

The U.S. Reorganization Regime in the Chinese Mirror: Legal Transplantation and Obstructed Efficiency*

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Abstract

In the past decade national lawmaking for regulating commerce has been driven by globalization and the transplantation of foreign laws. The new Chinese Enterprise Bankruptcy Law enacted in 2006 was modeled closely on the U.S. Bankruptcy Code, especially chapter 11, which puts the bargaining game at the center of corporate reorganization. Legal scholarship has not yet comprehensively explored how business law transplants from a market economy like that of the United States to a socialistic market economy like that of China. This article provides an in-depth comparison of the reorganization bargaining regimes of bankruptcy law in the United States and China, focusing on the socio-legal context in which these regimes operate. The comparison shows how the bargaining game at the core of chapter 11 suffers from obstructed efficiency when transplanted to a Chinese context, an obstruction caused by historical, political, economic, and social factors.

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The oranges that grow to the south of the Huai River are sweet oranges while the ones that grow to the north of the Huai River are bitter. The leaves of the sweet oranges and bitter oranges are similar but the fruits taste different. Why? The water and soil of the two places are different.

Yan Zi (578 BC–500 BC)¹

Introduction

In the past decade, national lawmaking for regulating commerce has been driven by globalization and the transplantation of foreign laws. Although many nations have

¹ See Yanzi, TALES OF YANZI (Chinese Edition) 70 (Liaoning Education Press 2013) (translation by author).

influenced bankruptcy lawmaking worldwide, the “U.S. leads the world in its experience with reorganization of corporations through bankruptcy law.”² Lawyers from the United States heading the International Monetary Fund, the World Bank, and other international organizations that drive global insolvency law reform have helped to make the global model for reform more or less resemble a “globalized localism,”³ a one-size-fits-all solution. The bankruptcy regime in China has undergone reform toward a market orientation since 1994.⁴ This reform has had the purpose of expanding the scope of bankruptcy law from narrowly applying to state-owned enterprises (SOEs) to broadly applying to all enterprises.⁵ The reform of Chinese Enterprise Bankruptcy Law, with its objective to rival the “[bankruptcy law] of other developed economies—at least on paper,”⁶ served as the primary impetus for reform in other sectors of China’s economy, a reform that has amounted, in aggregate, to a general shift from a planned economy toward a socialistic market economy.⁷ Scholars and professionals with Western educational backgrounds sat on the board that drafted the new Chinese Enterprise Bankruptcy Law, and the drafts were open to comment by experts from international organizations like the World Bank.⁸ The new Chinese Enterprise Bankruptcy Law was enacted in 2006 (hereinafter, Chinese EBL (2006)). Chinese EBL (2006) was regarded as a product of evident “Westernization,” on account of the contributions made to it by foreign experts and international organizations; such foreign contributions are rare for commercial legislation in China. Notably, the corporation reorganization regime, Chapter 8 of Chinese EBL (2006), was transplanted from chapter 11 of the U.S. Bankruptcy Code, as Professor Li, one

² Terence C. Halliday & Bruce G. Carruthers, *The Recursivity of Law: Global Norm Making and National Lawmaking in the Globalization of Corporate Insolvency Regimes*, 112 AM. J. SOC. 1135, 1187 (January 2007).

³ *Id.*

⁴ Guanyu Zhongguo Renmin Gongheguo Qiye Pochanfa Caoan de Shuoming (Statement Regarding EBL (draft)), (Jia Zhijie, in NAT’L PEOPLE’S CONG., Jun. 21, 2004).

⁵ *Id.* (The former Enterprise Bankruptcy Law (1986) only applied to state owned enterprises.).

⁶ Eu Jin Chua, *Bankruptcy Reform in China*, 1 PRATT’S J. BANKR. L. 552, 552 (2006).

⁷ See Henry R. Zheng, *Bankruptcy Law of the People’s Republic of China: Principle, Procedure & Practice*, 19 VAND. J. TRANSNAT’L L. 633, 665 (1986).

⁸ Bruce G. Carruthers & Terence C. Halliday, *Negotiating Globalization: Global Scripts and Intermediation in the Construction of Asian Insolvency Regimes*, 31 LAW & SOC. INQUIRY 521, 561-68 (2006).

of the drafters of Chinese EBL (2006), has claimed.⁹

Scholars and legal professionals in U.S. bankruptcy law can claim to have exported their bankruptcy reorganization regime to China,¹⁰ as mirrored in Chinese EBL (2006), a transplant to a civil-law country with a socialistic economic system. However, the reality of transplantation, once the law is implemented and enforced, is difficult to predict from the law as it is written on the books. That is because the letter of the law may be transplanted with relative ease, but the “soil” in which it takes root does not come with it.¹¹ Removed from its native soil, will a transplanted law still function effectively? That is a question that begs for analysis in the case of Chinese bankruptcy law. Also, the reorganization regime under Chinese EBL (2006) was not a wholesale transplant of chapter 11. Instead, it underwent some modifications, which made it different from chapter 11. What motivations were behind the modifications? Do the modifications promote or undermine the efficiency of its application? These questions deserve in-depth analysis.

Chapter 11 of the U.S. Bankruptcy Code is one distinguishing feature of a market economy based on the assumption that “successful reorganizations are neither primarily the product of the judicial process nor basically adversarial in nature, but instead reflect the persuasive power of ‘private ordering.’”¹² The U.S. business reorganization regime that derives from bankruptcy law achieves efficiency by providing a forum in which two parties can negotiate with each other without compromising the rights of any third parties.¹³ Negotiation is at the core of the U.S. corporate reorganization regime. Without such a core, the reorganization law, when

⁹ Li Shuguang & Wang Zuofa, *The Gap between Expectation of Legislation and Judicial Practice and its Resolution: Empirical Analysis of Bankruptcy Law's Three-years Implementation*, 2 J. CUPL 58, 61 (2011).

¹⁰ Professor Ugo Mattei suggests that most efficient legal doctrine can be transplanted and adopted around the world since the market force in the “market for legal culture” would choose the most efficient rules. Hideki Kanda & Curtis J. Milhaupt, *Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, 51 AM. J. COMP. L. 887, 890 (2003).

¹¹ Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 253 (2007) (stating that although “law on the books may be converging, the level of enforcement efforts seems to vary widely across national boundaries.”).

¹² J. Bradley Johnston, *The Bankruptcy Bargain*, 62 AM. BANKR. L.J. 213, 216 (1991).

¹³ Douglas G. Baird & Randal C. Picker, *A Simple Non-cooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311, 312 (1991).

transplanted to another country, cannot function as efficiently as might be expected.¹⁴ Despite the understanding that negotiation is at the center of chapter 11, neither the bankruptcy law literature nor the comparative law literature has comprehensively examined and compared the bargaining game under the U.S. Bankruptcy Code with its counterpart under Chinese EBL (2006).

This article provides an in-depth comparison of the reorganization bargaining regimes in the United States and in China, with particular attention paid to the socio-legal context in which the legal regimes operate. The comparison shows how imperfectly the bargaining game at the center of chapter 11 fared once transplanted to a Chinese context, with all the historical, political, economic, and social factors that came into play. The analysis advanced here may help international commercial lawyers (especially bankruptcy lawyers) distinguish the idealization of a transplanted law from its realization. It may also shed light on some long-debated questions in comparative law. Are harmonization and convergence possible through the transplantation of commercial law? How does one assess the effects of transplantation? Does a transplanted law change society, or is the transplanted law changed by society?

Part I of the article provides a theoretical framework for the analysis. Parts II and III examine the reorganization game under United States and Chinese bankruptcy law on the basis of efficiency. Part IV analyzes the reasons why the bargaining game, the centerpiece of chapter 11 in the United States, does not operate efficiently when transplanted to Chinese society.

I. Theoretical Framework

A. Legal Transplant and Efficiency

Legal transplantation of a bankruptcy regime has occurred in countries other than China. One example is Japan's absorption of Chapter X of the Chandler Act after World War II.¹⁵ Chinese bankruptcy law, a "patchwork of the U.S. Chapter 11 and

¹⁴ See the discussion of the bargaining game in bankruptcy reorganization, *infra* Part I.B.

¹⁵ David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1381 (1998).

English Administration,” serves as another example of bankruptcy law transplantation.¹⁶ How does the bargaining game, the centerpiece of U.S. bankruptcy reorganization, fare after transplantation to a new context, given the different historical, political, economic, and social factors that affect it? The answer to this question will be examined according to the degree of its efficiency.

As first introduced by Alan Watson, the concept of a “legal transplant” refers to “the moving of a rule from one country to another.”¹⁷ Legal transplantation is a way toward efficiency. As Professor Ugo Mattei suggests, the most efficient legal doctrine can be transplanted and adopted around the world since the market force in the “market for legal culture” would choose the most efficient rules.¹⁸

The efficiency of a legal transplant derives not only from adopting the imported rule as it exists on the books, but the law should also “actually be used in practice and [with] legal intermediaries responsible.”¹⁹ Despite its cost-saving and communication-facilitating aspects, transplanted law does not always work as efficiently in the recipient country as it does in the originator country, especially when the transplant occurs across countries with different legal traditions, cultural backgrounds, and socioeconomic conditions.²⁰ As Professors Kanda and Milhaupt claim, the “‘fit’ between the imported rule and the host environment is crucial to the success of a transplant.”²¹ The better an imported rule fits the micro setting (preexisting legal infrastructure in the host country) and the macro setting (the preexisting institutions of the political economy in the host country), the greater the

¹⁶ Lijie Qi, *The Corporate Reorganization Regime under China’s New Enterprise Bankruptcy Law*, 17 INT. INSOLV. REV. 13, 13 (2008).

¹⁷ ALAN WATSON, *LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW* 21 (2nd ed. Univ. Georgia Press, 1993). The movement can either be a process of “downloading” from internationally recognized norms, such as human right norms, or a “horizontal transplant” across national systems. See also Gregory Shaffer, *Transnational Legal Process and State Change*, 37 LAW & SOC. INQUIRY 229, 234 (2012).

¹⁸ Hideki Kanda & Curtis J. Milhaupt, *supra* note 10, at 890 (2003).

¹⁹ Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *The Transplant Effect*, 51 AM. J. COMP. L. 163, 167-168 (2003).

²⁰ See Pierre Legrand, *The Impossibility of ‘Legal Transplants’*, 4 MAASTRICHT J. EUR. & COMP. L. 111 (1997). Early scholars of legal transplantation have often disregarded the impact of moving between different social backgrounds. Alan Watson has claimed that ‘the transplanting of legal rules is socially easy’. However, it was later realized that transplantation of law cannot remain isolated from social context. See also Otto Kahn-Freund, *On Uses and Misuses of Comparative Law*, 37 MOD. L. REV. 1, 7 (1974) (“We cannot take for granted that rules or institutions are transplantable.”).

²¹ Kanda & Milhaupt, *supra* note 10, at 891.

efficiency that the transplant will achieve.²² A low level of either micro fit or macro fit will lead to inefficiency.²³

B. Path Dependence and Lock-in Effects That Obstruct Efficiency

In the case of legal transplantation of bankruptcy law, inefficiency may occur due to path dependence in both legislation and enforcement. Path dependence means “directions for future development are foreclosed or inhibited by directions taken in past development.”²⁴ Legal path dependency can be explained by the cost that diverging from past legal tradition incurs through assessing new information and accomplishing political persuasion.²⁵ For example, the 1990 amendment to the U.S. Bankruptcy Code “closely paralleled” the protections of financial products of the 1982 and 1984 amendments.²⁶ The goal of maintaining the established value of “certainty” for legislation leaves little space for deviation from former legislative patterns.²⁷

In some circumstances, dependence on a tested path can be economically efficient. Evolutionary economics argues that traits and practices that yield inefficient results will be challenged by better alternatives and consequently go extinct. The survival of a path indicates its efficiency.²⁸ Besides, abandoning a given path and establishing new institutions might not increase net return, due to large setup costs, learning and adapting costs, and the costs of breaking old coordination among linked

²² *Id.*

²³ Yuliya Guseva, *KGB'S Legacy: Transplanting Efficient Financial Infrastructures without Efficiency*, 36 U. PA. J. INT'L L. 525, 546 (2014).

²⁴ Bart Nooteboom, *Path Dependence of Knowledge: Implications for the Theory of the Firm*, in EVOLUTIONARY ECONOMICS AND PATH DEPENDENCE 57 (Edward Elgar ed., 1997).

²⁵ Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 WASH. & LEE L. REV. 1715, 1723 (2014). (“Informational burdens arise when the choice of one legislative course of action makes future assessments of alternative courses harder; actors become used to the “normal” state of affairs and find it hard to change course. Political burdens are created when groups or institutions sympathize with earlier legislative choices and wield their influence to maintain and perhaps magnify the patterns created by those choices.”)

²⁶ *Id.* at 1730. See Bill Pertaining to Title 11 of the United States Code, The Bankruptcy Code: Hearings on S. 1626, S. 1358, S. 1863, and S. 2279 Before the Subcomm. on Courts and Administrative Practice of S. Comm. on Judiciary, 100TH CONG. 672 (1988).

²⁷ *Id.*

²⁸ Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 642 (1996).

infrastructures.²⁹ Sticking instead to one path will avoid such costs.

The intractability of tradition can result in a “lock-in” effect such that path dependency rejects more efficient alternatives and the inferior practice prevails.³⁰ One example of inefficient lock-in is the QWERTY keyboard. It was first designed, as the arrangement of letters for early typewriters, to prevent mechanical failure by deliberately slowing down an operator’s typing speed. The design later became inefficient, as new computer keyboards were free from the mechanical errors caused by moving metal type, but the QWERTY arrangement of keys persisted due to stereotypical user perception.³¹ Similarly, it is plausible that legislators may make little change to current law, not for efficiency concerns but because it can guarantee perceived legitimacy and appropriateness.³²

Path dependency will add complications to the efficiency analysis of legal transplantation. In one respect, the transplanted law can eliminate “lock-in inertia” and bring about radical system change by instilling more efficient alternatives in an ossified old system.³³ In another respect, the “doggedly nationalistic” dependence on the old path may greatly raise transplanting costs,³⁴ thereby reducing the efficiency gained by legal transplantation. As highlighted by Douglass North, institutions and policies created by the existing legal order can be self-reinforcing, as they create infrastructures and linkages that serve to strengthen their own stability,³⁵ and to replace the existing institutions would be difficult and costly. Inefficiency can arise when newly transplanted law cannot work coherently within the path-dependent old

²⁹ Paul Pierson, *Increasing Returns, Path Dependence, and the Study of Politics*, 94 AM. POL. SCI. REV. 251, 254 (2000). See also ARTHUR W. BRIAN, *INCREASING RETURNS AND PATH DEPENDENCE IN THE ECONOMY* (1994).

³⁰ Arthur W. Brian, *Competing Technologies, Increasing Returns, and Lock-In by Historical Events*, 97 ECON. J. 116, 116-128 (1989).

³² Paul A. David, *Path Dependence and the Quest for Historical Economics: One More Chorus of the Ballad of QWERTY*, 20 OXFORD DISCUSSION PAPERS IN ECON. & SOC. HIST. 1, 9 (1997).

³² Bernhard Ebbinghaus, *Can Path Dependence Explain Institutional Change? Two Approaches Applied to Welfare State Reform*, MPIFG DISCUSSION PAPERS 5, 22 (2005).

³³ *Id.* at 17.

³⁴ Terence C. Halliday, Susan Block-Lieb & Bruce G. Carruthers, *Rhetorical Legitimation: Global Scripts as Strategic Devices of International Organizations*, SOCIO-ECONOMIC REV. 1, 28 (2009).

³⁵ Pierson, *supra* note 29, at 260. See also DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (1990).

system.³⁶

The problem then becomes how to effectively transplant bankruptcy law without loss of efficiency. To reverse the tendency to follow the trodden path, a “critical mass” of individuals adopting the new institution is required.³⁷ In the competition between the new path and the old path, the gain of choosing one path is positively related to the number of people who choose that path.³⁸ Once there is a sufficiently large proportion of people choosing the new path, the return on its use will increase enough to compensate the cost of diverting from the old one, and the new path will gain self-enforcing “deterministic properties.”³⁹ To reach the “critical mass” that overturns a historically determined path, a centralized administrator is necessary to provide direction and to convey information that persuades people to trust the new system.⁴⁰

II. Reorganization Bargaining in the United States

A. Reorganization under the U.S. Bankruptcy Code

The forerunner of present-day federal reorganization legislation in the United States can be traced back to the composition agreement in the 1874 bankruptcy law, which played an important part in keeping the railroads running undisturbed by

³⁶ For example, the Chinese “modern” company law has learned from its U.S. counterpart by conferring “much greater managerial autonomy on SOEs largely in order to enhance their efficiency.” But the efficiency of such transplantation was limited by path dependency in “the dominant position of state ownership,” and the existence of non-circulating state shares have undermined the efficiency of managerial autonomy. See Zhou Ling, *The Independent Director System and its Legal Transplant into China*, 6 J. COMP. L. 262, 274 (2011).

³⁷ Ebbinghaus, *supra* note 32, at 8.

³⁸ For example, when it is possible to choose between driving on the right or left, the advantage of choosing right increases with the number of people making the same choice, since staying with majority is likely to reduce accidents. See Brian, *supra* note 30.

³⁹ James Mahoney, *Path Dependence in Historical Sociology*, 29 THEORY & SOC. 507, 507 (2000) (“path dependence characterizes specifically those historical sequences in which contingent events set into motion institutional patterns or event chains that have deterministic properties”).

⁴⁰ Roe, *supra* note 28, at 666 (“If we could believe that what survives is efficient, then we would not need to consider the possibility that a centralized administrator might get the needed information fastest and make a correct decision to change the path. A mistrust of governmental action is more persuasive (and more satisfying in constructing a coherent belief system if we can convincingly presume the efficiency of most key economic in-situations. If we cannot, because too much depends on chaotic original conditions or path dependence, then the verbal space would widen in which to debate government action and directives for change.”).

restructuring.⁴¹ Similar to the modern reorganization provision, the composition agreement allowed debtors to keep control of property and propose payment over time in return for debt discharge.⁴² As the scope of bankruptcy legislation expanded during the Great Depression, the court-supervised administrator in railroad reorganization gradually evolved into federal reorganization laws,⁴³ codified in Chapter X and Chapter XI of the Bankruptcy Act of 1938 (the Chandler Act).⁴⁴

In 1978, the Bankruptcy Code replaced the old Chandler Act.⁴⁵ Chapters X and XI of the former Chandler Act were merged into the new chapter 11. Chapter 11 puts great emphasis on the debtor-in-possession (DIP) mode, in which current managers retain control over the firm's business operation.⁴⁶ To encourage reorganization, chapter 11 also "relaxes the requirements of the absolute priority rule."⁴⁷

B. The Bargaining Game in Bankruptcy Reorganization

Bargaining is the centerpiece of the U.S. bankruptcy reorganization regime.⁴⁸ A bargaining situation was first introduced by mathematician John F. Nash to resolve the equilibrium outcome when different parties "collaborate for mutual benefit."⁴⁹ The players in a bargaining game are assumed to be highly rational, which means that they

⁴¹ Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 22 (1995).

⁴² *Id.* at 21 ("If the proposed composition was accepted by a majority in number and three-fourths in value of the creditors, it was binding on all creditors named in the composition. Dissenters were protected by a "best interests" test, which required that creditors be paid as much as they would receive in a liquidation.").

⁴³ *Id.*

⁴⁴ Ch. 575, 52 Stat. 840 (1938) (repealed 1978). *See also* Mitchell S. Dvoret, *Bankruptcy Under the Chandler Act: Legislative History and Summary*, 27 GEO. L.J. 345 (1939).

⁴⁵ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-1330 (2016)).

⁴⁶ 11 U.S.C. §§ 1101 and § 1107 (2016), *see* David A. Skeel, Jr., *Rethinking the Line between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994).

⁴⁷ *Id.* at 56 ("Whereas Chapter X required that the absolute priority rule be satisfied in every case, the rule comes into play in Chapter 11 only with respect to a class of creditors or shareholders that votes against the reorganization plan."). *See* 11 U.S.C. §§ 1129(b) (2016).

⁴⁸ Baird & Picker, *supra* note 13.

⁴⁹ John F. Nash Jr., *The Bargaining Problem*, 18 ECONOMETRICA 155, 155-66 (Apr. 1950) ("A two-person bargaining situation involves two individuals who have the opportunity to collaborate for mutual benefit in more than one way . . . no action taken by one of the individuals without the consent of the other can affect the well-being of the other one.").

each fully understand their own desire and their opponent's desire, and act solely to maximize their own gain.⁵⁰ Efficient bargaining in reorganization can serve the purpose of reorganization well when it "maximizes the value of the debtor's assets and minimizes the creditors' collection costs."⁵¹

1. The Purpose of Reorganization

Corporate reorganization can serve as an effective way to protect a firm's value from creditors' unilateral attempts to "grab" assets under insolvency.⁵² Outside the regime of bankruptcy, being the first one to grab the debtor's assets can be rewarding, as a creditor's remedies outside bankruptcy law operate on a "first come, first served" basis.⁵³ Even when the automatic stay in bankruptcy law prevents such a run, a rational creditor, logically concluding that other creditors are also seeking to maximize their repayment, would respond to other creditors' claims in a hostile manner.⁵⁴

Confrontation among creditors may cause the liquidation of a troubled firm, even if there is a chance that the firm will revive. Creditors' uncoordinated unilateral action can lead to the liquidation of a potentially promising firm, which is a "prisoner's dilemma."⁵⁵ Reorganization can be a solution for such a prisoner's dilemma. In order to preserve the "present worth of future anticipated earnings,"⁵⁶ the attempt to seize liquidation value is suspended, and the troubled firm remains in operation, hence retaining the chance to recover and pay off its debts in full. Because the reorganization value is typically greater than the liquidation value,⁵⁷ reorganization

⁵⁰ *Id.* at 155.

⁵¹ Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319, 323 (1991).

⁵² *Id.* at 235. Under state law, the creditor who is first to make a formal claim against the assets of the firm will be first in line to receive payment from those assets.

⁵³ THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 209-224 (1986).

⁵⁴ Johnston, *supra* note 12, at 237 ("A creditor whose claim against the firm is in default will rationally assume he is not being paid because the firm has insufficient assets to meet all of its obligations and that he is not the only creditor whose claim is in default. Such a rational creditor will logically conclude that other creditors whose obligations are in default will be making the same assumptions and thus will be seeking to collect from the firm as soon as possible in light of the 'grab' aspects of state law.").

⁵⁵ Jonathan Masur, *Judicial Deference and the Credibility of Agency Commitments*, 60 VAND. L. REV. 1021, 1064 (2007).

⁵⁶ See *Protective Comm. v. Anderson*, 390 U.S. 414, 442 n.20 (1968).

⁵⁷ See *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510 (1941) (defining "reorganization

that results from bankruptcy bargaining can achieve a higher total repayment and create a win-win situation for debtors and creditors alike.

2. Different Classes in Reorganization Bargaining and Their Preferences

Even though reorganization can break the prisoner's dilemma among creditors and achieve higher repayment in aggregate, problems of noncooperation may still hinder the efficiency of bargaining, as different classes of bargainers have different goals and preferences.⁵⁸

Professor Mark Roe has identified different classes in reorganization bargaining: secured creditors, unsecured senior creditors, unsecured general creditors, junior creditors, trade creditors, management, and equity-holders.⁵⁹ Secured creditors are typically indifferent to the outcome of reorganization or liquidation, while some unsecured senior creditors may sacrifice current repayment in exchange for greater control in a reorganized firm.⁶⁰ Junior creditors and trade creditors would rather have a "bleeding liquidation," which can provide them with immediate cash, than have the "amorphous, uncertain benefit of increasing the long-run viability."⁶¹ Management and equity-holders, however, must strike a balance between maximizing the firm's future earning and satisfying the demands of creditors, with the goal of minimizing the negotiation costs and legal costs of potential reorganization litigation while preventing too severe a dilution of their controlling power in future business.⁶² Labor is another important party in reorganization that may have to "make some concessions in connection with the debtor's reorganization efforts," as labor's interest rests heavily

value" as "capitalization of future earnings").

⁵⁸ See Philip B. Heymann, *The Problem of Coordination: Bargaining and Rules*, 86 HARV. L. REV. 797, 818-19 (1973); see also Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 539 (1983) ("Stalemates occur. Even when all parties know that a particular proposed plan is better than the status quo, at least one party is often likely to reject the plan because yet another alternative is better for it, as long as that superior plan might be available if it holds out and holding out is unlikely to prevent falling back to something close to the first plan.").

⁵⁹ Roe, *supra* note 58, at 537-44.

⁶⁰ *Id.* at 541.

⁶¹ *Id.* at 542-43 ("[C]reditors in general are not necessarily interested in maximizing the viability of the firm. Ordinarily, absent the desire for repeated dealings discussed below, they want to obtain the greatest value as early as possible. They want to make the firm more viable only if viability enhances the chance or size of their repayment, or otherwise provides them with a greater net present value.").

⁶² *Id.* at 544.

on the survival of troubled company.⁶³ Even though a union can increase its bargaining power by collective bargaining, labor as a group must also “face up to the economic reality,” and balance between immediate benefit and long-term interest through improvement of debtor’s financial condition.⁶⁴

The above classification captures four key factors that distinguish different kinds of players in the reorganization bargaining game: 1) the ability to propose reorganization plans, 2) the patience to sacrifice immediate payment for future benefit, 3) the information available to the bargainers, and 4) the gain from holding out for alternative options. These factors influence the bargaining power of different parties in bankruptcy negotiation.

3. Bargaining Power of Different Parties in Reorganization

By acceding to and enforcing a reorganizing plan, the involved parties increase the value of the reorganized firm.⁶⁵ But what determines the bargaining power of different parties in reorganization?

The ability to propose a plan of reorganization contributes greatly to bargaining power. Outside of reorganization, the principals of an insolvent firm are left with nothing, since the firm’s total assets are insufficient to cover debt upon filing for bankruptcy. However, debtors have a strong bargaining power in reorganization since they can propose reorganization plans.⁶⁶ Chapter 11 imposes a 120-day “exclusive period” for debtors to file a reorganization plan, after which any interested party can file its plan.⁶⁷ The plan offered by debtors creates an “option value” for creditors, which equals to the firm’s expected value of future earning minus current value.⁶⁸

⁶³ Hon. William T. Bodoh & Beth A. Buchanan, *Ignored Consequences—the Conflicting Policies of Labor Law and Business Reorganization and its Impact on Organized Labor*, 15 AM. BANKR. INST. L. REV. 395, 410 (2007).

⁶⁴ *Id.* at 413.

⁶⁵ Johnston, *supra* note 12, at 245.

⁶⁶ The empirical study also shows that the debtors are significantly better off through bargaining. See Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, J. Fin. 747, 754-56 (1989).

⁶⁷ 11 U.S.C. §§ 1121(b), (c) (2016).

⁶⁸ Lucian Arye Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253, 265 (1992).

The creditors in a bargaining process act as “buyers” of the “option value,” and the price paid to debtors would be higher when debtors have a more exclusive right to propose a plan.⁶⁹

As previously mentioned, the equilibrium outcome of bargaining is related to each player’s patience, and a more patient bargainer will receive a larger portion of the total surplus. In the reorganization bargain, patience is not only determined by personal preference for future prospects over immediate repayment, but also by the external cost of delay. For creditors, the “financial distress cost” caused by inefficient management, loss of business partners, and failure to initiate lucrative project investments will “erode the value that debt-holders can expect to receive.”⁷⁰ For both debtors and creditors, each time an offer is rejected, the benefit of successfully reorganizing the firm decreases.⁷¹

The bargaining power for one party can also increase when that party can credibly threaten to exit the bargaining process and receive a higher payoff through alternative options. For instance, if managers can easily find other well-paying jobs elsewhere or if creditors can easily recover most of their debt from a convenient fire sale of assets, then it is likely that they would hold out in the bargaining process for more generous terms.⁷² Otherwise they would threaten to liquidate the firm.

C. Efficiency of Chapter 11 Bargaining

An efficient bankruptcy must focus on maximizing the total wealth of involved parties by enhancing bargaining. The following aspects of chapter 11 serve to guarantee the efficiency of reorganization.

⁶⁹ *Id.* at 263 (Consider an extreme case: “Control over the reorganization agenda is valuable. During each round in which the equity-holders have this control, they would capture all of the financial distress costs.”).

⁷⁰ *Id.* at 255.

⁷¹ Baird & Picker, *supra* note 13, at 335 (“Each time Creditor or Manager turns down an offer the other makes, the benefit of having Firm reorganized and back on track is lost for an additional period of time. For this reason, each party that makes an offer takes into account how anxious the other is to make a deal. The more anxious a party is relative to the other, the less she will receive. She will be more willing than her contracting opposite to accept a smaller share immediately, rather than a larger share at some later point.”).

⁷² Stuart C. Gilson, Kose John & Larry H.P. Lang, *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 321 (1990).

1. Consideration for the Time Value of Money

The value of money decreases with time: a dollar today is more desirable than a dollar in one month or in one year.⁷³ The inflation rate, interest rate, and uncertainty of future cash flow must be taken into account, for receiving one dollar in cash now is more desirable to creditors than being promised to be paid one dollar after a year.⁷⁴ However, in order to successfully reorganize a business and maximize total future value, creditors will have to sacrifice one dollar at present for future cash flow. It is thus efficient for debtors to offer a “premium” to creditors as time compensation, in order to gain support for a promising reorganization plan.⁷⁵

The respect for time value is codified in 28 U.S.C. § 1129, which states that claim holders will receive regular installments of cash payments “of a total value, as of the effective date of the plan, equal to the allowed amount of such claim.”⁷⁶ One court has explained, in *In re Hathaway Coffee House, Inc.*, the concept of “value as of the effective date of the plan” as “the promised payment under the plan must be discounted to present value as of the effective date of the plan.”⁷⁷ In such a manner, the patience of creditors is effectively compensated, and plans that can generate high future wealth can be favored.

2. Time Limit for Proposing a Plan

Chapter 11 imposes a 120-day “exclusivity period” for debtors to file a reorganization plan, after which any interested party can file its plan.⁷⁸ Although the bankruptcy court can extend the length of the exclusivity period, theoretically up to eighteen months, debtors cannot always expect to enjoy a time extension, as a formal

⁷³ Marie Mariscalco, *Reorganization —Chapter 11*, 1 BANKR. DEV. J. 370, 371 (1984).

⁷⁴ See Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 1 (1986).

⁷⁵ *Id.* at 10.

⁷⁶ 11 U.S.C. §§ 1129(a)(9)(C) (2016).

⁷⁷ *In re Hathaway Coffeehouse, Inc.*, 24 B.R. 534 (Bankr. S.D. Ohio 1982); *In re Moore*, 25 B.R. 131, 134 (Bankr. N.D. Tex. 1982) (“The appropriate discount (interest) rate must be determined on the basis of the rate of interest which is reasonable in light of the risks involved. Thus, in determining the discount (interest) rate, the court must consider the prevailing market rate for a loan of a term equal to the payout period, with due consideration of the quality of the security and the risk of subsequent default.”).

⁷⁸ 11 U.S.C. §§ 1121(b), (c) (2016).

hearing and sufficient reasoning are required.⁷⁹ Facing the pressure of potential rival plans after the expiration of the exclusivity period, debtors are motivated to expedite the reorganization process. In an empirical study of 284 reorganization cases, Altman noted that 54.2 percent of reorganization cases in the United States took less than eighteen months, with a median time length of seventeen months.⁸⁰ The shortening of reorganization cases can reduce the “financial distress cost”⁸¹ and increase the reorganized firm’s profitability, which would contribute to the present value of the firm.⁸²

3. Information Disclosure

The cost of delaying may impose a loss of value on all bargainers in reorganization and increase the total transaction cost.⁸³ However, the cost of delay can be minimized under conditions in which both players are provided with adequate information for decision making. With a perfect information supply, the bargaining process can reach an equilibrium outcome, and no delay cost will be incurred.⁸⁴ In fact, as Professor Baird points out, under the perfect information hypothesis, neither player can obtain any extra gain by delaying agreement for one more round, since accepting an equilibrium offer in the first round is just as attractive as in any other

⁷⁹ 11 U.S.C. §§ 1121(d)(2)(A) (2016).

⁸⁰ Edward I. Altman, *Evaluating the Chapter 11 Bankruptcy Reorganization Process*, 1993 COLUM. BUS. L. REV. 1, 3 (1993). The author has also examined the similar study of other scholars. “Hotchkiss examined 684 complete reorganizations and found the average time from filing to confirmation was 18 months with a median of 16.2 months. LoPucki has compared a number of empirical studies with respect to the median time spent in reorganization and concludes that the sample of firms helps to explain the differing results that smaller firms tend to complete the process quicker than larger ones.” See Edith Hotchkiss, *Does Chapter 11 Lead To Efficient Investment Decisions?* (1992) (unpublished Ph.D. dissertation, New York University, Stern School of Business) and Lynn M. Lopucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729 (1993).

⁸¹ Bebchuk & Chang, *supra* note 68.

⁸² Still, there may be inevitable cases of delay. For instance, the LTV Corp. bankruptcy (1986) was “mired by complex pension liability responsibility for well over six years”. See Altman, *supra* note 80, at 3.

⁸³ Colin F. Camerer & George Loewenstein, *Information, Fairness and Efficiency in Bargaining*, in PSYCHOLOGICAL PERSPECTIVES ON JUSTICE: THEORY AND APPLICATIONS 155, 159 (1993).

⁸⁴ Bebchuk & Chang, *supra* note 68, at 261. The equilibrium is reached though the “backward induction” process: for rational players with complete information in an N-round bargaining process, each player will examine the highest possible payoff in the final round. If the player is offered no less than the highest possible value in one round, then he or she will rationally accept it, and the bargaining will end without succeeding rounds. Keep rolling backward to the first round, and we find that the bargaining can end at the first round with an acceptable offer, which saves negotiation cost.

round.⁸⁵ Hence, neither party has the incentive to delay agreement.

With adequate information to evaluate a proposed plan, debtor and creditors can reach an efficient outcome without delay in the first round of bargaining. The necessary information for efficient decision making includes both “hard” factual information on the past and anticipated performance of the debtor, as well as “soft” information like professional opinions, projections, and estimates.⁸⁶ To urge information disclosure, 28 U.S.C. § 1125 requires that debtors provide “adequate information” that allows a “hypothetical investor typical of the holders of claims or interests in the case” to make “an informed judgment about the plan.”⁸⁷ At first glance, the expression of § 1125 may seem vague, but in practice it is enhanced by the self-interest of creditors’ committees, which are “given wide power of investigation and will be heard by the court on all issues.”⁸⁸ Further, the court may appoint trustees and examiners to assist in information gathering.⁸⁹ An economically efficient level can be reached, as the cost of gathering information and the benefit of that information can reach an optimal equilibrium under the committee members’ own rational choice. Besides, the creditors’ committee has the rejection power as leverage for information disclosure, as it can bargain for more detailed information in exchange for not voting against the plan.

III. The Case of China

A. The Motive for Modifying the Chinese Bankruptcy Code and the Transplantation of Western Models

The Chinese EBL (2006) has been described as “a patchwork of the U.S. Chapter 11 and English Administration.”⁹⁰ Chinese EBL (2006) was adopted by the Chinese

⁸⁵ Baird & Picker, *supra* note 13, at 335.

⁸⁶ Note, *Disclosure of Adequate Information in a Chapter 11 Reorganization*, 94 HARV. L. REV. 1808, 1823 (1981) (“Congress recognized that estimates of future performance are the essence of informed decision-making in a reorganization. Such estimates are necessarily projections or opinions rather than objectively verifiable facts. Thus, ‘adequate information’ should encompass ‘soft’ information such as projections, as well as ‘hard’ factual data on past performance relevant to an evaluation of the anticipated performance of the debtor.”).

⁸⁷ 11 U.S.C. §§ 1125(a)(1) (2016).

⁸⁸ 11 U.S.C. §§ 1103(2) (2016).

⁸⁹ 11 U.S.C. §§ 1103(c)(4) (2016).

⁹⁰ Qi, *supra* note 16, at 16 (“One of the most outstanding features of the new Chinese Bankruptcy Law

National People's Congress and became effective on June 1, 2007, replacing the 1986 Enterprise Bankruptcy Law.⁹¹ The 1986 Enterprise Bankruptcy Law was regarded as having "owed virtually nothing whatsoever to any outside law or legal system."⁹² Chinese EBL (2006), which took about ten years in the making, has the ambitious goal to "introduce a bankruptcy regime to rival that of other developed economies—at least on paper."⁹³

China is a developing country and, like other developing countries, has engaged in legal transplantation. According to the theory of Professor Miller, law drafters in developing countries tend to receive legislation from foreign countries, known as "dictated transplants," with gratitude for its cost savings. Transplants in developed countries, by contrast, tend to be entrepreneurial or legitimacy-generating transplants, in Miller's terms.⁹⁴ Different from other Asian countries with a Western colonial history, China has no inherited Western legal system. China is also a powerful country and can resist pressure from outside nations more effectively than smaller countries when it comes to legal reform.⁹⁵ Still, transplantation and Westernization were themes in China's legal modernization,⁹⁶ especially for the private law regime, since private law is easier to transplant compared with public law.⁹⁷

The reform of Chinese bankruptcy law was driven by combined forces: the internal agenda of economic reform, the influence of scholars, the desire of local elites and leaders, the 1997 Asian Financial Crisis as a significant precipitating event, and the influence of international financial organizations. Due to the combination of

is the introduction of a real formal corporate reorganization regime, basically a patch work of the U.S. Chapter 11 and English administration, into this jurisdiction for the first time in history.").

⁹¹ See Law on Enterprise Bankruptcy (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007) (China), translated version *available at* 2006 China Law LEXIS 5574 (hereinafter Chinese EBL (2006)).

⁹² Carruthers & Halliday, *supra* note 8, at 562.

⁹³ Chua, *supra* note 6, at 552.

⁹⁴ See Jonathan M. Miller, *A Typology of Legal Transplants: Using Sociology, Legal History and Argentine Examples to Explain the Transplant Process*, 51 AM. J. COMP. L. 839, 842-849 (2003).

⁹⁵ Professor Merry believed that large and economically powerful countries with their vast markets can more easily resist the pressure of transplantation than smaller ones. See Sally Engle Merry, *New Legal Realism and the Ethnography of Transnational Law*, 31 LAW & SOC. INQUIRY 975, 987 (2006).

⁹⁶ Zhou, *supra* note 36, at 262.

⁹⁷ See A. Watson, *Legal Transplants and Law Reform*, 92 LQR 79, 80 (1976) ("[W]hatever their historical origins may have been, rules of private law can survive without any close connection to any particular people, any particular period of time or any particular place.").

driving forces, the reform of the bankruptcy regime followed independent dual tracks, led by administrative agencies and by a special committee of the People's Congress.⁹⁸ The final version that became law was the result of a compromise between the two tracks and the interest groups they represented.⁹⁹ Due to concern that the new law could produce political and social instability by removing administrative intervention, the implementing rules of Chinese EBL (2006) issued by the administrative agency and the Supreme Court allowed space for government to intervene. This process is called a "recursive process."¹⁰⁰

The primary driving force of Chinese bankruptcy law reform was the internal agenda of economic reform. The interim bankruptcy law (1986) only applied to SOEs. The fast growth of the private economy called for a comprehensive bankruptcy law. Also, the interim bankruptcy law (1986) could not solve the problem for SOEs completely, owing to "the needs of workers who would be thrown out of work—and no social safety net existed."¹⁰¹ Therefore, there were dual tracks for the reform. One was led by the former State Economic and Trade Commission, which issued documents to deal with the debt resolution problems of SOEs, especially the sale of distressed firms' assets and payments made to banks and workers.¹⁰² Another track was led by the Finance and Economy Committee of the National People's Congress with the purpose of drafting a modern comprehensive bankruptcy law for both SOEs and private enterprises.¹⁰³ Different from the first track, the drafting team for the second track consisted of officers, judges, and academic scholars, and the drafts "confer[red] a distinctive Chinese character upon the features of insolvency found in most capitalist countries."¹⁰⁴ The two tracks seemed different but finally merged together to form one unified bankruptcy law in 2006. This merger was driven by the

⁹⁸ Halliday & Carruthers, *supra* note 2, at 1167.

⁹⁹ *Id.* at 1170.

¹⁰⁰ *Id.* at 1171.

¹⁰¹ *Id.* at 1167.

¹⁰² Halliday & Carruthers, *supra* note 2, at 1168.

¹⁰³ *Id.* at 1169.

¹⁰⁴ *Id.*

1997 Asian Financial Crisis, the influence of international organizations, and the input of academic scholars with a Western educational background.

The 1997 Asian Financial Crisis was the precipitating event pushing bankruptcy legislation forward in Asian countries, including China.¹⁰⁵ The modifying of Chinese bankruptcy law and the transplant of Western models was contemporaneous with similar reforms occurring in other Asian countries such as South Korea and Indonesia.¹⁰⁶ Although the 1997 Asian Financial Crisis did not cause significant widespread depression in China as compared with other Asian countries, it may have impressed upon the Chinese government the importance of instituting an insolvency regime for the resolution of debts in an orderly way.¹⁰⁷ According to an interview with Professor Weiguo Wang, a key drafter, the year 1997 is a watershed of bankruptcy law, which shifted from only solving the bankruptcy problems caused by SOEs to providing debt resolution for all distressed firms in a market-oriented way.¹⁰⁸ In such a context, U.S. bankruptcy law, especially market-oriented reorganization law, became attractive to Chinese drafters. Professor Weiguo Wang remarked on the leading status of U.S. bankruptcy law in international financial thinking at the time and on his familiarity with U.S. bankruptcy law.¹⁰⁹

Efficiency is a significant driving force for the transplantation of Western bankruptcy law (like that of the United States) to China, since learning from successful legislative ideas and techniques from an advanced system can reduce the costs of time and experimentation.¹¹⁰ As noted by Professors Carruthers and Halliday, the academic drafters of Chinese bankruptcy law worked hard to “push state

¹⁰⁵ *Id.* at 523.

¹⁰⁶ Carruthers & Halliday, *supra* note 8, at 562.

¹⁰⁷ Douglas W. Arner, Charles D. Booth, Paul Lejot & Berry F.C. Hsu, *Property Rights, Collateral, Creditor Rights, and Insolvency in East Asia*, 42 TEX. INT'L L.J. 515, 550 (2007) (“Nevertheless, at the time of the financial crisis, China was affected by domestic concerns resulting from the poor financial condition of its SOEs and state-owned banks.”).

¹⁰⁸ See Interview with Professor Wang Weiguo, *The Course of the Bankruptcy Law Reform in China*, available at <http://www.china-review.com/sao.asp?id=5059>.

¹⁰⁹ *Id.*

¹¹⁰ Miller, *supra* note 94, at 845 (“Even admitting that a transplanted rule must mesh with a society’s social and political context does not eliminate cost-saving as a motivation for transplants.”). See also Kanda & Milhaupt, *supra* note 10, at 889.

law-drafting officials more closely to global norms.”¹¹¹

Receiving a transplanted bankruptcy law from a more prestigious and influential nation can generate legitimacy for domestic legislation.¹¹² A key drafter, Professor Shuguang Li, commented to the official media of China that the adoption of an advanced bankruptcy regime like that of prestigious nations shows how China has become more and more integrated into globalization.¹¹³

The active promotion by international organizations for Asian insolvency law reform did accelerate the passing of Chinese EBL (2006).¹¹⁴ Theoretically, international treaties, agreements, and organizations may also create pressure for related nations to evolve their domestic legislation in coherence with international peers.¹¹⁵ In China, international financial organizations such as the World Bank and Asian Development Bank provided consultant opinion for both reform tracks of Chinese bankruptcy law.¹¹⁶ Although not the decisive force behind the reform, the opinions provided by international organizations opened a window for policy makers in China and helped to build a basis for merging the two tracks.

Legal scholars with Western education or training also actively promoted bankruptcy reform in China. For legal professionals and scholars, accepting a transplant of foreign law can help justify their endeavor “with reference to the need to meet international obligations.”¹¹⁷ As political scientists have concluded, legal transplant can serve as a device for local elites and leaders to obtain domestically desirable results in the face of meeting international standards.¹¹⁸ Chinese legislators relied on academic scholars to draft the bankruptcy law, scholars who had been

¹¹¹ Carruthers & Halliday, *supra* note 8, at 535.

¹¹² Miller, *supra* note 94, at 854.

¹¹³ Yan Wang, *China Has The New Bankruptcy Law, Taking the Experience of Global Insolvency Law Reform*, SINA FINANCE (Aug. 27th, 2006), <http://finance.sina.com.cn/roll/20060827/1936885734.shtml>.

¹¹⁴ *Id.* 525-529 (“[W]hile these pressures have been most acute in countries in financial crisis, such as Indonesia and Korea, they have also been substantial in growing economies, such as China’s.”).

¹¹⁵ Shaffer, *supra* note 17, at 14.

¹¹⁶ See generally World Bank, *Bankruptcy of State Enterprises in China—a Case and Agenda for Reforming the Insolvency System* (2000). See also Halliday & Carruthers, *supra* note 2, 1169-1170.

¹¹⁷ David Zaring, *International Law by Other Means: the Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT’L L.J. 281, 300-304 (1998).

¹¹⁸ Robert D. Putnam, *Diplomacy and Domestic Politics: The Logic of Two-Level Games*, 42 INT’L ORG. 427, 457 (1988) (“International negotiations sometimes enable government leaders to do what they privately wish to do, but are powerless to do domestically.”).

educated in or had visited countries of the West to observe their insolvency systems, including the reorganization regime in the United States.¹¹⁹ Professor Weiguo Wang, the key drafter already named, also mentioned visiting the United States and said he was very impressed by American reorganization law.¹²⁰

The passage of Chinese EBL (2006) was considered “a significant step forward” for Chinese bankruptcy legislation compared with the old 1986 bankruptcy law¹²¹ for several reasons. First, compared with the “limited” old law, which applied only to SOEs,¹²² the new law’s scope of application extended beyond SOEs to non-SOEs,¹²³ partnerships, and financial institutions.¹²⁴ Second, it allowed for both voluntary and involuntary filing,¹²⁵ whereas filing under the old law had required governmental approval.¹²⁶ Third, to amend the “inconsistent and oversimplified” old law, Chinese EBL (2006) provided detailed guidelines for an insolvency test, the appointment of an administrator, the meeting of a creditors’ committee, and other stipulations,¹²⁷ which served to “safeguard the order of Socialist market economy.”¹²⁸

Chinese EBL (2006) replaced the administrative process of bankruptcy with a judicial process of bankruptcy. *Figure 1* outlines the judicial process of reorganization in China. After filing for reorganization by either creditors or the debtor is granted by the court, the debtor or a trustee has up to nine months to propose a reorganization

¹¹⁹ Arner, Booth, Lejot & Hsu, *supra* note 107, 563-564 (2007).

¹²⁰ *Supra* note 108.

¹²¹ Steven J. Arsenault, *The Westernization of Chinese Bankruptcy: An Examination of China's New Corporate Bankruptcy Law through the Lens of the UNCITRAL Legislative Guide to Insolvency Law*, 27 PENN. ST. INT'L L. REV. 45, 45 (2008).

¹²² *Id.* at 47.

¹²³ Chinese EBL (2006), *supra* note 91, art. 2, which states that the law applies to “Corporate legal persons.”

¹²⁴ See Ann vom Eigen, *China's New Bankruptcy Law Encourages Investment*, 25 AM. BANKR. INST. J. 8 (2006).

¹²⁵ Chinese EBL (2006), *supra* note 91, art. 7. See also Steven J. Arsenault, *supra* note 121 (“In order to be eligible to file for bankruptcy under the new law a business entity must either be unable to repay debts that fall due and have insufficient assets to repay those debts in full, or a business entity must be clearly insolvent. A debtor meeting those basic filing criteria may submit a bankruptcy application to the People's Court. The standard applicable to an involuntary filing by a creditor, however, is lower than for a debtor filing: a creditor need merely show that the debtor is unable to repay the debtor's debt.”).

¹²⁶ Qi, *supra* note 16, at 14 (“A debtor enterprise cannot apply for bankruptcy without the agreement of its superior departments in charge, typically the government branch that should preside over the organization thereafter.”).

¹²⁷ *Id.* at 14.

¹²⁸ Chinese EBL (2006), *supra* note 91, art. 1.

plan.¹²⁹ The plan will be submitted to the creditors' committee for voting. If the plan fails in the first vote, the debtor and creditors from dissenting groups may privately negotiate for solutions and vote for a second time. If the plan still fails in a second vote, the debtor can apply to the court for a cram down.¹³⁰ If the plan is agreed to by the creditors' committee, it still requires a court's confirmation before it can be carried out.¹³¹

¹²⁹ *Id.* art. 79.

¹³⁰ *Id.* art. 87.

¹³¹ *Id.* art. 86.

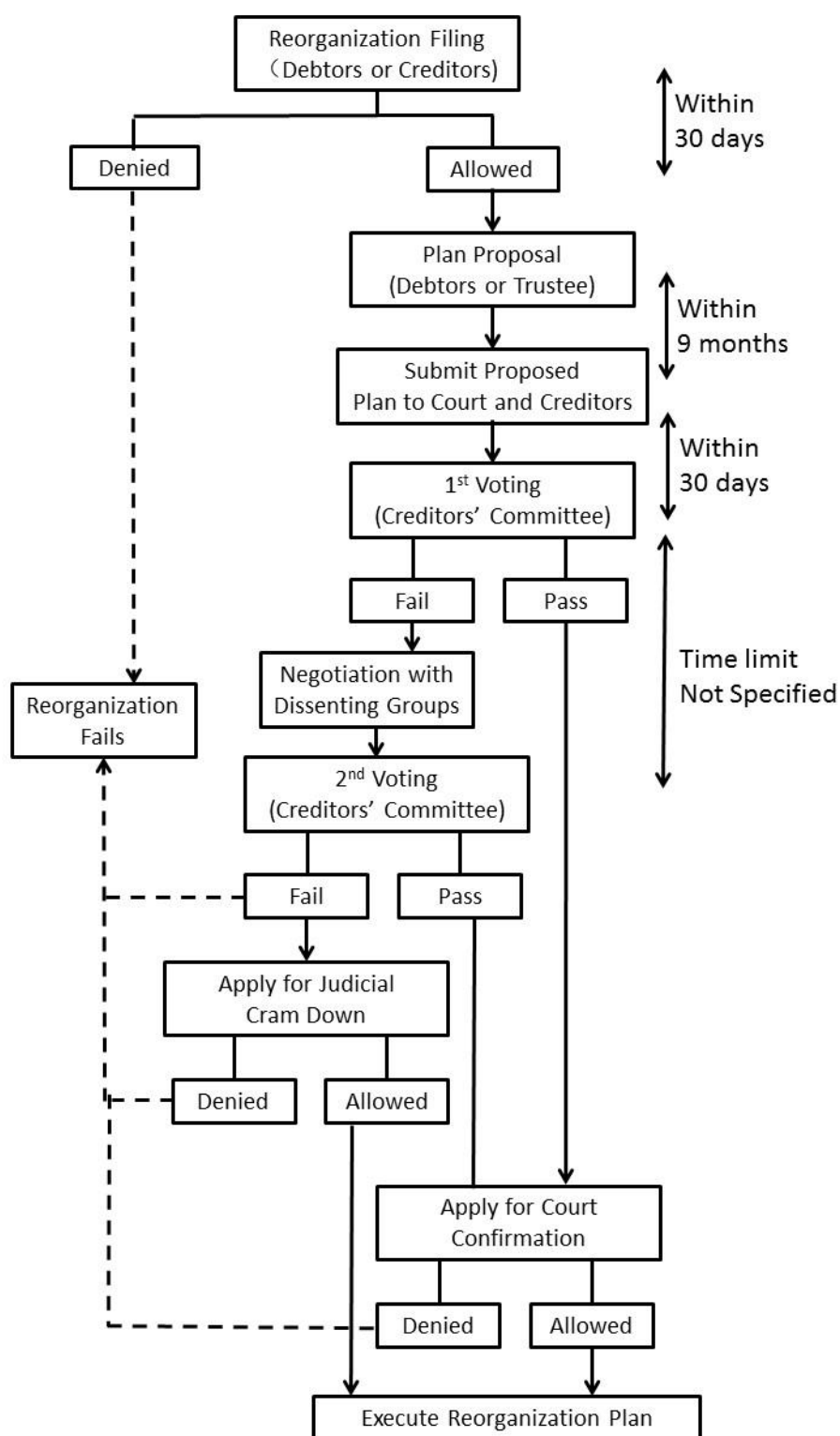


Figure 1: The Judicial Process of Reorganization in China

Perhaps most significant of all, Chinese EBL (2006) was China's first attempt to establish a statutory-based reorganization regime, which was transplanted from U.S. chapter 11.¹³² Chapter 8 of Chinese EBL (2006), titled "Reorganization," includes three sections: 1) Application for Reorganization and Reorganization Period, 2) Formulation and Approval of Reorganization Plan, and 3) Implementation of Reorganization Plan.¹³³ Under Chinese EBL (2006) both debtors (or the administrator) and creditors are allowed to apply for reorganization,¹³⁴ and the debtor (or the administrator) must present the drafted version of a reorganization plan to the creditors' committee for their vote within six months.¹³⁵ Similar to U.S. chapter 11, Chinese EBL (2006) also requires voting by classes and allows for judicial cram down,¹³⁶ that is, a court injunction can require parties to accept the terms of a proposed reorganization plan. However, Chinese EBL (2006) is not a comprehensive transplant of U.S. legislation, and the following section examines the differences between reorganization under Chinese EBL (2006) and the U.S. Bankruptcy Code.

B. Comparison of Chinese and U.S. Reorganization Legislation

The reorganization regime of Chinese EBL (2006) shares many similarities with chapter 11 of the U.S. Bankruptcy Code, such as the role and duties of the debtor-in-possession,¹³⁷ the acceptance of a reorganization plan by different classes,¹³⁸ and the court's discretionary power to cram down a plan.¹³⁹

However, there are also three striking differences between Chinese EBL (2006)

¹³² Li & Wang, *supra* note 9, at 61.

¹³³ Chinese EBL (2006), *supra* note 91, art. 70-94.

¹³⁴ *Id.* art. 70.

¹³⁵ *Id.* art. 79. If the debtor cannot come up with a draft plan within 6 months, and has a justifiable reason for the delay, the People's Court can extend the period for another 3 months.

¹³⁶ *Id.* art. 87.

¹³⁷ The DIP mode in Chinese EBL (2006) is similar to Chapter 11, *see* Steven J. Arsenault, *supra* note 121, at 59 ("Under the new Chinese bankruptcy law the debtor may apply to manage its property and business operations during the reorganization period under the supervision and monitoring of the receiver. This provision is similar to the U.S. concept of a "debtor-in-possession," under which the debtor is allowed to continue in possession of its property and current management is allowed to continue to manage the debtor's affairs.").

¹³⁸ 11 U.S.C. § 1126 (2016) and art. 84 of Chinese EBL (2006) both divide creditors into voting classes based on the nature of claims, and regard the acceptance of "at least two-thirds in amount and more than one-half in number of the allowed claims" as the acceptance from the whole voting group.

¹³⁹ Chinese EBL (2006), *supra* note 91, art. 87.

and chapter 11: 1) the parties entitled to propose a plan, 2) the classification of creditors, and 3) the “renegotiation” procedure of the dissenting creditor class.

First, debtors and administrators enjoy a full exclusive right to propose a reorganization plan, with no competing plans from any other interested parties under Chinese EBL (2006).¹⁴⁰ Unlike chapter 11, which allows “any party in interest” to file a plan when the debtor fails to gain acceptance for a plan within the time limit,¹⁴¹ Chinese law puts the creditors in a more passive situation in reorganization bargaining, in which they can only choose between accepting or rejecting a given plan without the opportunity to make counteroffers.¹⁴²

Second, Chinese law puts great emphasis on the protection of employees’ rights. It classifies creditors into four classes: secured claims, employees’ claims for wages, medical insurance and other compensation, taxes payable, and unsecured claims.¹⁴³ Under Chinese EBL (2006), in order to apply for a court’s confirmation of a plan, the employees’ claims must be fully satisfied,¹⁴⁴ whereas in chapter 11 a plan can be crammed down even if such a claim is impaired, as long as the classification of claims does not discriminate unfairly.¹⁴⁵ Under Chinese EBL (2006), the protection for employees is extended to liquidation, wherein employees’ claims get first priority in a repayment schedule, even ahead of a secured creditor’s claim.¹⁴⁶ One possible source of the strong protection of employees’ claims in Chinese EBL (2006) may be its aim to facilitate the “Gaizhi” (改制) (systemic transformation) of SOEs and to reduce the social impact of unemployment caused by the fall of large SOEs.¹⁴⁷

Third, Chinese EBL (2006) allows for, at most, two rounds of voting for any

¹⁴⁰ Yongqing Ren, *The “Control Model” in Chinese Bankruptcy Reorganization Law and Practice*, 85 AM. BANKR. L.J. 177, 181 (2011). See Chinese EBL (2006), *supra* note 91, art. 79.

¹⁴¹ 11 U.S.C. § 1121(c) (2016).

¹⁴² Ren, *supra* note 140, at 85 (“Compared with creditors in a Chapter 11 case, creditors in a Chinese EBL case are even more passive and under greater pressure to accept an unsatisfactory plan proposed by the DIP if they think they would fare even worse in liquidation.”).

¹⁴³ Chinese EBL (2006), *supra* note 91, art. 82.

¹⁴⁴ Chinese EBL (2006), *supra* note 91, art. 87.

¹⁴⁵ 11 U.S.C. § 1129(b)(1) (2016).

¹⁴⁶ Chinese EBL (2006), *supra* note 91, art. 113. See also Qi, *supra* note 16, at 24 (“[W]here there are not sufficient funds to pay worker’s claims, the workers’ unpaid claims get first priority, over the priority rights of the secured creditors, from the encumbered assets.”).

¹⁴⁷ Ross Garnaut, Ligang Song & Yang Yao, *Impact and Significance of State-Owned Enterprise Restructuring in China*, 55 CHINA J. 35, 55 (2006).

given class of claims. In cases where “some voting classes” do not accept the initially proposed reorganization plan in the first round of voting, Chinese EBL (2006) allows for one-to-one negotiation between the debtor and the dissenting class. The class may then vote for a second time.¹⁴⁸ By contrast, chapter 11 does not limit the rounds of bargaining, and the interested parties can make offers and counteroffers round after round.

C. Government as an Administrator in Reorganization Bargaining

The most significant change introduced by Chinese EBL (2006) was instituting the mechanism of administrator.¹⁴⁹ Under former Chinese bankruptcy law, liquidation was carried out under the supervision of a liquidation team, which consisted of local government officers. The new law was designed to break up the domination of government control and make bankruptcy become truly marketized, and the mechanism of administrator was a substitution for the liquidation team. However, the removal of government control faced opposition from local governments, which expressed disapproval of an individual having no affiliation with a firm or governmental organization acting as the administrator and expressed support for retaining the liquidation team and making the liquidation team the administrator.¹⁵⁰ The compromise was that Chinese EBL (2006) excludes an individual without affiliation (with an organization) from being the administrator.¹⁵¹ It also allows the liquidation team to be the administrator if the court approves.¹⁵² According to the law, administrators can also be professionals from law firms, accounting firms, or bankruptcy liquidation firms appointed by the People’s Court.¹⁵³ To limit intervention from the local government, the Supreme Court issued a judicial interpretation to explain when the People’s Court can appoint the liquidation team as the administrator,

¹⁴⁸ Chinese EBL (2006), *supra* note 91, art. 87.

¹⁴⁹ See Chinese EBL (2006), *supra* note 91, arts. 22, 25.

¹⁵⁰ Difang he Zhongyang Youguan Bumen dui QiYe Pochanfa Caoan de Yijian [Some Opinions about Chinese EBL (draft) from Local and Central Government], NAT’L PEOPLE’S CONG. GAZ. (2004).

¹⁵¹ See Chinese EBL (2006), *supra* note 91, art. 24.

¹⁵² *Id.*

¹⁵³ See *supra* note 3.

namely, when the liquidation team has been appointed according to the former bankruptcy law, which required a liquidation team (usually for an SOE or financial institution), or when the court believes it necessary to have the liquidation team as the administrator.¹⁵⁴

According to this judicial interpretation, the People's Court will only appoint the liquidation team (including government officers) to be the administrator under rare and exceptional circumstances. However, the opposite is the reality. An empirical study by Professor Li, one of the drafters of Chinese EBL (2006), found that up to year 2009 only one of the reorganizations of listed companies (i.e., companies listed on the stock exchange) was supervised by professionals while the others were all dominated by government.¹⁵⁵ The government took part in nonlisted companies' reorganization, as well.¹⁵⁶ Also, the parties to the bankruptcy liquidation preferred to have the government as the administrator rather than professionals trained in bankruptcy proceedings because many complex relationships and issues involved in bankruptcy cases in China need to be solved with the administrative power of the government. Therefore, having the government dominate the administrator role provides the parties more convenience than opting for private professionals.¹⁵⁷ However, the engagement of government in reorganization distorts the bargaining game and makes it effectively "fake."

D. The Fake Bargaining Game in China

As summarized by Douglas Baird, bankruptcy law serves to "frame the negotiations between creditors and the firm's manager-shareholder."¹⁵⁸ The bargaining between different parties can promote the efficiency of reorganization. However, the channel of effective bargaining in Chinese reorganization practice is

¹⁵⁴ Zuigao Renmin Fayuan Guanyu Shenli Qiye Pochan Anjian Zhiding Guanliren de Guiding, [Provisions of the Supreme People's Court on the Designation of Administrators during the Trial of Enterprise Bankruptcy Cases] (promulgated by the Sup. People's Ct., Apr. 12, 2007, effective June 1, 2007), art. 18.

¹⁵⁵ Li & Wang, *supra* note 9, at 67.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 68.

¹⁵⁸ Baird & Picker, *supra* note 13, at 335.

often obstructed by an inequality of bargaining power.

Under Chinese EBL (2006) the bargaining power of creditors against debtors consists only of the right to vote. Because creditors and other interested parties cannot propose competing plans, there is little competition from rival plans for the debtor.¹⁵⁹ In a game theoretic approach, this kind of power imbalance will create an “ultimatum game,”¹⁶⁰ where the first mover, in this case the debtor, will have greater bargaining power over creditors. The creditors will either accept the plan or be left to salvage what they can from liquidation.

Negotiation among parties is also obstructed by court action. The power imbalance between creditors and debtors is worsened by the court’s strong discretionary power in cram down. In China, an overwhelming majority of debtor applications for judicial confirmation of a reorganization plan have been supported by the courts.¹⁶¹ The courts can exercise broad discretionary power in the process of reorganization in two respects. First, the debtor must apply to the court to terminate the ongoing liquidation proceeding and turn to reorganization.¹⁶² Second, the criteria for a Chinese court to approve a cram down are left open to interpretation,¹⁶³ especially the feasibility test, which can be used to force liquidation because of

¹⁵⁹ Ren, *supra* note 140, at 181 (“While under Chapter 11, the voting parties may vote against the debtor-proposed plan with a view of proposing and accepting a competing plan in the future, under the Chinese EBL, there is no pressure from competing plans on the sole plan proponent.”).

¹⁶⁰ See generally Ariel Rubinstein, *Perfect Equilibrium in a Bargaining Model*, 50 *ECONOMETRICA* 97, 109 (1982).

¹⁶¹ Zou Hailin, *The Uncertainty of Court’s Confirmation of Reorganization Plan*, 11 *J.L. APPLICATION*, 24, 24 (2012) (“All the applications for cram down from listed companies are supported by court without exception, for instance *ST Baoshuo, *ST Jinhua, S*ST Guangming, *ST Dixian, *ST Guangxia.”).

¹⁶² Yujia Jiang, *The Curious Case of Inactive Bankruptcy Practice in China: A Comparative Study of U.S. and Chinese Bankruptcy Law*, 34 *NW. J. INT’L L. & BUS.* 559, 567 (2013) (“It is not clear whether, or even how, the creditor may convert the case from liquidation into reorganization; The issue is not addressed by the Chinese EBL (2006) and case law is not a binding authority in China.”).

¹⁶³ Chinese EBL (2006), *supra* note 91, art. 87. See also Jiang, *supra* note 162, at 577 (“If a plan still fails the second voting, a Chinese court may approve the plan over the objections of the dissenting classes, provided that the following six criteria are met: (1) the secured creditors will be paid in full or be compensated in a fair manner, without substantial impairment to the security interests, or are in such a class as has consented to the plan; (2) the employees’ claims and tax claims will be paid in full or are in such a class as has consented to the plan; (3) the unsecured creditors will get at least the same amount as under the liquidation regime, or are in such a class as has consented to the plan; (4) the adjustment made to the rights and interests of investors is fair and just or are in such a class as has consented to the plan; (5) members of the same voting group are treated fairly; and (6) the reorganizational plan is feasible.”).

political concerns.¹⁶⁴

In the reorganization of Suzhou Yaxin Electronics Ltd. (“Yaxin”), the court wielded discretionary power by declaring the voting result for the reorganization plan of a equity holders’ group “invalid” without basing its reasoning on Chinese EBL (2006). “Discretionary,” in a legal sense, has been defined as “involving an exercise of judgment and choice, not an implementation of a hard-and-fast rule, exercisable at one’s own will and judgment.”¹⁶⁵ In *Yaxin*, the voting group of equity holders rejected the proposed reorganization plan in the first round of voting and rejected it again in the second round after the breakdown of negotiation.¹⁶⁶ The capital contributors’ group was the only dissenting group against the proposed plan. However, the Wuzhong District Court decided that the group’s rejection was “unreasonable” and “ungrounded,” as the group “failed to provide any solution” to amend the reorganization plan and “did not raise effective objection to the net asset value report” provided to the court by a third party.¹⁶⁷ However, Chinese EBL (2006) did not require a voting group to provide alternative solutions or challenge the valuation of the company to justify their objection. Therefore, the court’s decision to disregard a certain group’s opinion was not based on Chinese EBL (2006), but rather on its own judgment.

The court in this case seems to apply a two-factor test to determine whether a voting group’s objection is valid: first, whether it has come up with a solution; second, whether it successfully challenged the valuation of bankruptcy assets. However, this test was not in Chinese EBL (2006) or in related judicial opinions from the Chinese Supreme Court, which are the only binding sources of authority in this case.¹⁶⁸ By arbitrarily introducing new test standards outside existing law, the court’s exercise of discretion has greatly undermined the certainty and predictability of law, adding excessive burden for the parties.

¹⁶⁴ An example is the bankruptcy of DongXing Airlines, which will be discussed in later in this part.

¹⁶⁵ BLACK’S LAW DICTIONARY 565 (10th ed. 2014).

¹⁶⁶ Jiangsu Sheng Suzhou Shi Wuzhong Qu Renmin Fayuan Minshi Caiding Shu (Jiangsu Province, Suzhou City Wuzhong Dist. Ct. Dec. 2008) (China).

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

While the court in *Yaxin* exercised discretionary power to act outside written law, the court in the Guangdong Zhonggu Sugar Co. Ltd. reorganization case acted in direct contradiction to Chinese EBL (2006). The Zhanjiang Middle Court ruled that the 24.54 million *yuan* debt owed to unsecured sugarcane farmers should be separate from other claims by creditors and must be paid in full “by future investors of Zhonggu Sugar Co. Ltd.”¹⁶⁹ The court reasoned that “if we do not pay cane farmers prior to other claims, the stability of sugar cane production will be in jeopardy.”¹⁷⁰ This policy concern, however, violated Chinese EBL (2006) in two ways. First, as the debtor or trustee is the only party to propose a reorganization plan under Chinese EBL (2006), the court cannot intrude and propose its own plan.¹⁷¹ But in this case the court has in fact proposed its own plan for sugarcane farmers to recover their debt in full. Second, as the sugarcane farmers are neither secured creditors nor employees of Zhonggu, they cannot legally enjoy first priority over the other creditors under Chinese EBL (2006). However, the court has *de facto* granted this unsecured group priority over all the other creditors, which is outside of policy regardless of Chinese EBL (2006). Although the court argued that this ruling was not opposed by the creditors’ committee,¹⁷² such an outright violation of written law nevertheless compromised the integrity and authority of Chinese EBL (2006).

Compared with the confirmation standard in 11 U.S.C. § 1129, the confirmation standards for judicial cram down under Chinese EBL (2006) Article 87 are rather conclusory and less specific.¹⁷³ While § 1129 provides detailed requirements of good faith, information disclosure, classification of impaired and secured classes, protection of interested parties, solvency tests, payment methods, etc.,¹⁷⁴ Chinese EBL (2006) Article 87 puts the court in the position to decide whether the plan is “fair and just,” without providing further test standards.¹⁷⁵ It has been argued that the “flexible

¹⁶⁹ Guangdong Zhonggu Tangye Jituan Gongshi Jiqi Xiashu Gongsi Pochan Chongzhengan (Zhanjiang Middle Ct. 2009) (China).

¹⁷⁰ *Id.*

¹⁷¹ Chinese EBL (2006), *supra* note 91, art. 79.

¹⁷² Guangdong Zhonggu Tangye Jituan Gongshi Jiqi Xiashu Gongsi Pochan Chongzhengan, *supra* note 169.

¹⁷³ Chinese EBL (2006), *supra* note 91, art. 87.

¹⁷⁴ 11 U.S.C. § 1129 (2016).

¹⁷⁵ Chinese EBL (2006), *supra* note 91, art. 87.

standards” under Article 87 “reaffirm the court’s discretionary power.”¹⁷⁶

One possible cure for the abuse of discretionary power is to instill more objective test standards into Chinese EBL (2006): for example, to incorporate elements of a “financial distress” test¹⁷⁷ to determine the feasibility of a plan and avoid ambiguous and vague phrasing like “obviously lack the ability to pay debt,” where the word “obviously” is open to discretionary interpretation.¹⁷⁸ For China, as a civil-law country, such reform must be accomplished either by the judicial opinion of the Supreme Court, which has an authority equal to congressional legislation binding on the lower courts,¹⁷⁹ or by future amendments to Chinese EBL (2006).

E. The Inefficiency of the Chinese Reorganization Model

The fake bargaining process under Chinese EBL (2006)—which distributes bargaining power disproportionally between debtors and creditors and grants the courts strong discretionary power—together with government intervention, leads to inefficient outcomes.

The first factor of inefficiency derives from the “one-to-one negotiation” procedure between debtors and dissenting groups.¹⁸⁰ As Chinese EBL (2006) does not allow competing plans from creditors and interested parties, the only opportunity for creditors to bargain with debtors and make counteroffers is to reject the plan in the first vote in order to gain access to one-to-one negotiation with debtors. As previously discussed, the cost of delay rests more on the creditors, so debtors can take advantage of delay.¹⁸¹ Debtors, foreseeing creditors’ tactical rejection in voting, may thus purposefully delay drafting of the plan as long as possible in order to exhaust creditors’ patience and force them into compromise. Under such an incentive, the reorganization plan may take a minimum of eleven months from filing, through the

¹⁷⁶ Jiang, *supra* note 162, at 562.

¹⁷⁷ Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 Yale L.J. 573, 580 (1998).

¹⁷⁸ Chinese EBL (2006), *supra* note 91, art. 87

¹⁷⁹ Li Wei, *Judicial Interpretation in China*, 5 WILLAMETTE J. INT’L L. & DISP. RES. 87, 109 (1997).

¹⁸⁰ See Chinese EBL (2006), *supra* note 91, art. 87. As for the acceptance of the reorganization plan, the dissenting group of creditors can vote for a second time after negotiation with debtors.

¹⁸¹ Bebchuk & Chang, *supra* note 68, at 265.

drafting of and voting on the plan, to eventually be carried out,¹⁸² thus imposing inefficient costs on all related parties.

We can use the following game model to illustrate creditor strategy under Chinese EBL (2006) and its consequences. Suppose there are two groups of creditors, A and B, and both can be repaid \$2 million if the plan is accepted. If one group accepts the plan while the other rejects it (then accepts in the second voting), then the dissenting group can enjoy \$1 million of extra gain from the enhanced bargaining power through one-to-one negotiation. If both groups reject the plan, however, the firm will be liquidated, leaving both groups with only \$1 million. Or the plan will be crammed down, with attendant legal costs and costs of delay.¹⁸³ For simplicity's sake we can assume the net return is the same as liquidation.

A curious situation then occurs at the first vote: namely, that a rational creditor will choose between accepting and rejecting a probability. If one player chooses to accept, then the best response would be to reject the plan and accept a more attractive one in the second vote; if one player rejects, then the best response is to accept, in order to avoid the loss of going-concern value and the judicial cost of liquidation. *Figure 2* depicts the limited negotiating options of creditors A and B schematically.

¹⁸² In a typical reorganization, it may take one month for the court to grant reorganization filing, nine months to put the proposed plan to a vote, one month to acquire the court's confirmation, and possible extra delay during the negotiation between 1st and 2nd voting. *See also* Emily Lee, *The Reorganization Process Under China's Corporate Bankruptcy System*, 45 INT'L LAW, 939, 943 (2011) ("[T]he People's Court would have to convene the creditors' meeting within thirty days from the date of receipt of the draft reorganization plan to entitle the creditors to vote on the draft reorganization plan. By this time, the procedure would have taken up a maximum of ten months already (6+3+1=10 months). Because it also requires the court's approval, the reorganization plan, once approved, requires a public announcement to be made within thirty days from the date of the court's receipt of the application. This means that it will take a minimum of eleven months (6+3+1+1=11 months) for a reorganization plan to be carried out successfully.").

¹⁸³ Chinese EBL (2006) does not specify the time limit for the court to make cram down decisions, which can lead to unpredictable time delays. *See Lee, supra* note 182, at 943 ("There also seems no prescribed time limit for the court to exercise discretion to 'cram-down' an unsuccessful reorganization plan that creditors failed to approve.").

		Creditor A	
		Accept	Reject
Creditor B	Accept	(2,2)	(2,3)
	Reject	(3,2)	(1,1)

(then accept in second voting)

Figure 2. Schematic of Creditor Strategy under Chinese EBL (2006)

The game structure is like an inefficient zero-sum “rock-paper-scissors” game¹⁸⁴ between creditors. As creditors are both unable to present their own plan and to participate in plan formation until voting, they cannot enjoy the surplus of the “value creation” aspect of reorganization.¹⁸⁵ Instead, creditors in the Chinese bankruptcy regime can only strive to increase individual gain in the “value claiming” aspect of bargaining, which is a zero-sum game where one benefits from the other’s loss. In such a game pattern it is individually optimal to hide real preferences and deliberately randomize between accepting and rejecting, as players who allow an opponent to predict their strategy will be taken advantage of. The game, when played under such conditions, may lead to an inefficient outcome when both creditors deliberately reject a promising plan, by coincidence, and find themselves worse off than they would have been by accepting the plan. Inefficiency also occurs when one party is forced to deviate from its real preference in order to beat the other player. In addition, the court’s strong discretionary power, combined with local government’s vested interest in controlling the fate of insolvent firms, may result in inefficient results.

One of the most infamous cases of government interference in enterprise reorganization was the failure of DongXing (East Star) Airline Co. Ltd.’s reorganization. A once successful privately owned airline company, DongXing’s

¹⁸⁴ Jacob Kreutzer, *The Difficulties of Encouraging Cooperation in a Zero-sum Game*, 65 ME. L. REV. 147, 150 (2012).

¹⁸⁵ Charles B. Craver, *The Inherent Tension Between Value Creation and Value Claiming during Bargaining Interactions*, 12 CARDOZO J. CONFLICT RESOL. 1, 9 (2010).

overly aggressive debt-financing strategy and insufficient preparation for soaring fuel prices led the company into financial trouble in 2008.¹⁸⁶ On March 30, 2009, one of DongXing's trading creditors filed for involuntary bankruptcy, and on August 27, the Wuhan People's Court refused DongXing's application for reorganization, reasoning that the plan lacked feasibility.¹⁸⁷ The decision was heavily disputed by legal professionals, as the "feasibility test" in Chinese EBL (2006) is used only for judicial cram down but not for procedural examination for initiating the reorganization process.¹⁸⁸ It was later revealed that the Wuhan Transportation Commission had agreed with Air China Ltd. to persuade DongXing to sell assets at a discount price in exchange for establishing key aviation facilities for the city,¹⁸⁹ which might be the decisive reason why Wuhan People's Court obstructed DongXing's reorganization.¹⁹⁰

The efficiency loss of DongXing's liquidation was obvious: over 30 domestic flight routes were cancelled; the lease of nine Airbus jets under contract was aborted; and, most disruptive of all, the confidence of private companies to enter the airline industry was severely affected. The continued monopoly of SOEs in China's airline industry may cause indirect efficiency loss for the industry.¹⁹¹

In *DongXing*, the debtor, creditors, judge, and local government were all involved in the game of reorganization. The judge in such a case must "accommodate two seemingly conflicting values"—that of avoiding direct conflict with local government and, at the same time, that of trying to maintain judicial independence.¹⁹² The debtor and creditors thus have an incentive to gain support from the government in return for a favorable ruling from the court. Such a "race to the bottom" may lead to judicial corruption and an abuse of power, thereby reducing the efficiency of a market

¹⁸⁶ Xinyan Chen, *The Reinvestigation of DongXing Airline's Bankruptcy*, SOUTHERN WEEKEND (Mar. 3, 2014), <http://www.infzm.com/content/99124>.

¹⁸⁷ Fang Yu, *The Myth of DongXing's Bankruptcy*, SINA FINANCE (JUNE 2, 2011), <http://finance.sina.com.cn/chanjing/gsnews/20110602/10409936957.shtml>.

¹⁸⁸ Ren, *supra* note 140, at 188.

¹⁸⁹ *Id.* at 187.

¹⁹⁰ Chen, *supra* note 186.

¹⁹¹ He Bangyuan & Liu Yuzhou, *DongXing Airlines Banned from Sky: A Critical Challenge for Private Airline Companies*, NETEASE FIN. (Mar. 2009), <http://money.163.com/special/002538T1/dongxing.html>.

¹⁹² Jiang, *supra* note 162, at 576. *See also* John J. Rapisardi & Binghao Zhao, *A Legal Analysis and Practical Application of the PRC Enterprise Bankruptcy Law*, 11 BUS. L. INT'L 49, 50 (2010).

economy.¹⁹³

DongXing provides another perspective by which to understand the behavior of government. Since the old Chinese bankruptcy law (1986) only applied to state-owned enterprises, government control would only affect the bankruptcy of state-owned enterprises. Of course, the government intervened openly under the old law. Chinese EBL (2006) expanded the scope of bankruptcy to all enterprises since the fast growth of private enterprises in China in the past decade called for expanding the bankruptcy regime. However, because the modifications to Chinese EBL (2006) and its implementing rules made legal room for government intervention, the government can now intervene in the bankruptcy of both state-owned enterprises and private enterprises. That means that the scope of government intervention actually expanded as a result of the new law, although local governments must do so indirectly by being the court-appointed administrator. DongXing Airlines is a private enterprise, and its bankruptcy was subject to Chinese EBL (2006). The government's intervention in *DongXing* illustrates the incomplete transplantation of chapter 11 by showing how the government can now exert control in the reorganization of private enterprises in addition to state-owned enterprises.

IV. The Reasons for Obstructed Efficiency in Legal Transplantation and Possible Solutions

A. The Reasons for Obstructed Efficiency

The law, as it exists on the books, is easier to transplant than the enforcement of it.¹⁹⁴ The reorganization regime of Chinese EBL (2006) was modeled on chapter 11 of the U.S. Bankruptcy Code, but we argue that adopting the text of U.S. law in Chinese reorganization law does not guarantee that efficiency will be achieved. The

¹⁹³ For example, the former Chairman of Gao Ke Ltd. and official of Zhuzhou city government, Wen Dibo, was accused of bribery during the reorganization of Taizinai Ltd. Wen Dibo was sentenced to 9 years imprisonment. See Lv Jinglian, *The "Forced Bankruptcy" of Taizinai*, SOUTHERN CITY NEWS (Sept. 16, 2010), <http://news.hexun.com/2010-09-16/124910360.html>.

¹⁹⁴ Jackson, *supra* note 11, at 253 (stating that although "law on the books may be converging, the level of enforcement efforts seems to vary widely across national boundaries.").

bargaining game, as designed by chapter 11 for the purpose of achieving efficiency, was not faithfully adopted by Chinese bankruptcy law. Obstructed efficiency in transplanted reorganization law may be caused by path dependence in existing legal institutions, the resistance of vested interests, the gap between legislation and reality, and legislators' and the populace's lack of acquaintance with the transplanted law.

1. Weak Enforcement of Creditor Rights under Non-Bankruptcy Law

Property rights in the assets of a bankrupt estate are decided by non-bankruptcy law (such as property law and the law of secured transactions).¹⁹⁵ Reorganization law is not isolated from non-bankruptcy law in creditor protection and will not provide different results from non-bankruptcy litigation. The enforcement of creditor rights under non-bankruptcy law will influence the design of reorganization lawmaking. The enforcement of creditor rights was criticized as very weak in China.¹⁹⁶ While U.S. law grants creditors and their attorneys judicial or semi-judicial powers in U.S. debt collection, such as issuing subpoenas and restraining orders, such powers are not enjoyed by Chinese creditors and their attorneys.¹⁹⁷ Creditors have very weak control over the debtor's assets since fraudulent conveyances are common while few are caught and punished for them.¹⁹⁸ This essentially makes judgment collection in China a cat-and-mouse game, as creditors have no control over debtors' assets.¹⁹⁹ Also, even if creditors win a lawsuit in the courts, the decision may not be enforced due to there being little assistance from the current legal system for collection²⁰⁰ and due to pressure from local protectionism and sectorial protectionism.²⁰¹ The weak enforcement of creditors' rights, even when the debtor is solvent, leads to a

¹⁹⁵ *Butner v. United States*, 440 U.S. 48, 55 (1979).

¹⁹⁶ According to research by Professors Arner, Booth, Lejot & Hsu, Mainland China got eight out of twenty for the enforcement of unsecured interest and secured rights, registration and disclosure of secured rights, and legislation of secured rights. Hongkong and Singapore both got twenty out of twenty-eight. See Arner, Booth, Lejot & Hsu, *supra* note 107.

¹⁹⁷ Arthur Anyuan, *Enforcing and Collecting Money Judgments in China from a U.S. Judgment Creditor's Perspective*, 36 GEO. WASH. INT'L L. REV. 757, 775 (2004).

¹⁹⁸ *Id.* at 776-777.

¹⁹⁹ *Id.*

²⁰⁰ *Id.* at 759.

²⁰¹ *Half of China's Civil Court Rulings Remain on Paper*, PEOPLE'S DAILY ONLINE (Mar. 13, 2004), http://en.people.cn/200403/13/eng20040313_137390.shtml.

weakening of the bargaining power granted by Chinese bankruptcy law to creditors.

2. Government as a Stakeholder in Bankruptcy Cases and the Specter of “Policy-Based Bankruptcy”

The biggest impediment to the efficient operation of bankruptcy law in China comes from the intervention of government. Chinese local government has long been an important stakeholder in enterprise bankruptcy. The failure of an SOE is often viewed as a failure of government leadership,²⁰² as SOEs are “the backbone” of China’s “political, economic, and social life.”²⁰³ Hence, local government would be reluctant to approve the bankruptcy of an SOE even when its operational loss accumulates.²⁰⁴ Instead, local government prefers to manage a “soft landing” for troubled SOEs by exerting administrative control during reorganization, while working to prevent a “domino effect” triggered by the enterprise’s liquidation that will result in unemployment, social unrest, and loss of local tax revenue.²⁰⁵ Besides the SOEs, listed companies are also part of the backbone of the local economy and directly reflect the performance of local government officials in terms of tax income and employment.²⁰⁶ Therefore, local governments are quite eager to engage in listed companies’ reorganization. As previously mentioned, almost all reorganization of listed companies is dominated by local governments.²⁰⁷ Governments also engage in large nonlisted companies’ reorganization.²⁰⁸

The driving force behind the enthusiasm of local governments to intervene comes from the linkage of job promotion for officeholders to growth in gross domestic product (GDP). China used to assess the performance of an official simply based on his record of boosting the economy.²⁰⁹ State-owned and big enterprises make great

²⁰² Pauline Ma, *A New Chinese Bankruptcy System: Made for Business or for the State?*, 11 AUSTL. J. CORP. L. 192, 205 (2000).

²⁰³ Deborah K. Johns, *Reforming the State-Enterprise Property Relationship in the People's Republic of China: The Corporatization of State-Owned Enterprises*, 16 MICH. J. INT’L L. 911, 914 (1995).

²⁰⁴ MARTIN J. OSBORNE, AN INTRODUCTION TO GAME THEORY 73 (2004).

²⁰⁵ *Id.* at 73 (“If SOEs are given free access to bankruptcy, a domino effect is also feared because many SOEs are deeply indebted to one another.”).

²⁰⁶ Li & Wang, *supra* note 9, at 62.

²⁰⁷ *Id.* at 67.

²⁰⁸ *Id.*

²⁰⁹ *No GDP Criteria in Promotion*, XINHUA PRESS (June 30, 2013),

contributions to local GDP; therefore, it is not surprising to find that the leaders of the administrator in many reorganization cases are the vice mayors of local governments.²¹⁰ The accountability system in China designed to “monitor the success of the government establishment through performance measurement” is another driving force behind the intervention of local government in enterprise reorganization.²¹¹ China began to use the accountability system after the SARS (severe acute respiratory syndrome) infectious disease outbreak in 2003.²¹² The current accountability system in China is not based on performance and the measurements are unreasonable,²¹³ which leaves officials on the hook to take all responsibility for accidents out of their control. Officeholders would thus be held somewhat responsible for the failure of “backbone” businesses in the area of their administration. Therefore, this pressure would drive the officers to intervene in the reorganization of local enterprises.

Besides the will to dominate the reorganization process, Chinese local governments also have the muscle to exert influence. Reorganization for Chinese enterprises often involves disposing of state-owned land and assets, dealing with workers’ social welfare, settling with state-owned banks, and seeking preferential treatment in taxation and foreign investment—all of which are actions that cannot be achieved without the government’s permission.²¹⁴ By wielding control over the above-named actions, local government can selectively give the green light to certain enterprises while hindering the reorganization of others.

3. Legislators and Professionals Are Not Familiar with the Transplanted Law

Studies have shown that “most of the transplanted laws (in China) were not well

http://www.china.org.cn/china/2013-06/30/content_29273006.htm. However, this criterion may be changed since President Xi Jinping: “We should never judge a cadre simply by the growth of gross domestic product (GDP).”

²¹⁰ Li & Wang, *supra* note 9, at 68.

²¹¹ XiuXia Tan, *Constructing a Performance-Based Accountability System for the Chinese Government*, 14 J. PUB. AFF. 154, 155 (2014).

²¹² *Id.*

²¹³ *Id.* at 155.

²¹⁴ Ren, *supra* note 140, at 184.

analyzed before transplantation. Transplanting institutions simply transplanted an individual clause.”²¹⁵ Even though international consultants and academics who contributed to the drafting of Chinese EBL (2006) had experience visiting the United States and other Western countries, these knowledgeable participants may only have informed legislators about the forms of Western bankruptcy law but not necessarily made them understand the spirit and substance of U.S. chapter 11 well enough that such understanding would be built into the law as passed. Also, the corresponding institutions for chapter 11 (reliance on state law to determine property rights, the judicial system, the professional trustee, and so on) cannot be transplanted to China in the short time that it takes to enact the law itself.

Research shows that “countries that have developed legal orders internally, adapted the transplanted law to local conditions, and/or had a population that was already familiar with basic legal principles of the transplanted law have more effective legality than ‘transplant effect’ countries that received foreign law without any similar pre-dispositions.”²¹⁶ By the terms of the above distinction, China fails the criterion of having trained professionals acquainted with the transplanted bankruptcy law. Aside from lacking familiarity with the law itself, few professionals in China are acquainted with the institutions that support and facilitate its proper implementation.

4. Gap between Legislation and Reality and the “Recursive Process”

The difference of contexts in the original country and the recipient country does not always mean that a transplanted law will not succeed so long as the transplanted law can serve the receiving system well.²¹⁷ If the transplanted law can serve the recipient society well, then it can flourish in the new soil of its surroundings.²¹⁸ However, there is a gap between transplanted bankruptcy law and the needs of society

²¹⁵ See S. Zhuang, *Legal Transplantation in the People's Republic of China: A Response to Alan Watson*, 7 EUR. J.L. REFORM 215, 231 (2005).

²¹⁶ Daniel Berkowitz et al., *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 165, abstract (2003).

²¹⁷ *Id.* at 662.

²¹⁸ Helen Xanthaki, *Legal Transplants in Legislation: Defusing the Trap*, 57 INT'L & COMP. L.Q. 659, 662 (2008).

in China. A former legislator spoke of this gap in an interview:²¹⁹

There is a massive gap between what happens on the ground and the drafting of the law—in fact, there is almost no relationship between the two. The law-drafters don't really know what's going on on the ground. And the people on the ground, actually dealing with SOEs, which are in terrible shape, don't know and don't care about the bankruptcy law.

The gap between the legislation and the reality makes the bankruptcy law effectively “useless” in reality. At the same time, different agencies compete to make the implementing rules. For example, the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC) issued a notice for reorganization of SOEs in 2007.²²⁰ Also, the Supreme Court issued interpretations.²²¹ This is called a “recursive process,”²²² which was subsequent to the passage of Chinese EBL (2006) in the name of eliminating its vagueness. Such a recursive process, however, actually “allowed much greater government control and arbitrary intervention . . . than would be permitted by a new bankruptcy law.”²²³

5. Small Market for Bankruptcy Professionals

As another source of obstruction in efficiency, China lacks legal professionals and administrators with expertise in insolvency.²²⁴ Chinese EBL (2006) has as a purpose to cultivate a bankruptcy professional market to make bankruptcy proceedings in China become increasingly market-oriented. The market for bankruptcy professionals was supposed to expand quickly after the promulgation of Chinese EBL (2006). However, since the government has dominated the role of administrator, professionals do not get many opportunities to participate in

²¹⁹ Halliday & Carruthers, *supra* note 2, at 1171.

²²⁰ SASAC, Guoziwei Guanyu Tuijin Guoyou Ziben Tiaozheng he Guoyouqiye Chingzu Zhidao Yijian de Tongzhi [Guiding Opinions of the SASAC about Promoting the Adjustment of State-owned Capital and the Reorganization of State-owned Enterprises] (promulgated by SASAC, Dec. 05, 2006).

²²¹ For example, Zuigao Renmin Fayuan Guanyu Shenli Qiye Pochan Anjian Zhiding Guanliren de Guiding [Provisions of the Supreme People's Court on the Designation of Administrators during the Trial of Enterprise Bankruptcy Cases] (promulgated by the Sup. People's Ct. Apr. 12, 2007, effective June 1, 2007).

²²² Halliday & Carruthers, *supra* note 2, at 1171.

²²³ *Id.*

²²⁴ Li & Wang, *supra* note 9, at 77.

bankruptcy reorganization and liquidation, which keeps the market for such professionals underdeveloped. Also, the parties to bankruptcy litigation would rather choose the government as the administrator than choose the professionals. The reason for this preference is that the economy of China is under transition, and many complex relationships and issues involved in a bankruptcy case need to be resolved with the intervention of the government. Therefore, having the government dominate administrator provides the parties with more convenience than the private professionals could provide.²²⁵ As a consequence, there is almost no market for private professionals.

B. Possible Solutions and Their Practicality

As we have noted, the fake bargaining game in Chinese bankruptcy law was caused by accommodations made to the transplanted law (instead of it being a wholesale transplant), its imperfect micro fitting (within the legal infrastructure of China) and its imperfect macro fitting (within the institutions of the political economy in China). However, we should also note that the fitting of a transplant is an evolving and dynamic process, which cannot be accomplished at one stroke. The ill fitting of the past and at present does not mean that we should scrap the transplanted law; instead, we need to find legal solutions to promoting fitting and efficiency. These solutions should solve the fitting problem at three levels: ameliorate the inefficient accommodations and recursive judicial interpretations that now apply to the transplanted law; reform some of the legal infrastructures in China; and reform some of the political economic institutions that now obstruct the efficient operation of bankruptcy reorganization. Because China now is undergoing a comprehensive reform in its legal system, its judicial system, and also its political institutions, the proposals we make are possible.²²⁶

²²⁵ *Id.* at 68.

²²⁶ See Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform Adopted, Third Plenary Session of the 18th Cent. Comm. of Communist Party of China (Nov. 12, 2013).

1. Ameliorate the Inefficient Accommodations to the Transplanted Law.

The reorganization regime under Chinese EBL (2006) is not a wholesale transplant of U.S. chapter 11. The right to propose a reorganization plan is exclusively held by the debtors and administrators without possibility of competing plans from any other interested parties.²²⁷ This exclusivity leads to an imbalance in the parties' bargaining power, which contributes to inefficiency. The best way to ameliorate this situation is to limit the exclusivity and allow "any party in interest" to file a plan when the debtor fails to gain acceptance for a plan within the time limit, which is what chapter 11 provides.

Also, one possible cure for the abuse of discretionary power of the court in cram down is to have more stringent confirmation standards. China could have more detailed requirements like those of 11 U.S.C. § 1129, such as good faith, information disclosure, classification of impaired and secured classes, protection of interested parties, solvency tests, payment methods, etc.²²⁸ Also, China could curb the abuse of discretionary power by adopting more objective test standards in Chinese EBL (2006). Those accommodations can be accomplished either by future amendments to Chinese EBL (2006) or by judicial opinions from the Supreme Court, which has binding power for the lower courts.²²⁹

2. Micro fitting: Remove the Recursive Documents and Cultivate a Bankruptcy Professional Market

Implementing rules by administrative agencies and judicial interpretations by People's Supreme Court are products of the "recursive process"²³⁰ which produced the subsequent overlay of judicial interpretation and procedural rules that determined how Chinese EBL (2006) would be put into effect. It was done in the name of eliminating its statutory vagueness, but it worked to obstruct the bargaining game that could have enabled its efficient operation. The recursive process "allowed much

²²⁷ See Chinese EBL (2006), *supra* note 91, art. 79.

²²⁸ 11 U.S.C. § 1129 (2016).

²²⁹ Li Wei, *Judicial Interpretation in China*, 5 WILLAMETTE J. INT'L L. & DISP. RES. 87, 109 (1997).

²³⁰ Halliday & Carruthers, *supra* note 2, at 1171.

greater government control and arbitrary intervention . . . than would be permitted by a new bankruptcy law.”²³¹ To limit the power of government to intervene in bankruptcy reorganization, these recursive documents, which betray the purpose of Chinese EBL (2006), should be lifted or nullified. Once the basis for local governments to dominate reorganization is gone, a bankruptcy professional market can be cultivated, which will gradually make bankruptcy proceedings in China become increasingly market oriented.

3. Macro fitting: Reduce the Incentive of Government to Intervene and Enhance the Independence of Judicial Authority.

The most direct cause of obstructed efficiency, and the reason for the fake bargaining game, is the government’s role as a stakeholder in bankruptcy cases. The driving force behind the enthusiasm of local governments for intervention comes from the linkage of job promotion for officeholders to growth in GDP. The insolvency and failure of big enterprises, including SOEs and listed companies, are big concerns for local governments. The best way to prevent the interference of local government is to change the evaluation system of local governments by using more comprehensive criteria for assessing the performance of government officials. Fortunately, reform is underway in China for using comprehensive criteria for assessment rather than GDP, which will gradually reduce the incentive of local officers to intervene in bankruptcy cases.²³²

Local governments can also intervene in the judicial decisions regarding insolvency and reorganization, including the bankruptcy bargaining game, since the local government decides the personnel and budget issues of local courts. Facing this problem, Chinese government decided to have a judicial reform to ensure independent judicial authority in order to guarantee “unified and accurate law implementation.”²³³

²³¹ *Id.*

²³² *No GDP Criteria in Promotion*, XINHUA PRESS (June 30, 2013), http://www.china.org.cn/china/2013-06/30/content_29273006.htm. However, this criterion may be changed since President Xi Jinping: “We should never judge a cadre simply by the growth of gross domestic product (GDP)”.

²³³ Xiang Li, Yu Hong, *China Ensures Independent, Fair Use of Judicial Authority*, PEOPLE’S DAILY ONLINE (Nov. 15, 2013), <http://en.people.cn/90785/8458142.html>.

The local courts will be independent from the local governments in deciding their personnel and budget issues.²³⁴ The reform also “calls for openness of trials and procuratorial affairs, such as recording the entire process of court trials, enhancing the reasoning of legal documents and disclosing judgment documents,”²³⁵ which will reduce the possibility that judicial discretionary power will be abused.

Generally speaking, a reform going forth in China is to reduce the role of state *dirigisme* and respect market autonomy under the leadership of President Xi and Premier Li.²³⁶ In such a reform context, a more market-oriented reorganization regime can become more and more desirable in Chinese society, and a wholesale transplant of chapter 11 will become more possible.

Conclusion

The Chinese Enterprise Bankruptcy Law of 2006 (Chinese EBL (2006)) was regarded as a product of evident “Westernization” due to the influential contributions of foreign experts and international organizations, which is rare for commercial law legislation in China. Especially the reorganization regime, Chapter 8 of Chinese EBL (2006), mirrored chapter 11 of the U.S. Bankruptcy Code. A transplanted law like this one, however, may not grow well when taken out its native soil. The company reorganization regime of U.S. bankruptcy law achieves its efficiency by providing a forum in which two parties can negotiate with each other. Negotiation is the core of the reorganization regime. Without such a core, the law, when transplanted to another country, cannot function as efficiently as desired.

A close examination of American and Chinese reorganization regimes has shown how the bargaining game, the centerpiece of chapter 11, fared poorly in its efficiency after transplantation to a Chinese context, given the interplay of historical, political, economic, and social factors. Chapter 8 of Chinese EBL (2006) distributes bargaining power disproportionally between debtors and creditors. As creditors can neither

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ See Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform Adopted, Third Plenary Session of the 18th Cent. Comm. of CCP, (Nov. 12, 2013) (“The market plays a decisive role in the allocation of resources.”).

present their own plan nor participate in plan formation until the act of voting, they cannot enjoy the surplus of value created by reorganization.²³⁷ Instead, creditors in the Chinese bankruptcy regime can only strive to increase individual gain in the “value claiming” aspect of bargaining, which is a zero-sum game. This model of game theory tends toward an inefficient outcome when multiple creditors deliberately reject a promising plan by coincidence and wind up being worse off than they would have been by accepting the plan. It is also inefficient when one party is forced to deviate from its real preference in order to beat the other player.

Moreover, Chapter 8 of Chinese EBL (2006) had the original aim of promoting market-oriented bargaining and cultivating a market for insolvency professionals, but, in fact, the court-interpreted implementing rules, in the name of eliminating legal vagueness, actually worked to allow for more government control and judicial intervention. Appointed by the court as administrators, local governments dominate the reorganization of SOEs, listed companies, and big companies, which form the backbone of local economies in China. The reality of Chinese bankruptcy law in practice would disappoint the foreign consultants and organizations that provided expert opinion for its drafting as well as disappoint the legislators who passed it. Due to the low efficiency of Chinese EBL (2006) as it operates in Chinese society, businessmen may choose private ordering over bankruptcy litigation to resolve their debts under the current insolvency resolution regime.²³⁸

The reasons behind the obstructed efficiency following its legal transplantation are many and complex: the result of path dependence by existing legal institutions, the resistance of vested interests, the gap between legislation and reality, and legislators’ and citizens’ lack of acquaintance with the transplanted law. The analysis in this article has shown that a law on the books is easier to transplant than the soil that allows for its successful enforcement. The success of a transplanted law depends on conditions that allow it to break up the lock-in effects of path dependence perpetuated by existing institutions and culture. By meeting the needs of the recipient society, a

²³⁷ Craver, *supra* note 185, at 9.

²³⁸ Empirical statistics showed that the number of bankruptcy liquidations decreased after the new bankruptcy law was issued. *See* Li & Wang, *supra* note 9, at 60.

transplanted law may be acceptable to the population and become successfully adapted to its new surroundings regardless of its origins. Unfortunately, Chinese bankruptcy law, as enacted in Chinese EBL (2006), does not have those merits; therefore, it cannot perform efficiently. This legal transplant has not changed Chinese society so much as Chinese society has changed it. It is like the orange tree that bears sweet fruit when grown in the south, but, when grown in the north, the orange tree, alike though it looks by its leaves, bears fruit that is bitter to the taste.

The inefficiency of the transplant is disappointing but not reason for despair, however. The fitting of a transplant is an evolving and dynamic process, and it cannot be accomplished at one stroke. We need to find legal solutions to promote fitting and efficiency. These solutions should remove inefficient accommodations and recursive judicial interpretations. They should also reform the legal infrastructure and political economic institutions that today obstruct the bargaining game required for bankruptcy law in China to operate efficiently, the mark of a successful transplantation. As China is now undergoing a comprehensive reform in its legal system, its judicial system, and also its political institutions, the proposals we endorse are ultimately possible.