptcy reorganization procedure is initiated, creditors’ individual debt-collection activities are automatically stayed\textsuperscript{164} and the debtor automatically becomes the debtor-in-possession (“DIP”), which means that its pre-bankruptcy managers continue in office and control the business management.\textsuperscript{165} Under Chapter 11, the DIP enjoys an exclusivity period for proposing a plan and soliciting acceptance for the plan. Within 120 days after the date of the order for relief, the debtor has the exclusive right to file a plan,\textsuperscript{166} and within 180 days after the date of the order for relief, the debtor has the exclusive right to solicit acceptances for its plan.\textsuperscript{167} The 120- and 180-day periods are collectively referred to as the “exclusivity period”.\textsuperscript{168} On the request of an interested party, after notice has been given and a hearing has taken place, the court may reduce or extend the 120-day or the 180-day

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\textsuperscript{164} 11 U.S.C. §362.
\textsuperscript{165} 11 U.S.C. 1101(1); 1107.
\textsuperscript{166} 11 U.S.C. 1121(b).
\textsuperscript{167} 11 U.S.C. 1121(c)(3).
period for cause. It has been remarked that in comparison with foreign bankruptcy reorganization systems, one of the most important features of Chapter 11 of the current US bankruptcy code is the exclusivity period.

3.1.2 Analysis of the exclusivity period under US law

If we take the debtor corporation as a nexus of contract, the debtor’s current managers, creditors and shareholders are investors who put different kinds of capital in the debtor and receive their repayment according to their contract. When the debtor is financially distressed, investors may choose to find the most efficient solution through a collective bargaining process. The final decisions of their collective bargaining constitute the reorganization plan. The reorganization plan, which is about how to deal with the investors’ investment or property, is essentially a new investment agreement among these investors.

Contract law permits the contractual parties to change their contract based on equal bargaining and the assent of all the contractual parties. Outside bankruptcy, if the investors want to conduct a collective rehabilitation and change their original contractual investment rights, all the investors of the debtor corporation have an equal right to propose a plan on how to deal with their property or investment. The exclusivity period changes their non-bankruptcy entitlement by depriving most investors of the right of proposing a plan on how to modify their old investment contract. The exclusivity period, by giving the DIP or the administrator the exclusive right to propose a plan, modifies the investors’ pre-bankruptcy entitlements and makes them bargain with the plan proponent under the control of the plan-proponent since no matter how efficient the idea of an interested party is, it is the DIP or the administrator that decides the content of the plan to be voted on and examined.

According to the creditors’ bargain theory, a bankruptcy reorganization system is efficient if it causes the collective procedure to operate in a way that results in efficient reorganization decisions that maximize the debtor’s overall value. Moreover, the creditors’ bargain theory

\[169\] 11 U.S.C. 1121(d)(1)


\[172\] For instance, Article 77 of the Contract Law of the People’s Republic of China permits modification of an existing contract if the contractual parties have reached mutual consent.
proposes that bankruptcy law should respect the bargaining parties’ pre-bankruptcy entitlements and can modify the non-bankruptcy entitlements only under the condition that it is necessary for preserving the benefits of the collective procedure and the benefits created by the modification should be greater than the damage caused by it. This section analyzes the efficient elements of the exclusivity period, on the basis of the preceding standards proposed by the creditors’ bargain theory, i.e. the necessity and the contribution of the exclusivity period to the collective procedure and efficient decision-making and the inefficient elements of the exclusivity period, i.e. the damage that the exclusivity period does to the collective procedure and efficient decision-making.

3.1.2.1 The Efficient Elements of the Exclusivity Period

(1) Encouraging the debtor to file the reorganization petition without delay

The exclusivity period’s main contribution to the collective procedure and efficient decision-making is that it provides the debtor with the incentive to make use of the reorganization procedure at an early stage. The exclusivity period was designed mainly from the respect of the “incentive” of the debtor. It induces the debtor to seek bankruptcy reorganization at an early stage by providing the debtor with power to control its reorganization for a limited period of time. If there were no exclusivity period for the debtor, the right to file a plan would be open to all the parties at the inception of the proceeding, the debtor would face plan competition and have the fear of losing control over its reorganization since the plan proposed by the debtor might be defeated by a competing plan. The fear of losing control over the reorganization might lead the debtor’s managers to delay the reorganization petition. The delay could cause deleterious effects to the debtor and its investors. During the delay, the debtor’s assets might have been depleted and the proper

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173 See Section 2.1.1.2 of Chapter I.

timing for achieving a successful reorganization might have been missed.\textsuperscript{175} The legislative material of the current US bankruptcy Code stated that “[p]roposed Chapter 11 recognized the need for the debtor to remain in control to some degree, or else debtors will avoid the reorganization provisions in the bill until it would be too late for them to be an effective remedy.”\textsuperscript{176} It is commented that the exclusivity period, which helps to counteract the debtor’s managers’ fear of losing control, is an important device adopted by Chapter 11 for fostering the proper use of the formal legal rescue device, i.e. the bankruptcy reorganization law.\textsuperscript{177}

(2) Expediting the reorganization decision-making process

Some scholars and judges consider that the exclusivity period’s other contribution to the collective procedure and efficient decision-making is that it expedites the reorganization decision-making process. Were there no exclusivity period, the interested parties and the court would be forced to “compare apples and oranges”, i.e. compare the competing plans that are substantially different from each other. Since it is often very difficult to judge which is the best among all the competing plans, plan competition may cause complicated debate and litigation and make the plan proposing process even more complicated, costive and time-consuming.\textsuperscript{178} In addition, plan competition potentially opens the way for liquidation

\textsuperscript{172}Ross L. Weston (1990), The Exclusivity Period in Section 1121: How Exclusive Is It?, 11 Cardozo L. Rev. 639, p.651.
\textsuperscript{176}House Report, p. 6191.
plans filed by a secured creditor, which may disturb the consideration of the debtor’s reorganization plan.  

3.1.2.2 The Inefficient Elements of the Exclusivity Period

(1) Causing forced acceptance of the debtor-proposed plan by excluding competing plans

Chapter 11 fundamentally aims at producing a reorganization plan through the structured bargaining among the interested parties, such as the debtor, the creditors and the shareholders. If the interested parties’ bargaining does not fail, their bargaining ends with a bargaining result, i.e. a reorganization plan that has gained consensual acceptance of all classes of the bargaining parties. By excluding the competing plans, the exclusivity period gives the debtor-proposed plan a special advantage in gaining acceptance. “The ability of a creditor to compare the debtor’s proposals against other possibilities is a powerful tool by which to judge the reasonableness of the proposals.” The exclusivity period takes this tool from creditors and thus provides special favor to the debtor’s plan. Compared with the
choice of giving a quick acceptance to the debtor’s plan, the choice of rejecting the debtor-proposed plan will cause further delay since the debtor will take further efforts in revising the draft plan and soliciting acceptance of the revised plan. Even if the exclusivity period ends up with a bargaining failure, the non-debtor parties need to bear an extra delay for the formulation of the competing plans since the exclusivity period prohibits the competing plans from being proposed simultaneously with the debtor’s plan. Time is expensive to the bargaining parties.\textsuperscript{183} During the exclusivity period, creditors bear cost for the delay without knowing the result of the delay since alternative plans are still unknown. Under this situation, creditors “are more likely to vote for the debtor’s proposal rather than risk unknown delay.”\textsuperscript{184}

Therefore, by preventing the competing plans from being proposed and compared with the debtor-proposed plan at the same time, the exclusivity period drives the bargaining towards forced acceptance of the debtor’s plan and makes the quality of the bargaining result, i.e. the efficiency of the debtor-proposed plan that gains consensual acceptance, questionable.\textsuperscript{185}

The influence of the exclusivity period over the bargaining result is considerable, because it not only excludes competing plans for a limited period, but also may exclude them forever. At first glance, we may think that the exclusivity period only bans competing plans for a limited period. However, this is not always the effect. Time is essential to the success of the reorganization.\textsuperscript{186} At the beginning of a reorganization case, whether there is an opportunity for a non-debtor party to propose a plan is unknown. A non-debtor party, who has a competing plan in mind, must wait until the exclusivity period ends. When the exclusivity period finally ends and he knows that he has got the opportunity, the good timing for formulating and proposing the competing plan may have been lost because the exclusivity

\textsuperscript{183}Abhinay Muthoo, BARGAINING THEORY WITH APPLICATIONS 3 (1999). Please refer to the following part, i.e. part (2) of this Section for discussions concerning the time cost of the creditors during the exclusivity period.

\textsuperscript{184}In re Century Glove, Inc., 860 F.2d 94, 102 (3rd Cir. 1988).

\textsuperscript{185}For example, the non-debtor parties may accept a debtor-proposed plan which will realize the debtor’s value at $100 because they do not know that there will be a competing plan after the exclusivity period ends which will realize the debtor’s value at $120, or because they think that even if a competing plan producing a value of $120 may be proposed and accepted 6 months after the exclusivity period ends, the present value of the $120 is less than the $100 now offered by the debtor’s plan (e.g. they may take into account the risk and cost accompanying the delay and discounting $120 to a present value of $95).

\textsuperscript{186}House Report states that time is essential to reorganization when talking about the lengthy process of Chapter X of the Bankruptcy Act of 1898. “In a reorganization where time is of essence….”. House Report, pp. 6181-2.
period took a long time, especially in large complex cases. The possible complete elimination of competing plans may hinder the non-debtor parties from hoping an efficient competing plan will emerge in the future and drive the bargaining toward forced acceptance of the debtor-proposed plan.

(2) Causing forced acceptance of the debtor-proposed plan by providing the debtor with the power of strategic delay

The exclusivity period provides the debtor with the power of delay. Since the exclusivity period is the time period for the debtor to propose a plan and solicit acceptance of the plan, the debtor first controls the time length of the initial exclusivity period used for proposing a plan and soliciting acceptance of the plan. What is more important is that the debtor may, to a considerable extent, control the extension of the exclusivity period by providing the required evidence and proving to the court that there are qualified causes for extension. Since the debtor controls the information concerning the debtor’s reorganization, it has a natural advantage in collecting and even in manipulating the information presented to the court for the purpose of extension. Besides its natural information advantage, the courts’ general recognition of the underlying policy of Chapter 11 of favoring reorganization and the courts’ lenient attitude towards the debtor’s rehabilitation efforts further help the debtor to gain the extension. The exclusivity period is almost routinely extended particularly in large, complex cases. Therefore, based on the exclusivity period, the debtor gains the power of controlling the length of the exclusivity period—the power of delay.

During the delay, creditors bear substantial time cost. First, during the delay, business is at risk and is uncertain because the managers’ incentives may not be right and the bankruptcy stigma may hinder other market parties from dealing with the debtor. Moreover,

190In the 43 Chapter 11 cases of large public corporations studied by LoPucki and Whitford, the exclusivity period was extended in 34 cases (78%). Lynn M. LoPucki and William C. Whitford (1993), Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, p. 693. Richard M. Cieri, Scott J. Davido, and Lennox Heather (1993), Applying an Ax When a Scalpel Will Do: The Role of Exclusivity in Chapter 11 Reform, 2 J. Bank. L. &Prac. 397, pp. 409-10.
administrative expenses, court costs and professional fees may accrue rapidly. All of the risks, uncertainties and cost, may reduce the debtor’s value and the possibility of successful rehabilitation, which will further lead to the reduction of the payment to creditors and shareholders. Moreover, the exclusivity period is accompanied by the automatic stay, which prevents creditors from quickly collecting their payments. It is very difficult for creditors to get compensation for the delay in receiving payment. Only over-secured creditors are entitled to receive post-petition interest payment and the calculation and payment of the post-petition interest is quite problematic. Threatened by the debtor’s power of delay and the substantial time cost accompanying the delay, creditors may choose to give a quick acceptance to the debtor’s plan.

To summarize, the exclusivity period provides the debtor with the power to control the reorganization decision-making process by excluding the competing plans and providing the debtor with the power of delay. By providing the debtor with the power of delay, the exclusivity period greatly favors the debtor’s plan and may shelter the debtor’s inefficient plan from critical screening. Even if the debtor’s managers know that their reorganization plan is less efficient than liquidation, they may take the exclusivity period as a safe harbor that keeps them away from the pursuing creditors and use as much time as possible to keep their pivotal position and gamble at creditors’ cost for an illusory rescue of their career and business. With the help of the power of control provided by the exclusivity period, an inefficient debtor’s plan may be accepted, which subsequently leads to the implementation of the debtor-proposed inefficient plan.

3.1.3 Measures for mitigating the inefficient elements of the exclusivity period

While adopting the exclusivity period, legislators of Chapter 11 designed a series of measures for counterbalancing the inefficient effects of the exclusivity period and strengthening the interested parties’ supervision over the debtor in order to ensure that the debtor is encouraged to propose an efficient plan. This section gives a brief description of the restraint measures available to the interested parties. According to creditors’ bargaining theory, an efficient bankruptcy law should foster the collective reorganization bargaining and encourage the interested parties to reach a final decision that maximizes the debtor’s overall value and the recovery of the participating parties as a group, with reference to this standard, this section analyzes the efficient elements of each restraining measure, i.e. the contribution of a restraining measure to the collective procedure and efficient decision-making, and the inefficient elements of each restraining measure, i.e. the damage that a restraining measure does to the collective procedure and efficient decision-making.

3.1.3.1 The committee device

In order to strengthen the bargaining and supervisory power of dispersed parties that hold substantially similar claims/interests and in large numbers, legislators of Chapter 11 used the committee device.

(1) Establishment of committees

Chapter 11 requires the establishment of unsecured creditors’ committee in each case\(^{194}\) with the exception that when a small business is involved, on the request of an interested party, the court orders that an unsecured creditors’ committee not be appointed.\(^{195}\) The current US Bankruptcy Code provides that if additional committees are needed to represent the interests of some claim or interest holders, such as subordinated creditors, tort creditors, and equity security holders, the court may, upon the request of a party in interest, order the establishment of such committees.\(^{196}\) The unsecured creditors’ committee and equity holders’ committee should include the holders of the seven largest claims or interests to be represented by the

\(^{194}\) 11 U.S.C. § 1102 (a)(1)
\(^{195}\) 11 U.S.C. § 1102 (a)(3)
\(^{196}\) 11 U.S.C. § 1102 (a)(2)
committee. The U.S. trustee shall, as soon as practicable after the commencement of a Chapter 11 case, appoint the unsecured creditors’ committee and may appoint any other additional committees if the U.S. trustee deems appropriate. If upon the request of a party in interest, the court orders the appointment of additional committees, the U.S. trustee shall appoint such additional committees according to the court’s order. In order to ensure the representative role of the unsecured creditors’ committee, secured creditors are completely excluded from the establishment process of the unsecured creditors’ committee since there is often conflict of interest between secured and unsecured creditors.

(2) Special emphasis on the unsecured creditors’ committee

The mandatory establishment of an unsecured creditors’ committee reflects the fact that the legislators of Chapter 11 placed special emphasis on the unsecured creditors’ bargaining power and their participation in the decision-making process. There are two main reasons for this special emphasis.

First, unsecured creditors are normally large in number and may not have enough at stake to motivate them to participate fully in the decision-making process. Therefore, they are often in need of representation.

Second, compared with secured creditors and shareholders, unsecured creditors stand at a special and important position in the reorganization decision-making process. Thus, their participation in the decision-making process through the representation device, i.e. the committee, should be given special emphasis. In the context of reorganization, secured creditors tend to push the debtor into the liquidation proceeding in which they might receive full payment without much delay. In cases where the debtor is deeply insolvent, shareholders have lost their residual owner status and their decision-making incentive is skewed toward continuation since they have nothing to lose, and everything to gain.

Moreover, fundamentally, in cases where the debtor is insolvent, it is creditors who pay for

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197 11 U.S.C. § 1102 (b)(1)(2)
198 11 U.S.C. § 1102 (a)(1)
the shareholders’ committee. Although shareholders may, just as unsecured creditors, face collective action problems, it is not necessary to establish an equity holders’ committee in every case, especially in cases where the debtor is deeply insolvent. Therefore, Chapter 11, while providing that the shareholders’ committee is only appointed where the nature of the case makes such a committee appropriate, mandates the establishment of unsecured creditors’ committees in every case.

(3) Reimbursement of Committees’ cost

Committees often depend on their professional advisors for assistance in order to fulfill their function. They need to employ professionals, such as attorneys, accountants, investment advisors so that they can get professional help in analyzing the debtor’s financial condition, the operation of the debtor’s business, the efficiency and feasibility of the debtor-proposed plan. Chapter 11 provides that an unsecured creditors’ committee may get compensation for the expenses incurred by hiring the professionals and that an additional committee may get compensation for the actual and necessary expenses if it makes substantial contribution to the case. Whether the members of the unsecured creditors’ committee may get reimbursement for the costs incurred by carrying out the duty of a committee member is not clearly provided. Some courts refused to compensate the members of unsecured creditors’ committees based on a strict literal interpretation the current US Bankruptcy Code. However, some courts allowed this reimbursement based on different grounds, such as that the committee’s members’ cost falls in the category of “actual, necessary costs and expenses of preserving the estate”; public policy, or the equity principles. It has been remarked that denying reimbursement to the costs of the members of the unsecured creditors’

208 11 U.S.C. § 503(b)(3)(D): “a creditor ... or a committee representing creditors or equity security holders other than a committee appointed under section 1102 of [the Code], in making a substantial contribution in a case under chapter 9 or 11 of [the Code] ....”. This has been interpreted by some courts as statutory prohibition of reimbursement for members of unsecured creditors’ committee. See, e.g., In re Mason’s Nursing Center, Inc., 73 Bankr. 360 (S.D. Fla. 1987); In re Lyons Mach. Co. Inc., 28 Bankr. 600 (E.D. Ark. 1983).
committee, whose establishment and participation is specially emphasized by the US Code, frustrates the effective function of the unsecured creditors’ committee and is contrary to the legislative policy of strengthening unsecured creditors’ participation.\(^1\)

(4) Function of committees

Committees represent the overall interests of their constituents and make the dispersed creditors or shareholders act as one, thus strengthening the bargaining power of a group. \(^2\)

Where the number of creditors, equity holders etc. is large, it is almost impossible for each and every one to fully participate in the bargaining process and actively supervise the debtor. Even if it would be possible, costs run up if every participant tries to extract information from the debtor, negotiates with different parties and struggles for his interests. Moreover, the dispersed parties may not have enough at stake to motivate them to participate actively and may not be sophisticated enough to bargain efficiently. \(^3\) The committee device, by choosing certain capable and active members to work as the fiduciary of their group and hiring professionals for professional advice, can effectively strengthen the bargaining and supervisory power of the group. \(^4\) Chapter 11 provides for a committees’ duty of bargaining with the other parties and the supervision of the debtor. It is provided that committees should participate in the plan formulation, collect information concerning debtor’s business management, look into the reorganization desirability and other matters relevant to the case or to the plan-drafting, advise its constituencies concerning the evaluation of the plan, solicit and file with the court acceptances of and objections to a plan, request the appointment of a trustee or examiner. \(^5\)

(5) The efficient and inefficient elements of the committee device

Viewed from the creditors’ bargain theory—the maximization of the debtor’s value, the committee device is efficient in that it restrains the DIP from proposing a plan that suits him rather than that suits the creditors and is inefficient in that it causes certain costs. Although

\(^{211}\) Blain Peter C. and Diane Harrison O’Gawa (1990), Creditors’ Committees under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties, 73 Marq. L. Rev. 581, p. 611.

\(^{212}\) House Report, pp. 6194-5.


\(^{214}\) House Report, pp. 6194-5.

\(^{215}\) 11 U.S.C. § 1103 (c)
committees strengthen the parties’ bargaining and supervisory power, committees are the representatives of the dispersed parties and, like its constituents, bargain with the DIP on the platform that is built by the exclusivity period which tilts towards the DIP. The committee device restrains the debtor’s use of its power of control, but cannot sufficiently counterbalance that power of control.

3.1.3.2 Judicial Supervision over the length of the exclusivity period

(1) Provision on the judicial supervision over the length of the exclusivity period
Legislators of the US Code tried to counteract the inefficient elements of the exclusivity period by providing the court with the power of discretion in deciding the exact length of the exclusivity period for every case. Under Chapter 11, the court, upon the request of a party in interest within the exclusivity period, after notice and hearing, may reduce or increase the exclusivity period. The moving party has the burden of proving cause for a reduction or extension.

It has been remarked that the legislators “tried to create a flexible exclusive right to serve the interest of a debtor as well the interests of creditors in a balanced way.” On the one hand, the legislators recognized the need for the debtor to keep control and thus adopted the exclusivity period device. On the other hand, they recognized the need for protection of the legitimate interests of creditors, whose money is in the enterprise, who should have a say in the future of the company and should not be held hostage to the exclusivity period for too long time. In order to ensure that the length of the exclusivity period is sufficient for the debtor to master the bargaining table and negotiate a settlement and not unduly long for creditors, the court is vested with the power of deciding the reasonable length of the exclusivity period for a specific case.

(2) The efficient and inefficient elements of the judicial supervision over the length of the exclusivity period
Judged against the standard proposed by the creditors’ bargain theory—the maximization of

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the debtor’s value, the judicial supervision on the length of the exclusivity period is efficient in that it helps to design a proper time span for the exclusivity period of a specific case and encourages the plan-proponent to propose a plan within a proper time period. It has inefficient elements in that it is not easy for the court to decide upon a proper duration for a specific case since it is the DIP who has direct access to the information concerning plan-formulation and who is the major party that provides the court with the evidence for the extension. Moreover, generally courts recognize that the underlying policy of Chapter 11 is to favor debtor’s reorganization efforts and take a lenient policy when deciding whether to extend the exclusivity period. This fact further limits the restraining power of this device. The exclusivity period, regardless of whether it is 6 or 10 or 14 months in a specific case, is by nature a device that helps the debtor to keep control. The judicial supervision over the length of the period for each case can help to avoid excessive delay, but can not sufficiently counterbalance the debtor’s control power.

3.1.3.3 The trustee device

A severe restraining measure over the debtor is the appointment of a trustee, which automatically leads to the termination of the exclusivity period.

(1) Cause for Appointment of a trustee

Chapter 11 provides that on the request of a party in interest or the U.S. trustee, the court shall order the appointment of a trustee for cause of fraud, dishonesty, incompetence and gross mismanagement or if such appointment is in the interest of all the constituencies or the whole estate, rather than any particular constituency. The finding for the “cause” or “interest” for appointing a trustee requires the court to exercise its discretion. In determining whether the appointment of a trustee is in the interest of all the constituencies and the whole estate, courts have described various factors, such as (i) the trustworthiness of the debtor; (ii) the debtor’s past and present performance and prospects for the debtor’s rehabilitation; (iii) the confidence or lack of confidence of the business community and of creditors in present management; and

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(iv) the benefits derived by the appointment of a trustee, balanced against the cost of the appointment.\textsuperscript{220} In general, these factors reflect a balancing of the benefits and cost of the appointment of a trustee.\textsuperscript{221}

Upon the appointment of a trustee, the debtor is removed from possession and the exclusivity period is automatically terminated. In this situation, the trustee and all the interested parties, including the debtor, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee, become equal plan proponents.\textsuperscript{222}

(2) Election of the trustee

Upon the request of a party in interest made not later than 30 days after the court orders the appointment of a trustee, the United States trustee shall convene a meeting of creditors for the purpose of electing one disinterested person to serve as trustee in the case. The election of a trustee should be conducted in the same manner as under the liquidation proceeding.\textsuperscript{223} At the meeting of creditors, creditors that are qualified for voting for a trustee may elect a trustee. A creditor that may vote should meet three conditions: (i) hold an allowable, undisputed, fixed, liquidated, unsecured claim; (ii) not have an interest materially adverse to the interest of creditors of his kind; (iii) not be an insider.\textsuperscript{224} Therefore, only unsecured creditors may be qualified as voting creditors for a trustee. Qualified voting creditors who hold at least 20% of the total amount of the claims held by all the qualified voting creditors may request the election of a trustee\textsuperscript{225} and a candidate is elected trustee if qualified voting creditors holding at least 20% of the total claims held by all the qualified voting creditors participated in the voting and the candidate receives the assent of creditors holding a majority in the amount of the total claims held by all the creditors that participated in the voting.\textsuperscript{226} After a trustee is elected, the United States trustee shall file a report certifying the election.\textsuperscript{227}

(3) Role of the trustee

Upon appointment of the trustee, the trustee replaces the debtor and runs the debtor’s business.

\textsuperscript{221} Barry L. Zaretsky (1993), Trustees and Examiners in Chapter 11, 44 S. C. L. Rev. 907, p. 929.
\textsuperscript{222} 11 U.S.C. 1121(c).
\textsuperscript{223} 11 U.S.C. § 1104(b)(1). It is provided that the election of a trustee should be conducted in the manner provided in subsections (a)(b)(c) of section 702.
\textsuperscript{224} 11 U.S.C. § 702.
\textsuperscript{225} 11 U.S.C. §702 (b)
\textsuperscript{226} 11 U.S.C. §702 (c).
\textsuperscript{227} 11 U.S.C. §1104(2)(A)
Because the exclusivity period is combined with the DIP system, the appointment of a trustee automatically leads to the termination of the exclusivity period. Thus, the appointment of a trustee deprives the debtor of the power of control over both the business and the reorganization decision-making.

(4) The efficient and inefficient elements of the trustee device

Judged against the standard proposed by the creditors’ bargain theory—the maximization of the debtor’s value, the trustee device is efficient in that it can remove the incompetent debtor from the controlling position. It is inefficient in that it is not easy for the court to judge whether a debtor is too incompetent to remain in possession. Legislative history indicates that, in line with the rationale of the exclusivity period and the underlying legislative policy for the appointment of a trustee, the appointment of a trustee should be used only in extremely serious circumstances as too frequent an appointment would hinder the debtor from the timely filing of the reorganization petition and thus leave the reorganization procedure largely unused. Generally, courts commonly recognize the lenient legislative policy of allowing a debtor to keep control and have been reluctant to use the trustee device if there are no compelling facts strongly advocating the use of it. To conclude, while the trustee device helps to remove the severely incompetent debtor from being in possession, the difficulty in deciding whether a debtor is so incompetent that he needs to be replaced by a trustee, coupled with the court’s lenient attitude towards debtor’s, limits the restraining effect of this device.

3.1.4 General comments on the US plan-drafting system

From the previous analysis one may infer that the US plan-drafting system is largely composed of two parts: the exclusivity period that provides the debtor with the power of control over the reorganization decision-making process and the restraining measures for supervising the debtor’s exercise of this power of control, which includes the committee device, judicial supervision over the length of the exclusivity period and the trustee device. While debtor control has the merit of inducing the debtor’s early use of the formal

228 House Report, p. 6193.
reorganization device and expediting the reorganization decision-making process, it is flawed in that it has a negative influence on the reorganization bargaining and the quality of the final reorganization decision. Judged against the standard proposed by the creditors’ bargain theory, i.e. the maximization of the debtor’s overall value, the crucial question is whether or not the US plan-drafting system is efficient. Some scholars commented that it strikes a perfect balance between debtor’s control and the restraint over the debtor’s control,\textsuperscript{230} while others have commented that it puts too much control in the debtor’s hand and is thus inefficient.\textsuperscript{231} The analysis above has shown that, although the restraining measures adopted by Chapter 11 help to mitigate the inefficient elements of the exclusivity period, those measures do not change the basic fact that the exclusivity period provides the debtor with the power of control over the decision-making in the plan-drafting process. In cases where the plan-proponent is unable to absorb the efficient ideas of the interested parties or potential competing plans are more efficient than the plan proposed by the sole plan-proponent, the restraining measures cannot solve the problem. To conclude, the exclusivity period, which provides the debtor with the power of control over its reorganization, has both positive and negative effects on reorganization decision-making. Although the restraining measures can help to mitigate the inefficient elements of the exclusivity period, it is questionable whether the restraining measures can sufficiently restrain and help the debtor to propose an efficient plan. According to the creditors’ bargain theory, whether the exclusivity period is efficient depends on whether its contribution to the collective procedure and efficient decision-making is greater than the damage it brings to collective procedure and efficient decision-making. A weighing of both sides is discussed in Section 3.2.5 of this book.

\textsuperscript{230} It is commented that Chapter 11 has made a good delicate balance between the debtor’s control and the limitation of the debtor’s control by providing the court with the power of discretion to decide the length of the exclusivity period for every specific case. Kenneth N. Klee (1995), A Brief Rejoinder to Professor LoPucki, 69 Am. Bankr. L. J. 583, p. 586.

\textsuperscript{231} “The United States is probably the only developed nation that leaves the debtor in unsupervised possession of the estate during a reorganization. In small cases, that often means that the debtor continues to operate the business until it runs out of cash and dies. In large cases, excessive debtor control manifests itself in the debtor's exclusive right to file a plan. Continued exclusivity means that the reorganization case goes forward on the debtor's terms or not at all. Professor Klee and other defenders of the status quo echo the claim of legislative history that Congress struck a careful balance between debtors and creditors in structuring the rules with respect to the debtor's right to exclusivity. The reality is that balancing plays almost no role. In by far the majority of large cases, exclusivity is routinely extended, not so much because of the complexity of the case as because the debtors have forum shopped for a district where the judge liberally grants extensions.” Lynn M. LoPucki (1995), Chapter 11: An Agenda for Basic Reform, Am. Bankr. L. J. 573, pp. 576-7.
3.2 The Plan-drafting System under Chinese Law

3.2.1 Statutory provision on the exclusivity period under Chinese law

Under the EBL, either the bankruptcy administrator or the DIP may be the plan proponent, who enjoys an exclusivity period for proposing a reorganization plan. The other interested parties will never get the opportunity to propose a plan. Below is a detailed description of the two kinds of plan-drafting processes with reference to the different plan proponents.

3.2.1.1 The administrator as the sole plan proponent

(1) The administrator as the sole plan proponent

Under the EBL, a debtor or its creditors may file a reorganization petition to the court. If the court, after examination, considers that the reorganization petition is in conformity with the provisions of the EBL, it will make a ruling that declares the court’s acceptance of the case and grants the court’s permission for the debtor’s reorganization.\(^{232}\) Where a debtor’s creditors file a liquidation petition to the court, after the court accepts the bankruptcy case and before the court officially declares the debtor’s bankruptcy, the debtor or its shareholders holding more than 1/10 of the debtor’s total registered capital, may file a reorganization petition to the court. If the court considers that the reorganization petition is in conformity with the provisions of the EBL, the court should make a ruling that permits the reorganization of the debtor. Upon the court granting its permission for the reorganization, the liquidation case is converted into a reorganization case.\(^{233}\) When the court rules to accept a bankruptcy reorganization case, it should designate an administrator for the case at the same time.\(^{234}\) Upon being designated, the administrator manages the debtor’s assets and business operation. Moreover, the administrator, by default, is the sole plan proponent who takes on the duty of proposing the reorganization plan within the exclusivity period.\(^{235}\)

(2) The appointment of the administrator

In order to get a clear understanding of the role of the administrator in the Chinese bankruptcy reorganization procedure, we need to know how the administrator is appointed for a specific
case and what the legal duties and powers of the administrator are in a specific case.

The Supreme People’s Court’s Stipulations concerning the Appointment of Administrators for Bankruptcy Cases (the “SPCS”) provides in detail how the reservoir of qualified administrators from which a court chooses an administrator for a specific case is established and how a court appoints an administrator for a specific case. Generally a high people’s court is in charge of compiling a list of administrators within its jurisdiction area. A high people’s court should compile the list of intermediary agency administrators and the list of individual administrators separately. The intermediary agencies mainly include law firms, accounting firms, and bankruptcy liquidation firms. All the intermediary agencies and professionals that meet with the legal qualification requirement may apply to be added to the list of administrators. Professionals possessing relative professional knowledge and holding professional licenses, who are members of intermediary agencies that have been included in the list, may apply to be included in the list of individual administrators. Agencies and individuals that are located outside of the jurisdiction area of the compiling court can not apply to be included in the list. However, agencies’ branches which are located within the jurisdiction area of the compiling court may apply to be put on the list. The court compiling the list of administrators should establish an examination committee with no less than seven members to decide whether an agency or individual is qualified. The final list of administrators should be publicized through the public media with national wide circulation and influence.

Generally the trial court, i.e. the court that has accepted a bankruptcy case, should appoint an administrator for the case from the list of administrators within its jurisdiction area. Moreover, the trial court generally should appoint an intermediary agency as the administrator.

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236 Issued by the Supreme People’s Court on April 4, 2007.
237 In China, every province, municipality directly under the Central Government, or autonomous region has one high people’s court. The province, or municipality directly under the Central Government, or autonomous region, where a high people’s court is located, is the jurisdiction area of this high people’s court. See The Organization Law of the People’s Courts of the People’s Republic of China, Article 26.
238 The SPCS, Art. 3.
239 The SPCS, Art. 4.
240 The SPCS, Art. 10.
241 The SPCS, Art. 12.
242 The SPCS, Art. 15.
for a bankruptcy case. However, for a case with clear facts, simple debtor-creditor relations, and concentrated assets, the court may appoint an individual as the administrator. The trial court should generally use stochastic methods, such as the methods of taking turns, balloting or lotto, to appoint administrators for a case.

What deserves special attention is that the court may in certain circumstances appoint a liquidation panel as the administrator. Article 18 of the SPCS provides that in the following circumstances, the court may appoint a liquidation panel as the administrator: (i) before the acceptance of the bankruptcy case, the liquidation panel has been constituted and its constitution does not violate Article 19 of the SPCS; (ii) the case is a case provided for in article 133 of the EBL; (iii) the relevant law stipulates that a liquidation panel should be established when a certain kind of enterprise is bankrupt; (iv) other circumstances in which the court considers it proper to appoint a liquidation panel. It should be noted that item (iv) of Article 18 provides the court with discretionary power in deciding whether to appoint a liquidation panel as the administrator for a case. With respect to the constituent members of the liquidation panel, Article 19 of the SPCS provides: (i) the court may designate persons from the relevant department of the government and financial asset management

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243 The SPCS, Art. 16.
244 The SPCS, Art. 17.
246 Article 19 of the SPCS contains rules on who can be the members of a liquidation panel and is introduced in the latter part of this paragraph following the discussion of Article 18.
247 This is a weird situation. According to the EBL, the administrator can only be designated by the court at the time the court rules in acceptance of a bankruptcy case, which implies that the liquidation panel as a kind of administrator can not exist before the court accepts a case. The possible explanation is that this provision refers to the special cases where before the bankruptcy application is filed, the debtor corporation has established a “semi-liquidation-panel” according to the SPCS to study the debtor’s problem and decide whether to file a bankruptcy reorganization petition and if so, how to reorganize. This kind of practice is expected by the Supreme People’s Court (the legislator of the SPCS) to be the common practice of the reorganization of big corporations. The Supreme People’s Court’s opinion concerning the “semi-liquidation-panel” is reflected in the discussions on the seminar held by the Supreme People’s Court and the China Securities Regulatory Commission, which is summarized in the following article: 许美征(Meizheng Xu), 《上市公司破产重整管理制度的探讨》(Exploring the Administrator System in the Bankruptcy Reorganization of Listed Corporations), 法制日报(Legal Daily), 2009年4月1日第012版( April 1, 2009, Page 012).
248 Article 133 of the EBL provides that the bankruptcy of state-owned enterprises within the time limit and scope provided by the State Council should be conducted according to the relative stipulations issued by the State Council. Article 133 of the EBL actually means that the bankruptcy of state-owned enterprises that has been included the official plan of policy-based bankruptcy should continue to be conducted according to the regulations issued by the State-Council even after the EBL takes effect. For the policy-based bankruptcy, please refer to part (3) of Section 1.3.2 for detailed analysis.
corporations, and intermediary agencies from the official list of qualified administrators to be members of the liquidation panel; (ii) the People’s Bank and the financial regulatory authorities may designate certain persons to become members of the liquidation panel according to relevant laws and regulations. The constitution of the liquidation panel suggests that it is a special kind of administrator because it allows government officials to become administrators of a bankruptcy case. Take the case of Qinling as an example. In this case, the liquidation panel included one lawyer, one financial consultant and 22 officers from all kinds of bureaus and departments of the government of the Tongchuan Municipality, such as two deputy majors, dean and deputy dean of the state-owned assets supervision and administration commission, the deputy director of the environment bureau, planning bureau, real estate bureau, employment and social security bureau, public security bureau etc.

It is noticeable that Article 18 of the SPCS allows a broad use of the liquidation panel as the administrator for a case. The decisions made in the bankruptcy reorganization case are business decisions. The administrator should be a bankruptcy professional who may help the interested parties to make the efficient business decision. It seems strange that the SPCS allows government officials to be the bankruptcy administrators. A further exploration of the legislative reasons and the practice of the use of the liquidation panel in the reorganization practice shows how Article 18 of the SPCS provides the ground for the government to control certain reorganization cases. A detailed analysis is given in Section 6.2.1.2.

(3) The duties and powers of the administrator

Once an administrator is appointed for a case, he controls the debtor’s assets and business management. The duty of administrators includes taking over the debtor’s property, seal, and files (such as accounting books and written documents etc.); investigating the debtor’s financial situation and making financial statements; deciding the debtor’s internal management, daily expenses and other necessary expenses; managing and dealing with the

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249 It should be noted that the financial asset management corporations in China are special wholly state-owned corporations for dealing with the bad credit of the state-owned banks. See Article 1, Regulation on Financial Asset Management Companies, passed by the State Council on November 1, 2000.

250 Shanxi Qinling Cement (Group) Corp. Ltd., a corporation listed on the Shanghai Stock Exchange. The code of its securities is 600217.

debtor’s property; participating in the litigation, arbitration and other legal procedures on behalf of the debtor; proposing to convene the creditors’ meeting; and performing other duties that the court considers should be performed by the administrator.\footnote{The EBL, Art. 25.} The administrator may, after getting the approval of the court, hire necessary workers.\footnote{The EBL, Art. 28.} In a reorganization case, the administrator may hire the debtor’s managers to manage the debtor’s business.\footnote{The EBL, Art. 74.} In addition to the duty of managing the debtor’s assets and business, as discussed above, the administrator takes on the responsibility of formulating a plan during the exclusivity period.

3.2.1.2 The DIP as the sole plan proponent

During the reorganization procedure,\footnote{Under the EBL, the reorganization procedure starts from the day the court permits the reorganization of the debtor, and ends on the day the court rules to terminate the reorganization procedure. The EBL, Art. 72. The court makes the ruling of the termination of the reorganization procedure when the court rules to confirm or not to confirm the proposed reorganization plan based on the voting result, or when the debtor-in-possession or the administrator fails to propose a reorganization plan during the exclusivity period. The EBL, Art. 87; 88; 79. In addition, during the reorganization procedure, if the debtor’s business operation and financial status deteriorates and the debtor loses the possibility of being rescued or if the debtor has conducted fraud or has maliciously decreased its assets, or conducted some other activity that is contrary to the interests of its creditors, upon the application of interested parties, the court should rule to terminate the reorganization procedure. The EBL, Art. 78.} the debtor may apply to the court for managing its assets and business operation, i.e. to be a debtor-in-possession (“DIP”). If the debtor gets the court’s permission, the DIP will manage its assets and business operation under the supervision of the administrator.\footnote{The EBL, Art. 73.} In this situation, the administrator, who has taken control of the debtor’s assets and business at the beginning of the case, should transfer the power of control to the DIP and the business management duties of the administrator provided by the EBL should be performed by the DIP.\footnote{The EBL, Art. 73.} Moreover, the DIP automatically becomes the sole plan proponent and is charged with the duty of proposing a reorganization plan within the exclusivity period.\footnote{The EBL, Art. 80.}

It should be noted that under the EBL, only the DIP or the administrator (in cases where the debtor does not become the DIP) is permitted to file a plan during the exclusivity period and the other parties can never get the chance to propose a plan. If the administrator or the DIP fail to propose a plan during the exclusivity period, or if the proposed plan fails to pass the
voting and confirmation procedure, the court will rule to terminate the reorganization procedure.\textsuperscript{259}

\subsection*{3.2.1.3 The length of the exclusivity period}

The initial exclusivity period for the DIP or the administrator to propose a plan is 6 months from the day when the court makes the ruling that permits the reorganization of the debtor.\textsuperscript{260} Before the initial exclusivity period expires, the plan proponent may apply to the court for extension. If the plan proponent proves justifiable grounds for the extension, the court may rule to extend the initial exclusivity period for 3 months.\textsuperscript{261}

\subsection*{3.2.2 Analysis of the exclusivity period under Chinese Law}

\subsubsection*{3.2.2.1 The control model of the plan-drafting process under the EBL}

(1) The standard for a debtor to be a DIP and the debtor-controlled model

Before analyzing the efficient and inefficient elements of the Chinese exclusivity period, it is necessary to explore the control model of the decision-making process under the Chinese law from a comparative perspective. Under the EBL, an administrator is appointed upon the commencement of a reorganization case and by default controls the debtor’s business. If the debtor wants to regain control over its business, he needs to get the court’s permission. Even if the debtor has been permitted to become the DIP, he is supervised by the administrator. By contrast, under Chapter 11, a debtor automatically becomes the DIP upon the commencement of reorganization procedure and there is no trustee supervising the debtor’s business management activities. Similar to Chapter 11, the EBL provides the DIP with an exclusivity period for proposing a plan.\textsuperscript{262} Just as the exclusivity period under the US law,\textsuperscript{263} the exclusivity period under the Chinese law helps the plan proponent to gain substantial control over the reorganization decision-making. Once a Chinese debtor is permitted by the court to be a DIP, just as a US DIP, the Chinese DIP possesses significant control power over its

\begin{itemize}
\item \textsuperscript{259} The EBL, art. 79; 88.
\item \textsuperscript{260} The EBL, Art. 79.
\item \textsuperscript{261} Id.
\item \textsuperscript{262} Id. The initial exclusivity period for the DIP or the administrator to propose a plan is 6 months and may be extended for 3 months. The EBL, Art. 79.
\item \textsuperscript{263} How the exclusivity period helps the sole plan proponent, the DIP in Chapter 11, to control the decision-making is discussed in detail Section 3.1.2.2 of this book.
\end{itemize}
reorganization decision-making.

When comparing the textual provision of Chapter 11 and the EBL, one finds that a US debtor enjoys more power of than a Chinese debtor, since a Chinese debtor needs to pass through a judicial screening in order to become a DIP and its business management is subject to the administrator’s supervision. This difference has caused some scholars to conclude that Chinese bankruptcy law adopts an administrator-controlled model, which is quite different from the debtor-controlled model of the US law.\textsuperscript{264} However, the difference between the control model of the Chinese and US reorganization procedure is not as big as it seems.

It should be noted that the US DIP can be challenged and may be replaced by a trustee.\textsuperscript{265} Although under the EBL there is a judicial examination procedure, it is not certain than when compared with a US debtor a Chinese debtor has fewer opportunities to become a DIP. If the court adopts the same standard as used in the US and refuses the debtor’s application only for cause of fraud, incompetence and gross mismanagement etc., the difference is only procedural instead of substantial. The EBL does not provide clear requirements that a debtor should satisfy in order to become a DIP. However, the legislative material of the EBL offers guidance to the spirit of the law. The legislative material states that the proposed law provides the debtor with the right of applying to the court for retaining control over its business management in order to make full use of the debtor’s information advantage with respect to the debtor’s business and encourage the debtor to seek the formal reorganization procedure at an early stage for solving the problem.\textsuperscript{266} Therefore, the legislative rationale of the Chinese DIP system is substantially similar to that of the US DIP system.\textsuperscript{267} It has been remarked that the Chinese DIP system is “basically a modified DIP approach”.\textsuperscript{268}

\textsuperscript{264} William J. Woodward, Jr. (2008), "Control" in Reorganization Law and Practice in China and the United States: An Essay on the Study of Contrast, 22 Temple Int’l & Comp. L. J. 141, p. 147(commenting that like the former Chapter X of the U.S. Bankruptcy Act, Chinese bankruptcy has, at its center, a bankruptcy administrator, to whom the law entrusts most of the decisions that will affect the future of the business while the American law chooses the DIP to control the reorganization procedure).

\textsuperscript{265} 11 U.S.C. 1104(a).

\textsuperscript{266} Zhijie Jia (2004), Explanations on the Draft Enterprise Insolvency Law of the People's Republic of China, the legislative report delivered on the 10th Session of the Standing Committee of the Tenth National People's Congress, which was held on June 21, 2004.


Moreover, the policy of favoring a DIP reflected in the legislative material has also been supported by the Chinese bankruptcy academia. Some leading Chinese bankruptcy scholars, who participated in the drafting of the EBL, have proposed that the court should adopt a generous policy. Based on the legislative material and the ideas expressed by the scholar-drafters of the EBL, we may infer that although the procedure provided in the EBL for a debtor to be a DIP is different from that under Chapter 11, the substantial standard for being a DIP under the EBL was not intended by the legislators to be more restricted than that under Chapter 11. Just as under US law, under Chinese law, DIP is intended to be a general principle.

As the substantial standard for a debtor to be a DIP in the EBL is intended to be the same as that in Chapter 11, one may further conclude that the decision-making model under the EBL, just as that under Chapter 11, is a debtor-controlled model since the DIP enjoys the exclusivity period for proposing a plan. It should be noted that the EBL only provides that the administrator supervises the DIP’s business decisions and does not put the DIP’s plan-drafting activities under the supervision of the administrator.

What is noticeable is that a Chinese DIP enjoys even more power to because the EBL completely excludes competing plans. Under the EBL, the interested parties, such as the creditors, the shareholders, or the creditors’ committee, do not have the opportunity to propose a plan. In sharp contrast, under Chapter 11, in cases where the debtor is replaced by a professional fiduciary such as the administrator, the creditors and shareholders have the opportunity to propose a competing plan.
trustee, the debtor fails to propose a plan, or the debtor’s plan fails to get acceptance from all
the impaired classes, the interested parties get an equal right in proposing a plan. While
under Chapter 11, the voting parties may vote against the debtor-proposed plan with a view to
proposing and accepting a competing plan in the future, under the EBL, there is absolutely no
pressure from competing plans on the sole plan proponent. Compared with creditors in a
Chapter 11 case, creditors in an EBL case are even more passive and under higher pressure to
accept an unsatisfactory plan proposed by the DIP if they think that they would fare even
worse in liquidation.

To summarize, the EBL has adopted a debtor-controlled decision-making model because the
standard for a debtor to be a DIP is substantially similar to that under Chapter 11 and the DIP
under the EBL enjoys the exclusivity period for formulating a plan with competing plans
being completely excluded during and after the exclusivity period. The efficiency of the
Chinese exclusivity period is discussed in the section below with reference to the adoption by
the EBL of the debtor-controlled model.

3.2.2.2 The efficient and inefficient elements of the exclusivity period under Chinese
law

Just as the exclusivity period under US law, the Chinese exclusivity period modifies the
interested parties’ pre-bankruptcy entitlements in that it deprives the non-debtor parties of the
right to propose a plan on how to modify the old investment contract and create a new one.

According to the creditors’ bargain theory, an efficient bankruptcy system should encourage
the interested parties to make an efficient decision that maximizes the debtor’s overall value
and if bankruptcy law modifies the interested parties’ non-bankruptcy entitlements, the
modification should be necessary to the collective procedure and that the benefits of this
modification should be greater than the damage caused by the modification. Judged against
these standards, this section analyses the efficient and inefficient elements of the Chinese
exclusivity period from a comparative perspective.

(1) Efficient and inefficient elements that are the same as those of the US exclusivity period

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271 11 U.S.C. 1121(c).
272 See Section 2.1.1.2.
The exclusivity period under the EBL, as a device that provides the DIP with the power of control over its reorganization decision-making, just as its counterpart under Chapter 11, has efficient elements, which are encouraging the debtor to file the reorganization petition without delay and expediting the reorganization decision-making process. The inefficient elements of the Chinese exclusivity period are causing of forced acceptance of the debtor-proposed plan by excluding competing plans and by providing the debtor with the power of delay.  

(2) The additional efficient and inefficient elements that make the Chinese exclusivity period different from the US exclusivity period

(i) The efficient and inefficient elements of the shortened period and the reduced discretionary power of the court in designing the length of the exclusivity period for a specific case

The Chinese exclusivity period is different from the US exclusivity period in that the maximum time length for the exclusivity period under Chinese law is much shorter than that of the US exclusivity period. The efficient element of shortening the exclusivity period is that it, to some extent, mitigates the plan proponent’s power of delay. However, it is inefficient in that the shortened period may be insufficient for the plan proponent to formulate an efficient and feasible plan in a complicated case.

Compared with Chapter 11, the EBL provides the court with less discretionary power in supervising the length of the exclusivity period. Under the EBL, the 6-month initial exclusive period may not be reduced and may be extended only once for 3 months. By contrast, under Chapter 11, the initial exclusivity period may be reduced or extended by the court subject to the limitation that the total length of the exclusivity period should be no longer than 18 months (for proposing a plan) and 20 months (for soliciting acceptances). The reduced flexibility in designing the length of the exclusivity period for a specific case, on the one hand, reduces the litigation cost caused by the various reduction and extension applications; on the other hand, it reduces the room for the court to design a proper time length for a specific case.

(ii) The efficient and inefficient elements of separating voting from the plan-drafting

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273 For a detailed analysis of the efficient and inefficient elements of the exclusivity period as a device that provides the debtor with the power of control, please refer to Section 3.1.2.1 and 3.1.2.2.

274 The maximum time length of the Chinese exclusivity period is 9 months. The EBL, Art. 79.

275 The maximum time length of the Chinese exclusivity period is the 18-month period for plan proposing and the 20-month period for soliciting acceptances. 11 U.S.C. §1121(d)(2).
process
In addition to the common character, some details of the design of the exclusivity period under Chinese law and US law are different. Under US law, the exclusivity period is a period for both proposing a plan and soliciting acceptance of the proposed plan. During the exclusivity period, the debtor may propose a plan, solicit acceptances of the draft plan by collecting the interested parties’ votes on the plan, modify the draft plan based on the voting result and then solicit acceptances for the modified plan.\textsuperscript{276} In sharp contrast, under the EBL, the exclusivity period is only a period for proposing a plan. Voting is done in the meeting held by the court within 30 days after the court receives the draft plan. If the plan fails to receive the acceptance of all voting classes, the plan proponent may negotiate with the dissenting classes. The dissenting classes may vote again after the negotiation. The plan can be voted for two times at maximum.\textsuperscript{277} Thus, plan formulation and official voting is separated under the Chinese law.

The separation is efficient in that it makes it difficult for the plan proponent to use the delay strategy in the exclusivity period. Under Chapter 11, the plan proponent may wait with the legally effective consent at hand until the objecting parties are forced to compromise. By contrast, under the EBL, it is not easy for the plan proponent to force out official consent via strategic delay. Once the objecting parties feel that the plan proponent does not propose the draft plan to the court because the plan proponent is waiting for their acceptance, they may say yes and vote no so as to avoid the delay. However, the separation is inefficient in that it may hinder the plan proponent from designing and modifying the draft plan based on the official voting result of the bargaining parties until he reaches a satisfying plan that gains the support and compromise from most of the bargaining parties. If some bargaining parties do not keep a consistent position, which means that they say yes but vote no, the efforts made by the plan proponent for a consensual plan based on the informal opinions he solicited during the exclusivity period will be wasted.

(iii) The efficient and inefficient elements of completely excluding competing plans
The Chinese exclusivity period differs from the US exclusivity period in that the EBL

\textsuperscript{276} 11 U.S.C. § 1126; §1127.
\textsuperscript{277} The EBL, Art.84; 87.
completely excludes competing plans. If the administrator or the DIP fails to propose a plan during the exclusivity period, or the proposed plan fails to pass the voting and confirmation procedure, the court will rule to terminate the reorganization procedure.\textsuperscript{278} Thus, under the EBL, the interested parties other than the DIP or the administrator never have the opportunity to propose a plan. In sharp contrast, under Chapter 11, if the debtor is replaced by a trustee or the debtor fails to propose a plan, or the debtor’s plan fails to pass the voting and confirmation procedure, all the participating parties have the right to propose a plan.

The complete exclusion of competing plans is efficient in that it motivates the debtor to seek to use of the reorganization procedure without delay and expedite the decision-making process since the voting parties have no other choices in the future. However, it is inefficient, in that it provides the sole plan proponent with much power of control and may cause forced acceptance of an unsatisfactory plan, which is less efficient than potential competing plans. Compared with the US exclusivity period, the Chinese exclusivity period provides the sole plan proponent with even more power of control. In a Chapter 11 proceeding, the voting parties may vote against the debtor-proposed plan with a view to accepting a competing plan in the future. However, in an EBL reorganization procedure, there is no pressure from competing plans whatsoever on the sole plan proponent. In an EBL case, creditors are even more passive than the creditors in a Chapter 11 case. If creditors think they would be even worse off in liquidation, then they will be forced to accept an unsatisfactory plan proposed by the administrator or the DIP. One may argue that the debtor’s management is forced to accept the voting parties’ opinions since they may also be worse off if the plan is rejected. However, what deserve special attention are the situations where the acting parties are not as honest and capable as we imagine. In cases where the debtor’s managers are unable to understand and absorb more efficient ideas or try to force a less efficient plan out of distorted incentives, compared with the US exclusivity period, the Chinese exclusivity period puts interested parties at a more disadvantaged position.

3.2.3 Measures for mitigating the inefficient elements of the exclusivity period

Just like Chapter 11, the EBL adopts some measures to counterbalance the inefficient effects

\textsuperscript{278} The EBL, art. 79; 88.
of the exclusivity period and strengthen the interested parties’ control over the sole plan-proponent in order to encourage the interested parties to reach an efficient decision. This section gives a brief description of the restraining measures and analyzes the efficient and inefficient elements of each restraining measure. According to the creditor’s bargain theory, an efficient bankruptcy system should motivate the interested parties to make an efficient decision, i.e. an efficient plan that maximizes the debtor’s overall value and the recovery of the participating parties as a group. \(^{279}\) Judged against the standard proposed by the creditors’ bargaining theory—maximization of the debtor’s value, this section analyzes the efficient elements of each restraining measure, i.e. the contribution of a restraining measure to the collective procedure and efficient decision-making, and the inefficient elements of each restraining measure, i.e. the damage or cost that a restraining measure brings to the collective procedure and efficient decision-making.

### 3.2.3.1 The committee device

(1) Establishment of creditors’ committee

While several kinds of committees may be established in a Chapter 11 case, in an EBL case only one committee may be established, which is the creditors’ committee. \(^{280}\) Whether to establish the creditors’ committee is decided by the creditors’ meeting. \(^{281}\) All the creditors holding claims that have been declared to and confirmed by the court may attend the creditors’ meeting. \(^{282}\) A decision of the creditors’ meeting is legally effective if it is supported by more than half of the creditors that actually voted and the supporting creditors hold more than half of the total unsecured credit. \(^{283}\) If a creditors’ meeting decides to establish a creditors’ committee, it should further vote on the members of the committee. The creditors’ committee should contain no more than nine members and should be comprised of representatives of creditors and one representative of the debtor’s employees or the employee’s union. \(^{284}\)

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\(^{279}\) See Section 2.1.1.1.  
\(^{280}\) The EBL, Article 67-69.  
\(^{281}\) The EBL, Article 67.  
\(^{282}\) The EBL, Article 59.  
\(^{283}\) The EBL, Article 64.  
\(^{284}\) The EBL, Article 67.
(2) Special emphasis on unsecured creditors’ power to influence

The voting rule of the creditors’ meeting reflects that the EBL intends to ensure that unsecured creditors’ interest is represented by the creditor’s meeting’s decision since it requires that the assenting creditors should hold more than half of the total amount of “unsecured credit”. If a decision is supported by all secured creditors but is supported by unsecured creditors holding less than half of the total amount of unsecured claim, this decision cannot be passed. If a decision is objected to by all secured creditors, but is supported by unsecured creditors holding more than half of the total amount of all unsecured claims, then it is possible that the decision will be passed, as unsecured creditors are generally larger in number than secured creditors.

(3) Role of the creditors’ committee

The duties and powers of the committee include: supervising the management and disposal of the bankrupt estate; supervising the distribution of the bankrupt asset; proposing to convene the creditors’ meeting; and perform other duties delegated by the creditors’ committee. Furthermore, the creditors’ committee may request the administrator and the debtor’s personnel to provide explanation and relative files with respect to matters within their duties. If those persons refuse to accept the supervision of the creditors’ committee, the creditors’ committee may file a petition to the court and request a judicial decision on the supervision matter. The court should make a decision within 5 days. 285 In addition, the EBL grants the committee’s special supervision over the administrator’s important business decisions. Where the administrator controls the debtor’s business management, the administrator shall report the important business management decisions to the creditors’ committee in a timely manner, which includes: transfer of real estates (e.g. land, house etc.); transfer of important property rights (e.g. mineral prospecting right, mining right, intellectual property right etc.); transfer of the total stock or business; borrowing money; establishment of security; transfer of credit and securities; performing a contract that has not been executed by the debtor and the other contractual party; abandonment of rights; repossession of collaterals; and other asset disposal decisions that have material influence over the creditors’ interest. If the creditors’ committee

285 The EBL, Article 68.
is not established, the administrator should report these actions to the court.\textsuperscript{286} To summarize, the committee’s role is mainly to supervise the business management decisions of the DIP or the administrator and the distribution of the bankrupt asset.

(4) Special problems with the EBL committee device

Compared with the committee device under Chapter 11, the EBL committee device has several problems which hinder it from functioning effectively and reduce its efficient elements.

(i) The problem concerning the establishment of committees

Under the EBL, only one committee, i.e. the creditors’ committee may be established. By contrast, under the U.S. law, in addition to the mandatory establishment of an unsecured creditors’ committee, additional committees, such as a committee of equity holders, tort claimholders etc. may be established. Whether to establish the additional committees is decided by the court based on the specific situation of a case. In comparison, the EBL lacks the provision for flexible establishment of additional committees. In a case where any group of dispersed creditors or shareholders need representation, such as the large number of workers hurt by poisonous materials or consumers being hurt by poisonous products, the court can not employ the committee device to strengthen these parties’ participation in the plan-formulation and decision-making.

(ii) The problem with grouping secured and unsecured creditors together

With respect to the establishment and operation of the creditors’ committee, the EBL does not make a clear distinction between secured and unsecured creditors. Both secured and unsecured creditors may vote for whether to establish the creditors’ committee and are equally qualified to be elected as committee members. In contrast, Chapter 11 lays special emphasis on the committee of unsecured creditors. Under Chapter 11, only unsecured creditors may vote for the members of the unsecured creditors’ committee and may be elected as the members.

There is often conflict of interest between secured and unsecured creditors in the context of reorganization. Secured creditors’ participation makes the decision-making process concerning whether to establish the creditors’ committee and who should become the members.

\textsuperscript{286} The EBL, Article 69.
members of the committee complicated and uncertain. Moreover, if both of them sit in the committee, the function of the committee may become uncertain and problematic. Some committee members may be friendly to secured creditors, while others may care about the unsecured creditors more than secured creditors. As discussed in part (2) of Section 3.1.3.1, emphasis on the committee of general unsecured creditors make sense in that general unsecured creditors need representation more than secured creditors and occupy a special position in the decision-making process. To the extent that the EBL does not establish a committee purely for general unsecured creditors, the general unsecured creditors’ participation in the decision-making may be weakened.

(iii) The problem in using the creditors’ committee to represent employees’ interest

The EBL, by requiring that one member of the creditors’ committee must be the representative of the debtor’s employees or the employee’s union, imposes the function of employee protection over the creditors’ committee. On the one hand, it is economical to use a creditors’ committee to represent both creditors and employees. On the other hand, mixing employee protection and general creditors’ protection together may do no good to either goal. In cases where the general creditors’ interest is congruent with that of employees, it is not necessary to put an employee representative into the committee. In cases where employee protection contradicts general unsecured creditors’ interests, it is unrealistic for the employee representative to play a constructive role in influencing the actions of the creditors’ committee. The employee representative member may create conflicts inside the committee, hinder the creditors’ committee from making decisions in an efficient way and obscure the function of the creditors’ committee. In this situation, a better solution is to establish a committee of employees.

Moreover, in the bankruptcy reorganization context, the employee’s interest mainly lies in the unpaid claims held by the employees and the job opportunity of the employees. The employees’ interest in receiving payment of their claims is protected by the superior priority of employee claims.\(^\text{287}\) As the EBL sets the employment claim at a priority level higher than that of general unsecured claims, employees and general unsecured creditors are basically

\(^{287}\) Article 87 of the EBL, which requires the full payment of the employment claims as the precondition of a crammed down plan. See Section 4.2.2.1 for the discussion of the whole payment priority order in the EBL.
classified into different groups. It is thus not necessary to use the creditors’ committee to represent the interest of employees. With respect to job opportunity protection, it is not proper to impose such a function on bankruptcy law. According to the creditors’ bargain theory, bankruptcy law should only deal with investor’s right, i.e. the property rights held by claimholders recognized by the non-bankruptcy law. Protection of non-investors’ interest, such as employees’ interest in respect of job opportunity should not be dealt with under bankruptcy law.\footnote{288} Therefore, taking into account that the employees’ interest as creditors are protected by the enhanced priority in receiving payment that is given non-bankruptcy and bankruptcy law,\footnote{289} there is no convincing reason for using the creditors’ committee to represent the interest of employees.

(iv) Problems with respect to the creditors’ committee’s duty and power

There are several problems in the EBL’s provision with respect to the committee’s duty and power.

First, although the EBL grants the creditors’ committee’s supervision over the important business decisions of the administrator,\footnote{290} it does not contain provisions concerning the creditors’ committee’s supervision over the DIP’s competence, the DIP’s important business decisions and the controlling party (the DIP or the administrator)’s reorganization decisions and the creditors’ committee’s right in participating in the plan-formulation etc. By contrast, Chapter 11 provides the committees with the power of supervising the DIP’s competence, the debtor’s business operation and reorganization decision-making of the case.\footnote{291} One may argue that Article 68 of the EBL does provide in a general way that the creditors’ committee supervises the management and disposal of the debtor’s asset. However, in order to foster the committee’s contribution to efficient decision-making and plan-formulation, detailed provisions like those in Chapter 11 are more effective than a short and general provision. The problems are mainly caused by the fact that under the EBL, the creditors’ committee is

\footnote{288} Section 2.1.1.2. 
\footnote{289} Please refer to Section 2.1.6.3 for discussion concerning the enhanced protection of employees’ claims under bankruptcy and non-bankruptcy law. 
\footnote{290} The EBL, Art. 69. See part (3) of Section 3.2.3.1 for the provision on the duty and power of the creditors’ committee. 
\footnote{291} Chapter 11 clearly provides that committees may request the appointment of a trustee or examiner, participate in plan-formulation, investigate the operation of the debtor’s business, the viability of the debtor etc. 11 U.S.C. 1103(c)
provided as a general device which is applicable in all the bankruptcy proceedings, i.e. the liquidation, reorganization or reconciliation proceeding. In contrast, under the U.S. law, the committee device is specially designed for the reorganization procedure. The committee device is more necessary in the reorganization procedure than in the liquidation and reconciliation proceeding, since reorganization involves much more complicated negotiation and examination of the reorganization plan. However, the EBL fails to design the committee’s duty and power from the perspective of the reorganization context.

Second, the committee, as the fiduciary of its constituents, should bear duties to its constituents. In order to motivate the members of the committee to carry out their duties, Chapter 11 provides the committee’s obligation of fiduciary, such as providing information access to its constituents and advising its constituents as to the quality of the proposed plan. By contrast, the EBL does not contain such detailed provisions.

Third, the EBL does not contain provisions that empower the committee to hire professionals to provide professional services for the committee or allow the reimbursement of the cost of committee members and committee-hired professionals.

To conclude, the legislative vacancy concerning the duties and powers of the creditors’ committee listed above weakens the committee’s contribution to efficient reorganization decision-making.

(5) The efficient and inefficient elements of the EBL committee device

The committee device under the EBL, just as its counterpart in Chapter 11, is efficient in that it restrains and helps the interested parties to produce an efficient plan, and is inefficient in that it causes certain costs. The creditors’ committee is the representative of the dispersed creditors and, like its constituents, bargains with the sole plan-proponent on the platform built

292 The EBL provides the regulation for the creditors’ committee in a separate chapter—Chapter VII, while it provides three different kinds of bankruptcy proceedings, which are reorganization, reconciliation and liquidation, in Chapter VIII, VIII and X. For the whole structure of the EBL, please refer to part (4) of Section 1.3.2, entitled “The Establishment of the new bankruptcy law”.

293 In the EBL, the establishment, duty and power of the creditors’ committee device is provided in an independent Chapter, i.e. Chapter 7, which implies that the provisions of this Chapter is applicable to all the bankruptcy proceedings in the EBL, i.e. the reorganization procedure (provided in Chapter 8), reconciliation proceeding (provided in Chapter 9) and liquidation proceeding (provided in Chapter 9). Please refer to Section 1.3.2 for the general structure of the EBL. By contrast, there are special provisions in Chapter 11 of the current US Bankruptcy Code dealing with the establishment and function of the committee device in the reorganization procedure. Hon. Samuel L. Bufford (2007), The New Chinese Bankruptcy Law Text and Limited Comparative Analysis, 16 J. Bank. L. & Prac. 5 Art. 3.

294 11 U.S.C. § 1102 (b)(3); 1103(c)(3).
by the exclusivity period which tilts towards the sole plan-proponent. It restrains the controlling party’s use of its power of control, but cannot sufficiently counterbalance that control power.

3.2.3.2 Judicial supervision over the length of the exclusivity period

The EBL provides that the court, upon application of the sole plan proponent, may extend the exclusivity period for 3 months.\footnote{The EBL, Art. 79.} The judicial supervision on the length of the exclusivity period under the EBL, just as its counterpart in Chapter 11, has efficient elements in that it helps to adjust a proper time length for the exclusivity period of a specific case and restrain the plan-proponent to propose a plan within a proper time period. It has inefficient elements in that it is not easy for the court to decide how long is proper for a specific case since it is the sole plan proponent who has direct access to the information concerning plan-formulation and who is the major party that provides the court with the evidence for the extension. The exclusivity period, regardless of whether it is 6, or 9 months, is by nature a device that helps the sole plan proponent to keep control. The judicial supervision can help to avoid a delay of 3 months, but cannot sufficiently counterbalance the debtor’s power of control.

3.2.3.3 The administrator’s control over the DIP

Under the EBL, the plan proponent is the controlling party, who controls both the business and reorganization decision-making. As discussed in Section 3.2.2.1, since legislators intended the court to adopt a lenient policy in dealing with the debtor’s application to be a DIP, the debtor is generally expected to be the controlling party. A prominent difference between the US and Chinese DIP system is that a Chinese DIP’s business management is under the supervision of a bankruptcy administrator. Because allowing the debtor to be a DIP is intended by the legislators to be the general model, in most cases, the administrator’s main contribution to the collective procedure is expected to be his professional supervision over the DIP. The administrator’s supervision over the DIP has both efficient and inefficient elements. Its efficient elements lie in that there is a professional supervision over the DIP, which encourages the DIP to practice efficient decision-making. Its inefficient elements mainly lie in
that it incurs cost. In addition, the problems in EBL’s provisions concerning the administrator’s supervisory power and the selection of an administrator for a specific case may hinder the administrator’s contribution to the decision-making. Detailed analysis is below.

With respect to the administrator’s supervision over the DIP, the EBL only contains a general provision that a DIP’s business management is under the supervision of the administrator.\textsuperscript{296} The EBL does not provide a detailed set of rules concerning the administrator’s supervision over the DIP’s business management. The EBL’s provisions with respect to the administrator’s supervision over the DIP’s plan-formulation activities have the defect of being too general and incomplete, which may lessen the administrator’s contribution to the efficient reorganization decision-making process. In order to enhance the administrator’s contribution to efficient reorganization decision-making, the EBL should provide rules on the administrator’s duty and powers with respect to the DIP’s business management and plan-formulation, such as the DIP’s duty of providing timely reports to the administrator about the important business decisions, the administrator’s duty and power in participating in the plan-formulation, inquiring and collecting information with respect to the process of the plan-formulation, the feasibility of the draft plan, providing periodical information to the interested parties about the plan-formulation and advising the interested parties about the efficiency and feasibility of the proposed plan etc.

The administrator’s contribution to the reorganization procedure, whether as a controller or a supervisor over the DIP, is related to his expertise. In the reorganization procedure, the administrator is to make the business decisions on how to deal with the debtor’s assets or to examine whether the DIP makes the proper business decisions. An administrator who is a turn around expert in the debtor’s business will do a better job than others who possess less expertise concerning the debtor’s industry. Selecting a suitable administrator for a specific case is important for achieving the goal of maximizing the overall value of the bankrupt estate and protecting and enhancing the overall interests of all the claimholders as a group. There are several problems in the SPCS’ provisions on the selection of the administrator for a specific case.

\textsuperscript{296} The EBL, Art. 73.
First, it is noticeable that the SPCS puts the power of selecting an administrator for a specific case in the hands of the court. The SPCS provides that the general method adopted by a court to appoint an administrator is to be objective or stochastic method. This method may be a good method for preventing judicial corruption and bias in choosing an administrator, it is not an ideal method for choosing a suitable administrator. Moreover, since the SPCS does not mandate the trial court to use a stochastic method, the trial court may choose a suitable administrator for the extant case by using its discretionary power. This leaves room for judicial corruption since no other provisions exist for enhancing interested parties’ participation in selecting a suitable administrator for their case and restricting the trial court’s discretionary power to the minimum. Compared with the judges, the interested parties, such as the debtor or the creditors, often know the debtor’s business better than the judge and have more incentive in selecting a competent administrator at a reasonable cost. It seems reasonable to give the interested parties the opportunity to play a role in selecting a suitable administrator for their case. One might worry that the debtor’s management and the creditors may have different opinions and may even have tainted incentives. However, if the system is delicately designed, for instance, allowing the parties to choose an administrator based on a public bidding result, the interested parties may be forced to reach a reasonable decision. Even if there may be corruption, it is more difficult for an administrator to buy consent from a voting group than from one judge.

Second, the selection of the suitable administrator is generally limited to the administrator who is registered in the jurisdiction area of the trial court. This artificial geographic limitation may hinder the most qualified administrator from being appointed for a specific case, especially in the areas where there is a limited number of skilled administrators. If the interested parties prefer to select a suitable administrator from other areas, then this geographical limit may become an obstacle to efficient reorganization. Generally, one may worry that hiring an administrator from an area far away from the trial court yields higher costs. However, if the law would give the interested parties, such as the unsecured creditors, the option to decide whether or not to limit the choice of the suitable administrator within the jurisprudence area of the trial court, there is no need to worry about the increased cost since

297 The SPCS, Art. 20.
interested parties will evaluate whether the increased cost is lower than the corresponding benefits.

3.2.4 General comments on the Chinese Plan-drafting system

Judged against the standard proposed by the creditors’ bargain theory—the maximization of the debtor’s overall value, the Chinese plan-drafting system is efficient in that it encourages the early filing of a reorganization petition and expedites the decision-making process by the adoption of the DIP system and the exclusivity period; it is inefficient in that it may cause forced acceptance of the plan proposed by the sole plan-proponent since it excludes competing plans from being proposed and considered. The EBL has adopted a series of measures in order to strengthen the participation of interested parties and restrain the sole plan-proponent. These measures help to mitigate the inefficient elements of the exclusivity period. However, these measures, by nature, can not sufficiently counterbalance the power of control given to the sole plan proponent by the exclusivity period.

3.2.5 Weighing the exclusivity period’s contribution against damage to the collective procedure and some reform suggestions for the exclusivity period

As discussed in the first paragraph of Section 3.1.2, the exclusivity period, by depriving non-debtor parties of the right to propose a plan on how to change their investment contract, modifies the interested parties’ pre-bankruptcy entitlements. According to the creditors’ bargain theory, the bargaining parties’ pre-bankruptcy entitlements can be modified under the condition that it is necessary for preserving the benefits of the collective procedure and the benefits created by the modification should be greater than the damages caused by it.298 In order to evaluate the exclusivity period, this section examines whether the exclusivity period is necessary to the collective procedure and whether the benefits it brings to the collective procedure is greater than the damages caused by it.

3.2.5.1 Whether the exclusivity period is necessary for the collective procedure

Can the collective decision-making process proceed without the exclusivity period or is it necessary to the collective bankruptcy proceeding? Unlike the automatic stay, the exclusivity

298 See Section 2.1.1.2.
period is not something that is essential to the existence and operation of the collective procedure. Bankruptcy law may choose whether to provide a special capable party, such as the debtor, with the exclusivity right of proposing a plan or to allow several or all the interested parties to propose a plan.

3.2.5.2 Examining the exclusivity period's contribution to the early filing of reorganization petition

According to the conventional opinions, the first efficient element of the exclusivity period is that it encourages the early filing of a reorganization petition because it helps the debtor’s managers to keep their position of control and their job during the reorganization procedure and may further help them to keep their position of control in the future since it improves the debtor-proposed plan’s chance of becoming effective. However, the influence of the exclusivity period over the preservation of the debtor’s managers’ jobs and the early filing of reorganization petition seems to be exaggerated in the conventional opinions.

(1) The exclusivity period can not help tainted managers to keep their jobs.

Empirical studies of Chapter 11 may serve as valuable indicia of the exclusivity period’s effect in preserving a manager’s job. According to these empirical studies, the turn over rate for the Chapter 11 debtors’ top managers has been extraordinarily high. According to Gilson’s study, 29% of the original top managers of the 69 publicly held companies that filed for bankruptcy under Chapter 11 survived over the four-year-period starting two years before the date of bankruptcy filing. LoPucki and Whitford studied 43 big bankruptcy reorganization cases and found that in 91% of these companies there was at least one change in CEO during the two year period beginning eighteen months before the bankruptcy filing and ending six months after the plan confirmations. Betker studied 75 firms that filed for bankruptcy under Chapter 11 and had their reorganization plans confirmed during the time period from 1982 to 1990 and found that only 25% of the original CEOs, who held office two years before default survived on emergence from bankruptcy.

management for companies not in financial distress for a comparable two-year period was about 6-10%.”

“If one assumes retaining their jobs is a high priority for managers, these findings suggest that managers have relatively little power during bankruptcy reorganization.”

The high turnover rate might be explained by a cultural norm that someone must take the blame for the massive loss that leads to bankruptcy reorganization.

(2) Without the exclusivity period, the debtor’s managers’ situation in preserving their jobs and keeping their position of control may not be seriously influenced.

If there would be no exclusivity period, a plan-competition system would be the natural choice. Plan-competition does not naturally cause the old managers to lose their pivotal position. The debtor’s managers possess natural advantages that help them to keep their pivotal position in the plan formulation and competition. First, the debtor’s managers naturally occupy the best position in relation to information about the debtor’s business.

Moreover, solving the debtor’s financial problem and drafting a reorganization plan is naturally their job and they are able to devote their time to the plan formulation. These natural advantages help them to play a central role in the plan formulation and competition.

Even if a non-debtor party has an efficient rehabilitation idea in mind, he needs the debtor’s managers’ cooperation in acquiring the necessary information. Since drafting a competing plan is an extra burden for a non-debtor party and he will bear dead weight loss if his plan fails in the competition, a non-debtor party, who has an efficient idea in mind, may choose to avoid the cost in plan formulation and the risk in plan competition by seeking cooperation from the debtor’s managers, especially in the reorganization of large public corporations, where the cost of drafting a plan is typically high. Therefore, plan competition will not absolutely turn the debtor’s managers and other plan proponents into hostile opponents, but may serve as a pressure that forces the managers to actively consider the competing ideas, adopt the most efficient ideas and draft the most efficient plan instead of lazily and stubbornly.

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304 Id, at 737.
306 Id, at 694.
insisting on their own ideas. Without the exclusivity period, the debtor’s managers will still be the major plan proponents and stand good chance of winning the plan competition if they work conscientiously towards collecting efficient ideas and proposing an efficient plan.

In addition, under a plan-competition system, the debtor’s managers may still stand a good chance of keeping their jobs in the reorganized debtor. Even if a competing plan proposed by the non-debtor parties wins, the new owners or investors of the debtor may not remove the old managers, since the old managers naturally know the debtor’s business better than anybody else and management consistency is important for the new owners. “Changes in management are disruptive; new management needs time to become informed, and that tends to delay the reorganization effort. Consequently, managers who had good credentials, demonstrated success, and had the confidence of the various parties to the reorganization were regarded as important assets.”

(3) Whether the debtor’s managers’ fear of losing their job is big enough to hinder their reorganization petition is unclear.

The debtor’s managers’ fear of losing their job is limited if the labor of the debtor’s managers can easily be sold on the labor market. Publicly held corporations are characterized by a separation of ownership and control. Professional managers are hired by the dispersed owners to run these corporations. The labor of the managers of large public companies, as a kind of professional labor, generally enjoys better marketability than that of managers of closely-held companies. Few managers of large public companies have firm-specific expertise which loses its value totally if they are removed from their position. The negative effect of canceling the exclusivity period is limited to the extent that the managers can find other, similar, jobs. Moreover, if they do possess such specific expertise that is necessary to the company, generally they can easily get the compensation for their expertise from the new owners of the reorganized company.

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308 See, e.g., ROBERT C. CLARK, CORPORATE LAW 359-60 (1986).
310 Id, at 150 (noting that there is a pool of managers in the market for public companies). Douglas G. Baird(1986), The Uneasy Case for Corporate Reorganizations, 15 J. Legal Stud. 127, 141-2 (noting that the managers in closely hold companies, who often are owners of these companies, often possess
have good fluidity. Managers of close corporations often have got firm-specific expertise, the value of which is closely combined with the existence of the debtor’s business. Without the exclusivity period, they may have a fear of losing their job and thus delay the reorganization petition. In this situation, it should be noted that whether they can keep the value of their firm-specific expertise depends on the market parties’ judgment over the debtor’s value, i.e. whether the debtor’s business really has a going-concern surplus. If their business really has a going-concern surplus, which is often combined with the special value of their firm-specific expertise, they can actively communicate with the old creditors or the new financers about the going-concern value, draft a rehabilitation plan, win the plan competition and keep their jobs. A reorganization law that artificially protects all the debtor’s managers from losing their jobs by providing them the power to control the reorganization decision-making process may produce contra-productive effect. Furthermore, without the exclusivity period, they will still choose to use the formal reorganization procedure without delay if they could not conduct rehabilitation out of court under the pursuit of creditors and early reorganization is the way of successful rehabilitation and keeping their job.

(4) The inducement from the exclusivity period is not necessary when there is only one formal proceeding for corporate reorganization.

While the Chinese exclusivity period is a product of learning from the US wisdom, the US exclusivity period was the product of the attempt to take over the successful part of the prior law—Chapter XI of the 1898 Bankruptcy Act. However, the contribution of the exclusivity period to the success of Chapter XI of the 1898 Bankruptcy Act is ambiguous. In addition to the lack of the exclusivity period, many other negative factors contained in Chapter X of the 1898 Bankruptcy Act, such as the appointment of a trustee in every case, the court’s long and intricate approval hearing over the trustee-proposed plan, the process of getting the Securities and Exchange Commission’s advisory report over the trustee-proposed plan etc., contributed to the market parties’ disfavor of Chapter X and their favor of Chapter XI. It is difficult to

311 Lynn M. LoPucki (1993), The Trouble with Chapter 11, 1993 Wis. L. Rev. 729, p. 758 (noting that without the owner-managers, most small corporations have no value at all).


313 House Report, at 6184-5. Lynn M. LoPucki and William C. Whitford (1990), Bargaining over
judge how much the exclusivity period has contributed to this result.

What is even more important is that the debtors’ reluctance in using Chapter X of the 1898 Bankruptcy Act resulted from the comparison of two available reorganization procedures. If the reorganization law provides two available proceedings, the debtor’s managers, of course, will compare and choose the more favorable one. However, under current US or Chinese bankruptcy law, there is only one proceeding for corporate reorganization. Even if it does not provide an exclusivity period for the debtor, the debtor may still actively choose to use this formal legal device because it provides special advantages compared with the out-of-court workouts, such as the protection from the creditors’ harassment provided by the automatic stay, the acceptance of a class based on a majority voting rule etc. The debtor’s managers may still file for the formal procedure at an early stage because they do not want to miss the good timing for a successful rehabilitation, which is often the practical way of saving their jobs and career record.

(5) The debtor’s managers are not the only parties that are relied upon to sense financial distress and file for reorganization.

The debtor’s managers are not the only party that is relied on to sense the financial distress and file for reorganization. Creditors, who can not receive payment for their credit, may actively push the debtor into reorganization if they are confident that the formal proceeding will help them to find the most efficient solution instead of forcing a debtor-proposed plan upon them. In situations where creditors have sensed the financial distress and pushed the debtor into the liquidation proceeding, the other parties seeing a going-concern surplus, such as the debtor, may further apply to the court for converting the liquidation case to a reorganization case.

3.2.5.3 Examining the exclusivity period’s contribution to the expedition of the reorganization decision-making process

The second efficient element of the exclusivity period is expediting the reorganization decision-making process. There is a conventional worry that plan competition will add delay,
confusion to the bargaining process and the cram down procedure since the voting parties and
the court will be faced with the problem of comparing “apples with oranges” and the
disturbance of the liquidation plans.\textsuperscript{314}
A powerful refutation to the argument that the exclusivity period expedites the
decision-making process is the commonly recognized delay strategy used by the debtor in
order to force a compromise from creditors. By contrast, under a plan-competition system,
strategic delay will no longer be an effective weapon, since if a plan proponent lags behind in
bargaining and communicating effectively with the voting parties within the specified time
period, his plan may become less attractive than it would have been and thus gain less support.
The competition pressure will motivate a plan proponent to abandon delay and work
diligently in communicating with the voting parties, collecting efficient ideas and optimizing
the quality of his plan.
Moreover, although one may worry that many competing plans will emerge and make the
decision-making process a chaos, it is unlikely, in most cases, that creditors would bear the
cost and trouble of formulating competing plans.\textsuperscript{315} The cost and confusion should not be
exaggerated.
Finally, the time cost during the plan formulation process need not dramatically increase
under a plan-competition system. A plan-competition system will not lead to extra delay in the
bargaining process since all the plan proponents will draft their plan, negotiate with the voting
parties concerning their plan, modify and solicit acceptance of their plan during the same
legal time period. It is not certain that forcing the interested parties to consider only the
debtor’s plan will help them to make a quick decision. By allowing all the alternative plans to
be compared at the same time, a plan-competition system may help the voting parties to judge
the quality of the plans and quickly settle on the best plan. Under the exclusivity period, it is
hard for the voting parties to judge whether the debtor’s plan is the best one available since
whether there is potentially a better plan is unknown.

\textsuperscript{314} See part (2) of Section 3.1.2.1.
\textsuperscript{315} Gerard McCormack (2008), Corporate Rescue Law: An Anglo-American Perspective, Edward Elgar
3.2.5.4 Examining the conventional opinions concerning plan-competition

The conventional opinion concerning a plan-competition system is that it is impractical because it makes little contribution to efficient reorganization while adding great delay and cost to the bargaining process and the cram down procedure since the voting parties and the court will be faced with the problem of comparing “apples with oranges” and the disturbance of the liquidation plans. There are several reasons for the “little contribution” argument. Creditors are considered to take little interest in rehabilitating a bankrupt debtor. They are unwilling to throw good money after bad. Even if a creditor, or other interested party, had a big financial stake in the debtor making rehabilitation efforts worthwhile, there are practical problems that make alternative plan formulation difficult, if not impossible. These problems include: lack of information about the debtor, expense of information gathering and plan formulation, debtor resistance etc. To conclude, plan competition seems to contribute little to the production of efficient plans while causing longer delay, higher cost while its cost may be disproportionally high to its contribution. Thus, the exclusivity period was justified as a practical and “second best” choice.

However, obviously, forcing the interested parties and the court to consider only the debtor-proposed plan is not in line with making the most efficient reorganization decision. No one would agree that the best way to find an efficient solution to the financial problem is to exclude the ideas from non-debtor parties and consider only the ideas from the debtor or the administrator. The ideal and reasonable way should be to allow all the ideas to be put forward and compared. The conventional wisdom concerning the longer delay, higher cost, and little contribution of a plan-competition system in comparison with the exclusivity period seems to be superficial. A detailed analysis is below.

(1) Examining the conventional “higher cost” argument concerning plan competition

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316 See part (2) of Section 3.1.2.1.
319 The conventional “longer delay” argument has been discussed in part “Examining the exclusivity period’s contribution to the expedition of the reorganization decision-making process”. The following part will discuss the “higher cost” and “little contribution” argument.
One may worry that plan competition adds cost, confusion or difficulty to the decision-making, since it may stir up the controversy in the bargaining process and the cram down proceeding, lead to the examination of different plans instead of one plan. However, it should be noted that while comparison of competing plans may be difficult in cases where there are equally good plans, in cases where the quality of the competing plans can easily be compared, plan competition can help the interested parties to make a choice without doubt. Although comparison is often difficult, when making a decision, we would generally appreciate a law under which we have the right to compare the available choices rather than a law under which we have one choice, the other choices being concealed. Without comparison of all the available choices, we may never know whether the choice is really the best one in practice.

The cost incurred by plan competition in the bargaining process should not be exaggerated because even under a plan-competition system, there are potential forces driving the bargaining parties to reach a consensual plan. Because the bargaining parties, especially creditors, bear time cost for the delay in reaching an agreement, they desire to reach an agreement as quickly as possible.\footnote{John Scutton, Non-Cooperative Bargaining Theory: An Introduction, 53 REV. OF ECON. STUD. 709, 710-2 (1986).} A reasonable way to do so seems to be to quickly accept the plan that maximizes the overall value of the debtor, since the plan that stands to gain the highest level of acceptance is the plan that maximizes of the size of the whole pie and benefits most classes of claimholders. Moreover, the threat from the possibility of cramming down a plan provides added incentive for the bargaining parties to accept the most efficient plan. In addition, since competing plans are not expected to be common,\footnote{Gerard McCormack (2008), Corporate Rescue Law: An Anglo-American Perspective, Edward Elgar Publishing, p. 254.} increased cost may not actually be a big problem.

The cost incurred by plan competition in the cram down proceeding may not be significantly increased because of several reasons. First, it should be noted, under the current system, based on the exclusivity period, valuation of the debtor’s plan without the helpful comparison from competing plans has always been a big problem.\footnote{See e.g. Kerry O’Rourke, Valuation Uncertainty in Chapter 11 Reorganizations, 2005 Colum. Bus. L. Rev. 403, 427-9 (2005); T. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83} Under plan competition, the law may
design rules for computing and comparing the voting results of different plans and provide
that the court in a cram down procedure only needs to value plans that have gained equal level
of acceptance and avoid the valuation plans that have gained a lower level of acceptance in
order to reduce the burden of judicial valuation. Knowing the rules in advance, when the
bargaining parties are asked to vote for the last time before cram down valuation, they will
have the incentive of concentrating their acceptance on one plan in order to avoid the costly
judicial valuation in cram down. Thus, even if there are competing plans, after the screening
effect of the voting procedure, it is to be expected that the quality of the competing plans will
become clear. The burden of the judicial valuation in cram down may not become a common
problem. Second, as discussed above, competing plans are not expected to be actually filed,\textsuperscript{323}
which further suggests that the higher cost in cram down may not be common.

Another worry is that a plan-competition system will provide secured creditors with the
opportunity of filing a liquidation petition, which may disturb the reorganization
decision-making.\textsuperscript{324} Although it is easy for a secured creditor to propose a liquidation plan,
the law may make it impossible for an inefficient liquidation plan to beat the other competing
plans and become effective. Legislators may design competition rules for the comparison
between a liquidation plan and other rehabilitation plans. A set of well-defined competition
rules may help to ensure that the most efficient plan wins the competition and restrains an
interested party from proposing a competing plan in an irresponsible manner.

(2) Examining the conventional “little contribution” argument with regard to plan competition
The contribution of plan competition lies more in the “potential pressure” than in “actual
plan-filing”. Even if the active filing of a competition plan by creditors is not common, plan
competition has important benefits. It puts pressure on the debtor and forces the debtor to
propose an efficient plan and do it as quickly as possible. It should be noted that the merit of
plan competition is not necessarily about creditors “actually” filing competition plans, but

\textsuperscript{323} Colum. L. Rev. 527, 548 (1983); Raymond T. Nimmer, Negotiated Bankruptcy Reorganization Plans:
\textsuperscript{324} Gerard McCormack (2008), Corporate Rescue Law: An Anglo-American Perspective, Edward
more about the threat of competing plans. Under the exclusivity period, the debtor’s managers may lazily, confidently and comfortably rely on the exclusivity period and simply propose a plan with which they themselves feel most comfortable instead of trying their best to design a plan which maximizes creditors’ recovery, since they may force acceptance from creditors. Under plan competition, the debtor’s managers will be motivated to collect and absorb the efficient ideas from other parties, which, if not being accepted by the debtor, may turn into a competitive plan.

3.2.5.5 Conclusion

After weighing the efficient and inefficient elements of the exclusivity period, the author has found that the exclusivity period’s contribution to the collective procedure is ambiguous and may not exceed its damage to the collective decision-making. Fostering the proper use of the formal reorganization procedure should not be achieved by a device that may damage the quality of the final decisions produced by the proceeding. When the exclusivity period is no longer available, in order to save their jobs the debtor’s managers would probably choose to work hard to find the most efficient rehabilitation project, communicate actively with possible new financers and old creditors about the going-concern value of their business in order to draft a really feasible and efficient rehabilitation plan and win the plan competition based on the quality of their plan. They may not choose to delay the reorganization petition until they miss the good timing of successful rehabilitation since a successful rehabilitation is the practical way to save their job and career record. The formal proceeding, even without the exclusivity period, is still attractive to them since it provides special protection that is not available in the out-of-court workout. Because of their historical relationship with the debtor, they possess special advantages in the plan competition and stand good chance of winning the competition and keeping their management position. To conclude, a plan-competition system may not result in chaos in the reorganization decision-making process and should result in the most efficient plan being proposed and help this to become effective at the end of the reorganization procedure. Therefore, replacing the exclusivity

period with a plan-competition system may be taken into serious consideration.

3.2.6 Reform suggestions for the Chinese plan-drafting system

Although the exclusivity period is challenged in the section above, overthrowing the exclusivity period is a radical reform and calls for the establishment of a plan-competition system, which is beyond this thesis. The following reform suggestions are proposed that could improve and strengthen the restrictive measures and foster the formulation of an efficient plan subject to the assumption that exclusivity period continues to exist.

3.2.6.1 Reform suggestions for the DIP system

Since the legislators intended to rely on the DIP as the general controlling party, in order to make full use of the merit of this system and avoid unnecessary procedural cost and burdens, it is suggested that the EBL abandons the judicial screening before a debtor becomes a DIP and provides the substantial conditions under which a debtor should be removed from DIP. A Detailed analysis of the reform suggestion is below.

First, the EBL should provide that the debtor becomes a DIP by default upon the official commencement of the reorganization procedure and that the administrator, or creditors holding specific amount of credit, or the creditors’ committee may apply to the court for removing the debtor from possession. There are three reasons for this suggestion. The first reason is that the reformed model avoids the procedural burden of transferring the business control to the administrator at the beginning and transferring it back to the debtor after the court’s confirmation of a DIP application. The second reason is that the reformed model avoids unnecessary judicial examination cost. It is difficult for the court to decide whether the debtor is qualified to be a DIP at the beginning of a reorganization case. In examining the debtor’s qualification, the court needs the interested parties’ active participation, such as providing evidence that proves the disqualification of the debtor. Under the reformed model,

326 Although it is suggested that the debtor becomes a DIP by default, this suggestion does not mean that there would be no administrator until the DIP is replaced by the administrator. Under the EBL, an administrator is always appointed by the court at the time the court accepts a bankruptcy case and serves as a supervisor of the DIP. The author suggests that at the beginning of a reorganization case the creditors’ meeting should be given the power of deciding whether to appoint an administrator for a reorganization case as a supervisor of the DIP. See part (2) of Section 3.2.6.4 for the detailed discussion concerning the appointment of the administrator.
the fact that the interested parties do not request the court to remove the debtor from possession serves as evidence that the debtor is qualified and there is no need for the court to conduct an examination. In this circumstance, the reformed model avoids the examination burden and the relevant costs. Finally, the reformed model does better in attracting the debtor to file a reorganization petition at an early stage without materially lowering the substantial standard for DIP and damaging the creditors’ interest.

Second, the EBL needs to state the conditions under which the debtor should be removed from possession in order to make full use of the merit of the DIP system and ensure a unified application of the law. Since the legislators intended to adopt a generous standard concerning DIP, the EBL may provide the conditions for removing the debtor from possession as below: at the request of the administrator, or creditors holding no less than 3% of the total debt, or shareholders holding no less than 3% of the total shares, the court should order that the debtor be removed from possession if the debtor is proved to have committed a fraudulent act or gross mismanagement or if the debtor’s trustworthiness and management capacity is reasonably challenged based on evidences such as the debtor’s dissatisfying performances before and after the commencement of the case, the debtor having tried to hide important files and information from the administrator and the interested parties, or the debtor’s inactive cooperation or non-cooperation with the administrator’s and interested parties’ supervision etc., or if the court finds that the DIP is substantially objected to and distrusted by the creditors, shareholders, and the administrator and that allowing the debtor to remain in possession is reasonably suspected to be contrary to the overall interest of the interested parties, the court may order that the debtor be removed from possession.

3.2.6.2 Reform suggestions for the committee device

First, the EBL may add the provision that the court may, at the request of an interested party and if it considers such necessary based on the facts of a specific case, order the establishment of other committees.

Second, the EBL may change the creditors’ committee into the unsecured creditors’ committee. With respect to the establishment of an unsecured creditors’ committee, it may provide that the unsecured creditors’ committee should be mandatory, unless requested
otherwise at the request of unsecured creditors holding a certain percentage of the total unsecured claim or the court considers that the number of unsecured creditors and the total amount of the unsecured claim is limited and there is no necessity for such a committee. Secured creditors should not be involved in the election of the members of the unsecured creditors’ committee. In addition, the EBL may cancel the requirement that one member of the creditors’ committee should be the representative of the employees or employee union.

Third, it should be provided that committees established according to the EBL may, after obtaining the court’s permission, employ the services of professionals, such as attorneys, accountants or investment advisors. The committees can have the costs of hiring such professionals reimbursed. Members of the committees can have the costs incurred by them when performing their duties reimbursed. The costs incurred by the committees should be paid by the bankruptcy estate.

Fourth, the EBL may add provisions with respect to the committees’ duties and power to supervise the controlling party (the DIP or the administrator)’s business management and plan-drafting activities and reorganization decisions and to participate in the plan-formulation and to request the court to remove the debtor from possession. In addition, it should impose obligations on the committees as the fiduciary of their constituents, such as participating in the negotiation and bargaining procedure; advising its constituents concerning the debtor’s business operation and reorganization; providing all the additional useful information it has collected to its constituents; soliciting and receiving comments from its constituents.

3.2.6.3 Reform suggestions for the administrator’s control over the DIP

Within the scope of the administrator’s supervision over the DIP, it is suggested that the EBL grant the administrator detailed powers and duties. For instance, the EBL may add the following provisions: (1) the DIP should make timely reports of all the daily business decisions and should provide prior reports of out-of-ordinary business decisions and obtain permission before implementing the out-of-ordinary business decisions; (2) if the administrator and the debtor hold controversial opinions concerning the daily business operations, the administrator should apply to the court for making the final decision. If the administrator objects to a DIP’s important business decision, which is of material influence
over the debtor’s overall value, the administrator and the DIP should provide adequate information to the constituents and the court and the court should, after a hearing, make the final decision; (3) the administrator may request the court to remove the debtor from possession; (4) the administrator shall participate in the plan formulation, inquire and collect all the necessary information concerning the debtor’s business management and reorganization, provide periodical report to the interested parties concerning the debtor’s business management and reorganization process, and provide professional advice to the voting parties concerning the feasibility and efficiency of the debtor’s plan and the desirability of the debtor’s rehabilitation; (5) if the debtor’s managers do not cooperate with the administrator when the administrator performs his legal duties, upon the application of the administrator, the court may order the debtor’s managers to correct their actions or order the removal of the debtor from possession and transfer the power of control to the administrator; The interested parties may file their opinions to the court within a reasonable time (such as 10 days). The court, after hearing all the objecting opinions, makes the final decision.

3.2.6.4 Reform suggestions for the administrator system

(1) Establishing a legal system for the integrated management of bankruptcy administrators
The operation of the EBL requires a team of professional administrators. In order to build such a team, the author suggests that the legislative authority provides a set of rules on the integrated management of bankruptcy administrators, which includes legal provisions on the acquisition of a professional license, a professional training system, an insurance system for the administrators’ professional risk, an official publication of the professional record of the administrators, a system for adjudicating complaints concerning administrator’s professional actions etc. The legal system for bankruptcy administrators can help to establish a team of qualified administrators and restrain their performance in the bankruptcy cases and foster the administrator’s contribution to efficient decision-making in bankruptcy cases.

(2) Selecting a suitable administrator for a specific reorganization case
Bankruptcy reorganization is a way of maximizing the debtor’s overall value and the decisions made in a reorganization case are essentially business decisions. Since in the context of reorganization, the administrator is designed to supervise the debtor and protect the
interest of all the claimholders, the debtor is not a suitable party for appointing the administrator. In addition, the corporations entering into bankruptcy reorganization are often insolvent and the shareholders of an insolvent corporation can not be trusted to have the right incentive in maximizing the debtor’s value since they stand to lose nothing and might gain something in reorganization. The author suggests that at the beginning of a reorganization case, creditors should be given the power to decide whether there is a need to appoint an administrator and if they think there is such a need, they should further be given the right of selecting a suitable administrator for the case. For instance, the EBL may provide that within three days after the court accepts a reorganization case or agrees to convert a liquidation case into a reorganization case, a creditors’ meeting should be held to decide whether to appoint an administrator for the reorganization case and to select a suitable administrator for the case (if the creditors’ meeting decides that they need an administrator).

(3) Limiting and stopping the use of the liquidation panel as administrators

Under the current provision, a liquidation panel may be appointed as the administrator for a case where the court considers this to be appropriate. However, generally, the government is not a proper party to serve as bankruptcy administrator. According to the creditors’ bargain theory, bankruptcy reorganization is a proceeding in which all the interested parties try to reach an efficient decision that maximizes the debtor’s overall value. The central questions in the context of bankruptcy reorganization of whether to reorganize and how to reorganize essentially involve a business decision. The administrator should be a professional who has the ability to examine the plan proposed by the DIP, such as the liquidation valuation, the reorganization valuation, the feasibility of the rehabilitation scheme etc. and to make the business decisions where the debtor does not become a DIP. The government officials are not market parties specializing in supervising or making such business decisions. According to the creditors’ bargain theory, bankruptcy provisions mimic the result of the ideal hypothetical bargain. Therefore, we need to ask what would be the result of the ideal hypothetical bargain. Since the interested parties incur costs in using the administrator device, we would

328 The SPCS, Art. 18. Please refer to part (2) of Section 3.2.1.1 for the content of this provision.
329 See Section 2.1.1.1.
expect interested parties to employ the administrator device only if the benefits that the administrator device brings to the collective procedure are greater than its cost and to use the administrator device in a way that minimizes the cost. We may expect the interested parties to bargain for employing only one professional as the administrator in order to get desirable professional help at minimum expense instead of employing both a professional and a number of government officials.

Therefore, it is suggested that the liquidation panel should not be appointed as the administrator for normal bankruptcy cases and should be used only in the unfinished policy-based bankruptcy cases of SOEs. When the policy-based bankruptcy cases of SOEs are finished, the use of the liquidation panel should be completely stopped. Article 18 of the SPCS should be modified into a provision clearly stating that a liquidation panel may be appointed as the administrator only in a case that falls within the scope defined by Article 133 of the EBL. To put it more clearly; the liquidation panel, as a kind of administrator, should only be used in the transitional period from the planned economy to market economy and should be removed from the field of administrators when the policy-based bankruptcy of SOEs is finished.

(4) Equally application of the bankruptcy law to the government’s participation

Some people have argued that the government’s dominance in the reorganization of listed corporations is reasonable since the reorganization of listed corporations involves many complicated issues, such as attracting new financers based on the local finance-attracting policies, the settlement of unemployed workers, dealing with the turmoil caused by the jobless workers etc., which can not be solved simply by intermediary agencies without the support of the government. The author disagrees with this opinion. Although rehabilitation

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330 See part (3) of Section 1.3.2 for policy-based bankruptcy of SOEs.
331 Article 133 of the EBL provides that the bankruptcy of state-owned enterprises within the time limit and scope provided by the State Council should be conducted according to the relevant stipulations issued by the State Council. Article 133 actually means that the bankruptcy of SOEs that are already included in the Policy-Based Bankruptcy Plan, should continue to be conducted according to the regulations issued by the State Council. For the details of policy-based bankruptcy, please refer to part (3) of Section 1.3.2 of this book.
332 For detailed discussion of the legal ground and the practice of the government’s control, please see part (2) of Section 3.2.1.1 and Section 6.2.1.2.
333 许正術(Meizheng Xu), 《上市公司破產重整管理人制度的探討》(Exploring on the Administrator System in the Bankruptcy Reorganization of Listed Corporations), 法制日報(Legal Daily), 2009年4月1日第012版(April 1, 2009, Page 012).
actions should comply with the local rules, such compliance does not justify the participation of the government, i.e. legislator of the local rules, in the rehabilitation process since bankruptcy professionals and judges can be trusted to know how to comply with all the legal rules. Moreover, even if the government officials are not appointed as members of the administrator, the government should carry out its legal responsibility to relieve some relevant social problems caused by the debt disputes and to address unemployment according to the relevant law.

The market economy requires a level playing field, unified application of law and unified protection of creditors. If the government is allowed to participate in a reorganization case at will and control the decision-making by requiring the court to designate a liquidation panel as the administrator for the case, the operating of the decision-making mechanism contained in the bankruptcy law is destroyed. Originally, the bankruptcy law provides a decision-making mechanism, in which the DIP takes initiatives in finding the most efficient solution and is under the supervision of the administrator, creditors, creditors’ committee etc. and the court exercises independent judicial supervision over the actions of all the participating parties. The government’s control destroys the unified and predictable operation of the bankruptcy law. Furthermore, the government’s control prevents the market parties from predicting how their investment will be treated, hinders them from arranging their investment before bankruptcy happens on the basis of the prediction of the treatment of their investment in bankruptcy and thus damages the operation of the market mechanism. Therefore, the government’s control over bankruptcy reorganization cases should be removed in order to ensure an efficient operation of the market economy.

In some cases, the government participates in reorganization because it is the majority shareholder or major creditor of the debtor before the debtor enters into bankruptcy reorganization. In special circumstances, where the government considers that a corporation should be reorganized because it is economically efficient or keeping the corporation alive has special value to the public interest, the government may participate in the reorganization as a new financier and becomes the new creditor or new shareholder of the reorganized debtor.

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In all these circumstances, bankruptcy law should be applied equally to the government’s participation. For instance, the new finance provided by the government should go through the same pricing procedure just as that provided by a market party. Where the rehabilitation is economically efficient, the government participates as a market financier and may profit from its investment. Where the rehabilitation is economically inefficient, the government bears the cost for keeping the corporation alive and protecting the public interest. Under the current law, in a case where the interested parties considers the debtor is economically inefficient, reorganization may still be conducted because the government considers that the debtor is economically efficient or that the debtor serves special social value, since the government can participate in the case as an administrator and make decisions that force the interested parties to bear the cost of the reorganization. Obviously, the current provision may create unfair situations, in which the interested parties are forced to bear the cost of the government’s decision and the government does not bear full responsibility for its decisions made in the reorganization case. Applying bankruptcy law equally to the government’s participation helps to avoid such unfair situations.
4 The plan-passing system

This chapter introduces the US and Chinese plan-passing system, analyzes the efficient and inefficient elements of both systems and provides reform suggestions for the Chinese plan-passing system.

4.1 The plan-passing system under US law

4.1.1 The classified voting system under US law

4.1.1.1 Overview of the classified voting

Under Chapter 11, a proposed plan should go through the voting and confirmation procedure in order to become effective. A proposed plan must designate all claims and interests, i.e. the claims held by creditors and interests held by shareholders, into different classes and specify the treatment of each class. A plan may put a claim or interest into a class only if it is substantially similar to the other claims or interests in that class. All claims or interests in a specific class should receive same treatment unless the holder of a particular claim or interest agrees to less favorable treatment. Under Chapter 11, all classes have the right to vote on the reorganization plan, except the classes that are unimpaired or the classes that will receive nothing under the reorganization plan. Unimpaired classes are deemed to have accepted the plan. Classes that will receive nothing under the plan are deemed to reject the plan.

There are two circumstances in which a class of claims is unimpaired. First, the plan leaves the legal, equitable, and contractual rights to which the claim entitles its holder unaltered.

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336 11 U.S.C. §1123(a)(2); (3).
341 11 U.S.C. § 1124(1). Keneth N. Klee suggested that the impairment test should not be applied to creditors' rights that have been altered by the operation of the Bankruptcy Code. The Bankruptcy Code clearly alters creditors' right from the moment the automatic stay takes effect. If the impairment test is applied absolutely to the creditors' pre-petition rights, the creditors' right will always be impaired. “The Code clearly alters a creditor's rights from the moment the automatic stay takes effect. Thus, the impairment test should be applied after Code driven alterations of rights to avoid the result that holders always have claims or interests in impaired classes for purposes of section 1124(1).”

Kenneth N. Klee (1994), The Concept of "Impairment" in Business Reorganizations, C946 ALI-ABA
Second, the plan may negate an acceleration clause (a clause that accelerates the payment of a claim after the occurrence of a default). In this situation, a claim is not impaired, if the plan reinstates the maturity of the claim as the maturity existed before the default without the approval of any other party, cures all the pre- and post-petition defaults,compensates the holders of the claim for any damage incurred as a result of the reasonable reliance on the defaulted contractual provision, and does not otherwise alter the right of the holders of the claim. The essence of the definition of being unimpaired is to indicate under what conditions the contractual rights of claimholders are considered as not being materially affected. Putting a claim in an unimpaired class has great influence over the rights of the holder of the claim. If a class is unimpaired, it cannot vote on the plan and is not entitled to the protection of the dissenting impaired classes provided in §1129(b). Pursuant to §1129(b), where a plan is to be crammed down over the objection of any impaired class, the plan must meet with the “non-discrimination test” and the “fair-and-equitable test” in order to ensure the protection of the interest of the dissenting impaired class. Klee commented that “[i]mpairment . . . determines which creditors or interest holders ought to have the right to vote to accept or reject a proposed plan. Those parties entitled to vote possess the leverage to bargain for favorable terms under a plan, and if negotiation reaches an impasse, they have the power to dissent from the unfavorable plan and thereby invoke the additional creditor protections set forth in section 1129(b).” By making a class unimpaired, the plan proponent actually excludes that class from participating in the negotiation and ratification of the plan and thus significantly influences the right that class may enjoy. The ability to make some claims unimpaired actually provides the plan proponent with an opportunity to decide whether to impair some claims and negotiate with the holders of these claims or to make these claims unimpaired and avoid negotiation with the holders of these claims.

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11 U.S.C. §1124(2)(A). It should be noted that the Code excuses the need to cure “a default which is a breach of a provision relating to -- the insolvency or financial condition of the debtor at any time before the closing of the case”. Kenneth N. Klee (1994), The Concept of "Impairment" in Business Reorganizations, C946 ALI-ABA 499.


See Section 4.1.2.1 for detailed analysis of these two tests.

A class of claims held by creditors accepts a plan, if at least two-thirds in amount (“the supermajority rule”) and more than one-half in number of the allowed claims of the class voted in favor of the plan.\textsuperscript{347} A class of equity interests held by shareholders accepts a plan, if at least two-thirds in amount (“the supermajority rule”) of the outstanding shares of the class voted in favor of the plan.\textsuperscript{348} After notice and hearing, the court may hold that a claimholder has not cast his vote in good faith or that a claimholder has not been solicited in good faith. In these events the vote will not be counted.\textsuperscript{349}

### 4.1.1.2 The efficient elements of classification

Classification is a fundamental element of the collective procedure. According to the creditors’ bargain theory, bankruptcy law should respect the interested parties’ non-bankruptcy entitlements. Classification is efficient in that it respects the interested parties’ non-bankruptcy entitlements by grouping claims that are substantially similar according to their nature as defined under non-bankruptcy law\textsuperscript{350} into one class and by treating these claims equally. The equal treatment of claims that are substantially similar in nature under non-bankruptcy law respects the parties’ non-bankruptcy entitlements, constrains unfair discrimination to substantially similar claims.\textsuperscript{351} Without classification, similar claims may receive discriminative distribution, which may cause forum shopping and strategic bargaining behavior. For instance, in the absence of equal treatment of substantially similar claims, parties who can get favorable treatment may choose a reorganization procedure even if it is not good for the collective parties as a whole and the parties holding substantially similar claims will not act as a group but struggle for individual advantage. Therefore, judged against the creditors’ bargain theory, classification is efficient because it respects the

\textsuperscript{347} 11 U.S.C. §1126(c).
\textsuperscript{348} 11 U.S.C. §1126(d).
\textsuperscript{349} 11 U.S.C. §1126(e). A vote should be disqualified if it was cast for the ulterior purpose of securing some advantage to the voting party. In re Lloyd McKee Motors, Inc., 157 B.R. 487, 489 (Bankr. D. N.M. 1993). Absent an ulterior purpose, such as malice, black mail, or the intent to destroy the debtor, the vote should be counted. In re Federal Support Co., 859 F.2d 17, 19 (4th Cir. 1988); In re Peter Thompson Assocs., Inc., 155 B.R. 20, 22 (Bankr. D. N.H. 1993).
\textsuperscript{350} For instance, general unsecured creditors are substantially similar to each other and are substantially different from subordinated unsecured creditors according to their contracts with the debtor and contract law.
\textsuperscript{351} Douglas G. Baird, ELEMENTS OF BANKRUPTCY, Foundation Press, 4th edition, 261-2 (2006) (Commenting that classifying similar claims into one class and providing the same treatment to similar claims is a practical way of counteracting unfair discrimination or unfair treatment of similar claims).
interested parties’ non-bankruptcy entitlements and hinders the plan-proponent from providing discriminative distribution to substantially similar claims.

Moreover, according to the creditors’ bargain theory, an efficient bankruptcy system mimics the result of a hypothetical bargain. In the hypothetical bargain, interested parties would agree to replace the individual debt-collection system with a collective procedure in which interested parties holding substantially similar claims will be put into one class and receive a pro rata distribution, so that all the interested parties can realize a structured debt-collection and avoid the uncertainty and cost under the individual debt-collection system. Classification is an important element of bankruptcy law that mimics the hypothetical bargaining result. Classification is efficient in that classification helps the interested parties to achieve a structured collective debt-collection procedure while at least respecting the non-bankruptcy entitlements with a view to maximizing the debtor’s overall value while minimizing the debt-collection cost. In addition to the efficient elements of classification, limiting strategic behavior, discussed in the preceding paragraph, classification helps to enhance interested parties’ bargaining efficiency and minimize the bargaining cost because it provides the foundation on which the holders of similar claims can bargain as a collective and for the application of a majority voting rule. Classification fosters reorganization bargaining in that holders of similar claims may bargain as a collective. By classification, claimholders who hold substantially similar claims are put into one class and may bargain as a collective. Classification channels the bargaining among many individual claimholders into bargaining among several classes and reduces the cost of the bargaining among all the individuals, makes the bargaining proceed in a more structured and manageable way. Based on classification, members of a class may bargain as a collective and bargain through some capable representatives, such as several powerful members of the class and/or the professional agents employed by the class and bargaining efficiency is enhanced by bargaining through capable representatives. In addition, classification fosters reorganization bargaining in that it

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353 W. Christopher Frost (1992), Running the Asylum: Governance Problems in Bankruptcy Reorganizations, 34 Ariz. L. Rev. 89, p. 116 (talking about the difficulty in direct involvement of individuals and the need of representation. The need of representation implies the importance of classification, since classification provides the basis for representation); Douglas G. Baird and Robert K.
provides the basis for the majority voting rule for class voting, which fosters the bargaining efficiency by allowing the opinion of a suitable majority to bind the objecting minority of one class.

To conclude, against the standard established by the creditors’ bargaining theory, classification is efficient in that it helps to reach maximum respect of the interested parties’ non-bankruptcy entitlements in the collective debt-collection proceeding, restrains discriminative distribution and strategic behaviors, fosters decision-making efficiency, and helps to minimize bargaining cost.

4.1.1.3 The inefficient elements of classification

The inefficient elements of the US classification system mainly lie in that it provides room for “gerrymandering” or “vote manipulation”. The ability to mold classes is powerful and has great impact over the distribution of the debtor’s value and the confirmation of a plan. It is often not easy to decide whether some claims in a specific case are substantially similar for the purpose of classification. For example, it is unclear whether the unsecured claims held by tort creditors, employees, loan creditors or trade creditors in a specific case are substantially similar to each other and should be put into one class. What makes the situation even more complicated is that Chapter 11 does not mandate that similar claims must be classified into one class. Generally courts hold that separate classification and disparate treatment of similar claims are permissible when the disparate treatment does not constitute unfair discrimination.

Rasmussen (2001), Control Rights, Priority Rights and the Conceptual Foundations of Corporate Reorganization, 87 Va. L. Rev. 921, pp. 930-1 (describing the early history of bankruptcy reorganization, during which the individual claimholders were classified and bargained through the representative of different classes, whom comprised the reorganization committee that dedicated to bargaining and drafting the reorganization plan. This classified bargaining and voting is further codified and inherited by the current US bankruptcy code. The development history of the US code demonstrates the contribution of classification to decision-making efficiency in reorganization context).


11 U.S.C. § 1122(a) only provides that claims being put into one class should be substantially similar and does not provide that similar claims must be put into one class. See e.g., Scott F. Norberg (1995), Classification of Claims Under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification, 69 Am. Bankr. L. J. 119, pp. 145-6. Bruce A. Markell (1995), Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification, 11 Bankr. Dev. J. 1, p. 34 (“Section 1122(a) addresses only improper combinations of claims, not allegedly improper segregation. It is silent on what claims "must" be classified together.”).

See e.g., Frito-Lay, Inc. v. LTV Corp. (In re Chateaugay Corp.), 10 F.3d 944, 957 (2d Cir.1993) (holding that separate classification and disparate treatment had rational basis); Jersey City Medical
The problem of gerrymandering is especially prominent in the context of cram down. The precondition for the debtor to cram down its plan is that the plan has gained the acceptance of one impaired class. This requirement is an important threshold for cram down since it helps to ensure some baseline protection of the interest of the impaired classes and restraint over the quality of the plan by forcing the debtor to try to negotiate with impaired classes and achieve some basic agreement in this negotiation.\textsuperscript{357} In practice, the debtor may try to satisfy this requirement by manipulating the classification. One method is artificial separation of similar claims, i.e. getting a friendly accepting impaired class by separating hostile claimholders from friendly ones so that the friendly claimholders will constitute the requisite majority of a voting class. \textsuperscript{358} Another method is artificial impairment, i.e. creating an accepting impaired

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\textsuperscript{357} J. Ronald Trost, Joel G. Samuels, and Lantry Kevin T. (1998), Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification, SD24 ALI-ABA 401, p. 416.

\textsuperscript{358} Peter E. Meltzer (1992), Disenfranchising the Dissenting Creditor through Artificial Classification or Artificial Impairment, 66 Am. Bankr. L. J. 281, p. 302.
\end{footnotesize}
class by artificially slightly impairing the interests of a friendly class.\textsuperscript{359} The court may play a role in counteracting the problem of classification manipulation. It is suggested that where there is suspected manipulation of classification, the court can solve the problem by ordering the debtor to put all the substantially similar claims into one class and to treat the members of a class equally.\textsuperscript{360} For instance, a plan proponent may put substantially similar claims into different classes, provide complex payout schemes that are difficult to value and assert that the claims allocated to the different classes are different in kind but equal in value. However, one class may claim that the debtor has been gerrymandering the voting or that they have been treated less favorably than the other similar claims that are put in a different class. In this situation, the court, if after examining the nature of the claims, it considers that those claims being put into different classes are actually similar, may solve the problem of gerrymandering and discrimination by requiring that the plan proponent puts all these substantially similar claims into one class and provides all the different kinds of payment as equal alternatives for the holders of the similar claims to choose between.\textsuperscript{361}

4.1.1.4 The efficient and inefficient elements of the supermajority rule

Judged against the standard established by the creditors’ bargain theory, the supermajority voting rule is efficient in that it fosters interested parties bargaining and helps the multiple parties to avoid the hold up by objecting minorities and to reach a consensual agreement on a plan that maximizes the debtor’s value.\textsuperscript{362} Under the assumption that a majority rule should

\textsuperscript{359} See e.g., In re Lettick Typografic, 103 B.R. 32, 38-9 (Bankr. D.Conn. 1989) (the court refused to confirm the plan based on three grounds, two of which were related to classification. One of the grounds was that the classifications in the plan attempt to improperly manipulate the unsecured creditor class and neutralize objections to the plan. Another ground was that the debtor artificially created an impaired class by amending the draft plan and deferring the payment to one secured class for fifteen days in the amended plan); In re Sandy Ridge Development Corp., 881 F.2d 1346, 1353 (5th Cir. 1989) (based on the fact that the creditors overwhelmingly rejected the plan, the court suspected that the plan artificially created the slightly impaired classes which were willing to give acceptance to the plan and that the debtor lacked good faith and remanded the matter to the bankruptcy court for reconsideration); In re Sun Country Development, 764 F.2d 406 (5th Cir. 1985) (change a creditor's status from unimpaired to impaired for the sole purpose of effecting a “cram down.”). See also Peter E. Meltzer (1992), Disenfranchising the Dissenting Creditor through Artificial Classification or Artificial Impairment, 66 Am. Bankr. L. J. 281, pp.316-8.


\textsuperscript{361} Id.

\textsuperscript{362} Thompson, Robert B. and Edelman, Paul H. (2009), Corporate Voting. 62 Vanderbilt Law Review 129, p. 132 (talking about one of the merits of majority voting is to help the group to avoid hold-up by the minority and reach a decision since there is no perfect way to aggregate the preferences of individuals into the preference of a group).
be adopted to avoid the hold up problem in the collective decision-making within one class, which majority rule is suitable in the context of reorganization bargaining needs further exploration. Compared with the simple majority rule, i.e. a rule that requires the consent of more than half of the total amount, the supermajority rule, which requires the consent of more than two thirds of the total amount, increases the threshold of the votes for the class’ acceptance of a plan. On the one hand a high majority requirement is efficient because it reduces the problem of minorities being expropriated by the majority. On the other hand, a high majority requirement is detrimental because it provides the minority with hold-up power in the sense that they can prevent the efficient decision from being made. The optimal majority requirement is the one with the best tradeoff between minority protection and hold-up minimization.

Skeel suspected that one of the reasons why legislators of Chapter 11 adopted the supermajority rule is that the supermajority rule provides stronger protection of the interests of the dissenting minorities of a class. As a reorganization plan often effectuates a material alteration of the pre-bankruptcy entitlements of a voting class, whether to accept the plan is closely related with the protection of the interests of the claimholders, the supermajority rule may provide better protection of the interests of claimholders since it requires the consent of more than two-thirds of the total amount. However, Skeel further pointed out that special protection of the minority is not quite necessary in the class voting of a bankruptcy reorganization procedure. The rest of this paragraph is a summary of Skeel’s main line of reasoning. The supermajority rule is prevalent in the context of close corporations, where the majority shareholders may abuse their dominant power to pass some corporate decisions, which by nature have disproportionate impact over the majority and minority shareholders.

365 For example, in a close corporation where the majority shareholders are top managers while minority shareholders are not managers and simply get benefits of their investment by receiving dividends, a decision that increases the salary of the corporations’ top managers and stops paying dividends, may have a disproportionate impact on majority shareholder and minority shareholders. David A. Skeel, Jr. (1992),
In a close corporation, a minority shareholder’s major fear is that the majority shareholders may vote for decisions that improve the welfare of majority shareholders without giving minority shareholders comparable benefits. For a minority shareholder holding 34% of the total share, the supermajority rule is more desirable than the simple majority rule, since the supermajority rule makes it difficult for the majority shareholders to pass decisions without the assent of the minority shareholder. However, in the context of a reorganization procedure, each member of a class is affected in the same way since the claims in one class must be substantially similar and the treatment of each class member must be the same. If the assenting members of a class receive a payment of 80% of their claims under a plan, so do the dissenting members of the same class. Because each member of the same class is affected in the same way by the outcome of the vote, the need to protect the interest of the dissenting minority and the need for the adoption of the supermajority rule is not as strong that in the context of a close corporation where the corporate decision may affect the majority shareholder and minority shareholder in a different way. Therefore, compared to the simple majority rule, the supermajority rule does not have an obvious merit in enhancing minority protection and increasing the probability of a correct decision is not obvious.

Norberg commented that the supermajority rule “decreases the instances in which the votes of insiders or others with additional stakes in the firm will be able to override the desires of disinterested claim holders.” For example, claims held by insiders may dominate a class and the insiders may vote to protect their interests as shareholders and managers instead of their interests as creditors. Another example is that under-secured creditors who also hold unsecured claims (the deficiency amount of an under-secured claim) may vote for their interests as secured creditors instead of as unsecured creditors. However, the supermajority


Frank H. Easterbrook and Daniel R. Fischel (1986), Close Corporations and Agency Costs, 38 Stan. L. Rev. 271, pp. 296-7 (discussing that the minority shareholders’ veto power is necessary for protecting their interests)


rule is not a proper and effective device for such a problem, because it is uncertain in a specific case how much percent of the total amount of the claims of one class will be held by members who vote with an incentive of promoting their other kinds of interests instead of their interest as the class members. If claims with right voting-incentives constitute more than one half but less than two thirds of the total amount of the class, the supermajority rule actually obstructs efficient decision-making and hinders the protection of the interests of the class. Therefore, this kind of problem should be solved by other devices, such as non-calculation of the votes of claimholders who hold other interests which materially conflict with their interests as class members, invalidating the votes of a claimholder who did not caste his vote with good faith.

Skeel suspected that another reason for the adoption of the supermajority rule is the problem of uninformed voting. Shareholders and unsecured creditors of a publicly held corporation “may be small and dispersed enough so that they have insufficient incentives to cast their vote in an informed fashion for or against a reorganization proposal”, since informed voting is accompanied by the costs incurred in securing and evaluating information, developing capacity etc. For example, many unsecured creditors may be willing to accept any payment—however small—rather than face further delay. Because this problem may give the plan proponent an upper hand, the supermajority requirement may be considered by the legislators as a response to this collective action problem. However, the supermajority rule is not a proper and effective device for such a problem. First, the problem of the dispersed members’ reluctance in bearing the cost for making an informed decision cannot be solved by lifting the standard of the requisite majority, but should be solved by devices that help the dispersed members to acquire the necessary information and to make an informed decision, such as the establishment of a committee for unsecured creditors and shareholders, the employment of professional agents by a committee etc. Since the uninformed decision may lead to incorrect rejection or acceptance, it is uncertain whether the supermajority rule may contribute to the quality of the decision. In order to improve informed decisions, legal

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devices, such as the committee device, information disclosure obligation of the debtor, are more suitable solutions.

To conclude, in the context of bankruptcy reorganization, compared with the simple majority rule, the merit of the supermajority rule with respect to the protection of the minority and the production of efficient decision is unclear or ambiguous.

4.1.2 The confirmation system under the US law

4.1.2.1 Overview of the confirmation system

Based on the result of class voting, there are two kinds of courts confirmation of the proposed plan: confirmation of a consensual plan and confirmation of a non-consensual plan (“cram down”). A plan that has been accepted by all classes during class voting (“a consensual plan”) will finally become effective if it is confirmed by the court. The court should examine the consensual plan judged against a series of requirements provided by Chapter 11. Since under Chapter 11, the requirements for the confirmation a consensual plan also apply in the confirmation of a non-consensual plan, these requirements are referred to as “general confirmation requirements”.

Among the general confirmation requirements, the major ones are the best-interest-test and the feasibility test. The best-interest-test requires that each dissenting member of an impaired class receives a distribution with a present value no less than what he would receive under a hypothetical liquidation on the effective date of the plan. This test is applied to each dissenting member of an impaired class rather than to his class as a whole. The

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371 “Confirmation” is a general term which means courts’ confirmation of both consensual plans and non-consensual plans. “Cram down” is a term that specially means confirmation of non-consensual plans. See e.g. Kenneth N. Klee (1979), All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133.


373 The general confirmation requirements that apply to non-consensual plans refer to the provisions in 11 U.S.C. § 1129(a), except 11 U.S.C. § 1129(a)(8), which requires that the plan should be either accepted by all the impaired classes and is a provision that deals with the definition of a consensual plan.


feasibility test requires that the plan is not likely to be followed by liquidation or the need of another reorganization of the debtor unless such liquidation or reorganization is proposed in the plan, or that the plan is likely to succeed in practice.\footnote{11 U.S.C. §1129(a)(5) provides that the purpose of the feasibility requirement is to prevent confirmation of a visionary scheme that promises more than the debtor can possibly achieve. In re Gulph Woods Corp., 84 B.R. 961, 973 (Bankr. E.D. Pa. 1988). The plan need only offer a reasonable assurance of success, not a guarantee. Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.), 843 F.2d 636, 649-50 (2d Cir. 1988).}

Besides the best-interest-test and the feasibility test, Chapter 11 contains other general confirmation requirements. Firstly, Chapter 11 requires that a plan should disclose any payments for the services or for costs and expenses in connection with the plan and the case (“adequate disclosure of all the reorganization fees”).\footnote{11 U.S.C. §1129(a)(4).} This is to ensure that all the expenses incurred in a reorganization case are under comprehensive supervision. Moreover, Chapter 11 requires that the plan and the plan proponent should comply with all the bankruptcy law and the plan has been proposed in good faith and not by any means forbidden by the law (“good faith and general validity test”).\footnote{11 U.S.C. §1129(a)(1); (2); (3).} This may serve as a general restraint over the plan proponent to ensure that the plan is proposed for achieving the legitimate purpose and is in conformity with all the applicable laws. The term “good faith” is not defined in the US Code. Case law suggested that a plan generally is considered as proposed in good faith “if there is reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Code.”\footnote{In re Gen. Teamsters, Warehousemen & Helpers Union, 265 F.3d 869 (9th Cir. 2001) (a good faith plan is one which satisfies the purposes of the Code, which include facilitating the successful rehabilitation of the debtor and maximizing the value of the estate). See also, In re PWS Holding Corp., 226 F.3d 224, 232 (3d Cir. 2000); In re Madison Hotel Assocs., 749 F.2d 410, 424-25 (7th Cir. 1984).} Courts have further held that in evaluating whether a plan has been proposed in good faith the court must look to the “totality of the circumstances” surrounding the development and proposal of the plan.\footnote{In re Machne Menachem, Inc., 48 Bankr. Ct. Dec. 23 (3d Cir. 2007) (The court affirmed the reversal of a confirmation order where an insider “gerrymandered” the voting process by purchasing unsecured claims during the case to ensure that an impaired class of claims would vote in favor of the plan. The insiders’ purchase of claims to ensure acceptance of the plan by an impaired class was deemed bad faith.) Financial Sec. Assurance v. T-H New Orleans Ltd. P'ship (In re T-H New Orleans Ltd. P'ship), 116 F.3d 790, 802 (5th Cir. 1997) (“The requirement of good faith must be viewed in light of the totality of circumstances surrounding establishment of a Chapter 11 plan, keeping in mind the purpose of the Bankruptcy Code to give debtors a reasonable opportunity to make a fresh start. Where the plan is proposed with the legitimate and honest purpose to reorganize and has a reasonable hope of success, the good faith requirement of § 1129(a)(3) is satisfied. A debtor's plan may satisfy the good faith requirement even though the plan may not be one which the creditors would themselves design and indeed may not be confirmable.”) (citations omitted).}
the plan must disclose the identity and affiliations of the top managers of the reorganized debtor, any of the debtor’s affiliations that participate in a joint plan or the successor of the debtor participating in the plan, the identity of the insiders that will be employed in the reorganized debtor and the compensation to be paid to such insiders (“adequate disclosure of information concerning the new and old management”).\textsuperscript{383} This provision forces the plan-drafter to disclose the necessary information to the interested parties which is essential for the judge and the interested parties to judge whether the reorganized debtor will be put in capable hands and whether the compensation to the debtor’s insiders is reasonable.\textsuperscript{384}

If a plan is not accepted by all voting classes, the plan proponent may apply for confirmation of the plan under the condition that at least one impaired class, excluding the votes of insiders,\textsuperscript{385} has accepted the plan.\textsuperscript{386} Because insiders may vote to promote their interests as shareholders or managers instead of their interests as creditors, this requirement helps to ensure that the vote is not tainted by these claimants’ conflicting equity or employment interests. It should be noted that the consent of a class that is deemed to have accepted the plan because it is unimpaired does not satisfy the one class’ consent requirement provided in §1129(a)(10).\textsuperscript{387} By excluding the ballots from insiders and the presumed consent of unimpaired classes, §1129(a)(10) aims to ensure that one “real” class of creditors accepts the plan.\textsuperscript{388} Besides the general confirmation requirements provided in §1129(a) and the one impaired class’ consent, a crammed-down plan must satisfy the cram-down requirements provided in §1129(b). The central content of the cram-down requirements is that the plan does not discriminate unfairly (“non-discrimination-test”) and that the plan is fair and equitable (“fair-and-equitable-test”).\textsuperscript{389} The cram-down requirements only apply to the dissenting classes rather than to all classes or the plan as a whole.

\textsuperscript{383} 11 U.S.C. §1129(a)(5).

\textsuperscript{384} See e.g., In re SM 104 Ltd., 160 B.R. 202 (S.D. Fla. 1993) (ruling that “[w]here the proposed officer or director has previously engaged in serious misconduct in managing the debtor . . . , employment is improper under § 1129(a)(5)”).

\textsuperscript{385} The term “insider” is defined in 11 U.S.C. § 101 (31) in a broad sense. If the debtor is a corporation, insiders include officers, directors, and any other person in control of the debtor.

\textsuperscript{386} 11 U.S.C. §1129(a)(10).

\textsuperscript{387} 11 U.S.C. §1129(a)(10).


\textsuperscript{389} 11 U.S.C. §1129(b)(1).
Among the two requirements, the non-discrimination-test plays a fundamental role. The non-discrimination-test is intended to “be complementary to a fair and equitable test and to permit the court to evaluate the complex relationship inherent in the relative priority of classes caused by partial subordination.” In determining whether a plan discriminates unfairly, focus is upon the classification and treatment of the different claims. “If the plan protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class, then the plan does not discriminate unfairly with respect to the dissenting class.”

For example, a plan that segregates similar claims into separate classes and provides disparate treatment for those classes may be found by the court to contain unfair discrimination. The notion of a fair-and-equitable-test is to ensure fair and equitable distribution of the debtor’s value to the dissenting classes. In order to determine whether a plan is fair and equitable, a concrete test—the absolute priority rule must be applied to check the distribution of the debtor’s value in the plan.

The absolute priority rule originated from the equity receivership cases for dealing with the problem of shareholders’ continued participation in the reorganized debtor while unsecured creditors did not receive full payment. It requires that a dissenting senior class must be paid in full before any junior class receives any payment and that no classes senior to a dissenting class may receive more than full payment. In other words, a dissenting senior class must receive full payment if classes junior to it receive anything and may receive less than full payment if classes junior to it receive nothing. A corollary of the absolute priority rule, not expressly stated in the US Code, is that classes senior to the dissenting classes should not receive more than full payment. Thus, the absolute priority rule allows the

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shareholders to receive the remaining value of the debtor after all the dissenting senior classes receive full satisfaction of their claims and prohibits the shareholders from receiving any payment before all the dissenting senior classes receive full satisfaction of their claims. Compared with the absolute priority rule under the 1938 Act, Chapter 11 adopts a relaxed version of the absolute priority rule in permitting senior assenting classes to give up value to a junior class as long as all dissenting classes with a priority level higher than that junior class receive full payment. The absolute priority rule is the substantial and concrete content of the fair-and-equitable test. Theoretically, it is not clear whether the treatment of secured creditors is within the regulation scope of the absolute priority rule. For instance, Baird thinks that the absolute priority rule is a general principle that is “to ensure that creditors in bankruptcy are paid according to their nonbankruptcy priorities.” By contrast, Klee thinks that the absolute priority rule is to regulate the distribution among unsecured creditors and shareholders and that 1129(b)(2)(A) is a specific provision which ensures that a dissenting class of secured creditors should be not only receive full payment in value and but this should also be one of the three specific kinds of payments. Nevertheless, the spirit reflected in protecting secured creditors in their receipt of full payment is the same as that of the absolute priority rule.


“The Code adopts three different tests to determine whether a plan is fair and equitable, depending on whether the dissenting class is comprised of secured claims, unsecured claims, or ownership interests. The tests regarding unsecured claims and ownership interests essentially apply a relaxed version of the traditional absolute priority rule….However, the test for secured claims is completely novel....” Kenneth N. Klee (1979), All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133, pp. 142-3. 399 The House Report on the 1978 Bankruptcy Code states that “The general principle of the subsection [§1129 (b)] permits confirmation notwithstanding nonacceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan. If it is paid in full, then junior classes may share. Treatment of classes of secured creditors is slightly different because they do not fall in the priority ladder, but the principle is the same.” House Report, p. 6369.
4.1.2.2 The efficient and inefficient elements of the confirmation system

The confirmation system is a type of judicial supervision that serves as the final-step in the screening of the content of the reorganization plan. Judged against the standard established by the creditors’ bargain theory, the efficient elements of the confirmation system mainly lie in that it helps to ensure that only the efficient plan, i.e. the plan that maximizes the debtor’s value, will take effect at the end of the reorganization procedure. The main substance of the general confirmation requirements, i.e. the best-interest-test and feasibility test, is analyzed below.

(1) The efficient and inefficient elements of the best-interest-test

According to the creditors’ bargain theory, the goal of the bankruptcy proceeding is the maximization of the debtor’s overall value and reorganization and liquidation are equal alternatives between which the interested parties may freely choose to achieve that goal.\(^{400}\) If the reorganization plan is efficient, the debtor’s overall value is maximized under the plan, the total recovery of the creditors as a whole is maximized. The best-interest-test is efficient in that it checks whether the plan is efficient by requiring that every objecting claimholder receives no less than what he would receive under liquidation. Generally one may assume that a reasonable claimholder will object to a plan if the value of the distribution he receives under the plan is less than what he would receive under a hypothetical liquidation. Thus, if a claimholder objects to a plan, even if the class, to which he belongs, has accepted the plan, there is a need for the court to step in and check whether reorganization is more efficient than liquidation and whether the dissenting claimholder receives no less than what he would receive under liquidation. Therefore, the best-interest-test is a device employed by the law to check the efficiency of reorganization where the plan meets with some objection and to provide an important baseline protection of the interests of the dissenting claimholders.\(^{401}\)

The best-interest-test is inefficient in that it incurs cost since it requires a series of complicated valuations. The best-interest-test requires the calculation of the debtor’s liquidation value and reorganization value, the present value of the distributions to the

\(^{400}\) See Section 2.1.1.1.

objecting claimholders under the reorganization plan and the value of the distribution to
objecting claimholder under a hypothetical liquidation. For instance, there are problems in
making a liquidation analysis, such as whether the court should adopt a going-concern
liquidation or piecemeal liquidation, an orderly sale or a quick sale,\textsuperscript{402} as the method for
getting the hypothetical liquidation value, how to calculate the liquidation value since the
hypothetical administrative expenses of liquidation may not be easily quantified.\textsuperscript{403} While it
is difficult to make the liquidation analysis, it may be even more difficult to make the
reorganization analysis, which involves the calculation of the debtor’s reorganization value
and the value of the distribution to the dissenting claimholders under the plan.\textsuperscript{404}

(2) The efficient and inefficient elements of the feasibility test

According to the creditors’ bargain theory, an efficient bankruptcy rule should help the
reorganization procedure to produce an efficient reorganization plan that maximizes the
debtor’s overall value. An efficient plan should be feasible. The feasibility test is efficient in
that it prevents “visionary schemes” from being confirmed and ensures that the confirmed
plan contains an efficient scheme. An efficient plan should not only promise a reorganization
value, which is higher than the liquidation value, but also contain a feasible operation scheme
that provides reasonable assurance of the realization of that higher value.\textsuperscript{405}

The feasibility test is inefficient in that it is costly for the court to judge whether a plan is

\textsuperscript{402}“Under an orderly liquidation approach, the debtor values its assets based on the pricing it may
obtain if it sells its assets to the market over time. In contrast, under a fire sale liquidation approach, the
debtor bases its pricing on flooding the market with its assets over a short period of time. In certain
circumstances, an orderly valuation may be the most appropriate methodology for preparing a
liquidation analysis, while in others, a fire sale approach may be preferred. The court determines
whether an orderly or fire sale valuation methodology is more appropriate depending on which
approach maximizes returns to creditors, and depending on the facts of each case.” Natalic Regoli
(2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test,

\textsuperscript{403}Natalic Regoli (2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest

\textsuperscript{404}See e.g., Natalic Regoli (2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best
Interest of Creditors Test, 41-SPG Tex. J. Bus. L. 7, p. 29-30; Kerry O’Rourke (2005), Valuation
Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 Colum. L. Rev. 527, p. 548;
Value Contributions, 36 Emory L. J. 1009, pp. 1046-7; Chaim J. Fortgang and Thomas Moers Mayer

\textsuperscript{405}See e.g., In re Bowman, 253 B.R. 233, 238-39 (8th Cir. BAP 2000); In re Sea Garden Motel & Apts.,
195 B.R. 294, 304 (D.N.J. 1996); Miller v. Nauman (In re Nauman), 213 B.R. 355, 358 (9th Cir. BAP
feasible or not. Case law has developed detailed standards for applying the feasibility test. “Sincerity, honesty and willingness are not sufficient to make the plan feasible, and neither are any visionary promises.” The court may not rely on highly speculative and unduly optimistic assumptions and must base its findings of feasibility on the evidence presented. Feasibility does not require absolute assurance of success but only reasonable assurance of success. Case law has suggested that bankruptcy courts frequently consider the following factors in determining the feasibility of a plan: (i) the debtor's prior performance, (ii) the adequacy of the debtor's capital structure, (iii) the earning power of the business, (iv) economic conditions, (v) the ability of management and the probability of the continuance of the same management, and (vi) any other matter that may affect the debtor's ability to perform the plan.

4.1.2.3 The efficient elements of cram down

Compared with confirmation of a consensual plan, confirmation of a non-consensual plan, i.e. the justification of cram down deserves special attention, since it imposes a plan on the dissenting classes. Moreover, if cram down is proved to be necessary, the cram down rules need to be examined in order to see whether they ensure that crammed-down plans maximize the debtor’s value, distribute debtor’s value in a fair and equitable way and protect the interest of the dissenting classes. In addition, since the parties bargain in the shadow of cram down, the cram-down rules have great impact over the parties’ decision on whether to

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407 See e.g., Pan Am Corp. v. Delta Air Lines, Inc., 175 B.R. 438, 508 (S.D.N.Y. 1994); In re Snider Farms, Inc., 83 B.R. 1003, 1014 (Bankr. N.D. Ind. 1988). In effect, a court is required to predict, based on the historical data provided by the parties, whether the debtor will be able to make all payments under the plan and to otherwise comply with the plan. In re Snider Farms, Inc., 83 B.R. 1003, 1006 (Bankr. N.D. Ind. 1988) (“A plan will not be confirmed where, for example, there is no realistic possibility of an effective reorganization and the debtor is merely seeking to delay the efforts of creditors to enforce their rights.”)
accept a plan. Therefore, the efficient and inefficient elements of the cram-down system and the substantial cram-down requirement—the absolute priority rule is explored in detail below.

Judged against the standard established by the creditors’ bargain theory, the efficient elements of cram down mainly lie in the fact that cram down makes it possible for an efficient plan to go ahead and become effective at the end of the reorganization procedure without being held up by a voting class that has a distorted decision-making incentive.

If all the participating parties in the reorganization procedure are equally positioned as residual owners of the reorganization decision and thus have the right decision-making incentives, the reorganization law may simply rely on the voting based on a majority rule to reach the final decision. However, in the reorganization context, the claimholders are differently positioned and their decision-making incentives maybe skewed. This leads to the necessity of cram down, which serves as an important device to help an efficient plan obtain legal effect even if it fails to get consensual acceptance in the voting procedure.

At bottom, the skewed incentives are caused by the valuation problem and the separation of cost-bearing from benefits-sharing in the reorganization procedure. In the reorganization decision making process, the participating parties faced with the liquidation vs. reorganization problem, will compare what they receive under liquidation with that under reorganization. To the extent they would receive different payment under liquidation, they bear different cost for reorganization. However, the costs borne by a class of claimholders for the reorganization when the decision between liquidation and reorganization is made is not the only factor determining how much reorganization value the claimholders will receive. The reorganization value is distributed according to special reorganization rules, such as the absolute priority rule. Jackson commented that, in bankruptcy reorganization, senior classes, who bear the cost for the reorganization, do not reap all the benefits of reorganization; junior classes, who

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411 "So long as the company remains in reorganization, the risk of investment loss is borne largely by senior classes while the possibility of investment gain accrues largely to junior classes." Lynn M. LoPucki and William C. Whitford (1993), Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, p. 753.
412 Thomas H. Jackson (2001), The Logic and Limits of Bankruptcy Law, Bear Books, pp.212-3 (commenting the relationship between distribution of the reorganization value and the absolute priority rule).
bear no cost for the reorganization, may enjoy part of the benefits of reorganization. This leads to the separation of cost-bearing from benefits-sharing, which may cause skewed decision-making incentives in different classes of claimholders. Where a debtor corporation is insolvent, junior classes, typically shareholders, who would receive nothing under liquidation, have a strong incentive to delay the shut down of the debtor’s business and pursue a risky reorganization, even if liquidation is efficient, since they will lose nothing if the reorganization fails and might gain something if it succeeds. Senior classes, typically being secured creditors, who may receive full payment, often have a strong incentive to push for immediate liquidation, since they bear the cost for the reorganization, but they often share the benefits with those who do not bear cost for the reorganization and may not get adequate compensation for the cost they bear because of the valuation problem in calculating the compensation, such as the difficulty in finding the proper post-petition interest rate and the post-confirmation interest rate for the delay in receiving payment caused by reorganization.

Because the voting parties’ decision-making incentives may be skewed, a reorganization law without cram down would allow a voting class with skewed incentives to turn down an efficient plan and destroy all the valuable rescue efforts. Cram down is efficient in that it may conquer the hold out by voting classes with distorted incentives. This results in a reliable reorganization procedure likely to lead to an efficient reorganization plan.

Moreover, cram down is efficient in that it puts pressure on the interested parties to strike a deal of their own. All the interested parties bargain in the shadow of cram down, if they expect to go through a costly cram-down procedure that results in confirmation of the same

415 “[T]he risks of failure to reach a settlement are so great, and the possible negative impact of the imposition of the cramdown powers so significant, that the cramdown power is used more as a threat than as a club actually employed in confirming a plan of reorganization. Further, in an arena where timing is often more important than the ideal result, the delay caused by invocation of the cramdown power is likely to result in harm to all.” (footnote omitted) Richard F. Broude (1984), Cram Down and Chapter 11 of the Bankruptcy Code: The Settlement Imperative, 39 Bus. Law. 441, p. 441.
plan they will be forced to vote in favor of such a plan that maximizes the debtor’s overall value.

4.1.2.4 The inefficient elements of cram down

Cram down has inefficient elements because the valuations involved in cram down are quite costly. First, cram down needs a valuation of the debtor’s reorganization value. The cram down procedure involves determination and comparison of the debtor’s value under the proposed plan and other alternatives, such as liquidation. To ensure that only efficient plans are confirmed, the court needs to make the right judgment of whether the debtor’s value under a proposed plan is higher than its value under other alternative deployment solutions, such as liquidation.\footnote{However, it is not easy to make a correct valuation. If the valuation of the debtor is wrong, an inefficient plan may be crammed down.} Second, cram down requires valuation of the different kinds of distribution to the different classes in order to ensure a fair and equitable distribution of the debtor’s value in cram down.\footnote{Second, cram down requires valuation of the different kinds of distribution to the different classes in order to ensure a fair and equitable distribution of the debtor’s value in cram down.} In order to check whether the plan being crammed down meets with the fair-and-equitable test, which revolves around the absolute priority rule, the cram down procedure requires a valuation of the distributions to different classes.\footnote{In order to check whether the plan being crammed down meets with the fair-and-equitable test, which revolves around the absolute priority rule, the cram down procedure requires a valuation of the distributions to different classes.} To get a good understanding of the inefficient elements of cram down, the problems in the valuation of the debtor and the distribution to the different classes of claimholders are discussed below.

(1) Problems with the judicial valuation of the debtor

In the cram down procedure, an important issue is the court’s valuation of the debtor based on the deployment project proposed by the plan. Chapter 11 does not provide clear rules for judicial valuation in cram down; the legislators intended the court to determine the value on a

\footnote{The best-interest-test provided in 11 U.S.C. 1129(a)(7)(ii) requires a valuation of the debtor in order to determine whether each dissenting member of an impaired class will receive under the plan no less than what it would receive under liquidation. In order to prove to the court that the proposed plan passes the best-interest-test, the plan proponent must prepare a liquidation analysis, which produces sufficient current financial information about the debtor, the debtor’s assets and liabilities. Moreover, it also requires the valuation of the present value of the distribution to the individual dissenting claimholders. Natalic Regoli (2005), Confirmation of Chapter 11 Bankruptcy: A Practical Guide to the Best Interest of Creditors Test, 41-SPG Tex. Bus. L. 7, pp. 23-6.}

\footnote{Omer Tene (2003), Revisiting the Creditors’ Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 Bankr. Dev. J. 287, pp. 360-2.}

\footnote{Chaim J. Fortgang and Thomas Moers Mayer (1985), Valuation in Bankruptcy, 32 UCLA L. Rev. 1061, pp. 1105-31.}
case-by-case basis. Judicial valuation in cram down is problematic. First, judges, who are generally not valuation professionals, may not apply the valuation methodologies correctly. Second, a judge often has his personal bankruptcy policy opinions and may thus be influenced by the policy and equitable factors in addition to economics. In choosing a higher or lower value, a judge tends to emphasize proper allocation of risk according to bankruptcy policy and equity, instead of making an independent economic calculation.

(2) Problems in calculating the present value of the distribution to secured creditors

With respect to the distribution to a dissenting class of secured creditors, Chapter 11 provides that the payment provided by the plan should conform to the specific kinds of treatment provided in §1129(b)(2)(A). In order to ensure that a dissenting class of secured creditors receives payment of which the current value is equal to the value of the secured claim and to ensure that their security right is not damaged, §1129(b)(2)(A) provides that a crammed down plan may contain three provisions in respect of secured creditors. First, the plan may provide deferred cash payment with the creditor retaining a lien on the same collateral regardless of who owns the collateral and the present value of the cash payment should be equal to the amount of the secured claim. Second, the plan may provide for selling the collateral free and clear of the lien under the condition that the creditor has the chance to bid and the lien attaches to the proceeds. In this situation, the plan may provide repayment to the class by using one of the two methods that are prescribed in the first and third provision. For the sake of clarity, this involves the conversion of collateral from a specific type of non-cash property into cash, using the cash as the lien for the creditors and adopting the payment method described in the first or third provision. Third, the plan may propose that the

421 “A statutory valuation formula would have been helpful. The committee has considered a number of suggested formulas but has been unable to come up with a satisfactory one. The valuation problem is, therefore, left to the referees and judges.” House Report, p. 6176. “Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case.” Id, p. 6312.


creditor realizes the “indubitable equivalent” of his allowed secured claim. The term “indubitable equivalent” is vague and makes this provision the most unclear of the three. It is uncertain whether unsecured notes or equity securities of the reorganized debtor constitutes “indubitable equivalent”. In practice, the application of the third provision generally turns out to involve collateral substitution combined with deferred cash payment (deferred cash payment with the creditors holding a lien on the cash proceeds from the sale of the collateral or a lien on a substitute collateral), or paying the creditors by abandoning the collateral to the creditor. 

Since deferred cash payment is an important kind of distribution to secured creditors and future cash payment offered under the plan should be discounted at a proper rate to calculate the present value, the choice of a proper discount rate becomes very important. A discount rate proposed in the plan and confirmed by the court, may be considered by a dissenting creditor as lower than the appropriate rate and thus the “full payment” confirmed by the court is considered by the dissenting creditor as less than full payment. Generally courts agree that the market rate of similar commercial loans (the “similar market rate”) should be the standard for determining the discount rate under cram down. How can the similar market rate be calculated? Some courts adopt the market rate of similar loans in the area including the general institutional lending rate or the lender’s own lending rate. Some courts select a formula rate, which is a riskless prime rate, such as the rate of U.S. Treasury securities of the same duration, plus a risk factor, such as 2%. Some courts adopt the pre-bankruptcy contract rate if they conclude that it reflects the market rate or if they lack other evidence of the market rate. The significant problem in determining the discount rate

427 Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 Cardozo L. Rev. 1495, pp.1539-42(discussing the controversy and ambiguity concerning whether the debtor’s unsecured debt and equity could be crammed down on a dissenting secured creditor). Kenneth N. Klee (1979), All You Ever Wanted to Know about Cram Down under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133, p. 156 (commenting that unsecured notes or equity securities of the reorganized debtor would not constitute the indubitable equivalent of secured claims).
430 Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 Cardozo L.
is that the discount rate determined by the court generally diverges from the reality of the loan contained in the crammed-down plan. In selecting the market rate, the court gives little weight to the actual characteristics of the debtor and the creditor, rarely analyzes the proper components of the market rate or the objective basis for quantifying the risk factor and decides the rate according to transactions of generalized debtors and creditors.

The fundamental reason for the divergence from reality is that there is no real loan market that is exactly similar to the loan transaction within the Chapter 11 procedure. In reality there is a limited loan market for debtors that have recently emerged from Chapter 11. Moreover, a forced loan in Chapter 11 also has special characteristics. In a Chapter 11 case where the creditor is under-secured, the secured portion is just equal to the value of the collateral. But in actual commercial markets, loans equal to the value of the collateral are not common, since any diminution in the value of the collateral would leave the secured creditor unsecured.

Another problem in selecting a proper rate is that courts often reduce the market rate by a ‘profit’ element. Usually, their decisions do not clearly explain what is meant by “profit”. The ground for denying the inclusion of the profit factor was that the underlying policy of the bankruptcy reorganization law is to make the creditors whole, but without “profit” because calculating the discount rate solely from the perspective of a hypothetical similar loan in the market requires that the profit component be included and this hypothetical market rate might be so high that it may defeat the rehabilitative ideal of the bankruptcy reorganization law.

\[\text{Rev. 1495, pp. 1516-7.}\]
\[\text{431 Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 Cardozo L. Rev. 1495, p. 1519. See e.g. In re Computer Optics, Inc., 126 B.R. 664, 672 (Bankr. D.N.H. 1991) ("[T]here is no 'market' in the real world for 'similar loans' when dealing with a reorganized entity coming out of a chapter 11 proceeding . . . ."); In re Aztec, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989) ("Chapter 11 does not implode merely because there is no "market" for loans of the sort that can be forced upon a secured claimholder under § 1129 (b)." ).}\]
\[\text{432 Jack Fridman (1993), What Courts Do to Secured Creditors in Chapter 11 Cram Down, 14 Cardozo L. Rev. 1495, p. 1519. Waltraud S. Scott (1988), Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest, 63 Wash. L. Rev. 1041, pp. 1046-51. See, e.g., In In re E.I. Parks No. 1 Ltd. Partnership, 122 B.R. 549, 554 (Bankr. W.D. Ark. 1990), the court noted: "Utilizing a hypothetical coerced loan as a governing analogy overlooks some important dissimilarities to the chapter 11 cramdown process. For example, the hypothetical coerced loan necessarily includes a factor for profit, a factor most courts have rejected for purposes of calculating the market rate of interest to be applied in a bankruptcy case. In addition, many lenders would decline to make any loan secured by collateral equal to 100% of the amount of the loan, especially to a debtor in chapter 11. When asked what rate they would charge for a hypothetical coerced loan, lenders invariably state that the rate charged would be the maximum allowed by law. Calculating the market rate of interest solely from the viewpoint of a coerced loan tends to jeopardize the success of a chapter 11 plan and defeat the rehabilitative purposes of bankruptcy reorganization." (citations omitted); In Barrington Oaks the court stated: “The}
Scott commented that “[a] nominal interest rate has three components: Inflationary expectations, a ‘real’ rate of interest, and certain risk premiums”, and that by denying the ‘profit’ element, courts refused to include a proper risk premium in the interest rate.\textsuperscript{433} Or in other words, the exclusion of the ‘profit’ element implies that “courts indirectly deny the creditors’ compensation for the coerced taking of the creditor’s current use of funds.”\textsuperscript{434}

(3) Problems in valuing the collateral for the purpose of determining the amount of the secured claim

For the purpose of making distribution to a secured claim, the amount of a secured claim must be determined first. In order to determine the exact amount of a secured claim, one needs to value the collateral. Valuation of the collateral presents complex problems, such as the valuation standard, the relationship of valuation for the purpose of adequate protection and plan confirmation. §506(a), which governs the determination of the value of the secured claim, simply provides that the value shall be “determined in light of the purpose of the valuation and of the proposed disposition or use of such property.”\textsuperscript{435} Obviously, the language of market may also overlook the purpose of Section 1129(b)(2)(A)(i)(II) to protect creditors from loss rather than to augment their opportunity for profitmaking under a plan. Moreover, it may give insufficient weight to the continuing jurisdiction of the court and other protective features of the Code, as well as the rehabilitative ideal.” Barrington Oaks, 15 B.R. 952, 964 (footnote omitted). In contrast, one court has specifically stated that the proposition that “profit” for a lender is not appropriate in the bankruptcy context has no authority in the 1978 Code. In re Arnold, 80 B.R. 806, 809-10 (Bankr. M.D. La. 1987).

\textsuperscript{433} Waltraud S. Scott (1988), Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest, 63 Wash. L. Rev. 1041, p. 1046. “If inflation occurs while a loan is outstanding, the amount of money lent will have a lower purchasing power when it is repaid. Lenders want to be protected against loss of purchasing power caused by inflation. Interest rates reflect the market's expectations about future inflation rates.” “The ‘real’ interest rate is the price required to induce a lender to effect an exchange between current and future consumption. Preferences and endowment tend to be stable, though recessions and booms, reflecting expected changes in productivity, may temporarily influence the real interest rate. [The real interest rate component is estimated to fluctuate between 2% and 4%.” “Inflationary expectations and the real rate of interest are the same for all borrowers. The risk premium accounts for differences in interest rates obtained by individual borrowers in the market. Interest rates on loans considered low-risk are lower than interest rates on high-risk loans.” Id, at 1046-50. In order to provide the creditors with proper compensation for the risk in a coerced Chapter 11 loan, risk premium should be calculated based on the specific risk in the Chapter 11 loan. Thus, courts denied to include the risk-premium if they support the debtor’s argument that a high interest rate will “give the creditor more than the value of its claim, to the detriment of other creditors and equity holders, and that it will threaten a successful reorganization”. Id, at 1055-7.

\textsuperscript{434} Id, at 1050.

\textsuperscript{435} “An allowed claim of a creditor secured by a lien on property …. is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.” 11 U.S.C. 506(a)(1).
§506(a) provides no clear guidance concerning the details of valuation. First, courts have used different standards for valuing the collateral. Some courts adopted the going-concern value method. They conducted a valuation from the perspective of the debtor and considered that the value should be the amount the debtor would have paid to purchase similar property elsewhere, i.e. replacement price or retail price or the value of the collateral as part of the operating business, i.e. the collateral’s going-concern value. Some courts considered that the valuation should be conducted from the perspective of creditors and adopted the liquidation-valuation method, i.e. wholesale price (the price for which an item is sold at wholesale), foreclosure price (the price that the creditor might receive in a foreclosure sale). Some courts adopted an intermediate position by choosing the midpoint between the two values. The underlying reasoning was that the debtor and the secured creditors would agree a deal splitting the difference between the two values between them if they were to bargain outside of bankruptcy or if that midpoint valuation is the most equitable solution to the disputes. Moreover, the collateral may be valued in differing circumstances. For

436 The U.S. Supreme Court commented that the words “the creditor's interest in the estate's interest in such property” does not impart any valuation standard. Associates Commercial Corporation v. Rash, 520 U.S. 953, 117 S.Ct. 1879, at 960-1.

437 See, e.g. In re Winthrop Old Farm Nurseries, 50 F.3d 72, 73-75 (1st Cir. 1995) (noting that some courts reason that “because the reorganizing debtor proposes to retain and use the collateral, it should not be valued as if it were being liquidated; rather, courts should value the collateral “in light of” the debtor's proposal to retain it and ascribe to it its going-concern or fair market value with no deduction for hypothetical costs of sale”, and that the court agrees with this reasoning); Taffi v. United States (In re Taffi), 96 F.3d 1190, 1192-93 (9th Cir. 1996) (“By agreeing to the Plan and allowing the [debtors] to retain their [collateral], the [[creditor] runs a risk. It is appropriate that it also benefits from the higher valuation.”); In re Trimble, 50 F.3d 530, 532 (8th Cir. 1995). Omer Tene (2003), Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 Bankr. Dev. J. 287, pp. 311-2; Chris Lenhart (1998), Toward A Midpoint Valuation Standard in Cram Down: The Rash Decision, 83 Cornell L. Rev. 1821, pp.1839-45.


439 Judge Posner opined that the midpoint serves as “a natural point to which bargaining parties will gravitate if they don’t want to waste a lot of time in bluffing and haggling”. In re Hoskins, 102 F.3d 311, 316 (7th Cir. 1996). In re Myers, 178 B.R. 518, 524 (Bankr. W.D. Okla, 1995) (holding that the midpoint valuation “represents a compromise” that will provide an equitable result). Omer Tene (2003), Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy
instance, a valuation for the purpose of adequate protection and a valuation for the purpose of plan confirmation. Generally it is considered that a court’s valuation calculated in an earlier stage is not binding on that which occurs in a later stage. Thus, the valuation made for the purpose of adequate protection during the automatic stay is not binding at plan confirmation stage. 440

(4) Problems in valuing the distribution to unsecured creditors and shareholders

In the cram down context, there are not only problems in valuing the distribution to secured creditors, but also problems in valuing the distribution to unsecured creditors and shareholders. In the reorganization of a big corporation, there may be claimholders of different priority, such as general unsecured claimholders, subordinated unsecured claimholders, preferred shareholders, and common shareholders. The distribution of the value to the claimholders of different priority must satisfy the fair-and-equitable test. The fair-and-equitable test revolves around the absolute priority rule that requires that a dissenting senior class must receive full payment before any junior class receives any payment. 441 Where a class of unsecured creditors or shareholders objects to the plan, complicated valuations will be needed in order to calculate the present value of the payment to the objecting class and the other relative classes.

Where the distribution to a class of dissenting unsecured creditors is deferred cash payment, like the deferred cash payments to secured creditors, the deferred cash payment to unsecured creditors involves the determination of the proper discount rate for calculating the present value. “To the extent that no underlying collateral secures the payout, risk increases and so should the discount rate. Otherwise, the determination of the proper discount rate for cram down of unsecured creditors should parallel the determination of rates for cram down of

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441 See Section 4.1.2.1 for the implication of the fair-and-equitable test and the absolute priority rule.
secured creditors.” Recall that there are problems in determining the discount rate for secured creditors, similar problems may lie in determining the discount rate for unsecured creditors.

Shareholders generally are paid by stock under a reorganization plan. Where the payment to a dissenting class of unsecured creditors or shareholders is made by shares, the valuation of the debtor’s stock is problematic. A senior class may claim that the present value of its distribution is less than full payment while a junior class may claim that a senior class has received more than full payment. The valuation of the debtor’s stock is based on the valuation of the debtor’s overall value. However, as discussed in part (1) of this Section, the judicial valuation of the debtor is problematic. The problems inherent in judicial valuation in calculating the present value of the stocks of the reorganized debtor affect the distribution to both unsecured creditors and shareholders. While the over-valuation of the stocks benefits the junior class, i.e. common shareholders, under-valuation of the stocks benefits the senior class, i.e. unsecured creditors.

4.1.2.5 The efficient elements of the absolute priority rule

The efficient elements of the absolute priority rule may be discussed with reference to three aspects.

First, according to the creditors’ bargain theory, the absolute priority rule is efficient in that by respecting the interested parties’ non-bankruptcy entitlements, it avoids wealth redistribution which may cause distorted incentives in the interested parties when they decide whether to adopt the reorganization procedure. Before entering into bankruptcy, the interested parties, based on their contract and non-bankruptcy law, have set up or bargained for a priority order for receiving payment in the situation where the debtor does not have enough assets to pay all the debts. For instance, subordinated unsecured creditors have bargained for a priority which

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443 See part (2) of this Section for the discussion of the problems in selecting the proper discount rate for the payment to secured creditors.
444 If shareholders are not paid by shares under a plan, it implies that their priority level is lifted under the plan, which will cause many problems, such as whether a senior dissenting class may be forced to take inferior securities while a junior class receives superior securities, to which the answer is unclear. Kenneth N. Klee (1990), Cram Down II, 64 Am. Bankr. J. 229, p. 237.
is below that of other general unsecured creditors; creditors have bargained to be paid before shareholders; preferred shareholders have bargained to be paid before the common shareholders. Some non-bankruptcy law, such as corporate law, may provide the priority order in paying all the claims and interest in cases where a debtor company has insufficient assets to pay its debts. According to the creditors’ bargain theory, bankruptcy law should preserve the non-bankruptcy priority order established by the interested parties’ contract and non-bankruptcy law and the bankruptcy priority order is simply a summarization and expression of the non-bankruptcy priority order. Jackson commented that the absolute priority rule, “as announced by Justice Douglas in Case v. Los Angeles Lumber Products Co., seems designed to mimic relative nonbankruptcy entitlements. Under the absolute priority rule as articulated in Case, claimants were entitled to have their relative values respected in full, according exactly to their nonbankruptcy entitlements.” Outside of bankruptcy, based on their contract and non-bankruptcy law, unsecured creditors generally have bargained for the right to withdraw their investment or to receive payment from the debtor before the shareholders in the event of business failure. The absolute priority rule is intended to guarantee that their pre-bankruptcy rights are respected inside bankruptcy. A bankruptcy procedure, be it a reorganization procedure or a liquidation procedure, is simply a procedure for maximizing the debtor’s overall value. Although the debtor’s overall value is enhanced in a bankruptcy procedure, the value should be distributed according to the order of priority.

445 For instance, courts in a bankruptcy procedure rely on the clear content of the subordinated contract to establish the priority order between the senior and junior unsecured creditors. see e.g., In re Southeast Banking Corp., 212 B.R. 682, 686, (S.D.Fla. 1997).
446 For example, Article 187 of the Company Law of the People’s Republic of China (“Chinese company law”) provides that where the debtor dissolves, the debtor’s assets should be liquidated and the proceeds should first be used to pay all the unpaid claims. After paying all the claims, the remaining property shall be distributed to its shareholders. Article 188 further provides that where the debtor’s assets are not enough to pay all the creditors, the company shall apply to the court for bankruptcy. Article 188 of Chinese company law reflects that although the bankruptcy priority order originally is a summarization and expression of the non-bankruptcy priority order, since bankruptcy law has come into existence and provided the priority order for all the claims and interests in a unified and clear way, the pre-bankruptcy contracts or non-bankruptcy law has become reliant on the bankruptcy law and may refer to the bankruptcy law for the priority order instead of directly providing the priority order.
449 Id.
established under non-bankruptcy law. The absolute priority rule is efficient in that it respects the pre-bankruptcy entitlements bargained for by the interested parties and distributes the debtor’s value among the unsecured creditors and shareholders in a reorganization procedure in accordance with the same order of priority as that under non-bankruptcy law and in a liquidation procedure. By respecting the non-bankruptcy order of priority, the absolute priority rule helps to avoid wealth redistribution in reorganization procedures, which may cause skewed incentives in the interested parties when they decide whether to adopt a reorganization procedure, liquidation procedure or out of court restructuring.

Second, the absolute priority rule helps to align risk-bearing with benefits-sharing and sets the right decision-making incentive for the interested parties. In reorganization, creditors generally bear more cost than shareholders. When the interested parties make the liquidation vs. reorganization decision, they compare what they receive under liquidation with that under reorganization. Insofar as under liquidation shareholders of an insolvent debtor would receive nothing, they bear no cost for the reorganization. By contrast, senior classes, who would receive full or partial payment under liquidation, bear a substantial part of the cost of reorganization. Therefore, it is efficient to distribute the debtor’s reorganization value according to the absolute priority rule, since this distributional model aligns cost-bearing with benefits-sharing and helps to ensure that interested parties an efficient decision about whether or not to reorganize.

Thirdly, the absolute priority rule fosters the reorganization bargaining and improves decision-making efficiency in bankruptcy reorganization. The interested parties bargain in the shadow of cram down. By setting up a clear distributional standard for a crammed-down plan, the absolute priority rule reduces the complexity in the bargaining over the distribution of the debtor’s value. The absolute priority rule structures the reorganization bargaining and shifts the reorganization bargaining effort away from the distribution of the debtor’s value to the maximization of the debtor’s overall value, i.e. including among other factors, the

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450 Id, pp. 209-13.
feasibility of the plan.

### 4.1.2.6 The inefficient elements of the absolute priority rule

The absolute priority rule is inefficient because its application is costly since it requires the valuation of the present value of the distribution to different classes. Although the absolute priority rule seems to be a good solution to the tension between the fair and equitable distribution of the debtor’s value and the pursuit of the most efficient deployment of the debtor’s assets, its application is problematic because of the difficulty in valuing the assets.\textsuperscript{453}

The absolute priority rule requires that a senior dissenting class must be paid in full before any junior class receives anything and that classes senior to a dissenting class should not receive more than full payment. While a dissenting senior class may claim that its payment is less than full payment, a junior class may insist that that senior class have received more than full payment. The application of the absolute priority rule is costly because of the difficult valuations.\textsuperscript{454}

### 4.2 The plan-passing system under Chinese law

#### 4.2.1 The Classified voting system under Chinese law

##### 4.2.1.1 Overview of the classified voting system

Under the EBL, a draft plan should be voted upon by creditors. For the purpose of voting on the draft reorganization plan, creditors’ claims should be divided into four classes, which are the class of secured claims, employment claims, tax claims, and general unsecured claims. Moreover, the court may order the establishment of a class of small-amount unsecured claims, if the court considers such to be necessary.\textsuperscript{455} The court should convene a creditors’

\textsuperscript{453} Thomas H. Jackson, The Logic and Limits of Bankruptcy Law (Bear Books, Washington, 2001), p. 213 (“Because the rigors of the absolute priority rule in practice turn on the accuracy with which valuations are made, the absolute priority rule was frequently circumvented in practice.”).

\textsuperscript{454} See Section 4.1.2.4 for the detailed discussion of the valuation problems in a cram down context.

\textsuperscript{455} Article 82 of the EBL provides: Creditors holding the following claims participate in the creditors meeting for the discussion of the reorganization plan. Creditors’ claims should be divided into the following classes for the purpose of voting on the plan:

1. claims being secured by the debtor’s specific assets;
2. claims arising out of employment relationships, which include unpaid wages, medical expense, wound and disability pension, pension for bereaved families, basic pension and medical care
meeting within 30 days from the date that the draft plan is received by the court. A class is deemed to have approved the plan if more than one-half of the creditors present at the meeting ("the simple majority rule") vote to accept the plan and the assenting creditors hold at least two-thirds of the total claim of the class ("the supermajority rule"). A minor difference between the voting rule of the EBL and Chapter 11 is that the EBL requires the consent of more than one-half of the members that are present at the meeting in which votes are cast while the Chapter 11 requires the consent of more than one-half of the total members of one class. This difference makes the voting rule under the EBL less strict than that under Chapter 11.

Under the EBL, shareholders do not always have the right to vote on the draft plan. In order to ensure that the opinion of shareholders is heard and considered by the creditors, the EBL provides that the representatives of shareholders may be present at the creditors’ meeting in which the draft plan is discussed. The EBL provides that in cases where the draft plan involves an adjustment of the interests of the shareholders of the debtor, the draft plan should be voted for by the class of shareholders. In total, under the EBL, all the claims may be divided into five classes: classes of secured claims, employment claims, tax claims, general unsecured claims and shareholders’ claims.

### 4.2.1.2 The efficient elements of the classified voting system

Similar to Chapter 11, the EBL adopts a classified voting system to foster decision-making efficiency. Judged against the standard established by the creditors’ bargaining theory—the maximization of the debtor’s value, the classified voting under the EBL, just like its counterpart under Chapter 11, is efficient in that it fosters bargaining efficiency and reduces bargaining cost since it changes the bargaining among many individuals into a bargaining among several structured classes, encourages the claimholders within one class to conduct

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insurance, and other compensations for the employees provided by the law and regulations;

(3) taxe claims owned by the debtor;

(4) general unsecured claims.

The court, if it deems, may decide to establish a class of small-amount unsecured claim for the purpose of voting on the plan.

456 The EBL, Art. 84.

457 The EBL, Art. 85, paragraph one.

458 The EBL, Art. 85, paragraph two.
collective bargaining and allows the consent of the majority to bind the objecting minority of one class. Moreover, the EBL is different from Chapter 11 in that the EBL provides clearly that all the creditors and shareholders should be divided into five classes while Chapter 11 empowers the plan proponent to design the proper classification based on the specific circumstances of the case. By adopting a fixed approach in classification, the EBL provides no room for the plan proponent to manipulate the voting result by strategic classification.

### 4.2.1.3 The inefficient elements of the classified voting system

The EBL’s classified voting system has inefficient elements because its provisions with respect to classification and shareholders’ voting rights are problematic, which may hinder the bargaining parties from making an efficient final decision. A detailed analysis is below.

1. Problems in the classification system

   The EBL’s classification system, which rigidly classifies all the creditors and shareholders into five classes, is problematic, since the claims or interests within one class may not be substantially similar.

   First, the secured claims of the debtor are often quite different from each other. The nature of a secured claim is mainly affected by two elements, i.e. the stability of the value of the collateral and the ratio of the nominal amount of the claim to the value of the collateral. Where the nature of the debtor’s secured claims is different, even if a plan provides the same payment scheme to these secured claims, whether or not a specific secured claim is treated fairly and equitably should be judged with reference to the specific nature of that secured claim. In this situation, it is unreasonable to put all the secured claims into one class and use the consent of some secured creditors to bind the objecting secured creditors. Suppose the debtor company X has three secured claims and the plan provides deferred cash payment in two years for all the secured claims. One secured claim is $2,000 secured by a new building valued at $4,000 and the value of the building is expected to increase in the next two years. Another secured claim is $1,800 secured by another old but solid building valued at $1,900 and the value of the building is expected to be stable in the next two years. The third secured claim is $1,600 secured by a car valued at $1,600 and the value of the car is expected to decline in the next two years. In order to provide compensation to the secured creditors for the
delay, the plan should choose a proper interest rate for different secured creditors based on the risk they bear. Obviously, the $1600 claim should be provided with a much higher interest rate for the deferred payment since the holder bears much higher risk than the other two secured creditors. However, even if the plan provides the same interest rate for the three secured claims and the holder of the $1600 claim objects to the plan, based on the classification and the majority voting rule of the EBL, the consent of the holders of the $2,000 and the $1,800 claim effectively results in the plan being accepted by the class of the secured claims. Obviously, the consent of some secured creditors can not be taken as evidence of fair and equitable treatment of the dissenting secured creditor since their claims are substantially different and thus should be treated differently.

Second, a similar problem exists in putting general unsecured claims or shareholders’ interests into one class. Within unsecured creditors, there may be groups with different priority levels. For instance, some unsecured creditors may have agreed to be paid after the other unsecured claims and thus there may be general unsecured creditors and subordinated unsecured creditors. Thus, the unsecured claims of the debtor may differ substantially and should not be put into one class. Among the shareholders, there may be preferred shareholders and common shareholders, whose interests are quite different and should be treated differently.

Based on the preceding analysis we may infer that the rigid classification system under the EBL can result in claims or interests being put into one class that may not be substantially similar. However, it is the fact that the claims within one class are substantially similar that provides the foundation for the equal treatment of claims within one class and the application of the majority voting rule (using the majority opinions of one class to bind the whole class) efficient bargaining through class representatives. The development history of US reorganization law and the provision of the current US bankruptcy code reveals that it is the character of being substantially similar that justifies the pro rata distribution or the same treatment of class members, the class members’ bargaining through representation, and the majority voting rule for the decision-making within one class.\footnote{The House Report states that §1122 “requires classification based on the nature of the claims or interests classified, and permits inclusion or interests in a particular class only if the claim or interest being included in substantially similar to other claims or interests of the class.” House Report, p.6326.}

Generally, the character of the security that guarantees the payment of a secured claim is
recognized as the major factor that decides whether secured claims are substantially similar. In contrast, the priority level of unsecured claims and shareholders’ claims is considered as the major factor that decides whether secured claims, unsecured claims, and shareholders’ claims are substantially similar to each other.\textsuperscript{460} The EBL’s broad classification method, which puts all the secured claims into one class without examining the character of each secured interest, and puts unsecured claims or shareholders’ claims into one class without examining their priority level, fails to ensure a proper classification of the claims and interests, undermines the operation of classification and the majority voting system and damages the efficiency of the decision produced by the voting mechanism.

(2) Problems in the voting right of shareholders

With respect to the voting right of shareholders, the EBL’s provision is problematic. The EBL provides that in cases where the draft plan involves an adjustment of the interests of the shareholders, it should be voted on by the class of shareholders.\textsuperscript{461} What does the term “adjustment of the interests of the shareholders” mean? A study of the cases may provide an explanation. The disclosed information concerning the voting on the draft plan in the 18 reorganization cases revealed that if a plan contains a distribution of shares of the reorganized debtor to the old creditors or new financers, the plan was considered as involving “adjustment of the interests of the shareholders of the debtor” and was voted on by the shareholders.\textsuperscript{462} However, even if a plan does not use the debtor’s shares to pay the old creditors or the new investors, the plan still affects the interest of the shareholders. First, deciding the debtor’s overall value and the present value of the distribution to the different classes needs shareholders’ participation. The voting system reveals that the EBL, just as Chapter 11, first permits the interested parties to bargain for the purpose of reaching an agreement concerning the debtor’s value and the distribution of the debtor’s value. Therefore, under Chapter 11, all

\begin{footnotesize}
\textsuperscript{460} “Creditors who have liens or security interests in property of the debtor are entitled to preferential treatment by virtue of their security interests. Others ranked in order of priority in accordance with the rules of bankruptcy law and their rights under prevailing nonbankruptcy law.” Brian A. Blum (2006), Bankruptcy and Debtor/Creditor: Examples and Explanations, Aspen Publishers, 4th Ed. , p. 99. The House Report states that secured creditors, by nature, are most often in single-member class. House Report, p.6195.

\textsuperscript{461} The EBL, Art. 85, paragraph two.

\textsuperscript{462} In 5 of the 18 cases, i.e. the case of Hualong, Beiya, Haina, Cixian, and Chaohua, the old shareholders continue to keep all the shares of the reorganized debtor and the plan was voted only by creditors. In the other 13 cases, the plan was voted by the class of shareholders because a certain portion of the shares of the reorganized debtor was distributed to the old creditors or new financers. See Appendix B.
\end{footnotesize}
the interested parties, including shareholders, should participate in the collective bargaining and have a say about the debtor’s reorganization value and how much they are entitled to receive. The holders of common stock are entitled to the debtor’s residual value. In a case where a plan does not provide the debtor’s shares as a form of payment to creditors or new financers, if the debtor’s overall value or the distribution to creditors is under-valued, the plan damages the interest of shareholders. For example, the interest rate contained in the deferred payment scheme for the secured creditors or general unsecured creditors may be so high that the plan unfairly reduces the value remaining to the shareholders. Therefore, since the EBL adopts structured bargaining among interested parties to reach agreement, i.e. a reorganization plan, on how to deploy the debtor’s assets, the value of the debtor and how to distribute that value, shareholders should always be allowed to participate in the voting, since a reorganization plan always influences the shareholders’ interests. Without a voting right, shareholders cannot bargain to protect their interest.

4.2.2 The confirmation system under Chinese law

4.2.2.1 Overview of the confirmation system

Under the EBL, if a plan is accepted by all the voting classes, within 10 days of the date on which the consensual acceptance was gained, the plan proponent should apply to the court for confirmation of the plan. The court should examine the plan and decide whether to confirm it within 30 days. If the court, after examination, considers that the plan is in conformity with the provisions of the EBL, it should rule to confirm the plan, terminate the reorganization procedure and issue public notice. If a draft plan is accepted by some but not all of the

463 The parties, whose rights are to be affected, “should be able to make informed judgment of their own, rather than having the court or the securities and exchange commission inform them in advance of whether the proposed plan is a good plan.” House Report, p. 6185. Brian A. Blum (2006), Bankruptcy and Debtor/Creditor: Examples and Explanations, Aspen Publishers, 4th Ed., pp. 492-3.
465 Since all the claimholders have the incentive of trying to get a higher distribution, there are conflicts between the senior classes and junior classes concerning valuation of the debtor and the valuation of the different kind of distributions to the different classes designed in the reorganization. See Chaim J. Fortgang and Thomas Moers Mayer (1985), Valuation in Bankruptcy, 32 UCLA L. Rev. 1061, pp. 1105-31; Lucian Arye Bebchuk (1988), A New Approach to Corporate Reorganization, 101 Harv. L. Rev. 775, pp. 778-9.
466 The EBL, Art. 86.
voting classes, the plan proponent may negotiate with the dissenting classes. The negotiation result should not damage the interests of the other classes. The dissenting classes may vote on the plan again after the negotiation.\footnote{The EBL, Art. 87, paragraph one.} If the dissenting classes refuse to vote on the plan or vote against the plan in the second round of voting, the plan proponent may apply to the court for cramming down the draft plan. Under the EBL, a plan may be crammed down if it meets with the following requirements ("cram-down requirements"):\footnote{The EBL, Art. 87, paragraph two.}

1. the class of secured claims will receive full payment and fair compensation for the delay in receiving the payment and their security right is not materially damaged; or such class has accepted the draft plan;

2. the class of employment claim and tax claim will receive full payment; or such classes have accepted the draft plan;

3. the repayment ratio of the class of unsecured claim is not lower than that under a hypothetical liquidation procedure; or such class has accepted the draft plan;

4. the adjustment of the interest of shareholders is fair and equitable; or the class of shareholders has accepted the draft plan;

5. the draft plan treats the members of one class fairly and the payment order does not violate Article 113 of the EBL;\footnote{Article 113 of the EBL defines the priority order among unsecured claims in the liquidation procedure. It provides that bankruptcy assets, after being used to pay the bankruptcy fee and the fees incurred for common benefits, should be paid according to the following priority order: (1) salary claims, medical fee claims, wound and disability compensation claims, social insurance claims that should paid to the employees’ bank account, other compensations that should be paid to the employees according to the applicable laws and regulations; (2) social insurance claims that are not included in the claims listed in item (1) and tax claims; (3) general unsecured claims. In item (2), the term “social insurance claims that are not included in the claims listed in item (1)” actually means the social insurance fee that should be paid to the relevant insurance organizations To summarize, the priority order among the unsecured claims is such: employment claims; second, social insurance claim held by non-employee parties and tax claims; third, general unsecured claims. By referring to Article 113, Article 87 provides that among unsecured claims, insurance fee claims held by insurance organizations should be paid first before other general unsecured claims.}

6. the debtor’s operation scheme is feasible.

If the court, after examining the draft plan, considers that the draft plan satisfies the cram-down requirements, the court should rule to confirm ("cram down") the plan within 30 days from the date of receiving the application, terminate the reorganization procedure and

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\footnote{Article 113 of the EBL defines the priority order among unsecured claims in the liquidation procedure. It provides that bankruptcy assets, after being used to pay the bankruptcy fee and the fees incurred for common benefits, should be paid according to the following priority order: (1) salary claims, medical fee claims, wound and disability compensation claims, social insurance claims that should paid to the employees’ bank account, other compensations that should be paid to the employees according to the applicable laws and regulations; (2) social insurance claims that are not included in the claims listed in item (1) and tax claims; (3) general unsecured claims. In item (2), the term “social insurance claims that are not included in the claims listed in item (1)” actually means the social insurance fee that should be paid to the relevant insurance organizations To summarize, the priority order among the unsecured claims is such: employment claims; second, social insurance claim held by non-employee parties and tax claims; third, general unsecured claims. By referring to Article 113, Article 87 provides that among unsecured claims, insurance fee claims held by insurance organizations should be paid first before other general unsecured claims.}
issue public notice.  

4.2.2.2 The efficient elements of the confirmation system

Just as Chapter 11, the EBL adopts the court’s confirmation as the final step of the decision-making process of the reorganization plan. Judged against the standard proposed by the creditor’s bargain theory, the judicial confirmation of consensual plans is efficient in that it adds a necessary screening of the consensual plans, the court will screen the content and make sure that only an efficient plan is confirmed by the court and becomes effective. The court’s cram down of non-consensual plans is efficient because it causes the bargaining parties to accept a plan that meets with the cram-down requirements and helps an efficient plan to become effective and to avoid being held up by a class with distorted decision-making incentives.

4.2.2.3 The inefficient elements of the confirmation system

Just as its US counterpart the EBL’s confirmation system is inefficient in that it requires a costly valuation of the debtor and the distribution to the dissenting classes. In addition, compared with its US counterpart, the EBL’s confirmation system is inefficient in that the EBL’s provisions concerning the general confirmation requirements and cram-down requirements have some problems which may hinder the interested parties and the court from devising an efficient plan. A detailed analysis is below.

(1) Lack of detailed provisions on the general confirmation requirements

With respect to the general confirmation requirement, i.e. the confirmation requirement for the consensual and non-consensual plans, the EBL does not provide any detailed requirement. It simply provides that the court should confirm a consensual plan if the plan is in conformity with the provision of the EBL. The court is left with no detailed guidance in examining a consensual plan. By contrast, Chapter 11 provides a series of detailed general confirmation requirements, such as the best-interest-test, the feasibility test, adequate disclosure of all the reorganization fees, good faith and general validity test, adequate disclosure of information concerning the new and old management.  

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470 The EBL, Art. 87.
471 See Section 4.1.2.1.
Although efficient plans cannot be completely identical to each other, they contain certain common elements and meet certain standards. If bankruptcy law does not codify such contents and standards as requirements for plan confirmation, bargaining parties need to conquer great difficulties in each case in order to reach a consensual agreement that contains such elements and meets such standards. However, sometimes efficient plans might fail to be produced due to factors such as bounded rationality, conflicts of interests, lack of information, inactive participation in the bargaining etc. Chapter 11 is more efficient than the EBL since it codifies these elements and standards in bankruptcy law as mandatory requirements so the bargaining parties are guided to reach an efficient plan and in the process avoid substantial bargaining cost. According to the creditors’ bargain theory, efficient bankruptcy law should mimic the hypothetical bargaining result and help the interested parties to avoid the problems in their real bargaining and to reach an efficient plan at minimal cost. The EBL is inefficient because its legislative vacancy in detailed provisions on the general confirmation requirement may lead to bargaining cost and even a failure to produce an efficient plan.

(2) Lack of the best-interest-test and feasibility test as a general confirmation requirement

The best-interest-test, which is a general confirmation requirement for protecting every dissenting member of an assenting class under Chapter 11, is adopted by the EBL only as a cram-down test for the distribution to a dissenting class of general unsecured claims. Similarly, the feasibility test, a general confirmation requirement under Chapter 11, is only a cram-down test under the EBL. Recall that the best-interest test and the feasibility test are very essential confirmation requirements for ensuring that the confirmed reorganization plan is efficient. By seriously limiting the application scope of these two tests, the EBL lowers its protection of the dissenting claimholders’ interests and its screening of the efficiency of both consensual and non-consensual plans.

In order to study the feasibility of the confirmed plans in China, the author put the main content of the description of rehabilitation in the plans of the 18 cases together and made Appendix C. Among the plans of the 18 cases, 8 plans stated that the debtor would try to find the new financier but did not make it clear who would be the new financier. In the 10

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472 See Section 4.1.2.2 for the detailed analysis.
473 The plan of the following 8 cases: Baoshuo, Jiufa, Hualong, Huayuan, Beisheng, Guangming, Danhua, Dixian.
plans that stated the identity of the new financier, only 5 plans\textsuperscript{474} stated how much new finance would be needed and only one plan\textsuperscript{475} stated the consideration for the new finance. Moreover, in the 18 plans, only 5 plans\textsuperscript{476} talked about the business that the debtor would do in order to improve its profitability.\textsuperscript{477} Finally, none of the 18 plans stated the adequacy of the debtor’s capital and the expected earning capacity.\textsuperscript{478}

According to detailed standards of the feasibility test developed by US case law, a feasible plan should show a feasible operation scheme; visionary promises, sincerity, honesty or willingness does not fulfill the feasibility test; to meet with the feasibility test, the plan should show the adequacy of the debtor’s capital structure, the earning power of the business, and the ability of the management etc. Judged against the standards under US case law, none of the 18 plans stated a feasible business operation scheme.\textsuperscript{479} Although the feasibility test is provided as a cram-down requirement in the EBL, none of the four crammed down plans contained an operation scheme which met with US the feasibility test.\textsuperscript{480} In the four crammed down plans, only the plan of Dixian stated what business it would do in order to improve its operation. Moreover, only the plan of Jinhua disclosed who would be the new financier and the other three plans just stated that the debtor would try to find a new financier. In addition, none of the four plans talked about the adequacy of the debtor’s capital and the expected earning ability of the debtor.\textsuperscript{481} Therefore, the empirical study shows that some Chinese courts have failed to apply a strict standard to check whether a plan meets with the feasibility test. Since China does not have a case law system, in order to help the court to apply a general feasibility test in the way that is expected by the legislators, it is necessary to provide in the bankruptcy law standards that are as detailed as possible concerning the application of the general feasibility test.

\textsuperscript{474} The five plans were the plans of the following 5 cases: Beiya, Qinling, Xiaxin, Danhua, Haina.
\textsuperscript{475} The plan of Xiaxin.
\textsuperscript{476} The plan of Beiya, Qinling, Xintai, Jinhua, Shentai. The plan of Jinhua and Shentai said that the debtor would continue its old business and that the reorganizer would help the debtor to explore new projects, but did not say what the new business would be.
\textsuperscript{477} See Appendix C.
\textsuperscript{478} See Appendix C.
\textsuperscript{479} Although a feasibility test is provided in the EBL as a test for cram-down plans, the author explored whether there is a feasible scheme in both consensual plans and non-consensual plans because the feasibility test is provided as a test for all the confirmed plans in the US and it is useful to explore whether the EBL consensual plans contain feasible schemes from the perspective of comparative study.
\textsuperscript{480} The four cases are the case of Baoshuo, Jinhua, Guangming, and Dixian. See Appendix B for the voting result.
\textsuperscript{481} See Appendix C.
With respect to the overall cram down requirement, the EBL’s provisions have a series of defects. The cram-down requirements in the EBL may be summarized as such: full payment plus delay compensation to a dissenting class of secured claims; full payment to a dissenting class of tax claims and employment claims; a payment ratio no lower than liquidation payment ratio for a dissenting class of general unsecured claims; a fair and equitable adjustment of the interests of a dissenting class of shareholders; fair treatment of members of one class and no violation of the priority order among unsecured claims specified in Article 113; deployment scheme being feasible. Compared with Chapter 11’s provisions on cram-down requirements, the EBL’s provisions on cram-down requirements are problematic. Unlike Chapter 11, the EBL does not contain the general requirements, i.e. the “non-discrimination-test” and “fair-and-equitable-test”. The non-discrimination test, which is a cram-down requirement applying to the treatment of all dissenting classes under Chapter 11, is used for preventing all kinds of discrimination to a dissenting class in Chapter 11 cases. In contrast, in the EBL it is just a device for preventing discrimination within one class. The fair-and-equitable test, which is a cram-down requirement applying to the treatment of all dissenting classes under Chapter 11, is used by the EBL only for testing the treatment of a dissenting class of shareholders. The limited scope of application of the non-discrimination-test and fair-and-equitable-test implies that the dissenting classes in an EBL case do not enjoy the comprehensive protection provided by these general rules. For instance, in a hypothetical EBL case, a dissenting class of general unsecured creditors, considers that the discount rate for the delayed payment is too low and that they receive less than full payment, while shareholders receive some distribution. This class does not have any weapon with which is can object to the court’s cram-down confirmation, if they receive more than they would receive under a hypothetical liquidation. However, if it would have been a Chapter 11 case, the dissenting class of unsecured creditors might have referred to the non-discrimination test by claiming that they bear higher risk than secured creditors and that the plan uses a discount rate which is at least equal to the one used for valuing the claims of

482 The EBL, Art. 87. Please refer to Section 4.2.2.1 for the content of Article 113.
secured creditors. Moreover, the dissenting class of unsecured creditors might have referred to the fair-and-equitable test by claiming that shareholders receive a distribution before they receive full payment.

In addition, what deserves serious attention is that the core content of the fair-and-equitable test under Chapter 11, i.e. the absolute priority rule, is missing in the EBL cram-down requirements. The problems caused by lack of provision on the absolute priority rule are discussed in detail below.

(4) Incomplete provision on the absolute priority rule

In answer to the question of whether the EBL contains a provision on the absolute priority rule, different opinions arise within the Chinese bankruptcy academia. Some scholars comment that the absolute priority rule is provided in item (1), (2), (5) of paragraph two of Article 87, while some scholar conclude that the EBL fails to provide the absolute priority rule. Do item (1), (2), (5) of paragraph two of Article 87 provide the absolute priority rule? We should carefully examine the three items one by one. Item (1) provides the requirement on the treatment of the class of secured creditors. If the absolute priority rule is considered as a general principle that is “to ensure that creditors in bankruptcy are paid according to their nonbankruptcy priorities,” this reflects part of the absolute priority rule. Item (2) provides that the plan should provide full payment to a dissenting class of employment claims and tax claims, while item (5) provides that the payment does not violate the priority order provided in Article 113, a provision that defined the priority order among unsecured claims. To conclude, item (1), (2), (5) of paragraph two of Article 87 fail to provide the absolute priority rule in a complete way since an important content of the absolute priority rule, which is that the unsecured creditors and shareholders should be paid according to their nonbankruptcy priorities, is missing.

483 王欣新、徐阳光 (Xinxing Wang & Yangguang Xu), 《破产重整立法若干问题研究》(Study on Several Bankruptcy Reorganization Legislative Issues), 载《政治与法律》(Politics and Law), 2007年第1期，第93页。(issue 1 of 2007, p. 93)

484 李志强 (Zhiqiang Li), 《关于我国破产重整计划批准制度的思考—以债权人利益保护为中心》, (Thoughts on our bankruptcy reorganization plan confirmation system—from the perspective of the protection of creditors' interest) 载《北方法学》(North Law Journal), 2008年第3期第54-55页（Issue 3 of 2008, pp. 54-55).


486 Please refer to Section 4.2.2.1 for the content of Article 113 of the EBL.
In order to get a complete answer, we need to further examine the other cram down requirements contained in the other items in paragraph two of Article 87. Item (2) which requires that the payment ratio of unsecured claims should not be lower than that under a hypothetical liquidation does not touch upon the priority order among unsecured creditors and shareholders. Item (4), which provides that the adjustment of the interest of shareholders should be fair and equitable, is quite ambiguous. While the standard for judging whether the treatment of shareholders is fair and equitable is clear under Chapter 11 because of the absolute priority rule, it is unclear under the EBL. For instance, assume in an EBL case XX, the ratio of payment to general unsecured claims under a hypothetical liquidation is 20%. Is a non-consensual plan that provides general unsecured creditors 30% payment of their claims and leaves the remains to the shareholders fair and equitable to the shareholders? In this case, general unsecured creditors may insist on receiving 100% payment of their claims before shareholders receive any distribution while shareholders may insist on paying general unsecured creditors 20% payment of their claims and keeping all the remains for shareholders. Since the EBL only mandates a payment ratio for general unsecured creditors that is no less than that under a hypothetical liquidation, one cannot get a clear answer to the question of which kind of treatment is fair and equitable to shareholders in this case. Item (4) may be considered as narrowly touching upon the absolute priority rule, if the court interprets this to mean that item (4) requires that classes superior to the dissenting class of shareholders should not receive more than full payment. However, without a clear statutory provision, the court may interpret item (4) in different ways. \(^{487}\) Recall that the complete content of the absolute priority rule is that a dissenting senior class must receive full payment before classes junior to it receive anything; classes senior to the dissenting class should not receive more than full payment. \(^{488}\) To conclude, the EBL fails to provide the absolute priority rule in a complete and clear way.

Recall that the absolute priority rule is an important doctrine under Chapter 11, which helps to ensure a fair and equitable distribution of the debtor’s value among the unsecured creditors.

\(^{487}\) Facing a case XX, a court may hold that 20%, 30%, or 100% payment to the class of general unsecured creditors is fair and equitable to the class of shareholders, since the EBL only mandates the payment ratio should not be less than that under liquidation, which is 20% in case XX.

\(^{488}\) See Section 4.1.2.1 for the implication of the absolute priority rule.
and shareholders and sets the right decision-making incentives in using the bankruptcy reorganization. The EBL’s failure in providing the absolute priority rule in a complete way may lead to an unfair distribution model in both consensual plans and cram down plans which may further cause distorted use of the reorganization procedure. A detailed analysis is below.

The lack of a complete provision on the absolute priority rule leads to an inefficient distribution model with respect to cram-down plans. In the 18 cases studied by the author, 4 cases ended with a cram-down plan, Baoshuo, Jinhua, Guangming, and Dixian. In these four cases, the percentage of shares of the reorganized debtor distributed to the old shareholder was 69%, 70%, 92%, 100% respectively, while the class of general unsecured claims received partial payment. Based on the disclosed information, the author was able to approximately calculate the overall ratio of payment to general unsecured claims in the case of Baoshuo, which was about 13.08%. In contrast to the low payment ratio of general unsecured claims, the old shareholders in the case of Baoshuo held a high percentage of the shares of the reorganized debtor, which was 69%. The plan of Baoshuo was crammed down over the objection of the class of general unsecured claims. Is it is efficient to leave a substantial percentage of the reorganized debtor’s shares to the old shareholders while unsecured creditors are partially paid? According to the creditors’ bargain theory, the absolute priority rule is efficient in that it respects the pre-bankruptcy priority order, avoids wealth redistribution, sets up a fair and equitable distribution model, aligns cost-bearing with benefits-sharing, sets the right incentives in reorganization bargaining and prevents a distorted use of the reorganization procedures. The EBL, because of its defective provision on the

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489  See Section 4.1.2.5 for detailed discussions on the efficient elements of the absolute priority rule.
490  See Appendix B.
491  See Appendix B. The ratio of general unsecured claims paid by shares was not calculated in the plan. According to the Public Notice No. 2008-016, on February 5, the court made a cram-down confirmation over the reorganization plan. According to the public Notice No. 2008-019, on February 25, 2008, the public auction of 45,130,937 shares held by the biggest shareholder was conducted and the highest bid price was RMB 23,500,000, which implied the price per share in the auction was RMB 0.52. According to the Public Notice No. 2008-002, the total unsecured claims were RMB 4,652,888,753.28. According to Public Notice No. 2008-042, 7,310,731 shares were used to pay unsecured claims. Based on the price in the public auction, the value of the shares paid to the class of unsecured claims was RMB the share-payment ratio was about 0.08%. Taking into consideration of the 13% paid by cash, the total payment ratio was about 13.08%. Because the information disclosed in the other three cases are very insufficient, the author can not calculate the overall ratio of payment to general unsecured claims in the other three cases.
492  See Public Notice No. 2008-011 made by Hebei Baoshuo Co., Ltd.
493  See Section 4.1.2.5 for the efficient elements of the absolute priority rule.
absolute priority rule, fails to respect the non-bankruptcy priority order and may have a negative effect on the interested parties’ bargaining and cause wealth redistribution which leads to distorted incentives of interested parties when they decide whether to use the reorganization procedure.\textsuperscript{494}

The effect of the EBL’s defective provisions on the absolute priority rule over the interested parties’ bargaining is reflected in the content of consensual plans. As the interested parties bargain in the shadow of the cram-down requirements, the EBL’s defective provisions on the absolute priority rule leads to an inefficient distribution in consensual plans.\textsuperscript{495} The absolute priority rule sets the bargaining leverage of unsecured creditors and shareholders. Under Chapter 11, because of the absolute priority rule, it is unsecured creditors that decide whether they would like to abandon part of the wealth to the shareholders, since the absolute priority clearly specifies that the debtor’s value should be first used to pay unsecured creditors in full before shareholders are to receive anything. However, under the EBL, after paying unsecured creditors what they would receive under liquidation, how much additional value a plan may provide to the unsecured creditors depends on how generous the shareholders are. Taking into consideration that the bargaining delay is costly to creditors, general unsecured creditors, knowing that they can only be guaranteed to receive what they would receive under liquidation even if they enter into the cram-down procedure, may be forced to choose to support a plan which provides a payment only a little bit higher than what they would receive under liquidation. In 14 cases, among the 18 cases that were studied, the interested parties reached a consensual plan in which the average ratio of the shares of the reorganized debtor being held by the old shareholder was either clearly stated, or could be calculated based on the relevant information. The average ratio of the shares of the reorganized debtor being held by the old shareholder was 80\%.\textsuperscript{496} Although a consensual plan was reached in 14 cases, only in 8 cases did the plan state the overall payment ratio to the class of general unsecured claims and the average ratio of payment was 35\%.\textsuperscript{497} The high percentage of consensual plans and

\textsuperscript{494} See Section 2.1.1.2. for the discussion of wealth redistribution and bankruptcy forum shopping.
\textsuperscript{496} In 14 of the 18 cases, a consensual plan was reached. See Appendix B for the distribution in the cases that ended with a consensual plan.
\textsuperscript{497} The 8 cases are Hualong, Huayuan, Beiya, Qinling, Shentai, Pianzhuan, Haina, Xingmei. Please see
the comparatively low percentage of payment to unsecured creditors while the old shareholders retained a high percentage of the shares of the reorganized debtor reflect the effect of the EBL's defective provisions on absolute priority rule over the interested parties’ bargaining and the wealth distribution in consensual plans.

The analysis reveals that due to the incomplete provisions on the absolute priority rule, the EBL establishes a wealth redistribution model which favors shareholders, while putting unsecured creditors at a disadvantaged position. The lack of a complete provision on the absolute priority rule and the inefficient distribution model may lead to a distorted use of the reorganization procedure, i.e. using bankruptcy reorganization as a legal device for getting rid of unsecured claims. Under the EBL’s cram-down provision, because of the lack of provisions on the central content of the absolute priority rule, it seems that the more insolvent a debtor is, the better is the old shareholders’ position in receiving wealth distribution, since the baseline standard for the payment to unsecured creditors is what they would receive under liquidation. If the debtor has got an efficient reorganization plan, the old shareholders might first deepen insolvency and then enter into reorganization, reap most of the reorganization profits and get rid of the general unsecured creditors by paying a low percentage of their claims which is equal to or a little bit higher than what they would receive under liquidation. Thus, bankruptcy reorganization can be used by the debtor and its shareholders as a device of “legally” eliminating general unsecured claims and magically turning the unprofitable companies into profitable ones. Some bankruptcy professionals have noticed the vulnerable position of creditors and the emerging sign of the abuse of the reorganization procedure.

4.2.2.4 Reform Suggestions for the Chinese Plan-passing System

Based on the discussion above, the following reform suggestions are proposed so that the

Appendix B. The plan in the other 10 cases did not state the payment ratio of general unsecured claims and the author can not calculate the ratio based on the limited information.

498 See e.g. 汤晓明(Xiaoming Tang), 《从破产重整制度看银行债权的保护 》(Examining the Protection of Bank Claims from the Perspective of Bankruptcyreorganization procedure), Available at: http://www.cnstock.com/index/gdbb/201006/588712.htm (visited June 19, 2010); 郑重 (Zhong Zheng), 《政府主导*ST 九发破产重整 债权银行成“待宰羔羊”》(Government Dominating the Bankruptcy Reorganization of *ST Jiufa Creditor banks Becoming Goats to Be Killed), 中国时报(China Times), Page 010 of November 1, 2008; 俞坚(Jian Yu), 《“策划“*ST 宏盛破产重整 舜东投资疑似“项目公司”》(“Planning” the Bankruptcy Reorganization of *ST Shunsheng Shundong Investment Suspected to Be “Project Corporation”), 上海证券报(Shanghai Securities daily), Page F08 of February 10, 2010.
EBL’s plan-passing system may provide clear guidance to the bargaining parties in designing an efficient plan, realize a powerful screening of the quality of the plans and ensure that the confirmed plan produced at the end of a reorganization procedure is a plan that maximizes the debtor’s value and distributes that value efficiently.

4.2.2.5 Reform suggestion for the classified voting system

(1) Reform suggestion for classification

It is suggested that the EBL should provide that claims and interests that are substantially similar should be put into one class. Secured claims that are secured by the same collateral with the same priority level and that should be paid pro rata by the value of the collateral in the case of default should be considered as being substantially similar and should be put into one class. Unsecured claims and shareholders’ interests that enjoy the same priority level in receiving payment according to the priority order set up by the pre-bankruptcy contracts, non-bankruptcy law, and the bankruptcy liquidation provisions, should be considered as substantially similar and be put into one voting class. A detailed analysis of the reform suggestion is below.

Under Chapter 11, the debtor is allowed to freely mold the classification according to the specific circumstances of a case, since Chapter 11 only requires that the claims or interests being put in one class should be substantially similar and does not mandate that claims and interests that are substantially similar be put into one class. Chapter 11’s flexible classification system causes the problem of gerrymandering. To avoid the problem of gerrymandering, it is suggested that the EBL mandates that claims or interests that are substantially similar should be put into one class.

What factors are determinative in judging whether the claims or interests are “substantially similar”? A common recognition is that the nature of a secured claim is mainly determined by the character of the security that guarantees the payment of a secured claim and that the nature of unsecured claims and shareholder’s claims is mainly determined by their priority level. Thus, the author suggests that secured claims, which are secured by the same...
collateral with the same priority level, should be put into one class. How can the priority level of all the unsecured claims and shareholders’ interests be calculated for the purpose of classification? The priority level of all the claims and interests is defined by the pre-bankruptcy contracts among the interested parties and non-bankruptcy law and is clearly illustrated in the liquidation provisions. The pre-bankruptcy priority order, which is originally defined explicitly or implicitly by the interested parties’ pre-bankruptcy contracts and non-bankruptcy law, is summarized and expressed as a whole by the priority order provided in the liquidation procedure because the liquidation procedure is a procedure for selling the debtor’s assets and distributing the proceeds according to a clear and complete list of all kinds of claims drawn up in order of priority. Compared with the liquidation procedure, the reorganization procedure is more complicated in that it involves a complicated process for making the most efficient deployment decision. Where a consensual plan is reached, the priority order is defined in the consensual plan through bargaining. Where the interested parties fail to reach a consensual plan, how the debtor’s value should be distributed to the dissenting classes is a problem that needs to be solved by the law. The absolute priority rule is a device employed by US law to solve this problem. The spirit of the absolute priority rule is to keep the priority order in the reorganization procedure in line with the liquidation and non-bankruptcy priority order. To conclude, the priority order applied during the liquidation procedure can be used as a standard for setting the priority level of claims or interests for the purpose of classification. Where the liquidation priority order is not complete, the court has to refer to the pre-bankruptcy contract and non-bankruptcy law for determining the priority level of a specific claim. Therefore, the author suggests that, with respect to the classification of unsecured claims and shareholders’ interests, the EBL may specify that: unsecured claims and shareholders’ interests that enjoy the same priority level in receiving payment as that set up in pre-bankruptcy contracts, non-bankruptcy law, and the bankruptcy liquidation provisions, should be considered as substantially similar and be put into one voting class. For instance, general unsecured claims should be put into one class, while


subordinated general unsecured claims should be put into another class. Similarly, preferred shareholders’ interests and common shareholders’ interests should be put into different classes.

According to the creditors’ bargain theory, bankruptcy law should respect the interested parties’ non-bankruptcy entitlements and try to establish a collective procedure that maximizes the debtor’s overall value and minimizes the debt-collection costs.\textsuperscript{502} The reform suggestion is efficient in that it respects the interested parties’ non-bankruptcy entitlements, helps to achieve “equal treatment to same claims” (interested parties with substantially similar non-bankruptcy entitlements receive equal treatment), and limits forum shopping and strategic behaviors. Compared with Chapter 11’s classification system, the proposed classification system leaves no room for the plan proponent to freely mold classification and avoids the costs caused by the bargaining and litigation over proper classification and the gerrymandering problem.

(2) Reform suggestion for shareholders’ voting right

As discussed above, whether a plan distributes the shares of the reorganized debtor to the creditors or not, it affects shareholders’ interests. Only if shareholders are given voting rights, will they have the opportunity to participate in the bargaining with regard to the content of the plan. Since the EBL has adopted the method of allowing the interested bargaining to reach a solution through bargaining and since it is unclear on the commencement of the bargaining what the most efficient method for deploying the debtor’s assets is, how much the debtor’s value is or how the value should be distributed, the shareholders should not be excluded from the bargaining. Thus, it is suggested that shareholders always be given the right to vote on the plan in order to ensure the bargaining is not manipulated by the creditors, shareholders’ opinions are fully expressed and their interests are equally protected.

(3) Reform suggestion for the majority voting rule

The optimal majority requirement is the best tradeoff between minority protection and hold up minimization.\textsuperscript{503} As discussed in Section 4.1.1.4, compared to the simple majority rule, the supermajority rule does not have an obvious strength in enhancing minority protection and

\textsuperscript{502} See Section 2.1.1.1 and 2.1.1.2.

increasing the probability of a correct decision. Moreover, in bankruptcy reorganization, the dissenting minority of an assenting class can be protected by the best-interest-test. Therefore, the author proposes the replacement of the supermajority rule by the simple majority rule.

4.2.2.6 Reform Suggestions for the Confirmation system

First, the EBL should add some general confirmation requirements to ensure that the reorganization plan is economically efficient and contains a feasible deployment scheme, the reorganized debtor has a capable management team, the debtor’s managers’ receive reasonable remuneration during the reorganization period, the expenses incurred during the reorganization period are reasonable, the reorganization procedure is not used for improper purpose, the plan is proposed in good faith and in conformity with all the application laws. It is suggested that the following detailed description of the general confirmation requirements be inserted in Article 86 as a final paragraph to this article:

“For the purpose of confirmation, a plan, no matter whether it has been accepted by all the voting classes or not, shall at least meet with the following requirements:

(1) All the dissenting holders of claims or interests shall be paid an amount that is not less than the amount they would receive under liquidation, regardless of whether or not the class to which they belong accepts the plan;

(2) A feasible reorganization scheme of the debtor’s business shall be established; in examining the feasibility of the reorganization scheme, the court may consider factors, such as: (i) the debtor's prior performance, (ii) the adequacy of the debtor's capital structure, (iii) the earning power of the business, (iv) economic conditions, (v) the ability of the management and the probability of the same management continuing, and (vi) any other matter that may affect the debtor's ability to execute the plan;

(3) The interested parties shall be adequately informed regarding the identity and affiliations of the top managers and insiders of the reorganized debtor and the other corporations that will participate in the rehabilitation project, the affiliations and remuneration of the top managers and insiders of the debtor that will be employed in the

504 This guidance is borrowed from US case law. Since China does not have a case law system, it is better to make the statutory provision as detailed as possible so as to provide a clear but non-exclusive guidance to the court in applying a general requirement, such as the feasibility test.
reorganized debtor and their compensation and any other information that is necessary for the interested parties to make an informed judgment of the future management of the debtor and the feasibility of the plan;

(4) The interested parties shall be adequately informed regarding any court fees, professional service fees and other expenses relevant to the reorganization case;

(5) The reorganization petition shall be filed in good faith; the plan shall be proposed in good faith and shall comply with any applicable bankruptcy and non-bankruptcy law.”

Second, in the context of cram down, it is important to provide comprehensive protection to the dissenting classes by adopting the fair-and-equitable test and the non-discrimination test, the absolute priority rule in particular, which is a material device for achieving fair and equitable distribution to the dissenting classes. Thus, the author suggests that the following cram-down requirements should be inserted into Paragraph two of Article 87 of the EBL:

The plan shall arrange fair and equal treatment to a dissenting class and does not unfairly discriminate a dissenting class. In order to guarantee such fair and equal treatment to a dissenting class of unsecured claims or shareholder’s interests a plan should ensure that no classes senior to the dissenting class receives more than full payment in terms of present value under the plan and no classes junior to the dissenting class receive any payment before the dissenting class receives full payment in terms of present value. For the purpose of examining the present value of the distribution, where the payment is made in debtor’s shares, an objective, reasonable and convincing valuation report on the debtor’s reorganization value shall be attached.\(^{505}\) With respect to a class of priority shareholders’ interests, full payment shall be the greatest of any liquidation amount or redemption price to which the shareholders are entitled.

Third, in bankruptcy reorganization, valuation is a fundamental problem.\(^{506}\) In the stage of confirmation, a series of valuations must be conducted, which may include calculating the debtor’s reorganization value and liquidation value, the value of the collateral, the present value of the payment to the dissenting members of a consenting class, the present value of the payment to a dissenting class of secured creditors, unsecured creditors, preferred shareholders

\(^{505}\) The detailed standards for the sustainable valuation report, such as the proper valuation method and valuation content, are beyond the scope of this thesis.

\(^{506}\) See 4.1.1.3 and 4.1.2.4 for a detailed discussion.
for the purpose of applying the best-interest-test and the absolute priority rule. Although valuation is uncertain, it is better to have a set of valuation rules that are as detailed as possible in order to limit the valuation mistakes and achieve a stable and reasonable valuation result. The US practice has suggested that there can be many controversial ideas and practices with respect to the valuation method of the debtor, the valuation of the collateral, the relationship between the valuation of the collateral for the purpose of adequate protection and plan-confirmation. With respect to valuation uncertainty, the Chinese legislative authority can draw useful lessons from the US practice and establish a team consisting of valuation specialists, bankruptcy lawyers and judges with an aim of producing a set of deliberately designed valuation rules.\textsuperscript{507} Despite the fact that valuation can never be certain and accurate, it is better to establish a set of valuation rules than have no rules at all. A set of deliberately designed rules will help the debtor, the plan proponent and the bankruptcy judges to achieve the most reasonable, clear, objective and consistent valuation result that can be achieved in our practical world and this valuation result may help the bargaining parties and the bankruptcy judge to make an informed judgment of the draft plan.\textsuperscript{508}

\textsuperscript{507} Designing detailed valuation rules needs professional financial knowledge and is beyond the scope of this thesis.

\textsuperscript{508} Valuation is also involved during the plan-drafting process for the purpose of determining the adequate protection of the secured creditors’ interest. This reform suggestion on valuation applies to the valuations involved in the whole reorganization procedure. Since it is discussed here, it will not be repeated again in Chapter 5 of the book.
5 The reorganization-fostering system: automatic stay and post-petition financing

This chapter introduces the US and Chinese reorganization-fostering system, analyzes the efficient and inefficient elements of both systems and finally proposes reform suggestions for the Chinese reorganization-fostering system.

5.1 The automatic stay system in the US and China

5.1.1 The US Automatic Stay System

5.1.1.1 Overview of the US Automatic Stay System

Under the current US bankruptcy Code, the automatic stay comes into force immediately upon the filing of a bankruptcy petition.\(^{509}\) The automatic stay prohibits creditors’ individual debt-collection activities vis-à-vis the debtor and preserves the debtor’s assets for the operation of the collective bankruptcy procedure.\(^{510}\) For secured creditors, the stay “suspends the terms of the original loan and in effect forces the creditor to make a new loan equal to the amount of the secured claim”.\(^{511}\) The automatic stay imposes risk on the secured creditors since the reorganization procedure takes time and during the reorganization procedure, the debtor continues to use the collateral in order to work on reorganization. “If the attempt at rehabilitation fails, the delay in enforcement of rights caused by the stay could have resulted in irreparable damage to a creditor.”\(^{512}\)

Secured creditors may protect their interests by applying for relief from the automatic stay. First, the US Code requires the court to grant relief from the automatic stay on the ground that the debtor has no equity in the property and the property is not necessary to an effective reorganization.\(^{513}\) In essence, the basis for this kind of relief is that neither the debtor nor the bankrupt estate will obtain an economic advantage by keeping the property, so the creditor’s

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\(^{512}\) Brian A. Blum (2006), Bankruptcy and Debtor/Creditor: Examples and Explanations, Aspen Publishers, 4th Ed., p. 239.

right to enforce its claim to the property should not be further suspended. Second, the current US Bankruptcy Code requires the court to grant relief from the automatic stay on the ground that the debtor fails to provide “adequate protection” to secured creditors’ interest in property. The US Code requires that if the debtor fails to provide adequate protection, the stay should be lifted by the court upon the request of the creditor. §361 of the US code provides three kinds of adequate protection, which are: (1) providing cash payment or periodic cash payment to reduce the debt and maintain the ratio between the claim and the collateral value; (2) providing additional or replacing the existing lien with a lien on collateral of greater value; (3) providing other kinds of protection that result in an indubitable equivalence of the security interest. The meaning of the term “indubitable equivalence” is ambiguous. It is considered that §361(3) “sets a standard for measuring the protection, rather than suggesting a means of providing it. It requires the court to decide whether a means of protection…ensures that the claimant will certainly receive no less than the value of its property interest.” §361(3) clearly provides that granting the compensation a priority that is equal to the administrative expense does not constitute adequate protection. The legislative material of the US Code states clearly that “the concept of adequate protection is based as much on policy grounds as on constitutional grounds. Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section recognizes the availability of alternate means of protecting a secured creditor’s interest. Though the creditor might not receive his bargain in kind, the purpose of adequate protection is to ensure that the secured creditor receives in value essentially what he bargained for.”

518 House Report, p. 6295.
5.1.1.2 Protection of the Secured Creditors’ Interest during the Pendency of the Automatic Stay

(1) Whether time value compensation should be included in adequate protection

The statutory provision suggests that adequate protection of the secured creditor’s interest is the precondition of automatic stay over the collateral. Due to the ambiguity of the statutory provision on the content of adequate protection, there are opposing opinions on whether adequate protection includes time value compensation in addition to the compensation of physical depreciation of the collateral. 510 Time value compensation, sometimes called opportunity cost compensation, post-petition interest payment or pendency interest payment (payment of interest that accrue on creditors’ claims from the date of the filing of the reorganization petition to the effective date of the confirmed plan), 520 is the compensation paid to secured creditors for their loss resulting from being unable to foreclose the collateral, sell it and earn an interest by investing the proceeds of the sale. 521 Some courts refused to give secured creditors’ time value compensation 522 while some courts held that time value compensation should be included in adequate protection. 523 Courts


522 See e.g., In re Smithfield Estates, Inc., 48 Bankr. 910, 914 (Bankr. D.R.I. 1985) (noting that adequate protection is a protection against any depreciation or diminution in the value of the collateral and that opportunity cost, or interest on the value of money should not be included within the definition of adequate protection); General Elec. Mortgage Corp. v. South Village, Inc., 25 Bankr. 987, 1002 (Bankr. D. Utah 1982) (holding that “[a]dequate protection is the fulcrum upon which the rights of debtors and creditors are balanced in a reorganization case. Congress knew that the payment of interest would be an impossible burden for debtors, many of whom file because of cash shortages. Congress allowed “periodic cash payments” in Section 361(1), but these are keyed to depreciation, not interest, and they are optional, not mandatory. If interest were required, it would run afoul of the nonprescriptive character of Section 361, as well as other provisions of the Code.”).

523 See e.g., In re American Mariner Indus. 734 F.2d 426, 430-2 (9th Cir. 1984) (holding that the legislative history suggests clearly that what is covered by the adequate protection under §§ 361 and
denying time value compensation held that one goal of the US Code was to facilitate reorganization and that paying time value compensation would reduce the resources available to the debtor to make a successful reorganization. Courts that agreed to include time value compensation referred to the legislative history and the principal of “no bankruptcy windfall” to support their opinion. Those courts held that the legislative history, the House and Senate Reports clearly expressed the congressional intention to provide protection for secured creditors’ interests in the collateral and not merely the physical value of the collateral. Secured creditors’ interests should not go unprotected simply because they are involved in a bankruptcy proceeding. To the extent that in bankruptcy the debtor can prevent secured creditors from enforcing their rights and thus benefit from the use of the secured creditors’ money, the debtor and its unsecured creditors receive a windfall at the expense of the secured creditors. Discrepant treatment of secured creditors’ interests inside and outside bankruptcy results in a windfall for the debtor and unsecured creditors merely by reason of the happenstance of bankruptcy. Adequate protection prevents such a windfall and insures that secured creditors receive the benefit of their bargain. From the discussions above, one may infer that at bottom, the opposing opinions of the courts on time-value compensation are caused by their different opinions as to whether the goal of facilitating reorganization of the US Code could override secured creditors’ pre-bankruptcy entitlements and whether bankruptcy reorganization law could change secured creditors’ pre-bankruptcy entitlements without providing full compensation.

Although at the beginning of the application of the US Code there were different judicial judgments representing two distinct directions, several years after the US Code became effective denying time value compensation became the trend. Finally, in 1988, in United

362(d) is “the secured creditor’s interest and not merely the value of the collateral”, and that adequate protection means to protect the “present value” of the secured creditors’ interest. See In re Deeter, 53 B.R. 623, 626-7 (Bankr.N.D.Ind.1985) (holding that Congress seems to have recognized that the secured creditor’s rights of repossession and sale are part of its ‘bargain’; section 361 insures it will receive at least “in value” if not “in kind” of what it has bargained for; “the test of adequate protection is twofold: first, the protection must adequately safeguard principal, and second, the protection must ... effectively ... compensate the secured creditor for loss of value.”).

525 In re American Mariner Indus., 734 F.2d 426, at 430 (9th Cir. 1984).
526 In re American Mariner Indus., 734 F.2d 426, at 435 (9th Cir. 1984).
527 Douglas G. Baird and Thomas H. Jackson (1984), Corporate Reorganizations and the Treatment of
Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs. (“Timbers”), the Supreme Court provided an authentic answer to this question by holding that adequate protection is to protect the secured creditors’ interest in property and does not protect the creditor's right to immediate foreclosure and that secured creditors were not entitled to interest as compensation for delay caused by automatic stay in foreclosing on collateral.528 The Supreme Court further held that §506(b)529 permits post-petition interest to be paid out of the “security cushion” (hereinafter referred to as “the cushion”)—the value of the collateral in excess of the amount of the secured claim.530 From then on, the case law has come to the common conclusion that “‘adequate protection’ is meant only to assure that a secured creditor does not suffer a decline in the value of its interest in the estate's property, rather than to compensate the creditor for the bankruptcy-imposed delay in enforcing its rights in that property”;531 in the context of over-secured creditors, the term “secured creditor's interest in property” or the protectable value covered by the adequate protection is the amount of the claim instead of the total value of the collateral.532 To summarize, according to case law, for over-secured creditors, adequate protection means to keep the value of the collateral at the level equal to the principal amount of the claim; for under-secured creditors, adequate protection means to keep the value of the collateral against a decline; for both over- and under-secured creditors, adequate protection

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529 11 U.S.C. § 506(b) provides:
To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.
531 In re Addison Properties Limited Partnership, 185 B.R. 766, 784 (Bankr.N.D.Ill. 1995) (The court stated that although the implication of adequate protection was once in substantial doubt, it is now clear that adequate protection is to ensure the value of the collateral to the level of the principal amount of the secured claim and is not to compensate the creditors for the bankruptcy-imposed delay.) David Gray Carlson (1989), Postpetition Interest under the Bankruptcy Code, 43 U. Miami L. Rev. 577, p. 602 (noting that the Supreme Court has ruled out the possibility that adequate protection routinely implies post-petition interest).
532 In re Lane, 108 B.R. 6, at 7-8 (Bankr. D. Mass. 1989) (The court held that “[l]ack of adequate protection is decline in value of secured creditor's interest in property”; “Section 362(d)(1) of the Bankruptcy Code grants a party relief from the automatic stay ‘for cause, including lack of adequate protection of an interest in property of such party in interest’…in the context of an oversecured creditor, it is apparent that the value of the ‘interest in … property’…is equal to the amount of the debt and not the value of the collateral”; “[t]here is no lack of adequate protection when equity cushion in excess of allowed amount of claim is eroding through decline in collateral value or increase in claim due to accrual of interest or expenses”; “[o]nce equity cushion disappeared, value of mortgage interest would begin to decline….mortgagor was entitled to adequate protection against that decline in value”).
does not mean time-value compensation for the delay caused by the automatic stay; it is based on §506(b) rather than the adequate protection provided in §361 as a result of which over-secured creditors can receive post-petition interest to the extent of the value of the cushion.

(2) When to value the collateral for the purpose of adequate protection

In order to determine whether there is a necessity to provide adequate protection, the court needs to establish a benchmark by establishing the value at a beginning point. Based on the benchmark, the court further needs to find out whether there is a risk that this value will decrease. Some courts held that the benchmark value should be the value of the collateral at the date of filing, i.e. the date of the bankruptcy petition. Since adequate protection is to protect the secured creditor against a decline during the automatic stay, in order to determine whether there is a need for adequate protection, the court must decide whether the value fixed on the date of filing will be subject to a risk of decline. However, some courts held that the benchmark value should be the value of the collateral on the motion date, i.e. the date that the creditor motioned for the adequate protection. These courts worried that the debtor might be forced to bear a large makeup payment burden if the date of filing is taken as the benchmark valuation date and the creditor files its motion of adequate protection later. If the debtor is unable to pay the unexpected adequate protection burden, the reorganization efforts may be seriously hindered. From this reasoning one may infer that the courts’ recognition of the bankruptcy policy of fostering the debtor’s reorganization has influenced them to choose the motion-date value as the benchmark value.

(3) Determining the proper interest rate

Where a creditor is over-secured and is entitled to post-petition interest payment, there is the


534 See e.g., In re Reddington/Sunarrow Ltd., 119 B.R. 809 (Bankr.D.N.M.1990) (The court held that since the collateral’s value fixed on the date of filing did not risk a decline, there was no need of adequate protection payment during the course of the case.)

535 See, e.g. In re Cason, 190 B.R. 917, 930 (Bankr. N.D. Alabama 1995) (“The creditor must affirmatively act in order to protect its interest after the debtor files its bankruptcy petition …. [v]aluation at the time of the motion would not reward the creditor for inaction, as would valuation at the time of petition …. if the creditor waited until late in the bankruptcy proceeding to file its motion, there could be a sizeable difference in value from the date of the petition until the date of the motion. If the date of petition is kept for valuation purposes, the debtor could be forced to deal with “sizeable makeup payments.””).

159
problem of how to determine the proper rate for post-petition interest payment. Some courts adopted the market rate on the ground that the appropriate post-petition interest rate should be a rate that compensates the creditors’ loss caused by the delay or that would be charged by the creditor for a similar loan in the market.\footnote{536} Some courts held that the proper post-petition interest rate should be decided according to the bankruptcy policy—an equitable distribution of the debtor’s assets.\footnote{537} For instance, in re Vest Assocs., the court noted that in deciding the proper post-petition interest rate, courts generally adopt an equitable approach in deciding whether to use the contract default rate.\footnote{538} “A court will refuse to enforce [contract default rates] if they are deemed to be penalties or forms of coercion instead of compensation for injuries that the lender incurred. In contrast, default rates with a much lower differential have been found reasonable subject to other equitable concerns.”\footnote{539} “If a debtor is solvent, there is much more leeway to grant the default rate because other creditors will not be injured”; if a debtor is insolvent, a default rate, which is considered as significantly high, is often rejected by the court, because it “sweeps up virtually all proceeds in the estate for the secured creditor, leaving virtually nothing for other creditors” and conflicts with the aim of the bankruptcy process, which is an equitable distribution of the estate.\footnote{540} “Nearly all courts agree that the basis for an equitable analysis of postpetition interest is rooted in the proposition that the Supreme Court set out long ago: ‘It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of

\footnote{536} See, e.g. In re Victory Constr. Co., 9 Bankr. 570, 574 (Bankr. C.D. Cal. 1981) (the appropriate rate should be a rate that equates to and protects against the creditor’ loss measured by a market rate); In re Landmark at Plaza Park, Ltd., 7 Bankr. 653, 657 (Bankr. D.N.J. 1980) (the appropriate rate should be the rate which would be charged by a creditor making a loan to a third party with similar terms, duration, collateral and risk); In Re Colegrove, 771 F.2d 119, 123 (6th Cir.1985)(noting that the appropriate post-petition interest rate should be the "prevailing market rate of interest on similar types of secured loans at the time of allowance of the creditors' claim and the confirmation of the plan in bankruptcy with a maximum limitation on such rate to be the underlying contract rate of interest.").

\footnote{537} See e.g., In re Hollstrom, 133 B.R. 535, 541 (Bankr. D. Colo. 1991) (noting that“[b]ankruptcy essentially is, after all, a process of equitably adjusting contending creditors' claims and rights, and effectuating a fair distribution of a debtor's property among those creditors.”) One situation in which courts consistently have declined to award the default rate of interest is where doing so would have diminished the recovery of junior creditors; In re Vest Assocs., 217 B.R. 696, 703-4 (Bankr. S.D.N.Y. 1998); Foss v. Boardwalk Partners (In re Boardwalk Partners), 171 B.R. 87, 92 (Bankr. D. Ariz. 1994).


\footnote{539} Id.

\footnote{540} Id, at 703.
equities between creditor and creditor or between creditor and debtor.\textsuperscript{541-542}

(4) Overall comments on the treatment of secured creditors’ interest under Chapter 11

Under Chapter 11, case law has made it clear that adequate protection, as a general rule, means preserving the value of the collateral at the level of the principal amount of the secured claim and does not include time value compensation. Although over-secured creditors are entitled to post-petition interest based on § 506(b), the post-petition interest payment may not compensate the creditors’ loss measured by the proper market rate, i.e. the rate that the creditors would charge for a similar loan on the market since under § 506(b) the overall amount of the post-petition interest payment is limited to the value of the cushion and the court may choose an interest rate lower than the proper market rate in order to achieve equitable distribution of the bankruptcy assets. Under-secured creditors can not receive any post-petition interest. In addition, some courts do not require the debtor to bear the adequate protection obligation for the period between the date of filing and the date of motion for adequate protection. To conclude, due to the reasons set out above, although Chapter 11 uses the term “adequate protection”, under Chapter 11 the protection of secured creditors’ interest is not really adequate.

5.1.1.3 The Delay Compensation to Unsecured Creditors of Solvent Debtors

Generally one would expect that debtors entering the bankruptcy procedure are insolvent and do not have enough assets to pay the total unsecured claims. According to the creditors’ bargain theory, the unsecured creditors of insolvent debtors would like to participate in a collective procedure to maximize their recovery because the delay they bear during the collective procedure is justified by the advantages they enjoy, i.e. receiving a higher distribution by maximizing the debtor’s overall value and reducing certain costs accompanying the recovery of their credit.\textsuperscript{543} Thus, in cases where there are not enough assets to pay the unsecured creditors, there is no need to talk about post-petition interest for the delay under the automatic stay. However, where the debtor is liquidation solvent (i.e. the

\textsuperscript{541} Vanston Bondholders, 67 S.Ct. 237 at 241.
\textsuperscript{543} Thomas H. Jackson (1982), Bankruptcy, Non-Bankruptcy Entitlement, and the Creditors' Bargain, 91 Yale L. J. 857, pp. 860-8.
debtor’s liquidation value, after paying the secured debt, is higher than the principal amount of its unsecured debts), or where the debtor is reorganization solvent but liquidation insolvent (i.e. the debtor’s liquidation value, after paying the secured debt, is lower than the principal amount of its unsecured debts, but its reorganization value, after paying the secured debt, is higher than the principal amount of its unsecured debts), the question of whether unsecured creditors are entitled to post-petition interest payment is pressing and requires a clear legal provision.

Chapter 11 does not contain any statutory provision directly dealing with this question. Some courts held that based on the principle of equity, unsecured creditors of solvent debtors should be awarded post-petition interest. In re Manville Forest Products Corp., the court first quoted that “the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor” and then held that where the debtor is solvent, it would be unfair and inappropriate to return all the surplus after paying the principal amount of the creditors’ claims to the debtor without paying post-petition interest to creditors.

Some courts drew the same conclusion by holding that equity indicates that the priority order in Chapter 7 and Chapter 11 should remain the same. In re Gaines, the court held that although section 726(a)(5) does not directly apply to Chapter 11 cases, if in Chapter 11, unsecured creditors of solvent debtors could not receive post-petition interest, the priority level in Chapter 11 would be different from that in Chapter 7 and the debtor would receive a windfall at the expense of creditors by using Chapter 11. Equity dictates that the Chapter 11 windfall should not happen. Some courts came to the same conclusion by a systematic explanation of §726(a)(5) and §1129(a)(7).

In re San Joaquin Estates, the Ninth Circuit Bankruptcy Appellate Panel held that a bankruptcy court abused its discretion by not

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544 See e.g., In re Beverly Hills Bancorp, 752 F.2d 1334, 1339 (9th Cir.1984) (“the award of post-petition interest is dependent upon the equities of the case.”); In re Manville Forest Products Corp., 43 B.R. 293, 299-300 (Bankr.S.D.N.Y.1984).
546 In re Gaines, 178 B.R. 101, 103-4 (Bankr. W.D. Va. 1995). See also, In re Shaffer Furniture Co., 68 Bankr. 827, 829 (Bankr. E.D. Pa. 1987) (holding that “there are numerous guideposts and unanimity among the precedents that exist which establish that the distribution priorities in Chapter 11 cases should be the same as that expressly established by §§ 726(a)(5) and (a)(6) in Chapter 7 cases.”);
548 In re San Joaquin Estates, Inc., 64 Bankr. 534 (Bankr. 9th Cir. 1986)
awarding post-petition interest to an unsecured claimant when the debtor is “very solvent, [and] similar creditors in Chapter 7 would receive post-petition interest on their claims.”

§726(a)(5) provides that where the debtor is solvent and there is surplus left after paying the principals of unsecured claims according to the priority order, the surplus should be used to pay post-petition interests to unsecured creditors before the debtor may retain any value from his estate. §1129(a)(7) provides the best-interest test as one of the plan confirmation requirements in a Chapter 11 procedure, which is that every dissenting creditor should receive no less than what they would receive under a hypothetical liquidation. If a dissenting unsecured creditor of a solvent debtor would receive post-petition interest in liquidation proceeding, the Chapter 11 plan, which does not provide post-petition interest to him, fails to meet with §1129(a)(7) and should not be confirmed.

In cases where the debtor is liquidation insolvent but reorganization solvent, it is uncertain whether a class of unsecured creditors of a reorganization solvent debtor should receive the payment of post-petition interest. Some courts used the fair and equitable requirement provided in §1129(b) to reach the decision that post-petition interest should be paid to unsecured creditors before shareholders get anything. However, the fair and equitable requirement is too broad a standard and can only be used to protect the dissenting classes of unsecured creditors. It remains uncertain whether the other courts will adopt this approach and whether an assenting class of unsecured creditors of a reorganization solvent debtor should receive the payment of post-petition interest. This uncertainty may cause heated debate during the plan-drafting stage and costly litigation in the plan confirmation phase.

In addition to the ambiguity concerning whether post-petition interest is required for unsecured creditors, there remains the problem of how to determine the proper interest rate for unsecured creditors of solvent debtors. Courts have adopted different interested rates,

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550 Id. at 536.
551 Id (“We look to a liquidation analysis under §§ 726(a)(5) and 1129….A Chapter 11 creditor is entitled to at least as much as it would receive under Chapter 7.”).
552 11 U.S.C. §1129(b) requires that a plan to be crammed down must be fair and equitable to a dissenting class. See Secion 4.1.2.1 for the detailed discussion.
such as the federal legal rate\(^{555}\) or statutory interest of the state law\(^{556}\). The lack of clear and uniform provisions on the proper interest rate may cause debate and litigation.

To conclude, all the ambiguity discussed above leads to uncertainty and inconsistency with respect to post-petition interest payments to unsecured creditors of solvent debtors and may cause prolonged and costly bargaining and litigation.\(^{557}\)

5.1.1.4 The Efficient Elements of the US Automatic Stay System

The automatic stay is efficient in that it provides the foundation for the collective bankruptcy procedure and helps to maximize the value of the debtor and minimize the debt-collection costs. Automatic stay, which protects the bankruptcy estate from harassment, pursuit and dismemberment, is an essential component of bankruptcy law. Without automatic stay, all the creditors would try to pursue individual debt collection under non-bankruptcy law and the collective bankruptcy procedure would be neither orderly nor effective. Automatic stay, by staying individual debt-collection activities, provides the foundation for the operation of a collective procedure. According to the creditors’ bargain theory, bankruptcy, regardless of whether the procedure is one of liquidation or reorganization, is just a way to maximize the debtor’s overall value.\(^{558}\) Only when the bankruptcy assets are kept from being dismembered, will the claimholders, under the supervision of the court, be able to conduct an orderly liquidation or reorganization that maximizes the debtor’s overall value and their recovery as a group.\(^{559}\) In a reorganization procedure, if the creditors’ individual collection activities were not stayed, the debtor’s assets would be dismembered and the interested parties would not be able to bargain collectively, reach an efficient rescue plan or maximize the debtor’s overall value through the implementation of the plan. Judged against the value-maximization standard proposed by the creditors’ bargain theory, the automatic stay is efficient in that the

\(^{555}\) See e.g., In re Gaines, 178 B.R. 101, 106 (Bankr. W.D. Va. 1995).

\(^{556}\) See e.g., In re Shaffer Furniture Co., 68 Bankr. 827, 831 (Bankr. E.D. Pa. 1987).

\(^{557}\) Alexander F. Porter (2008), Postpetition Interest on Unsecured Claims in the Case of a Solvent Debtor: Toward a More Consistent Statutory Regime, 81 S. Cal. L. Rev. 1341, pp. 1358-60.


\(^{559}\) Brian A. Blum (2006), Bankruptcy and Debtor/Creditor: Examples and Explanations, Aspen Publishers, 4th Ed., p. 238 (commenting that the automatic stay gives the debtor sanctuary from creditor pressure so that orderly liquidation can be arranged or a plan can be produced for the debtor’s rehabilitation).
automatic stay, by stopping the creditors’ individual collections and establishing the collective procedure, helps to maximize the debtor’s value and minimize the creditors’ debt-collection costs.\textsuperscript{560}

5.1.1.5 The Inefficient Elements of the US Automatic Stay System

The inefficient elements of the automatic stay mainly lie in that it creates wealth redistribution, which may cause interested parties to have skewed incentives when they decide whether to use the reorganization procedure or when they bargain over the content of the plan during the plan drafting and voting process. A detailed analysis is below.

Under the automatic stay system, creditors are prohibited from pursuing individual debt-collection and thus bear time-value cost for the delay in receiving payment. It is however, difficult to provide reasonable compensation to creditors for this delay.\textsuperscript{561} As discussed above in Section 5.1.1.2 and 5.1.1.3, under Chapter 11, over-secured creditors may bear substantial time-value cost because of the problems in respect of the post-petition interest payment; unsecured creditors of solvent debtors may also bear time-value cost for the delay because of the ambiguity concerning their entitlement to post-petition interest payment.

According to the creditors’ bargain theory, creditors’ pre-bankruptcy entitlements should be respected inside bankruptcy. Otherwise, bankruptcy wealth redistribution would be created, which may cause a series of inefficient effects. In the context of automatic stay, respecting creditors’ pre-bankruptcy entitlements means that both over-secured and under-secured creditors should get time-value compensation for the delay caused by the automatic stay since they have bargained to be paid by the value of the collateral; unsecured creditors of solvent debtors should get time-value compensation before shareholders receive any remaining value since they have bargained to be paid before shareholders. Under the current provisions of Chapter 11, there is bankruptcy wealth redistribution. Creditors receive insufficient compensation for the delay while the debtor and its shareholders benefit from the automatic stay by continuing to use the creditors’ money without paying the corresponding interest and receive a reorganization windfall. The wealth redistribution may cause the interested parties to

\textsuperscript{560} See Section 2.1.1.1.
\textsuperscript{561} Thomas H. Jackson (2001), The Logic and Limits of Bankruptcy Law, Bear Books, p. 216.
have skewed incentive when they decide whether to enter the reorganization procedure. On the one hand, the shareholders or the debtor may try to use the reorganization procedure with as a means of using the creditors’ money without paying the corresponding interest.\(^{562}\) On the other hand, creditors may try to avoid the use of the reorganization procedure to avoid the time-value cost. Even after the reorganization procedure has been initiated, creditors may try to apply to the court to terminate the reorganization procedure to avoid their time-value cost.\(^{563}\)

Moreover, the wealth redistribution may give rise to skewed incentives in the reorganization bargaining and distort the operation of the bargaining mechanism. On the one hand, creditors may be forced to accept a compromise in the form of an inefficient reorganization plan in order to avoid the time-value cost. On the other hand, junior classes may try to use the delay strategy to extract more distribution when they bargain during the plan-drafting and voting process even if they think the plan facing them is an efficient plan.\(^{564}\)

5.1.2 The Chinese Automatic Stay System

5.1.2.1 Overview of the Chinese Automatic Stay System

Under the EBL, once the court accepts a bankruptcy case, creditors’ individual debt collections are automatically stayed.\(^{565}\) Paragraph two of Article 75 of the EBL provides that during the reorganization procedure, secured creditors should suspend enforcement of their

\(^{562}\) “Junior classes, be they equity holders or unsecured creditors, resort to reorganization in bankruptcy because they want the opportunity to sort things out for their benefit and to capture any upside potential in giving their firm a future, however uncertain. The precise nature of that uncertainty is irrelevant, but if the choice between liquidation and reorganization of the firm is not to be skewed, the residual classes must pay for the opportunity they seek. Such a requirement does not violate any well-conceived notion of fairness or equity. After all, someone must bear the risk that the reorganized firm will fail. To insist that the residual class bear the burden by way of a rule that provides secured creditors with the value of their rights under state law does not prevent desirable reorganizations. To the contrary, it encourages junior owners to put the firm’s assets to the use that the owners as a group would prefer.”, Douglas G. Baird and Thomas H. Jackson (1984), Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. Chi. L. Rev. 97, p. 129. Theodore Eisenberg (1981), Bankruptcy Law in Perspective, 28 UCLA L. Rev. 953. Thomas H. Jackson (1982), Bankruptcy, Non-Bankruptcy Entitlement, and the Creditors' Bargain, 91 Yale L. J. 857, pp.875-7. Scott Robert E. and Scot (1986), Through Bankruptcy with the Creditors’ Bargain Heuristic, 53 U. Chi. L. Rev. 690, pp. 694-6, 707-8.


\(^{565}\) The EBL, Article 19. This article provides that all the enforcement proceedings against the debtor’s assets should be stopped.
security rights. With regard to the protection of secured creditors’ interest during the automatic stay, paragraph two of Article 75 of the EBL provides that secured creditors may apply to the court for relief from the automatic stay if there is probability that the collateral may be damaged or the value of the collateral may decrease and that the damage or decrease in value will be big enough to affect the secured creditors’ interest. The EBL does not provide time-value compensation for the delay caused by the automatic stay.

5.1.2.2 Efficient Elements of the Chinese Automatic Stay System

Just as the automatic stay under Chapter 11, the automatic stay under the EBL is efficient in that it provides the foundation for the operation of the collective bankruptcy procedure and helps to maximize the overall value of the debtor. For the purpose of avoiding duplicated discussion, in this part of the book, the efficient elements of the automatic stay are not discussed in detail again. 566

5.1.2.3 Inefficient Elements of the Chinese Automatic Stay System

(1) The lack of time-value compensation to secured creditors

Recall that under Chapter 11, although time-value compensation to secured creditors as a general principal is rejected, over-secured creditors may receive post-petition interest for the delay under the automatic stay and the total amount of the compensation is limited to the value of the collateral in excess of the secured claim. 567

The EBL does not contain a provision dealing with the time-value compensation to secured creditors for the delay caused by the automatic stay. Item (i) of paragraph two of Article 87, which provides the cram down requirements for secured creditors’ distribution, requires that a dissenting class of secured creditors should receive “fair compensation for the delay in receiving payment”. 568 Should this provision be broadly interpreted as including compensation for the delay under the automatic stay and the delay under the plan? With this question in mind, the author studies the crammed down plans. Among the four crammed

566 For the detailed analysis on the efficient elements of the automatic stay, please refer to Section 5.1.1.4.
567 See Section 5.1.1.2.
568 See Section 4.2.2.1 for the complete provision of Article 87 of the EBL.
down plans, the plan of Jinhua, Guangming, and Dixian was objected to by the class of secured creditors. A study of these three plans showed that the court did not require the debtor to pay secured creditors compensation for the delay under the automatic stay. To conclude, there is no delay compensation for automatic stay. Thus, under the EBL, the debtor may pursue rehabilitation by continuing to use the assets of secured creditors without paying the corresponding interest. According to the creditors’ bargain theory, failure to provide time-value compensation to secured creditors will cause wealth transfer from the secured creditors to the debtor and the junior classes, which may cause the interested parties to have skewed incentives when they decide whether to use the reorganization procedure and when they bargain over the content of the reorganization plan.

(2) Problems in the protection of secured creditors’ security interest

Similar to Chapter 11, the EBL intends to protect secured creditors’ security interest. The EBL provides that a secured creditor may apply for a relief from the stay if there is a risk of a decline in the collateral’s value that is big enough to affect the secured creditors’ interest. The EBL’s provision concerning the protection of secured creditors’ security interest is ambiguous, incomplete and inflexible due to the following reasons.

The provision is ambiguous in that it does not prescribe in detail which kind of risk constitutes the eligible risk for relief from the stay. For instance, if the value of the collateral exceeds the amount of the secured claim, i.e. there is an equity cushion in the collateral, then does a risk of a decline in the value of the cushion but not in the part of the collateral’s value equal to the principal amount of the secured claim constitute a valid basis for relief from the stay? In order to avoid inconsistent results in similar cases, the EBL should provide whether

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569 See Appendix B.
570 The Plan of Jinhua was a plan crammed down over the objections of the class of secured claims and the class of general unsecured claims. The plan stated that the amount of the confirmed secured claims was RMB 1,023,445,518.51; the estimated value of the collateral was RMB 400,724,297.05; assume that the proceeds from the sale turned out to be RMB 400,724,297.05, the actual amount of secured claims should be RMB 400,724,297.05, secured creditors receive full payment from the value of the collateral, and the unpaid amount of RMB 622,721,221.46 should be classified into the class of general unsecured claims. The same kind of treatment was provided to the dissenting class of secured creditors in the plan of Guangming and Dixian. Clearly, in these three cases, although the plan was crammed down over the dissenting class of secured creditors, “fair compensation for the delay in receiving payment” provided in Article 87 was not interpreted to include the time-value compensation for the delay caused by the automatic stay. See Jinhua’s Public Notice issued on August 3, 2010; Guangming’s Public Notice No.2010-047; Dixian’s Public Notice No. 2008-06.
571 Please refer to Section 5.1.1.5 for detailed analysis of the negative effects of wealth transfer.
572 The EBL, Art. 75.
the risk of a decline in the collateral’s total value or in the part of the collateral’s value that
equals the principal amount of the secured claim constitutes the eligible risk for relief from
the stay.
Moreover, compared with Chapter 11, the EBL’s provision is incomplete in that it does not
provide that a secured creditor may apply for relief from the automatic stay where the
collateral is not necessary for an effective rehabilitation and the debtor has no equity in the
collateral.\footnote{573}
Finally, the EBL’s provision is inflexible in that it does not provide the debtor with the
opportunity of providing “adequate protection” in exchange for keeping the collateral under
the automatic stay. Under Chapter 11, if the debtor provides “adequate protection” of the
secured creditors’ interest in the collateral, such as providing periodic cash payment,
additional or replacement lien, the debtor may still keep the collateral and use it.\footnote{574}
Compared with the EBL, Chapter 11’s provision concerning the protection of secured creditors’ security
interest is more flexible. Through the provision of “adequate protection”, Chapter 11 may
achieve the goal of helping the debtor’s reorganization and protecting the secured creditors’
security right in the meantime. To the extent that there is no such a flexible method available
for the debtor provided in the EBL, the debtor in an EBL case may be hindered from using the
necessary collateral for the pursuit of an efficient reorganization even if the secured creditors’
interest may be protected by other ways, such as periodic cash payment, additional lien or
replacement lien.
(3) Lack of provision on the post-petition interest for unsecured creditors of solvent debtors
Although the EBL allows a solvent debtor to file the reorganization petition and enter into the
reorganization procedure,\footnote{575} it does not contain any provision on the post-petition interest
payment for the delay caused by the automatic stay to unsecured creditors of a debtor that is
solvent at the time of bankruptcy filing. Moreover, it does not provide whether unsecured
creditors of liquidation insolvent but reorganization solvent debtors may receive post-petition
interest payment for the period of the automatic stay. In cases where the debtor is solvent or
liquidation insolvent but reorganization solvent, the fact that unsecured creditors can not

\footnote{573} This is provided in 11 U.S.C. § 362 (d)(2).
\footnote{574} This is provided in 11 U.S.C. § 361.
\footnote{575} The EBL, Art. 7.
receive any time-value compensation for the delay under the automatic stay will result in a wealth transfer from the unsecured creditors to the shareholders.

5.1.3 Reform Suggestions for the Chinese Automatic Stay System

5.1.3.1 Providing Adequate Protection of the Secured Creditors’ Interest

(1) The content of adequate protection of secured creditors’ interest

It is proposed that the EBL adopt adequate protection of the pre-bankruptcy interests of secured creditors as the basic principle for the treatment of secured creditors under the automatic stay. Recall that under the US law, the term “adequate protection” implies that the debtor should maintain the value of the collateral to a level that is equal to the principal amount of the secured claim and that time-value compensation is not included in adequate protection. It is necessary to note that the term “adequate protection” in the reform suggestion means time-value compensation and protection of the security interest (maintaining the value of the collateral to secure the payment of both the principal amount and the post-petition interest). It is suggested that the EBL may provide that if the debtor fails to provide adequate protection, the court shall, upon application from the relevant secured creditors, grant the secured creditors relief from the automatic stay.

Outside of bankruptcy, secured creditors have bargained to realize their collateral and reinvest the proceeds at the market interest rate. Adequate protection is to ensure that secured creditors will receive what they would receive under a hypothetical foreclosure and thus will be as well off as they would be if there was no automatic stay. Adequate protection, as a device for respecting and protecting secured creditors’ interest under non-bankruptcy law, should include time-value compensation as part of its content. In addition, before entering into the bankruptcy reorganization procedure, secured creditors have bargained for a collateral to secure the payment of the principal amount and the interest. Respecting the negotiated security interest requires the value of the collateral to be maintained to secure the payment of

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576 See Section 5.1.1.2..
577 “The difference between the real value and the nominal value of the secured creditor's protected fund is measured by interest. Hence, postpetition interest should accumulate on behalf of secured creditors, regardless of whether they are over- or under-secured.” Omer Tene (2003), Revisiting the Creditors’ Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 Bankr. Dev. J. 287, p. 349.
the principal amount and the expected amount of post-petition interest. During the automatic stay, if there is any risk of the value of the collateral declining to a level below the principal amount and the expected amount of post-petition interest the debtor should provide adequate protection of the security interest by feasible means, such as providing an additional lien, a replacement lien, periodic cash payment etc.

(2) Reasons for the adequate protection of secured creditors’ interest

According to the creditors’ bargain theory, bankruptcy law should respect the interested parties’ pre-bankruptcy entitlements. Otherwise, there would be wealth redistribution that would cause a distorted use of the reorganization procedure and strategic bargaining behaviors. By providing adequate protection of secured creditors’ interest, bankruptcy law respects the pre-bankruptcy entitlements of secured creditors and prevents the inefficient effects of wealth redistribution. A detailed analysis is below.

First, adequate protection prevents wealth transfer from the secured creditors to the junior classes and prevents the junior classes from pursuing inefficient reorganization at the cost of secured creditors. Adequate protection to secured creditors will serve as a device that filters out the inefficient rehabilitation. It will force the junior classes and the debtor to calculate whether the rehabilitation will yield returns in excess of the time-value compensation plus the decline of the collateral’s value. If a rehabilitation project produces a return that is less than the value that secured creditors would gain by foreclosing the collateral and reinvesting the money, the rehabilitation project is not efficient for the economy as a whole. Adequate protection of the secured creditors sets up a basic profit threshold for the rehabilitation project and restrains the junior classes and the debtor from pursuing an inefficient rehabilitation at the cost of secured creditors. Moreover, if bankruptcy law fails to provide adequate protection, secured creditors would try to avoid the use of the reorganization procedure before the debtor enters into the reorganization process and apply to the court to terminate the reorganization procedure after the debtor has embarked upon reorganization with the incentive of reducing their cost. In addition, secured creditors, who know how their security right will be treated if the debtor enters into the reorganization procedure, will take market strategies to counterbalance the risk they foresee. For instance, they may increase the interest or refuse to

578 See Section 2.1.1.2.
give loans to debtors that they think run the risk of going bankrupt. The increased secured loan interest or the increased difficulty in getting a secured loan may damage the whole economy by making it more expensive or difficult for corporations to get secured loans.\textsuperscript{579} Second, on the one hand, the lack of adequate protection will lead to the effect that secured creditors may be forced to agree a compromise in the form of an inefficient and unfair plan in order to cut off their time-value cost. On the other hand, the lack of adequate protection may induce junior classes to extract more in their collective bargaining in the reorganization procedure by using the delay strategy.\textsuperscript{580} Adequate protection can help to avoid these inefficient effects.

(3) Details of the design of the adequate protection

How should we calculate the post-petition interest payment or time-value compensation? The time period for paying the post-petition interest should be the period during which the automatic stay lasts less the average time for a secured creditor to realize the security right. How we should choose the proper interest rate for calculating the time-value compensation is another important detail that is discussed in Section 5.2.3.3. Recall that in US case law there are two different opinions on the bench mark value used to determine the adequate compensation paid as protection against the decline of the value of the collateral. If there were no automatic stay, the secured creditors would have the collateral’s value at the beginning of the automatic stay as the security. Since the adequate protection against the decline of the collateral’s value is intended to protect the secured creditors’ bargained-for security interest and to maintain the collateral’s value for the purpose of securing the payment of the principal amount and the interest, it is suggested that the bench mark value should be the value of the collateral at the beginning of the automatic stay. Under this suggested method, the debtor is forced to be vigilant regarding the decline of the value of the collateral and the efficiency of the reorganization efforts. Where the value is expected to decline rapidly during the automatic stay, the debtor has to calculate whether its continued


\textsuperscript{580} Thomas H. Jackson (1982), Bankruptcy, Non-Bankruptcy Entitlement, and the Creditors' Bargain, 91 Yale L. J. 857, pp. 875-6.
business will produce income that overcomes the decline of the collateral’s value; if not, the debtor has to stop pursuing such an inefficient reorganization. If the application time, i.e. the time that the creditors applied to the court for debtor’s payment against the decline of the collateral’s value, is taken as the bench mark, a debtor may try to hide the fact that the value of the collateral is declining to delay the creditors’ application and the debtor will not voluntarily abandon an inefficient reorganization plan since it is the secured creditor who bears the loss of the decline of the collateral’s value that happened before the date that the creditor files application for the protection of the collateral’s value. Therefore, taking the collateral’s value on the date on which the automatic stay commenced as the bench mark is efficient since this method respects the secured creditors’ pre-bankruptcy entitlements, avoids wealth transfer from the secured creditors to the debtor and forces the debtor to pursue an efficient reorganization that produces more income than the cost incurred by the reorganization.

5.1.3.2 Providing Time-value Compensation to Unsecured Creditors of Solvent Debtors

According to the creditors’ bargain theory, bankruptcy, be it liquidation or reorganization, is simply a procedure for maximizing the debtor’s value. Although the debtor may realize a higher value in the reorganization procedure than in the liquidation procedure or a private restructuring, the distribution order in the reorganization should remain the same as that in a liquidation procedure or under non-bankruptcy law. The creditors’ bargain theory emphasizes that bankruptcy law should respect interested parties’ non-bankruptcy entitlements in order to avoid wealth redistribution during bankruptcy. Respecting non-bankruptcy entitlements requires that the bankruptcy priority order should be the priority order bargained for by the interested parties under non-bankruptcy law. Since unsecured creditors have bargained for being paid before shareholders under non-bankruptcy law, in both the liquidation and reorganization procedure, unsecured creditors should be paid post-petition interest before shareholders receive any payment in order to fully respect the interested parties’

non-bankruptcy entitlements. It should be noted that in a case where the debtor is liquidation insolvent but reorganization solvent, the fact that the debtor is liquidation insolvent does not constitute a sufficient reason for denying post-petition interest to unsecured creditors, since in a reorganization procedure, the value to be achieved and distributed is the debtor’s reorganization value while the liquidation value is just a hypothetical estimation for proving the efficiency of the reorganization operation scheme. Denying unsecured creditors post-petition interest payment means that shareholders are allowed to use unsecured creditors’ assets for reorganization without paying the corresponding interest. Thus, wealth transfer from unsecured creditors to shareholders is created. According to the creditors’ bargain theory, wealth transfer from unsecured creditors to shareholders under bankruptcy law will cause inefficient effects.\(^\text{582}\) Thus, it is proposed that the EBL should provide time-value compensation to unsecured creditors of solvent debtors, i.e. debtors that are liquidation solvent or reorganization solvent.

5.1.3.3 The Practical Method of Determining the Proper Interest Rate

In a reorganization procedure, under the automatic stay, secured creditors are actually making a forced secured loan to the debtor. The ideal interest rate for providing time value compensation should be the market rate, i.e. the rate that the creditors would charge for a similar loan on the market. “[I]t is consistent with the reason for granting interest during the automatic stay to use the market interest rate as opposed to the contract rate or state interest rate ceiling. The market rate fully compensates the secured creditor for his loss due to the debtor’s remaining in possession of the collateral and thereby gives him ‘in value essentially what he bargained for.’”\(^\text{583}\) “The market rate fully compensates the secured creditor because, had he been allowed to foreclose and realize the collateral’s value, he could have loaned the proceeds at the current market interest rate. Compensation at less than the market rate would result in a subsidy to the debtor's reorganization,”\(^\text{584}\) a “bankruptcy windfall” to the junior classes and the debtor, or wealth redistribution inside bankruptcy which, according to the

\(^\text{582}\) Please refer to Section 5.1.1.5 for a detailed analysis of the negative effects of wealth transfer from unsecured creditors to shareholders.


\(^\text{584}\) Id, at 323.
creditors’ bargain theory, will cause inefficient effects.\textsuperscript{585}

However, it is difficult to determine the proper market rate. The court needs to consider the factors peculiar to the case, such as the debtor’s character, the stability of the value of the collateral, the expected length of the automatic stay etc., and further examine how these factors influence the risk of the loan to the debtor and the rate to be determined. Because the factors in each case are specific and complicated, the rate determined by the court in a case on the basis of the judge’s subjective weighing of the specific and complicated factors of the case might very well be arbitrary. “Ideally, the court would provide the creditor with the ‘rate of interest which would be charged . . . by a creditor making a loan to a third party with similar terms, duration, collateral and risk.’ The difficulty in effecting this level of compensation is that the court, rather than the borrower and lender operating in an open market, must determine how factors peculiar to the transaction should affect the rate charged. Such effects are difficult to gauge outside of the market, and, as a result, the court's determination is likely to be inaccurate.”\textsuperscript{586}

Since it is difficult and costly for the court to find the ideal market rate, a practical solution is to adopt a fixed method, i.e. using a standard prime rate plus a risk premium to determine the rate.\textsuperscript{587} For example, the law may set the rate for a one-year Treasury bond as the prime rate and further provide a risk premium, such as 3%, or 4%. Although such a formula rate does not really match the specific risk in the forced loan in a specific case, it does have the advantage of certainty and predictability and it saves the debtor and creditors the cost in the determination of the proper market rate. Therefore, it is suggested that this fixed method may be adopted as a practical way for calculating the proper market rate.\textsuperscript{588}

\textsuperscript{585} Please refer to Section 5.1.1.5 for a detailed analysis of the wealth transfer from secured creditors to the junior classes.


\textsuperscript{587} Waltraud S. Scott (1988), Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest, 63 Wash. L. Rev. 1041, p. 1061 (“A case-specific market interest rate that reflects the characteristics of the debtor, the creditor, or the loan is a costly requirement…. Costs are not limited to the expense of expert testimony to establish market interest rates. They also include the cost of increased litigation and loss of private control over outcomes as a result of unpredictable court decisions. On balance, a uniform, predictable interest rate better serves the purposes of the bankruptcy system.”)

Similar to secured creditors, unsecured creditors of solvent debtors are also providing a forced unsecured loan to the debtor. Where the debtor is liquidation solvent or liquidation insolvent but reorganization solvent, unsecured creditors are entitled to receive post-petition interest. According to the creditors’ bargain theory, the rate for a similar unsecured loan in the market (“the market rate”) should be the proper rate. A rate less than the market rate would cause wealth transfer from unsecured creditors to shareholders, which could cause inefficient effects.\(^{589}\) However, as discussed in the two preceding paragraphs, since it is difficult and costly to find the proper market rate, the fixed-rate method may be adopted as a practical solution.

5.2 The Post-Petition Financing system in the U.S. and China

5.2.1 The US Post-Petition Financing System

5.2.1.1 Overview of the US Post-Petition Financing System

Post-petition financing is often called debtor-in-possession financing (“DIP financing”) in the American bankruptcy academia, since Chapter 11 adopts a debtor-in-possession model.\(^ {590}\) In order to help the debtor to get post-petition financing, Chapter 11 provides attractive priority to post-petition financiers. Under Chapter 11, a debtor may get post-petition financing with different kinds of priority levels. First, the debtor may, without getting the court’s authorization, borrow on an unsecured basis and provide the post-petition financier with priority equal to the administrative expenses (“administrative-expense-priority”) in the ordinary course of its business. Second, if the debtor can not get post-petition financing by providing the post-petition financier with administrative-expense-priority, the debtor may, after getting the court’s authorization, provide the post-petition financier with priority superior to the administrative expenses (“super-administrative-expense-priority”) or provide the post-petition financier with a lien on unencumbered assets or a lien on encumbered assets junior to that of the prepetition creditors (“new lien”). Third, the debtor may, after getting the

\(^{589}\) See Section 5.1.1.5.

court’s authorization, provide the post-petition financier with a lien on encumbered bankruptcy property equal or senior to that of the prepetition secured creditors (“equal-lien or super-lien”). To do so, the debtor must show that it cannot get credit otherwise and that it has provided adequate protection to the existing secured creditor.\footnote{11 U.S.C. § 364.} The third kind of post-petition financing, which provides enhanced security to post-petition lenders, is the most noteworthy aspect of the US post-petition financing system. Although the law requires that when the debtor provides the DIP financing with an equal- or super-lien, the debtor must prove that there is adequate protection of the existing lien holder’s interest, it is difficult to achieve this “adequate protection” goal since establishing an equal security, especially a superior security on the same collateral, reduces the security level of the pre-petition lien holders. The requirement of “adequate protection” is quite problematic in this context. If the value of the collateral is really sufficient to provide adequate protection, the post-petition lender will not specifically ask for a super-lien. The new lender’s objection to lending without a super-lien shows that the collateral’s value is not enough for paying the new lenders after paying the old lenders and thus there is no adequate protection.\footnote{James J. White (2004), Death and Resurrection of Secured Credit, 12 Am. Bankr. Inst. L. Rev. 139, p. 169.} In practice, courts rely on the value of the collateral to see if there is adequate protection of the pre-petition secured creditor’s interest.\footnote{James J. White (2004), Death and Resurrection of Secured Credit, 12 Am. Bankr. Inst. L. Rev. 139, p. 170. See e.g., In re Snowshoe, 789 F.2d 1085, 1090 (4th Cir. 1986) (approving district courts’ permission to allow trustee in bankruptcy to obtain additional credit by granting senior lien on property of estate pursuant to 364(d) over objection of Snowshoe's major creditor Shenandoah). Shenandoah claimed that their interest in the estate was not adequately protected, and that Snowshoe had not made sufficient efforts to secure additional credit. Id. at 1087-88. The appellate court approved the district courts’ authorization to incur up to $2 million in debt, based on the findings that: Snowshoe owed Shenandoah between $13 and $14 million dollars, the estate was worth over $19 million dollars, and the trustee made a good faith effort to secure credit without granting the super-priority. Id. at 1089. See also Anchor Sav. Bank FSB v. Sky Valley, Inc., 99 B.R. 117, 119 (N.D. Ga. 1989) (district court approving bankruptcy court's authorization for super-priority financing of approximately $425,000). The objecting creditor had a first priority security interest on collateral worth $8 million to secure a loan of $3 million. The creditor's objection was that, "the debtor has no equity in its property, considering all encumbrances against all assets, and because the debtor has sustained negative cash flow and is not likely to reorganize." Id. at 118. The district court affirmed the bankruptcy court's finding that the creditor was adequately protected by the equity cushion and approved the financing. Id. at 119.}

5.2.1.2 The Efficient Elements of the US Post-petition Financing System

(1) Helping the debtor to gain post-petition finance by lifting the priority level of
A troubled debtor generally does not have enough cash on hand. If it intends to avoid liquidation and pursue reorganization, it often needs new finance to keep its business going. However, new lenders are often reluctant to lend since there is great risk of payment failure. The US post-petition financing system helps the debtor to gain post-petition finance by providing the post-petition finance priority, which may override or prime the pre-bankruptcy security rights. Because Chapter 11 offers “so much protection for lenders who provide post-petition financing, there is an active market for DIP financing.”

5.2.1.3 The Inefficient Elements of the US Post-petition Financing System

(1) Inducing inefficient post-petition financing

By allowing the DIP financier to enjoy a super-lien, Chapter 11 may induce inefficient post-petition financing, which relies on the cushion created by earlier investments instead of on the improved operation of the debtor’s business for receiving repayment. It is difficult and costly to define whether the collateral’s value is greater than the existing secured credit, because even if there is a large cushion for existing secured creditors, existing creditors need this cushion to ensure the post-petition interest payment for the delay under the automatic stay. The total amount of these payments is uncertain since the time period of automatic stay is often uncertain at the time of deciding the post-petition financing transaction. Therefore, allowing post-petition financing to leap over existing secured creditors damages the existing secured creditors’ pre-bankruptcy entitlements. According to the creditors’ bargain theory, this provision is inefficient since damaging pre-bankruptcy entitlements without compensation generates bankruptcy forum shopping and wasteful strategic behaviors. For instance, the debtor and its shareholders may choose to use the reorganization procedure with a view to acquiring new finance at the cost of pre-petition secured creditors. A new lender may choose

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596 See Section 2.1.1.2.
to provide new finance given an incentive of being able to rely on the value contributed by the pre-petition lenders for repayment. Pre-petition secured creditors may try to save their interest by becoming the pre-petition lenders who control the debtor’s managers and push the debtor’s managers to serve their interest.\footnote{See the two paragraphs below for the pre-petition secured creditors’ strategic behavior for saving their interest.}


\footnote{David A. Skeel, Jr. (2003), Creditors’ Ball: The "New" New Corporate Governance in Chapter 11, 152 U. Pa. L. Rev. 917, p. 931.}

\footnote{George W. Kuney (2004), Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, pp. 69-70.}


\footnote{George W. Kuney (2004), Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, pp. 74-90.}

(2) Being used as a controlling device for inefficient goals

Against the background that a Chapter 11 debtor is often in dire need of new finance, the post-petition financiers often use short-term, restrictive financing contracts to control the debtor’s business operation through a series of stringent contractual terms.\footnote{David A. Skeel, Jr. (2003), Creditors’ Ball: The "New" New Corporate Governance in Chapter 11, 152 U. Pa. L. Rev. 917, pp. 926-8.}

For instance, the financing contract require the debtor to make a periodic financial report to the lender; restrict the debtor’s operating activities, use of the loan, disposition of assets, and cash payout; require the debtor to maintain specific financial ratios; require a significantly high interest rate. In addition, they may control the debtor’s bankruptcy reorganization through oppressive contractual terms. The post-petition financing contract may provide for the appointment of a specific chief restructuring officer as a condition for providing new finance.\footnote{George W. Kuney (2004), Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, pp. 926-8.}

If they want to keep on the current managers, the contract may provide that the debtor will default if the debtor’s managers change.\footnote{George W. Kuney (2004), Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, pp. 69-70.} A post-petition financing contract may stipulate that the debtor defaults if the debtor fails to arrange for a sale of some or all of its assets or business by a specific date. It may also prescribe that the debtor shall not seek confirmation of a plan objected to by the lender.\footnote{George W. Kuney (2004), Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, pp. 70-72. Douglas G. Baird and Robert K. Rasmussen (2002), The End of Bankruptcy, 55 Stan. L. Rev. 751, p. 785. David A. Skeel, Jr. (2003), Creditors' Ball: The "New" New Corporate Governance in Chapter 11, 152 U. Pa. L. Rev. 917, pp. 926-8.}

Post-petition lenders may, through their power to influence, help the debtor’s managers to stay on and/or obtain a bonus agreement, which incentivizes the managers to act in line with the preferences of the lenders.\footnote{George W. Kuney (2004), Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, pp. 74-90.} For instance, if they prefer a quick sale, they may try to link the debtor’s managers’ bonus to the time used in the sale
and/or the price gained in a sale. To summarize, the post-petition lenders have adopted the post-petition financing as a tool with which they can exert substantial control over the debtor’s business operation and serve their own interest. If the post-petition financing arrangement, while serving the interest of the post-petition lenders, enhances the debtor’s value, it is efficient. However, if the post-petition financing arrangement serves the interest of the post-petition lenders but reduces the debtor’s value, it brings inefficient effects.

Post-petition financiers are often prepetition secured creditors. When a post-petition lender is also a pre-petition lender, he may try to enhance the prospects for repayment of his prepetition debt by including specially designed terms, such as a cross-collateralization clause and roll up clause, in the post-petition financing contract and enhance the recovery of his interest as a pre-petition secured creditor. One reason that pre-petition lenders choose to provide pre-petition financing may be that they generally know the debtor better than the other lenders and are willing to provide new finance when they see a going concern surplus in the debtor. Another possible reason is that since the debtor may provide a post-petition financier with a super-lien, prepetition secured creditors fearing that their security interest will be damaged, may choose to take action to save their interest. Through the post-petition financing contract, pre-petition secured creditors are able to bargain for a high interest and exert control over the debtor’s managers and ensure the repayment of both post- and pre-petition loan. If the pre-petition lenders’ control over the debtor’s managers through


604 Empirical study found that fifty-eight percent of DIP financiers were pre-petition lenders. Sandeep Dahiya et al., Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence, 69 J. Fin. Econ. 259, 265 (2003).

605 Cross-collateralization is a design under which the lender obtains security not only for postpetition loans, but also for its prepetition loans. A roll up clause provides that the post-petition finance is used, in whole, or in part, to pay prepetition secured debt. George W. Kuney (2004), Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, pp. 60-3.


post-petition financing contracts enhances their own interest but reduces the debtor’s overall value, this leads to inefficient results.

5.2.2 The Chinese Post-petition Financing System

5.2.2.1 Overview of the Chinese Post-petition Financing System

With respect to post-petition financing, the EBL provides that the debtor-in-possession or the administrator may obtain a post-petition loan in order to continue the debtor’s business and may provide security to the post-petition lender. The EBL does not contain special provisions which grant administrative-expense-priority, super-administrative-expense-priority, equal lien or super-lien to post-petition financiers. According to Chinese security law, i.e. the law on the various kinds of security being used to ensure the payment of debts, generally, the priority order among the different lien holders on the same collateral should be determined by the time that the lien contract came into effect. The earlier the lien contract came into effect, the higher priority the lien holder enjoys. While it is possible for the DIP or administrator to provide a post-petition lender with a lien on unencumbered assets, or a junior lien on encumbered assets, it is not possible to provide a post-petition lender with administrative-expense-priority, super-administrative-expense-priority, equal-lien or super-lien (a lien equal to or superior to pre-petition lien on the same collateral), since the EBL does not provide these special kinds of priority. Therefore, an EBL post-petition lender can not get an equal-lien or super-lien on encumbered assets unless the pre-petition lien holder voluntarily abandons his priority right and agrees to give the post-petition lenders special benefits.

608 The EBL, Art. 75.
610 Detailed provisions are as follows. According to Art. 42 and 54 of Guaranty Law of China, mortgage contracts in which the collateral is land-use right, buildings, forest, airplane, vessel, vehicle, or the facilities and/or inventory of a company("special collateral"), may take effect only after the mortgage contract is officially registered. The priority of mortgage holders that hold a mortgage right on a special collateral should be determined according to the time of registration. Mortgage contracts in which the collateral is not a special collateral, may take effective on the date when the contract is formed or signed, and the priority among mortgage holders based on this kind of contracts should be determined according to the date on which the mortgage contract becomes effective. However, the contractual parties of a mortgage contract that takes effect upon the parties’ signing may choose to register their contract. Under this circumstance, the holder of registered mortgage should be paid before a mortgagee who did not register his mortgage contract.
5.2.2 The Efficient and inefficient elements of the Chinese Post-petition Financing System

Compared with its US counterpart, the EBL’s provision on post-petition financing has both efficient and inefficient elements. The Chinese post-petition financing system is efficient in that it does not modify the existing lien holders’ pre-bankruptcy bargained-for rights and will not cause inefficient post-petition financing that relies on the cushion created by previous investment instead of debtor’s improved operation for repayment. The inefficient elements of the Chinese post-petition financing system mainly lie in that it does not provide special priority to post-petition financing and thus provides no special help to the debtor in obtaining post-petition financing and can not foster the debtor’s rehabilitation as powerfully as its US counterpart. 611

5.2.3 Reform suggestions for the Chinese Post-Petition Financing System

How to achieve a good balance between the protection of the old investors and the attraction of new finance for a financially distressed is a quite difficult problem. A tentative suggestion is proposed here with the aim of attracting better ideas. The tentative suggestion is that the EBL may add a provision, which provides that the DIP or the administrator may, after getting the court’s permission, provide new financing administrative-expense priority (priority equal to the administrative expense); or super-administrative-expense priority (priority superior to the administrative expense); or an equal lien (a lien equal to pre-petition lien on the same collateral). Where administrative-expense priority or super-administrative-expense priority is provided to the post-petition financier, the DIP or the administrator should provide to the court and interested parties a valuation report proving that the post-petition financing project is essential to the debtor’s rehabilitation and will enhance the debtor’s overall value and that the debtor’s pre-petition unsecured creditors and shareholders will receive from the debtor no less than what they would receive under hypothetical liquidation;612 Where specific security

611 Hon. Samuel L. Bufford (2007), The New Chinese Bankruptcy Law Text and Limited Comparative Analysis, 16 J. Bank. L. & Prac. 5 Art. 3 (“Unlike U.S. bankruptcy law, there is nothing in the EBL to authorize financing that primes existing secured creditors. This is an important omission because it is very difficult to find DIP financing unless the lender can obtain priority over existing secured creditors.”)
612 This is to ensure that the post-petition lender receives payment from the improved operation and the enhanced profit instead of from the old investment made by the unsecured creditors and shareholders and that the interest of the classes junior to the post-petition lender is not damaged by the post-petition
is provided to the post-petition financier, the DIP or the administrator should provide to the
court and the interested parties a valuation report proving that the post-petition financing
project is essential to the debtor’s rehabilitation and will enhance the debtor’s overall value;
that the collateral’s value is sufficient enough for securing the repayment to pre- and
post-petition secured creditors’ principal and interest. The reasons for the reform suggestions
are discussed below.

First, the proposed system, by providing special protection to post-petition lenders, helps the
debtor attract new finance. In the context of bankruptcy reorganization, granting special
protection to the new lenders is necessary, since corporations in a reorganization procedure
are often insolvent and in dire need of new financing and may not be in a position to obtain
additional loans unless they can ensure that the new finance will not flow directly into
existing creditors’ hands. The importance of post-petition financing to the debtor’s
rehabilitation is commonly recognized and providing post-petition financing with special
priority is a part of global consensus on bankruptcy law reform.613

Second, the proposed system tries to achieve a delicate balance between the attraction of
efficient post-petition finance and protection of pre-petition claimholders’ interests. Some
scholars commented that providing new finance to a debtor in reorganization is similar to
salvaging a vessel in distress. An analogy may be drawn between post-petition financiers and
the “salvors” under admiralty law. The Admiralty law generally grants priority to salvors’
claims over existing mortgages, based on the reason that there would have been no vessel for
creditors to seize if the salvors had not invested in a rescue operation.614 However, it should
be noted that there is a difference between bankruptcy reorganization and vessel salvage. In

financing arrangement.

613 UNCITRAL Legislative Guide on Insolvency Law (2004) states that, “[t]he insolvency law should
establish the priority that may be accorded to post-commencement finance, ensuring at least the payment
of the post-commencement finance provider ahead of ordinary unsecured creditors, including those
unsecured creditors with administrative priority.” Available at:
Guidelines for Effective Insolvency & Creditor Rights System (Apr. 2001) recommends in principle 18
that “[t]he law should provide for a commercially sound form of priority funding for the ongoing and
urgent business needs of a debtor during the rescue process, subject to appropriate safeguards.” available
at:
http://siteresources.worldbank.org/GILD/PrinciplesAndGuidelines/20162797/Principles%20and%20G

2118-20. 2118-21.Omer Tene (2003), Revisiting the Creditors’ Bargain: The Entitlement to the
the context of vessel salvage, because without the salvor’s help, the collateral for post-petition mortgagees, i.e. the vessel, would disappear, it is reasonable to grant super-security to the salvors. In the context of reorganization, without new finance, the debtor can not realize its going-concern surplus, but the collateral and the debtor’s liquidation value, unlike the distressed vessel, will not disappear. Thus, in the reorganization context, while providing protection to the post-petition lenders, there is a need to protect the value that the pre-petition lenders would realize under liquidation. The requirement of the valuation report and the cancellation of the super-lien serve this purpose. Only when the new financing transaction enhances the debtor’s overall value and does not encroach upon the pre-petition investors’ money, will it be accepted.

With respect to the protection of the pre-petition secured creditors, the US post-petition financing system is problematic. The US system allows the new lenders to leap over old lenders under the condition that existing secured creditors are adequately protected. It implies that if the collateral has sufficient value to pay both the old and the new lenders, the law does not damage the old lenders’ interest even if the law ranks the old lenders below the new ones. However, if there is really adequate protection of the old lenders’ interest, there is no need to put the old lenders below the new lenders. The new lenders’ objection to being ranked below the old lenders proves that there is actually no adequate protection of the old lenders. Because it is difficult for the court to make an accurate valuation of the collateral, providing new lenders super-lien creates room for inefficient post-petition finance whose lenders rely on the contribution of the pre-petition investors to receive repayment. Since the rationale for providing a lien on an encumbered property to new lenders is that the value of the collateral is sufficient enough for paying both the old and the new loan, the reform suggestion, which provides the new lender with an equal lien, reduces the room of inefficient post-petition financing without materially lowering down the protection of post-petition lenders’ interest. The fact that the new financer agrees to the equal lien is a signal that there is sufficient value to pay the old financiers since they rank at the same level.

According to the creditor’s bargaining theory, pre-bankruptcy entitlements should be fully respected and damaging pre-bankruptcy entitlements without compensation generates
bankruptcy forum shopping and inefficient strategic behavior.\textsuperscript{615} Bankruptcy law, while fostering the collective reorganization efforts, should respect pre-bankruptcy entitlements of the interested parties in order to avoid the inefficient results. By refusing to provide post-petition lenders a super-lien and requiring the valuation report obligation on the business decision-maker, the reform suggestion tries to achieve a delicate balance between the attraction of efficient post-petition finance and the protection of pre-petition claimholders’ interests.

6 Overall Comparison of US and Chinese bankruptcy reorganization law and practice, Conclusion

6.1 Overview of the US and Chinese bankruptcy reorganization Law

From the perspective of the reorganization decision-making mechanism, Chapter 2, 3 and 4 of this book analyze and compare the efficiency of the three major components of US and Chinese bankruptcy reorganization law, these being the plan-drafting system, plan-passing system and the reorganization-fostering system. The similarities and differences between US and Chinese bankruptcy reorganization law may be summarized as below.

In respect of the plan-drafting system, the two laws share the same feature in that they allow the qualified debtor to be a DIP and provide the DIP with an exclusivity period for proposing a plan. The DIP system combined with the exclusivity period reflects that both laws intend to establish a debtor-controlled decision-making mechanism in the plan-drafting process. Both laws have adopted measures for strengthening the non-debtor parties’ participation in the decision-making process and for restraining the DIP, such as the committee device, the judicial supervision over the length of the exclusivity period and the trustee device. The plan-drafting system of US and Chinese bankruptcy reorganization law differ in relation to the following aspects: a US debtor becomes a DIP by default, while a Chinese debtor must file an application to the court and get the court’s permission before becoming a DIP; under US law, a trustee is appointed to replace the debtor’s management only when the debtor’s management is too incompetent to be the controller and should be removed from possession, while under Chinese law, an administrator is always appointed for every case and the DIP’s business management is under the supervision of the administrator; under US law, the trustee is just a bankruptcy professional who replaces the incompetent debtor’s management, while under Chinese law, besides bankruptcy professionals, liquidation panels may be the administrator and government officials can influence or control the decision-making of specific reorganization cases through being members of the liquidation panel; US law allows

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616 Brian A. Blum (2006), Bankruptcy and Debtor/Creditor: Examples and Explanations, Aspen Publishers, 4th Ed. , p. 110 (noting that the qualifications of a trustee include “honesty, impartiality, professional qualifications (such as a law degree or a CPA), and requirements of general competence and experience” according to the relative US laws).
plan-competition in cases where the debtor is replaced by a trustee, or where the DIP fails to propose a plan, or the plan proposed by the DIP fails to gain consensual acceptance within the exclusivity period, while under Chinese law, the non-debtor interested parties can never get the chance of proposing a plan and it is the business controller (DIP or the administrator) that has the right to propose a plan.617

The US and Chinese plan-passing systems are similar in that both systems require a draft plan to go through two steps, i.e. classified voting and judicial confirmation, before becoming effective. Both systems adopt the supermajority rule for class voting and both systems provide that the court may cram down a non-consensual plan if the plan meets with the cram-down requirements. The differences between the US and Chinese plan-passing system are quite prominent.

The US law provides the plan proponent the right to mold classification. The US law, on the one hand, requires that the claims being put into one class should be substantially similar, on the other hand, it does not mandate that claims that are substantially similar should be put into one class. The Chinese law adopts a rigid classification method by putting all the claims into five classes, these being secured claims, employee claims, tax claims, general unsecured claims and shareholders’ claims. Under US law, all classes have the right to vote while unimpaired classes are deemed to accept the plan and classes receiving nothing are deemed to reject the plan. Under Chinese law, creditors always have the voting right and shareholders can vote only when the plan involves an adjustment of the shareholders’ interest. Compared with the US plan-confirmation requirements, the Chinese plan-confirmation requirements are too general and loose. With respect to a consensual plan, Chinese law just requires the court to check whether it is in conformity with the law and does not state any detailed tests. By contrast, US law contains detailed general confirmation standards, such as the best-interest test and the feasibility test etc. for the confirmation of both consensual and non-consensual plans. With respect to the cram down of non-consensual plans, the EBL contains certain requirements that are too loose compared with the US cram down requirements. The most prominent defect of the Chinese cram-down requirements is the lack of complete provision on the absolute priority rule. On the whole, compared with the US plan-passing system, the

617 Please refer to Chapter 3 for a detailed comparison and analysis.
Chinese plan-passing system is problematic in the respect of classification, shareholders’ voting right, the general confirmation requirements and the cram-down requirements, which may cause inefficient elements.\textsuperscript{618}

In order to foster the collective reorganization efforts, both US and Chinese bankruptcy reorganization law contain reorganization-fostering systems, the most prominent being provisions on the automatic stay and post-petition financing. While the protection of creditors’ interest under the US automatic stay system is recognized as being inadequate, the protection of creditors’ interest under the Chinese automatic stay system is even weaker. Under Chapter 11, although time-value compensation to secured creditors as a general principal is rejected, over-secured creditors may receive post-petition interest for the delay under the automatic stay and the total amount of the compensation is limited to the value of the collateral in excess of the secured claim. The EBL fails to provide time-value compensation to secured creditors for the delay caused by the automatic stay. With respect to the protection of secured creditors’ interest, the EBL only contains one provision, which says that a secured creditor may apply for a relief from the stay if there is a risk of a decline in the collateral’s value that is big enough to affect the secured creditors’ interest. However, it is unclear what risk constitutes the eligible risk for a relief. For instance, if the value of the collateral exceeds the amount of the secured claim, i.e. there is an equity cushion in the collateral, then does the risk of a decline in the value of the cushion but not in the part of the collateral’s value equal to the principal amount of the secured claim constitute a valid basis for relief from the stay? Compared with US law, the EBL fails to provide that a secured creditor may apply for relief from the automatic stay where the collateral is not necessary for an effective rehabilitation and the debtor has no equity in the collateral. While US law offers the debtor the opportunity of providing “adequate protection” in exchange for keeping the collateral under the automatic stay, Chinese law does not contain such a rehabilitation-fostering element.

The US post-petition financing system helps the debtor in attracting post-petition financing by providing special priority to the post-petition lenders. By contrast, the Chinese post-petition financing system does not offer the debtor so much special help in acquiring new finance.

\textsuperscript{618} Please refer to Chapter 4 for a detailed comparison and analysis.
since it does not provide the post-petition lenders with special priority. Compared with US law, Chinese law is less powerful in helping the debtor to attract new finance. However, Chinese law keeps the pre-bankruptcy creditors’ interest from being materially influenced by post-petition financing and limits inefficient post-petition financing.  

6.2 Overview of the US and Chinese Bankruptcy Reorganization Practice

6.2.1 The Control Model in US and Chinese Bankruptcy Reorganization Practice

6.2.1.1 The Control Model in US Bankruptcy Reorganization Practice

US bankruptcy reorganization practice is generally divided into two phases: the debtor-controlled phase and the DIP-lender-controlled phase. In the 1980s and early 1990s the debtor quickly seized upon the super protection offered by Chapter 11. The number of reorganization cases increased dramatically. During the reorganization case, the debtor could stiff-arm creditors, drag out the cases for inordinate periods of time until they forced out settlement from creditors. The practice of Chapter 11 in the early stage of its application is commonly summarized being a long, costly procedure. From late the 1990s, the practice of Chapter 11 has changed dramatically and Chapter 11 has entered into a new era of secured creditors’ control, to be more exact, DIP lenders’ control. DIP lenders’ control stems from the special US DIP financing system, which provides the post-petition financiers with super protection and induces an active DIP financing market.

The development process of the DIP lenders’ control may be summarized as below. During the bitter period of being oppressed by the debtor at the early stage of Chapter 11’s application, secured creditors quickly “found the holes and handles in chapter 11 and have

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619 Please refer to Chapter 5 for a detailed comparison and analysis.
used them to their advantage." The most prominent handles have been found in DIP financing and § 363 sale. Since Chapter 11 has made the debtor’s managers the controller of the decision-making, Secured creditors created their own way of control—achieving control of the reorganization decision-making by controlling the debtor’s managers. A debtor in financial distress is often in dire need of new capital. DIP lenders, while providing new finance to the debtor, restrain the decision-making actions of the debtor’s management by the oppressive provisions of DIP financing contracts. The DIP lenders’ control over the reorganization often results in using the Chapter 11 as a procedure for selling all or virtually all of the debtor’s business before the confirmation of a plan under § 363 of Chapter 11.

In contrast to the universal critics of Chapter 11 in the era of debtor control, in the era of DIP lender control, Chapter 11 has been praised. It is commented that because of the DIP lenders’ control, Chapter 11 reorganization is no longer the long, expensive process that depletes the debtor’s value, but is a swift, market-driven process that quickly moves the assets of troubled firms into more capable hands. Some scholars worried that the DIP lenders, while pursuing their self-interest, may influence the debtor to deviate away from the direction of maximizing its overall value.

To summarize, the US law established a debtor-controlled decision-making model. In the

625 See Section 5.2.1.3 for the discussion of the control of DIP lenders.
early stage of the practice of Chapter 11, the debtor did control the decision-making. However, from the late 1990s, creditors have learned to achieve control through becoming the DIP lenders and controlling the DIP by oppressive DIP financial contractual terms. The US practice reveals that although bankruptcy law may provide controlling leverage to a certain party, the market parties’ natural bargaining leverage, such as their possession of the cash that is necessary to the debtor’s rescue, plays a significant role in the decision-making of bankruptcy reorganization. Bankruptcy reorganization law may respond to the practice and provide restraining measures that prevents the capable market parties, such as the DIP lenders, from using its bargaining leverage in a way that is not in line with the maximization of the debtor’s overall value.

6.2.1.2 The Control Model in the Chinese Bankruptcy Reorganization Practice

While the current US bankruptcy reorganization law has been operating for more than thirty years and has shown two different stages in its practice, Chinese bankruptcy reorganization based on a market economy is still at an early stage since the current Chinese bankruptcy law has been operating for less than four years.630 With respect to the control model of bankruptcy reorganization, Chinese bankruptcy reorganization law adopts the debtor-controlled model as the main model.631 Although the legislators intended to adopt a debtor-controlled model, in practice, the government’s control is quite significant in the reorganization of listed corporations. Recall that the SPCS provides that in some cases, the court may appoint a liquidation panel, which is mainly constituted by government officials. 632 By allowing the court to appoint a liquidation panel as the bankruptcy administrator for a reorganization case, Chinese law provides a legal way for the government to exert control in special bankruptcy cases.

While it is understandable that certain qualified bankruptcy professionals, such as lawyers and accountants, maybe be legally allowed to serve as bankruptcy trustee, it is very special that Chinese law allows the liquidation panel to be the bankruptcy trustee. The discussions at a

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630 The EBL had been operating for less than four years by the time the author wrote this Chapter (February, 2011), since it came into effect on June 1, 2007
631 See Section 3.2.2.1.
632 Article 18 of the SPCS. See part (2) of Section 3.2.1.1 for a detailed discussion of the appointment of the liquidation panel as the administrator.
seminar, which was held by the Supreme People’s Court, and the Listed Corporation Supervision Department and Law Department of the China Securities Regulatory Commission in October 2007, provides a valuable indication of the reason why the liquidation panel was provided as a special kind of administrator. At the seminar, the dominant opinion was that keeping the liquidation panel as a kind of administrator was a pragmatic solution based on the practical situation of China. There were three main reasons for allowing the government to participate as the administrator.

First, since most of the listed corporations in China are SOEs with the state as the controlling shareholder, the bankruptcy reorganization of SOEs involves special problems, such as how to deal with the state-owned assets, how to solve the problems accompanying a great amount of jobless workers etc., which can not be solved without the participation of the government.

Second, bankruptcy reorganization often involves a reduction of creditors’ claims. The cancellation of the state-owned bank’s credit should be approved by the risk management department of the bank’s headquarter. Only certain government agencies or officials may have the capacity and influencing power to negotiate with the risk management departments of the state-owned banks. Without the government’s participation, it is difficult to reach a compromise with the state-owned bank concerning the reduction of the debt.

Third, bankruptcy reorganization often needs new finance. In order to attract a new financier, the local governments often provide some preferential treatments in relation to tax or land-use rights etc. The preferential treatment needs government’s approval and thus justifies the government’s participation.

When one takes the rule of law as a given, the reasons mentioned above, such as the treatment of the state-owned shareholders’ interest, the settlement of workers, the reduction of

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state-owned bank creditors’ claims, preferential treatment of the new investors, may all be solved according to the relevant legal rules instead of by the government’s special help. However, China is still in a transitional period, during which China needs to transfer its old political management system to the rule of law and change its planned economy to the market economy. The rule of law and a developed market based on the rule of law has not yet been established in China. In this transitional period, the market parties involved in bankruptcy reorganization can not solve some problems without the government’s help and thus there arises the need for the government’s participation. The opinion the Supreme People’s Court—the legislator of the SPCS, reveals the legislative rationale of the provisions on the liquidation panel: Chinese bankruptcy reorganization law has to allow the government to participate or even take control in some special bankruptcy reorganization cases if in these cases many important problems can not be solved simply according to the law and can only be solved by negotiation between different governments or with the approval of a specific government agency.

In addition to the legal provisions on the liquidation panel, the lack of judicial independence contributes to the government’s control. China is still its way towards the complete establishment of the rule of law. In China, the judicial power is not completely independent of the administrative power. Against this background, although item (iv) of

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635 In March 1999, Article 5 of the Constitution of the People’s Republic of China was amended to include the principle of “governing the country according to law and establishing a socialist, rule of law country”. However, it takes time to achieve the rule of law and China is still on the march to the rule of law. See e.g., Randall O. Peerenboom, China’s Long March Toward Rule of Law (2002); Yingyi Qian & Jinglian Wu, China’s Transition to a Market Economy: How Far across the River?, available at http://cenet6.nsd.edu.cn/userfiles/2009-9-16/20090916234149833.pdf, accessed on October 1, 2010.

636 “The market is not fully developed in the transition period. The less developed market provides justification for government interference. The implementation of the [bankruptcy] Law lacks an open and transparent market. The backward market provides very narrow room for the market intermediaries and professional practitioners to participate in bankruptcy cases. Since many problems to be solved in bankruptcy cases are not simply market issues, to transfer the control of the cases to those market intermediaries and professionals might instead aggravate the difficulty and costs of the case.” Shuguang Li and Zuofa Wang (2010), China’s Bankruptcy Law after Three Years: The Gaps Between Legislation Expectancy and Practice and the Future Road (Part Two), 7 Intl Corp Rescue 371, p. 379.

Article 18 of the SPCS provides that the court may designate the liquidation panel as the administration where the court deems proper. One may suspect that whether it is proper to involve the government in the reorganization of a specific corporation is not independently judged by the court. The fact that a liquidation panel is designated by the court as the administrator serves as an indication that the government wants to control the decision-making in a particular case.

To conclude, the legal provisions that allow a liquidation panel to be the administrator, combined with the government’s influence over the judicial power, provides a government-controlled model that is used in cases where the government wants to ensure a certain result.

In practice, the liquidation panel has been commonly designated as the administrator in the reorganization of listed corporations. The author found that 18 listed corporations entered into the bankruptcy reorganization procedure and came out with a confirmed plan during the twenty four months after the effective date of the EBL.638 In 17 cases, the administrator was a liquidation panel.639 Moreover, it is worth noting that in cases where a liquidation panel was appointed as the administrator, it was the administrator, i.e. the liquidation panel, rather than the DIP that controls both the business management and plan formulation.640 As discussed above, the appointment of a liquidation panel as the administrator may be taken as a sign that the government wants to control the process to ensure a certain result in a reorganization case. Some bankruptcy experts commented that the government has been dominant in the reorganization of listed corporations.641

Since the court does not publish the details of tried cases, authentic documents revealing the role of the liquidation panel and the government can not be found. The stories reflected by the public media and some scholar’s articles about the reorganization of Jiufa Edible Fungi Co.,

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638 Since China does not have legal provisions that require mandatory public disclosure of the tried cases, the author collected information concerning the reorganization cases of listed corporations from the public notice on the website of the Shanghai Stock Exchange and the Shenzhen Stock Exchange in order to get a clear view of the practice of the EBL. The author cannot guarantee that the list is exhaustive.

639 See Appendix A.

640 See Appendix A.

Ltd. (“Jiufa”) and East Star Airline Co. Ltd. (“ESA”) shed some light on the government’s controlling role in a bankruptcy reorganization. Newspaper and internet articles reveal that the local government regarded Jiufa as an important listed corporation. The local government contacted potential new financers, and sent the court a paper named “Letter on the Feasibility of Bankruptcy Reorganization of Jiufa Corp. Ltd.” (“the feasibility letter”), which stated: because no listed corporations located in Shandong province had been delisted, the bankruptcy and delisting of Jiufa would damage the financial image and overall image of the province and the local government and the government was determined to rehabilitate Jiufa. According to the story in the public media, government had chosen the reorganizer of Jiufa before the reorganization case was initiated and the public auction of the shares of the controlling shareholder was organized in such a way that the government ensured that certain investors would win the auction and become the new controlling shareholder and reorganizers of the debtor.

While the story of Jiufa tells how the government could foster the rehabilitation of a specific corporation, the story of East Star Airline Limited Corporation (“ESA”) indicates how the government could obstruct the rehabilitation of a corporation. ESA, a privately owned airline, was once highly profitable but became financially distressed in 2008. After ESA entered the liquidation procedure upon the application of one creditor, Wuhan Intermediary People’s

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642 The author wants to emphasize that the information in the story of Jiufa and ESA discussed in the following three paragraphs, as shown in the footnote, is mainly from newspapers and websites, which is not as authentic as the material officially published by the authentic institutes, such as the court, the Securities Exchange, or the relevant government department. The author has endeavored to collect information from the comparatively influential and large newspapers and websites in China. In China the law dictates that the public media, i.e. newspapers and websites, and the authors of the articles published by the public media must provide true information; they have to take legal responsibility for any false reports, which helps to ensure the reliability of the information revealed by these public media.

643 This is supported by newspaper articles. For example, Shandong Jiufa Bankruptcy Reorganization, available at [http://www.qdtzw.com/VisitContent.asp?ID=10424](http://www.qdtzw.com/VisitContent.asp?ID=10424), accessed on September 28, 2010. This supports the information article. There are no further details available. In general practice, the bid deposit is 10% to 20% of the expected market price of the object under auction. In Jiufa, the bid deposit was RMB 100 million (information from the website article). The final price in the auction was about RMB 15,918,980.50 (revealed in the public notice No.2008-072 of Jiufa at the website of Shanghai Securities Exchange), which means that the bid deposit was higher than 6 times of the auction price. Shandong Jiufa, Seller Being “Secretly Determined”, available at [http://www.qdtzw.com/VisitContent.asp?ID=10424](http://www.qdtzw.com/VisitContent.asp?ID=10424), accessed on September 28, 2010; and the public notice made by Jiufa, available at [http://static.ssc.com.cn/sseportal/cs/zhs/scfw/gg/ssgs/2008-11-17/600180_20081117_1.pdf](http://static.ssc.com.cn/sseportal/cs/zhs/scfw/gg/ssgs/2008-11-17/600180_20081117_1.pdf), accessed on September 28, 2010.
Court accepted the bankruptcy case and designated a liquidation panel as the administrator.645 The ESA’s controlling shareholder and some of the ESA’s creditors, one after another, applied the case to be converted from a liquidation procedure into a reorganization procedure. The applicants presented several draft reorganization plans to the court in order to support their reorganization petition and to prove the viability of ESA.646 The trial court denied all the reorganization petitions on the basis that the debtor lacked viability and the draft plans were not feasible.647 The newspaper articles reflected that at the court hearing on whether to convert the case to a reorganization procedure, the administrator insisted that the debtor lacked viability and the draft plans were not feasible648 and that the government’s favor of the big state-owned enterprise, i.e. Air China Ltd., was one of the factors that led to the death of the ESA.649

A Chinese scholar commented that the court did not apply the law properly since the EBL requires procedural instead of substantive examination for the initiation of a reorganization procedure.650 In the author’s opinion, the court in the case of the ESA acted contrary to Chinese bankruptcy law in requiring the shareholders and creditors to provide a feasible reorganization plan at the time of the reorganization petition as described by the public media, since feasibility is provided in Article 87 of the EBL as a standard against which the court

645 索佩敏（Peimin Suo），《破产管理人铁心清算东星 中航油坚持重整》（Bankruptcy Administrator Determined to Liquidate the East Star, CNAF Insisting on Reorganization），上海证券报（Shanghai Securities News），2009年7月13日（July 13, 2009），available at http://paper.cnstock.com/html/2009-06/25/content_71017852.htm，accessed on September 6, 2010. CNAF is the abbreviated name of China National Aviation Fuel Group Corp. Ltd. and was said to be the biggest creditor of the ESA.

646 叶晓红(Xiaohong Ye),《重整申请的困惑——屡败屡战的东星航空重整申请之路》(“Confusions concerning the Bankruptcy Reorganization Application—the East Star Airline’s repeated fight for Rehabilitation Opportunity after repeated defeat”), 公司法评论(Company Law Review), 第10卷(Vol. 10), 418-25.

647 Id, at 418-25.

648 索佩敏（Peimin Suo），《破产管理人铁心清算东星 中航油坚持重整》（Bankruptcy Administrator Determined to Liquidate the East Star, CNAF Insisting on Reorganization），上海证券报（Shanghai Securities News），2009年7月13日（July 13, 2009），available at http://paper.cnstock.com/html/2009-06/25/content_71017852.htm，accessed on September 6, 2010. CNAF is the abbreviated name of China National Aviation Fuel Group Corp. Ltd. and was said to be the biggest creditor of the ESA.

649 毕舸（Bi Ke），从东星航空破产看“国进民退”（Discerning the Advance of the State and the Retreat of the Private from the Liquidation of the ESA），上海证券报（Shanghai Securities News), 2009年8月28日第6版（August 28 of 2009, Page 6）.

650 叶晓红(Xiaohong Ye),《重整申请的困惑——屡败屡战的东星航空重整申请之路》(“Confusions concerning the Bankruptcy Reorganization Application—the East Star Airline’s repeated fight for Rehabilitation Opportunity after repeated defeat”), 公司法评论(Company Law Review), 第10卷(Vol. 10), 418-425.
should examine the plans to be crammed down.\textsuperscript{651}

It should be noted that the government is not the controlling party of every bankruptcy reorganization case. In cases where the government has no interest in controlling the decision-making process, the administrators were not liquidation panels, but professionals, such as accounting firms and/or law firms. Nevertheless, even if the administrator is not a liquidation panel, the government might still provide support for the rehabilitation. For instance, in the reorganization of five solely foreign-owned enterprises in the city of Changshu, all subsidiaries of one foreign corporation, the administrator was Jiangsu Zhuhui Law Firm and was the controller since the administrator controls both the business management and plan-drafting.\textsuperscript{652}

To summarize, the EBL provides a debtor-controlled model. In addition, the SPCS, by allowing the liquidation panel to be the bankruptcy administrator, opens the way for government control. In practice, based on the fact that the judicial power is still not separated from the administrative power, the government may become the controller in cases where the government intends to achieve a certain result, especially in the reorganization case of big listed corporations. In the author’s opinion, the adoption of a liquidation panel as a kind of bankruptcy administrator in Chinese bankruptcy legislation and the government’s control of

\textsuperscript{651} The EBL contains three articles concerning the initiation of a reorganization procedure. Article 3 provides that the debtor may apply to the court for reorganization when there is obvious probability of losing payment ability. Article 70 provides that where the creditors apply for the liquidation of the debtor, shareholders holding more than 10\% of the registered capital of the debtor may file an application for reorganization after the court accepts the case and prior to the court’s declaration of the insolvency. Article 71 provides that the court, if after examination, deems that the application is in conformity with the law, shall rule to reorganize the debtor. To summarize, the EBL does not provide any substantial conditions that a case shall satisfy for the purpose of entering into reorganization. In the author’s opinion, the examination made by the court should be mainly a procedural one, as it is almost impossible for the judge, who is not well equipped with business knowledge and expertise, to do the essential business judgment on the viability of the debtor in a short time. This should be further clarified by supplementing legislations in order to make sure that the court does not abuse its discretionary power in permitting the initiation of a reorganization procedure.

\textsuperscript{652} The five enterprises were Changshu Kehong Material Tech Corp. Ltd., Changshu Xingyu Xinxing Construction Material Corp. Ltd., Changshu Xingdao Xinxing Construction Material Tech Corp. Ltd., Changshu Xinghai Xinxing Construction Material Tech Corp. Ltd., Changshu Changgang Bancai Corp. Ltd., generally called as the “科弘系(Kehong Series)”. 丁国锋（Guofeng Ding），《国内最大一起企业破产重整案前幕后》（The Front and the Back of the Big Reorganization Case），法制日报（Legal Daily），2009年9月16日第004版（September 16 of 2009, page 004）. In the reorganization of the foreign-invested enterprise, Jiatong Sci-Tech (Suzhou) Corp. Ltd., the administrator was Jiangsu Wuzhou Law Firm and Anyong Huaming Accounting Firm. 张帅（Shuai Zhang），《从400亿中“重生”》（“Rehabilitation” from the Big Deficit of 400 Million），苏州日报（Suzhou Daily），2009年12月20日第A03版（December 20 of 2009, Page A03）.
some bankruptcy cases in Chinese bankruptcy practice is a phenomenon in the transitional period from the planned economy to the market economy and should phase out with the development of the market economy and the perfection of the rule of law. 653

6.2.2 The Time Length to a Confirmed Plan, Confirmation Rate, Consummation Rate in US and Chinese Reorganization Practice

6.2.2.1 The Time Length to a Confirmed Plan, Confirmation Rate, Consummation Rate in US and Chinese Reorganization Practice

When it first came into effect Chapter 11 was criticized for the length of its procedures. Now procedures under Chapter 11 are considered to be swift procedures compared with the early practice. 654 With respect to Chapter 11’s early practice, Lopucki’s study showed that debtors who got a confirmed plan in the Madison Division of the Western District of Wisconsin in 1987 and 1988 were in Chapter 11 for a median time of 17.5 months, 655 Jesen-Conklin studied all Chapter 11 cases filed in the year from 1980 to 1989 in the U.S. Bankruptcy Court for the Southern District of New York located at Poughkeepsie (“Poughkeepsie Study”) and found that the average time for plan confirmation was about 22.04 months. 656 Warren and Westbrook made a study on the late practice of Chapter 11. They studied the cases filed in 1994 and 2002 and found that the median time used for confirmation of a plan was about 9 months. 657 How long does it take for a Chinese debtor to reach a confirmed plan? Empirical study of the 18 cases showed that on average, the time period used by a Chinese listed corporation to reach a confirmed plan was 105 days. 658 Therefore, compared with the US cases, reorganization procedures under Chinese law are very short.

With respect to the confirmation rate, the US empirical studies showed a low confirmation in

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653 See Shuguang Li and Zuofa Wang (), See Section 3.2.6.4 for the reform suggestion concerning the liquidation panel and government’s participation in bankruptcy.
658 See Appendix D: Time length of the in the bankruptcy reorganization of 18 listed corporations.
the reorganization of all kinds of corporations and a high rate for large, publicly held corporations. According to the FICS (Fee Information and Collection System) database, 26% of the cases filed between 1989 and 1995 ended up with a confirmed plan. Jesen-Conklin found in the Poughkeepsie Study that the confirmation rate was about 17.3%. Warren and Westbrook studied the cases filed in 1994 and 2002 and found the respective confirmation rate was 30.3% and 33.4%. LoPucki and Whitford studied the reorganization cases filed after the effective date of the Current US bankruptcy Code (Oct. 1, 1979) and before March 15, 1988 by publicly held companies reporting at least $100 million in assets at filing and found that the confirmation rate was about 96%. With respect to the consummation rate, Jesen-Conklin’s Poughkeepsie Study showed that about 58% of the confirmed plans were consummated.

What is the confirmation rate and consummate rate in China? The empirical study of the reorganization of 18 listed corporations showed that the confirmation rate was 100%. In China, the debtor is in charge of the implementation of the confirmed plan and the administrator supervises the implementation of the confirmed plan. The administrator should file a report to the court on the supervision of the implementation of the confirmed plan when the supervisory period expires. If a debtor fails to carry out the plan, the court should make a ruling terminating the implementation and convert the case to liquidation procedure.

In practice, when the debtor fulfills the debt-payment obligation contained in the confirmed plan, the administrator files a report to the court to this effect and the court makes a ruling which confirms that the debtor has fulfilled its debt-payment obligations in the

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659 Two percent of the cases remained open as of December 1, 1997.
664 The EBL, Art. 89; 90.
665 The EBL, Art. 91.
666 According to Article 93 of the EBL, if the debtor fails to or does not implement the plan, the court shall, upon the application of the administrator or the interested parties, rule to terminate the implementation and declare the bankruptcy of the debtor. On the study date, i.e. February 15, 2011, 16 plans had been consummated. Baoshuo failed to carry out the plan within the time period stipulated in the plan and its controlling shareholder was taking efforts for achieving a successful implementation of the plan. Pianzhuan was still in the process of implementation.
confirmed plan, that the debtor has no legal obligation to pay the debt reduced by the plan and that the administrator’s supervisory duty is terminated.\textsuperscript{667} Based on the information concerning the court’s ruling on the debtor’s fulfillment of the debt-payment obligations disclosed by the listed corporations, the consummation rate was 100\%.\textsuperscript{668} Therefore, the comparison showed that the confirmation rate and consummation rate in China is high. In addition, the author found that the average time used for plan consummation is 238 days.\textsuperscript{669} It is unfortunate that the author failed to find any empirical study result concerning the time used for consummation of confirmed Chapter 11 plans.

6.2.2.2 Exploring the factors contributing to the prominent features of Chinese reorganization practice

What factors have contributed to the short time period used for reaching a confirmed plan, the high plan-confirmation rate and high plan-consummation rate in Chinese bankruptcy reorganization practice? The author suspects that the possible reasons are EBL’s loose plan confirmation requirements as compared to the US plan confirmation requirements, the most prominent being the loose feasibility test, the lack of the best-interest test and the lack of absolute priority rule. A detailed analysis is below.

(1) Exploring the factors contributing to the short time period used for reaching a confirmed plan and the high plan-confirmation rate in Chinese reorganization practice

As discussed in Chapter 4, the EBL does not require a consensual plan to be checked against the standards of the feasibility test and the Chinese courts have adopted very loose standards when applying the feasibility test in the cram down stage. Thus, in a Chinese reorganization case, a plan, whose operation scheme fails to meet with the US feasibility test, can be confirmed by the Chinese court. The empirical study of the 18 cases showed that none of the 18 confirmed plans contained an operation scheme that met with the US feasibility test.\textsuperscript{670} Moreover, the EBL’s loose confirmation requirements lead to the result that a Chinese plan may be confirmed without some valuations that are a necessary in relation to a US confirmed

\textsuperscript{667} See the public notices disclosing the court’s ruling of the termination of the implementation of the confirmed plan in Appendix D.
\textsuperscript{668} See Appendix D.
\textsuperscript{669} See Appendix D.
\textsuperscript{670} See Section 4.2.2.3 and Appendix C.
plan. The EBL differs from Chapter 11 in that it does not adopt the best-interest-test as a general confirmation requirement, nor does it contain the absolute priority rule as a cram-down requirement. These differences lead to the result that a Chinese plan can be confirmed without providing a convincing valuation of the debtor’s liquidation value, reorganization value, the distribution to the objecting claimholder of an assenting class, and the distribution to an objecting class and some relevant classes, which a US confirmed plan in a similar case must provide. In the US, even if a plan has gained consensual acceptance of the voting classes, if it is objected to by any claimholder of an assenting class, the plan needs to include a calculation of the debtor’s liquidation value, reorganization value and the value of the distribution to the objecting claimholder under liquidation and reorganization in order to prove that it passes the best-interest-test. However, under the EBL, a consensual plan does not need to prove the objecting members of a consenting class receive no less than what they would receive under a hypothetical liquidation since there is no best-interest-test for the confirmation of a consensual plan. In the US, a non-consensual plan must calculate the debtor’s reorganization value and the value of the distribution to the objecting classes and the other relevant classes in order to prove that it passes the fair-and-equitable-test, which contains the absolute priority rule. By contrast, in China, a non-consensual plan does not always need to provide the exact amount of the present value of the reorganized debtor and the distribution to the objecting classes because of the lack of a complete provision on the absolute priority rule. In a Chinese case, if the plan proponent of a non-consensual plan can prove that the dissenting classes of secured claims, and/or tax claims and/or employee claims receive full payment and the dissenting class of general unsecured creditors receive more than what they would receive under liquidation without a calculation of the debtor’s reorganization value, the plan may still be crammed down. For instance, if the payment to the dissenting class of general unsecured creditors under liquidation is expected to be 5%, a plan which provides the dissenting class of unsecured claims with 5% cash payment and shares of the

671 See Section 4.1.2.2 for the valuations required by the best-interest-test; See Section 4.1.2.4 for the valuations involved in cram down.
672 See Section 4.1.2.2 for the valuations required by the best-interest-test in a Chapter 11 case.
673 See Section 4.2.2.3.
674 See Section 4.1.2.4 for the valuations involved in Chapter 11 cram down procedure.
675 See Section 4.2.2.3.
reorganized debtor meets with the cram-down requirement and there is no need to calculate the value of the shares or the debtor’s reorganization value.

The study of the 18 cases shows that although there is no mandatory valuation requirements on a consensual plan, influenced by the cram-down requirements, most plans (13/18) provided a comparison of the payment to the class of general unsecured creditors under the hypothetical liquidation and the plan.\footnote{See the column of “Hypothetical Liquidation Payment Ratio to General Unsecured Creditors” in Appendix B.} However, most plans (12/18) avoided valuation of the reorganized debtor and still achieved the goal of proving that general unsecured creditors receive more than what they would receive under hypothetical liquidation.

It should be noted that even when a Chinese plan touched upon the valuation of the reorganized debtor, the valuation is rough and simple in comparison to the US practice.

Among the 18 plans, 6 plans, i.e. the plans of Jiufa, Huayuan, Qinling, Xiaxin, Shentai and Beisheng, used the debtor’s shares to pay general unsecured creditors and touched upon the pricing of the share of the reorganized debtor in an attempt to estimate the value of the shares distributed to unsecured creditors. For the purpose of calculating the value of the shares of the reorganized debtor, the plan of Jiufa, Huayuan and Qinling used the closing price of the debtor’s share on the day before the trade suspension of the debtor’s shares.\footnote{E.g., the plan of Huayuan and the plan of Qinling used this standard. See Jiufa’s Public Notice NO. 2008-068 and 2009-079; Huayuan’s Public Notice 2008-12-07 and Qinling’s Public Notice No. 2009-053.} The plan of Xiaxin and Shentai used the average of the price of the shares within a certain period that was near the date of the plan-confirmation as the price of the shares of the reorganized debtor.\footnote{E.g. the plan of Xiaxin and the plan of Shentai used the average of the prices of the debtor’s share in the 20 days before the trade suspension of debtor’s share. See Xianxin’s Public Notice No. 2009-044 and Shentai’s Public Notice issued on May, 8, 2010.}

To summarize, 5 of the 6 plans, i.e. the plan of Jiufa, Huayuan, Qinling, Xiaxin, and Shentai, adopted the debtor’s pre-reorganization share price as the price of the reorganized debtor without stating the reason for such a method. It is noticeable that by adopting the price of the debtor’s shares just before the debtor’s reorganization as the price of the reorganized debtor, these five plans neglected the difference between the debtor’s value before and after reorganization. In contrast, the plan of Beisheng, showed a special notice to this difference.
investment in the future and the increase of the shares, the price of each share is determined as RMB 3.0.\footnote{679} Thus the plan of Beisheng failed to discuss in detail how the debtor’s reorganization valuation is calculated and why the valuation is reasonable for the case. In contrast, in US bankruptcy practice, valuation takes place in a more meticulous way. In a US case, at the stage of plan confirmation, the propriety of the valuation is the center of debate since valuation provides the foundation for judging whether the plan passes the best-interest test and complies with the absolute priority rule.\footnote{680} A plan proponent in a US case should at least provide valuation based on one proper method and sometimes provides competing valuations based on several applicable methods in order to provide a convincing valuation.\footnote{681} Thus, compared with a Chinese plan proponent, a US plan proponent needs more time to prepare a proper and convincing valuation. The comparison shows that the interested parties and professionals and judges involved in a Chinese reorganization have not paid proper attention to the importance and science of valuation in the context of bankruptcy reorganization.

To conclude, compared with Chapter 11, the EBL’s confirmation requirements are quite relaxed. This leads to the result that a Chinese plan proponent only needs to prepare a plan containing simple content. It takes much less time to formulate a plan that states a sincere reorganization attempt and provides a simple and rough valuation than to propose a plan which contains a feasible operation scheme, proper valuation of the debtor’s liquidation value, reorganization value and the distribution to the dissenting classes and/or claimholders based on the feasible operation scheme. Moreover, it is more difficult for a plan proponent to get its plan confirmed when the confirmation requirements are stricter. Therefore, the EBL’s loose confirmation requirements fundamentally lead to the short time period between reorganization initiation and high plan confirmation rate.

(2) Exploring the factors contributing to the high plan-consummation rate in Chinese reorganization practice

\footnote{679} See Beisheng’s Public Notice No. 2009-004.
\footnote{681} Id. See also, Stuart C. Gilson, Edith S. Hotchkiss, and Ruback Richard S. (200), Valuation of Bankrupt Firms, 13 Rev. Fin. Stud. 43, p. 45.
Judged against the background of the EBL’s loose confirmation requirements, the content of the Chinese confirmed plans were mainly a rehabilitation wish and a debt-restructuring scheme.\(^{682}\) In the shadow of the EBL’s cram-down requirements, the debt-restructuring model of the Chinese confirmed plans may be summarized as such: full payment to the class of secured claims, tax claims, employment claims; partial payment to the class of unsecured claims; paying a substantial percentage of the shares of the reorganized debtor to old shareholders. The empirical study of the 18 cases showed that the confirmed reorganization plans in China are just plans concerning the payment of reduced debt. In all the 18 cases, why a certain amount of debt (for instance, why 80% instead of 60% of the general unsecured debt should be reduced in a case) should be reduced is never discussed. What is discussed is that creditors will receive something that is higher than what they would receive under a hypothetical liquidation.\(^{683}\) In sharp contrast to this, in a US case, it is mandatory for the confirmed plan to contain a feasible operation scheme and for the plan’s debt-restructuring scheme, based on the debtor’s reorganization value calculated on the basis of the future income from operations, to be a feasible scheme. As discussed in Section 4.2.2.3, because of the lack of a complete provision on the absolute priority rule, unsecured creditors are much more passive in the bargaining procedure and may be forced to accept a low percentage of payment only if it is higher than what they would receive under the hypothetical liquidation. Taking all these factors into account, a possible reason for the high consummation rate of the Chinese plans is that the plan proponent has made the central content of the plan, i.e. the debt-restructuring scheme easier for the debtor to carry out. The loose feasibility test, the lack of a complete provision on the absolute priority rule, the negligence of proper valuation and justification for the reduced amount of the debt combined makes it possible for the confirmed Chinese plans to simply provide a debt-restructuring scheme that the debtor can fulfill and that the debtor can force the creditors to accept or in respect of which the debtor can apply to the court for cram-down.

In addition, it is worthwhile noting that the loose feasibility test, the negligence of accurate valuation of the debtor’s reorganization value, the lack of the best-interest-test and the lack of

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\(^{682}\) See Section 4.2.2.3 and Appendix B and C.

\(^{683}\) See Section 4.2.2.3 and Appendix B.
the absolute priority rule are consistent with each other. When there is not a feasible operation scheme in the plan, it is not possible to make an accurate calculation of the debtor’s reorganization value. The lack of the best-interest-test for consensual plans and the lack of a complete provision on the absolute priority rule provide the legal foundation for the negligence of an accurate calculation of the debtor’s reorganization value. These three factors combined reflect the underlying policy of Chinese reorganization law, which is that the confirmation of a plan is justified if the plan can make the debtor’s shell or business continue and pay creditors what they would receive under a hypothetical liquidation. Chinese law puts the creditors’ interest in a vulnerable position and may induce abuse of the reorganization procedure.  

Chinese practice corresponds to the law very well and has shown that creditors are really under the control of the debtor. In Chinese practice, the reorganization plans are just a debt-payment arrangement since the confirmed plans do not contain a feasible operation scheme and an accurate valuation of the debtor’s reorganization value and the reorganization procedure is just a device with which to legally get rid of a substantial percentage of the unsecured debts with the old shareholders retaining a substantial percentage of the shares of the reorganization debtor. In contrast, the US law emphasizes whether the debtor’s value is enhanced under a feasible operation scheme and whether there is fair and equitable distribution of the enhanced value. When a Chapter 11 plan is crammed down over the objecting general unsecured creditors, the justification for the confirmation is that the crammed down plan contains the most efficient operation scheme which could help the debtor to maximize its value and that the debtor’s reorganization value should be distributed to the claimholders in a fair and equitable way, i.e. be distributed according to the pre-bankruptcy priority order. Based on this logic, in the cram-down stage, the US law adopts plan competition (allows all the interested parties to propose a plan) and the absolute priority rule.

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684 See Section 4.2.2.3..
685 See Section 4.2.2.3 and Appendix C.
686 See Section 6.4.2.
687 See Section 4.2.2.3 and Appendix B.
689 11 U.S.C. 1121(c). Although the limited use of plan-competition in US law is considered insufficient for promoting efficient decision making, it is better than Chinese law which completely excludes plan competition. A detailed discussion of the exclusivity period and plan competition is in Section 3.1.2.2.
rule to check how much the debtor’s reorganization value is based on the feasible operation of the scheme contained in the competing plan, whether the crammed-down plan can realize the highest reorganization value and whether a plan makes a fair and equitable distribution of the reorganization value or distributes the reorganization value in accordance with the absolute priority rule. The comprehensive comparison of the Chinese and US reorganization law and practice shows that the legal regulation over bankruptcy reorganization in China is superficial and immature.

6.3 Conclusion

The US and Chinese bankruptcy reorganization laws are quite similar in relation to the main structures. The Chinese bankruptcy reorganization law is basically a product of transplanting the US law. In the transplantation, the Chinese legislators made certain modifications, such as adding the administrator’s supervision over the DIP, allowing the liquidation panels whose main members are government officials to be administrators and refusing to provide special priority to post-petition lenders. In addition, some valuable parts of the US law are not properly incorporated into the Chinese law. This leads to the problematic elements of the EBL, the most prominent being the inadequate protection of the creditors’ interest under the automatic stay, the unreasonable classification, improper design of the shareholders’ voting right and the loose confirmation requirements. On the whole, the comparison has showed that Chinese law and practice are much less developed than the US counterparts. The prominent manifestation of the immature nature of Chinese reorganization law and practice is the lack of the best-interest test and feasibility test for consensual plans, the lack of a complete provision on the absolute priority rule, the loose feasibility standards, and the negligence of the proper valuation of the debtor’s reorganization value. The study finds that Chinese reorganization law needs to be improved in many aspects and that at the early stage of the reorganization practice, the reorganization procedure is simply a device with which to legally getting rid of

690 11 U.S.C. 1129(b)(2)(B); (C).
691 See e.g., In re Coram Healthcare Corp., 271 B.R. 228 (The Chapter 11 trustee and equity holders’ committee sought to confirm their competing Chapter 11 plans. The court compared the valuations in the competing plans and made a judicial decision over the debtor’s reorganization value and then decided which plan is preferable and should be confirmed.)
unsecured debts. With more and more reorganization cases emerging and ending, the positive and negative sides of bankruptcy reorganization law and practice will be observed and studied. As the Chinese legislators, judges and the bankruptcy professionals accumulate their knowledge and experience, they will further develop Chinese bankruptcy reorganization law into a mature legal system that helps and encourages the interested parties to achieve the maximization of the debtor’s overall value and a fair and equitable distribution of the overall value.
Appendix A: Study on the liquidation panel's role in the Bankruptcy Reorganization of Listed Corporations

<table>
<thead>
<tr>
<th>Full Name of the corporation</th>
<th>Stock code</th>
<th>Stock Exchange</th>
<th>Bankruptcy Administrator</th>
<th>The Business and Reorganization controller (DIP or the Administrator)</th>
<th>The public notice date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hebei Baoshuo Co., Ltd.</td>
<td>600155</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2008-042</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2008-05-24</td>
</tr>
<tr>
<td>Shangdong Jiufa Edible Fungi Co., Ltd.</td>
<td>600180</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2008-068</td>
</tr>
<tr>
<td>Gugangdong Hualong Groups Co., Ltd.</td>
<td>600242</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2008-29</td>
</tr>
<tr>
<td>Shanghai Huayuan Stock Co., Ltd.</td>
<td>600094</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2008-094</td>
</tr>
<tr>
<td>Guangxi Beisheng Yaoye Co., Ltd.</td>
<td>600556</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2009-057</td>
</tr>
<tr>
<td>Beiya Shiye (Group) Co., Ltd.</td>
<td>600705</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2008-017</td>
</tr>
<tr>
<td>Shanxi Qinling Cement (Group) Co., Ltd.</td>
<td>600217</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2009-030</td>
</tr>
<tr>
<td>Xiaxin Electronics Co., Ltd.</td>
<td>600057</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2009-12-16</td>
</tr>
<tr>
<td>Xintai Scientific Technology Co., Ltd.</td>
<td>600728</td>
<td>Shanghai</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2009-031</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2010-029</td>
</tr>
<tr>
<td>Jin Hua Group Chlor-Alkali Co., Ltd.</td>
<td>000818</td>
<td>Shenzhen</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2010-031</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2010-101</td>
</tr>
<tr>
<td>Shenzhen ShenXin TaiFeng Group Co., Ltd.</td>
<td>000034</td>
<td>Shenzhen</td>
<td>Law firm</td>
<td>Administrator</td>
<td>2010-37</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2010-05-08</td>
</tr>
<tr>
<td>Guangming Group Furniture</td>
<td>000587</td>
<td></td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2010-047</td>
</tr>
</tbody>
</table>

1These 18 listed corporations entered into the bankruptcy reorganization proceeding after the effective date of the EBL, i.e. June 1, 2007, and came out with a confirmed plan before August 1, 2010. The data concerning these cases is collected from the public notices made by the listed corporations on the official website of Shanghai Stock Exchange (http://static.sse.com.cn/sseportal/ps/zhs/ggts/ssgsgqyw_full.shtml) and Shenzhen Stock Exchange (http://disclosure.szse.cn/in/search0425.jsp).
2“Stock Code” in this table is show the code of the stock of the corporation used at the Stock Exchange. “Stock Exchange” is to show on which Stock Exchange the corporation is listed.
3This column is to show who is the controlling party of the case. Since Article 80 of the EBL provides that the business controller (the DIP or the administrator) should be the sole plan proponent, under the EBL, the business controller and reorganization controller should be the one party. This column shows that in all the cases where the liquidation panel is appointed as the administrator, it controls the business management and plan formulation. Thus, it can be inferred that the liquidation panel plays a significant controlling role in reorganization practice of listed corporations.
4“The Public Notice” in this table is to show the number or the issuing date (if no number is designed for the public notice) of the public notice that discloses the information in this table.
<table>
<thead>
<tr>
<th>Company Name</th>
<th>Code</th>
<th>Location</th>
<th>Type</th>
<th>Position</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Co., Ltd.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Xianyang Pianzhuan Co., Ltd.</td>
<td>000697</td>
<td>Shenzhen</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2010-015</td>
</tr>
<tr>
<td>Dandong Chemical Fibre Co., Ltd.</td>
<td>000498</td>
<td>Shenzhen</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2009-12-02</td>
</tr>
<tr>
<td>Zhenjiang Haina Sci-tech Co., Ltd.</td>
<td>000925</td>
<td>Shenzhen</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2007-091</td>
</tr>
<tr>
<td>Xingmei United Co., Ltd.</td>
<td>000892</td>
<td>Shenzhen</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2007-11-26</td>
</tr>
<tr>
<td>Chengde Dixian Textile Co., Ltd.</td>
<td>200160</td>
<td>Shenzhen</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2008-66</td>
</tr>
<tr>
<td>Zarva Technology (Group) Co., Ltd.</td>
<td>000688</td>
<td>Shenzhen</td>
<td>Liquidation panel</td>
<td>Administrator</td>
<td>2007-011</td>
</tr>
</tbody>
</table>
Appendix B: Study on the wealth distribution in the bankruptcy reorganization of 18 listed corporations

<table>
<thead>
<tr>
<th>Name of the case</th>
<th>Payment to S (secured creditors)</th>
<th>Payment Ratio to General Unsecured Creditors</th>
<th>Hypothetical Liquidation Payment Ratio to General Unsecured Creditors</th>
<th>Distribution to Shareholders</th>
<th>Did the Plan Get the Acceptance of All Voting Classes?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baoshuo</td>
<td>S: 100%</td>
<td>For each claim, The part ≤ 100,000 RMB: 100%; unknown</td>
<td>The part ≤ 10,000: 90%; 10,001—50,000: 80%;</td>
<td>The part ≤ 10,000: 90%; 10,001—50,000: 80%;</td>
<td>No 2008-042</td>
</tr>
<tr>
<td></td>
<td>E: 100%</td>
<td>The part &gt;100,000 RMB: cash-payment ratio being 13% and some share-payment</td>
<td>50,001—3,000,000: 70%;</td>
<td>50,001—3,000,000: 70%;</td>
<td>2008-044</td>
</tr>
<tr>
<td></td>
<td>T: 100%</td>
<td>Overall payment ratio: unknown</td>
<td>3,000,001—22,000,000: 60%;</td>
<td>3,000,001—22,000,000: 60%;</td>
<td>2008-011</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>The part &gt;22,000,000: 25%, In total: 60.18%.</td>
<td>The part &gt;22,000,000: 25%, In total: 60.18%.</td>
<td></td>
</tr>
<tr>
<td>Jiufa</td>
<td>S: 100%</td>
<td>For each claim, The part ≤ 100,000 RMB: 100%;</td>
<td>3.08%</td>
<td>The controlling shareholder: 29.80%</td>
<td>Yes 2008-079</td>
</tr>
<tr>
<td></td>
<td>E: 100%</td>
<td>The part ≤ 100,000 RMB: 100%;</td>
<td>Other shareholders: 70%</td>
<td>Other shareholders: 70%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>T: 100%</td>
<td>The part &gt; RMB 100,000: 20.43% Overall payment ratio: 15.7%</td>
<td>In total: 60%</td>
<td>In total: 60%</td>
<td></td>
</tr>
</tbody>
</table>

1 “The Public Notice” in this table is to show the number or the issuing date (if no number is designed for the public notice) of the public notice that discloses the information in this table.

2 This means that for a specific part of the total shares held by an old shareholder, a specific percentage was applied in allowing the old shareholder to keep their interest in the reorganized debtor. For the part that is below and equal to 10,000 shares, 90% of these shares were retained by the old shareholder, for the part from 10,001—50,000 shares, 80% of these shares were retained by the old shareholder, for the part from 50,001—3,000,000 shares, 70% of these shares were retained by the old shareholder; for the part from 3,000,001—22,000,000 shares, 60% of these shares were retained by the old shareholder; for the part of shares that were above 22,000,000, 25% of these shares were retained by the old shareholder. In total, 39.82% of the total shares were given up. In total, all the old shareholders held 60.18% of the shares of the reorganized debtor. The data of the following cases should be read in the same way.

3 This means, the controlling shareholder could keep 29.80% of its total shares and the other shareholders could keep 70% of their shares. In total, about 60% percentage of the shares of the reorganized debtor was held by the old shareholders. The data of the following cases should be read in the same way.
| Company | S: 100% | E: 100% | T: 100% | Overall payment ratio: | Unknown | Overall share-payment ratio: | 50% | All shareholders: 100% | Yes 

2008-30 |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hualong</td>
<td>Overall payment ratio: 13%</td>
<td>Unknown</td>
<td>The controlling shareholder: 13%</td>
<td>Yes</td>
<td>2008-094</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Huayuan</td>
<td>Overall payment ratio: 14.42%</td>
<td>0.59%</td>
<td>Other shareholders: 76%</td>
<td>In total: 60%</td>
<td>2009-004</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beisheng</td>
<td>For each claim,</td>
<td>27.43%</td>
<td>All shareholders: 77%</td>
<td>Yes</td>
<td>2008-028</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beiya</td>
<td>Overall payment ratio: 24.1%</td>
<td>7.5%</td>
<td>All shareholders: 100%</td>
<td>Yes</td>
<td>2008-026</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Qinling</td>
<td>Overall cash payment ratio: 20%</td>
<td>10.97%</td>
<td>The controlling shareholder: 57%</td>
<td>Yes</td>
<td>2009-053</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Xianxin</td>
<td>For each claim,</td>
<td>unknown</td>
<td>The controlling shareholder: 0%</td>
<td>Yes</td>
<td>2009-046</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4 The voting result was disclosed in the public notice of Annual Report of 2007, which was issued on April 30, 2008.
<table>
<thead>
<tr>
<th>Company</th>
<th>Type</th>
<th>Percentage</th>
<th>Payment Ratio</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Xintai</td>
<td>S: 100% E: 100% T: 100%</td>
<td>The part ≤ 100,000 RMB: 100%</td>
<td>16.77%</td>
<td>Shareholders holding tradable shares: 94% Yes 2009-044</td>
</tr>
<tr>
<td>Jinhua</td>
<td>S: 100% E: 100% T: 100%</td>
<td>Overall payment ratio: unknown</td>
<td>0%</td>
<td>All shareholders: 70% No 2010-101</td>
</tr>
<tr>
<td>Shentai</td>
<td>S: 100% E: 100% T: 100%</td>
<td>Overall payment ratio: 20.33%</td>
<td>0.46%</td>
<td>Shareholders holding tradable shares: 90% Yes 2010-37</td>
</tr>
<tr>
<td>Guangming</td>
<td>S: 100% E: 100% T: 100%</td>
<td>For each claim, The part ≤ 90,000 RMB: 100%; The part &gt; RMB 90,000: 5%</td>
<td>8.58%</td>
<td>For shareholders holding tradable shares: No 2010-047</td>
</tr>
<tr>
<td>Pianzhuan</td>
<td>S: 100% E: 100% T: 100%</td>
<td>Overall payment ratio: 100%</td>
<td>unknown</td>
<td>The controlling shareholder: 0% Yes 2010-015</td>
</tr>
<tr>
<td>Danhua</td>
<td>S: 100% E: 100% T: 100%</td>
<td>For each claim, The part ≤ 50,000 RMB: 100%; The part &gt; RMB 50,000: 21.30%</td>
<td>0%</td>
<td>The controlling shareholder: 60% Yes 2009-72</td>
</tr>
</tbody>
</table>

Based on the value of the capital accumulation fund, new shares were issued and paid to creditors. In total: 75%
<table>
<thead>
<tr>
<th>Name</th>
<th>S: not exist</th>
<th>Overall payment ratio: 25.35%</th>
<th>14.82%</th>
<th>All shareholders: 100%</th>
<th>Yes</th>
<th>2007-091</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E: not exist</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2007-11-26</td>
</tr>
<tr>
<td></td>
<td>T: not exist</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name</th>
<th>S: 100%</th>
<th>Overall payment ratio: 30%</th>
<th>4.91%</th>
<th>Shareholders holding tradable shares: Yes 100%</th>
<th>Shareholders holding non-tradable shares: 50%</th>
<th>In total: 65%</th>
<th>2008-43</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E: 100%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2008-44</td>
</tr>
<tr>
<td></td>
<td>T: 100%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name</th>
<th>S: 100%</th>
<th>Overall cash-payment ratio: 50%</th>
<th>1.082%</th>
<th>All shareholders: 100%</th>
<th>No</th>
<th>2008-66</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E: 100%</td>
<td>Payment ratio by liquidated assets: unknown</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>T: 100%</td>
<td>Overall payment ratio: unknown</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name</th>
<th>S: 100%</th>
<th>Overall cash-payment ratio: 10%</th>
<th>unknown</th>
<th>All shareholders: 100%</th>
<th>Yes</th>
<th>2007-088</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E: 100%</td>
<td>90% of the total debt being transferred to the buyer of the total assets of the debtor</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>T: 100%</td>
<td>Overall payment ratio: unknown</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

5 The term “not exist” means there were no such claims in the case and thus the payment ratio for this class was not an issue in the case.

6 In the reorganization, a newly established corporation, named “Chongqing Haojiang Trade Co., Ltd.” (“Haojiang”), bought all the assets of Chaohua under the condition that Haojiang would bear all the unpaid debt of Chaohua, i.e. 90% of the total debt. However, Haojiang went bankruptcy soon after the reorganization case was terminated, which led to a failure of payment to the creditors of Chaohua again. See, 王瑛、乔加伟 (Ying Wang & Jiawei Qiao), 《S*ST 萧华破产重整“后遗症”：西昌电力“喊冤”》 (The “Hangover” of the Bankruptcy Reorganization of Chaohua: Xichang Dianli “Claiming Injustice”) 21世纪经济报道 (The Twenty-First Century Economic Report), 2010年1月8日第014版 (Page 014 of January 8, 2010). The reorganizer of Chaohua, i.e. the party who would reorganize Chaohua bought the shares from the old shareholders through normal share trading and there was no adjustment of the shareholders’ right in the reorganization plan. See Annual Report of 2007 of Zarva Technology (Group) Co. Ltd., in the public notice issued on April 25, 2008.
**Appendix C: Statement of the Rehabilitation in the Plan of 18 Listed Corporations**

<table>
<thead>
<tr>
<th>Name of the case</th>
<th>Content of the operation scheme for achieving the rehabilitation</th>
<th>Did the plan touch the reorganization value?</th>
<th>Time length to plan confirmation</th>
<th>The Public Notice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baoshuo</td>
<td>The new financer would provide new cash and assets of good quality in order to enhance Baoshuo’s profitability and receive a certain amount of the shares given up by the old shareholders.²</td>
<td>No</td>
<td>34 days</td>
<td>2008-044</td>
</tr>
<tr>
<td>Jiufa</td>
<td>Jiufa would liquidate the bad assets and try to find the new financer and transfer the shares given up by the old shareholders to the new financer; the new financer would provide profitable assets valued at RMB 0.33 billion to improve the debtor’s operation.³</td>
<td>Yes⁵</td>
<td>73 days</td>
<td>2008-079</td>
</tr>
<tr>
<td>Hualong</td>
<td>The new financer would input profitable assets into the debtor; Hualong’s main business would be changed into real estate business.</td>
<td>No</td>
<td>38 days</td>
<td>2008-30</td>
</tr>
<tr>
<td>Huayuan</td>
<td>Huayuan would dispose the bad assets; try to find the new financer and transfer part of the shares given up the old shareholders to the new financer; the new financer would input profitable assets of a value no less than RMB 1 billion to restore the debtor’s profitability.</td>
<td>Yes⁵</td>
<td>82 days</td>
<td>2008-094</td>
</tr>
</tbody>
</table>

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¹ “The Public Notice” in this table is to show the number or the issuing date (if no number is designed for the public notice) of the public notice that discloses the information in this table.
² On February 5, 2008, the plan was crammed down. On May 23, 2008, Baoshuo issued a public notice (No. 2008-044) on the reorganization scheme, which stated: which corporation would be the new financer and the share percentage held by the new financer; the new financer would provide new fund to Baoshuo; the new financer planned to input the profitable chlorine and alkali chemical industry business into Baoshuo. Thus, it can be inferred that the confirmed plan just contained a reorganization vision and the reorganization scheme was formed after the plan was confirmed.
³ On December 9, 2008, the court confirmed the plan. On December 31, 2008, the debtor signed contract with the new financiers for the purpose of implementing the plan. See public notice No. 2009-013.
⁴ See Chapter VI for the detailed discussion of the valuation.
⁵ See Chapter VI for the detailed discussion of the valuation.
<table>
<thead>
<tr>
<th>Company</th>
<th>Description</th>
<th>Action</th>
<th>Success</th>
<th>Days</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beisheng</td>
<td>Beisheng would dispose the bad assets and try to find the new financier; the new financier would input profitable assets of a value no less than RMB 0.7 billion to restore the debtor’s profitability.</td>
<td>Yes</td>
<td>34</td>
<td>2009-004</td>
<td></td>
</tr>
<tr>
<td>Beiya</td>
<td>The biggest shareholder planned to input profitable railway transport assets (worth no less than RMB 2 billion and with a net assets income ratio at about 10%) into Beiya, and would improve the corporate governance and the management of Beiya.</td>
<td>No</td>
<td>81</td>
<td>2008-028</td>
<td></td>
</tr>
<tr>
<td>Qinling</td>
<td>The reorganizer, i.e. Jidong Cement Corporation Ltd., had promised to do the followings: to provide new fund worth no less than RMB 80 million for keeping the normal operation; to provide new fund of no less than RMB 500 million to build up a cement production line; to input its cement assets into Qinling to improve the profitability.</td>
<td>Yes</td>
<td>195</td>
<td>2009-053</td>
<td></td>
</tr>
<tr>
<td>Xiaxin</td>
<td>Xiaxin would liquidate all of its assets; Xiamen Xiangyu Cop. Ltd. would be the reorganizer; the reorganizer has promised to provide RMB 100 million for paying Xiaxin’s debt and assets worth no less than RMB 1 billion into Xiaxin for restoring its profitability; the reorganizer would receive a certain amount of the shares given up by the old shareholders as the consideration for its investment</td>
<td>Yes</td>
<td>70</td>
<td>2009-046</td>
<td></td>
</tr>
<tr>
<td>Xintai</td>
<td>Xintai would use its business income and the proceeds from the sale of non-productive assets and the shares given up by the old shareholder to pay the creditors; if the proceeding cash resource is not enough to realize the promised payment to creditors, Xintai would try to get loan from its first and second biggest shareholder to make up the deficiency; Xintai would concentrate on its main business, strengthen the research and development of the new product and marketing, and improve its profitability.</td>
<td>No</td>
<td>232</td>
<td>2009-044</td>
<td></td>
</tr>
<tr>
<td>Jinhua</td>
<td>Jinhua would improve its management and continue its old business and improve its profitability, the new No</td>
<td>134</td>
<td>2010-08-03</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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6 Beisheng’s plan, when calculating the value of the distribution to general unsecured creditors, stated that “taking into account of the asset investment in the future and the increase of the price of the shares, the price of the shares distributed to general unsecured creditors is taken as RMB 3/ share.” However, this is a very rough estimation of the debtor’s reorganization since the valuation was not based on a feasible rehabilitation scheme. See Appendix D for further information about the formulation of the feasible rehabilitation scheme. See Chapter VI for the detailed discussion of the valuation.

7 See Chapter VI for the detailed discussion of the valuation.

8 See Chapter VI for the detailed discussion of the valuation.
controlling shareholder would, within 5 years invest new fund in the debtor to increase the debtor’s flowing fund, improve the quality of the debtor’s assets, explore new project and improve the debtor’s operation.

<table>
<thead>
<tr>
<th>Company</th>
<th>Proposal Content</th>
<th>Decision</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shentai</td>
<td>Shentai, as an enterprise for controlling and managing its subsidiaries, would improve its control over its subsidiaries and improve the operation of its subsidiary; its subsidiaries would concentrate on their core-business and dispose the non-profitable assets; One subsidiary, i.e. Xi Ge Ma Group Co., Ltd. would be the reorganizer and invest high-quality assets into Shentai in order to help Shentai to restructure its assets and improve its operation.</td>
<td>Yes</td>
<td>162 days 2010-05-08</td>
</tr>
<tr>
<td>Guangming</td>
<td>Guangming would dispose all of the old assets and try to find the new financier as the reorganizer; the new financier would invest profitable assets in Guangming to keep and increase the debtor’s earning capacity.</td>
<td>No</td>
<td>270 days 2010-047</td>
</tr>
<tr>
<td>Pianzhuan</td>
<td>The controlling shareholder would transfer its shares to the reorganizer; the reorganizer would invest profitable assets into Pianzhuan as the consideration of the shares being transferred from the controlling shareholder to increase the debtor’s earning capacity; the controlling shareholder would purchase the assets to be disposed by Pianzhuan.</td>
<td>No</td>
<td>156 days 2010-05-18</td>
</tr>
<tr>
<td>Danhua</td>
<td>Danhua would liquidate all of its assets to pay its debts, would try to find a new financier as the reorganizer; the reorganizer would invest profitable assets worth no less than RMB 1 billion into Danhua to restore its profitability.</td>
<td>No</td>
<td>199 days 2009-12-02</td>
</tr>
<tr>
<td>Haina</td>
<td>The big shareholder of Haina has promised to provide cash equal to the value of the assets of Haina for paying the reorganization fee and the debts and would become the new debtor of Haina.</td>
<td>No</td>
<td>68 days 2007-11-26</td>
</tr>
<tr>
<td>Xingmei</td>
<td>The reorganizer, i.e. Xinyi Shiye Co., Ltd., would provide cash to Xingmei for paying its debts; the reorganizer’s affiliated corporation would provide profitable assets into Xingmei to achieve the</td>
<td>No</td>
<td>43 days 2008-44</td>
</tr>
</tbody>
</table>

9 The new controlling shareholder got the shares held by the old controlling shareholder through public auction during the pendency of the reorganization conducted on July 30, 2010 because the old controlling shareholder entered into bankruptcy liquidation. See public notice of Jinhua, No. 2010-102.

10 See Chapter VI for the detailed discussion of the valuation.

11 The date of confirmation of the plan was disclosed in the public notice of financial advisor’s report issued by Pianzhuan on May 18, 2010, and there was no public notice number designed for this file.
reorganization; all the unencumbered assets of Xingmei would be sold to a third party and the proceeds
would be used for paying the unsecured creditors.

<table>
<thead>
<tr>
<th>Company</th>
<th>Description</th>
<th>Duration</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dixian</td>
<td>Dixian would try to attract new financers who would invest in the debtor with new cash, facilities, technology and management experiences to enhance its textile printing and dyeing business, clothes-production business, pulp and paper-production business</td>
<td>52 days</td>
<td>2008-66</td>
</tr>
<tr>
<td>Chaohua</td>
<td>All of Chaohua’s assets would be sold to Haojiang Trade Co. Ltd. and all of Chaohua’s debts would be taken by the asset-purchaser; Gansu Jianxin Shiye Co. Ltd. has promised to invest profitable assets into Chaohua to restore its profitability.</td>
<td>40 days</td>
<td>2007-088</td>
</tr>
</tbody>
</table>
## Appendix D: Study on the Time used for reaching a confirmed plan and the time Used for Consummating the Confirmed Plan in the 18 listed corporations

<table>
<thead>
<tr>
<th>Name of the case</th>
<th>Date of Initiation of Reorganization Proceeding (Year-Month-Day)</th>
<th>Date of the Plan Confirmation (Year-Month-Day)</th>
<th>Time length to plan confirmation</th>
<th>Time length of plan consummation</th>
<th>Date on which the plan’s implementation was successfully finished (Year-Month-Day)</th>
<th>The Public Notice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baoshuo</td>
<td>2008-01-03716</td>
<td>2008-02-05</td>
<td>34 days</td>
<td>Unknown</td>
<td>Not finished717</td>
<td>2008-044</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2011-010</td>
</tr>
<tr>
<td>Jiufa</td>
<td>2008-09-28</td>
<td>2008-12-09</td>
<td>73 days</td>
<td>176 days</td>
<td>2009-06-01</td>
<td>2008-068</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td>2008-079</td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td>2009-042</td>
</tr>
<tr>
<td>Hualong</td>
<td>2008-03-11</td>
<td>2008-04-17</td>
<td>38 days</td>
<td>264 days</td>
<td>2009-01-05718</td>
<td>2008-26</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2009-03</td>
</tr>
<tr>
<td>Huayuan</td>
<td>2008-09-27</td>
<td>2008-12-07719</td>
<td>72 days</td>
<td>145 days</td>
<td>2009-04-30</td>
<td>2008-094</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2009-026</td>
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<td></td>
<td>2009-08-31</td>
</tr>
<tr>
<td>Beisheng</td>
<td>2008-11-27</td>
<td>2008-12-30</td>
<td>34 days</td>
<td>304 days</td>
<td>2009-10-29</td>
<td>2009-057</td>
</tr>
<tr>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>2010-01-20</td>
</tr>
<tr>
<td>Beiya</td>
<td>2008-02-03</td>
<td>2008-04-24</td>
<td>82 days</td>
<td>968 days</td>
<td>2010-12-27</td>
<td>2008-018</td>
</tr>
<tr>
<td></td>
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<td>2008-060</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>2010-012</td>
</tr>
<tr>
<td>Qinling</td>
<td>2009-08-23</td>
<td>2009-12-14</td>
<td>114 days</td>
<td>311 days</td>
<td>2010-10-20</td>
<td>2009-053</td>
</tr>
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<td></td>
<td></td>
<td></td>
<td>2010-051</td>
</tr>
<tr>
<td>Xiaxin</td>
<td>2009-09-15</td>
<td>2009-11-23</td>
<td>70 days</td>
<td>150 days</td>
<td>2010-04-21720</td>
<td>2010-006</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2010-029</td>
</tr>
<tr>
<td>Xintai</td>
<td>2009-03-17</td>
<td>2009-11-03</td>
<td>232 days</td>
<td></td>
<td>2010-09-07721</td>
<td>2009-044</td>
</tr>
</tbody>
</table>

713 The initiation of a reorganization proceeding is the date when the court rules that the corporation enters into the reorganization proceeding.
714 If not specially explained, the date in this column is the date on which the court ruled that the plan had been successfully implemented.
715 “The Public Notice” in this table is to show the number or the issuing date (if no number is designed for the public notice) of the public notice that discloses the information in this table.
716 Baoshuo entered into the bankruptcy liquidation proceeding on January 25, 2007 and transferred into the reorganization proceeding on January 3, 2008 based on its reorganization application and court’s ruling that permits its reorganization application.
717 The plan implementation period expired on February 5, 2011. The controlling shareholder promised to help to reach agreement with the creditors concerning the unpaid debt. See Baoshuo’s public notice No. 2011-010. Thus, up to February, 15, 2011, it was uncertain whether the plan would be consummated or not.
718 This is the date that Hualong received the court’s ruling on the termination of the plan implementation.
719 This is the date that Huayuan issued public notice that it has received the court’s ruling which confirmed the plan. However, the notice does not say clearly on which date the court made the confirmation ruling. For the convenience of analysis, this date was used as the confirmation date.
720 This is the date that Xiaxin received the court’s ruling on the termination of the plan implementation.
721 This is the date that Xintai issued public notice about the court’s ruling on the termination of the plan.
<table>
<thead>
<tr>
<th>Company</th>
<th>Filing Date</th>
<th>End Date</th>
<th>Days to Cram-Down</th>
<th>Cram-Down Date</th>
<th>Days to Consummation</th>
<th>Consummation Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jinhua</td>
<td>2010-03-19</td>
<td>2010-07-30</td>
<td>309 days</td>
<td>2010-04-03</td>
<td>134 days</td>
<td>2010-08-03</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shentai</td>
<td>2009-11-20</td>
<td>2010-04-30</td>
<td>293 days</td>
<td>2010-05-08</td>
<td>162 days</td>
<td>2010-10-28</td>
</tr>
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<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Guangming</td>
<td>2009-11-09</td>
<td>2010-08-05</td>
<td>270 days</td>
<td>2010-04-07</td>
<td>179 days</td>
<td>2011-01-30</td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pianzhuan</td>
<td>2009-12-03</td>
<td>2010-05-07</td>
<td>156 days</td>
<td>2011-02-01</td>
<td>Unknown</td>
<td>2009-04-05</td>
</tr>
<tr>
<td></td>
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</tr>
<tr>
<td>Xingmei</td>
<td>2008-03-11</td>
<td>2008-04-22</td>
<td>43 days</td>
<td>2008-43</td>
<td>254 days</td>
<td>2008-12-31</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dixian</td>
<td>2008-11-10</td>
<td>2008-12-30</td>
<td>51 days</td>
<td>2008-66</td>
<td>118 days</td>
<td>2009-02-00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chaohua</td>
<td>2007-11-16</td>
<td>2007-12-24</td>
<td>39 days</td>
<td>2008-01-11</td>
<td>98 days</td>
<td>2008-03-31</td>
</tr>
</tbody>
</table>

On average, the time period used for reaching a confirmed plan is 104 days.

On average, the time period used for plan consummation is 238 days.

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722 The court made the cram-down confirmation just on the date that the administrator filed the application for cram-down.

723 This is the date that Guangming received the court’s ruling on the termination of the plan implementation.

724 Up to February 25, 2011, the plan implementation was still in process.

725 The date of confirmation of the plan was disclosed in the public notice of financial advisor’s report issued by Pianzhuan on May 18, 2010, and there was no public notice number designed for this file.

726 This is the date that Danhua received the court’s ruling on the termination of the plan implementation.

727 This is the date that Dixian received the court’s ruling on the confirmation of the plan. Taking into account that Dixian applied for plan-confirmation on the day before this date, this date is probably the date that the court made the ruling. For convenience of analysis, this date was taken as the date of court’s confirmation date.

728 This is the date that Dixian received the court’s ruling on the termination of the plan implementation.

729 This is the date that Chaohua received the court’s ruling on the termination of the plan implementation.
Summary of the Book in Dutch (Nederlandse samenvatting)

Dit boek is een rechtsvergelijkende studie naar de wetgeving over de reorganisatie van ondernemingen in financiële moeilijkheden in de Verenigde Staten van Amerika en China. Het beoogt bij te dragen aan een efficiënt systeem voor reorganisatie in China. Teneinde de efficiënte en inefficiënte elementen van de Amerikaanse en Chinese reorganisatiewetgeving te analyseren, worden eerst verschillende theorieën van faillissementsrecht met elkaar vergeleken. In dit onderzoek wordt vervolgens voor de theorie van de *creditors’ bargain* gekozen. De reorganisatieprocedure dient te leiden tot een efficiënt reorganisatieplan, dat wil zeggen een verzameling beslissingen over de aanwending van de activa van de schuldenaar en de wijze van verdeling van de totale waarde. Dit boek onderzoekt of de Amerikaanse en Chinese reorganisatiewetgeving een besluitvormingsmechanisme bevat dat de deelnemende partijen tot een efficiënt reorganisatieplan brengt, waarvan de uitvoering leidt tot het verwerkelijken van het met dat plan nagestreefde doel. Met het oog op het besluitvormingsproces wordt het systeem van het ontwerpen van en de stemming over het plan onderzocht, alsmede de faciliteiten om de mogelijkheden voor een reorganisatie te koesteren, telkens in het Amerikaanse en Chinese recht.

Wat het ontwerp van het akkoord betreft, staat de reorganisatiewetgeving van de beide landen toe dat de capabele schuldenaar het beheer en de beschikking over zijn vermogen houdt (‘debtor in possession’ of ‘DIP’) en kent deze wetgeving de DIP een periode toe waarin hij als enige een plan kan voorstellen (‘de exclusiviteitsperiode’). Dit systeem waarin de schuldenaar het beheer en de beschikking over zijn vermogen houdt samen met de exclusiviteitsperiode beoogt een beslissingsprocedure in het leven te roepen waarin de schuldenaar de controle heeft over het ontwerp van het plan. De wetgeving in beide landen kent maatregelen die de positie van andere partijen dan de schuldenaar in het beslissingsproces versterken en de DIP beteugelen, zoals het instrument van de commissies, het rechterlijk toezicht op de lengte van de exclusiviteitsperiode en de mogelijkheid tot het aanstellen van een curator. Het systeem van het ontwerp van het plan in de Amerikaanse en Chinese wetgeving verschilt op de volgende punten: in de VS behoudt de schuldenaar van rechtswege het beheer en de beschikking over zijn vermogen, terwijl een Chinese schuldenaar daartoe een verzoek bij de
rechtbank moet indienen en toestemming van de rechtbank moet krijgen. Naar Amerikaans recht wordt slechts een curator aangesteld om het bestuur van de schuldenaar te vervangen als dat bestuur te incompetent is om de controle te behouden en het beheer en de beschikking over zijn vermogen dient te worden ontnomen, terwijl naar Chinees recht altijd een bewindvoerder wordt benoemd die toezicht uitoefent op het bestuur van de schuldenaar. Naar Amerikaans recht is de curator gewoonweg een deskundige op het terrein van insolventie, die in de plaats treedt van het incompetente bestuur van de schuldenaar, terwijl naar Chinees recht niet alleen dergelijke deskundigen, maar ook ‘liquidatiecommissies’ als bewindvoerder kunnen worden aangesteld. Overheidsfunctionarissen kunnen het besluitvormingsproces in specifieke faillissementen beïnvloeden of beheersen door deel uit te maken van de ‘liquidatiecommissie’. Het Amerikaanse recht kent de mogelijkheid dat concurrerende plannen worden ingediend enkele curator wordt aangesteld of de ‘DIP’ er niet in slaagt een plan voor te stellen of zo’n plan niet binnen de exclusiviteitsperiode wordt geaccepteerd, terwijl naar Chinees recht andere belanghebbenden dan de schuldenaar nooit een plan kunnen voorstellen en alleen degene die de onderneming voert (de ‘DIP’ of de bewindvoerder) het recht hebben een plan voor te stellen.

Het Amerikaanse en Chinese systeem voor het stemmen over een plan komen overeen waar zij beide vereisen dat een ontwerpplan twee stadia moet doorlopen: een plan dient met een gekwalificeerde meerderheid te worden aangenomen en door de rechter te worden gehomologeerd voordat het bindend is. In beide systemen wordt in klassen gestemd waarbij een gekwalificeerde meerderheid dient te worden gehaald en in beide systemen kan een plan dat is verworpen toch door de rechter worden vastgesteld (‘cram down’), mits aan de voorwaarden is voldaan. De verschillen tussen de Amerikaanse en Chinese stemprocedures zijn nogal groot. In het Amerikaanse recht kan de schuldenaar de classificatie van de aanspraken in klassen vormgeven. Enerzijds dienen aanspraken in een bepaalde klasse in wezen soortgelijk te zijn. Anderzijds geldt dit niet de eis dat in wezen soortgelijke aanspraken ook per se in dezelfde klasse moeten worden ingedeeld. De Chinese wetgeving kent een strikt systeem van classificatie waarin alle aanspraken in vijf klassen worden ingedeeld: geseignoreerde vorderingen, werknemersvorderingen, belastingvorderingen, concurrente vorderingen en aanspraken van aandeelhouders. Volgens het Amerikaanse recht hebben alle
klassen stemrecht en wordenklassen wier positie door het plan niet wordt aangetast geacht voor het plan te hebben gestemd en klassen die niets ontvangen geacht tegen het plan te hebben gestemd. Naar Chinees recht hebben schuldeisers steeds stemrecht en kunnen aandeelhouders slechts stemmen indien het plan aanpassing van hun aandeelhoudersbelang meebrengt. In vergelijking met de Amerikaanse eisen voor homologatie zijn de Chinese eisen te algemeen en te weinig restrictief. De Chinese wetgeving vergt voor homologatie van een aanvaard plan slechts dat de rechtbank toetst of het in overeenstemming met de wet is en bevat geen gedetailleerde toets. Daartegenover kent het Amerikaanse recht gedetailleerde algemene eisen voor homologatie van zowel aanvaarde en verworpen plannen, zoals de 'best-interest test' en de haalbaarheidstoets etc. Met betrekking tot het vaststellen van een verworpen plan, zijn de eisen in de Chinese faillissementswet voor ondernemingen ('EBL') in vergelijking met het Amerikaanse recht te weinig restrictief. Het belangrijkste gebrek is het ontbreken van een volwaardige bepaling over de 'absolute priority rule'. In zijn algemeenheid is de Chinese stemprocedure problematisch waar het betreft de classificatie, het stemrecht van aandeelhouders, de algemene vereisten voor homologatie en de vaststelling van een verworpen plan, hetgeen tot inefficiënties kan leiden.

Zowel de Amerikaanse als de Chinese wetgeving bevat faciliteiten om de mogelijkheden voor reorganisatie te koesteren. De belangrijkste bepalingen betreffen het moratorium en de financiering gedurende de faillissementsprocedure. Waar de bescherming van de belangen van de schuldeisers naar Amerikaans recht onvoldoende wordt bevonden, is de bescherming van schuldeisersbelangen gedurende het moratorium volgens het Chinese systeem zelfs nog geringer. Het Amerikaanse systeem van financiering gedurende de faillissementsprocedure helpt de schuldenaar bij het aantrekken van financiering door een bijzondere prioriteit toe te kennen aan degenen die na de faillietverklaring financiering verstrekken. Daartegenover biedt het Chinese systeem de schuldenaar weinig steun bij het verkrijgen van nieuwe financiering, nu het financiers geen speciale prioriteit toekent. In vergelijking met Amerikaans recht, is de Chinese wet minder krachtig bij het helpen van de schuldenaar bij het verwerven van nieuwe financiering. Echter, de Chinese wet beschermt het belang van faillissementsschuldeisers tegen een wezenlijke beïnvloeding door financiering gedurende de faillissementsprocedure en beteugelt inefficiënte financiering.
Teneinde een beter begrip van het recht te krijgen, biedt het laatste hoofdstuk een vergelijking van de praktijk van reorganisatie in beide landen en verkent het de relatie tussen recht en praktijk. Met betrekking tot het controlemodel van de besluitvormingsprocedure, heeft de Amerikaanse wetgeving een door de schuldenaar beheerst model geschapen. De Amerikaanse praktijk toont dat. In de begindagen van Chapter 11, beheerste de schuldenaar de besluitvorming. Maar vanaf de late jaren negentig hebben schuldeisers geleerd invloed uit te oefenen door op te treden als financiers van de DIP en hem door beperkende contractuele voorwaarden aan banden te leggen. Naar de letter genomen hanteert het Chinese recht, dat wil zeggen, de EBL, een door de schuldenaar beheerst model. In aanvulling daarop, biedt de uitvoeringsregelgeving van de EBL, de SPCS (Supreme People’s Court’s Stipulations concerning the Appointment of Administrators for Bankruptcy Cases), de mogelijkheid van overheidscontrole door de aanstelling van een liquidatiecommissie als bewindvoerder. In de praktijk, omdat de rechterlijke macht nog steeds niet onafhankelijk is van de uitvoerende macht, kan de overheid de bepalende instantie zijn in de gevallen waarin de overheid een bepaald resultaat beoogt te bereiken, in het bijzonder bij de reorganisatie van grote beursgenoteerde bedrijven.

Wat betreft de tijd die werd genomen om tot een gehomologeerd plan te komen, is Chapter 11 in de praktijk van de begindagen bekritiseerd als een langdurige procedure. In vergelijking daarmee wordt Chapter 11 in de recente praktijk gezien als een snelle procedure. Wat betreft de praktijk in de begindagen heeft Lopucki’s onderzoek laten zien dat bij schuldenaren die tot een gehomologeerd plan kwamen, daarmee 17,5 maanden (mediaan) gemoeid waren; uit het Poughkeepsie-onderzoek bleek een gemiddelde duur van circa 22,05 maanden. Warren en Westbrook onderzochten de recente praktijk ten aanzien van Chapter 11 en daaruit bleek dat de gebruikte tijd om tot een gehomologeerd plan te komen circa 9 maanden (mediaan) was. Hoeveel tijd is er voor een Chinese schuldenaar gemoeid met een gehomologeerd plan? Uit empirisch onderzoek van de Chinese faillissementen bleek dat door een Chinese beursgenoteerde onderneming gemiddeld 105 dagen werden genomen om tot een gehomologeerd plan te komen. In vergelijking met de VS is de tijd die in China in de reorganisatieprocedure wordt gebruikt kort.

Wat het percentage van plannen betreft dat wordt gehomologeerd, lieten de Amerikaanse
empirische studies een laag percentage zien waar het het totaal van ondernemingen betrof en een hoog percentage voor grote, beursgenoteerde ondernemingen. Volgens de FICS (Fee Information and Collection System) database eindigde 26 procent van de procedures die tussen 1989 en 2002 zijn begonnen met een gehomologeerd plan; Jensen-Conklin concludeerde in het Poughkeepsie-onderzoek dat het homologatiepercentage circa 17,3 procent was; Warren en Westbrook onderzochten de procedures die in 1994 en 2002 begonnen en concludeerden dat het homologatiepercentage 30,4 respectievelijk 33,4 procent was. LoPucki en Whitford bestudeerden de reorganisatieprocedures die een aanvang namen na de inwerkingtreding van de huidige Amerikaanse faillissementswet (1 oktober 1979) en vóór 15 maart 1988 met betrekking tot beursgenoteerde onderneming met minimaal $100 miljoen aan activa ten tijde van de aanvang van de procedure en stelden vast dat het percentage gehomologeerde plannen circa 96 procent was. Wat betreft het percentage van ten uitvoer gelegde plannen betreft, liet Jensen-Conklin’s Poughkeepsie-onderzoek zien dat circa 58 procent van de gehomologeerde plannen ten uitvoer werd gelegd. Wat is het percentage van gehomologeerde en ten uitvoer gelegde plannen in China? Het empirisch onderzoek naar Chinese faillissements liet een percentage van honderd procent gehomologeerde plannen zien. Daarnaast bleek uit het empirisch onderzoek dat 100 procent van de gehomologeerde akkoorden ook ten uitvoer werd gelegd. Voorts bleek dat in Chinese faillissements gemiddeld 238 dagen werden gebruikt voor de uitvoering van het plan. Het is spijtig dat de auteur er niet in is geslaagd enig empirisch onderzoek te vinden naar de tijd die werd gebruikt voor de tenuitvoerlegging van gehomologeerde plannen in het kader van Chapter 11. De omstandigheden die hebben bijgedragen aan de snelheid waarmee tot een gehomologeerd plan wordt gekomen en de hoge percentages van gehomologeerde en ten uitvoer gelegde plannen in de Chinese praktijk zijn de – in vergelijking met Chapter 11 – weinig restrictieve vereisten voor homologatie in de EBL. Met name van belang zijn de weinig restrictieve haalbaarheidstoets en het ontbreken van de ‘best-interest test’ en de ‘absolute priority rule’. Concluderend, de Amerikaanse en Chinese reorganisatiewetgeving zijn nogal soortgelijk wat de hoofdstructuren betreft. De Chinese wetgeving voor reorganisatie van ondernemingen in financiële moeilijkheden is in wezen het resultaat van het transplanteren van Amerikaans recht. Daarbij heeft de Chinese wetgever enige wijzigingen aangebracht. Sommige
belangrijke delen van het Amerikaanse recht zijn niet adequaat in de Chinese wetgeving opgenomen. Dit leidt tot enige problemen in het ontwerp van de EBL. De belangrijkste hiervan zijn dat de belangen van de schuldeisers gedurende het moratorium onvoldoende worden beschermd, de onredelijke classificatie van aanspraken, de onjuiste invulling van het stemrecht van de aandeelhouders, de weinig restrictieve homologatievereisten. In zijn algemeenheid bleek uit het rechtsvergelijkend onderzoek dat recht en praktijk in China veel minder ontwikkeld zijn dan in de VS. Het belangrijkste voorbeeld van het onvoldragen karakter van de reorganisatiewetgeving en praktijk zijn het ontbreken van de ‘best-interest test’ en een haalbaarheidstoets voor aanvaarde plannen, het ontbreken van een adequate bepaling over de ‘absolute priority rule’, de te weinig restrictieve eisen die aan de haalbaarheid van het plan worden gesteld en het ontbreken van een adequate taxatie van de waarde van de onderneming bij reorganisatie. De Chinese reorganisatiewetgeving dient op veel punten te worden verbeterd. In het huidige, vroege stadium van de reorganisatiepraktijk is de reorganisatieprocedure slechts een instrument om op legale wijze van concurrente schulden af te komen. Wanneer we er rekening mee houden dat een markeconomie, gebaseerd op de ‘rule of law’ nog niet volledig is gerealiseerd in China en dat de op de markt gebaseerde wetgeving ter zake van de reorganisatie van in financiële moeilijkheden verkerende ondernemingen minder dan vier jaar bestaat, is het onvoldragen karakter van het recht en de praktijk in China begrijpelijk. De Chinese wetgever heeft een grote prestatie geleverd. De hoop bestaat dat China in de nabije toekomst een voldragen wettelijk systeem van reorganisatie zal ontwikkelen dat de belanghebbende partijen helpt en beteugelt teneinde de waarde van de onderneming van de schuldenaar te maximaliseren en op een eerlijke en billijke wijze te verdelen.