State Council Notice Nullifies Statutory Rights of Creditors

by Donald C. Clarke, Esq.

The real message of the recent notice issued by China's State Council, Donald Clarke writes, is not just "creditors, beware." It is that expectations about the transformation of the Chinese legal system into one with which Western lawyers are comfortable and familiar—expectations that are almost always expressed in terms of optimism—are misplaced. The Chinese legal system, for better or for worse, and despite increasing surface similarities with Western systems, "remains in many ways profoundly different in its most basic assumptions."

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Since the passage of the Enterprise Bankruptcy Law[1] (the Bankruptcy Law) in 1986, the Chinese government has been searching for ways to realize the law's purpose—to close down money-losing state-owned enterprises—without antagonizing urban workers by putting them out on the street.

This concern has been particularly pressing since the unrest of 1989, following which the government declared stability to be its overriding imperative. The problem has always been a lack of jobs into which to move unemployed workers, and a lack of funds with which to "resettle" them—that is, to provide training for new work or give them what essentially would be an early retirement payment sufficiently large to prevent resentment.[2]

While the number of state-owned enterprises (SOEs) closed down in bankruptcy proceedings has increased from year to year as a result of growing government alarm at state sector losses, the fear of worker unrest nevertheless has remained a real constraint on policy in this area. It is the desire to remove this constraint that has led to the State Council's issuance recently of regulations that have the effect of staking a claim to *all* valuable assets connected with the enterprise, regardless of the rights of creditors, in order to fund worker resettlement.

The State Council promulgated the Supplementary Notice on Issues Concerning the Trial Implementation in Several Cities of State-Owned Enterprise Bankruptcy and Merger and Reemployment of Staff and Workers (the 1997 Notice) on March 2, 1997. It works fundamental changes in the rights of creditors.(both secured and unsecured) provided by the Civil Procedure Law,[3] the Bankruptcy Law, and the Security Law,[4] stripping them of their expectancy in a search for funds to pay for the resettlement and reemployment of employees of bankrupt SOEs.

Creditors of bankrupt enterprises covered by the 1997 Notice—state-owned industrial enterprises in what are now the 111 cities[5] in the State Council's Capital Structure

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Optimization (*youhua ziben jiegou*) program for enterprises—are now to be paid only out of assets remaining after the costs of resettlement have been met.

Significance of the Notice

The 1997 Notice, with its sweeping disregard for the priorities and rights established in prior legislation, is obviously of concern to banks and other actual and potential creditors of state-owned industrial enterprises. Perhaps more important from a broader perspective, however, is what the issuance and implementation of the 1997 Notice says about the state of China's legal system.

In a constitutional system in which legislation passed by the National People's Congress and its Standing Committee is supposed to be superior to regulations promulgated by the State Council, the 1997 Notice is not just an arguably misguided administrative implementing regulation. It is an out-and-out setting aside of the statutory regime in situations where the State Council considers that regime to be inconvenient.

The 1997 Notice makes no bones about proclaiming its priority over the Bankruptcy Law: it states at one point that "[w]hen state owned enterprises not in the trial cities and regions go bankrupt, the bankruptcy can only be handled in accordance with the provisions of the Bankruptcy Law."[6] And at another, it states that "following the payment of employee resettlement costs, any remaining revenues from the disposition of the assets of the bankrupt enterprise shall be used to repay debts proportionately in accordance with the provisions of the Bankruptcy Law."[7]

While it does not explicitly claim priority over the Security Law, the 1997 Notice contains provisions clearly at odds with parts of that law, most notably with Article 33, which provides that mortgagees—for example, lenders with a security interest in land use rights—have a priority right to the proceeds of the security.

The application of the 1997 Notice is broad, but it is not universal. It does not cover nonindustrial—for example, commercial—state-owned enterprises in cities within the Capital Structure Optimization program, or any type of state-owned enterprise outside those cities (the bankruptcy of which is governed by the Bankruptcy Law), nor does it cover non-state-owned enterprises anywhere (the bankruptcy of which is governed by the relevant provisions of the Civil Procedure Law).[8] It does, however, cover every major industrial and coastal city.

Priority of Claims under Bankruptcy, Civil Procedure Laws

Under the Bankruptcy Law, claims of secured creditors are paid (to the extent of the value of the assets securing the debt) before any other claims, even before administration costs and taxes, which are to be paid from the "bankruptcy assets" (*pochan caichan*). Article 28 of the Bankruptcy Law states that "assets that have been encumbered as security interests shall not form part of the bankruptcy assets" except to the extent that the value of such encumbered assets exceeds the value of the obligation secured.

The bankruptcy assets—essentially all property of the enterprise except that which has been encumbered and used to pay secured creditors—are to be used to pay the following claims in order:

1. expenses incurred in administration, liquidation and distribution of the estate;[9]
2. legal expenses incurred in the bankruptcy case;[10]
3. other expenses incurred for the joint benefit of creditors during the proceedings;[11]
4. wages and labor insurance costs owed;[12]
5. taxes owed;[13] and
6. unsecured creditors' claims.[14]

The rule of proportional distribution within each class applies.

Essentially the same order is set forth in Articles 199 to 206 of the Civil Procedure Law; these provisions govern bankruptcy proceedings not governed by the Bankruptcy Law. Like the Bankruptcy Law, Articles 203 and 204 of the Civil Procedure Law provide that secured claims get paid before all other claims to the extent that such claims are covered by the value of the security. Remaining assets constitute the bankruptcy assets and are used to pay the following claims in the order listed:

1. costs of administration (presumably broadly defined);
2. wages and labor insurance costs owed;
3. taxes owed; and
4. unsecured creditors' claims.

As with the Bankruptcy Law, the rule of proportionate distribution within each class applies.

The 1994 Notice

The 1997 Notice must be read in conjunction with its predecessor, the 1994 State Council Notice on Issues Concerning the Trial Implementation in Several Cities of State-Owned Enterprise Bankruptcy[15] (the 1994 Notice), which made significant changes to the rules of the Bankruptcy Law, particularly regarding priority of repayments. The 1994 Notice is still in effect, to the extent that it is not overridden by contrary provisions in the 1997 Notice; the 1997 Notice was intended to supplement the 1994 Notice.

The 1994 Notice is problematic in two basic respects. First, it throws into confusion established state policy regarding the commoditization of land use rights. Second, without legal sanction, it creates a set of claims with priority over the claims listed in the Bankruptcy Law and the Civil Procedure Law.

Land Use Rights

Chinese land law makes a key distinction between "allocated" land use rights—essentially a nontransferable permission to use land, given by the state to the enterprise, revocable at will, for which the state receives perhaps a small fee in the nature of a tax—and "granted" land use rights, which have been commoditized, and for which the state has already received payment at full market value.

Under Chinese law, an enterprise is effectively entitled to the value of allocated land use rights only at the moment it is using them. It has no right to compensation

should it lose those rights in the future, and it has no right or power to sell any future right to use the land. This rule is rooted in the reasonable principle that since the enterprise never paid any money for the use of the land, it makes no sense simply to give away the value of such land use rights to the enterprise. To do so would not only deprive the state of funds it might have had, but would also violate the general policy of putting land to its most valuable use, with the determination of what is valuable increasingly left to market forces.

The 1994 Notice provides that the "lawfully obtained" land use rights of bankrupt enterprises should be transferred (that is, sold) through auction or other forms of bidding, with the income from the sale used for the resettlement of employees. It is not clear what is meant by "lawfully obtained." More importantly, however, the 1994 Notice does not distinguish between allocated and granted land use rights. In failing to make this distinction, it cheats the state, to the benefit of employees and unsecured creditors.

All creditors are aware of the nature of allocated land use rights. Consequently, they do not have and never did have any legitimate expectation of being able to look to the value of such rights in order to satisfy their claims. Before land use rights can be sold and their value realized, they must be commoditized, that is, changed into granted land use rights. It has always been clear that the value of the land use rights, at the time of this transformation, is to go to the state. Thus, making the value of allocated land use rights available to creditors represents a windfall to creditors at the expense of the state.

Giving away the value of land use rights to an enterprise instead of making the enterprise pay for such rights is, of course, simply a subsidy, and there might be sound policy reasons for granting such a subsidy. But even if this is the case, there is no particular reason why the size of the subsidy should match exactly the value of the land use rights. There is simply no necessary relationship between the amount of money required to resettle employees of an enterprise and the amount of money that can be realized through the commoditization and sale of the enterprise's land use rights. Allocated land use rights are an asset belonging to the state, and like all such assets, may be sold for cash to fund obligations the state wishes to take upon itself, such as the resettlement of unemployed urban workers. The extent of that obligation clearly must depend on a number of factors—principally the perceived extent of the need, the resources available, and the strength of competing demands. But it should not depend on the value of the land use rights that happen to be held by the enterprises.

This subsidy, therefore, does not represent sound policymaking, but rather reflects the continued fiscal weakness of the Chinese state. Military funding, for example, has become in part a function of the profitability of hotels that the People's Liberation Army is allowed to run (independent of some rational determination of national security needs), simply because the state does not have the ability to raise the necessary funds from society. In the same way, the policy of worker resettlement will be implemented in any particular enterprise only to the extent that that particular enterprise happens to be sitting on valuable land.

Overriding Claims of Creditors

The second problem with the 1994 Notice is that it overrides, without clear statutory authority, the claims of creditors under existing statutes.

Granted land use rights, unlike allocated land use rights, *should* form part of the bankruptcy assets available for distribution to creditors,[16] but they are, as noted, first appropriated for resettlement costs. Where the sale of land use rights is not sufficient to cover such costs, other bankruptcy assets may be used as well, again at the expense of unsecured creditors.

This ordering suggests that the 1994 Notice is indeed intended to cover allocated land use rights as well as granted land use rights: despite the irrationality of making the size of the government subsidy depend on the value of the land use rights, it still makes sense to say that noncommoditized assets to which creditors had no expectancy should be used to pay resettlement costs before commoditized assets, including land use rights as well as the more familiar machinery and equipment, are used to do so. It does *not* make sense to distinguish between land use rights, once commoditized, and other assets of the enterprise as sources of funds from which workers or creditors can be paid.

The 1994 Notice also provides that loans made by workers to the enterprise before bankruptcy are to be treated after bankruptcy as unpaid wages, and thus given priority over the claims of other unsecured lenders. This priority may not be as unfair to other unsecured creditors as it first appears. Borrowing from employees is probably a last resort for both the enterprise and the employees. The employees may be coerced into making such loans, and it is unlikely that they make them with the hope of any commercial gain. They really do it just to keep the enterprise afloat a while longer. Thus, such loans are quite similar to loans and sales by suppliers made on credit after a company has filed for bankruptcy in Western bankruptcy law, claims for which are given priority over the claims of other unsecured creditors.

Certain other facilities associated with the enterprise are the subject of a rule so vague that it can only be interpreted as a general directive to the relevant authorities to "do what you can with what you have." This rule states that worker dormitories, schools, nursery schools, hospitals and other similar welfare facilities "in principle" should not be made part of the bankruptcy assets, but should be taken over and disposed of by the local government, with their employees to be taken in or resettled by the unit that takes over the particular facility. Where it is "not necessary" that such facilities continue in existence and they can be sold as a whole, then they "may" be counted as bankruptcy assets, and presumably sold for cash.

This rule makes a complete hash of attempts to develop any law in the area of enterprise property. It is impossible to know in advance which assets belong to the enterprise and are available to creditors, and which assets do not. Apparently it is all up to the local government to decide after the fact.

The 1994 Notice pays more respect to the provisions of existing law in the section on handling assets over which a security interest can be granted. In brief, the 1994 Notice states that the security interest must be respected. It anticipates a provision of the subsequently passed Securi-

ty Law in stating that where more than one party has a security interest in the same asset, they shall be repaid according to the order of their security interest. Presumably this means that the creditor whose security interest was valid first must be fully paid off before the later creditor can take anything.

Employees of bankrupt enterprises who find new jobs on their own and are willing to give up their status as SOE employees are eligible to receive a one-time resettlement payment of approximately three times their annual salary.[17]

The 1994 Notice allows a further set of claimants to get in ahead of all others: medical and pension claims by retired workers either where the relevant insurance fund is insufficient to cover such claims or where insurance was never procured in the first place. As with resettlement costs, funds necessary for such claims are to come first out of revenues from the sale of land use rights, and then, if such revenues are insufficient, out of the general pool of bankruptcy assets.

Questions of Legislative Competence

Regardless of its wisdom as policy, the 1994 Notice raises questions as to whether the notion of legislative competence has any real meaning in China, or whether what a legislative body has the power to enact is limited only by what it has the power to enforce.

As a general principle, the State Council does not have the authority to overrule the provisions of legislation enacted by the National People's Congress or its Standing Committee. It has often been observed, however, that in China's *de facto* constitutional order, contrary to the constitutional order of many nations, it is frequently the legislation passed at the lowest level of government that has the most practical effect, while the Constitution, for example, is practically meaningless as a *legal* document. But this is not a phenomenon that the government publicly sanctions, or in most cases even admits to.

The State Council did claim a certain statutory basis for the 1994 Notice. This basis was not, however, what might have been expected: that is, the general grant of authority to undertake measures to implement the Bankruptcy Law, which is contained in Article 43 of that law.[18] Instead, the 1994 Notice found its source of authority in Article 4 of the Bankruptcy Law, the provision stating that "the state through various methods appropriately arranges for the reemployment of the staff and workers of bankrupt enterprises, and ensures their basic living needs prior to reemployment. Specific measures shall be separately stipulated by the State Council." It is difficult to find in this simple declarative sentence a license from the Standing Committee of the National People's Congress to overturn a major part of its legislative work.

The 1997 Notice

In 1997, evidently prompted by problems in the implementation of the 1994 Notice, the State Council issued the 1997 Notice. The 1997 Notice stresses that the 1994 Notice should apply only to enterprises in cities that are part of the Capital Structure Optimization program:

> When state-owned enterprises not in the trial cities and regions go bankrupt, the bankruptcy can only be handled in accordance with the provisions of the Bankruptcy Law. That is, income realized from the disposition of assets of the bankrupt enterprise must be used for the proportionate repayment of debts; expenses for the resettlement of employees of the bankrupt enterprise must come from channels such as local government subsidies, civil affairs relief funds and social security.[19]

It further reminds government officials that the bankruptcy of non-state-owned enterprises should be carried out strictly in accordance with the Civil Procedure Law.

The 1997 Notice states that the State Economic and Trade Commission is in charge of general organization and coordination efforts respecting the merger and bankruptcy of enterprises and the reemployment of their employees. It calls for the establishment of a special Leading Group, to be composed of representatives from numerous ministries and government agencies, to take charge of such work.

The 1997 Notice provides rules on bankruptcy assets that expand on and clarify the provisions of the 1994 Notice. In its provisions on the source of resettlement funds, however, the 1997 Notice makes an even greater hash of the Bankruptcy Law's provisions and completely overrides, without any statutory basis, the rights of secured creditors under the Security Law.

Like the 1994 Notice, the 1997 Notice provides that the cost of the resettlement of employees shall be paid for first by revenues from the disposition of land use rights; this time, allocated land use rights are clearly included.[20] The problem is that the 1997 Notice specifically states that land use rights that have been *encumbered with security interests* are also to be used for funding resettlement costs before any of the income from their disposition is used to pay off secured creditors.[21]

This expropriation[22] of encumbered land use rights to fund State Council policies completely ignores the rights of secured creditors set forth in the Security Law. "Land use rights" are treated generally in the 1997 Notice, and there is no stipulation that unencumbered land use rights are to be used before encumbered land use rights.

It gets worse. Only if land use rights, encumbered and unencumbered, are insufficient to fund resettlement costs does the 1997 Notice call for the use of proceeds from the sale of, first, other unencumbered property, and then other encumbered property. This puts lenders with a security interest in land use rights in a worse position than all other secured lenders. It is hard to imagine sound policy grounds behind such a result.

Finally, the 1997 Notice states that if the revenues from the auction of all the above-mentioned assets are still insufficient to fund employees' resettlement, then the people's government at the administrative level at which the enterprise is owned shall bear such costs.

As provided in the 1994 Notice, resettlement costs are set in general at about three times a worker's annual wage,[23] and a worker who finds his or her own employment will be given this sum as a one-time payment. Provisions for the payment of pension and medical expenses of retirees are similar to those for resettlement expenses.

While unpaid back wages have a high priority in the Bankruptcy Law and the Civil Procedure Law, the 1997 Notice assigns an even higher priority to "living expenses" of employees following the commencement of bankruptcy proceedings. It does this by deeming them to be "admin-

istrative expenses" of bankruptcy, which receive top priority for distributions from the bankruptcy assets. Like resettlement costs, these expenses are essentially local government expenses that, prior to the issuance of the 1994 and 1997 Notices, would have been paid directly by local government, to the extent they were paid at all.

Issues Raised by the Notices

The rules established by the 1994 and 1997 Notices raise several important issues.

Makes Lending to SOEs Riskier

First is the question of whether they in fact represent sound policy. It is not for this author to question the wisdom or urgency of providing resettlement payments for employees put out of work by the bankruptcy of state-owned enterprises. This is the primary decision driving everything else. The interesting policy question is whether creditors and allocated (not yet commoditized) land use rights are the best source for the funds needed for resettlement.

Clearly, these measures make lending to state-owned enterprises a vastly riskier business than before. Foreign banks would be well advised to steer clear of such enterprises entirely. Domestic banks, which are perhaps in a better position to understand fully the credit risks of any particular loan, will also be much more reluctant to lend to SOEs, and will demand higher interest rates and a shorter payback period. Indeed, they may end up lending only if forced to do so by local government pressure—something that would run entirely counter to the general policy of putting bank lending on a more commercial basis, and that would put the government even more firmly in the business of guaranteeing the activities of commercial banks, a business from which it has been trying to extricate itself.

Cash-strapped enterprises that perhaps could be saved by a loan to buy new machinery (with a security interest in the machinery granted to the lender) will now find it much more difficult, and perhaps impossible, to obtain such a loan. The employees of such an enterprise were not made any worse off by the pre-1997 Notice rule allowing the bank first crack at the proceeds of the security—without the loan, the machinery would not have been there in the first place. They *are* made worse off by the 1997 Notice's rule, which gives the bank no incentive to make the loan, and thus may paradoxically hasten the bankruptcy of an enterprise whose survival may be economically justified. And since the 1997 Notice's rule applies only upon bankruptcy, secured creditors from now on will have a powerful incentive to declare the debt in default and foreclose upon the security immediately once it appears that the enterprise may be heading in that direction—an act that would cripple the enterprise if it were not already in deep trouble. In short, the 1997 Notice could hardly have been better designed had it actually been intended to put cash-starved enterprises into bankruptcy by cutting off their sources of credit.

Approach to Bankruptcy

The second issue raised by the two Notices is the continued dominance of a systemic, not enterprise-centered, approach to bankruptcy.

In other words, bankruptcy law and policy in China is only tangentially concerned with the rights of creditors of a particular enterprise, or creditors in general. It is moderately concerned with the fate of particular bankrupt enterprises and their workers. But its primary *raison d'être* remains what it always has been: the strengthening of state finances by the provision of a means for the orderly exit of money-losing enterprises from the state sector with a minimum of social disruption. (This is why the Bankruptcy Law's title still bears the parenthetical "For Trial Implementation": its application to the insolvency of any particular enterprise has always remained under strict government control. It is not a tool to be picked up and used at will by creditors.)

In this sense, it is fair to argue that the two Notices do not in fact conflict with the *spirit* of the Bankruptcy Law (although they do conflict with both the spirit and the letter of the Civil Procedure Law, and the 1997 Notice conflicts with the spirit and letter of the Security Law). Since protection of creditors is only an incidental feature of the Bankruptcy Law, it is not necessarily misguided as a policy matter to sacrifice their interests in order to achieve the primary goal of that law.[24] Nevertheless, the question remains as to the extent to which the State Council can declare the letter of the law a nullity on the grounds that its spirit was not violated.

What They Say about the Legal System

Even assuming the rules of the two Notices represent sound policy, what does their weak legal basis say about the Chinese legal system as a whole? The message of the two Notices in this respect is clear: reports of the birth of respect for procedural regularity in the Chinese legal system have been greatly exaggerated.

It is difficult to overstate the breadth of power the State Council is claiming for itself, in the 1997 Notice in particular. It has simply nullified the rights of creditors under the Security Law, a statute that was passed by the Standing Committee of the National People's Congress and that contained *no* grant of power to the State Council to formulate interpretive or implementing regulations. There is no apparent limiting principle to this claim of power—it is hard to see why the State Council could not, under a statute granting it the right to make "appropriate arrangements" for urban beautification, impose the death penalty on litterers and provide for its imposition by secret tribunals of trash collectors.

An interview in May 1997 with a senior official of the Bankruptcy Department of the State Economic and Trade Commission, which drafted the 1997 Notice for the State Council, confirms that procedural regularity simply does not have a high priority in the minds of government officials when there appears to be a pressing problem in need of an immediate solution.

The senior official confirmed that the legal basis for both the 1994 Notice and the 1997 Notice was Article 4 of the Bankruptcy Law.[25] The theory, then, seems to be that the State Council, if given a mandate to do something, can adopt *any method it likes* to carry out that mandate, whether or not the method is consistent with existing statutory law.[26] This is not an overstatement: note, for example, that the State Council, in the 1997 Notice, must neces-

sarily be claiming authority under a provision in the *Bankruptcy Law* to nullify provisions of the *Security Law* enacted nine years later.[27] As noted, the Security Law itself does not authorize the State Council or any other government body to formulate implementing regulations or interpretive rules.

Whether or not this theory is "correct" or justifiable under China's Constitution is an interesting question, but in the end less important than simply noting that this is the way things are in the Chinese legal system at present. Under a statutory mandate to implement Statute X, the State Council claims the authority to nullify major provisions not only of Statute X, but also of Statute Y, even though the National People's Congress has *not* given the State Council any mandate with respect to the latter.

One is driven, therefore, to the conclusion that the supreme legislative body in China is *in fact* the State Council, not the National People's Congress.

Other justifications offered by the senior official are also revealing. According to this official, any modification of existing statutory rights was permissible because the National People's Congress was "consulted" during the formulation of the 1997 Notice. Under the Constitution, however, the National People's Congress and its Standing Committee do not act by "consultation." They act by considering bills and resolutions according to particular procedures and then voting them up or down. The opinion of their permanent staff cannot be given greater weight than an enacted statute.

Some may argue that there is nothing more irregular about such a consultation procedure than one in which the U.S. Internal Revenue Service, in the course of formulating regulations under a new tax statute, might consult with the staff of the House Ways and Means Committee for advice on the Committee's thinking with respect to certain aspects of the statute. The difference is that regardless of the advice the IRS receives, the regulations it eventually formulates must ultimately pass the test of being consistent with the statute authorizing them, in the view of an independent arbiter not connected with or unduly influenced by the IRS. This is emphatically not the case with the 1997 Notice. It is impossible to imagine that a Chinese court handling a bankruptcy case would even consider the possibility that the validity of the 1997 Notice could be questionable.

The senior official also stated that the Bankruptcy Law was under revision, presumably implying that the revision would reflect in law what the State Council was doing in administrative regulations. What is behind this statement is the *de facto* view of the Chinese constitutional order outlined above: the higher the level at which a legal norm is promulgated, the less legally relevant it generally is. Thus, the Constitution is a kind of political manifesto; National People's Congress statutes represent broad statements of policy; State Council documents represent the rules people are supposed to follow. The senior official was really saying that the relevant policy change had already been made and would shortly be reflected in the statute. Since the State Council makes rules on the basis of policy, nothing was therefore irregular about the 1997 Notice.[28]

Finally, the senior official stated that the 1997 Notice was experimental and to be implemented only in certain cities. This view suggests that the deviation from the law is acceptable if it is not too great or is limited in geographic scope. (Whether this deviation, which applies "only" in 111 cities,[29] including all major industrial and coastal cities, can be called limited is certainly open to question.)

This is not a principle most Western lawyers would feel comfortable with, but there is no reason why the Chinese legal system cannot adopt such a principle. Certainly, there appear to be many examples of it in the Chinese system. Chinese legislation regularly calls for some act to be done or not done "in general" or "in principle," allowing the implementing authorities room for modest deviations from the norm. Ren Jianxin, the President of the Supreme People's Court, once, in the course of the same speech, both blasted the foreign press for "slandering" China by claiming that the rules respecting public trials were not being followed, and admitted that many courts as yet had no physical facilities in which to conduct such trials.[30]

In short, a rule is being followed if, looked at from a broader systemic perspective and not instance by instance, it is *usually* being followed, and where not followed, the subject of a good faith effort to do so under prevailing circumstances and possibly conflicting priorities.[31]

My point is not to criticize this principle, even though it raises obvious difficulties, such as knowing how much deviation is too much. My point here is to suggest that the senior official's response indicates the continued vitality of this principle, and that analyses of Chinese legislation and the legal system must take this into account, instead of accepting at face value claims that the Chinese legal system is rapidly becoming just like that of its Western trading partners.[32]

The real message of the 1997 Notice is not, therefore, just "creditors, beware." It is a message that a kind of facile optimism (or more precisely, an expectation that is almost always expressed in terms of optimism) about the transformation of the Chinese legal system into one with which Western lawyers are comfortable and familiar is misplaced. Despite increasing surface similarities, the Chinese legal system, for better or for worse, remains in many ways profoundly different in its most basic assumptions.

Footnotes

[1]People's Republic of China Enterprise Bankruptcy Law (for Trial Implementation), enacted December 2, 1986, effective November 1, 1988 (the Bankruptcy Law). The Bankruptcy Law applies by its terms only to state-owned enterprises.

[2]"Sufficiently large" appears to be about three times the annual salary. *See infra* text accompanying note 23.

[3]People's Republic of China Civil Procedure Law, effective April 9, 1991.

[4]People's Republic of China Security Law, effective October 1, 1995. The Security Law covers secured transactions generally.

[5]The relevant cities are listed in an appendix to the 1997 Notice and include Beijing, Changchun, Changsha, Chengdu, Chongqing, Dalian, Fuzhou, Guangzhou, Haikou, Harbin, Jilin, Nanjing, Ningbo, Qingdao, Shanghai, Shenyang, Shenzhen, Tianjin, Wuhan, Xiamen, and Wuxi.

[6]1997 Notice, Preamble.

[7] *Id.*, § 5. It is important to note that in the Bankruptcy Law and the Civil Procedure Law, employees who are owed wages already have a higher priority than other unsecured creditors and even than the tax authorities.

[8] Article 74 of the Supreme People's Court Opinion on Several Issues in the Implementation of the "People's Republic of China Enterprise Bankruptcy Law (for Trial Implementation)," issued November 7, 1991, provides that bankruptcy and repayment procedures for non-state-owned enterprise legal persons (*fei quanmin suoyouzhi qiye faren*) should be handled in accordance with the provisions of the Civil Procedure Law. The term "non-state-owned enterprise legal persons" probably means enterprise legal persons that are not state owned, but it could mean legal persons that are not state-owned enterprises, or even "situations involving [parties] other than state-owned enterprise legal persons"). The relevant provisions of the Civil Procedure Law are Articles 199 to 206.

[9] Bankruptcy Law, Art. 34.

[10] *Id.*

[11] *Id.*

[12] *Id.*, Art. 37.

[13] *Id.*

[14] *Id.*

[15] Promulgated by the State Council on October 25, 1994. The 1994 Notice does not apply to all state-owned enterprises. It applies only to state-owned enterprises in the 18 cities selected as trial points for the Enterprise Capital Structure Optimization program: Baoji, Bengbu, Changchun, Changzhou, Chengdu, Chongqing, Harbin, Liuzhou, Qiqihar, Shanghai, Shenyang, Taiyuan, Tangshan, Tianjin, Qingdao, Wuhan, Zhuzhou, and Zibo.

[16] It would appear that the 1994 Notice rule on selling land use rights does not apply to land use rights over which a security interest has been granted. Thus, secured creditors appeared to keep the value of their expectancy under the 1994 Notice. They lose it under the 1997 Notice. *See infra* text accompanying note 21.

[17] *See* 1994 Notice, § 5.

[18] Article 43 of the Bankruptcy Law provides that "concrete provisions and steps for the trial implementation of the law shall be stipulated by the State Council."

[19] 1997 Notice, Preamble. A case of misapplication of the 1994 Notice is reported in the June 24, 1997 issue of the *Renmin Fayuan Bao* (People's Court Daily). In handling the bankruptcy of an SOE in Yong'an City in Fujian, the local court applied the 1994 Notice "by analogy," giving resettlement payments to employees priority over payments to creditors and thus leaving the latter with nothing. Both the relevant Intermediate Level People's Court and the Fujian Higher Level People's Court rejected this part of the lower court's ruling on the specific grounds that Yong'an was not one of the cities in the Capital Structure Optimization program and was therefore not covered by the 1994 Notice.

[20] A problem that arises when "selling off" allocated land use rights is that such rights have no specified term. Thus, to stipulate vaguely that allocated land use rights shall be sold off does not tell us the term of years that is to be offered for sale. Presumably, given the revenue-maximizing aim of the 1994 Notice and the 1997 Notice, the land use rights are to be sold for the maximum available term, which varies according to the use of the land.

[21] *See* 1997 Notice, § 5.

[22] In their essentials, the 1994 and 1997 Notices are simply condemnations by the government of existing creditors' rights. Were the government to take granted land use rights directly from the enterprise, it would be required to pay compensation under Article 42 of the State Council's Provisional Regulations of the People's Republic of China on the Grant and Transfer of State-Owned Urban Land Use Rights (the Grant Regulations), promulgated and effective May 24, 1990. The Grant Regulations—possibly by oversight—do not, however, provide any relief for secured creditors, and I know of no other regulations that can be reasonably read to do so. Chinese law contains no general rule, similar to that of the Fifth Amendment of the U.S. Constitution, that the government must compensate the owner of "property" that it takes. In China, the duty to compensate arises only out of specific statutes describing specific situations. Consequently, there is no point in analyzing the degree to which unsecured and secured creditors' rights should be deemed "property" and the degree to which they have been "taken" by the two Notices.

[23] *See* 1997 Notice, § 5.

[24] I argue above, of course, that this sacrifice of the interests of creditors could well lead to *more* bankruptcies, even when not economically desirable.

[25] *See supra* text following note 18.

[26] It is worth at least a footnote to point out that the relevant mandate stipulates that "the state" is to provide for the reemployment of workers; it does not put this burden on creditors of the enterprise, who are the ones that are in fact being asked to pay, through the loss of their statutory rights.

[27] The 1994 Notice was enacted before the Security Law and, in any case, respects the rights of secured creditors and does not infringe on the Security Law's provisions.

[28] A similar process can be observed in the history of regulations regarding land leasing in China, something formerly prohibited under the Constitution. The State Council first allowed experimentation in some cities pursuant to administrative regulations; when this seemed to work, a statute was passed enabling the practice; and in the end, after some years of practical experience and when everyone was sure, the Constitution was amended to allow it. Thus, while the Constitution is undoubtedly important in its own way, it is misleading to think of it as a supreme "law."

[29] *See supra* note 5.

[30] *See* Ren Jianxin, "Zuigao renmin fayuan gongzuo baogao" ("Supreme People's Court Work Report"), *Fazhi ribao* (*Legal System Daily*), April 11, 1990, at 2.

[31] A good analogy from American jurisprudence is the kind of rule-following called for by the U.S. Supreme Court in *Brown v. Board of Education* when it ordered the dismantling of school segregation "with all deliberate speed." This formulation was widely criticized, however, precisely because it was so at odds with prevailing principles of legality; one of its inventors himself labeled it "entirely unprincipled," "simply indefensible" and "just plain wrong" as a matter of constitutional principle. *See* Philip Elman, "The Solicitor General's Office, Justice Frankfurter, and Civil Rights Litigation, 1946-1960: An Oral History," 100 *Harv. L. Rev.* 817, 827-828 (1987).

[32] The Chinese government often sends two entirely different messages in this respect. Sometimes it says that the Chinese legal system is really just like the Western ideal: judges are independent, legislative procedure is respected, rights are rigorously enforced, etc. At other times it stresses that China's legal system is one with "Chinese characteristics," and that it cannot be judged by the standards used to judge Western legal systems. Both claims can be found, for example, in the State Council's 1991 White Paper on Human Rights.