Secured Creditor Protection and the Treatment of different unsecured Creditor Classes under the Chinese draft Bankruptcy Code – A Comparative Analysis

A. Introduction

I. Overview

The Financial and Economic Committee of the People’s Republic of China has recently\(^1\) drawn up a new Draft Law of Bankruptcy and Reorganisation (the new Draft Law). This draft represents a new step forward in a longer-lasting legislative drafting process.\(^2\) Since the new Draft Law was shortly published before this article has been finished, the author added the substantial amendments of the new Draft Law in the paper and attempted to compare and review the path the Chinese insolvency regime is taking.

Determined by the socialist planned economy system, the pre-1980 Chinese legal regime did not provide for any rules on enterprise insolvency. However, after having turned towards a socialist market economy, the need of a insolvency regime, dealing with failing enterprises, became soon apparent.

Reacting to these needs, the Standing Committee of the National People’s Congress enacted in December 1986 the Law on Enterprise Bankruptcy\(^3\) (the 1986 Law) which went into effect on 1\(^{st}\) November 1988. Since private enterprises were hardly existing the 1986 Law governs only the liquidation, merger or restructuring of state-owned enterprises (SOE’s). Some other laws\(^4\) and regulations attempt now to rule the insolvency of private enterprises since their number has been tremendously increasing in the last two decades.\(^5\)

However, the present legal framework on enterprise insolvency remains still incomplete, not compatible with requirements of a modern market economy and unclear in its scope and application.\(^6\)

In order to overcome the deficiencies of the prevailing insolvency regime, the Chinese legislator has been re-examine the current rules on bankruptcy and has consequently prepared the above-mentioned drafts.

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\(^1\) The latest Draft Enterprise Bankruptcy and Reorganisation Law was published in February 2002
\(^2\) The previous drafts date back to June 2000 (the 2000 draft) and January 2001 (the 2001 draft)
\(^3\) Law of the People’s Republic of China on Enterprise Bankruptcy (for Trial Implementation), adopted by the Standing Committee of the National People’s Congress of the People’s Republic of China on 2\(^{nd}\) December 1986
\(^5\) Gebhardt/Olbrich-New Developments, 110: “Today, there are more private enterprises than state enterprises in China.”
\(^6\) Gebhardt/Olbrich-New Developments, 110
This article neither intends to cover the entire new Draft Law nor does it claim to comprise all possible interpretations and applications of the relevant provisions on the topic. It rather attempts to analyse the intentions of the legislator to cope with the economical, political and social problems of the ongoing transition process. Thereby, the author focused mainly on two important issues: the protection of secured creditors and the impact of priorities granted to several types of unsecured creditors. In doing so, firstly, it is provided for a more detailed theoretical foundation on the two issues, followed by a in-depth analysis of the 2001 draft and the new Draft Law and, finally, the relevant provisions and developments of some other transition economies and developed market economies are outlined and examined. After an analyses of the underlying legal and economical theories the article intends to suggest possible solutions applicable to the unique situation of China’s insolvency regime and offers some recommendations for the further drafting process on the issues covered.

The claim of the article to be comparative in its nature has a double meaning: firstly there is a comparison between the Chinese 2001 draft and the new Draft Law – and secondly, there are several comparative analyses of insolvency laws of other jurisdictions.

II. Reasoning for security and different priority classes among unsecured creditors

One of the major shortcomings of insolvency laws of various transition economies are their provisions on the treatment of secured creditors and several classes of unsecured creditors holding priority status over general unsecured creditors. Legislators in those jurisdictions are frequently tempted to implement some non-economical policies through tools of the insolvency law by, for example, re-balancing deficiencies of the social welfare system or the national tax collection system or by the implementation of other social and political policy goals. Nevertheless, some “abuse” of insolvency proceedings might be justified by the transition status of those jurisdictions – whereby other desirable goals might be better achievable through other devices.

There are several more or less important objectives of insolvency which frequently conflict with each other.

In order to foster market economical development, the policy maker needs to balance the different objectives and bring them in line with the prevailing situation in the relevant jurisdiction. Prioritising one of those objectives may mean simultaneously giving less

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7 Bufford, Samuel, “What is Right about Bankruptcy Law and Wrong about its Critics”, 72 Washington University Law Quarterly, 838 (1994) (hereinafter cited as: Bufford-What is Right); Smid, Stefan, Das Insolvenzverfahren in den Beitrittsstaaten, Wirtschaft und Recht in Osteuropa, 2000, 393 (hereinafter cited as: Smid-Das Insolvenzverfahren)

8 See the subsequent discussion on C.VI.

weight to others. The policy decisions will and should finally reflect social consensus and prevailing expectations within the society. Deriving from its collective nature, including all creditors in one single process, a main objective of insolvency is the equitable treatment of creditors. *(par creditium creditorum)*

Thereby, equitable treatment does not necessarily require equal treatment – creditors with different bargaining power (e.g. secured creditors) and different risks and interests might be treated differently.\(^10\)

According to the well-established principle of market conformity\(^11\), the insolvency law should generally honour pre-insolvency entitlements existing outside insolvency.\(^12\) Otherwise, participants may use insolvency proceedings strategically to circumvent such entitlements and gain “*windfall profits*”.\(^13\) In doing so, the law should recognise and uphold market rules and forces, respect rights and entitlements created outside insolvency, stimulate and foster negotiations among the various classes of claimants and, whenever necessary, promote efficient market exchange processes.\(^14\) Thereby, the law should avoid weakening or redistributing valuable pre-insolvency rights or entitlements, such as title in movables sold under a reservation of title clause, set-off rights and security interests.\(^15\) Moreover, the law should evade extensive interference with pre-insolvency contracts and the introduction of unjustified priority rules.\(^16\)

A prominent example provides the treatment of secured creditors.\(^17\) Those claimants have obtained a specific right to seize and sell the collateral under certain circumstances. Those rights should be generally respected in insolvency proceedings.\(^18\) Dishonouring security may have a converse effect on the whole economy since it may discourage creditors to extend further credit to acceptable conditions.

However, from this pure economical approach may have to be made some exceptions in the case of an economy in transition from a planned towards a market economy. In this phase different preconditions may require some unique solutions in order to support the prevailing economical, social and political needs.

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\(^10\) Smid-Das Insolvenzverfahren, 393


\(^13\) Balz, Manfred, Logik und Grenzen des Insolvenzrechts, ZIP 1988, 1439 (hereinafter cited as: Balz-Logik und Grenzen)

\(^14\) Balz-Market Conformity, 173

\(^15\) Baird/Jackson-Corporate Reorganisations, 121: “It is the difference between the size of the slices and the size of the pie. Only the latter is a bankruptcy question.”

\(^16\) Baird/Jackson-Corporate Reorganisations, 110

\(^17\) See for secured credit: Baird/Jackson-Corporate Reorganisations, 98

B. Position of Secured Creditors

I. General treatment of secured creditors in insolvency – excluded from or included in proceedings?

One of the main obstacles for rather traditional bankruptcy laws\(^{19}\) is that they commonly exclude secured creditors from the insolvency process, with the consequence, that they may enforce their rights outside proceedings and thereby negatively affect the outcome of the reorganisation and liquidation process.

More modern insolvency codes\(^{20}\) usually include secured creditors in the process and make them thus subject to the general effects of insolvency.

The treatment of secured creditors reflects the natural tension between the objective of maximisation of asset value for the benefit of all creditors with along going enhancement of the chances of a successful reorganisation and, on the other hand, the need to protect secured creditor and their interest in the collateral. Since any erosion of the value of security interests undermines the availability of affordable credit, balancing these two objectives requires careful consideration. The key question is: to what extent can the insolvency law interfere with contractual rights of secured creditors by suspending their individual rights in exchange for a conversion into a collective right to claim and share in the estate of the debtor?

On a international perspective there exist mainly two ways to deal with the problem:

1. Exclusion: secured creditors may enforce their security rights outside insolvency proceedings

Firstly, there is the option to exempt secured creditors altogether from insolvency proceedings, with the effect, that they can enforce their contractual rights and recover the collateral outside the ongoing insolvency proceedings.

One argument in favour of this approach is that it creates strong incentives for a financially sound behaviour of the debtor. Furthermore, this policy reduces the costs of credit since lenders are more convinced that their secured rights are protected and effectively enforceable. Moreover, the creditor who paid for the asset should have a right to the asset: the conditional security right is a fair exchange for the credit\(^{21}\).

On the other hand, there are arguments, especially in the context of a rescue or going-concern-sale, which are in disfavour of this option. The overwhelming objective of asset value maximisation may require preserving key assets of the enterprise. One might

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\(^{19}\) Prior to the recent changes, the Russian, the Polish and the (old) German Bankruptcy Code, did exclude secured creditors from bankruptcy proceedings. The Slovakian and the Indonesian Bankruptcy Code, for example, do still exclude secured creditors from proceedings; See more generally: Balz, Manfred, Schiffman, Henry, “Insolvency Law Reform For Economies in Transition – Comparative Law Perspective”, Butterworths Journal of International Banking and Financial Law, January 1996, 19, 27 (hereinafter cited as Balz, Schiffman); see for a detailed discussion on the German insolvency reform: Smid, Stefan, Grundzüge des neuen Insolvenzrechts, 214 pp., Muenchen 1999, 3rd edition (hereinafter cited as Smid-Grundzüge)

\(^{20}\) As for example the new German Insolvency Code or the US-Bankruptcy Code

think on the situation where for the debtor’s production necessary raw material, machines or other equipment is encumbered with security interests and the respective creditor would have a right to remove and sell those goods. The proceeds may or may not satisfy the creditors claim, but will most probably damage the remaining asset pool and as a result decreases the remaining asset value disproportionately.

But even in a liquidation situation, where chances for a successful rescue or a going-concern sale of the debtor business do prognostically not exist, the liquidator may need some time to arrange for the orderly asset sale with a maximum return.

The existing key assets are regularly encumbered by security interests and would fall outside the insolvency process. In particular, in modern commercial relations, where many debts are secured, such a policy would jeopardise the outcome of the whole insolvency process. Moreover, enforcing security outside the insolvency process violates the equitable treatment of creditors and thus infringes the pari-passu principle.

Excluding collateral may even be against the interest of secured creditors as a class itself, if, for example, their claims are worth more when the debtors going concern value can be preserved and when assets are worth more than in a piecemeal liquidation.

In short, extending the collectivisation of debt collection in insolvency to secured creditors is an absolute necessity in any modern economy. Only when secured creditors having usually the largest claims and possess most business sense are involved in the collective bargaining the objective of asset value maximisation may be reached and a potential rescue gets a real chance.

2. Inclusion: secured creditors become subject to general effects of proceedings in exchange for an adequate protection

Secondly, there is the possibility to generally include secured creditor in the process for preferably a specified short period of time during which the administrator seeks to sell the debtor enterprise as going concern in order to negotiate a reorganisation plan or to sell assets piece-meal.

During this period, the secured creditors interest in the collateral should be protected against erosion, waste and improper conduct, supplemented with a right to accrued interest on their claim. Thereby, the law should avoid any interference with the actual value of the secured claims. Value of secured claims means thereby not only the amount of the underlying claims but also the relative value which provides the concrete security interest.

One way of protecting the value of the secured claim is to protect the value of the collateral itself on the understanding that, upon liquidation, the proceeds of the sale of the collateral will be directly distributed to the secured creditor. (fixing value)

Frequently found means to obtain such a protection is the granting of compensation for any depreciation occurred during the stay, the payment of interest during the stay,

22 Baird/Jackson-Corporate Reorganisations, 117; Balz-Sanierung, 26
23 Balz, Manfred, “Insolvency Law Reform in the Russian Federation”, unpublished – on file with the author (hereinafter cited as Balz-Russia), 40
25 E.g. US-Bankruptcy Code § 362(d)(1) gives the court the right to grant relief from the automatic stay, when the collateral is not adequately protected
26 Baird/Jackson-Corporate Reorganisations, 97
27 E.g. Croatian Bankruptcy Code, Art.80
but only to the extent that the respective creditor is over secured and the protection and compensation for use and sale of collateral. 29

When the administrator fails to sell the business or part of it, when the bid does not exceed the amount of the secured creditors claim upon the expiration of such a temporary stay and when the administrator or liquidator cannot guarantee the protection of the collateral, the secured creditor should have the right to immediately enforce his contractual rights and to recover its collateral. This result is usually reached by a clause 30 allowing the secured creditor to file for a lifting of a stay under such circumstances. 31

Modern Western laws 32 protect the secured creditor’s interest in specific collateral through requirements of adequate protection, stay relief to enforce security interests on pledged assets, compensation for depreciation 33, interest accrual for the over-secured creditors, and various other protections. 34

Another technique of protecting the secured creditors claim is preserving the value of the asset used as security. (preserving value) The asset is valued upon the commencement of proceedings, the amount based on this valuation remains fixed throughout the proceedings and is finally distributed as priority claim to the secured creditor. 35

This approach is to a certain degree pursued by several jurisdictions 36 in transition from a planned to a market economy but they usually do not grant a first priority to secured creditors.

3. Balancing different interests: maximisation of asset value versus essential protection of secured creditors

The obvious advantage of the inclusion of secured creditors in the process is the maintenance of the pari-passu principle among all creditors in order to maximise the recovery for all of them. On the other hand, this approach renders rights of secured creditors and their ability to recover debts less certain, what results economically in a higher pricing of credit. 37

28 E.g. Romanian Insolvency Code, Art.37; Bulgarian Commercial Code, Art.724 (1)
30 E.g. US-Bankruptcy Code § 362(d)(1) gives the court the right to grant relief from the automatic stay, when the collateral is not adequately protected
32 E.g. US-Bankruptcy Code § 361; German Insolvency Code, § 169
33 German Insolvency Code, §172 grants the administrator the right to use the encumbered asset but obliged him at the same time to compensate the secured creditor respectively
34 Averch-Lien Stripping, 82
35 IMF-Report, 27
36 E.g. Russia, Poland and Hungary; for a more detailed discussion on the priority ranking of secured credit for those countries see the subsequent discussion under C.I.
A more factual argument emphasis’ that in modern credit systems encumbered assets of participants reach often 75% of the available assets or even more.\(^{38}\) Hence, excluding secured credit from insolvency proceedings would render the process almost unnecessary.\(^{39}\)

Furthermore, a stay of secured creditor action is tolerable when the general law on secured credit allows creditors to “over secure” themselves, with other words, to take a substantial higher value of collateral than the amount of the underlying claim and thus being protected from delays and depreciation during the duration of the stay.\(^{40}\)

Others\(^{41}\) suggest, that secured creditors should be only affected from insolvency proceedings of its debtor, when there is a prospect of rescue. Where it is clear that the corporate debtor will be liquidated piecemeal the rationale of saving key assets for reorganisation measures is no longer relevant and thus proceedings should only affect unsecured creditors. Nevertheless, this approach requires under a unitary system\(^{42}\) that until a decision is made whether to liquidate or reorganise the insolvent debtor the general commencement effects should be extended to secured creditors as well.\(^{43}\)

Furthermore, a general inclusion of secured creditors in the insolvency process encourages the debtor to volunteer in a prospective rescue process. This behaviour is crucial to initiate the highly desirable rescue of enterprises since usually mainly the debtor initiate’s rescue-type proceedings.

The inclusion and protection of secured creditors might be also justified from another point of view. Generally, secured creditors are interested in speedy proceedings to be promptly satisfied from the proceeds of the collateral hold. They usually favour outright liquidation over any long-lasting rescue attempts. General creditors and shareholders, on the other hand, favour naturally rescue proceedings since it may increase the prospects of higher returns. Consequently, the inclusion of secured creditors in the process may be usually in favour of general creditors, subordinated creditors and shareholders.\(^{44}\) Therefore, it is reasonable to require a contribution from them in the form of additional compensation and interest payments to secured creditors as described above.\(^{45}\) With other words, market conformity requires that those interested in delay and inclusion pay

\(^{38}\) Smid-Grundzuege, 34

\(^{39}\) Balz, Schiffman, 69

\(^{40}\) Balz, Schiffman, 25; under Chinese guaranty law, the scope of a pledge, guarantee or mortgage includes also interest, default fines, compensation for damages and costs of enforcement, see Arts.67, 21, 46 Guarantee Law of the People’s Republic of China; according to Lowitzsch, Jens, Pacherowa, Paulina, Das novellierte polnische und slowakische Insolvenzrecht, Zeitschrift für Ostrecht und Rechtsvergleichung 1998, 211, 216 (hereinafter cited as: novellierte Lowitzsch/Pacherowa-Das polnische und slowakische Insolvenzrecht) is this expected in Poland after the recent introduction of a stay under the Polish Bankruptcy Code


\(^{42}\) To unitary or semi-unitary proceedings is referred to when insolvency proceedings are commenced without the initial decision whether to liquidate or reorganise the debtor; or where a conversion from one type of proceedings is easily possible; see for more details on unitary proceedings: Falke-Insolvency Law Reform, 167; WB-Towards Principles, 11;

\(^{43}\) Balz, Schiffman, 24; IMF-Report, 49

\(^{44}\) ADB-Report, 97

\(^{45}\) Baird/Jackson-Corporate Reorganisations, 129

\(^{46}\) Balz-Logik und Grenzen, 1441; Baird/Jackson-Corporate Reorganisations, 129
those who are interested in avoiding it. That consequently reduces the incentive for junior classes to prolong proceeding. The underlying economic theory proposes that the outcome of insolvency proceedings should reflect the pre-insolvency entitlements among participants and thereby provide for market conformity. Rights, established outside insolvency, should be recognised and protected in both their existence and value. A security interest provides its owner with the comfort to seize and sell the collateral and acquire the proceeds of the sale when the debtor fails with his repayment obligation. This right can be expressed in monetary terms and it is usually referred to as time value of the security interest. Any delay or other interference with the right of the secured creditor, to seize and sell the collateral, leads to value depreciation of that right and is thus not consistent with the principle of market conformity. Is the automatic stay imposed on secured creditors interferes the insolvency law with the pre-insolvency rights of the secured creditor by deteriorating the time value of the pre-insolvency security interest. In order to rebalance these consequences on the time value of this right the law should provide for sufficient compensation for the loss. Compensating the secured creditor thereby means to put him financially in a situation where he would be without the interference by the insolvency law. This in turn suggests the payment of interests, the compensation for depreciation of value during the stay or the compensation for the use of collateral.

II. Analysis of the respective provisions in the Chinese draft law

1. Relevant provisions

The Chinese draft law mentions the issue in several provisions. Art.19 2001 draft provided that after the acceptance of an insolvency case by the court and prior to the bankruptcy adjudication the exercise on rights of mortgage and pledge or other property rights shall stop immediately. However, with the new Draft Law, the Chinese legislator has now abolished this provision and places a stay merely on actions and enforcement measures concerning the debtor’s property. On the other hand, Art.63 2001 draft – systematically placed in a chapter on debtors property and right to separate satisfaction – stated that holders of rights to separate satisfaction may exercise such rights without being subject to bankruptcy liquidation and composition procedures. Art.62 2001 draft defines rights of mortgage, pledge and lien against the debtors property as rights to separate satisfaction. The new Draft Law extends the scope of such security rights covered and refers to mortgage, pledge and lien only as example. The section placed under Chapter VIII. on Bankruptcy Liquidation is titled with Right for Return and Right to Separate Satisfaction. Beside these systematic modifications remains the general statement that security holders shall be not subject to

46 Balz-Market Conformity, 175
47 See generally: Balz-Market Conformity; Balz-Sanierung
48 Balz-Market Conformity, 174
49 For the valuation of the secured creditor’s right see: Baird/Jackson-Corporate Reorganisations, 114
50 Baird/Jackson-Corporate Reorganisations, 115
51 Art.19 new Draft Law; assets encumbered with security interests do not belong to the debtor, see Art.23 and Artt.119 new Draft Law
52 Art.119 new Draft Law
liquidation nor composition proceedings but shall enjoy a preferential right to be paid off on the subject matter of the security right.

Furthermore, according to Art.124 2001 draft – located at the chapter on reorganisation – a stay of any security enforcement action takes effect during the period of reorganisation protection. The new Draft Law now includes any kind of security – and is not limited to mortgage, pledge and lien – and suspends any rights of the secured creditor during the period of reorganisation protection.

2. Automatic stay and the right to separate satisfaction – a drafting mistake?

On a first glance it remained unclear which path the Chinese legislator intended to follow in its draft laws – Art.19 2001 draft seemed to be in favour of the general inclusion of secured debt since a stay shall take effect on secured creditors immediately with acceptance of a case while the wording of Art.120 new Draft Law, or the similar phrased Art.63 2001 Draft – also by reading it in connection with Art.71 new Draft Law, or the similar worded Art.124 2001 draft – suggests for the exclusion of security from liquidation proceedings.

According to these latter provisions, only during reorganisation proceedings are secured creditors clearly suspended from enforcing their rights outside insolvency. However, as mentioned before, the inclusion of secured creditors might be also essential for successful liquidation proceedings when the administrator needs time to organise the sale, the auction of the assets or intents to sell the debtor as going concern.

Taking into account the 2000 draft and applying a historical interpretation approach only some clearance comes to the issue. Art.136 of the 2000 draft granted holders of security a priority – but Art.137 also stated that by enforcing that right the secured creditor may not be subject to the bankruptcy liquidation procedure. In changing the wording from priority to separate satisfaction, it may be assumed that the legislator intended to point out that the secured claim may not participate in the distribution process according to chapter VIII, section 4 (Appraisal, Disposition, Distribution) new Draft Law but rather take place outside this process and hence is only related to the proceeds of the respective asset encumbered. The underlying asset is kept within the estate of the debtor but the secured creditor has the right to receive payment directly from the proceeds of the security once sold or auctioned. This interpretation would correspond with the above-mentioned method of fixing value and is also supported by the diction of Art. 119 par.2 new Draft Law, Art.62 par.2 2001 draft which provides that creditors with the right to

\[\text{53 Art.120 par.1 new Draft Law}\]
\[\text{54 Art.119 par.2 new Draft Law}\]
\[\text{55 Art.71 new Draft Law}\]
\[\text{56 see therefore Art.71 new Draft Law, Art.124 draft 2001; see for the previous draft: Gebhardt/ Olbrich-New Developments, 116}\]
\[\text{57 For a detailed discussion on going-concern sales: Falke-Insolvency Law Reform, 163}\]
\[\text{58 See for a discussion on priorities and the position of secured creditors under the 2000 draft: Ho, Lusina, Chapter VI., Section 6 – Right of Priority and Section 7 – Appraisal and Distribution, Section 7, Bankruptcy Law of the People’s Republic of China – Symposium, July 2000, www.gtz-commercial-laws.org.cn/contents-npc/english/content/bankruptcy/symposium/symp_s03.html, 12th March 2002}\]
\[\text{59 See B.I.2. above}\]
separate satisfaction shall enjoy the preferential right to be satisfied from the objects of such rights – namely the respective collateral.

However, there are also justifiable arguments which would support the interpretation resulting in the complete exclusion of secured creditors from liquidation proceedings. Firstly, the legislator has clearly provided for the inclusion of secured creditors during the period of reorganisation protection in Art.71 new Draft Law, Art.124 2001 draft and even established some rules to protect affected creditors. It might be argued that the legislator would have structured the law in a similar way for liquidation proceedings, when he would have intended to include secured creditors also in liquidation proceedings. Secondly, the wording of Art.120 new Draft Law, and the similar phrased Art.63 2001 draft is straightforward – secured creditors may exercise their security rights without being subject to liquidation nor composition proceedings – with other words: enforcing their security interests without having the disadvantageous commencement effects of insolvency imposed on the collateral.

In reorganisation proceedings, only affected secured creditors of movables are granted some protection in the case the security interest will be damaged or devalued during the reorganisation protection period.60 Therefore, the law provides only for the right of the creditor to enforce the security interest in the case of damage or devaluation during the stay but does not contain provisions for compensation nor payment of interest. However, the new Draft Law61 makes the right of the damaged creditor to have the stay lifted subject to further court approval.

The new Draft Law brings some substantial changes to the issue: firstly, Art.19 2001 draft is abolished without substitution; secondly, the section on rights of secured creditors in liquidation has been considerably amended62. This section distinguishes now between owners of property which does not belong to the debtor and holders of security rights. Whereas the first have a right to have their property returned63 in insolvency the latter have only a right for preferential payment out of the subject matter of their security interest.64

The complete elimination of Art.19 2001 draft in the new Draft Law may not necessarily effect in the exclusion of secured creditors in liquidation proceedings. Since the law now expressly distinguish between holders of property which does not belong to the estate of the debtor and secured creditors the inclusion of the latter might become a essential interim result since the law does not grant a similar right for the return of the collateral to secured creditors as to owners of non-debtor assets. According to these provisions, the secured creditor has only the right to be paid off on the subject matter of the security – what consequently requires that the administrator has the right to realise the asset value independently from the secured creditor.

60 See Art.124 2001 draft
61 Art.71 par.1 sent.2 new Draft Law
62 Artt.117 new Draft Law
63 Art.117 new Draft Law
64 Art.119 par.2 new Draft Law
III. Situations and solutions in other jurisdictions

On a global perspective and also among a variety of transition economies exist very different approaches to the treatment of security in insolvency.

The former Russian liquidation procedure (1992), for example, excluded collateral from the insolvency estate and did consequently not impose any stay on secured creditor action.65 The only exception in insolvency proceedings was in a moratorium connected with external administration, but the stay was only temporarily for a maximum of 18 month.66

The new Bankruptcy Code (1998) does now include security in insolvency proceedings67 and imposes a stay on any creditor action68.

However, once insolvency proceedings are commenced, secured creditors lose pledge rights in rem against specific assets of the debtor.69 In return, secured creditors obtain a preferential right to recover ahead of general unsecured creditors but behind administrative costs, personal injury and wage claimants.70 All secured creditors participate in the distribution of the proceeds on a pro rata basis, without regard as to whether had held primary or subsequent security interests in the specific property of the debtor. A third priority is only granted in the amount, which was originally encumbered by the security interest. Any excess claim amount would be treated as a fifth priority general unsecured claim.

The major obstacle for secured creditors is the provision that imposes a stay on any individual enforcement action and at the same time, stripping collateral under the distribution scheme, without providing for the lifting of the stay.72

However, the Russian Bankruptcy Code attempts to protect value of the secured claim through a provision granting secured creditors priority over general unsecured creditors.73

Generally speaking, the statutory disregard for the property interest in the collateral itself may not necessarily mean that the Russian law is unfair to secured creditors and may result in the same or even greater recovery for a secured creditor than results from many Western systems.74 The loss of the interest in the specific collateral results only in a reduced recovery for the secured lender, when the payment of the claims with super, first or second priority diminish the amount distributable to secured creditors to less than the fair market value of the security interest.

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65 Balz-Russia, 22
66 Balz-Russia, 39
67 Russian Bankruptcy Code, Art.103, 104
68 Russian Bankruptcy Code, Art.11 (4), each stage of the insolvency proceedings has similar stay provisions. See Russian Bankruptcy Code, Art. 57, 69, 98
69 Russian Bankruptcy Code, Art.109 (3); hence, the Russian legislator followed the preserving-value-method
70 Russian Bankruptcy Code, Art.106 (1)
71 Russian Bankruptcy Code, Art.106 (2)
72 European Bank for Reconstruction and Development, Summary of Major Aspects of the Russian Insolvency System, London April 2000 (on file with the author), (hereinafter cited as:EBRD-Summary of the Russian System), 6
73 Averch-Lien Stripping, 85
74 Averch provides an illustrative example: Averch-Lien Stripping, 85
The separation of secured claims and respective property rights to the collateral in the case of insolvency may on the other hand support the rescue policy and hence, foster thus reorganisation – a policy particularly crucial in transition economies. Under the Russian system, originally encumbered (key-) assets are in insolvency proceedings freely available for rescue or reorganisation attempts.

The Polish Bankruptcy Law did originally not include secured creditors in insolvency proceedings, but granted the secured creditors a right to realise its security rights outside the insolvency process. However, the Polish legislator recently amended the law and now includes secured creditor in the proceedings. Similar to the Russian regulation, secured creditors loose their interest in the individual collateral at the opening of proceedings in the exchange for a third priority claim in the estate. Nevertheless, the Polish bankruptcy regime excludes secured creditors still from arrangements with the debtor and allows such proceedings only with the non-preferential creditors.

According to the Hungarian Bankruptcy Code, security agreements are terminated with the opening decision, the respective collateral is returned to the administrator and secured creditors receive as compensation for the loss of their collateral a third priority in the distribution of the proceeds of the liquidation.

The Romanian law generally includes secured credit in proceedings but does not provide for an explicit provision providing for the lifting of the stay in respective circumstances. Differently to the above mentioned insolvency laws separates the Romanian Insolvency Code security generally from other unsecured assets of the debtor in the distribution process and assigns the proceeds from the liquidation of the collateral directly to the respective secured creditor with the effect that the secured creditor will be satisfied prior to all other unsecured creditors. Furthermore, the Code allows for the accrual of post-petition interest on secured claims.

Similarly includes the Bulgarian Commercial Code, the Czech Bankruptcy and Composition Act and the Croatian Bankruptcy Code secured creditors in

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75 Averch-Lien Stripping, 88
76 Bickford, Pamela, Schiffman, Henry, “Bankruptcy Law Reform in Eastern Europe”, 28 The International Lawyer, 927 (1994) (hereinafter cited as: Bickford-Bankruptcy Law Reform), 948; Lowitzsch/Pacherowa-Das novellierte polnische und slowakische Insolvenzrecht, 216
77 Lowitzsch/Pacherowa-Das novellierte polnische und slowakische Insolvenzrecht, 216; Dziennik Ustaw 1998, No. 117, item 756; Polish Bankruptcy Code, Art.150 §2
78 Lowitzsch/Pacherowa-Das novellierte polnische und slowakische Insolvenzrecht, 216; Polish Bankruptcy Code, Art.204 (2b); See also the discussion on priorities
79 Polish Bankruptcy Code Art.171
80 Hungarian Bankruptcy Code, Art.38(5)
81 Hungarian Bankruptcy Code, Art.57(1)(b)
82 Romanian Insolvency Code, Art.106
83 Romanian Insolvency Code, Art.37
84 Bulgarian Commercial Code, Art.722(1) 1
85 Czech Bankruptcy and Composition Act, Section 28
86 Croatian Bankruptcy Code, Art.81
proceedings and remains the interest of the secured creditors in the actual collateral in the insolvency process.

The Slovakian Bankruptcy Code\textsuperscript{87}, on the other hand, excludes collateral generally from proceedings and permits secured creditors to seize and sell their collateral outside the collective provisions of the insolvency process.\textsuperscript{88}

The Indonesian Bankruptcy Law\textsuperscript{89} provides that secured creditors are generally entitled to enforce their rights regardless of ongoing insolvency proceedings. However, for a limited period of up to ninety days from the court’s declaration of insolvency secured creditors will generally not be entitled to enforce their security rights.\textsuperscript{90} This grace period may serve to maximise the asset value of a debtor enterprise or to improve the environment for rescue negotiations among the participants.\textsuperscript{91}

The new German Insolvency Code\textsuperscript{92} now also includes secured creditors generally in proceedings and provides the administrator with the corresponding right to remain encumbered assets in the estate. Similar to the new Draft Law distinguishes the German InsO between holders of property which does not belong to the estate of the debtor\textsuperscript{93} and creditors with a right to separate satisfaction\textsuperscript{94}.

IV. Recommendations for the Chinese drafting process

As already illustrated, the system of the draft laws concerning the treatment of secured creditors is inconsistent with the principles established above and hence lacks predictability and transparency indispensable particularly in business transactions. Since the Chinese legislators seems to ensue the principle of fixing value when including secured creditor also in liquidation proceedings some additional provisions should be included to protect affected secured creditor. The degree of protection necessary to secured creditors should be similar in reorganisation proceedings as in liquidation

\textsuperscript{87} Slovakian Bankruptcy Code, §14 (1)(c), 28
\textsuperscript{88} See also: Lowitzsch/Pacherowa-Das novellierte polnische und slowakische Insolvenzrecht, 216
\textsuperscript{89} Indonesian Bankruptcy Code (1998), Art.56; Kilgus, Stefan, Yayang Setiadarma, Monika, Das neue indonesische Insolvenzrecht, RIW 1999, 47, 49 (hereinafter cited as: Kilgus-Das neue indonesische Insolvenzrecht)
\textsuperscript{90} Indonesian Bankruptcy Code (1998), Art.56 A (1)
\textsuperscript{91} Kilgus-Das neue indonesische Insolvenzrecht, 49
\textsuperscript{92} The German Insolvency Code (German InsO) came into effect on 1\textsuperscript{st} January 1999 after a reform and drafting process of more then 25 years; see German InsO, §166; for the underlying reasons for the change of the German law see: Allgemeine Begründung des Regierungsentwurfes, BT-Drucksache 12/2443, 72f, 80f; Uhlenbruck, Wilhelm, Das neue Insolvenzrecht, Insolvenzordnung und Einführungsgesetz nebst Materialien, Berlin 1994 (hereinafter cited as: Uhlenbruck-Neues Insolvenzrecht), 64; Gottwald, Peter, Adolphsen, Jens, Die Rechtsstellung dinglich gesicherter Gläubiger in der Insolvenzordnung, in Kölner Schrift zur Insolvenzordnung, Hrsg. Arbeitskreis für Insolvenz- und Schiedsgerichtswesen e.V., Köln 1997, 805
\textsuperscript{93} The German Insolvency Code uses the term “Aussonderungsrecht” and assigns to those claimants the rights existing outside insolvency – mainly the right to have the property returned, see Art.47 German InsO; see also Smid-Grundzuege, 44pp.
\textsuperscript{94} The German Insolvency Code uses the term “Absonderungsrecht” and assigns to those creditors the right to be satisfied directly from the proceeds of the encumbered asset by granting the administrator the right to realise the value of the asset through sale, use, processing and other means, see Artt.49-51, 165-173 German InsO; see also Smid-Grundzuege, 34pp.
Firstly, the law should explicitly spell out that the administrator may in liquidation as in reorganisation proceedings use the encumbered asset for a limited period for the continuance of the business of the debtor or otherwise realise the collateral for the benefit of the debtor estate. During this period, the secured creditor is suspended from enforcing its security right. However, if the administrator intends to sell the asset, the secured creditor shall be informed and have the right to suggest a more beneficial utilisation of the collateral.

Secondly, the law should provide for the payment of interest or usage fees for the period the secured creditor is exempted from enforcing its security right. Those amounts should be paid continuously out of the debtors estate.

Thirdly, the affected secured creditor should have a right to inspect the encumbered asset and the respective books of the debtor. If the administrator is unable to protect the security means from deprecations and other damages or incapable of paying the amounts due, the secured creditor should have the right to enforce its security interest immediately.

After realisation of the secured asset by the administrator, the secured creditor should have a direct claim for the proceeds against the estate. However, the costs for the assessment, administration and enforcement of the security may be only considered as unsecured claim.

C. Priority hierarchy of diverse creditors

The insolvency law should generally incorporate provisions which provide for a ranking between different categories of creditors. That seems not to be straightforward since one of the main objectives of insolvency law is the equal treatment of creditors (par creditium creditorum). However, equal treatment shall only apply to similar situated creditors and the ranking shall reflect the different pre-insolvency positions or the different bargaining power of creditors.

A principal policy choice when designing or redesigning any insolvency regime are the priorities given to diverse creditor classes in regard to the distribution process of debtor assets.

A different treatment of diverse creditors for distribution purposes does not necessarily violate the pari-passu principle since creditors have different bargaining power.

As a general rule, the hierarchy of claims established outside insolvency, or the rule of absolute priority, should be possibly maintained in insolvency. Where an insolvency
regime disregards the terms of pre-existing contracts perverse incentives for the abuse of the process may be created. Generally, senior claims should therefore be paid in full before more junior claims (including equity). Clear rules for ranking the priority of both existing and post-petition creditor claims are important in order to provide clarity to creditors who may be deterred if there is uncertainty as to where they stand in the event of insolvency proceedings.101

However, as will be discussed in more detail in due course the traditional privileges and priorities for certain pre-insolvency creditors may re-value or re-inflate claims by the very fact of insolvency and thereby redistribute wealth under a presumed standard of equity.102

Furthermore, priority rules are an important tool to control creditor behaviour and to achieve desirable macroeconomic, social and political goals. By the way of example, granting secured creditors a high priority, means encouraging secured credit.103

I. Secured creditors in the priority system

As demonstrated above, the Chinese legislator appears to follow the principle of fixing value and thereby includes secured creditors in reorganisation but possibly to a certain extend also in liquidation proceedings. Although there is clearly no indication found, that those creditors are partaking in the collective distribution process on a possible priority basis, it might be nevertheless valuable considering the treatment of secured creditors when including them in the process.

1. Principle of First Priority Rule for secured creditors

Generally, the insolvency law should provide secured creditors with a high priority over other claims. Depending on how protection of secured claims is achieved in the proceedings104, creditors should have a first priority claim according the claim value preserved or the value fixed. For the amount that the claim exceeds the value of the collateral, the creditor may have only an unsecured claim against the estate. Exceptions to this general rule should be very limited, but may be possible for administrative costs and post-petition credit.105

However, others argue, that the first-priority-rule of collateral shall be without exceptions and that in the case, administrative claims and some other privileged unsecured creditors supersede secured credit, secured creditor are unable to calculate in advance what their claims will be worth in insolvency. The advantage of secured credit – namely, security – would be lost.106

2. Limitations on the First Priority Rule107

101 G22-Report, 46
102 Balz-Market Conformity, 171
103 IMF-Report, 39
104 Either through preserving value or through fixing value, See for a respective discussion B.II.
105 IMF-Report, 39
106 See Smid-Das Insolvenzverfahren, 396, for the case that employee claims receive a higher priority than secured creditors.
Mike Falke: Secured Creditor Protection and the Treatment of different unsecured Creditor Classes under the Chinese draft Bankruptcy Code – A Comparative Analysis

Some jurisdictions\textsuperscript{108} have considered a system, whereby secured creditors would have to give up a certain percentage of the value of their collateral for the benefit of administrative and unsecured creditors. Critics fear, that such a system would weaken the credit system, since secured credit would become more expensive and more difficult to attain.\textsuperscript{109}

Systematically, two ways may be possible: the general limitation of secured credit\textsuperscript{110} (fixed-fraction priority or partial priority rule) or the retention of a proportion of the collateral for unsecured creditors.\textsuperscript{111}

\begin{itemize}
\item[a.] The different interests involved
\end{itemize}

However, justification for such a regulation of the market might be not easy to find.\textsuperscript{112} Generally, secured credit reduces the costs of credit, since the repayment risk of creditors decreases. A secured creditor can rely on a valuable security interest and is not referred to the general ability of the debtor to repay (its solvency). Such a risk reduction affects the price for credit – interests rates of secured credit are generally below the rates of unsecured credit. On the other hand, however, increases the granting of security the repayment risk for unsecured creditors since secured creditors “absorb” valuable assets of the estate, originally additionally available for the satisfaction of unsecured creditors. The granting of security therefore negatively affects the remaining unsecured creditor and impairs their repayment chances in the case of the debtors’ insolvency. Generally, one may as a consequence distinguish between the granting of security for existing debt and the granting of security for new money. The first situation may impair the position of unsecured creditors, since previously available assets are “removed” from a future estate of the debtor without any comparable advantage for the remaining creditors.

The latter situation is different: unsecured creditors are given a valuable asset as well – they receive the equivalent benefit in form of the proceeds of the loan or other credit. There is even a possible further gain for unsecured creditors – the new money may improve liquidity and financial stability of the debtor enterprise and thereby reduce the repayment risk for all creditors in general.\textsuperscript{113}

\begin{itemize}
\item[b.] Four different scenarios
\end{itemize}

Going more into detail, one may be able to shape four different situations, which may require different treatment in relation to the initial question: collateral may be granted for new money (or credit in general) at a time when the debtor is already insolvent or at the

\textsuperscript{108} See for example Czech Bankruptcy and Composition Act, Section 28 (4)
\textsuperscript{109} Balz, Schiffman, 69; Schwarcz, Steven, The Easy Case for the Priority of Secured Claims in Bankruptcy, 47 Duke Law Journal , 425, 428 (1997), (hereinafter cited as: Schwarcz-The Easy Case)
\textsuperscript{111} Balz, Schiffman, 69: “The authorities of an Eastern European country recently considered a system whereby secured creditors would have to give up a certain percentage of the value of their collateral for the benefit of administrative or unsecured creditors.”
\textsuperscript{112} Balz, Schiffman, 69
\textsuperscript{113} Schwarcz-The Easy Case, 442
“vicinity of insolvency” (1); or at a time where the debtor is fully solvent (2); or for pre-
existing debt when the debtor is solvent (3); and finally, for pre-existing debt in an
situation, where the debtor is already insolvent or at the “vicinity of insolvency” (4).
The last case is frequently dealt with by preference rules of the insolvency law. In such
a case, unsecured creditors are obviously prejudiced, since they loose an asset,
originally available for their satisfaction in the case of the insolvency of the debtor and
they do not obtain any equivalent for the loss, since the debtor grants the security for an
already existing credit.
Case number three describes the situation, where a solvent debtor grants a security
interest for a pre-existing debt. The situation to the foregoing is similar, with the only
difference that the debtor is still solvent and hence possibly able to repay creditors from
the remaining pool of assets even without the collateral granted for the pre-existing
debt. Nevertheless, it does affect the value of the remaining pool of assets without
compensating the remaining unsecured creditor with the inflow of a new credit. Also
this situation may be more susceptible for legislative interference.
The second case on the other hand, is different to number 3 and 4 in so far, as it covers
the situation, where the solvent debtor grants a security interest in exchange for new
credit. One could argue, that the debtor receives an equivalent for the given security
interest in the form of the credit. If this would be true, unsecured creditors would be not
negatively affected by the transfer of collateral, since the net value of the assets
available for unsecured creditors would be the same, prior and after the transaction.114
However, this might be only a pure economical and theoretical explanation without
taking the reality into account. The security granted has usually a predictable long-term
value (e.g. mortgages), while the credit is frequently money. Money is easier than most
other forms of assets to hide or misuse. To prevent such misuse, most of the
commentators assume, that some form of general monitoring of the debtor is
desirable.115 Some116 of them suggest, that secured creditors should be exposed to
increased risk in order to encourage them to efficiently monitor their borrowers.
Thereby, the risk increase could be achieved through the reduction of security by
granting only partial priority.117
On the other hand, one may assume, that new money or other credit, which is extended
in exchange for the transfer of the collateral, may decrease the default risk of the
debtor.118 Notwithstanding, whether the debtor uses the money for the extension of its
operation or the mere reduction of its external indebtedness, the risk of illiquidity119 and
the following insolvency will be considerably reduced. The consequences for unsecured
creditor are significant: by avoiding insolvency, unsecured creditors are paid in full,
while this outcome is unusual in insolvency120, even with a limited impact of secured

114 Schwarz-The Easy Case, 443
115 Schwarz-The Easy Case, 436
116 Bebchuk-The Uneasy Case, 909
117 Bebchuk-The Uneasy Case, 909: Under this partial priority rule a fixed fraction of a secured creditor’s
claim would be treated as a secured claim, and the remainder would be treated as an unsecured claim. Thus,
under a 75% fixed-fraction rule, 75% of a secured claim would be given full priority over unsecured
claims, and the remaining 25% would become an unsecured claim.
118 Schwarz-The Easy Case, 441
119 Schwarz-The Easy Case, 444: Illiquidity is perhaps the leading cause of business bankruptcies.
120 Schwarz-The Easy Case, 455: In the US historical data show that a typical unsecured creditor recovers
usually only a very small portion of its claim, perhaps 5 to 20 cents on the dollar.
credit. Some scholars\textsuperscript{121} assume and attempt to proof, that the advantage unsecured creditors gain from the insolvency risk reduction of the debtor through the inflow of new money may considerably exceed the disadvantage, which unsecured creditors face by the partial loss of assets to secured creditors.

The last argument would favour a full priority rule over a partial priority rule. Another argument opposing a partial priority rule might be the fact, that such a rule possibly restricts the availability of credit.\textsuperscript{122} A partial priority rule would consequently render 25\% of the secured claims unsecured and thereby impose the general default risk in that proportion among secured lenders. As a result, creditors may be less willing to extend secured credit or at least would have to raise price of credit accordingly.

On the other hand, one should consider, that such a rule would commonly apply to all creditors in the market. Market conditions would probably change, with a possible increase of interest rates but creditors would still need to do business – and this business is extending credit to market conditions.

The increase of respective interest rates would shift the burden from other unsecured creditors to the debtor – a justifiable result, which is in line with the advantages gained from the new money.

c. Provisions of and remarks to the Chinese draft laws

The main obstacle of the Chinese draft laws is the inconsistency and vagueness regarding the treatment of secured creditors within insolvency proceedings. As mentioned before, the law does supports rescue attempts only in reorganisation proceedings but does not consider its necessity in the liquidation process.

Thus, during the period of reorganisation proceedings the debtor may guarantee post-petition loans with property not encumbered with security interests (Art.72 par.2 new Draft Law, Art.125 par.2 2001 draft). However, there is no provision which enables the debtor to grant security for post-petition credit during liquidation proceedings in general or an attempted going-concern sale in particular.

The above-mentioned situation (4) and possibly also alternative (3) is dealt with by the Chinese New Draft Law in Art.33 (3), Art.24 (3) 2001 draft which grant the court avoidance power in the case the debtor has pledged security for a pre-existing debt within 1 year prior to the acceptance of the insolvency case.

Where security is granted by a solvent debtor for new money Art.119 par.2 new Draft Law or the similar worded Art.62 par.2 2001 draft rules that the secured creditor shall be satisfied directly from the proceeds of the secured asset. Only if he gets not fully repaid from these proceeds the secured creditor may enforce the remaining claim within the insolvency process (Art.120 par.2 new Draft Law, Art.63 par.2 2001 draft).

Consequently, the Chinese draft law follows the \textit{fixed-value-principle} without interfering with the \textit{first-priority-rule} for security.

3. Legislative approaches and experiences of other jurisdictions

\textsuperscript{121} Schwarcz-The Easy Case, 465
\textsuperscript{122} Balz, Schiffman, 69; Schwarcz-The Easy Case, 475:”I will assume that a 75\% partial priority rule would cause between 10 and 25\% of debtors that need liquidity to be unable to find willing lenders”
Under the Russian Bankruptcy Code (1998)\textsuperscript{123} administrative costs\textsuperscript{124}, tort creditor\textsuperscript{125} and employee claims\textsuperscript{126} rank ahead claims of secured creditors\textsuperscript{127}. But even in liquidation secured creditors have no right to the collateral or the respective liquidation proceeds from the individual security interest but only to a monetary claim according to the proportion of their claim in relation to claims of other secured creditor.\textsuperscript{128}

Once a debtor is declared bankrupt, secured creditors lose pledge rights \textit{in rem} against specific assets of the debtor.\textsuperscript{129} In return, secured creditors receive a preferential right to recover ahead of general unsecured creditors but behind administrative costs, personal injury tort claims and wage claims.\textsuperscript{130} In fact, the law attempts to preserve the value of the asset used as security\textsuperscript{131} and not the security itself.

All secured creditors participate in the distribution of bankruptcy proceeds on a \textit{pro rata} basis, without regard as to whether the secured creditor had held primary or subsequent security interests in a specific property of the debtor.\textsuperscript{132}

One might wonder why the Russian legislator did not consider frequent criticism and advise\textsuperscript{133} when deciding to take over the existing priority ladder insofar unchanged from the 1992 law. How have been the experiences with a system which is usually not in the favour of international lenders, western policy makers and financial organisations? Has the lower priority granted to secured creditors really distracted lenders and other creditors which usually extend credit only for first-priority-security?

Insolvency laws are frequently viewed from either a creditor’s perspective or a debtor’s perspective. From a pure secured creditor’s viewpoint the higher distribution priority for administrative, tort and wage claims may provide the secured creditor with some unpredictability by complicating the risk assessment at the time of the investment decision. Particularly the amount of tort claims may be somewhat unforeseeable – one just imagines a mining accident, explosion or other disaster. But also administrative costs may become substantive and might be able to significantly devalue the collateral.

As established elsewhere in this paper, according to economical analysis\textsuperscript{134}, the insolvency law should avoid any unnecessary interference with pre-insolvency entitlements or other entitlements created outside insolvency. A consequent effect of any disregard of pre-insolvency entitlements is that it provides a perverse incentive to general creditors to file for insolvency. The law should provide for market conformity: the creditor’s bargain, in sum, ask what the creditors would agree to in advance to maximise returns from a limited pool of assets, if they knew that individual creditors’ rights could not be enforced and that they would be forced into a collective proceeding like insolvency.\textsuperscript{135}

\begin{itemize}
  \item \textsuperscript{123} Russian Bankruptcy Code, Art.106
  \item \textsuperscript{124} Russian Bankruptcy Code, Art.54
  \item \textsuperscript{125} Russian Bankruptcy Code, Art.107
  \item \textsuperscript{126} Russian Bankruptcy Code, Art.108
  \item \textsuperscript{127} Russian Bankruptcy Code, Art.109
  \item \textsuperscript{128} Russian Bankruptcy Code, Art.114 (3); Russia followed the \textit{principle of preserving value}
  \item \textsuperscript{129} Russian Bankruptcy Code, Art.109 (3)
  \item \textsuperscript{130} Russian Bankruptcy Code, Art.106
  \item \textsuperscript{131} See the respective discussion: B.1.2.
  \item \textsuperscript{132} EBRD-Summary of the Russian System, 6
  \item \textsuperscript{133} See Balz-Russia
  \item \textsuperscript{134} See Baird-Corporate Reorganisations, 103
  \item \textsuperscript{135} Averch-Lien Stripping, 90
\end{itemize}
On one hand, one could argue that the Russian Code does not comply with these theories since it re-values and upgrades the position of tort and wage claimants against secured creditors compared to the pre-insolvency situation. On the other hand, it could be argued that the Russian insolvency system adequately addresses the creditors’ bargain and common pool issues. Specifically, the stripping of security interests permits the efficient liquidation of assets and may thereby maximise the common pool for all creditors. Moreover, the security interest stripping may enhance the prospect of a successful reorganisation of the debtor. Replacing the secured creditors’ security interest with a priority over general unsecured claims represents the type of bargain, which creditors would have reached in advance of insolvency.\textsuperscript{136} However, insolvency deals not only with money and related monetary matters of creditors but is also considering and balancing other community and social interests.\textsuperscript{137} Granting administrative costs a super priority is commonly accepted as a pre-condition for any successful liquidation or rescue.

The higher priority for tort claimants may be justifiable by the fact, that those creditors did not extent credit voluntarily but were forced into their creditor position. A comparison with a contractual creditor may fail since the tort creditor did not have the chance to negotiate security interests or other preferential treatment. A reasonable justification for the priority of wage claimants may be more difficult to find. They are contractual creditors with a general possibility to negotiate security interests or other preferential treatment in advance. However, usually employees do not have the bargaining power to negotiate any preferential treatment with its employers. Generally, one may consider employees as employees rather than as contractual creditors of the debtor.\textsuperscript{138}

Furthermore, the social security system in the Russian Federation does in its current stage not provide the necessary financial protection for employees of insolvent companies. Wages are frequently not paid for several months until a company goes into insolvency proceedings. Nevertheless, a limitation of this preferential treatment and the immediate development of a sufficient social safety net should be considered.\textsuperscript{139} The Russian Code provides for another instrument which may lessen the negative effect of the existing priority rules on secured creditors. Generally, outside insolvency secured creditors may simply ask to have the collateral returned in cases where the debtor has not paid the secured claim. This option is restricted as soon as insolvency proceedings are commenced. The Code provides tort claimants and employees certainly with a higher priority than secured creditors but does not grant them the right to file a petition and thus initiate proceedings.\textsuperscript{140} This restriction increases indirectly the chances of secured creditors to enforce their security rights individually outside insolvency. Policy choices in insolvency should always comply with the underlying cultural attitude in a society. The Russian Law limits freedom of contract by preferring the interests of certain classes of creditors – tort and wage claimants – regardless of what a security

\textsuperscript{136} Averch-Lien Stripping, 90
\textsuperscript{137} See for a comprehensive discussion on social and community aspects of insolvency in transition economies: Falke-Insolvency Law Reform, 59 pp.
\textsuperscript{138} Gross, Karen, Failure and Forgiveness – Rebalancing the Bankruptcy System, 1997, Yale University Press (hereinafter cited as: Gross-Failure and Forgiveness), 152
\textsuperscript{139} See C.IV.
\textsuperscript{140} Gutbrod, Max, Vogel, Frank, Das neue russische Insolvenzgesetz – ausgewählte Aspekte, RIW 1999, (hereinafter cited as:Gutbrod-Das neue russische Insolvenzrecht), 41
agreement may provide. This policy has deep roots in both, Russian and Soviet civil law and Russian society, based on paternalistic policies, established by the tsars and followed by the protective communistic state. The fact that it does not accord with Western notions of security or the nature of insolvency does not necessarily mean that it is “wrong”, “unfair”, or even inappropriate in a market economy. Another related obstacle is the fact that secured creditors will be given a third priority for their whole claim irrespectively of the value of the underlying collateral. Originally, unsecured creditors may tend to upgrade their fifth priority claims to third priority claims by acquiring worthless collateral. As mentioned earlier, secured claims are satisfied by a simple quotation of the remaining values (after first and second priority claims are paid in full), regardless of the actual value of a single security interest. However, the Russian law may provide for a protection against such dilution of the respective creditors rights by stipulating that claims may only have a third priority as far as they are secured by a respective security interest.

As mentioned before, the Polish Bankruptcy Code now includes secured creditors in insolvency proceedings. The Polish law grants to general secured creditors a third priority after administrative costs and secured tax and social security creditors. Thereby, it is an interesting development to grant tax and social security creditors the right to acquire collateral in the debtor enterprise and grant to them explicitly a higher priority as to general secured creditors.

The Romanian Insolvency Code separates security generally from other unsecured assets of the debtor in the distribution process and assigns the proceeds from liquidation of the collateral directly to the respective secured creditor, with the effect, that the secured creditor will be satisfied prior to all other unsecured creditors. The Romanian Code follows in that way a system, which protects the value of the secured claim by retreating the value of the security interest itself. Nevertheless, the Code allocates the costs and expenses of the sale of the encumbered asset to the respective secured creditor and thereby reduces the impact of the administration of the security on unsecured creditors. Such a treatment seems fair, since those costs are caused by secured creditors and should therefore been not born by the estate.

The Romanian legislator newly introduced a provision, dealing explicitly with under-secured or partially secured claims. According to this provision, the amount of the

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141 Averch-Lien Stripping, 92
142 Russian Bankruptcy Law, Article 114 (2) incorporates the idea of the absolute priority rule
143 Gutbrod-Das neue russische Insolvenzrecht, 40
144 Polish Bankruptcy Code, Art.204 (2b)
145 Polish Bankruptcy Code, Art.204 (1)
146 Polish Bankruptcy Code, Art.204 (2a)
147 Romanian Insolvency Code, Art.106
148 See B.1.2.
149 Romanian Insolvency Code, Art.106 (1) 1.; for a similar provision provides the German Insolvency Code, § 170
150 Romanian Insolvency Code, Art.106 (2); See for the situation before the changes: European Bank for Reconstruction and Development, Summary of Major Aspects of the Romanian Insolvency System, London April 2000 (on file with the author), 3; Bufford, Samuel, “Romanian Bankruptcy Law: A Central
underlying debt not covered from the proceeds received through the sale of the collateral, are solely unsecured claims without priority treatment. Furthermore, the Code\textsuperscript{151} allows for the accrual of post-petition interest on secured claims in order to protect the interests of secured creditors in the time value of the affected collateral.

An interesting example for the application of the partial priority rule offers the Czech Bankruptcy and Composition Act.\textsuperscript{152} The law grants secured creditors generally the right to receive full satisfaction directly from the sales proceeds of the respective collateral, but limits this to 70 percent of the value of it, in the case, that the remaining assets would not be sufficient to pay the trustee’s expenses and the costs for the administration of the estate.

V. Costs of administration

1. General

Administrative expenses are generally court costs and the fees of the administrator and other professionals, payments relating to contracts, which were entered into or continued by the liquidator after commencement and all other costs, related to collection, management and distribution of the assets of the debtor estate.\textsuperscript{153} However, since it might be desirable to treat administrative costs in a closer sense (fees of the administrator and related professionals and court costs) differently to administrative costs in a wider sense (costs, which are born by ongoing business activities of the administrator – post-petition credit) the law should clearly define, what it considers as administrative costs.\textsuperscript{154} Administrative claims may receive preferential treatment\textsuperscript{155} and even priority over secured credit.\textsuperscript{156}

The justification for this privileged treatment is obvious, because only such a privileged ranking may attract the necessary financial and human resources since nobody wants to extend voluntarily credit as unsecured or respectively non-priority creditor to an insolvent party.\textsuperscript{157} Experienced and well-trained professionals as administrator, counsel, European Example”, 17 New York Law School Journal of International and Comparative Law Review, 251 (1997) (hereinafter cited as: Bufford-Romanian Bankruptcy Law), 262

\textsuperscript{151} See: Romanian Insolvency Code, Art.37

\textsuperscript{152} Czech Bankruptcy and Composition Act, Section 28 (4)

\textsuperscript{153} The Hungarian Bankruptcy Code, sec.57 (2) provides for an unusual extensive definition of “costs of liquidation”, which is granted a first priority. It covers beside more common debts also pre-insolvency wages and other personnel costs including social security contribution. (Sec.57 (2)(a))

\textsuperscript{154} See for example: Croatian Bankruptcy Code, Art.205 (2)

\textsuperscript{155} Bulgarian Commercial Code, Art.722 (1) 3., grants bankruptcy costs a third priority after secured credit and claims for which the right to foreclose is exercised; Czech Bankruptcy and Composition Act, Section 31 (2) with a comprehensive list on preferential claims which arose after the opening of proceedings, expenses of the trustee and costs for the administration of proceedings have thereby the highest priority; Croatian Bankruptcy Code, Art.205 (1) 1., provides costs of the bankruptcy proceedings a first priority and in Art.205 (1) 2., obligations that have arisen after the opening a second priority

\textsuperscript{156} Hungarian Bankruptcy Code, Section 57 (1)

\textsuperscript{157} IMF-Report, 40
accountant or investment banker are more and more essential for a successful insolvency administration.
Similarly, post-petition credit is indispensable for the reorganisation, the going-concern sale or the sound liquidation of the debtor but may rank behind real administrative costs.158
In the case that the available assets do not satisfy all administrative claims the law should provide for a ranking among different classes of administrative costs with a priority for the fees and expenses of the administrator.159
The law should generally not give priority to administrative costs over secured debt. However, as mentioned before, it might grant priority over secured claims for the preservation, insurance and the sale of the collateral.160

Nevertheless, experiences in Western jurisdictions reveal that especially costs for several professionals may extremely inflate administrative cost and thus impair dramatically the chances for repayment of unsecured non- or lower-priority creditors. Therefore, the law should provide for an upper ceiling, limiting the ability for professional fees to be considered as priority administrative claims. One possibility to do this might be to link the amount of professional fees considerable as priority claims to the total amount of outstanding debt or to the respective size of the debtor.

2. Provisions of the Chinese draft laws161

Art.39 new Draft Law and the similar worded Art.65 2001 draft define costs of administration as litigation costs, costs for the management of the assets and administrators and supervisors remuneration and expenses. Administrative costs are granted a super-priority in Art.41 par.2 new Draft Law, Art.67 par.2 2001 draft, ranking ahead debts of common benefit and other unsecured debt.162 However, it remains unclear, whether administrative costs and debts of common benefit are paid on a pro-rata basis when remaining assets are not sufficient to satisfy both classes completely – so the wording of Art.41 par.3 new Draft Law, Art.67 par.3 2001 draft; or whether administrative costs shall be paid first and thereby applying the absolute priority rule163 - so the clear wording of Art.41 par.2 new Draft Law, Art.67 par.2 2001 draft. In the case that the debtors assets are insufficient to pay off administration expenses, the court may follow a request by the administrator to close the insolvency case.

Art.40 new Draft Law, Art.66 2001 draft defines debts of common benefit as claims arising from contracts assumed by the administrator after the acceptance of an insolvency case, the negotorium gestio in favour of and unjust enrichment obtained by the debtor, 164

158 See therefore the subsequent discussion on the ranking of post-petition credit
159 German InsO, §§ 209, 54; a good example provides also the Czech Bankruptcy and Composition Act, Section 31 (2); Croatian Bankruptcy Code, Art.205 (1)
160 Balz, Schiffman, 69; e.g.: Romanian Insolvency Code, Art.106 (1) 1.
162 Hence the legislator did not follow the suggestion of Gebhardt and Olbrich to grant administrative costs a higher priority than post-petition credit. See: Gebhardt/Olbrich-New Developments, 116
163 Absolute priority rule describes a situation, where a senior class of creditors has to be paid in full, before any junior class can receive anything.
post petition labour expenses and social security premiums and liabilities for damages caused by the administrator or the debtor estate. As mentioned before, the law does grant both administrative costs and debts of common benefit a super-priority whereby the ranking between the two classes remains vague. In the case, that the estate of the debtor is deficient to repay those claims completely, the new Draft Law does not provide for an additional ranking among the different types of administrative expenses.164

3. Examples of other jurisdictions

The Russian law165 treats all administrative costs (fees of the administrator, court costs and claims arising from the continued business of the debtor) on equal footing and gives a super priority to such claims over other all claimants.

The Polish Bankruptcy Code grants cost of bankruptcy or arrangement proceedings a first166 and dues generated from the acts of the official receiver and administrator during the proceedings a second167 priority.

The Romanian Code168 gives taxes, stamps and any other expenses related to the procedure a first priority among unsecured creditors.

4. Recommendations for the Chinese drafting process

Generally, the Chinese draft considers the importance of administrative costs by granting a super-priority to those expenses. However, the draft lacks in some elements behind the standards established above.

Firstly, the legislator should decide whether to deal with administrative costs and debts of common benefit on equal footing or rather to privilege administrative costs over the latter. Preferably, Art.41 par.3 new Draft Law, Art.67 par.3 2001 draft should be deleted.

Secondly, Art.39 new Draft Law, Art.65 2001 draft should contain some rules for a internal ranking among several administrative costs headed by the remuneration of the administrator/ supervisor and followed by the relevant court costs.

III. Post-petition credit169

1. General means of protection of post-petition creditors

One of the major problems in rescue and liquidation situations where it is necessary to continue with the business for a period or where a sale as going concern is focused is that the debtor enterprise is frequently in urgent need of ongoing funding in order to pay for necessary supplies of goods and services to maintain its business activities. In the state of insolvency, creditors are normally not willing to extend further credit because of

165 Russian Bankruptcy Code, Art.106 (1)
166 Polish Bankruptcy Code, Art.204 §1 (1)
167 Polish Bankruptcy Code, Art.204 §1 (2)
168 Romanian Insolvency Code, Art.108 (1)
169 see generally for the 2000 draft: Gebhardt/Olbrich-New Developments, 109
the threatening repayment risk. In order to promote rescue efforts of the debtor where feasible the law should provide some kind of assurance for the eventual repayment or recovery of this funding.

The best way to pursue this goal is by granting a super or high priority for post-petition credit.\textsuperscript{170} Generally, the law should not grant to post-petition credit a higher priority than to secured credit since it might run the risk of undermining the value of security.\textsuperscript{171}

Another way, followed by certain jurisdictions, is an option which allows the administrator to give a security interest on unencumbered assets to the post-petition creditor. Frequently, there will be no unencumbered assets available for security purposes since the level of secured financing and trading is generally high and remaining assets might be not suitable or sufficient as security. One could consider the possibility of imposing additional or further security on existing secured property interests for the purpose of protecting a creditor of post-petition credit. That would mean consequently, that the post-petition creditor acquires a “secured priority” on an asset, which already serves as collateral for a secured creditor. Undoubtedly, such a provision may undermine certainty, predictability and significance of secured credit and thus damage the credit system as a whole.\textsuperscript{172}

However, one might consider applying the principles of the partial priority rule\textsuperscript{173} with the consequence that ordinary secured creditors would have to give up a portion of their collateral in order to protect post-petition creditors in the case they would not be satisfied in full under a respective distribution according to the priority ladder and other unencumbered assets are not available.

The provision on post-petition credit is a main obstacle of many insolvency laws of transition economies with severe consequences for the prospect of rescues and even the sale of a debtor as a going concern. Many jurisdictions do not mention the possibility of “new money” at all\textsuperscript{174} and others do not provide for a sufficient protection of post-petition creditors.\textsuperscript{175}

\begin{thebibliography}{99}

\bibitem{170} WB-Towards Principles, 68; See for example: Croatian Bankruptcy Code, Art.205 (1) 2., grants post petition credit a second priority after costs of the administration; Hungarian Bankruptcy Code, Section 57 (1)(2) grants costs of liquidation a first priority, which seem to include cost for the temporary continuation of activities as well, secured creditors have only a second priority; Slovakian Bankruptcy Code, § 32 (1)(a) grants post-petition credit a second priority after the fees of the trustee; Romanian Bankruptcy Law, Art.108 (1)(2) grants post-petition financing a second priority after administrative costs; US-Bankruptcy Code, §364 (d)(1) grants post-petition financing only a super-priority if financing is not available on any other basis; German Insolvency Code, §55 (2) grants post-petition credit a super-priority

\bibitem{171} IMF-Report, 60; see also the discussion above on the \textit{first priority rule} for secured credit

\bibitem{172} ADB-Report, 99

\bibitem{173} See the discussion above C.1.2.

\bibitem{174} ADB-Report, 37: E.g. Indonesia, Malaysia, Philippines

\bibitem{175} ADB-Report, 37: E.g. Korea, Thailand; Bulgarian Commercial Code, Art.722 (1) 7., provides only a seventh priority for receivables which have emerged after the opening of proceedings; Czech Bankruptcy and Composition Act, Section 31 (2)(e) provides for claims arising from contracts concluded by the trustee or which were not cancelled at the opening of proceedings only a fifth priority after taxes and social security contributions

\end{thebibliography}
2. Approach of the Chinese draft laws

Debts arising during the period of reorganisation protection for the purpose of continuance of the debtor’s business (post-petition credit) are considered as debts of common benefit and hence, have a super-priority status ahead of other unsecured debt. However, post-petition credit is only dealt with in the draft in the case of a reorganisation but not in a piecemeal liquidation or going-concern sale of the debtor. Furthermore, the draft laws provide that the debtor may grant security over unencumbered assets for post-petition loans during the period of reorganisation protection. Hence, post-petition security is explicitly permitted and receives the same treatment as pre-petition security granted for new money. Nevertheless, Art.72 par.3 new Draft Law, Art.125 par.3 2001 draft stipulates that the purpose of such loans shall be specified and might be subject to “some necessary control and supervision”. This provision may contrary affect the purpose of the provision since it does not clearly spell out scope, authority and sanctions of such control and supervision.

3. Other jurisdictions (Russia, Romania, Poland)

The new Russian law (1998) mentioned the issue in the case of an External Administration but does not grant those post-petition claims automatically and explicitly a high administrative priority without consent of the creditors. On the other hand, the law grants the law administrative priority to obligations of the debtor, which arose in the course of observation, external administration, or bankruptcy liquidation.

The Romanian Insolvency Code grants claims representing credits, granted by banks during the period of reorganisation, as well as the claims resulting from the continuation of the debtor’s activity, a second priority after administrative costs.

The Polish Code does not mention the problem of post-petition explicitly, but grants obligations, entered into by the administrator during the insolvency proceedings, a second priority.

4. Recommendations for the Chinese drafting process

Again, super-priority status for post-petition credit might be also elementary in

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176 Art.72 par.1 new Draft Law, Art.125 par.1 2001 draft
177 This wording is a clear challenge compared with the 2000 draft, where was only vaguely stipulated, that bankruptcy costs and common debts shall be paid off from the debtor’s property at an time.(Art.48 2000 draft); see also Gebhardt/Olbrich-New Developments, 116
178 Only payments for labour and social security premiums needed for the continuance of the debtor's business operation after acceptance of an insolvency case are considered as debts of common benefit and hence are treated as super-priority claims, Art.40 (4) new Draft Law, Art.66 (4) 2001 draft
179 Art.72 par.2 new Draft Law, Art.125 par.2 2001 draft
180 Russian Bankruptcy Code, Art.79
181 EBRD-Summary of the Russian System, 6
182 Russian Bankruptcy Code, Art.106 (1)
183 Romanian Insolvency Code, Art.108 (2)
184 Polish Bankruptcy Code, Art.204 §1 (2)
liquidation proceedings where the administrator is in need to continue the business of the debtor for a limited period or where the success of a going-concern-sale of the debtor depends on the completeness of its working equipment, machinery and other essential assets. The Chinese legislator has extended some protection for post-petition creditor only for reorganisation proceedings but did not consider a necessary privilege for post-petition creditors in a piecemeal liquidation or going-concern-sale situation. Therefore, a provision should be added regarding any credit – whether trade or finance which has been extended after the acceptance of a insolvency case and for the continuance of the debtors business as debts of common benefit in the sense of Art.40 new Draft Law, Art.66 of the 2001 draft.

IV. Wages and benefits

1. General, social and other policy considerations

Comparing several jurisdictions, there are certain categories of creditors, who will receive payment prior to other unsecured creditors. The underlying ranking reflects frequently political or economical policies prevailing in the respective country. As commendable those policies might be, the introduction of additional priority creditors undermines the efficiency and overall effectiveness of the proceedings for a number of reasons. Firstly, they may distract other unsecured creditors to participate in the insolvency process since they re-valuate the claims of a privileged class of unsecured creditors. Furthermore, they may complicate negotiations of a reorganisation plan to the extent, that they require the creation of separate creditor classes to reflect the priority in question.185

The types of privileged unsecured creditors vary from country to country. Some jurisdictions grant priority for employee salaries and benefits. Those countries attempt to afford employees special protection by giving them priority over other unsecured creditors. Such privileges are generally consistent with the special protection, which is afforded to employees in other areas of insolvency law.187 On the other hand, one might argue, that such privileges do discourage the promotion of efficient social safety net systems – a probably more systematic tool to protect redundant employees.188 Modern economies usually provide redundant employees affected by the insolvency of its employer with a safety net, which is commonly funded by contributions of solvent enterprises and their employees. However, similar instruments are frequently not available in transition economies or at least not stuffed with the necessary funds to support victims of potential mass insolvencies.

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185 IMF-Report, 40; the Chinese law provides in Art.80 (2) (3) new Draft Law, Art.133 (2) and (3) 2001 draft for separate classes for wage and tax claims
186 Russian Bankruptcy Code, Art.106 (2) grants employees a second priority after administrative costs (super priority) and tort claims (first priority); Romanian Insolvency Code, Art.108 (3) grants employees a third priority after administrative costs (first priority) and post-petition credit (second priority); Croatian Bankruptcy Code, Art.71 2., grants employee claims a second priority after tax and state budget claims (first priority); Bulgarian Commercial Code, Art.722 (1) 4., grants employees for wages emerged one year prior to the opening a fourth priority after security, claims for which the right to foreclose is exercised and bankruptcy costs
187 IMF-Report, 40
188 ADB-Report, 98
But apart from these social considerations exist several other reasons to grant employees priority over other unsecured creditors. Firstly, they may not be capable to cover the losses effected by the loss of their jobs and consequently unable to pay their own creditors. That may lead to knock-on insolvencies and social hardship and might thereby affect other communities not legally connected with the debtor.\textsuperscript{189}

Secondly, employees do usually not voluntarily extend credit to their employers since they do not enter willingly in a debtor-creditor relationship but in an employer-employee relationship. Employees are regularly not able to make an ex-ante assessment of the insolvency risk of their employers nor do they have the bargaining power to negotiate a contractual security interest for their salaries. Furthermore, if employees are not paid in the insolvency of their employer they may be not willing to work and participate in the reorganisation phase. Because when a work force is critical to a reorganisation effort it makes sense to pay these workers as their labours will inure to the benefit of other creditors.\textsuperscript{190}

The priority for employee salaries may also include social security charges\textsuperscript{191} (e.g. health insurance, pension contributions) not paid by the debtor prior to the commencement of proceedings.

2. Chinese draft law and recommendations for the drafting process

Art.135 par.1 the new Draft Law, Art.85 par.1 2001 draft grants wages, salaries and unpaid social security premiums a first priority after administrative expenses and debts of common benefit have been paid off preferentially. The privileged claim is neither limited by its amount nor by the period covered. Considering the heavy workforce prevailing among most of the Chinese enterprise, the privilege may negatively affect chances for repayment of subsequent unsecured creditors. Until the social security system is capable of cushion the social hardship, naturally along going with comprehensive liquidation or reorganisation measures, the law should limit the time period applicable to privilege wage claims.\textsuperscript{192} Therefore, a period of six month prior to the acceptance of the insolvency code would be a reasonable limitation to balance the interests of both – the employees and other subordinated creditor. In addition, there exist some other possible devices to substitute privileges by maintaining their desired social, political or economical functions.\textsuperscript{193}

Likewise, the law\textsuperscript{194} provides also other expenses “that shall be paid to the labours according to provisions of laws and administrative regulations” with the same priority. Such a vague extension of claims possibly covered under this priority might distract creditors since existence and scope of provisions and regulations protecting redundant workers monetarily may be unpredictable and unforeseeable for them. Therefore, Art.135

\textsuperscript{189} See for a comprehensive discussion on social and community aspects of insolvency in transition economies: Falke-Insolvency Law Reform, 59 pp.
\textsuperscript{190} Gross-Failure and Forgiveness, 152
\textsuperscript{191} So also the Chinese draft law, Art.135 (1) new Draft Law, Art.85 (1) 2001 draft covers also unpaid social insurance premiums (health, unemployment and pension)
\textsuperscript{192} See also the discussion on social security as device to replace privileges, C.IV.2.a.
\textsuperscript{193} See therefore C.VI.; see also: Falke-Insolvency Law Reform, 315 pp.
\textsuperscript{194} Art.135 (1) new Draft Law, Art.85 (1) 2001 draft
(1) new Draft Law, Art. 85 (1) 2001 draft should either not contain this clause at all or at least specify these provisions and regulations in a predictable manner.\textsuperscript{195}

The new Draft Law introduces under Art. 10 par. 2 a provision which seems to shift some responsibility for redundant employees to local governments. According to this provision, local governments are supposed to arrange the “settlement and the life guarantee” of the employees affected by the insolvency of its employer. However, it remains unclear, whether this procedure is generally deemed to financially soften the social hardship and the loss of wages usually along going with insolvency and particularly whether it covers unpaid wages, not recoverable in the insolvency process.\textsuperscript{196} Accordingly should the law reconsider the granting of unlimited priority for wage claimants, since a need for further financial protection of redundant employees might be outdated and unnecessary.

V. Tax and state budget claims

1. General policy considerations

Other jurisdictions\textsuperscript{197} grant priority to tax and budget claims with the possible justification, that it may be beneficial in a reorganisation procedure since tax authorities can delay the collection of taxes in order to support rescue efforts of the troubled company.\textsuperscript{198} However, such incentives can be counterproductive since it constitutes state subsidies and undermines the disciplinary function of market forces.\textsuperscript{199} Furthermore, such rights may encourage inefficient government tax collection systems, a main obstacle especially in transition economies.\textsuperscript{200}

Other policies justify tax priorities by the government’s necessity of tax revenues. Furthermore, one may suspect, that in the case, a company would be able to discharge their tax liabilities under the insolvency law, many companies may only initiate insolvency proceedings to reduce the annoying tax burden.


\textsuperscript{196} The experience in China is that there is no general and equal treatment of redundant employees – it depends firstly whether the insolvent enterprise was state-owned and secondly on the type of the SOE. The affected workers may receive a settlement fee up to 3 month salary or a preferential payment directly from the proceeds of land-use fees.

\textsuperscript{197} ADB-Report, 49: e.g. Indonesia gives tax claims priority over all other claims; Russian Law (1998) grants mandatory payments to the budget a fourth priority, Art. 106 (2); Romanian Insolvency Law, Art. 108 (4), grants taxes, fines and other public income also a fourth priority; Polish Bankruptcy Code, Art. 204 §1 (3), taxes and other public tributes as well as social insurance premiums due for one year preceding the opening of proceedings have a fourth priority; Croatian Bankruptcy Code, Art. 71 1., grants taxes and other revenues of the state budget or budget of local governments a first priority; Czech Bankruptcy and Composition Act, Section 31 (2)(d) grants taxes and social security contribution a fourth priority ranking ahead claims for post-petition credit


\textsuperscript{199} IMF-Report, 40

\textsuperscript{200} ADB-Report, 98
On the other hand, the state budget may, in contrast to employees and other small or medium sized creditors, sustain losses from an insolvent debtor. Granting tax a priority may contagiously affect other taxpayers with even a negative end result for the fisc. Imagine, the priority granted to the fisc deprived several other creditors of their claims and influences their solvency as well. The fisc may gain its revenue with the first debtor but may loose with the other failing creditors. Furthermore, other creditors may claim deductions on income tax returns for bad debts by creditors who will receive little or nothing as a result of the fisc’s privilege.\footnote{Balz, Schiffman, 68}

2. Chinese draft laws and recommendations for the drafting process

The Chinese draft laws grants under Art.135 par.2 new Draft Law, Art.85 par.2 2001 draft taxes owed by the debtor a second priority ranking behind wages and labour costs. Similarly to wage claimants the unlimited privilege on tax claims may also negatively affect the pool of remaining assets for other subordinated creditor.

One considerable way to limit this negative impact of this priority would be again a inclusion of a time limit according to which a priority for outstanding tax is granted. This clause could grant, for example, a priority for outstanding tax claims only for a period of six month prior to the acceptance of the insolvency case. As mentioned above, there might also exist some other devices to limit the negative impact on priorities.\footnote{See therefore C.VI.; see also: Falke-Insolvency Law Reform, 315 pp.} Since tax remains the biggest revenue source of the state budget and will therefore continue to receive preferential treatment in insolvency. However, the Chinese legislator should consider the above-mentioned possible negative long-term and side effects of unlimited priority for tax claims and amend the respective provision accordingly.

3. Other jurisdictions for comparison

Granting priorities to the public fisc may discourage creditors to externalise costs of the default. Thereby, priorities may be granted in liquidation as well as in reorganisation. Under Chapter 11 of the US-Bankruptcy Code, for example, a reorganisation plan may be not confirmed unless the tax debts are scheduled for repayment in full.\footnote{US-Bankruptcy Code, § 1129(a)(9)(C)} Nevertheless, the US-Bankruptcy Code does allow debtors to stretch out tax obligations for a period up to six years with or without the consent of the taxing authority.\footnote{Bufford-What is Right, 841; US-Bankruptcy Code, § 1129(a)(9)(C)}

The Polish Code\footnote{Polish Bankruptcy Code, Art.204 §1 (3)} provides an interesting limitation on the priority for tax and other state claims. It limits the period in which such claims would receive a priority up to one year prior to the filing of insolvency. Consequently, the fisc has an incentive to collect outstanding taxes on a timely basis and subordinated creditors are protected from extensive tax and social insurance claims.

As mentioned elsewhere, another interesting provision of the Polish Bankruptcy Code\footnote{Polish Bankruptcy Code, Art.204 §1 (2a)} provides that tax or social security creditors secured with a pledge or mortgage, ranking ahead “general” secured creditors.

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\footnote{Balz, Schiffman, 68}

\footnote{See therefore C.VI.; see also: Falke-Insolvency Law Reform, 315 pp.}

\footnote{US-Bankruptcy Code, § 1129(a)(9)(C)}

\footnote{Bufford-What is Right, 841; US-Bankruptcy Code, § 1129(a)(9)(C)}

\footnote{Polish Bankruptcy Code, Art.204 §1 (3)}

\footnote{Polish Bankruptcy Code, Art.204 §1 (2a)}
VI. Priority rules: possible substitutions or limitations

1. Policy considerations behind

Privileges are frequently justified by the following reasons: existing social needs to protect less powerful market participants; certain creditors have not voluntarily extended credit (tort creditors) and had therefore not the chance to risk assessment and negotiation of contractual security interests; contractual security is not available to certain groups of creditors; there are strong social and economical incentives for certain creditors to not enforce their claims individually before insolvency and finally general fiscal and budget implications.

But even when those reasons may be recognised as urgent policy issues in the respective jurisdictions, it might be debatable, if there is a justification for a general application of some priority rules in transition economies. Mainly to criticise is the effect of privileges in the context of the absolute priority rule, where a senior class of creditors has to be paid in full, before any junior class can receive anything.\textsuperscript{207} This treatment is neither able to satisfy main objectives of insolvency nor to balance diverse interests and rights of participants. Furthermore, privileges are jointly accountable for the frequently found disinterest of general unsecured creditors in proceedings. Under various insolvency laws of transition economies, which are still having a separate composition law, priority creditors have to receive payment in full before a rescue would be permissible – this reduces the chances of a successful reorganisation significantly. Finally, privileges violate one of the basic tenets of the economic analysis of insolvency law; they distort the value of pre-insolvency entitlements.

2. Devices to substitute priority rules

However, there might be several instruments and devices available, which may render privileges unnecessary or at least limit their negative impact on the outcome for proceedings but at the same time, attempt to support valid goals, some privileges, particular in transition economies, may have.

a. Social security system

In order to foster social security in relation to insolvencies and its impact on redundant employees, a country should introduce a social safety net for employees in insolvency. Germany, for example, has a system based on insurance, where the unpaid employees get paid up to 3 month` of outstanding salary\textsuperscript{208} and the insurer is then subrogated to employee claims as a general creditor in insolvency proceedings. This system is financed by the non-insolvent enterprises.\textsuperscript{209} (Insolvenzausfallgeld)

\textsuperscript{207} Balz-Russia, 33
\textsuperscript{208} German Social Code, §§183
\textsuperscript{209} German Social Code, §§358
A similar system exists under Polish law. Every solvent employer pays 0.5% of the salary of his employees into a “Fund for guaranteed employee contribution”. In the case of the insolvency of the employer and its inability to pay outstanding pre-insolvency wages, the Fund will pay up to three month of the outstanding wages.\footnote{Brol, Jan, Das polnische Konkursrecht in der Praxis, Jahrbuch für Ostrecht, 1997 2. Halbband, Themenband: Insolvenzrecht in Deutschland und Osteuropa, 305, 313} Exceeding wage claims get a first priority together with administrative cost and post-insolvency claims are treated as post-petition credit with super-priority.\footnote{Polish Bankruptcy Code, Art.204 §1} The Chinese system currently lacks adequate ways for redundant employee settlement and has not yet established a comprehensive and efficient social welfare system.\footnote{Shuguang, Li, Bankruptcy Law in China: Lessons in the past Twelve Years, Harvard Asia Quarterly, Winter 2001, 39-45; Harmer, Ronald, Insolvency Law and Reform in the People’s Republic of China, 64 Fordham Law Review (1996), 2581-2582}

b. Partial priority

A means to limit the impact of privileges on non-priority claimants is the reservation of a maximum percentage of assets for privileged classes: privileged classes of creditors may be satisfied only from a percentage of available assets.\footnote{See also the discussion on the Partial Priority Rule for secured credit; C.I.2.} The German law,\footnote{German Insolvency Code, §123, see also Schwertner, Peter, Der Sozialplan im Eröffnungsverfahren und nach der Verfahrenseröffnung, Kölner Schrift zur Insolvenzordnung, Hrsg. Arbeitskreis für Insolvenz- und Schiedsgerichtswesen e.V., Köln 1997, 1127, 1137} for example, provides under certain circumstances for a Social Plan, according to which redundant worker may receive up to two and a half month of salary as super priority claim ranking ahead other privileged and non-privileged creditors. However, the therefore available assets are limited to one-third of the total assets and payments to the respective redundant workers are reduced pro rata when the total payment would exceed one third of the available assets.

c. Weighting of different types of privileges

To circumvent the impact of a strict lexical ordering of privileges, a legislator may grant different multipliers to various groups of claimants. Thereby, for example, a tort claimant may get a multiplier of 2.0 for his claim, an employee 1.5 and other general unsecured creditor 1.0. These weightings would be not only recognised in the distribution but possibly also in the voting process, with the consequence, that none of the unsecured creditors would be completely locked out from the outcome of proceedings. Furthermore would such a treatment of different claims allow allocating respective rights more flexible and equitable among varying creditors.\footnote{Balz, Schiffman, 67; Balz-Russia, 34} However, this approach has not been tested in actual legislation yet.

d. Limitations on privileged claims\footnote{See especially for the 2000 draft a suggestion to either abolish priorities completely – as done with the new German Insolvency Code – or at least limit the scope of priorities: Gebhardt/Olbrich-New Developments, 119}
A more frequently found approach to the problem is the introduction of monetary and time limitations on certain privileged claims. Therefore, respective creditors may only receive a privilege up to a certain amount of the claim and/or within a certain time period before the acceptance of an insolvency case. Such limitations may serve several purposes: they may reduce moral hazard among management and foster managerial discipline, promote an efficient tax collection process and protect other subordinated creditors. These limitations are applied by several jurisdictions primarily for general wages\(^{217}\), managerial wages\(^{218}\) and taxes revenues\(^{219}\).

3. Priority for creditors irreparably injured by pro-rata treatment?

Nevertheless, there may be also situations calling for the consideration of a preferential treatment of creditors. As mentioned before, one goal of the insolvency process is to achieve creditor equality – commonly attempted to achieve through a pro-rata distribution among unsecured creditors. But pro-rata treatment among very different situated unsecured creditors may not provide for equality in terms of the respective outcome of proceedings. For one creditor, immediate cash payment may be from vital importance while a wealthier creditor may be not depending on the claim at all.

On the other hand, economical theories suggest avoiding any re-distributive effect of the insolvency law. However, one may be able to identify situations where it might be justifiable to deviate from pro-rata sharing among unsecured creditors and to rebut the presumption of equality of treatment among unsecured creditors.\(^{220}\)

Such a situation would be conceivable, if a general unsecured creditor, by receiving its quote of the remaining asset value after secured and priority creditor are paid, would come under existential pressure by suffering irreparable injury.

This approach could be implemented by creating an accelerated priority for those creditors and deleting one of the other less justifiable priorities.\(^{221}\) Thereby, one of the above discussed instruments or devices might be used to limit the impact of privileges on the other participants. Particularly the weighting system as suggested above might be suitable to have a limiting effect on such a privilege.

Creditors, claiming such a priority would bear the burden of proof at a hearing before the competent court. They would need to establish that the failure to receive different treatment would cause a hardship and irreparable injury. Defining this term may provide some difficulties but the reason for such a treatment may bring some clearance. This approach reflects a social dimension of insolvency focusing on the prevention of social hardship. Accordingly, a creditor should be eligible to this priority as soon as pro-rata treatment would negatively affect his viability. Generally, this applies to both

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\(^{217}\) US Bankruptcy Code: 90 days prior to insolvency, $4,000 per employee; Romanian Bankruptcy Code, Art.108 (3) wages for a period up to six month prior filing; Slovakian Bankruptcy Code, § 33 (3) wages generally only for up to three month prior to the opening and Bulgarian Commercial Code, Art.722 (1) 4., wages only for one year prior to the opening decision

\(^{218}\) Slovakian Bankruptcy Code, §66 h, wages of management only up to the amount of 10,000 Sk monthly

\(^{219}\) Polish Bankruptcy Code, Art.204 (3) grants priority for taxes only for up to a year prior insolvency

\(^{220}\) Gross-Failure and Forgiveness, 165

\(^{221}\) Such a method may be combined with the weighting system suggested above
natural person creditors and creditors with legal personality. However, potential candidates of this exception to the general pro-rata rule may be individual creditors (e.g. free contractor) or small creditors (small trade creditors). But beside the social goal the approach may satisfy some other objectives of insolvency as well. By preventing the eligible creditors to fail on their obligations it may prevent a chain of knock-on insolvency. Furthermore, this technique may protect entrepreneurial resources by protecting those creditors.

The method is supposed to be particularly valuable for transition economies since there small businesses do regularly not have the financial cushion to outlive the insolvency of a major business partners or customers. Furthermore, individual entrepreneurs and small businesses are as correlative to SOE’s an important force in the transition process and essential for the development of an efficient and well-functioning market economy. The protection of them may be justifiable against the interference with general pro-rata treatment among unsecured creditors.

On the other hand, requirements on the standard of proof and substantial demands for eligibility should be high and allow the remedy only for a specific, narrow set of circumstances. Otherwise, the approach would negatively affect mainly large businesses what might result in a reduced willingness of those creditors to lend and thereby affect debtors, which are depending on the credit of large creditors.

Viewing the technique from a creditor perspective, one might argue that creditors as a whole dislike the suggested approach since it provides for a further deterioration of the pro-rata sharing rule and some creditors could obtain a greater and earlier distribution than others. But, on the other hand, creditors may be convinced from the merits of the system and may appreciate the system since it would be available to them if they need it prospectively. Additionally, if creditors were aware of the possibility that a limited pool of creditors may receive such preferential treatment they could assess and respectively price this risk in advance.

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