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Partnerships with Limited Liability and Creditor Protection in China: A Comparative Perspective from the UK and US

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Abstract

This thesis is mainly concerned with the expansion of limited liability within partnerships in the UK, US, and China and the concomitant need to strengthen creditor protection. Limited liability used to be a privilege largely restricted to shareholders of corporations, who are liable for corporate debts only to the extent of their capital contributions in the corporation. Recent years have witnessed an innovative combination of limited liability and the partnership structure. In this thesis, the hybrid entities of limited liability and partnership structure will be referred to as partnerships with limited liability, which include the limited partnership, the limited liability partnership (LLP), and the limited liability company (LLC).

As limited liability induces opportunism against creditors, corporate law contains many stringent rules to mitigate risks for creditors. However, despite having the liability shield similar to that of corporations, partnerships with limited liability have a much lighter regime for creditor protection. This allows businesses to utilise limited liability while circumventing the creditor protection rules under the corporate law.

This thesis will highlight such regulatory asymmetry of creditor protection between corporations and partnerships in the UK, US, and China and consider whether it is necessary to transpose corporate rules for creditor protection to partnerships with limited liability. Further, this thesis will make an overall evaluation of the creditor protection regime in China and propose further improvements, drawing on the experience of the UK and US. It is worth noting that “UK law” in this thesis refers to the law of England and Wales, excluding law in Scotland unless otherwise indicated.
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As I am writing here, the everyday scene of my typing in the attic of the law school building keeps flashing back. I think of the trees outside my window turning from green to gold, the warm yellow light exuding from the Adam Smith building which stands right across the lawn, the solemn humming of the church organ, the sentimental echoes of Scottish pipes played for weddings, and also the excited clamour of students posing for photos in their caps and gowns. I am happy and proud that I can soon be one of them, but at the same time I am reluctant to say goodbye to a place where I found spiritual peace and the intellectual power that will illuminate my future.
Author’s Declaration

I declare that, except where explicit reference is made to the contribution of others, this dissertation is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

Signature: Wei Chuyi

Printed Name: WEICHUYI
Abbreviations

BC: Bankruptcy Code

CA: Companies Act

CSRC: China Securities Regulatory Commission

DGCL: Delaware General Corporation Law

DLLCA: Delaware Limited Liability Company Act

DRULPA: Delaware Revised Uniform Limited Partnership Act

DTI: Department of Trade and Industry

EBL: Enterprise Bankruptcy Law

EU: European Union

IA: Insolvency Act

IRS: Internal Revenue Service

LAO: Law Affairs Office

LLC: Limited Liability Company

LLP: Limited Liability Partnership

LLPA: Limited Liability Partnerships Act

LPA: Limited Partnership Act

MoF: Ministry of Finance

NPC: National People’s Congress
NYBOL: New York Business Organisation Law

PEL: Partnership Enterprise Law

RMBC: Revised Model Business Corporation Act

SAIC: State Administration for Industry and Commerce

SASAC: State-owned Assets Supervision and Administration Commission

SME: Small and Medium Enterprises

SOE: State Owned Enterprises

SPC: Supreme Court of China

SAT: State Administration of Taxation

UCC: Uniform Commercial Code

UFTA: Uniform Fraudulent Transfer Act

ULLCA: Uniform Limited Liability Company Act

ULPA: Uniform Limited Partnership Act

UPA: Uniform Partnership Act

JSC: Joint Stock Company
Introduction

1. Objectives of the Thesis

This thesis will pursue two objectives. First, it will consider the issue of creditor protection in partnerships with limited liability in the context of the UK, US, and China. It is worth noting that “UK law” in this thesis refers to the law of England and Wales, excluding law in Scotland unless otherwise indicated. Second, it will make an overall evaluation of the Chinese creditor protection regime and make suggestions for its further reform, drawing on the experience of the UK and US. These two objectives will be pursued in the following analysis.

1.1 Reconsidering Creditor Protection with Rise of Partnerships with Limited Liability

In recent years, China has been eager to emulate Anglo-American commercial law, especially aspects of US law. In this thesis, the hybrid entities with partnership structure and limited liability will be analysed in particular and referred to as partnerships with limited liability, which include the limited partnership, the limited liability partnership (LLP), and the limited liability company (LLC), a unique US non-corporate entity. Partnerships with limited liability have become popular vehicles for professional firms, private equity firms, and other businesses that want to utilise limited liability while circumventing the double taxation and stringent regulation of corporations.

Limited liability used to be a feature restricted to corporations. As a core feature of corporate law, limited liability limits claims of corporate creditors to the corporate assets and prevents creditors from reaching the personal assets of shareholders. Although limited liability can encourage investment and entrepreneurialism, it also induces opportunism against creditors. To safeguard the interests of creditors, many corporate rules are designed to mitigate the

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1 The LLC here refers to a unique US non-corporate business entity, different from the UK limited company and the Chinese limited liability company, both of which are corporations. Both the LLC and LLP provide limited liability for all of its owners, while in the limited partnership only the limited partners can enjoy limited liability, and general partners still undertake unlimited liability. See Chapter 1.
risks of limited liability, such as legal capital rules, fiduciary duties, insolvency rules, and piercing the corporate veil.

Traditionally, partners assume unlimited liability for the debts of the partnership. Therefore, partnerships are not subject to the creditor protection rules as seen in corporate law, which are designed to deal with problems under limited liability. However, when the liability shield in partnerships is becoming closer to that of corporations, one has to wonder whether there is a need to transpose creditor protection rules under corporate law to partnership law.

To answer the question, this thesis will examine the risks of limited liability and basic corporate rules to counteract such risks under the UK, US, and Chinese law. Then it will consider whether these rules should be extended to partnerships with limited liability. Although partnerships with limited liability have become increasingly prevalent in the UK, US, and China, they still feature much less in scholarly discussion than corporations. This thesis will contribute to the discussion of partnerships with limited liability, especially those in China, by focusing on the aspect of limited liability and the concomitant issue of creditor protection.

1.2 Evaluating the Creditor Protection Regime in China on the Verge of Debt Crisis

In considering whether to extend corporate rules for creditor protection into partnerships, this thesis makes an overall evaluation of the creditor protection regime in China, based on a comparison with its UK and US equivalents. On the surface, China has already established a creditor protection regime that converges with those in the UK and US. However, as a country that only started to transform into a market economy in the 1980s and make the accommodating legal reforms, China still experiences many difficulties in the theory and practice of creditor protection. Therefore, an evaluation of its creditor protection regime is necessary to reveal its problems and inform its future reform.

Further, the creditor protection issue has never been so relevant in China, as this thesis is being written when the country’s debt has risen to an
unprecedented level. After decades of miraculous growth, many believe that China is on the verge of a “Bear Stearns moment”\(^2\) and that its credit-fuelled growth is destined for a catastrophic hard landing. There are many signs that seem to confirm this view: the excessive investment in infrastructure, the industrial overcapacity, the rapid growth and large scale of the shadow banking system, the rising rates of intra-bank lending, and most recently, the first corporate bond default in China.\(^3\)

Statistics also indicate an alarming scale of credit in China. According to the China Balance Sheet published by the Chinese Academy of Social Sciences (CASS) in 2013, China’s total debt, including corporate debt, government debt, and household debt, reached RMB 111.6 trillion ($18.3 trillion) at the end of 2012, equaling 215.7 percent of that year’s GDP. Corporate debt accounted for the largest share of China’s debt, amounting to 113.5 percent of GDP, with household debt at 31.1 percent and financial sector debt at 17.6 percent.\(^4\)

Many hold the assumption that the Chinese state can always be the lender of last resort and rescue local governments, banks, and state-owned enterprises (SOEs), which are too big to fail.\(^5\) Therefore, most observers do not expect a major debt crisis in China. However, even if a full-blown crisis does not happen, it is foreseeable that the country will not maintain its fast growth, many businesses will be shut down, and as a result many creditors will face defaults.

The imminent “debt crisis” in China is an important factor that prompts this thesis to focus on the issue of creditor protection. Under such circumstances, sound legal rules to protect creditors are crucial for maintaining the stability of the market and creditors’ faith in China’s investment environment.

\(^2\) Bear Stearns is a US investment bank that failed in 2008 and was regarded as a symbol for the financial crisis starting in 2008.


2. Structure

This thesis will be principally divided into six chapters. To set the context of the discussion, the first chapter will make an introduction to the legislative background of partnerships with limited liability in the UK, US, and China and compare their essential features including entity status, limited liability, and tax treatment. The second chapter will discuss the issue of limited liability and make an overall comparison of the creditor protection regimes in the UK, US, and China. The third chapter will discuss creditor protection rules that operate outside the formal procedure of insolvency, including self-protection of creditors, legal capital rules, liability insurance, fiduciary duties and rule of veil-piercing. Chapter Four will evaluate corporate bankruptcy rules in China based on a comparison with those in the UK and US and propose to establish a bankruptcy regime for partnerships. Chapter Five will be the concluding chapter to summarise the whole thesis.
Chapter 1 Introduction to Partnerships with Limited Liability in UK, US and China

Introduction to Chapter 1

To set the context of the discussion of this thesis, this chapter will give an introductory overview of partnerships with limited liability in the UK, US, and China, including limited partnerships, limited liability partnerships (LLP), and limited liability companies (LLC), a unique business organisation in the US. With the creation of these entities, corporations are no longer the only business organisation that can offer limited liability protection to owners.

This chapter will be divided into three sections. In section 1.1, the legislative background of partnerships with limited liability in the UK and US will be introduced. It should be noted that corporate and partnership law in the US is enacted by individual states, but they often choose to adopt model laws with some variations. Here, the model laws on partnerships\(^1\) and the laws of some particular states will be considered, especially the laws of Wyoming, which was the first state to establish LLCs, and Delaware, which is a major destination for business charters. Section 1.2 will focus on Chinese partnerships with limited liability and compare their characteristics with their counterparts in the UK and US. The final section will consider the regulatory competition theory as the explanation for the fast expansion of partnerships with limited liability, despite their downsides for the interests of creditors.

\(^1\) The model laws discussed here include the Uniform Partnership Act (UPA), Uniform Limited Partnership Act (ULPA) and Uniform Limited Liability Company Act (ULLCA), all of which are promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL). While the UPA and ULPA were widely adopted among the US states, the ULLCA is less so. For more information, see the official website of NCCUSL: [http://uniformlaws.org/Default.aspx](http://uniformlaws.org/Default.aspx).
1.1 The Legislative Background of Partnerships with Limited Liability in the UK and US

1.1.1 The US

i. US LLCs

Traditionally, separate legal personality and limited liability were regarded as the core defining features of the corporation.\(^2\) Separate legal personality refers to the notion that a corporation is a legal entity separate from its shareholders, directors, employees, creditors, and other parties involved.\(^3\) Limited liability means that shareholders of a business organisation are liable for the corporation’s debts only to the extent of the capital they have invested in the corporation.\(^4\) While separate legal personality allows a corporation to own assets and prevents shareholders and their creditors from taking corporate assets out of the corporation, limited liability limits claims of corporate creditors to the corporate assets and prevents creditors from reaching the personal assets of shareholders.\(^5\) Although separate legal personality is not necessarily linked with limited liability,\(^6\) it can facilitate limited liability by delineating assets of the corporation and those of its shareholders.\(^7\)

\(^2\) A business corporation has five defining characteristics: (1) legal personality; (2) limited liability; (3) transferable shares; (4) centralised management; (5) ownership shared by equity investors. See Reinier Kraakman, Paul Davies, and Henry Hansmann, *The Anatomy of Corporate Law: a Comparative and Functional Approach*, (Oxford: Oxford University Press, 2009), p 5.


\(^4\) Ibid., p 53.

\(^5\) Some scholars describe separate legal personality as the strongest form of “entity shielding” in that it shields the corporate entity from withdrawal of its owners and claims of their personal creditors, while limited liability is viewed as “owner shielding” as it protects owners from claims of creditors of the business entity. It is worth noting that entity shielding is not equivalent to separate legal personality. When partnerships were still not viewed as entities under the common law, they already had a weak function of entity shielding. Also, limited liability is not necessarily associated with separate legal personality and limited partnerships are a case in point. See Henry Hansmann, Reinier Kraakman, and R Squire, “Law and the Rise of the Firm,” *Harvard L. Rev.* 119 (2005): 1335.

\(^6\) Limited liability can exist in organisations without separate legal personality, for example, limited partnerships; also, under the Anglo-American law, corporations have acquired separate legal personality before limited liability. See 2.1.1.

\(^7\) Davies, *Introduction to Company Law*, p 10 (above note 3).
In the US, the assumption that only corporations can acquire separate legal personality and limited liability started to crumble when the LLC was created as a legal entity and gained full-fledged limited liability protection for its members. Compared with corporations, the US LLC offers the additional benefits of structural flexibility and partnership tax treatment. In this thesis, the LLC will be viewed as a form of partnership with limited liability due to the LLC’s flexible structure and light regulation, which resemble partnerships more than corporations.

The first US LLC act was passed in the state of Wyoming in 1977 as a result of the lobbying efforts of lawyers who were seeking combination of limited liability and transparent taxation for their clients. Later, the LLC was established throughout the 50 states and the District of Columbia. Besides the enactment of LLC statutes in individual states, a uniform LLC law was also being created. In 1996, the National Conference of Commissioners on Uniform State Laws (NCCUSL), a quasi-political organisation aimed at promoting uniformity of law at the national level, promulgated the first version of the Uniform Limited Liability Company Act (ULLCA). The statutes provided by the NCCUSL are model laws, which each state can choose to adopt or not. Not many states have adopted the ULLCA 1996 and its updated version in 2006, and therefore state LLC laws remain differed on many issues.

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8 The LLC is defined as a legal entity separate from its members under the US law, for example, section 104 of the ULLCA 2006 states that

“(a) A limited liability company is an entity distinct from its members...”


13 The number of the states that have adopted the ULLCA can be found at http://www.uniformlaws.org/Act.aspx?title=Limited%20Liability%20Company%20 (accessed on November 12, 2013).
LLCs have challenged the position of corporations as the dominant business organisation. It is estimated that in the US the number of new LLCs formed outpaced the number of new corporations formed by a margin of nearly two to one in 2007. In Delaware and Colorado, the ratio of new LLCs to new corporations was higher than 3:1 in 2007. In ten states and the District of Columbia, the ratio was higher than 4:1. The highest ratio, which was found in Connecticut, was a staggering 11.826 to 1.14

Many have argued the appeal of LLCs lies in the fact that they provide corporate features with the additional benefits of greater flexibility and partnership tax treatment.15 To understand why the partnership tax treatment can be an attractive feature of LLCs, the different treatment of partnerships and corporations under the tax law will be elaborated here. Although corporations can attract business owners with their limited liability shield and separate legal personality, which can significantly reduce risks for shareholders, they are at a disadvantage to partnerships in terms of taxation. As the corporation has legal personality separate from its owners, it suffers double taxation. To be specific, the corporation will be taxed for its profits, and at the same time, its shareholders will pay income tax for dividends distributed to them by the corporation. In contrast, partners will pay income tax for profits made by the partnership while the partnership itself will not be taxed.16 Under the common law, the fundamental reason for this is that partnerships are traditionally regarded as merely aggregates of individual partners rather than independent entities.17 Although partnerships now, including limited partnerships and limited

15 See for example, Friedman, “The Silent LLC Revolution--the Social Cost of Academic Neglect” (above note 9).
liability partnerships (LLPs), have become recognised as legal entities in the US,\(^\text{18}\) the traditional transparent approach of partnership tax has been retained.

Similar to the partnership, the LLC is also regarded as transparent in the eyes of tax law and only its members will be taxed for its profits. Thus, the LLC is an ideal alternative to business owners who want the benefits of separate legal personality and limited liability, which used to be restricted to corporations, and also have the benefit of partnership tax treatment.\(^\text{19}\)

To summarise, the LLC marks the start of a revolution that introduces limited liability into non-corporate organisations. The LLC is defined as a legal entity under US law. Following the LLC, other forms of partnerships with limited liability will also gain force across the US. This will be further discussed below.

ii. US LLPs

After the creation of LLCs, the appearance of the LLP across the US further challenged the notion that limited liability is restricted to corporations. The first LLP legislation in the US was passed in Texas in 1991,\(^\text{20}\) when a widespread debt and loan crisis caused great fear among lawyers and accountants for being held liable for their role in the failures of financial institutions. The Texas Business Law Foundation, a registered lobbying body representing interests of lawyers, played a very active role in the passing of the LLP Act in Texas.\(^\text{21}\)

\(^{18}\) UPA 1997 § 201(a); ULPA 2001 § 104(a).


The Texas LLP Act passed in 1991 is a prototype of the first generation of US LLP legislation, which limited partners’ tort liability in order to provide “peace of mind” for partners who were not directly involved in other partners’ misdeeds. Under the Texas LLP Act 1991, a partner was shielded from the tort liability of the partnership arising from “errors, omissions, negligence, incompetence or malfeasance” of other partners.

Following Texas, the majority of states in the US adopted LLP legislation at a remarkable speed, stimulated by the multistate professional firms that needed recognition of the limited liability in other states. The New York LLP Act, promulgated in 1993, and the Minnesota LLP Act, promulgated 1994, exemplify a second generation of LLP legislation, which extended partners’ limited liability protection from tort liability to ordinary business debts, shielding partners from all tort and contractual liabilities of the partnership. This was a drastic step in the expansion of limited liability. The second generation of LLP acts in the US departed significantly from the original rationale of the LLP: to protect partners in professional firms from malpractice liabilities that they cannot foresee or control. LLPs with extended liability shields bear more resemblance to LLCs rather than the Texas prototype. Since 1993, the comprehensive liability shield created by the Minnesota LLP Act became the mainstream formula in the US. Even Texas amended its LLP legislation in 1997 to provide that partners of LLPs are shielded from both tort and contract liabilities of the partnership.

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22 ibid., 1066.
23 Texas Revised Civil Statute, article 6132b-3.08 § a(2) (See above note 20).
28 ibid., 1095.
The extensive liability shield of the second generation of LLP legislation has been incorporated by the model partnership law. In the US, most states have adopted the Uniform Partnership Act (UPA), which was first promulgated by the NCCUSL in 1992 to replace the old model partnership law enacted in 1914 and has been amended several times. As the US LLP is a species of partnership, a model law for the US LLP has been included in the UPA since the amendment in 1996.\(^\text{31}\) The latest version of the UPA, the UPA 1997, which has been adopted by most states\(^\text{32}\) provides that:

> “An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner. This subsection applies notwithstanding anything inconsistent in the partnership agreement that existed immediately before the vote required to become a limited liability partnership under Section 1001(b).”\(^\text{33}\)

It is noticeable that even under such an extensive limited liability protection, partners’ protection in the LLP is not unrestricted. First, all LLP legislation provide that partners will be responsible for their own negligence and misconduct. This is a logical deduction from the general agency theory under the common law, that actors will be liable for their own actions even if they act as

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\(^\text{31}\) § 801(a): “Except as provided by the partnership agreement, a partner is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for any obligation of the partnership incurred while the partnership is a limited liability partnership.”


\(^\text{33}\) UPA (1997) § 306(c).
agents of others. Second, the LLP acts usually provide that partners are liable for the conduct of those under their direct control or supervision.

iii. US Limited Partnerships

Unlike LLCs and LLPs, which are relatively recent inventions, US limited partnerships came into being in the nineteenth century. The first US limited partnership legislation was passed in New York in 1822, only a decade later than the first US incorporation legislation was passed in New York in 1811. Also, in 1916, the NCCUSL promulgated the first version of the Uniform Limited Partnership Act (ULPA). It was found that few businesses chose to organise as limited partnerships in the US and UK when the structure was first introduced in the nineteenth and early twentieth century. However, with the development of the private equity industry, limited partnerships became the dominant form for private equity firms since the 1980s.

As private equity firms became increasingly important in the US, the limited partnership was further adopted to meet the needs of the private equity firms. Evidence can be found in the latest version of the model limited partnership law, the ULPA 2001, which has strengthened the limited partnership’s feature of an entrenched, centralised management structure.

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38 For a legislative history of the ULPA, see http://www.uniformlaws.org/Shared/Docs/Limited%20Partnership/ulpa%20last%20amended%202013%20summary.pdf (accessed on November 12, 2013).
Furthermore, the ULPA 2001 has expanded the limited liability shield in limited partnerships. Under the ULPA 2001, the “control rule” that curbed the limited liability of limited partners was abolished. The “control rule” was stated in ULPA 1916 as: “A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.” The eradication of the control role in the ULPA 2001 means that limited partners will have limited liability even if they participate in the management. The removal of the control rule has been attributed to the uncertainty it caused.

Moreover, ULPA 2001 even provides for the choice of limited liability limited partnership (LLLP) in which all partners have limited liability protection. The ULPA 2001 states that a limited partnership can elect to be a LLLP by stating in its certificate that the limited partnership is a LLLP. This corresponds with the trend of extending limited liability protection in LLPs to both contractual and tort liabilities.

Another fundamental change of the ULPA 2001 from previous uniform laws is that it is a stand-alone act without the need to refer to the general partnership law. In the US, previous versions of the ULPA were linked with partnership statutes in the sense that they contained rules that referred to the general partnership law; for example, the duties of general partners must be determined by reference to the general partnership law. Given the fact that limited partnerships involve relationships fundamentally different from those in small and informal partnerships and the problems caused by linking these two entities, the drafting committee of the ULPA 2001 eschewed the linkage between the ULPA and the general partnership law.

45 ULPA 2001 §102(9); § 201(a)(4); §404(c).
47 ibid., 585.
48 ULPA 2001, prefatory note.
Summary of 1.1.1

In summary, in the US, the corporation has long ceased to be the only business organisation that can take advantage of limited liability. The LLC was the first non-corporate entity to formally acquire the feature of limited liability and has already challenged the dominant position of corporations. Later, the US LLP was created to protect partners of professional firms from tort liabilities arising from other partners’ mistakes, and the liability shield of LLP partners in many states has expanded to both contractual and tort liabilities. The expansion of limited liability into partnerships is also marked by a rediscovery of the limited partnership, which has become a popular vehicle for private equity firms since the 1980s. A similar trend has also emerged on the other side of the Atlantic, which will be discussed in the following subsection.

1.1.2 The UK

i. UK LLPs

Originally, the UK LLP was designed to meet the specific needs of professional firms as were LLPs in the US. However, given strong opinions in the consultation process against restricting LLP to professionals, the Limited Liability Partnership Act (LLPA) 2000 finally devised the LLP as a body corporate that can be used by not only professional firms but also by small enterprises as an alternative to the ordinary partnership and private company.49

Since a UK LLP is a body corporate with its members acting as its agent, it will be liable for debts caused by a member’s wrongful act or omission in the course of the business of the LLP or with its authority.50 The member who directly caused the debt, for example a lawyer who has been negligent towards her client, can be held liable through a tort action. Although other members are not liable for the partnership debts, they will be required to contribute to the LLP’s assets if their withdrawal of capital has rendered it insolvent.51

49 G Morse, Partnership Law, (Oxford: OUP, 2010), 293.
50 LLPA 2000, s 6(4).
51 Insolvency Act 1986, s 214A.
With limited liability and separate legal personality, the LLP is subject to a regulatory regime similar to that imposed on companies, such as public disclosure requirements and insolvency procedures. Its members will also be regulated by the Company Directors Disqualification Act 1986. However, seemingly contradictory to its corporate status, the LLP is not only treated as a partnership under tax law, but it also has the flexible internal governance of a partnership. According to the LLPA 2000, the internal relations of the LLP are governed by agreement between the members and will be subject to default regulatory provisions where the agreement is silent.

As LLPs were originally envisaged for the needs of large professional firms, it is doubtful whether they can meet the needs of small enterprises, which may just as well organise as private companies and ordinary partnerships. After all, UK LLPs are subject to cumbersome disclosure and insolvency rules analogous to corporations. In addition, the partnership treatment under tax law may not be a great advantage for small firms in the UK, since they enjoy great tax reliefs if they organise as private companies. In reality, although many law and audit firms have converted to LLPs, including the “Big Four” (PwC LLP, KPMG LLP, Deloitte & Touche LLP, and Ernst & Young LLP), small enterprises in the UK usually prefer to stay as private companies or ordinary partnerships.

ii. UK Limited Partnerships

In the UK, the limited partnership legislation reform is also oriented towards the needs of private equity firms. Since the Inland Revenue and the Department of Trade and Industry (DTI) approved the limited partnership as an organisational form, it has been used by many private equity firms.

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52 UK LLP Regulations 2001 (SI 2001/1090).
54 LLPA 2000, s 10.
55 LLPA 2000, s 5.
57 ibid., 904.
form for venture capital on May 26, 1987, the UK limited partnership has flourished as a private equity vehicle. However, the Limited Partnership Act (LPA) in the UK seems to be stagnant without much change since it was enacted in 1907.

In 2000, Myners made a suggestion in a report on institutional investors to abolish the 20-partner limit in the limited partnership. Also, the report noted the uncertainty caused by the provision similar to the US “control rule,” namely the rule that participation in management will trigger unlimited liability for limited partners. The report pointed out that since many institutional investors who invested as limited partners also played an investment advisory/oversight role, it is difficult to determine when they have crossed the line and invited unlimited liability.

At the request of the DTI in 1997, the Law Commission and the Scottish Law Commission initiated a reassessment of both the Partnership Act 1890 and the LPA 1907 and issued three reports in 2000, 2001, and 2003. The final report in 2003 considered reform on issues including the entity status of limited partnerships. As pointed out by the report, traditionally under the Anglo-

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59 Venture capital is a type of private equity specializing in investing in start-up companies.


62 LPA 1907, s 6.


American law, a partnership is regarded as an aggregate of individual partners rather than an independent entity.\(^66\) This is one of the major differences that distinguishes partnerships from corporations. The exception is the Scottish partnership, which has separate legal personality under the law.\(^67\) The final report in 2003 proposed to accord separate legal personality to English partnerships, including limited partnerships, to solve the difficulties caused by the “aggregates” approach. First, the aggregates approach under the English partnership law hinders the continuity of partnerships; to be specific, a partnership will terminate because of change of the identity of partners.\(^68\) Second, as partnerships have no separate legal personality, they cannot become owners of property, and this causes great problems regarding settlement of deeds, enforcement of partnership debts, transfer of partnership property, and partnership insolvency.\(^69\) Finally, adopting the entity approach towards the partnership would also improve conceptual clarity in English law and its consistency with rules in other common law jurisdictions, including Scotland and the US.\(^70\) The solution advanced by the report is to recognise partnerships as entities without regarding them as bodies corporate and importing corporate law into partnerships.

Corresponding with the Myners report, the final report in 2003 also observed the lack of guidance to determine what activities constituted participation in management and triggered loss of limited liability for limited partners.\(^71\)

However, despite the various suggestions made by the Myners report and the final report on partnership law, up until now changes have not taken place regarding entity status of partnerships and “management rule” in limited partnerships.

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\(^{66}\) ibid., at para 2.5-2.9.

\(^{67}\) Morse, Partnership Law, 7-8 (above note 49).


\(^{69}\) ibid., at paras 5.20-5.24.

\(^{70}\) ibid., at para 5.25-5.36. The US has defined partnerships, including both limited partnerships and LLPs, as legal entities. See discussion above regarding US partnerships.

\(^{71}\) ibid., at para 17.3-17.4.
Summary of 1.1.2

In summary, the UK has also witnessed an expansion of limited liability in the partnership, marked by the creation of LLPs and the reform of limited partnerships. Similarly to the US, the momentum behind this movement came from the private equity industry and professional firms. However, some aspects of the partnerships with limited liability in the UK are distinctive. First, the UK LLP differs from its US counterpart in that it is designed for the needs of both professional firms and small enterprises. Second, while the US LLP is viewed as a species of ordinary partnership, the UK LLP is defined as a body corporate. Finally, as to limited partnerships, the legislation in the UK seems to be stagnant compared with the revolutionary changes in the US, especially in terms of the entity status of partnerships and the “management” rule that will trigger loss of limited liability. The next section will proceed to describe the legislative background of partnerships with limited liability in China and compare their main features with their UK-US counterparts.

1.2 Partnerships with Limited Liability in China

1.2.1 Introducing Limited Partnerships and SGPs into China

Following the promulgation of the new company law in 2006, China introduced limited partnerships and LLPs by the enactment of the Partnership Enterprise Law (PEL) in 2006. As in the UK and US context, considerations for specific industries were the reason for this reform in partnership law. The purpose of introducing the limited partnership was unequivocally stated as encouraging venture capital investments, which was viewed as a new source of financing for innovative high-tech enterprises.\(^72\) The PEL 2006 also provides for the equivalent of the LLP, the Special General Partnership (SGP), which is restricted to use by professional firms.\(^73\)

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\(^73\) PEL 2006, article 55.
Before the formal introduction of limited partnerships in China, private equity investments had already been flourishing for decades, and private equity partnerships registered in the US had been well known in the country.\(^74\) It was estimated that venture capital firms in China had raised $1.17 billion in 2005, far more than $325 million in 2002.\(^75\) To facilitate formation of private equity firms, some regions, for example Shenzhen, had already permitted use of limited partnerships.\(^76\) Since the formal introduction of the limited partnership in 2006, the private equity industry in China has expanded rapidly. In 2008-2009, China ranked third worldwide in terms of the amount private equity investment, after only the US (first) and Britain (second).\(^77\) The prosperity of the private equity industry has boosted the use of limited partnerships. As reported by \textit{China Daily}, the major English newspaper in China, the number of private equity firms in China organised as limited partnerships had reached 7,511 at the end of 2012.\(^78\)

Since the reform of law firms and accounting firms from governmental affiliates to private agencies started in 1998, Chinese law and accounting industries have thrived and become increasingly globalised.\(^79\) As a result, the SGP was introduced to facilitate their further development and follow the international trend to limit liability for professionals. With promotion by the state, the SGP has become the main form of organisation for large accounting firms in China. In 2010, the Ministry of Finance and the State Administration for Industry and Commerce (SAIC) jointly issued the Temporary Measure for Promoting Large and


Medium-sized Accounting Firms to Adopt the Special General Partnership,\(^\text{80}\) which mandated large accounting firms to convert to SGPs and encouraged medium size firms to do the same.

Large law firms have also started to embrace SGPs as the Law on Lawyers\(^\text{81}\) and Regulation on Law Firms\(^\text{82}\) expressly permit law firms to organise as SGPs. For example, Dacheng, one of the largest law firms in China, has converted to an SGP in 2009.\(^\text{83}\) It is worth noting that SGPs are intended for the needs of large professional firms. The threshold to use the SGP form for accounting firms is “25 partners, 50 accountants and assets worth 10 million Yuan,”\(^\text{84}\) and there is a similar standard for law firms.\(^\text{85}\) Thus, SGPs are actually denied to small professional firms.

Chinese legal and auditing practices have been rapidly expanding in recent years and exposed to increased risks as they step into international businesses. For example, Chinese arms of the “big four” accounting firms have been charged for their involvement in the alleged accounting frauds committed by some Chinese companies listed in the US and Canada.\(^\text{86}\) The increased risks make it essential for partners of professional partnerships to have limited liability protection. It is


\(^{81}\) Law on Lawyers 2007, article 15.


\(^{84}\) Temporary Measure for Promoting Large and Medium-sized Accounting Firms to Adopt the Special General Partnership (draft), article 5 (above note 80).

\(^{85}\) Administrative Measures for Law Firms 2008, article 6 (above note 82).

foreseeable that more and more large law firms and accounting firms will organise as SGPs in the future.

Summary of 1.2.1

In summary, as in the UK and US, China has also seen the rise of partnerships with limited liability stimulated by similar forces. China introduced limited partnerships in order to promote private equity investments with the promulgation of PEL 2006. The PEL 2006 also provides for the SGP, the equivalent of the LLP, to meet the needs of large professional firms. As Chinese limited partnerships and SGPs closely resemble their UK and US counterparts, it is obvious that China has noticed the benefits of these new business organisations in the UK and US and decided to make a reproduction. However, a closer examination will reveal that although Chinese partnerships with limited liability converge with their UK-US counterparts in principle, they differ in important matters, and the partnership legislation contains many ambiguities and inconsistencies. Based on comparisons with the UK and US, the following subsection will examine the main features of Chinese partnerships with limited liability, including the extent of their independence from partners, the scope of limited liability for partners, their advantage in taxation, and the linkage of their legislation to ordinary partnership law.

1.2.2 Characteristics of Chinese Partnerships with Limited Liability

i. Entity Status

The Chinese PEL is silent on whether partnerships, including limited partnerships and SGPs, are legal entities separate from their partners. However, partnerships in China effectively resemble legal entities in many ways. Under the Chinese law, partnerships have independent assets, have the capacity to sue or be sued in their own name, and are permitted to go bankrupt.

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87 PEL 2006, article 20.
In the UK, while limited partnerships and ordinary partnerships are still not viewed as entities, the UK LLP is defined as a body corporate with a separate legal personality. The UK LLP can own property, has continuity of existence regardless of changes of membership, and can sue and be sued in its own name. Also, it is worth noting that unlike the US LLP and Chinese SGP, both of which are categorised as a species of general partnerships, the UK LLP is regarded as a new entity distinguished from both partnerships and corporations.

The US has undergone a more revolutionary trend in the partnership law. In the US, different versions of the UPA since the one in 1994 have provided that the partnership is a legal entity. Consistent with this approach, the Uniform Limited Partnership Act (ULPA) 2001 also provides that the limited partnership is a legal entity.

As discussed earlier, lack of entity status for English partnerships is a source of problems. The lack of entity status for Chinese partnerships will cause less severe problems as they are effectively treated as entities in many ways. However, to avoid practical and theoretical confusion, it is advisable for the Chinese partnership law to clearly define partnerships as legal entities independent from their partners.

**ii. Limited Liability**

China is circumspect in shielding limited partners from liabilities of the partnership. In terms of limited partnerships, the PEL provides that a limited partner “shall not manage partnership affairs or represent the partnership in its relations with people outside the partnership.” This is consistent with the traditional rule that limited partners’ liability rests on their passivity. Also, a list

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89 Partnership Act 1890, article 1: “Partnership is the relation which subsists between persons carrying on a business in common with a view of profit.” Also see 1.1.2 (ii).
90 LLPA 2000, s 1.
91 Siems, “Regulatory Competition in Partnership Law..” 784 (above note 58).
92 For the latest version of UPA, see UPA 1997 § 201(a).
93 ULPA 2001 § 104(a).
94 See 1.2.2 above.
95 PEL 2006, article 68
of safe harbours is provided, defining activities that fall outside of managing the partnership’s affairs.\textsuperscript{96}

However, there is no specific provision regarding whether this list is exhaustive, and the definition of and exceptions to “management” clearly needs further clarification. In both the UK and US, similar problems have been noticed. In the US, after several attempts at clarification of the “control rule,” the ULPA 2001 finally abolished it for the difficulty it caused. In China, such drastic approach is unlikely to be adopted in the near future. However, with the increasing number of limited partnerships, it has become imperative to clarify the meaning of “management” and delineate the liability shield of limited partners.

Besides the management rule, the liability shield of limited partners is also restricted by the “estoppel rule” provided by the Chinese PEL. The PEL contains a rule similar to the estoppel rule under the common law\textsuperscript{97} and states that limited partners holding themselves out to third parties as general partners will be liable to such third parties for the partnership’s debts.\textsuperscript{98} Also, limited

\textsuperscript{96} PEL 2006, article 68:

“The following acts of a limited partner shall not be deemed to be management of partnership affairs:

(1) to participate in deciding on a general partner’s entering into or retiring from the partnership;
(2) to raise suggestions concerning the operation and management of the partnership;
(3) to participate in the selection of a public accounting firm responsible for providing auditing services to the partnership;
(4) to obtain the audited financial statements of the partnership;
(5) where his personal interests are involved, to consult the financial materials of the partnership such as the accounting books;
(6) when his interests in the partnership are infringed upon, to claim his rights from the partners who are liable or to initiate a lawsuit;
(7) when the managing partners neglect to exercise their rights, to urge them to do so, or to initiate a lawsuit in his own name for the benefit of the partnership; and
(8) to provide guaranty for the partnership according to law.”

\textsuperscript{97} The estoppel rule in the limited partnership context means that if creditors of the partnership extend credit on the reasonable belief that the limited partner is in fact a general partner, the limited partner is estopped from denying personal liability to such creditors. See Carter G Bishop, “The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?,” \textit{Suffolk UL Rev.} 37 (2004): 677, 681.

\textsuperscript{98} PEL, article 76.
partners will be liable for losses caused by unauthorised execution of the partnership’s affairs.\textsuperscript{99}

The liability shield granted to SGPs under Chinese law is even more restrictive than that given to limited partnerships. As a general rule, partners of SGPs still assume unlimited liability (jointly and severally) for the partnership’s debts. However, when a partner incurs debts by intentional acts or gross negligence in the course of business of the partnership, other partners will only be liable to the extent of their share in the partnership.\textsuperscript{100} Further, after the debts are paid off with the property of the partnership, the partner who incurred the debts by her intentional acts or gross negligence shall reimburse the partnership in accordance with the partnership agreement.\textsuperscript{101}

In the US, with the promulgation of the second generation of LLP acts, the scope of limited liability protection of partners of LLPs has been extended from tort liability caused by malpractice to ordinary business debts. However, even under such statutes, partners will still be liable for their own negligence and misconduct as well as the conduct of those under their direct control or supervision. Similarly, in the UK, although the liability shield of an LLP is extensive, it is not impregnable. Members who are wrongful or negligent can be held liable through a tort action, and other members will be required to contribute to the LLP’s assets if their withdrawal of capital has rendered the LLP insolvent.\textsuperscript{102}

The liability shield of the Chinese SGP seems to be too narrow compared with those of LLPs in the UK and US. While partners of LLPs in the UK and some US states are shielded from both contractual and tort liability incurred by other partners, partners of Chinese SGPs are only protected from tort liability caused by intentional or grossly negligent acts of other partners.\textsuperscript{103} The liability shield of SGPs cannot fully meet the demands of Chinese law firms and accounting

\textsuperscript{99} ibid., article 98.
\textsuperscript{100} ibid., article 57.
\textsuperscript{101} ibid., article 58.
\textsuperscript{102} Insolvency Act 1986, s 214A.
firms, which are expanding rapidly both domestically and internationally. When a professional firm has operations across the country, it is unreasonable to require a partner to be liable for the mistake of others who work at a distance. In a word, the liability shield of Chinese SGPs should be expanded, although measures of client protection, for example malpractice insurance, should be strengthened at the same time.\textsuperscript{104}

iii. Tax Treatment

Under the Chinese PEL, only partners will be taxed for the profits of the partnership, and no additional income tax will be imposed on the partnership.\textsuperscript{105} This is similar to the current stance in the US and UK, where partnerships, including partnerships with limited liability, are subject to transparent tax treatment.

In the Anglo-American legal system, the transparent tax treatment used to be associated with the aggregate nature of partnerships. As partnerships are regarded as merely aggregates of individual partners rather than independent entities, partnerships themselves should not be subject to tax. However, today, the rationale for the tax treatment is based on practical considerations rather than theories. Even when partnerships with limited liability have acquired entity status and limited liability that used to define corporations, they can still enjoy the transparent tax treatment because it is attractive for business owners.

The similar pragmatic approach can also be found in the Chinese context. Although partnerships are treated as legal entities in many ways under the Chinese law, they are subject to transparent tax treatment. The tax treatments for private equity partnerships in China are made even more attractive due to competition among local governments. This will be further considered in the final section of this chapter.

\textsuperscript{104} This will be further discussed in 3.3.
\textsuperscript{105} PEL, article 6.
iv. Linkage

In China, the rules for ordinary partnerships, as well as for limited partnerships and SGPs, are provided in the single statute of PEL 2006. It provides that the rules of the ordinary partnership will apply where there is a lack of specific rules on the limited partnership and the SGP.\(^{106}\) Compressing rules of three different entities into a single statute saves lots of efforts for the legislature. However this can lead to a great deal of incoherence of rules and unpredictability of judicial practice.

In the US, the ULPA was linked with partnership statutes before 2001 in the sense that they contained rules that refered to the general partnership law. Drawbacks of such linkage have been observed. First, it will increase information costs, as those who want to form a new entity need to refer to several different statutes. Second, it may result in incoherence by linking incompatible rules to the new entities. Third, the courts may interpret the new statute in a way that is inappropriate for the relationship governed by the new statute.\(^ {107}\)

It is likely that these problems will also emerge in the Chinese context and become even more acute. There are only four articles regarding SGPs in the partnership law, and articles dealing with limited partnerships are also too succinct. Many important issues, for example duties of general partners to limited partners in limited partnerships, must be read from the provisions regarding ordinary partnerships.

Although it is unlikely that China will enact separate legislation for the SGP and limited partnership as is the practice in the US, detailed regulations for each of them can be promulgated regarding specific problems such as their different standards of bankruptcy.\(^ {108}\)

\(^{106}\) PEL, articles 55 and 60.


\(^{108}\) See 4.2.1 (iii).
Summary of 1.2.2

The above discussion has summarised the essential characteristics of Chinese partnerships with limited liability, including entity status, limited liability, tax treatment, and linkage of law. Drawing from experience in the UK and US, amendments to the basic principles of the Chinese partnership law have also been considered. First, the limited liability shield in the Chinese partnership law needs to be clarified and expanded. Second, the Chinese partnership law should formally define partnerships as independent legal entities. Third, under the current partnership law framework, detailed regulations can be promulgated to reflect the individual traits of SGPs and limited partnerships and provide a more useful guide than the PEL in theory and practice. From the discussions made so far, it can be seen that partnerships of limited liability have expanded at a fast pace in the UK, US, and China, ending the traditional practice that only corporations can obtain limited liability for business owners. The next section will make a brief review of the regulatory competition theory, which has been propounded to explain the fast spread of partnerships with limited liability.

1.3 Regulatory Competition and the Rise of Partnerships with Limited Liability

1.3.1 Interstate Regulatory Competition in the US

As discussed above, proliferation of LLCs, LLPs, and limited partnerships is owed to their appeal to business owners with the combined benefits of limited liability, entity status, tax advantage, and structural flexibility. They are especially desirable for certain industries including private equity, law, and accounting. However, there is also a downside to these business organisations. By segregating owners from the debts of the business, limited liability reduces the pool of assets available to creditors of the business. Therefore, limited liability effectively reduces creditors' chances of being paid and puts them in a riskier position than under an unlimited liability arrangement.\footnote{Jonathan M Landers, “A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy,” \textit{U. of Chicago L. Rev.} (1975): 589, 614.} In corporations, various devices have been designed to constrain the risks of limited liability.
However, in partnerships with limited liability, not only are creditors not protected by the traditional partnership rule of unlimited liability, measures for creditor protection are much lighter than in corporations.  

In the US, fears about the dark side of limited liability have led to an outpouring of criticism against partnerships with limited liability. For example, in commenting on the expansion of limited liability within US LLP statutes, one scholar was worried that such legislation would be regarded as “lawyer’s legislation” and lead to “further erosion of the image of the legal profession,” which was already not held in the highest esteem. Further, it has been commented that expansion of limited liability within partnership law was not based on a “principled and spirited exchange of views,” but rather, it was propelled by “partnership syndicators and the professionals who either represent them or are sensitive to their needs.” In this process, interests of trade creditors and employees have been ignored.

One has to wonder why partnerships with limited liability have spread so quickly despite so much criticism. A viable explanation can be found in the regulatory competition theory, which first emerged in the US corporate context. It has long been observed that there is fierce competition for corporate charters among US states, which resulted in corporate laws that mostly consist of “enabling rules.” In the US, corporations can choose their place of incorporation and thereby choose their governing law. This is because under the Anglo-American law, corporations are governed by the law of the jurisdiction where they incorporate, and their place of incorporation is regarded as the domicile. Corporations can have their main business operations, directors, or shareholders

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in jurisdictions other than its place of incorporation and still be governed by the law of the latter.\textsuperscript{114}

States are incentivised to compete for corporate charters which come with a one-off incorporation fee and a periodic franchise tax.\textsuperscript{115} Delaware is undisputedly the winner of the competition for corporate charters. A small state with a narrow tax-base, Delaware was forced to look to incorporations for revenue.\textsuperscript{116} It has become the leading state for incorporation since the 1920s, with more than half of the Fortune 500 firms registered there. Its success has been attributed to its commitment to a favorable business environment and efforts in cultivating a sophisticated judiciary in business law.\textsuperscript{117} However, Delaware has also been severely criticised for making its corporate law appealing to management, who usually decide where to incorporate to the detriment of other constituencies. As commented by Cary, Delaware had led the “race to the bottom” in the US corporate law.\textsuperscript{118}

Directly opposed to the "race to the bottom" theory is the "race to the top" argument. It justifies Delaware's permissiveness towards the management on the ground that the management is motivated by market discipline, namely the possibility of a hostile takeover, to register the company under the optimal company law.\textsuperscript{119} On this view, a corporation incorporated under inefficient company law will produce lower return on capital for shareholders and is prone to fail in the market, leading to decline of the firm's stock and making it an easy target for hostile takeovers. Therefore, the management will choose to incorporate under the law that can maximise the value of the firm, and thus states will compete to enact value-maximising legislation, which is in line with shareholders' interests.


\textsuperscript{115} Siems, “Regulatory Competition in Partnership Law.,” 779 (above note 58).


With the rise of partnerships with limited liability in the US, the discussions on regulatory competition have spread to these entities. Like companies, partnerships\textsuperscript{120} and LLCs\textsuperscript{121} can choose their place of registration and consequently their governing law, so it can be argued that they will also choose to register in a jurisdiction with the most favourable legislation. This argument has been substantiated by empirical findings. First, Delaware has become the major destination for large LLCs, with its deference to freedom of contract\textsuperscript{122} and judicial expertise in business law. It is found that all fifteen LLCs that filed for or completed an initial offering between 31 March 2004 and 31 March 2010 were chartered in Delaware.\textsuperscript{123} Also, a study in 2009 suggested that 61% of large LLCs, defined in this study as those with more than fifty employees that formed outside of their home states, were chartered in Delaware.\textsuperscript{124} Second, it has been found that all publicly traded limited partnerships or master limited partnerships are registered in Delaware due to their high degree of flexibility under the Delaware law.\textsuperscript{125} Finally, it has been found that states offering full limited liability to LLP partners usually have a larger number of LLPs than those offering only partial protection.\textsuperscript{126}

Against such a backdrop, the debates on “race to the bottom” or “race to the top” have also emerged in the partnership context. Some have argued that the expansion of limited liability in non-corporate entities in the US, especially LLCs, is not supported by sound theoretical bases or consideration for public interest.\textsuperscript{127} Others contend that although new legislation that grants limited liability is stimulated by regulatory competition, it does not mean that it is not efficient. For example, as the leading scholar of non-corporate business entities,

\begin{itemize}
\item \textsuperscript{120} Siems, “Regulatory Competition in Partnership Law,” 775 (above note 58).
\item \textsuperscript{122} ibid., 225. Also see 3.2.1 (iii) discussing the freedom to contract out fiduciary duties in Delaware LLCs.
\item \textsuperscript{123} ibid., 202.
\item \textsuperscript{124} Kobayashi and Ribstein, “Jurisdictional Competition for Limited Liability Companies,” 116 (above note 12).
\item \textsuperscript{125} Siems, “Regulatory Competition in Partnership Law,” 778 (above note 58).
\item \textsuperscript{126} ibid., 778.
\item \textsuperscript{127} “Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded”, 957 (above note 19).
\end{itemize}
Ribstein believes that as a result of regulatory competition, LLC legislation is evolving towards efficiency. Ribstein argues that regulatory competition among the states can produce legislation that meets the needs of the market and facilitates the efficient evolution of business entities, while legislation by a central planner cannot. The gist of his argument is that a market-oriented evolutionary process is more likely to produce efficient results than top-own central planning. This line of argument can be traced to Hayek, who cast doubts on the ability of a central planner to command all the necessary knowledge to make an optimal decision.

Summary of 1.3.1

To summarise, the regulatory competition theory, which was initially used to explain the deregulation of US corporate law, can also provide an answer for expansion of limited liability within partnerships. However, as in the corporate context, it is debatable whether regulatory competition will lead to efficient legislation.

1.3.2 Regulatory Competition in the EU

As businesses can choose their place of formation under the free establishment principle in the European Union (EU), it seems that the EU has a market for corporate law which is parallel to that of the US. However, due to the fact that the EU consists of independent states that each imposes regulatory barriers to business mobility, there is unlikely to be a regulatory competition for corporate charters as fierce as the one in the US. Furthermore, unlike the US where businesses can choose to be governed by a body of law by choosing its incorporation place, there are two conflicting theories within the EU regarding how to determine the governing law for businesses.

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130 Treaty on the Functioning of the European Union (TFEU), articles 49, 54.
Chapter 1 Introduction to Partnerships in UK, US and China

The real seat doctrine adopted by most continental countries requires that a company is governed by the law of the country where a company has its head office or its main business operations. Countries with the real seat approach will assert control over and tax corporations operating within their jurisdiction, even if the corporations are incorporated in other jurisdictions.

This is in stark contrast to the incorporation doctrine adopted by the UK and some other EU countries, which decides a company’s governing law based on its place of registration. As the incorporation approach allows companies to opt for light regulation and avoid taxes by choosing the place of incorporation, it gives rise to concerns that it will produce race to the bottom effects, especially the deleterious effects on creditors and minority shareholders.

A series of ECJ rulings based on the free establishment principle have indirectly supported the incorporation doctrine. In Centros, the Danish authorities refused a registration of a branch of a UK company on the ground that the company had no operations in the UK and was only formed in the UK to evade the minimum capital requirement imposed by Denmark. The ECJ stated that although the company was incorporated in the UK to avoid the minimum capital

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131 The real seat theory is adopted by Germany, Austria, France, Belgium, Greece and Spain, etc. See Klaus Heine and Wolfgang Kerber, “European Corporate Laws, Regulatory Competition and Path Dependence,” European Journal of Law and Economics 13, no. 1 (2002): 47, at note 2.


133 The incorporation approach is adopted by the UK, Ireland, Sweden, Finland, the Netherlands, etc. See Heine and Kerber, “European Corporate Laws, Regulatory Competition and Path Dependence,” at note 3 (above note 131).

134 Hadari, “The Choice of National Law Applicable to the Multinational Enterprise and the Nationality of Such Enterprises”, 7-9 (above note 132). See also previous discussion on the incorporation rule in the US.


137 Case C-212/97 Centros Lt. v Erhvervs-og Selskabsstyrelsen ECR [1999] I-1459.
requirement in Denmark, it did not mean that formation of a branch by a UK company in Denmark was not covered by freedom of establishment. As a company registered in a member state would be prevented from exercising its freedom of establishment by another Member State’s practice to register its branch, such practice was tantamount to a breach of freedom of establishment. Then, the court considered whether there was sufficient evidence of fraud or abuse, and whether the refusal to register the branch was justified as a measure intended to prevent abuse of the freedom of establishment. The court concluded that “the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment. The right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty.”

In *Uberseering*, Uberseering was incorporated in the Netherlands and therefore should be governed by Dutch law according to the incorporation theory adopted by the Netherlands, but the German courts found that its real seat was in Germany and therefore its entity status should be decided by German law. However, since the company had not been formed under German law, it was regarded as having no legal capacity and no right to sue in a German court unless it was reincorporated under German law. The ECJ decided that as the company was validly incorporated in the Netherlands, it was entitled to exercise its freedom of establishment in Germany. The fact that its shares were acquired by German nationals did not cause it to cease to be a legal person under Dutch law. The requirement of reincorporation in Germany constituted an

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138 ibid., at para 20.
139 ibid., at para 21.
140 ibid., at para 27.
142 ibid., at para 80.
infringement of freedom of establishment.\textsuperscript{143} By the decision in \textit{Uberseering}, the ECJ has confirmed that a company formed in accordance with the legislation of one member state could transfer its registered office or actual place of administration to another member state without losing its legal personality.\textsuperscript{144}

In \textit{Inspire Art},\textsuperscript{145} the ECJ considered whether the Netherlands could impose minimum capital on a company incorporated in the UK when it sought to operate in the Netherlands. Citing \textit{Centros}, the ECJ stated that the fact that Inspire Art was formed in the UK to avoid the stricter minimum capital rule under the Dutch company law did not preclude it from the freedom of establishment.

The ECJ has confirmed in these cases that a company is entitled to freedom of establishment once it is validly formed in one jurisdiction, and its legal personality cannot be stripped away based on the real seat approach. Also, it is not an abuse the freedom for a company to incorporate in a jurisdiction in order to avoid laws in another.\textsuperscript{146} The ECJ has also confirmed that non-corporate businesses are also entitled to the freedom of establishment. For example, in \textit{Cartesio},\textsuperscript{147} the ECJ stated that a limited partnership was also protected by the freedom of establishment. Therefore, it is theoretically possible for enterprises looking at a partnership form to register in a jurisdiction with the most attractive regulatory regime.

However, it is worth noting that decisions in these cases are made based on the freedom of establishment and have avoided ruling directly on the merits of the incorporation theory versus real seat theory.\textsuperscript{148} Without a formal recognition of the incorporation theory, companies still face uncertainties in taking legal arbitrage strategies within the EU. Therefore, it is unlikely that the EU will see a regulatory competition movement as seen in the US. Furthermore, as the

\begin{flushleft}
\textsuperscript{143} ibid., at para 81.
\textsuperscript{144} ibid., at para 70.
\textsuperscript{145} Case C-167/01 \textit{Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.} ECR [2003] I-10155.
\textsuperscript{147} Case C-210/06 \textit{Cartesio Oktato es Szolgaltato bt.} ECR [2008] I-09641.
\textsuperscript{148} ibid., 30.
\end{flushleft}
country with most competitive advantage in corporate law, the UK has not charged a significant fee for corporate registration.\footnote{W Schön, “Playing Different Games? Regulatory Competition in Tax and Company Law Compared,” \textit{Common Market L. Rev.} 42, no. 2 (2005): 331, 346.} There are also no significant franchise fees for corporations within the EU.\footnote{Ibid., 339.} Therefore, it is unlikely that member states will try to beat the UK to the bottom.

In fact, the regulatory competition within the EU is better described as “defense regulatory completion,” since member states are not so much interested in attracting foreign corporations as keeping local businesses from leaving.\footnote{Martin Gelter, “The Structure of Regulatory Competition in European Corporate Law,” \textit{J. Corp. L. Stud.} 5 (2005): 247, 424.} For example, since Centros, the UK has seen an increasing number of private companies from continental Europe to incorporate under its law.\footnote{Siems, “Regulatory Competition in Partnership Law,” 800 (above note 58).} This trend is mostly driven by the eradication of the minimum capital requirement for private companies in the UK. In order to prevent companies from leaving, some EU countries have abolished or lowered their minimum capital requirements.\footnote{Armour, “Who Should Make Corporate Law? EC Legislation Versus Regulatory Competition”, 398 (above note 146).} The effect of regulatory competition within the EU in this aspect has been positive, as minimum capital is a redundant and ineffective measure for creditor protection.\footnote{See 3.1.2.}

In addition, the legislative history of UK corporate law has suggested that its reform in corporate law, including its measures to relax regulatory burdens for private companies, is mainly intended to facilitate the growth of domestic businesses rather than to attract corporate charters from outside.\footnote{Schön, “Playing Different Games? Regulatory Competition in Tax and Company Law Compared,” 346 (above note 149).} Also, the consultation paper issued before reform of the LPA 1907 clearly refers to the competition from other EU jurisdictions as part of the reason for reform.\footnote{Limited Partnership Act 1907: a Joint Consultation Paper (2001), at para 1.10 (above note 64).} This demonstrates that although the UK is not much interested in attracting charters from other jurisdictions, it is keen in keeping businesses from leaving. The
enactment of the LLPA 2000 can provide further evidence for this, which was enacted partly out of the fear that law firms and accounting firms would leave for Jersey, which was the first to introduce the LLP in Europe.\footnote{Mathias M Siems, “Convergence in Corporate Governance: A Leximetric Approach,” 2010, http://ssrn.com/abstract=1444860 (accessed August 21, 2013), 800.}

**Summary of 1.3.2**

To summarise, as a result of a series of ECJ cases based on freedom of establishment, it is likely that a form of regulatory competition will emerge in the EU, although it has not been settled whether businesses within the EU are governed by the law of its place of incorporation or real seat. However, the regulatory competition within the EU diverges from that in the US where states have strong incentives to attract enterprises from other jurisdictions. In the EU, the regulatory competition is defensive in the sense that the priority of member states is to keep its local businesses and facilitate business vitality. The enactment of the UK LLPA 2000 and reform of the LPA 1907 have clearly been propelled by such “defensive competition.”

**1.3.3 Regulatory Competition in China?**

The above discussions have considered regulatory competition as the motivating force behind the proliferation of partnerships with limited liability in the US and UK. In the US, state legislatures compete to attract businesses by producing flexible company statutes and providing for partnerships with limited liability. In the UK, while the incentive to attract businesses from other jurisdictions is not so strong, the legislature is motivated to reform company law and provide for partnerships with limited liability in response to competition from other EU countries.

A similar theory cannot be applied to the Chinese context. The fundamental reason lies in the fact that China has a centralised legislative system, in stark contrast to the decentralised lawmaking power in the US and EU.\footnote{Li Yahong, “The Law-Making Law: a Solution to the Problems in the Chinese Legislative System,” Hong Kong LJ 30 (2000): 120, 125.} In the US, the federal legislature and state legislatures form two separate legal systems. In
fact, most legal areas belong to state powers, including corporate law, partnership law, and law on other business entities. As observed by one commenter, for lawyers, state statutes are in fact the most common form of law.  

In contrast, China has a unified legislative system in which the NPC and its Standing Committee have supremacy and the ultimate lawmaking power. However, the Legislation Law promulgated in 2000 has delegated some lawmaking power to congresses and governments at both the provincial and local levels. According to the Legislation Law, localities can make two forms of law: local regulations enacted by local congresses and local rules made by local

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160 Constitution (promulgated in 1982, most recently amended in 2004), article 3:


The National People's Congress and the local people's congresses at various levels are constituted through democratic elections. They are responsible to the people and subject to their supervision.

All administrative, judicial and procuratorial organs of the State are created by the people's congresses to which they are responsible and by which they are supervised.”

161 ibid., article 58: “The National People's Congress and its Standing Committee exercise the legislative power of the State.”

162 Legislation Law 2000, article 56: “The State Council shall, in accordance with the Constitution and laws, formulate administrative regulations.”

article 63: “The people's congresses or their standing committees of the provinces, autonomous regions and municipalities directly under the Central Government may, in light of the specific conditions and actual needs of their respective administrative areas, formulate local regulations, provided that such regulations do not contradict the Constitution, the laws and the administrative regulations….”

article 71: “The ministries and commissions of the State Council, the People's Bank of China, the State Audit Administration as well as the other organs endowed with administrative functions directly under the State Council may, in accordance with the laws as well as the administrative regulations, decisions and orders of the State Council and within the limits of their power, formulate rules.”

article 73: “The people's governments of the provinces, autonomous regions, municipalities directly under the Central Government and the comparatively larger cities may, in accordance with laws and administrative regulations and the local regulations of their respective province, autonomous regions or municipalities, formulate rules….”


163 Legislation Law 2000, article 63.
governments,\textsuperscript{164} provided they are not in contravention of the Constitution and the laws enacted by a higher authority. It is unclear from the Legislation Law in what specific areas localities can make legislation. Under the Legislation Law, local regulations and rules can be formulated to implement higher level laws on matters that require the formulation of local regulations/rules.\textsuperscript{165}

Due to the centralised legislative system in China, it is impossible for local governments to enact their own company or partnership laws and to compete for businesses by offering less restrictive legislation. Instead, to promote the growth of local economies, Chinese local governments have competed fiercely to attract businesses and investments by offering tax deductions.\textsuperscript{166} This is evident with private equity firms, which have become an increasingly important source of financing for Chinese enterprises. In China, many local governments have offered tax incentives and other supportive measures for private equity firms. The greater tax reductions for private equity partnerships offered by Xinjiang and Tibet, which are relatively less developed regions, have attracted many private equity partnerships, and some companies even chose to relocate to these two regions and reregister as limited partnerships.\textsuperscript{167}

The tax reductions offered by many local governments have conflicted with the regulations on taxation of partnerships issued by the Ministry of Finance (MoF) and State Administration of Taxation (SAT).\textsuperscript{168} According to the regulations

\textsuperscript{164}ibid., article 73.
\textsuperscript{165}ibid., article 64 and 73.
issued by the MoF and SAT, partners, including limited and general partners in limited partnerships, will be taxed as “self-employed industrial and commercial households” for their income and be subject to progressive tax rates ranging from 5 percent to 35 percent.\textsuperscript{169} However, many local governments have lowered the income rate of partners in private equity partnerships to 20 percent.\textsuperscript{170} This has attracted attention of the MoF and SAT, which have issued an announcement in 2009 to stress that the legislative power on taxation is concentrated with the central government, and the tax reductions that have exceeded the authority of local governments will be rescinded.\textsuperscript{171}

**Summary of 1.3.3**

In summary, the regulatory competition theory cannot be used to explain the introduction of partnerships with limited liability in China, as China has a centralised legislative system. The enactment of new forms of partnership is a response to the fast growth of private equity firms and professional firms and is aimed at to promote their further development. Although local governments are competing to attract private equity partnerships by offering tax reductions, it is foreseeable that those rules that conflict with national tax laws and regulations will soon be rescinded.

**Conclusion of Chapter 1**

In the UK, US, and China, the corporation is no longer the only business organisation that can take advantage of limited liability. Partnerships with limited liability can now serve as an alternative for business owners who want to utilise limited liability while not being subject to double taxation. In the US, the

\begin{footnotesize}
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\item \textsuperscript{169} Individual Income Tax Law, article 3.
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LLC was the first non-corporate entity to formally acquire the feature of limited liability and has already challenged the dominant position of corporations. Later, the US LLP was created to protect partners of professional firms from tort liabilities arising from other partners’ mistakes, and the liability shield of LLP partners in many states has expanded to both contractual and tort liabilities. Similar phenomena have also emerged in Britain, which has also seen limited partnerships become a major form for private equity firms and enacted its LLP statute in 2000. China has also embraced this trend by introducing limited partnerships and SGPs with the promulgation of the new partnership law in 2006.

Despite the fact that limited liability can increase risks for creditors and that partnerships usually contain lighter rules for creditor protection, partnerships with limited liability have expanded at a rapid speed from one jurisdiction to another. In the UK and US, regulatory competition can provide an answer for this phenomenon. However, in China, where lawmaking power is centralised, introduction of partnerships with limited liability can only be viewed as a legal response to the fast growth of the private equity industry and professional firms, out of the desire to promote their further development.

Well aware of the benefits of limited partnerships and SGPs, China has ignored the issues heatedly debated in the UK and US. As a result, legislation on these new entities is fraught with theoretical and practical pitfalls. Most importantly, the risks of limited liability to creditors are usually ignored. The next chapter will compare the history of limited liability in the UK, US and China to explain why limited liability now is rarely viewed with suspicion in China, despite its incongruity with the traditional Chinese business model. Then it will discuss the risks of limited liability to creditors, an issue often ignored by Chinese scholars, and measures that are designed to mitigate these risks.
Chapter 2 Limited Liability and Creditor Protection

Introduction

While limited liability can reduce risks for business owners and thus encourage investments, it in fact increases risks for creditors of the business as their claims are limited to the business assets and they cannot reach the personal assets of owners. In corporations, the risks to creditors caused by limited liability have been mitigated by various measures. However, in partnerships with limited liability, where the traditional partnership rule of unlimited liability has been eradicated, protection for creditors is much lighter. This problem has been noticed in both the UK and US, where specialised creditor protection rules have been applied to partnerships with limited liability and even transposed some corporate rules into them. However, in China, it is rare to see any reflection on the downsides of limited liability or protective measures for creditors of partnerships with limited liability. This chapter will argue that China should strengthen creditor protection in partnership law along with the introduction of limited liability and it is worth considering whether corporate-style rules for creditor-protection should be transposed onto partnerships. In the first section, to understand why discussions on limited liability are voluminous in the UK and US while few in China, the history of limited liability in the UK and US will be presented in a contrasting light to the legislative history of limited liability in China. The second section will explore the risks of limited liability by looking at the doubts cast on limited liability in the UK and US and scholarly discussions on its efficiency. Finally, section three will compare the creditor protection regime of China to those in the UK and US. It will be shown that despite having the corporate rules of creditor protection similar to those in the UK and US, China has failed to devise a partnership creditor protection regime that is proportionate to the increased risks caused by limited liability.
2.1 History of Limited Liability in the UK, US and China

2.1.1 Development of Limited Liability in the UK and US

Limited liability has been deemed an essential feature of the corporation in the Anglo-American legal system and most jurisdictions around the world. Under most circumstances, the corporation is closely associated with limited liability to such an extent that they seem to be inextricable. Much legal research start with the assumption that limited liability naturally flows from the corporation and is at its core. Some even argue that limited liability is the main reason that businesses incorporate. For example, Hugh Sowards claims, "The hallmark of the corporation is limited liability. This is usually the central reason for incorporation."\(^1\)

However, in fact, limited liability had existed in Europe long before it was written into modern corporate law. It had been used in the sea trade as early as in medieval times. Here follows a brief examination of the origin of limited liability in the medieval Europe and the development of limited liability as a corporate feature under Anglo-American law.

i. Historic origin in Medieval Europe

By the twelfth century, the compagnia, a form of partnership, was widely used to conduct the overland trade in the cities of Italy.\(^2\) The compagnia is similar to modern general partnerships in that its members assumed joint and several liability for the partnership debts.\(^3\)

Around the same period, medieval Italy also saw the flourishing of another form of partnership for sea trade- the commenda-which had a liability shield for its partners.\(^4\) The commenda involved a travelling partner and an investing partner.

\(^3\) ibid., 74.
\(^4\) ibid., 75.
The travelling partner would embark on a dangerous voyage while the investing partner would provide only funding for the trip and stay on land. Usually three fourths of the profits of the voyage would go to the investing partner while only one fourth would go to the travelling partner. This arrangement may seem unfair to modern eyes as the travelling partner was at the risk of losing his life, while the investing partner’s losses were limited to his capital contribution to their voyage.

The commenda is regarded as the predecessor of the modern limited partnership, which also combined capital with labour and skill. However, the commenda is not a long term organisation like today’s limited partnership or company. It ended as soon as the ship arrived at the shore with the proceeds of the voyage being divided between the sea traders and the passive investors. Although partnerships and companies today can also be used only for a one-time venture, by default they will have a longer continuity until certain circumstances cause the dissolution.

During the medieval times, the commenda was used across the Europe and provides evidence that in Europe, limited liability arrangement preceded the creation of the business corporation in the modern sense. Although the commenda was not introduced into British law during the medieval times, there is evidence that it was known in England as early as in the thirteenth century. Therefore, it can be concluded that the combination of limited liability and a business organisation was not a strange new concept to Britain when it started to see the wide use of limited liability and finally established it within its corporate law. The following section will discuss how limited liability becomes to be viewed as a feature of corporations under the Anglo-American law.

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ii. Limited Liability Became a Corporate Feature under Anglo-American Law

In Britain, limited liability became a feature of chartered companies during the era of great discovery, when European countries started to launch ambitious voyages to the rest of the world. For Portugal and Spain, the monarchs played a major role in financing these voyages. In contrast, British voyages relied mainly on charted joint stock companies (charted companies).  

10 The formation of a charted corporation required the state to pass a special act granting a charter, which usually gave monopoly privileges.  

11 Chartered companies had acquired limited liability, entity status, centralised management and tradable shares in the seventeenth century.  

12 With trademarks similar to modern corporations, chartered companies obtained capital from diversified sources like today’s public companies. For example, the British East India Company advocated “noblemen, gentlemen, shopkeepers, widows, orphans, and all other subjects may be traders, and employ their capital in a joint stock.”  

13 With the advent of the industrial revolution in Britain in the eighteenth century and later in North America, more capital-intensive businesses started to flourish and they needed to form as corporations in order to raise capital.  

14 As it was difficult to obtain charters to form a chartered company in both Britain and America and privileges associated with charters were not essential for most businesses, unincorporated joint stock companies were created to emulate features of chartered companies including limited liability. An unincorporated joint stock company (JSC) was actually a partnership with its assets held by a trust.  

15 The trustee managed the business for the benefit of the partners, while partners, as the equitable owner of the trust property, retained tradable claims...
on their investment. Through the trust structure, JSCs could achieve centralised management, entity status, tradable shares and limited liability-privileges that were granted to chartered corporations by the state.

However, with the enactment of general incorporation legislation, the corporation created by the state started to gradually replace the partnership and its variant JSC as the main form of business venture. Britain passed its first general incorporation act in 1844 (Joint Stock Companies Act 1844), which required all companies with transferable shares and companies with twenty-five or more members (with or without transferable shares) to be registered with the state. Although this act made the corporation more widely accessible, it did not make limited liability the default rule of the corporation. It was only ten years later, when Parliament passed the Limited Liability Act 1855 and the Joint Stock Companies Act 1856 that limited liability institution was established within corporations. Later, the single most significant case in English corporate law, Salomon v A. Salomon & Co Ltd, confirmed separate personality and limited liability of a company even for a de facto one-man company. In that case, Mr. Salomon was a sole trader and sold his business to a company in which he owned most of the shares. Other shareholders in the company, namely his wife and children, were only nominal as they held shares only to fulfill the threshold of seven members for a company to be registered as required by the Companies Act 1862. Therefore, Mr. Salomon was effectively the sole controller of the company. Besides being the controlling shareholder and director, Mr. Salomon was also a secured creditor of the company as he sold his business to the company in exchange for an amount of debentures. When the company slipped into financial difficulty and had only enough assets to pay the debentures, its outside creditors claimed that Mr. Salomon should take liability for its outstanding debts and the debt owed to Mr. Salomon should not be paid as the company actually acted as his agent. The House of Lords found that the Companies Act only required seven members holding at least one share each for a company to be registered, it did not require members to be independent or have substantial shareholding. Hence,

19 [1897] AC 22 (HL)
although Mr. Salomon effectively controlled the company, the company was a separate legal person and Mr. Salomon was not liable for its debts in the absence of fraud and illegal purpose. Further, as a secured creditor (holder of debentures), he was entitled to be paid in priority to unsecured creditors. This case confirms that small businesses can also take advantage of the separate personality and limited liability provided by the corporate form. Thus, it opened the floodgates for private companies in Britain.\(^\text{20}\)

As early as in 1811, New York passed the first incorporation act in the US, and other states soon followed.\(^\text{21}\) Limited liability gradually became the general rule in corporate law in the US after it was adopted by a Massachusetts statute in 1830.\(^\text{22}\) As limited liability became the default rule of incorporation, limited liability was increasingly regarded as a feature restricted to corporations. Even when owners of other business organisations arranged for limited liability contractually, it was usual for courts to invalidate such arrangement.\(^\text{23}\)

The exception was limited partnerships, which were also granted limited liability by legislation. In this business organisation, although the general partners still undertake unlimited liability for the losses of the partnership, the limited partners are only liable to the extent of their investments. In the US, limited partnership had become available since the early 19th century. The first limited partnership legislation was passed in New York in 1822.\(^\text{24}\) Many have traced the origin of limited partnerships to the medieval *commenda*.\(^\text{25}\) The US limited partnership was introduced from France and it was a New York lawyer who first used “limited partnership” as the equivalence of *société en commandite simple* in the French commercial code.\(^\text{26}\) Britain was more circumspect than the US on the expansion of limited liability, however, it at last enacted the Limited

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\(^{22}\) Blumberg, “Limited Liability and Corporate Groups,” 593 (above note 14).


\(^{25}\) Hillman, “Limited Liability in Historical Perspective”, 621 (above note 5).

Partnership Act in 1907. It has been found that few businesses chose to organise as limited partnerships in the US and UK when the option was first introduced in the nineteenth and early twentieth century. 27 As discussed in Chapter 1, limited partnerships only become popular when private equity firms found them suitable to their needs.

Summary of 2.1.1

In summary, under the Anglo-American law, the development of limited liability preceded the corporation in the modern sense, but limited liability was not formally established until general corporate laws were enacted. However, even before limited liability was established a corporate feature under the Anglo-American law, it was known in Britain as a feature of the Italian partnership commenda, which was used across the medieval Europe.

In contrast, limited liability was a strange notion to China when it initiated its legal reform in the early twentieth century. In fact, for China, limited liability, with the package of corporate law, was an import or “legal transplant” from the Western legal systems. The process of this importation or “legal transplant” of limited liability into China will be discussed in the following section.

2.2.2 Limited Liability as a “Legal Transplant” into China

i. The Early Modern Era

In the traditional Chinese society, partnerships organised by kinship or close personal relationships were the dominant form of business. 28 Partnerships did

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28 Wuxiong Tufei, A Study on Partner’s Liability [Hehuo Gudong Zeren Zhi Yanjiu 合伙股东责任之研究], (Beijing: China University of Political science and Law Press, 2004), p 22. This book was first published in 1936 as a product of the researches on the Chinese society conducted by the Japanese before the outbreak of the war in 1937. These researches were intended to assist Japanese in their invasion and governing in China, however, today they provide invaluable insights into various aspects of the early modern Chinese society.
not provide limited liability to their partners and the alternative institutions to limit liability, for example insurance, were also absent.\textsuperscript{29}

However, before the first modern incorporation law, Company Law 1904 (gongsi lv 公司律), was enacted by the Qing government, the Chinese society was already exposed to various Western business organisations. For example, the British East India Company, a chartered company, had a presence in China since the 18th century.\textsuperscript{30} Also, from 1866 onwards, shares of British companies were traded in the stock market in Shanghai.\textsuperscript{31} In 1872, the first modern corporation in China, the China Merchant’s Steam Navigation Company, was created as part of the governmental efforts to promote modern business corporations.\textsuperscript{32} The company limited its liability by using the guarantor mechanism. Namely, if it failed to fulfill its contractual obligations, the guarantor would be responsible for all outstanding liabilities.\textsuperscript{33}

In 1904, the first modern corporate legislation in China was enacted after the empire had encountered unprecedented humiliations by Japan and Western powers.\textsuperscript{34} The Company Law 1904 was based on a mixture of Japanese and English company law.\textsuperscript{35} It provided four types of business entities: partnership,\textsuperscript{36}


\textsuperscript{30} ibid., 47. References to British East India Company can be found in many books finished around 1840, the year that first Anglo-Chinese war broke out, see Shujun Wei, \textit{A Study on Corporation Law in Modern China [Jindai Zhongguo Gongsifa Shilun 近代中国公司法史论]}, (Shanghai: Shanghai Social Sciences Academy Press, 2009), p 11-12.


\textsuperscript{32} The establishment of the China Merchant’s Steam Navigation Company marked the start of a generation of corporations managed by merchants while supervised by the government. However, corporations emerged in this period were tightly controlled by the government and not business corporations in the real sense. See Wei, \textit{A Study on Corporation Law in Modern China [Jindai Zhongguo Gongsifa Shilun 近代中国公司法史论]}, p 15 (above note 30).

\textsuperscript{33} Kirby, “China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China,” 47 (above note 29).

\textsuperscript{34} Kirby, “China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China,” 47 (above note 29). For more information on the legislative background of the Company Law 1904, see Wei, \textit{A Study on Corporation Law in Modern China [Jindai Zhongguo Gongsifa Shilun 近代中国公司法史论]}, p 34-38 (above note 30).

\textsuperscript{35} Kirby, “China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China,” 47 (above note 29).

\textsuperscript{36} 合资公司 (hezi gongsi).
limited partnership, \(^\text{37}\) joint stock company of limited and unlimited liability shareholders, \(^\text{38}\) and company limited by shares. \(^\text{39}\) The objectives behind the Company Law were to facilitate the growth of Chinese industrial enterprises, establish a legal system that measured up to Western standards and consequently entrench the authority of the central government. \(^\text{40}\)

However, the influence of the Company Law 1904 was very limited. It failed to encourage the growth of Chinese enterprises in the form of modern corporations. Enterprises in China still preferred to stay as they were. \(^\text{41}\) Business people were unwilling to register their enterprises with the government because they were guarded towards the government and saw registration as a threat to privacy. They were also suspicious about the public and this led to their reluctance to be listed on the stock market. \(^\text{42}\) Another important factor for the failure of the Company Law 1904 was the uncertainty of how courts would adjudicate cases that involved corporations. \(^\text{43}\)

After the fall of the Qing government in 1911, its efforts in modernising the Chinese legal system were carried on by its successors until the Communist Party took over in 1949. Corporate legislation was promulgated in 1914, 1929 and 1946. \(^\text{44}\) However, these enactments were no more successful than the 1904 law at transforming Chinese businesses into modern corporations. According to one study, on the eve of the founding of the People’s Republic of China in 1949, there were 1.3 million industrial and commercial enterprises among which only

\(^{37}\) 合资有限公司 (hezi youxian gongsi).
\(^{38}\) 股份公司 (gufen gongsi).
\(^{39}\) 股份有限公司 (gufen youxian gongsi).
\(^{40}\) Kirby, “China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China,” 43-44 (above note 29).
\(^{41}\) A Study on Corporation Law in Modern China [Jindai Zhongguo Gongsifa Shilun 近代中国公司法史论], p 45 (above note 30).
\(^{42}\) Kirby, “China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China,” 50 (above note 29). The tradition of privacy and secrecy of traditional Chinese businesses is also recorded in Tufei, A Study on Partner’s Liability [Hehuo Gudong Zeren Zhi Yanju 合伙股东责任之研究], p 212 (above note 28).
\(^{44}\) Specific discussions on each of these company acts can be found in Wei, A Study on Corporation Law in Modern China [Jindai Zhongguo Gongsifa Shilun 近代中国公司法史论] (above note 30).
10,000 were companies, and the rest were sole proprietorships or partnership enterprises. And out of the 10,000 companies, 1250 (11.7%) were unlimited companies similar to partnerships. 45

ii. Communist China

After 1949, the Communist Party put an end to private ownership and abolished the emerging modern legal system laid down by previous governments. However, when the failure of the planned economy was painfully felt, the party decided to adopt a policy called “reform and opening up” in the 1980s, aimed at establishing a socialist market economy, which could serve as the engine for economic growth. In order to build a legal environment facilitative to market economy, the government started to borrow legislation from developed countries and resumed the theme of legal reforms that ran through the modern Chinese history. 46

Most significantly, a new Company Law was passed in 1993. Since the enactment of the Company Law 1993, businesses can incorporate in the form of limited liability companies or joint stock companies to obtain limited liability protection. The joint stock company is similar to public companies under the English company law, while the limited liability company resembles private companies.

The main aim of the Company Law 1993 was to facilitate the restructuring of the SOEs. Since the 1990s, the majority of SOEs in China have been transformed into joint stock companies. In 60% of such companies, the state is the largest shareholder. 47 As a transitional law, the Company Law 1993 contained many outmoded rules; for example, it imposed onerous capital requirements. 48 More than a decade later, a new Company Law was promulgated in 2005 to better meet the needs of businesses with the deepening of the market-oriented reform. In 2006, limited partnership and SGPs were introduced with the enactment of the PEL and the same year saw the passing of Enterprise Bankruptcy Law (EBL).

46 ibid., 47.
48 See 3.2.
iii. Limited Liability as a Legal Transplant

It can be concluded from the history of limited liability in China as discussed above that limited liability did not originate in Chinese society. Rather, as a feature of modern corporations, limited liability is an imported legal rule or “legal transplant” for China.

“Legal transplant” was a term in the comparative legal study first used by Alan Watson.49 In his book published in 1974, he describes legal transplant as the “moving of a rule or a system of law from one country to another”.50 Watson’s main observations on legal transplant are two-folds: first, legal transplant of an individual legal rule or a large part of legal rules is extremely common; second, legal transplant is “socially easy”.51 His optimism with legal transplant is based on the assumption that “usually legal rules are not particularly devised for the particular society in which they now operate.”52

Watson’s argument has met with strong opposition since it was first advanced. One of the most vehement of his critics is Pierre Legrand, who denies his argument completely by stating that legal transplant is impossible.53 For Legrand, “A rule is necessarily an incorporative cultural form. As an accretion of cultural elements, it is supported by impressive historical and ideological formations. A rule does not have any empirical existence that can be significantly detached from the world of meanings that characterizes a legal culture.”54 To summarise, Legrand does not believe that legal rules can be transplanted because they are endogenous to a particular cultural context. He cautions legal comparatists that “[l]aw is part of the symbolic apparatus through which entire communities try to understand themselves better...[U]nless the comparatist can learn to think of law as a culturally-situated phenomenon and accept that the law lives in a profound

50 ibid., 21.
51 ibid., 95.
52 ibid., 95.
54 ibid.,116.
way within a culture — specific-and therefore contingent — discourse, comparison rapidly becomes a pointless venture."\(^{55}\)

Admittedly, it is right for Legrand to stress the influence of specific cultures on legal rules, however, he has taken this point to an extreme. As a matter of fact, legal transplants happen all the time and in many cases legal rules are well accepted by the recipient country. Furthermore, the influence of culture on legal rules is not absolute and unchangeable, as the culture itself is also constantly changing. China is a case in point. In the past, Chinese businesses were run around family ties. As family businesses were seen as inseparable from family members and consequently every member had personal liability for the debts of the businesses,\(^{56}\) people were hesitant to borrow money as an individual’s debts would be equated with his family’s, and failure to pay debts would result in a perpetual stigma. This partly accounts for people’s hesitance to embrace limited liability when it was first introduced into Chinese society. In addition, traditional Chinese businesses were largely regulated by custom and moral codes instead of formal legal regime established by the state. Thus, even after corporate law was transplanted into China in the early twentieth century, Chinese businesses remained mostly as family businesses and were reluctant to be registered with the state and organise as formal corporations.\(^{57}\)

However, in today’s China, with its rapid economic development, the influence of the traditional culture is fading and the general population are more ready to accept foreign notions. Despite the failure of transplanted corporate rules to fit with the local society in the early twentieth century, China has witnessed a relatively successful legal and economic reform since the 1980s. With enactment of the Company Law 1993, the company has become a common form for both large and small businesses. At the same time, limited liability is widely used in today’s China. Investors are used to buying corporate shares without the concerns of being held liable for corporate debts. They are equally at ease in becoming limited partners in private equity partnerships.

\(^{55}\) ibid.,124.


It is true that transplanted legal rules in China still meet the problems of mismatch with the local society and many rules cannot function as well as in their original context. However, for China, legal transplant is inevitable, as its own legal traditions cannot meet the needs of building a modern state. Therefore, it is more meaningful to consider how to adapt transplanted rules to the local environment rather than to dismiss legal transplant completely. Kahn-Freund’s argument on the influence of political factor on legal rules can throw some light on this issue. In his 1974 article, Kahn-Freund cautioned that legal rules were shaped by the social and political institutions of a given country and could not be easily adapted to the social and political context of another. He believed that political institutions, rather than geographical, economic, or cultural elements were the principal factor that influenced legal rules. This was because economic and cultural diversity were being reduced by industrialisation, urbanisation and development of communications, while political differentiation was on the increase.

Kahn-Freund’s insight may well explain the mismatch of many imported rules with Chinese society, especially those imported from the Anglo-American law. China differs from the UK and US politically in many fundamental aspects. First, China has a statute-based legal system with the legislature at the centre. The judiciary in fact has no law-making power under Chinese law and is shackled as to its discretion. This means that Chinese courts cannot accommodate legal rules to the changing circumstances as can their counterparts in the UK and US. Second, neither the legislature nor the judiciary can be described as independent as they are tightly controlled by the government. Thus, there are hardly any constraints on the government and it can easily interfere with the

59 ibid., 9.
60 Constitution (promulgated in 1982, most recently amended in 2004), article 3:
“The State organs of the People's Republic of China apply the principle of democratic centralism. The National People's Congress and the local people's congresses at various levels are constituted through democratic elections. They are responsible to the people and subject to their supervision. All administrative, judicial and procuratorial organs of the State are created by the people's congresses to which they are responsible and by which they are supervised.”
legal procedures. Third, the Chinese legislation usually fails to balance interests of different social groups as most of them are excluded from the lawmaking process and are rarely engaged in discussions on pending legislation. In the case of limited liability, China has extended limited liability to partnerships to facilitate the growth of specific industries, especially private equity firms and law and accounting firms. However, there is little discussion on the risks of limited liability in China and the interests of creditors are largely ignored. In contrast, in the UK and US, many scholars have discussed risks of limited liability\(^{61}\) and their concerns have been incorporated into the legal rules. For example, UK LLPs are subject to financial disclosure requirements and insolvency rules similar to companies.\(^{62}\)

In a nutshell, one century ago, economic and cultural factors were the main reasons that transplanted corporate rules including limited liability are not well accepted in the Chinese society. However, in today’s China, as the influence of economic and cultural factors are receding, the political factor becomes the principal force that contributes to the failure of transplanted rules to adapt to the Chinese society. In terms of limited liability, lack of debates in the lawmaking process has led to the neglect of creditors’ interests in the legislation.

**Summary of 2.1.2**

To summarise, when limited liability was first transplanted into China in the early twentieth century, economic and cultural factors were the main reason that was not well accepted. Today, limited liability has become commonplace in Chinese society and can be adopted by both companies and partnerships. This can be explained by the fact that the influence of the tradition culture has faded and the general population are more ready to accept foreign notions as China is transforming into a modern state based on market economy. However, political institutions in China are still remarkably different from those in the


developed countries whose legal rules are being emulated. This can contribute to the mismatch of imported rules with the Chinese society. In the case of limited liability, its risks to creditors have not been sufficiently recognised by Chinese law due to the failure to involve different groups in the lawmaking process. To shed some light on the discussion and reform regarding limited liability under Chinese law, the next section will examine the debates on limited liability in the UK and US.

2.2 Debates on Limited Liability

2.2.1 Acceptance of Limited Liability in the UK and US

i. Early Doubts on Limited Liability

In China, the legitimacy of limited liability has been taken for granted since it was introduced with the package of company law. However, in the UK and US where limited liability has developed for a long time, it is often regarded with suspicion, especially in the early nineteenth century. For example, in the 1800s, Thomas Cooper denounced limited liability as a “mode of swindling, quite common and honorable in these United States” and “a fraud on the honest and confiding part of the public.” Another example is an editorial issued by The Times on 25 May 1824, which lashed out at limited liability:

“Nothing can be so unjust as for a few persons abounding in wealth to offer a proportion of their excess for the information of a company, to play with that excess—to lend the importance of their whole name and credit to the society, and then should the funds prove insufficient to answer all demands, to retire into the security of their unhazarded fortune, and leave the bait to be devoured by the poor deceived fish.”


In the UK, the Limited Liability Act 1855 was passed over strong opposition. After limited liability became the default in the corporation, the public remained suspicious about it for a long time. It was just as Jeffery had observed, “no well tried mechanism of company promotion and investment existed, and the concept of limited liability had still to win acceptance in commercial and industrial circles schooled in the concept of partnership liability ‘to the last shilling and the last acre’.” By 1885, only 5 percent to 10 percent of the total number of important business organisations were limited companies. These companies were concentrated only in shipping, iron and steel, while there were few in other industries. In terms of the size of the firm and amount of fixed capital, until the mid-1880s of the nineteenth century the majority of the manufacturing firms in the UK remained as family businesses.

Although the US was earlier than the UK in enacting for limited liability, some form of personal liability were imposed on shareholders by most states. This practice survived well into the twentieth century. Further, as in the UK, introduction of limited liability into general corporate laws in the US did not lead to immediate replacement of corporations for partnerships. In 1949, corporations accounted for less than forty percent of the multi-owner firms in the US. The proportion increased to about sixty-five percent thirty years later but this might have been driven by the high ratio of personal to corporate income tax.

**ii. Change of Attitude Towards Limited Liability in the Twentieth Century**

Since corporations became the dominant business form in the twentieth century, the general perception of limited liability has dramatically shifted. Early in the

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twentieth century, President Butler of Columbia University acclaimed that limited liability corporation was “the greatest single discovery of modern times” and even steam and electricity stood no comparison. Further, the famous British magazine, Economist on 18 December 1926 stated:

“The economic historian of the future may assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honor with Watt and Stephenson, and other pioneers of the Industrial Revolution. The genius of these men produced the means by which man’s command of natural resources was multiplied many times over; the limited liability company, the means by which huge aggregations of capital required to give effect to their discoveries were collected, organized, and efficiently administered.”

Today, limited liability has become a common feature of modern commercial society with the corporation as the dominant business form. Legislation even extends limited liability to partnerships. However, the general acceptance of limited liability is not the evidence of its theoretical soundness. According to the path dependence theory, past social institutions or contingent historical events can lead to inefficient institutions. This theory can offer an explanation to the legitimation of limited liability. When it first attains legitimacy contingently, a self-reinforcement cycle starts as preconceptions of what is appropriate determines future decisions. Although unlimited liability was regarded as more reasonable in the past, limited liability now has become the norm and its extension into partnership law seems natural as a result of its long-standing legitimacy in corporate law. However, in the UK and US, limited liability did not expand without questions. Many scholars have cast doubt on its soundness over the years. Efficiency is the core issue in the scholarly discussions on limited liability in the UK and US. The

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71 Quoted from Matheson and Eby, “The Doctrine of Piercing the Veil in an Era of Multiple Limited Liability Entities: an Opportunity to Codify the Test for Waiving Owners,” 154 (above note 63).


74 ibid., 513.
next section will look at the scholarly discussion on limited liability surrounding the criterion of efficiency.

2.2.2 Efficiency of Limited Liability

1. Arguments for the Efficiency of Limited Liability

While limited liability can encourage investments and entrepreneurship,\(^{75}\) it actually transfers risks of failure from business owners to creditors of the business. To be specific, by segregating owners from the debts of the business, limited liability reduces the pool of assets available to creditors of the business.\(^{76}\)

To justify limited liability, many law and economics theorists argue for its efficiency. Before starting a discussion on the efficiency of limited liability, the standard of efficiency used by law and economics scholars needs to be clarified. The mostly frequently mentioned efficiency-related notions are Pareto efficiency and Kaldor-Hicks efficiency. Pareto efficiency requires that at least one person was made better off (in her own estimation) with no one made worse off.\(^ {77}\) Limited liability cannot be “Pareto efficient,” as it makes creditors worse off by segregating business owners from claims of creditors of the business and reduces the pool of assets available to creditors. Therefore, limited liability can only be evaluated against Kaldor-Hicks efficiency, which has a lower requirement than Pareto efficiency. Under Kaldor-Hicks efficiency, it is efficient when someone gains and another suffers losses as long as the gainer is able to compensate the loser and still have a net gain (which means there is a net increase in the total utility).\(^ {78}\) By this notion of efficiency, limited liability is efficient only when the gains to the owners of the business exceed the costs to the creditors.

\(^{75}\) This can be demonstrated by its facilitative role for development of capital-intensive enterprises during the industrial age, for example, railways. See Blumberg, “Limited Liability and Corporate Groups”, 584 (above note 14).


\(^{78}\) ibid., 41.
Numerous scholarly discussions on limited liability have argued for the efficiency of limited liability. As early as 1967, Manne argued that limited liability is indispensable for the smooth functioning of a publicly held corporation, which is a capital raising mechanism with wide public participation. His observation is that limited liability allows individuals to invest fractions of their capital in different enterprises, avoiding a disastrous financial loss. Namely, limited liability facilitates diversification of investments. In contrast, under a pro-rata liability rule, because wealthier investors are liable to a larger proportion of the corporation’s losses, they will be discouraged from investing in the first place. Also, a pro-rata liability rule may not give creditors more protection since it involves great difficulty and costs in recovering from individual investors.\(^7^9\)

Halpern, Trebilcock, and Turnbull further explain the important role limited liability plays in an organised securities market.\(^8^0\) Under an unlimited liability rule, as individual equity investors will be required to undertake debts of the corporation to the extent of their personal wealth, wealthier investors are discouraged from investments by the larger amount of potential losses. Further, an organised securities market cannot exist under an unlimited liability rule. This is because each individual investor will assess the share price according to their personal wealth and thus the share price will be different for each individual investor. In other words, shares of a company will reflect different values and become non-fungible.

Following Manne and Halpern, Easterbrook and Fischel render a more detailed examination of the efficiency of limited liability.\(^8^1\) First, limited liability can reduce monitoring costs for shareholders. As shareholders face less potential losses with limited liability, they will be less keen on monitoring managers than under an unlimited liability regime. Similarly, they will also reduce their monitoring on each other. Under unlimited liability, the liability to pay the company’s debts will transfer to certain shareholders if others cannot pay.


Limited liability makes the wealth of other shareholders irrelevant since everyone’s liability is limited to their investment. Second, limited liability facilitates free transfer of shares with shares fixed with a homogeneous market price. Third, because shares have a homogeneous market price under limited liability, they can efficiently reflect the information about the value of the firms and save investors the costs of searching and negotiating price of shares individually. In contrast, with unlimited liability, shares of a corporation will have different prices and investors have to investigate and negotiate on their price. Also, as shares can reflect the value of the corporation, managers of the corporation will be incentivised to improve the value. Fourth, limited liability greatly reduces the risk of investment and leads to diversification of risks because investors can invest in different corporations without the risk of losing all of their investment in one bankruptcy. Fifth, limited liability can lower costs of capital for a corporation. This is because when shareholders face less risk with limited liability, they will demand a lower rate of return for their investment.  

ii. Arguments Against Limited Liability on the Ground of Excessive Risk-Taking

Although the benefits of limited liability in public traded companies are widely accepted by scholars of law and economics, limited liability is objectionable on some grounds. One of the most common objections against limited liability is that it encourages excessive risk-taking. When the assets of the corporation are insufficient to pay off debts, owners and managers who act as the corporation’s agents will have the incentive to take excessive risks as they will gain all the benefits while they can shift costs to creditors that exceed the assets of the corporation. However, it is argued that such moral hazard can be constrained by voluntary creditors through contracts. Voluntary creditors, namely those who

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82 One view is that although equity investors’ losses are limited, creditors will be facing a greater possibility of default and therefore will demand a risk premium on debt interest. So the lowered costs of equity financing will be offset by the increased costs of debt financing and the choice of liability rule will not have a real impact on transaction costs. See Richard A Posner, “The Rights of Creditors of Affiliated Corporations,” U. of Chicago L. Rev. (1976): 499.

Such view is an extension of the Modigliani–Miller irrelevance rule which states that in a perfect market, i.e., one without taxes, bankruptcy costs, agency costs, and asymmetric information, firm value will be unaffected by how the firm is financed (by equity or debt). See Martin F Hellwig, “Bankruptcy, Limited Liability, and the Modigliani-Miller Theorem,” The American Economic Review (1981): 155.

become creditors through voluntary contracting, can negotiate terms for self-protection and receive ex ante compensation from the corporations for the freedom to take risks.\textsuperscript{84} On the other hand, involuntary creditors, namely tort creditors, cannot charge ex ante compensation or protect themselves by contract;\textsuperscript{85} they may suffer most from excessive risk-taking as they are treated as unsecured creditors. Further, employees and small trade creditors usually lack bargaining power and are also susceptible to the harm caused by risky corporate behaviour.

iii. Arguments Against Limited Liability In Private Companies

Another strong criticism against limited liability is related to its function in private companies, which are usually owner-managed and have concentrated ownership.\textsuperscript{86} Most theories that argue for the efficiency of limited liability are based on the observation of publicly traded companies with independent management and freely transferable shares. Even if these theories hold true in the case of public traded companies, the situation is completely different in private companies. First, as there is usually an overlapping of management and ownership in private corporations, the monitoring costs on the management are already low. Thus, limited liability cannot reduce monitoring costs on the management in such corporations in a significant way.\textsuperscript{87} Second, because there are a small number of shareholders, who usually have family ties or at least are familiar with each other, it is also not necessary to introduce limited liability in order to reduce the monitoring costs on other shareholders. Third, the shares in private companies are usually not freely transferable because of lack of a ready market, so managers will not be influenced by the share price. Fourth, diversification is almost impossible for owners of private companies. Owners of small companies are usually required to provide personal guarantee to their corporation’s debts and effectively undertake unlimited liability for the losses of

\textsuperscript{84} Voluntary creditors are employees, consumers, trade creditors and debt investors who voluntarily enter into contracts with companies. Involuntary creditors are victims of torts who cannot negotiate with companies in advance.


\textsuperscript{86} Freedman, “Limited Liability: Large Company Theory and Small Firms,” 331 (above note 62).

\textsuperscript{87} Easterbrook and Fischel, “Limited Liability and the Corporation,” 110 (above note 81).
the corporation. In addition, owner-managers have invested their human capital in the corporation, which cannot be diversified.

Finally, the excessive risk-taking problem will be magnified in private companies and this may lead to inefficient risk bearing. This is because owner-managers have stronger incentive to engage in risky projects and transfer risks to creditors and benefits to themselves. To protect themselves, creditors in strong bargaining positions can require owners of small corporations to provide personal guarantee and contract around limited liability. However, those in a weaker position may simply accept the default limited liability rule and consequently bear the losses of the corporation. This means that the ultimate risk-bearers are those less capable of bearing risk. In a word, limited liability in private companies may not produce the benefits as argued in public companies. Similar analysis holds true in partnerships with limited liability, which are usually owner-managed.

The risks from private companies to creditors had been discerned by Kahn-Freund as early as 1944. In his seminal article in 1944, Kahn-Freund argued that the privilege of incorporation and limited liability had deviated from its original purpose to encourage capitalists to undertake risky adventures as now businesses could incorporate even when no outside capital was needed. Concerned with abuse of incorporation and limited liability to the detriment of creditors, he denounced the decision of *Salomon* as “calamitous” and lamented that forming a company in the UK was unbelievably cheap. His suggestion on reform of UK company law was to increase the threshold of minimum capital and to abolish private companies or to transform them into partnerships. In doing so, he believed that the company could be restored to its original function and the

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89 The exception is the US LLCs which can be member-managed or manager-managed. Also, in the US, there are public limited partnerships and LLCs which have been listed in the stock market and therefore have many passive investors. See Chapter 4.
91 ibid., 54.
92 ibid., 57.
93 ibid., 59.
partnership, which was intended for small businesses, could regain its proper place in business life. However, in reality, the company law and partnership law has taken a contrary course to Kahn-Freund’s recommendation.

iv. Arguments Against The Efficiency Standard

The above discussion has summarised the arguments on limited liability revolving around the standard of efficiency. However, even if limited liability can be justified on the ground of efficiency, there are disputes as to whether it is reasonable to make efficiency the overarching value of law. First, as it is impossible to gauge efficiency in practice, the efficiency standard is elusive. For example, under both Pareto and Kaldor-Hicks efficiency, whether one gains or loses and the amount of gain or loss is determined by one’s subjective evaluation. Therefore, efficiency of a legal rule cannot be accurately calculated. Second, setting efficiency as the primary goal of law is consequentialist in the sense that it evaluates everything based on the outcome and sees rights as instruments to promote efficiency. By this logic, protecting creditors’ rights from risks of limited liability is not desirable if it decreases or fails to increase efficiency.

Lastly and most importantly, the efficiency criterion only looks at the total utility without regard to the distribution problem. As the Pareto efficiency is almost impossible to achieve in reality, most law and economics discussions use the approach of cost-benefit analysis with the goal to achieve Kaldor-Hicks efficiency. Kaldor-Hicks efficiency requires that the gainer be able to compensate the loser and still have a net gain, hence, there is a net increase in the total utility. However, it does not require the gainer to pay actual compensation to the loser. Under this criterion, as long as owners of a corporation can gain enough to be able to compensate the creditors in theory, they are permitted to engage in excessive risk taking and transfer wealth to themselves without compensating them.

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94 ibid., 57.
95 See previous discussion on the standards of Pareto and Kaldor-Hicks efficiency.
96 Objections against utilitarianism from which the notion of efficiency derived can also be applied directly to efficiency. See C JJ, Smart and Bernard Williams, Utilitarianism: for and Against, (Cambridge: Cambridge Univ Press, 1973), 79-82.
In a nutshell, although efficiency is a useful notion in academic discussions, it cannot be regarded as the sole and supreme value of legal rules. In the discussion of creditor protection, it must be admitted that creditors’ rights have intrinsic values and are not merely instrument to the end of efficiency. Further, efficiency must be tempered with a regard to the fairness of distribution. Efficiency cannot be the only criterion to assess limited liability. It is also imperative to balance distribution of risks and gains between creditors and owners of businesses.

**Summary of 2.2.2**

In summary, limited liability cannot be fully justified by efficiency and entails huge risks for creditors. Therefore, creditor protection should be strengthened when there is liability shield in business organisations. The next section will discuss the agency problem between businesses and their creditors, which is amplified by limited liability. It will also look at the creditor protection regimes under both corporate and partnership law in the UK, US and China.

**2.3 Creditor Protection Regime in the UK, US and China**

**2.3.1 Creditor Protection under Corporate Law in the UK, US and China**

i. **Agency Problem and Creditor Protection**

The above discussion has pointed out the costs of limited liability for creditors. However, even without limited liability, owners of business organisations may act to the detriment of creditors. The existence of limited liability magnifies such risks and consequently increases the need for creditor protection. It needs to be stressed that this study focuses on voluntary creditors, especially those who invest in businesses in the form of lending. It excludes the protection of tort creditors and employees.
Chapter 2 Limited Liability and Creditor Protection

The risks faced by creditors of a business organisation can be analysed from the perspective of the agency problem theory. Viewed broadly, the agency problem can exist in any contractual relationship in which one party acts as an agent for the other (principal). It arises because information is asymmetric between the agent and the principal and therefore the agent can behave opportunistically against the principal. The classic agency problem exists between owners and managers of a business organisation when the managers run the businesses and the owners are removed from the management. Without enough monitoring by the owners, managers may “shirk” their duties or engage in self-profiting behaviors such as paying high compensation to themselves, self-dealing, and transferring assets to themselves. Another agency problem within a business organisation arises between majority shareholders, who usually decide the important affairs of the business organisation, and minority shareholders who are usually passive.

An agency problem also exists between creditors and borrowers because borrowers in effect manage the loan on behalf of creditors and between them there is great information asymmetry. The agency problem between the borrower business and its creditors is aggravated with the introduction of limited liability into the business. As limited liability shields owners of a business from its creditors, owners as well as director who act in their interests will have more incentive to behave opportunistically against the creditors, for example, raise new credits with higher priority or divert assets from the business. Therefore, creditors need more protection when dealing with businesses with limited liability.

101 Information asymmetry occurs when one party of a transaction has more information than the other, information asymmetry exists in markets such as insurance and second-hand cars. See N Mankiw, Principles of Economics, 6 ed., (London: Cengage Learning, 2011), 599.
102 Specific types of agency problems between creditors and business organisations are discussed in 3.1.1
ii. Creditor Protection Devices under Corporate Law

To constrain the agency problem in corporations in which owners are protected by limited liability, several legal devices are employed. Here a summary will be made of the basic legal rules for creditor protection in the UK, US and China.

(a) Legal Capital: Legal Capital consists of minimum capital and capital maintenance requirements. Minimum capital is imposed as a threshold for incorporating and capital maintenance is a limitation on the company’s returning its capital to shareholders in ways such as purchase or redemption of its own shares, or dividends distribution. Although legal capital was once considered as essential for creditor protection, its effectiveness has been cast into doubt and it is losing its appeal. In the UK, US, as well as China, there is reform to lessen the burden of legal capital for companies. This will be further discussed later.\(^\text{103}\)

(b) Mandatory Insurance provisions: As an alternative to minimum capital, mandatory insurance is also frequently discussed. Similarly to the minimum capital requirement, it is difficult to set the appropriate level of insurance. It may also impede the entry of new businesses, which will face higher insurance premiums or even cannot afford insurance at all. The difference between minimum capital and mandatory insurance requirements is that while the former decreases the incentive for excessive risk taking, the latter may even increase such incentive in the absence of adequate monitoring by the insurer.\(^\text{104}\) Mandatory insurance is uncommon in the corporate sphere except for specific industries; however, as will be discussed later, professional partnerships are usually required to purchase liability insurance.\(^\text{105}\)

(c) Personal liability: It is also believed to be necessary to impose personal liability on directors, including shareholders who act as directors, for a business organisation’s misconducts against creditors. Unlike passive shareholders, directors and managing shareholders are the real decision makers in the daily running of a business organisation. Therefore, it seems unfair for them to be

\(^{103}\) See 3.1.2.

\(^{104}\) Easterbrook and Fischel, “Limited Liability and the Corporation,” 115 (above note 81).

\(^{105}\) See 3.1.3.
shielded from the liability incurred by their own negligence or misconduct. To protect creditors, company law in both the UK and US have developed the doctrine that directors must consider the interests of the creditors of the company as part of their duties to the company in the event of financial distress.\textsuperscript{106} In the UK, such duty is reflected in the fraudulent and wrongful trading clauses of the insolvency law, which apply to UK LLPs as well.\textsuperscript{107} Additionally, the UK Companies Act 2006 imposes on directors a statutory duty to consider the interests of creditors as part of the duty to promote the success of the company.\textsuperscript{108} The Company Law 2005 in China imposes duties of diligence\textsuperscript{109} and loyalty on directors.\textsuperscript{110} Most scholarly discussion on directors’ duties in China have regarded enactment of duties of diligence and care as an emulation of fiduciary duties in the common law; however, a general creditor-regarding duty on directors has not been developed in China.\textsuperscript{111}

(d) Corporate insolvency law: Corporate insolvency law is indispensable for creditor protection. In fact, in the UK and US, insolvency law, rather than company law, has assumed the major role of creditor protection. With the enactment of the Enterprise Bankruptcy Law (EBL) in 2006, China has established a corporate bankruptcy regime similar to those in the UK and US in terms of structure and basic rules. However, its operation in reality is often obstructed by state intervention and in many cases the interests of creditors are sacrificed for political goals.\textsuperscript{112}

(e) “Piercing the corporate veil”: As an exception to the separate legal personality of corporations, piercing the corporate veil is the final resort to impose personal liability on shareholders or directors. In the UK and US, the doctrine of piercing the corporate veil is developed gradually through case law.


\textsuperscript{107} Insolvency Act 1986, ss 213-214, extended to LLPs by the UK LLP Regulations 2001(SI 2001/1090)

\textsuperscript{108} Companies Act 2006, s 172.

\textsuperscript{109} The equivalent of duty of care under common law.

\textsuperscript{110} Company Law 2005, articles 148-149.

\textsuperscript{111} See 4.5.

\textsuperscript{112} See 4.1.3.
Cases of veil-piercing usually involve private companies, corporate groups, fraud and undercapitalisation.\textsuperscript{113} As the veil-piercing rule is based on case-specific analysis, it has been accused of producing inconsistent results and has also been criticised for being an ex post remedy for damage already done.\textsuperscript{114} In China, the veil-piercing provision refers to a clause in the Company Law 2005, which states that “Where the shareholder of a company abuses the independent status of the company as a legal person or the limited liability of shareholders, evades debts and thus seriously damages the interests of the creditors of the company, he shall assume joint and several liability for the debts of the company.”\textsuperscript{115} The application of the veil-piercing rule in China is problematic and usually involves “commingling of assets,” namely commingling personal assets of shareholders with corporate assets.\textsuperscript{116}

Summary of 2.3.1

In summary, in the UK, US and China, various rules can be found to constrain the agency problem between creditors and the business organisation, which is magnified by the limited liability institution. In principle, the rules to protect creditors of companies under the Chinese law resemble those in the UK and US. This demonstrates that the need to protect creditors of business organisation through mandatory law has also been recognised by China. However, while both the UK and US have strengthened regulation of partnerships to correspond to the risks of limited liability, China has failed to devise a creditor protection regime for partnerships proportionate to the increased risks caused by limited liability. This will be discussed in the next section.


\textsuperscript{114} Easterbrook and Fischel, “Limited Liability and the Corporation,” 109 (above note 81).

\textsuperscript{115} Company Law 2005, article 20.

\textsuperscript{116} See 3.3.2.
2.3.2 Creditor Protection under Partnership Law in UK, US and China

i. UK and US

Traditionally, partnerships in the UK and US are subject to much lighter regulation than corporations. The principal reason for this is that partners assume vicarious liability for the debts incurred on the partnership’s behalf by people acting as agents of the partnership. However, with the expansion of limited liability into partnership law, stricter creditor protection rules are imposed on partnerships. First, although there is no corporate-style legal capital requirement for partnerships with limited liability, some LLC and LLP statutes require firms to purchase liability insurance or maintain segregated funds to meet potential liabilities. In the UK, although the LLP statute does not provide for mandatory insurance, professionals such as lawyers are mandated to purchase professional indemnity insurance. Second, personal liability can be imposed on partners to constrain their opportunism against creditors. For example, members of UK LLPs can be held personally liable under fraudulent and wrongful trading provisions although the fiduciary duties of owners of LLPs are not explicitly provided in the LLP Act and remain debatable. Additionally, LLPs in the UK and Delaware are subject to the “claw-back” provisions. In the UK LLPs, distributions made to members in the two years before insolvency will be clawed back if the member “knew or ought to have realised” at the time of the distribution that there was no reasonable prospect of avoiding an insolvent winding up. In Delaware, partners are liable to return any distribution made within three years from the date of distribution if they knew at the time that they received the distribution that liabilities of the LLP would exceed net asset value. Third, partnerships with limited liability in both the UK and US are subject to bankruptcy rules modelled on corporate bankruptcy regime, which aims at maximising assets available to creditors. Finally, numerous scholarly

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119 See 3.2.1.
120 IA 1986, s 214 A (inserted by UK LLP Regulations 2001 SI 2001/1090). See 4.3.1
121 Delaware Revised Uniform Partnership Act (DRUPA) §15-309.
122 See 4.2.
articles have discussed whether courts should apply corporate rules, such as fiduciary duties and piercing the veil doctrine to partnerships with limited liability. In practice, some US courts have already applied the veil-piercing rule to partnerships with limited liability.

ii. China

In China, creditors of partnerships are protected through various provisions under the partnership law. First, partners are prohibited from severing the partnership assets prior to the liquidation of a partnership. Second, it is mandatory for Chinese SGPs, which are restricted to professional firms, to carry professional liability insurance. Chinese SGPs are also required to maintain an occupational risk fund (ORF) for the purpose of “paying the debts incurred by partners in their business activities.” However, until now the specific implementing rules for the ORF have not been promulgated. Therefore, currently, professional liability insurance is the most important safeguard for creditors of SGPs. Third, as to limited partnerships, the PEL provides that a limited partner “shall not manage partnership affairs or represent the partnership in its relations with people outside the partnership.” Further, it provides that limited partners holding themselves out to third parties as general partners will be liable to such third parties for the partnership’s debts. Also, limited partners will be liable for the losses caused by unauthorised execution of the partnership’s affairs.

Summary of 2.3.2

In summary, in the UK and US, with the introduction of limited liability into partnerships, some corporate rules for creditor protection were transposed into

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124 See 3.3.1 (ii).

125 PEL 2006, article 21.

126 ibid., article 59.

127 ibid., article 68.

128 ibid., article 76.

129 ibid., article 98.
partnership law in order to mitigate the increased risks and scholars are still debating on introducing more corporate rules into partnership law. In contrast, in China although there are creditor protection rules under the partnership law, these rules do not reflect the risks of limited liability and the issue of importing corporate rules into partnership law is rarely considered.

Conclusion of Chapter 2

The scholarly discussions in the UK and US have revealed that limited liability cannot be fully justified by efficiency and entails huge risks for creditors. Therefore, the limited liability institution should be constrained with various devices and creditor protection should be strengthened when there is limited liability shield in business entities.

In corporations, various devices have been designed to mitigate the risks of limited liability. In the UK and US, although specialised devices have been designed for creditor protection in partnerships with limited liability, partnerships are subject to much lighter regulation than corporations. Therefore, it is worth discussing whether corporate-style rules for creditor protection should be transposed into partnerships. In the US, there is already judicial practice to apply veil-piercing to partnerships with limited liability and this will be further discussed later.

As limited liability is a legal transplant into China and has only become common after the reform and opening up in the 1980s, discussions on limited liability are much more limited than in the UK and US. The rest of this thesis will focus on improving the creditor protection regime for Chinese partnerships to reflect the risks of limited liability and consider whether certain corporate-style rules should be transposed into partnership law. First, this thesis will look at the current partnership rules for creditor protection in the UK and US and consider whether they can be instrumental if introduced into China. Second, the thesis will consider the discussions on transposing corporate rules to partnership law in the context of UK and US. In considering whether certain corporate rules can be introduced into partnership law, many scholars have started with an examination on the soundness of these rules in the corporate context. As put by one scholar,
“the availability of new types of limited liability entities (LLEs) provides an opportunity to reevaluate doctrines that have become entrenched in common law.”\textsuperscript{130} Similarly in the Chinese context, the creation of limited partnerships and SGPs also provide an opportunity to assess the overall creditor protection regime that has developed over the decades. This thesis will take this opportunity by making an assessment of the current creditor protection regime under Chinese corporate law and considering whether certain rules can be applied to partnerships.

\textsuperscript{130} Huss, "Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine Into the Statutory Age", 95 (above note 61).
Chapter 3 Creditor Protection outside Insolvency

Introduction to Chapter 3

This chapter will consider the measures for creditor protection that are implemented outside the formal insolvency procedure. First, it will consider creditors’ self-protection, legal capital and liability insurance, which are closely linked and have the same purpose of increasing the possibility of repayments for creditors. Second, it will focus on fiduciary duties in both the corporate and partnership law. Fiduciary duties are relevant to the discussion of creditor protection first because they can reduce the costs of internal conflicts of businesses and benefit the creditors indirectly. Further, in the US and UK, when a corporation is approaching insolvency, the management is considered to owe a fiduciary duty to creditors and therefore has to take into account creditors’ interests in making business decisions. This dimension of fiduciary duties will be considered in Chapter 4 as directors’ duty to creditors is implemented in the insolvency procedure and thus falls outside the scope of this chapter. Finally, this chapter will consider the rule of veil-piercing, another open-ended rule that impose personal liabilities on directors and partners. Although the veil-piercing rule usually applies to a financially distressed debtor, it is a rare and drastic measure and is not part of the formal insolvency procedure. This is why it is considered in this chapter rather than the chapter on insolvency.

3.1 Self-Protection, Legal Capital and Liability Insurance

3.1.1 Self-Protection

In the UK and US, it has become a truism that when the market can do its own work, there is no need for state interference. The US corporate law, which consists mostly of default rules,\(^1\) is an encapsulation of such a stance. In the UK-US context, sophisticated creditors are usually able to protect themselves by complex covenants, and the state only intervenes where private ordering fails.

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However, the same thing cannot be said of creditors in China. The reliance on creditors’ self-protection, as the approach in the UK and US, is definitely not appropriate for China. The fundamental reason for this is not so much that Chinese creditors are not sophisticated enough as the legal and institutional environment is not developed enough for creditors’ self-protection. The purpose of this subchapter is to examine whether creditors’ self-protection will function in China as well as in the UK and US. Section (i) will briefly discuss the function of creditors’ self-protection to counteract the agency problems between creditors and business owners. Section (ii) will look at the legal and institutional obstacles in China that obstruct creditors from protecting themselves contractually, especially the problem of information asymmetry. Section (iii) will make a succinct examination of security interests under Chinese law, which are the primary means for creditors’ self-protection in China.

i. The Function of Creditor Self-Protection in Constraining Agency Problem

As discussed in Chapter 2, agency problems exist between creditors and borrowers because borrowers in effect manage the loan on behalf of creditors, and between them there is great information asymmetry. The agency problems between the borrower firm and its creditors are aggravated with the introduction of limited liability into the firm. Basically, there are four types of agency problems between creditors and borrowers that can reduce the assets available for repayment of creditors:

1. Claim dilution
Subsequent borrowing by the debtor to finance new projects or issue dividends will reduce the claims of earlier creditors in two ways. First, while subsequent creditors can adjust their interest rates based on the previous borrowings, earlier creditors offer a rate without consideration for subsequent borrowings. Second, if the subsequent borrowings are secured, earlier creditors will be subordinated in repayment.

\[\text{Information asymmetry occurs when one party of a transaction has more information than the other, information asymmetry exists in markets such as insurance and second-hand cars. See N Mankiw, Principles of Economics, 6 ed., (London: Cengage Learning, 2011), 599.}\]

(2) Asset withdrawal
Transfer of assets or the proceeds of sold assets will reduce the collateral available to creditors.

(3) Underinvestment
When a firm’s debt exceeds its wealth, it will have no incentive to invest in profitable projects since the benefits will accrue to creditors.

(4) Asset substitution
The debtor firm has an incentive to substitute assets with risky investments, since it gains most of the profits when the investments succeed while creditors bear most of the losses when they fail.

To ameliorate these agency problems, creditors can bargain with the debtor to achieve favourable contracting terms. First, creditors can adjust the rate of interests in accordance with the extent of risks of the business activity. Second, they can constrain shareholder opportunism by inserting covenants into the contract. For example, to counteract the problem of claim dilution and discourage excessive risk taking, creditors can set restrictions for the borrower to incur new debts, such as ratios of net assets to total debt.

Another common condition of loan is to require a charge or guarantee.

Given the sophisticated covenants used by creditors for self-protection, the prevailing argument in the US is that the role of corporate law should be confined to reducing transaction costs of contracting and that private parties should be free to negotiate their rights and obligations through contract. However, the function of creditors’ self-protection should not be exaggerated. First, mandatory rules, such as fiduciary duties, mandatory insurance, insolvency rules and veil-piercing rule, are still indispensible for protecting creditors. Second, even if creditors can be trusted to protect themselves in developed markets such as the UK and US, the same cannot be said of creditors in China, where creditors are less sophisticated and, most importantly, the legal and

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6 See 3.2.1 (iii) for discussion on contractarian theory of the firm.

7 These will be further discussed in subsequent chapters.
institutional environment are still under development. This will be discussed further in the next section.

ii. Obstacles to Creditors’ Self-protection in China

(a) Obstacles to Contractual Self-protection in China

It is usually believed in the UK and US that sophisticated creditors such as banks can protect themselves by contract. However, in China, creditors’ self-protection is obstructed by many legal and institutional obstacles.

First, as the Chinese government tightly controls the lending interest rates, financial institutions cannot charge interest rates in a highly differentiating manner. However, it is noticeable that a significant change has taken place. In July 2013, the central bank of China, People’s Bank of China (PBOC) announced the relaxing of the controls on lending rates as part of its efforts in liberalising interests rates. Most noticeably in this announcement, the maximum discount of interest rates that can be offered by commercial banks is as much as 30% of the benchmark rates. This means that now Chinese financial institutions can offer more differentiating lending rates based on the risks of borrowers.

Second, it is difficult and cumbersome to enforce contracts in China, even if creditors insert loan covenants for self-protection. Chinese financial institutions including banks have been found to be able to devise sophisticated contracts for self-protection. For example, when accepting a floating charge, some banks demand specified assets to be put in custody of a certified warehouse and set a maximum amount of assets that the debtor can transfer unilaterally. However, although it is possible to negotiate covenants for self-protection, creditors usually find judicial enforcement of contracts a formidable procedure. A survey carried out in 2013 found that enforcement of judgment would take 190 days in

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a Chinese court in comparison to 62 days in the UK and 100 days in the US.\textsuperscript{10} It is worth noting that this survey was carried out in a district court in Shanghai, which is the most progressive region in China. Therefore, the time for enforcement in other cities is very likely to be much longer. The result of this is that creditors do not have much confidence in the effectiveness of contracts.\textsuperscript{11}

Third, creditors’ ability of self-protection is hampered by lack of financial information. In the real market, different parties usually have asymmetrical information,\textsuperscript{12} and this will lead to inefficiency and market failures. As obtaining financial information can be difficult and costly, some creditors may choose to be rationally ignorant of the relevant information.\textsuperscript{13} Instead of trying to assess the credibility of each debtor, they will raise all interest rates to compensate the potential costs of default. The result is that some loans will be overvalued while others will be undervalued. Then, adverse selection\textsuperscript{14} will occur since high costs of borrowing will drive out financially sound companies, and only companies with high risk of default will remain.

In China, the information asymmetry problem is acute. First, accounting frauds are widespread among Chinese companies. The most high-profile cases involve companies publicly listed in the US and Canada which were charged with accounting frauds.\textsuperscript{15} Second, the credit referencing system is still incomplete in China. Even banks find it difficult and costly to garnish financial information.\textsuperscript{16} The difficulty of verifying the creditworthiness of small enterprises is the most important reason for banks’ reluctance to offer loans to small enterprises.


\textsuperscript{12} Information asymmetry occurs when one party of a transaction has more information than the other. See N Mankiw, Principles of Economics, 6 ed., (London: Cengage Learning, 2011), 599.


\textsuperscript{14} Adverse selection can be succinctly described as the bad drives out the good. For more discussion on adverse selection, see 3.1.3 (ii).


However, as will be discussed below, the problem on lack of information of potential borrowers has been ameliorated by both governmental and private efforts.

(b) Amelioration of Information Asymmetry between Borrowers and Creditors in China

Since 2006, the PBOC has been building a database of credit information in order to assist financial institutions in investigating potential borrowers' creditworthiness. According to a report issued by the PBOC in 2013, the credit database has established credit records for a large number of individuals and enterprises. At the same time, a diverse range of credit service agencies is thriving, including private or state-backed credit investigation agencies and credit rating agencies. The same report also points out the necessity of further developing the credit referencing system and relevant legal regime.

In addition to the governmental efforts, market forces may also play a part in ameliorating the information asymmetry between creditors and borrowers. Instead of investigating into individual companies, online financial institutions have started to use “big data” to analyse borrowers’ creditworthiness. Alibaba, the world's largest e-commerce company, has started to offer loans to small businesses on its business platform (Alifinance) since 2011. Based in Hangzhou China, Alibaba has a diverse range of on-line business platforms, including those for exports and imports, wholesale (Aliexpress) and consumer-to-consumer shopping (Taobao).

Using the data collected on those platforms regarding revenue growth, transaction record and customer ratings, Alifinance establishes a credit scoring model to assess potential borrowers. It has been found that non-performing-

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loans account for less than 0.0005% of the RMB 105 billion outstanding loans offered by Alifinance.\(^{20}\) Ali has also partnered with eight Chinese banks and provides suppliers’ records to them to assess the credibility of loan applicants. Its innovative approach to credit rating will also assist banks in screening potential borrowers. However, despite the convenience and low costs, the scale of loans of Alifinance is still small compared with bank loans,\(^{21}\) and the enterprises that Alifinance serves are restricted to those making transactions on the online platforms. The ultimate solution to the information asymmetry problem between creditors and borrowers lies in the establishment of comprehensive databases of credit records and development of professional credit rating agencies.

### iii. Self-Protection of Creditors by Security in China

In China, creditors usually protect themselves by demanding security. A survey among several Chinese banks carried out in 2007 has found that most of the loans they issued were secured and that the security was a significant factor in their decision of lending.\(^{22}\)

Chinese legislation on security interests are scattered in the Security Law (Guaranty Law) 1995,\(^{23}\) the Property Law 2007,\(^{24}\) which has amended many rules in the Security Law 1995, and an array of judicial interpretations and administrative regulations.\(^{25}\) In China, security interests can take forms of mortgage, pledge and lien.\(^{26}\) Here these basic forms of security interests will be discussed separately. Further, the “floating charge” under Chinese law, which is defined as a subcategory of mortgage, will also be discussed in more details.

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\(^{20}\) ibid.


\(^{23}\) Security Law 1995, the Security Law has also been translated as Guaranty Law.

\(^{24}\) Property Law 2007.


\(^{26}\) Williams and Lu, “Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?,” 23 (above note 9).
(a) Pledge and Lien

Under the Chinese law, a pledge is a security interest created through transfer of a possessory interest in property, and the pledgee/creditor can sell the pledged property when the debtor defaults. Pledge under Chinese law is similar to that under the English law in that it also requires a transfer of possession. According to the Property Law 2007, a pledge can be set over movables or proprietary rights, including intellectual property rights and book debts. A pledge over movables is created upon transfer of possession, and a pledge over proprietary rights requires registration.

A lien under the Chinese law is similar to the concept of possessory lien in the common law. It gives a creditor the right to possess the debtor's movables until the debtor fulfills certain obligations. The Property Law provides that “if a debtor defaults, the creditor may retain the debtor’s movables which have been legally possessed by the creditor and shall have the priority in being paid with the said property”.

(b) Mortgage

The most obvious distinction between the mortgage and pledge under Chinese law is that mortgage does not require a transfer of possession, and in this regard, the Chinese mortgage is similar to its English counterpart. A mortgage of movables is created upon conclusion of the mortgage agreement, while mortgage over immovable property requires registration. The mortgagee has a priority interest in the mortgaged property and can be repaid through sale of the property.

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28 Property Law 2007, chapter 17, section one.
30 A mortgage under English law also does not require transfer of possession, however, it is different from its Chinese equivalence in operation. A mortgage under English law requires a transfer of ownership of the mortgaged assets to creditors and the assets will be reconveyed to the debtor when the secured debt has been paid. However, this no longer applies to mortgage of land. See Goode and MacKendrick, *Goode on Commercial Law*, 586 (above note 27).
31 Security Law 1995, article 43.
Among all the security interests provided under Chinese law, the mortgage is the most common security interest taken by creditors. The properties that can be mortgaged are specified in Article 180 of the Property Law, a list expanded from that provided by the Security Law, including: (1) buildings and other attachments on the ground; (2) land use right for construction; (3) the contractual management right to barren land, etc. obtained through bidding, auction, open consultation or other means; (4) production equipment, raw and semi-finished materials, semi-finished products and finished products; (5) buildings, vessels and aircraft under construction; (6) transportation vehicles; and (7) other property that is not prohibited from being mortgaged by laws or administrative regulations.\(^3^3\) It is worth noting that land itself cannot be transferred in China, as land is publicly owned under the Chinese constitution.\(^3^4\) However, land use rights in the cities can be sold, acquired and mortgaged in the market, while rural land use rights cannot be transferred as a principle.\(^3^5\)

With the booming of the Chinese real estate market, the mortgage of land use rights have become increasingly important for obtaining loans. However, mortgage under Chinese law has several flaws that are detrimental to the interests of creditors. First, mortgage of real estate requires registration with governmental authorities, which is lengthy, complex and costly in China.\(^3^6\) Second, debtors may intentionally postpone or refuse to register the mortgage after they obtain loans. As the mortgage of real estate does not exist without registration and time of registration also determines the priority rank of mortgagees,\(^3^7\) failure or delay in registration will severely undermine the

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\(^3^3\) Property Law 2007, article 180.

\(^3^4\) Constitution, article 6.


\(^3^6\) Williams and Lu, “Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?,” 48 (above note 9).

\(^3^7\) Property Law, Article 199: “Where a piece of property is mortgaged to two or more creditors, the proceeds from auction or sale of the mortgaged property shall be used for liquidation according to the following provisions:

1. Where the mortgage interest is registered, the liquidation shall be made in the order of the registration of the mortgage interest; if the order of registration is the same, liquidation of the claims shall be made on a pro rata basis;

2. The claim secured by a registered mortgage interest shall be satisfied prior to the unregistered ones; and
interests of the creditor. Under such circumstances, the creditor’s only remedy under Chinese law is an action for damages and not performance in specie of the debtor. Third, it is costly to enforce the mortgage when the debtor defaults. Under Chinese law, when a debtor defaults, the creditor cannot automatically acquire the title of the mortgaged property. The mortgagee needs to conclude an agreement with the mortgagor regarding the sale of the mortgaged property or apply to the court for a judicial sale. In reality, negotiation usually fails and implementation of mortgage has to go through judicial process. The judicial process can run for a long time and provide opportunity for fraud and corruption.

(c) ‘Floating Charge’

In addition to pledge, lien and ordinary mortgage, the Property Law 2007 creates a new type of mortgage, which is similar to the floating charge under English law. Under English law, a floating charge “creates an immediate security interest, however, upon crystallisation, no specific asset is appropriated to the security and the debtor company is therefore free to deal with the asset in the ordinary course of business.” Under article 9 of the US Uniform Commercial Code (UCC), a floating lien which closely resembles the English floating charge can be created, despite some nuanced differences. The ‘floating charge’ under the Chinese Property Law, described as a species of mortgage, has echoed this definition of floating charge. It provides that a mortgage can be set over a firm’s present and future assets and that the mortgagee shall have priority in being repaid with the mortgaged property. The floating charge is intended to be an effective protective device for creditors, as they will have security interests over a pool of assets when issuing loans. Another purpose envisaged for the floating charge is to facilitate debt financing for small and medium

(3) Liquidation of unregistered mortgage interests shall be made on a pro rata basis in respect of the claims.”

40 Williams and Lu, “Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?,” 54 (above note 9).” 54.
41 Goode and MacKendrick, Goode on Commercial Law, 678 (above note 27).
42 ibid., 725.
44 Property Law 2007, article 181.
enterprises (SMEs), which are always struggling with financing despite their increasing role in the Chinese economy. As the major loan providers in China, the Chinese banks have been noted for the tendency to favor large state-owned enterprises (SOEs), especially those concentrated in industrial areas. This is because SOEs are presumed to be backed by the government and usually have large assets as their collateral. SMEs, on the other hand, are usually opaque in financial information and wanting in assets eligible for security. Thus, banks are reluctant to offer loans to SMEs, and many SMEs are forced to borrow money through personal relationships and other informal financial sources.

One of the most salient features of ‘floating charge’ under Chinese law is that it is available to a wide range of businesses. Under English law, only business entities with separate legal personality can create a floating charge. Therefore, the floating charge is a privilege for companies and LLPs. In the US, however, a floating charge can be set up by corporations, partnerships sole proprietorship as well as LLCs. China has adopted a similar stance to the US in this aspect. The Chinese Property Law permits the use of floating charge by both corporations and non-corporate businesses, including partnerships and sole proprietors. It states that "enterprises, self-employed industrial and commercial households and agricultural producers and distributors" can create a floating charge over their assets. Under Chinese law, "enterprise" refers to all business organisations, including companies, partnerships and sole proprietors. "Self-employed industrial and commercial households" are small businesses operated by individuals or families, without the limited liability protection. "Agricultural producers and distributors" are those who have contracted for land and engage in farming. The extension of the floating charge to rural agricultural producers is intended to

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48 Williams and Lu, “Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?,” 30 (above note 9).
50 Property Law 2007, article 181.
facilitate the financing of agriculture and balance rural and urban development.  

Another noticeable feature of the Chinese floating charge is that it can only be applied to a restrictive list of movable assets. This is different from its counterparts in the UK and US, both of which can be applied to a wide range of tangible and intangible assets.  

The Chinese Property Law states that a floating charge can only be set over “production equipment, raw and semi-finished materials, semi-finished products and finished products.”  

Immovable property, including land-use rights, are excluded from this list and can only be mortgaged with a fixed value. In addition, intangible assets such as book debts, intellectual property rights can only be pledged under Chinese law.

The Chinese floating charge is unlikely to fulfill the dual goals of protecting creditors and facilitating financing of small businesses and agriculture. The most important reason for this is that a floating charge requires a high degree of creditworthiness of the borrower. In China, a sophisticated system of credit rating is still developing. Consequently, offering loans to small businesses and those engaging in the rural agriculture involves high costs of verifying and monitoring. Given the huge transaction costs, the return for lending to small or agricultural businesses is too small to be attractive for banks.

In reality, many banks are reluctant to accept a floating charge and prefer a pledge as the security when it comes to movables. This is first because a pledge involves a transfer of possession and thus is more reliable in the eyes of banks. When banks actually accept a floating charge, they may require specified assets to be put in custody of a certified warehouse and demand covenants that set a

51 Williams and Lu, “Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?,” 32 (above note 9).
53 Property Law 2007, article 181.
54 Property Law 2007, article 230; also see Williams and Lu, “Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?,” 32 (above note 9).
55 Williams and Lu, “Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?,” 33 (above note 9).
maximum amount of assets that the debtor can transfer unilaterally. However, as revealed by a recent case involving Dezheng Resources, a metal company based in Qingdao, the reliability of pledges is also highly questionable. In the case, the company had pledged its inventories three times using the receipts of commodities issued by the Qingdao port and borrowed RMB 14.8 billion from 18 domestic banks. As it is common practice for Chinese companies to deposit their commodities in a warehouse and use receipts issued by the warehouse to obtain bank loans, this case has cast doubt on the reliability of pledges.

In addition, the absence of a centralised registry in China has made it costly and complicated to set up a floating charge. As in both the UK and US, a floating charge under Chinese law must be registered in order to be perfected, namely to be effective against third parties. However, there no centralised registry in China for different types of movable collaterals. Therefore, a floating charge can involve simultaneous registrations with different governmental authorities. For example, the collateral over equipment, raw materials, products is to be registered with the authorities of administration for industry and commerce; while that over the aircraft, ships or vehicles is to be registered with the transportation divisions. This leaves the secured creditor to be subject to a lengthy process of registration, which involves excessive amounts of documents and conflicted regulations of different governmental authorities. To improve the efficiency of the floating charge, and the whole system of security interests in China, a centralised registration system for all properties must be established. Particularly, electronic filing can be adopted to reduce costs and inconvenience of registering a floating charge.

Finally, a floating charge under Chinese law must be enforced with a judgment and an execution order made by the court. Also, court officials are in charge of

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56 ibid., 41.
seizure and sale of the collateral. This process is lengthy and costly and can give rise to hiding and fraudulent transfer of the collateral. In the UK, a floating charge is enforced through the receivership mechanism which is more likely to preserve the collateral for secured creditors and ensure an efficient enforcement. Further in the US, under article 9 of the UCC, a secured creditor can use a self-help mechanism to enforce the security interest. To be specific, a secured creditor can take possession of the collateral as long as it can do so without breach of the peace. In a word, the procedure of implementing a floating charge should be simplified in China and secured creditors can be given some power of self-help.

To summarise, creditors in China are faced with restrictions on lending rates, weak enforcement and severe information asymmetry. As a result, they tend to rely on security for self-protection. However, the legal rules on security interests contain many flaws to the detriment of creditors. Therefore, before fundamental changes take place, it is unrealistic to leave creditors in China to protect themselves through private contracting. It is safe to conclude that mandatory rules of creditor protection will continue to assume a major role in China in the near future. The next subchapter will discuss legal capital, which is usually regarded an essential mandatory rule for creditor protection in company law.

3.1. 2 Legal Capital

Legal capital is a traditional corporate rule for creditor protection in many countries, especially for those in continental Europe. A legal capital regime usually consists of two basic rules: the minimum capital requirement that prescribes a threshold capital necessary for corporations to get registered, and the capital maintenance rule that forbids the company from returning to

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60 ibid., 16.
61 Williams and Lu, “Expanding Secured Credit for Firms in China: Is the Floating Charge an Appropriate Transplant?,” 52 (above note 9).
62 UCC § 9-609(b); also see LoPucki, Abraham, and Delahaye, “Optimizing English and American Security Interests,” 1803 (see above note 43);
shareholders their capital contributions, which are made as the consideration for shares of the company.

In contrast, partnerships, including partnerships with limited liability, are generally not subject to such capital requirements. However, it is worth discussing whether legal capital should be introduced into partnerships with limited liability, as the risks for creditors of partnerships have increased with the extension of limited liability. The following discussion will attempt to answer this question by examining the relevance of legal capital in corporate law under current conditions in the UK, US and China. If legal capital has become out of date in the corporate context, there is no reason to introduce it into partnership law. The following discussion will be divided into three parts. First, the theoretical criticisms against legal capital will be explored. Second, the reform of legal capital in the UK and US and the underlying rationale will be examined. The final part will look at the development and reform of legal capital in Chinese corporate law.

i. Theoretical Criticisms against Legal Capital

Today the basic rationale for legal capital is that it can constrain agency problems between creditors and borrower firms and protect creditors against opportunistic behaviour that reduce the assets of the borrower.64 It has been argued that a substantial level of capital contribution by shareholders can reduce the chance of the company becoming insolvent when it cannot pay debts that fall due. Also, legal capital can increase the chance of creditors being repaid once the company is insolvent.65 However, many scholars have cast doubt on the function of legal capital, as creditors can better protect themselves by covenants and some ex post legal rules. Here a review will be made on the criticism against legal capital in the context of the UK and US.

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64 Basic forms of agency problem are (1) Claim dilution (2) Asset withdrawal (3) Underinvestment (4) Asset substitution, see 3.1.1 (i).

(a) Minimum Capital

Minimum capital has long been viewed as a safeguard for creditors. However, the initial purpose of the minimum capital requirement was to reduce the risk of investing in corporations and to encourage investment when formation of corporations gradually ceased to be a privilege conferred by the state during the nineteenth century in the UK and US.\textsuperscript{66} After the general incorporation legislation was enacted, it became free for anyone to incorporate a business and call for contribution of capital. Therefore, minimum capital was regarded as necessary for shareholder protection and encouraging investments in enterprises. A minimum amount of assets of a company was a reassurance to investors that the company was formed with seriousness. However, after limited liability was formally established within the corporation, the minimum capital requirement came to be viewed as a price to pay for limited liability, which shields shareholders from the debts of the company, and the purpose of the minimum capital requirement became creditor protection.\textsuperscript{67} In 1944, Kahn-Freund observed that it was unbelievably easy and cheap to form companies in Britain and that the private company had almost displaced the partnership. Therefore it was necessary to make it more costly and difficult to form a company, specifically to set a capital threshold even for private companies, in order to “restore the limited company its original function, and to the partnership its proper place in business life.”\textsuperscript{68}

However, legal scholarship today has found minimum capital to be defective as a measure for creditor protection. First, there is no reason that the government is more capable of assessing risks than creditors. It is actually impossible for the state to set a one-size-fits-all minimum capital, as the extent of risk varies across industries and firms with different scales. An amount of capital may be appropriate for a manufacturing company but too high for a service company.\textsuperscript{69}

\textsuperscript{66} See 2.1.


If the minimum capital requirement is set too high, it may lead to high entry barriers and monopoly prices. However, if the minimum capital requirement is too low, it may only cover a small fraction of actual losses and prove to be meaningless.

Second, the minimum capital requirement only provides an indicator of the capital at the time of formation and cannot provide any substantial protection to creditors later on. Even when a company is in compliance with a minimum capital requirement that is relatively high, gradually, it will lose its initial capital due to shareholder opportunism, business failure and asset depreciation.

In a nutshell, it is very likely that the minimum capital requirement will fail the objective of creditor protection. It is only meaningful as a deterrent to frivolous incorporations and sends a signal to owners of corporations that they need to pay for corporate debts.

(b) Capital Maintenance

Like the minimum capital rule, the capital maintenance rule was also created to encourage investment in corporations. However, gradually it became a means to combat shareholders’ abuse of limited liability. As early as in the nineteenth century, capital maintenance was seen as essential to protecting creditors against the risks of limited liability. For example, in Re Exchange Banking Company, Flitcroft’s Case, Jessel M.R. observed that “the creditor, therefore, I may say, gives credit to the capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of...

the business, and he therefore has a right to say that the corporation shall keep its capital and not return it to the shareholders...”

However, the effectiveness of the capital maintenance rule in creditor protection is questionable. The “capital” here refers to the capital contributed by shareholders as the consideration for shares they acquire, rather than the net worth of the business, which is a more accurate indicator of the financial situation of a business. By its definition, the capital maintenance rule can only prevent shareholders from withdrawing their capital contributions before the company is wound up. Therefore, it may be useful in constraining shareholders diverting the business assets to some extent, but it cannot prevent other types of shareholder opportunism, namely, changing investment decisions after loans have been obtained and diluting creditors’ claims by issuing new debts. Hence, the capital maintenance rule does not guarantee that the company is capable of fully compensating creditors.

The creditor protection function of the capital maintenance rule is only valid to the extent that it fortifies the subordination of shareholders to creditors in insolvency by forbidding the company from returning capital to shareholders first. However, the same effect can also be achieved by covenants negotiated between creditors and borrowers. As found by an empirical study, lenders in the UK and the US usually negotiate covenants based on gearing and other financial ratios rather than on the nominal value of share capital. The argument that legal capital can be replaced by creditors’ self-protection will be further discussed in the following subsections.

(c) Self-Protection by Contractual Creditors

It has been argued that creditors’ self-protection is more effective than mandatory legal rules such as legal capital, especially in the UK and US where the market participants are well informed and supporting institutions are fully

76 Net worth in the economic sense is the assets minus the liabilities.


developed. Compared with the legal capital regime, a major advantage of negotiated covenants are that they are based on the financial situation of the company when credit is extended rather than that at the company’s formation. Creditors can adjust the rate of interest in accordance with the extent of risks of the business. Further, although they cannot foresee the risks caused by shareholder opportunism at the time of borrowing, they can constrain shareholder opportunism by inserting covenants into the contract. For example, they can condition the loan on the financial situation of the company by restricting assets distribution and specifying a debt-to-equity ratio or cash flow level. Another possible covenant is a floating charge over the present and future assets of the company that will crystallise in the future. Creditors can also ask for personal guarantees by the shareholders. Additionally, market disciplines such as reputation of the borrower and the directors will also reinforce the self-protection of the creditors.

(d) Protection of Non-Adjusting Creditors

It can be argued that legal capital is meaningful for non-adjusting creditors, namely those who cannot protect themselves through negotiating contracts. These creditors include tort victims, suppliers who rely on a buyer company as their major source of income, and employees whose livelihood depends on their employer. Unlike financial institutions, these creditors are unable to devise or negotiate a complex contract to protect themselves. Therefore, it has been argued that legal capital is indispensable for their interests.

However, upon closer examination, such an argument does not have much strength. First, the benefits of contracts are not restricted to creditors who negotiate such contracts, and other creditors can in fact freeride on their efforts. For example, when a contract specifies a debt-to-equity ratio for the company, other creditors will also benefit because it ensures the financial soundness of the company. Second, for tort creditors, legal capital cannot guarantee that they

79 See 3.1.1.
80 See 3.1.1.
will be fully compensated because legal capital rules usually impose the same capital requirement for companies from all industries, not specifying a higher amount for particularly hazardous ones. Also, tort victims usually receive little after secured creditors are paid. In reality, tort creditors will get more protection from insurance since insurance can adjust to the extent of risk of a particular activity and the insurance company will monitor the company on an ongoing basis.\(^{83}\) Third, employees will not receive much benefit from the legal capital and labour law and workers’ compensation insurance is more instrumental in protecting their interests. Finally, as to trade creditors, although there is evidence that they usually offer the same interest rate to all borrowers, they can adjust the amount of credits that they extend according to the financial prospects of each borrower.\(^{84}\)

In summary, legal capital is ineffective for protection of creditors including tort creditors. In fact, creditors can protect themselves by adjusting interest rates and negotiating covenants. Admittedly, mandatory legal rules are still important for protecting creditors. The next section will look at the reform of legal capital in the US and UK and the ex post legal rules that are more effective alternatives to legal capital.

ii. Reform of Legal Capital in the US and UK

(a) Reform of Legal Capital in the US

*Distribution Rule under US Corporate Law*

In the US, legal capital has been seen as an outdated legal rule, and the task of creditor protection has largely been left to contract and insolvency law. A majority of states in the US require no minimum capital and have abolished the notion of legal capital to adopt the distribution rule in the Revised Model Business Corporation Act (RMBCA).\(^{85}\) The distribution rule based on the

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\(^{83}\) Machado, “Effective Creditor Protection in Private Companies: Mandatory Minimum Capital Rules or Ex Post Mechanisms?,” 16-18 (above note 67). For more discussion on the function of insurance, see 3.1.3.

\(^{84}\) Armour, “Legal Capital: an Outdated Concept?,” 11 (above note 4).

\(^{85}\) This will be further discussed in the following.
insolvency test has replaced the traditional capital maintenance rule, together with the fraudulent transfer law.

Distribution under the RMBCA is defined as “a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares.” Distribution can take the form of dividend, repurchase of shares, or “a distribution of indebtedness.” Under the RMBCA, the legitimacy of distributions turns on the “insolvency test.” The essence of the insolvency test is to prohibit distributions to shareholders if such distributions would make the corporation insolvent. Two types of insolvency that can be used to determine the legitimacy of distributions are defined by the RMBCA. The first type of insolvency is in the cash-flow sense, i.e. “the corporation would not be able to pay its debts as they become due in the usual course of business.” The second refers to insolvency in the balance-sheet sense, i.e. “the corporation’s total assets would be less than the sum of its total liabilities plus amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.”

The distribution rule built on the insolvency test in the RMBCA was retained in subsequent versions of the model law and has been adopted by a majority of states in the US. However, there are some exceptions, including two important jurisdictions, Delaware and New York. Under the corporate law in both Delaware and New York, a corporation may pay dividends out of surplus or the net profits from the current or preceding year. As an additional requirement, New York provides that the corporation not be (or be rendered) insolvent. Under the corporate law in Delaware and New York law, surplus is the amount by which net

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86 RMBCA § 1.40 (6).
87 RMBCA § 1.40(6).
88 RMBCA § 6.40(c).
90 Delaware General Corporation Law (DGCL) § 170(a); New York Business Organisation Law (NYBOL) § 510.
91 NYBOL § 510.
assets exceeds stated capital.\(^{92}\) Although the distribution rule under New York and Delaware seem to be more stringent than that under the RMBCA, they leave lots of discretion to the board of directors in making distributions to shareholders. For example, the board has almost total discretion to determine the stated capital, and par value of shares can also be reduced or abolished by amending the articles of incorporation.\(^{93}\)

**Fraudulent Transfer Law in the US**

In reality, there is only limited litigation against “distribution” in the US, as the distribution rule under the RMBCA only refers to open distributions and repurchases. Most cases concerned with transferring corporate assets to shareholders are addressed by the fraudulent transfer law, which aims at constraining “hidden distributions” and also refers to the standard of insolvency.\(^{94}\) The fraudulent transfer law exists at both the state and national levels. The fraudulent transfer law on the federal level can be found in Section 548 of the Federal Bankruptcy Code. Many states have promulgated their own fraudulent transfer statutes based on the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act (UFTA).\(^{95}\) Under the fraudulent transfer law, a transfer will be deemed as fraudulent if it is made with actual intent to hinder, delay, or defraud any creditor or without receiving reasonably equivalent value in return. Absent the “actual intent” element, a transaction can also be deemed as “constructive fraud”. The provisions regarding constructive fraud are most relevant for distributions to shareholders. Constructive fraud arises when the debtor transfers an asset or incurs an obligation without receiving a reasonably equivalent value in exchange and thus the debtor was rendered insolvent or left with unreasonably small capital.\(^{96}\) The basic purpose of the fraudulent transfer law is to give unsecured creditors recourse when the debtor transfers assets to evade their claims. Creditors can recover the property from the person to whom

\(^{92}\) DGCL § 154; NYBOL § 102.

\(^{93}\) DGCL § 241, 242; NYBOL § 801, 802.


\(^{96}\) BC § 101(32); BC § 548(2); UFTA § 4(a)(2), also see Engert, “Life Without Legal Capital: Lessons From American Law,” 28-33 (above note 89).
it has been transferred if there has been a fraudulent transfer.\textsuperscript{97} In reality, the fraudulent transfer rule, as well as the distribution rule, is usually enforced in the bankruptcy procedure.\textsuperscript{98} The fraudulent transfer rule in the US bankruptcy law will be further considered in later discussions.\textsuperscript{99}

Although the fraudulent transfer law does not directly impose liability on directors, directors can be held liable under the fiduciary duties of care and diligence. Furthermore, controlling shareholders and directors can be held liable to creditors by the veil piercing doctrine. Although the veil-piercing doctrine has been applied inconsistently among states, it has been found that fraud and undercapitalisation are among the principal reasons for veil piercing in the US.\textsuperscript{100}

\textbf{(b) Reform of Legal Capital in the UK}

In continental Europe, limited liability has been perceived as a privilege conferred on shareholders at the expense of creditors. In stark contrast to the attitude to legal capital in the US, the European Union regards legal capital as essential for creditor protection, and such perception is embodied by its Second Company Law Directive, which provides capital maintenance rules for public companies.\textsuperscript{101} With a legal system similar to the US and influence from the EU, the UK adopts a mixed approach. It shares the indifference to minimum capital with the US and provides no minimum capital requirement for private companies. Also, it only imposes a minimum share capital of GBP 50,000 on public companies,\textsuperscript{102} an amount of only symbolic value for most public companies. However, Britain seems to have embraced the European perception that

\textsuperscript{97} See the summary of the Uniform Fraudulent Transfer Act (UFTA) on: \url{http://www.uniformlaws.org/Act.aspx?title=Fraudulent%20Transfer%20Act%20now%20known%20as%20Voidable%20Transactions%20Act} (accessed on September 1, 2014). It is worth noting that the Uniform Fraudulent Transfer Act is now known as Uniform Voidable Transactions Act (UVTA) due to amendments made in 2014.


\textsuperscript{99} See Chapter 4.

\textsuperscript{100} Booth, “Capital Requirements in United States Corporation Law,” 131 (above note 98)


\textsuperscript{102} CA 2006, s 763.
shareholders obtain limited liability at the expense of creditors,\textsuperscript{103} therefore it is necessary for law to provide adequate protection to creditors where there is limited liability. In addition to a creditor-oriented insolvency regime, it has also promulgated relatively rigorous capital maintenance rules applicable to both private and public companies.

Most UK legal capital rules are contained in the Companies Act 2006 (CA 2006), including gold-plated rules of the Second Company Law Directive\textsuperscript{104} as well as those developed by UK case law. The capital maintenance regime under the UK company law mostly consists of rules on distribution, capital reduction, share repurchase, and financial assistance to the purchaser of the company’s shares. An examination on these rules will demonstrate that it is more difficult for UK companies to make distributions to their shareholders than for companies in the US, where the distribution rule is usually allowed unless the company is or is rendered insolvent. First, the distribution rule contained in Part 23 of the CA 2006\textsuperscript{105} provides that companies cannot make any form distribution of corporate assets unless it is made “out of profits available for the purpose,” which are basically calculated as accumulated realised profits less accumulated realised losses.\textsuperscript{106} The distribution rule for public companies is even more stringent, as they have to satisfy an additional requirement that their net assets will not be less than the aggregate of share capital and undistributable reserves as a result of making a distribution.\textsuperscript{107} Second, while corporate statutes in the US generally do not prohibit capital and share repurchases,\textsuperscript{108} the CA 2006 provides that shares can only be redeemed or repurchased by a company out of the distributable profits of the company or proceeds of a fresh issue of shares\textsuperscript{109} so that the share capital will not be reduced by share redemption or repurchase.\textsuperscript{110} The exception is that private companies are allowed to repurchase shares out of

\textsuperscript{103} Payne, “Legal Capital in the UK Following the Companies Act 2006,” 5 (above note 77).
\textsuperscript{104} Ibid., 7.
\textsuperscript{105} Distribution under the CA 2006 is a broad conception including dividends, redemption, and repurchase of shares, with a few exceptions. See CA 2006, s 829.
\textsuperscript{106} CA 2006, s 830.
\textsuperscript{107} CA 2006, s 831.
\textsuperscript{109} CA 2006, s 692, see Paul Davies and Sarah Worthington, \textit{The Principles of Modern Company Law}, 326-329 (above note 65).
\textsuperscript{110} Payne, “Legal Capital in the UK Following the Companies Act 2006,” 31 (above note 77).
capital under some circumstances.\(^{111}\) Third, reduction of legal capital requires a special resolution of the members upon confirmation of the courts.\(^{112}\) For private companies, a special resolution of the members is still necessary. However, it needs to be supported only by a solvency statement signed by directors instead of courts’ confirmation.\(^{113}\)

Finally, there is the financial assistance rule in the UK that prohibits public companies from giving financial assistance to a person for the acquisition by that person of the company’s shares, whether the assistance is given before or after the acquisition.\(^{114}\) The CA 2006 removed the financial assistance restriction on private companies.\(^{115}\) This rule has reflected a general policy of creditor protection in an era where leveraged takovers have become commonplace. However, as financial assistance may not affect a company’s legal capital, nor will it necessarily reduce the company’s net assets, the UK financial assistance rule is criticised for being too broad and not distinguishing between good and bad leveraged takovers.\(^{116}\) In contrast, in the US, financial assistance is generally not prohibited unless it contravenes the fraudulent transfer law.\(^{117}\)

As discussed above, legal capital is not really effective in protecting creditors and can be replaced by creditors’ self-protection and ex post legal rules. As the UK has a legal environment similar to that of the US, legal capital is in fact redundant for creditor protection. Most importantly, the UK has a range of ex post measures for creditor protection, which are aimed at actual instances of shareholder opportunism. First, the equivalent of the US fraudulent transfer law can be found in sections 238 and 423 of the UK Insolvency Act 1986. Sections 238 and 423 address problems of constructive fraud (undervalued transactions) and

\(^{111}\) CA 2006, ss 709-723.

\(^{112}\) CA 2006, s 641 (1)(b).

\(^{113}\) ibid., s 641 (1)(a).

\(^{114}\) ibid., s 678.

\(^{115}\) ibid., ss 667-680.


actual fraud, respectively.\textsuperscript{118} Second, directors will be subject to sanctions if they engage in fraudulent or wrongful trading under the UK law.\textsuperscript{119} Finally, as in the US, courts in the UK can pierce the corporate veil to hold shareholders liable for the company’s debts when a company is undercapitalised.\textsuperscript{120} In a word, given the existence of ex post measures in the UK, legal capital seems to be redundant for creditor protection. With increasing domestic awareness for flaws of legal capital and effective alternatives, it is curious to see that the UK retains most of its onerous legal capital rules. The most direct explanation is that the UK has to implement the Second Directive.\textsuperscript{121}

However, there are signs of change in Europe, which may bring about changes in the UK. First, there is increasing recognition of the benefits of the US model within the EU. For example, the Winter Report, which was produced by the EU Commission’s High Level Group of Company Law Experts, points out the inadequacy of legal capital in creditor protection and suggests a distribution rule similar to the approach under US law. Under the proposed distribution rule, the company can make distributions to shareholders only when such distribution does not render the company insolvent.\textsuperscript{122} Second, in a series of cases, the ECJ has confirmed that businesses can circumvent the legal capital rules by choosing their state of incorporation.\textsuperscript{123} For example, in Centros,\textsuperscript{124} the ECJ held that a company had the right to incorporate in the UK while operating in Denmark through a branch, even though this company did so only to evade the minimum capital requirement imposed by Denmark. Further, the ECJ in Inspire Art\textsuperscript{125} decided that it was unjustifiable for the Netherlands to impose a minimum capital requirement on a company registered in the UK and that doing so was in violation of freedom of establishment. Third, in order to prevent their

\textsuperscript{118} See 4.1.3 (ii).
\textsuperscript{119} See 4.3.
\textsuperscript{120} See 3.3.1 (i).
\textsuperscript{121} Payne, “Legal Capital in the UK Following the Companies Act 2006,” 33 (above note 77).
\textsuperscript{123} For a detailed discussion of these cases, see 1.3.2.
\textsuperscript{124} Case C-212/97 Centros Ll. v Erhvervs-og Selskabsstyrelsen ECR [1999] I-1459.
\textsuperscript{125} Case C-167/01 Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd. ECR [2003] I-10155.
businesses from leaving, other states within the EU may lower their legal capital requirements to match Britain. Currently, Britain seems to be the most attractive incorporation destination in Europe, with the absence of minimum capital requirement for private companies and a relaxed capital maintenance regime under the CA 2006. However, it is foreseeable that other countries will modify their legal capital as an effort of “defensive regulatory competition.”

iii. Reform of Legal Capital in China

(a) Legal capital under Company Law 1993

Initially, China placed great emphasis on legal capital as a creditor protection technique. Legal capital is called “registered capital” in the legal documents, as it is a prerequisite for registering a company. The first market-based company law in contemporary China, Company Law 1993, provided for stringent capital requirements. There are two main types of companies under the Company Law 1993: limited liability companies (private companies) and joint stock limited companies (public companies).

Under Company Law 1993, private companies were classified into four categories and had different capital requirements accordingly. Companies doing manufacturing and wholesale business were required to have a legal capital of RMB 500,000. For those doing retail sales the capital requirement was RMB 300,000, and for services companies the requirement was RMB 100,000. As for public companies, they were subject to a capital threshold of 10 million RMB. Such requirements were prohibitively high for private investors given the average yearly wage in China was approximately RMB 2,700 in 1992-1993.

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127 Armour, “Legal Capital: an Outdated Concept?,” 13 (above note 4). For more discussion on defensive competition within EU, see 1.3.2.
129 Company Law 1993, article 23.
130 ibid., article 25.
addition, the financial burden of investors were exacerbated by the requirement that legal capital must be fully paid up before a company was registered.\textsuperscript{132}

Besides being financially burdensome, the minimum capital requirement under the Company Law 1993 was unreasonable on other grounds.\textsuperscript{133} First, capital requirements varied for different businesses, but the list of businesses under the Company Law 1993 was non-exhaustive. Second, the requirement of fully paid-up capital as a prerequisite for incorporation imposed heavy burdens on investors and led to widespread falsifying of statements of capital in the early 1990s. As a means to curb the practice, in the redraft of the Chinese Criminal Law in 1997, falsifying statements of capital was criminalised and was punishable by up to three years’ imprisonment.\textsuperscript{134}

The reason for such onerous and unreasonable legal capital was that the main purpose of the Company Law 1993 was to facilitate the restructuring of the SOEs, and therefore it did not take into account the needs of small private enterprises. Since the 1990s, the majority of SOEs in China have been transformed into joint stock companies and the state still retains its control over many SOEs as their shareholder. It has been estimated that in sixty per cent of SOEs that have been transformed into joint stock companies, the state is the largest shareholder.\textsuperscript{135}

(b) Legal Capital under the Company Law 2005 and Reform in 2013

In 2005, an overhaul of the company law was launched, ending in a new company law. The Company Law 2005 acknowledged the need for encouraging private investment and the development of small enterprises. It has greatly reduced the minimum capital requirement for small enterprises. The minimum capital requirement was reduced to RMB 30,000 for limited liability companies with two or more shareholders\textsuperscript{136} and RMB 5 million for joint stock companies.\textsuperscript{137} The one-person company is formally recognised for the first time under the

\textsuperscript{132} Company Law 1993, articles 25 and 82.
\textsuperscript{133} ibid., 230.
\textsuperscript{134} Criminal Law 1997, article 158.
\textsuperscript{135} ibid., 232.
\textsuperscript{136} Company Law 2005, article 26.
\textsuperscript{137} ibid., article 81.
Company Law 2005. To reflect the higher risks to creditors of a one-person company, its capital threshold is set relatively high at RMB 100,000.\textsuperscript{138}

The payment rule of registered capital has also been changed. Except for one-person company whose investor is required to pay capital contribution in full,\textsuperscript{139} investors are allowed to pay capital contributions by instalments, provided the initial contributions are no less than 20\% of the total capital and the remainder are paid within two years of incorporation or five years in the case of investment companies.\textsuperscript{140}

However, the Company Law 2005 has retained a rigorous capital maintenance regime. First, before the company is established, the promoters and subscribers shall not withdraw their share capital after making payments for the shares unless the company is not established.\textsuperscript{141} Second, a company is not allowed to repurchase its shares except for the legitimate reasons listed in the Company Law. The Company Law 2005 has enlarged this list to include capital reduction, merging with a shareholder company, rewarding employees, and purchasing shares at the request of shareholders who object to merger or split-up decisions.\textsuperscript{142} Third, the Company Law 2005 provides that a company must draw at least 10\% of its after-tax profits as its reserved funds and can only distribute dividends to its shareholders out of the remaining profits. If the reserved funds are equal to or greater than 50\% of the registered capital, the company is no longer obligated to set aside profits as its reserved funds.\textsuperscript{143} Finally, when the company decides on reduction of registered capital, the company must notify creditors of the decision within ten days and make a public announcement on a newspaper within 30 days. The creditor can demand the company to pay off the debt or provide security within 30 days after receiving the notice, or within 45 days after the issuance of the public announcement if it fails to receive the

\begin{footnotesize}
\begin{enumerate}
\item[138] ibid., article 59.
\item[139] ibid., article 59.
\item[140] ibid., articles 26 and 81.
\item[141] ibid., article 92.
\item[142] ibid., article 143.
\item[143] ibid., article 167.
\end{enumerate}
\end{footnotesize}
notice. In addition, the reduced capital cannot be lower than the minimum capital mandated by law.\textsuperscript{144}

There is also a financial assistance rule for listed companies under Chinese law. Although the concept of financial assistance is not stated in the company law, however, listed companies are actually prohibited from giving financial assistance to their purchasers by regulation.\textsuperscript{145} The financial assistance rule in China is principally devised to curb the widespread managerial asset diversions in the SOEs. It is not uncommon to see the management in SOEs use the corporation’s assets to acquire ownership in the process of restructuring. The purpose of the financial assistance rule is to prohibit purchasing an SOE’s shares with its assets, leading to depletion of the company’s assets and damage of the state’s interests.

Although China has adhered to a stringent legal capital regime, its recent reform has showed a trend toward relaxing the legal capital as an effort to lower the entry barrier for new enterprises. At the end of 2013, an amendment to the Company Law 2005 was passed to abolish the minimum capital requirement for limited liability companies, one-person companies, and joint stock companies.\textsuperscript{146} This amendment came into effect on 1 March 2014. Further, the subscribed capital regime has replaced the paid-in capital requirement. This means that a capital contribution that actually has been paid is no longer a prerequisite for registration of a company.

To summarise, legal capital has become an archaism and should not be extended to partnerships with limited liability, as creditors can be protected by covenants and a panoply of ex post legal rules. In China, as well as the UK and US, a reform has been made on legal capital in the corporate law. The next section will

\textsuperscript{144} ibid., article 178.


discuss liability insurance, which is a better alternative to legal capital in terms of creditor protection.

### 3. 1.3 Liability Insurance

Liability insurance, also termed as third-party insurance, covers the insured’s potential liability to a third party. Common forms of liability insurance include drivers’ liability insurance and employers’ liability insurance.\(^{147}\) It is instrumental in protecting tort creditors and voluntary creditors who are not on an equal footing with the firm, such as employees. In the UK and US, liability insurance is a product of the industrial era and has evolved into a range of forms corresponding with the mounting liabilities in the society.\(^{148}\) Under circumstances similar to industrial Britain and America, liability insurance flourishes in today’s China.

The reasons for considering liability insurance in this thesis are two-fold. First, although this thesis principally considers voluntary creditors, especially those who invest in businesses in the form of lending, it will tangentially consider tort creditors. As discussed above, one argument that supports the legal capital regime is that it can protect non-adjusting creditors including tort victims.\(^{149}\) However, in both the UK and US, employees and tort victims are usually compensated by liability insurance. The legal capital regime seems to have achieved little in compensating tort victims.

Second, professional partnerships with limited liability, which are part of the focus of this thesis, are usually required to purchase professional liability insurance. In the US, some LLC and LLP statutes require firms to purchase liability insurance or maintain segregated funds to meet potential liabilities. In the UK, although the LLP statute does not provide for mandatory insurance, professionals such as lawyers are mandated to purchase professional indemnity

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\(^{148}\) The first type of liability insurance to come into being was the employers’ liability insurance. See Mary Coate McNeely, “The Genealogy of Liability Insurance Law,” *U. of Pittsburgh L. Rev.* 7 (1940): 169.

insurance. In China, it is mandatory for SGPs, which are restricted to professional firms, to carry professional liability insurance.

Here an analysis will be made on the function of liability insurance and then it will proceed to provide an overview of liability insurance in China.

i. The Function of Liability Insurance

The basic function of liability insurance is transferring risk of liability from the insured to the insurer, who can effectively reduce risk of liability and predict potential losses. To be specific, liability insurance can reduce risks through the following ways:

(1) Risk spreading: With liability insurance, economic consequences of catastrophic events are spread across social groups. This is because the insurer, who has accumulated funds from different policyholders, will absorb the economic consequences which would otherwise be borne by individuals.

(2) Variance reduction: As the number of independent events increases, the variance of the mean value of the losses will decrease. This means a large number of insurance policies for independent events will improve the predictability of the magnitude of potential losses according to which insurers can charge premiums.

(3) Segregation of risks: Insurers can segregate different classes of policyholders according to the extent of risk. They can adjust policy terms and premiums to the risks posed by different groups.

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151 PEL 2006, article 59.

(4) Encouraging loss reduction measures: Insurers can require potential insureds to meet specific loss prevention standards before providing insurance. Also, insurers can incentivise insureds to adopt loss reduction measures by offering premium reductions to low risk groups, for example, reductions for non-smokers in life insurance.

(5) Monitoring and control: Insurers will vet potential policyholders before offering insurance and will continue to monitor their policyholders.

In summary, because insurers can reduce the risk of liability and predict potential losses, it is efficient to allocate risks to them. Another socially beneficial aspect of insurance is that insurers can play a quasi-regulatory role. To be specific, they can incentivise the insured to adopt risk-reduction measures ex ante and monitor them to comply with legal standards on a continual basis.

However, in the real world, the function of liability insurance is undermined by information asymmetry and general uncertainty. Information asymmetry occurs when one party of a transaction has more information than the other. When information asymmetry exists, the twin problems of moral hazard and adverse selection will arise. Moral hazard refers to the risk of dishonest or inappropriate behavior by those who possess more information. In the case of insurance, the insureds usually know more about the extent of risks they face than insurance companies and will have less incentive to take measures to reduce risks once they are insured.

Adverse selection can be succinctly described as the bad drives out the good. The most classic example of adverse selection is the market for “lemons.” “Lemon” is American slang for a defective car. In a second-hand car market, it is difficult for buyers to distinguish good cars from bad ones, so they will only pay

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154 Ibid., 946.
a price that reflects the average quality of cars. The owners of good cars, unsatisfied with the price, will retreat from the market, leaving only bad cars in the market. A similar phenomenon can also happen in the insurance market. When insurers find the overall risk is rising, they will raise the premiums for all potential policyholders. Then insureds with lower risks will find it undesirable to purchase insurance, and only those with high risk profiles will remain.

Even if there is no such information asymmetry between the insurers and insureds, the efficiency of liability insurance will be impeded by the general uncertainty of the market. Liability insurance can be profitable only if insurers can predict the frequency and magnitude of insured losses. As argued by Frank Knight, there is a distinction between uncertainty and risks.\(^{158}\) Insurance can only work efficiently with risks, or probabilities that can be quantified and predicted, while uncertainty, namely unpredictable probabilities, will hinder insurers from setting appropriate prices and diversifying risks.\(^{159}\)

Given the imperfections of the market, insurers have to take various means to reduce their costs, including ex ante screening of potential insureds, offering differentiating rates of premiums based on past claims of the insureds, ex post monitoring of the insureds, and offering services to prevent occurrence of liability and defense services once the liability arises.\(^{160}\)

ii. Overview of Liability Insurance in China

Nearly two centuries behind the UK and US, China finally fully embraced the power of industrialisation in the twenty-first century. Enterprises are flourishing in all sectors and the economy is growing at an unprecedented pace. The dark side is heavy pollution, overpacked cities, omnipresent industrial hazards, and widening social inequality. Under such circumstances, liability insurance was


\(^{159}\) Abraham, “Environmental Liability and the Limits of Insurance”, 948 (above note 153).

introduced in China as a means to cope with escalating social conflicts in all areas. Since 2003, the government has put frequent emphasis on the function of liability insurance as a “pressure reducer.”

Currently, liability insurance only accounts for a small proportion of the Chinese insurance market. However, the range of liability insurance products is expanding. Common forms of liability insurance include drivers’ liability insurance, employer’s liability insurance, public liability insurance, and product liability insurance. Adding to this list are newer products such as professional indemnity insurance, directors liability insurance, and environmental liability insurance.

Like for many industries in China, the decisive factor in the trajectory of liability insurance is governmental support. Therefore, unsurprisingly, the types of liability insurance supported by the government are the most successful, for example, drivers’ liability insurance, which has been mandatory since 2006. Other examples include insurance for school public liability, production safety liability in high-risk industries, and medical malpractice. Another field of potential growth is environmental liability insurance as the environment deteriorates. The fog plagued Chinese cities have become a symbol of China’s version of industrialisation, echoing the London smog, which cost thousands of lives in 1950s.

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162 ibid.


164 ibid.


insurance has been introduced in 2006 and made mandatory for many heavy polluting industries in 2013.\textsuperscript{167}

It is foreseeable that liability insurance will assume an increasingly important role in Chinese society. First, as China is a transitional society undergoing rapid change, there is great uncertainty about the scope of liability for those who run businesses. New legislation is being drafted every year with new liabilities being created. For example, the most recent version of tort law, enacted in 2009, which allows suing for environmental pollution, pain and suffering, and damage to reputation online, could lead to a sharp rise in lawsuits.\textsuperscript{168} Liability insurance can alleviate business people’s fear for overwhelming liability. Second, with overemphasis on economic growth, the society is fraught with indifference to people’s welfare. Injuries due to product safety defects, medical malpractice, environmental pollution, accidents in factories and mines are commonplace. In many cases victims are not compensated. Liability insurance certainly will improve this situation by offering compensation to the victims who otherwise would bear great losses.

In summary, liability insurance in China is still at a primitive stage. However, it will become increasingly important in the future. This is inevitable as the economic and social circumstances become more complex and businesses are exposed to increasing liabilities.

**Summary of 3.1**

In summary, given the legal and institutional obstacles, it is unrealistic for creditors in China to fend for themselves through private contracting. In contrast to the UK and US where mandatory rules have gradually given way to creditors’ self-protection, in China mandatory rules will continue to play a major role in creditor protection. In the past, legal capital is regarded as an indispensible


measure for creditor protection. However, its effectiveness now has been cast
into doubt and even China is making a gradual reform to relax the stringent
provisions of legal capital. One of the arguments that support the retention of
legal capital is that it can be used to compensate non-adjusting creditors of
businesses including tort victims. However, in fact, liability insurance can better
fulfill this purpose. Therefore, it is advisable for the Chinese government to
further promote the development of liability insurance while it is axing the legal
capital provisions. However, the Chinese insurance industry needs to strengthen
its expertise in monitoring the insureds. Otherwise insured businesses will lack
the incentive to prevent the occurrence of liability.
3.2 Fiduciary Duties

3.2.1 Fiduciary Duties in UK-US Corporations and Partnerships

i. Fiduciary Duties of Partners and Corporate Directors

Fiduciary duties are produced by equity, which refers to the body of rules developed by the English court of equity to temper the rigidity of common law and to achieve justice in individual cases.¹ Rules of equity are noted for their flexibility, fact-sensitivity and open-endedness. However, on the other side of the coin is their uncertainty. As a product of equity, fiduciary duties also possess these qualities.²

Fiduciary duties are usually imposed on one party (fiduciary) who act on behalf of another (beneficiary) and has discretion to manage critical resources owned by the latter.³ The main function of fiduciary duties is to compel the person who manages property or affairs on behalf of others to abstain from self-interest and put their interests before her own.⁴ In partnerships, partners are co-owners of the partnership and presumed to manage the partnership together.⁵ Therefore, partners owe fiduciary duties to each other⁶ and the partnership.⁷

In the context of corporations, corporate directors are subject to fiduciary duties because they manage affairs on behalf of others. As corporate directors manage corporate business on behalf of shareholders as a whole, the US

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⁴ ibid., 1408.
⁵ ibid., 1484.
⁶ Partner’s duty to each other was described by Justice Cardozo in these words: “Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm’s length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” See Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).
corporate law stipulates that corporate directors owe fiduciary duties to shareholders as a whole, however, not to individual shareholders. The language in the UK company law is slightly different, which states that corporate directors owe duties to the company. As corporate directors do not owe duties to individual shareholders under the Anglo-American company law, they can only allege breach of fiduciary duties through derivative suit. Derivative suit was developed as an exception to Foss v. Habottle, which has established that only the company can sue against the wrong done to it since the company is a separate legal entity from the shareholders. However, as the board may refuse to file a suit, especially when the controlling directors have misbehaved against the company, shareholders are allowed to file derivative actions against breach of fiduciary duties on behalf of the company. Although derivative actions are developed by case law, it is worth noting that the UK Companies Act (CA) 2006 has brought derivative action to a statutory basis.

There are at least two recognised fiduciary duties imposed on corporate directors and partners under common law-duty of care and duty of loyalty. The duty of loyalty requires directors/partners to act in the best interests of the firm and put the interests of the firm before their own. Common behaviour forbidden by the duty of loyalty including self-dealing and competing with the firm. The duty of care requires directors/partners to make informed business decisions for the firm. In the US, the business judgment rule is frequently cited as a constraint on enforcing the duty of care against corporate directors. The business judgment rule presumes that corporate directors have exercised due care by acting on an informed basis, in good faith and in the honest belief that their actions are in the best interests of the corporation unless a rebutting
evidence can be provided. The justification for the business judgment rule is that if directors can be held liable for good faith decisions that result in negative results, they may become overly cautious for fear of personal liability. As a result of the business judgment rule, it is rare for the US courts to hold directors liable for breach of duty of care. In the UK, the common law rule that courts will not substitute their judgment for that of directors as long as they make the judgment in good faith has been preserved in section 172 of the CA 2006. However, it has been argued that this subjective standard of good faith judgment can be undermined by section 174, which has introduced a mixture of subjective and objective criterion to determine whether directors have exercised the care, skill and diligence expected of a reasonably diligent person. Section 174 differs from the US business judgment rule in that it has no presumption of a directors’ good faith.

ii. Fiduciary Duties in Partnerships with Limited Liability

Partners of partnerships with limited liability are subject to fiduciary duties imposed by statutes. Under the UK Limited Partnership Act 1907 (LPA), general partners of limited partnerships also have duties like those of general partners, including a general duty of good faith, duty of partners to render accounts, accountability for partners for private profits, duty of partner not to compete with firm and the duty to exercise reasonable skill and care. Although the UK

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17 CA 2006 s 174 (2): “This means the care, skill and diligence that would be exercised by a reasonably diligent person with—
(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
(b) the general knowledge, skill and experience that the director has.”
19 ibid., 27
20 Partnership Act 1890, ss 27-30. Provisions of Partnership Act apply to limited partnerships unless the otherwise has been stated by the LPA. Therefore, fiduciary duties specified by the Partnership Act apply to limited partnerships as well.
LPA 1907 does not exempt limited partners from fiduciary duties, there is a small chance that they will be held liable for breach of fiduciary duties as they are usually segregated from management by the provision that they will lose their liability shield if they participate in the management of the partnership.\(^{21}\)

The UK LLP, a body corporate distinguished from both the corporation and partnership presents a more complicated picture. In *F&C Alternative Investments (Holdings) Limited v Francois Barthelemy*,\(^{22}\) the court distinguished the duties of LLP members from partners of a general partnership.\(^{23}\) It is observed by the court that positions of partners in a UK LLP are different from partners in traditional partnerships so the general principle of partners' fiduciary duties does not apply to the UK LLP. Moreover, the UK LLPA 2000 does not provide that members of LLPs owe duties to each other. Whether members owe fiduciary duties to each other and the LLP should be decided upon specific facts. Based on this line of reasoning, the court found representatives of the corporate member on the board of the LLP to owe fiduciary duties to the LLP given the degree of control they had over the LLP's business.

The standard the court relied on in deciding the existence of fiduciary duties is whether one assumes responsibility for the management of another's property or affairs. Following this logic, the circumstances that cause LLP members' to owe fiduciary duties to each other are limited, as it rare for LLP members to manage other members' affairs or property. In comparison, members' fiduciary duties to the LLP are more likely to arise because such duties arise when members have direct control of the LLP's affairs or property. Another point worth noting in this UK LLP case is how much emphasis the court put on the authority of the governing agreement.

As to the US LLP, a species of the general partnership, there is no dispute that its partners are subject to fiduciary duties similar to partners of a general partnership.

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\(^{21}\) LPA 1907, s 6.


partnership. In a US limited partnership, similar to its UK counterpart, only general partners are subject to the fiduciary duties as applied to partners of general partnerships and limited partners can enforce such duties through derivative suits. The ULPA 2001 provides that general partners are subject to duty of care and duty of loyalty, however, limited partners have no fiduciary duties “solely by reason of being a limited partner” and are only imposed with contractual obligation of good faith and fair dealing. However, in the US, with the erosion of the “control rule” in the US, it becomes easier for limited partners to interfere with the management. Therefore, it is possible that limited partners in the US will be held liable for breach of fiduciary duties although they are presumed to have none. The US case law has confirmed that limited partners will be subject to fiduciary duties as general partners if they participate in the management.

As hybrids of corporations and partnerships, US LLCs have fiduciary duties with mixed features. In the US, LLCs can be divided to be member-managed and manager-managed according to their governing agreements. The former category of LLCs resembles general partnerships with managerial powers shared by partners while the latter is more like limited partnerships or public corporations with managerial power vested in the general partner or the board of directors. The most recent version of Uniform Limited Liability Company Act (ULLCA), promulgated in 2006, also imposes duties of care and loyalty and contractual obligation of good faith and fair dealing on LLC managers and members of member-managed LLCs. However, members of manager-managed

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24 The UPA 1997 contains special provisions for LLPs and general provisions of partnerships will also apply to LLP. The fiduciary duties of partners are provided in section 404, which states that “The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care”. It will be further discussed later.

25 ULPA 2001 § 408.

26 ULPA 2001 § 305.

27 See 1.1.1 (iii).


31 ULLCA 2006 § 409.
LLCs and non-managing members of member-managed LLCs, who have the position similar to shareholders in corporations, are not subject to these duties.\textsuperscript{32}

iii. Whether Fiduciary Duties can be Opted out

As flexibility is a major appeal of partnerships with limited liability, questions arise as to whether private parties can contract out fiduciary duties in partnerships with limited liability. Fiduciary duties have long been criticised for the uncertainty caused by judicial discretion and many have argued for allowing parties to contract out fiduciary duties.\textsuperscript{33}

Traditionally, under the Anglo-American law, fiduciary duties imposed on directors are more rigid than those on partners. In principle, partners can vary their duties to each other although they cannot completely eliminate fiduciary duties. The UK Partnership Act clearly states in section 19 that mutual rights and duties of partners may be varied by the consent of all the partners while case law demonstrates such variation is still subject to judicial scrutiny.\textsuperscript{34} Similarly, the section 103 of the US UPA 1997 provides that although partnership agreement can modify fiduciary duties, it cannot eliminate them. In contrast, in corporations, traditionally only upward contractual modification of fiduciary duties is allowed.\textsuperscript{35} Although US Delaware has amended its corporate statute to allow for opting out duty of care, it still forbids limitation of duty of loyalty and good faith or the wholesale elimination of fiduciary duties. In addition, even when it comes to elimination of duty of care, the Delaware case law has demonstrated a narrow interpretation of duty of care and a restriction to the scope of the duty that can be opted out.\textsuperscript{36}

As partnerships with limited liability are modeled on partnerships in most aspects, it is reasonable to grant them the extent of contractual freedom similar

\textsuperscript{32} Ribstein, \textit{The Rise of the Uncorporation}, 177 (above note 28).
\textsuperscript{33} ibid., 203.
\textsuperscript{34} G Morse, Partnership Law, (OUP, 2010), 159 (above note 13).
\textsuperscript{35} However, in other contexts where contractual and fiduciary relationships coexist, for example, in an agency relationship, contracts will determine the scope of fiduciary duties. See Kelly \textit{v} Cooper [1993] AC 205 (Privy Council), 216.
\textsuperscript{36} Ribstein, \textit{The Rise of the Uncorporation}, 170 (above note 28).
to ordinary partnerships. However, it is debatable whether it is justified when US Delaware started to permit limited partnerships and LLCs to closely mimic public corporations and at the same time to completely eliminate fiduciary duties.\(^{37}\)

The debates on whether fiduciary duties can be contracted out are related to the divided views on the nature of the firm. Theories regarding the nature of the firm in the discussion of corporate law are split into two major threads—contractarian theory and concession or communitarian theory. The arguments for permitting eliminating fiduciary duties are usually based on the contractarian theory of the firm, which characterises the firm as a creature of contracts and only serves the interest of contracting parties and argues for minimum government interference. In contrast, the proponents for imposing mandatory fiduciary duties see the firm as a concession granted by the state and with a public interest function, and therefore they demand more government regulation to keep the firm from infringing the interests of the outsiders of the firm and the whole community.\(^{38}\) The communitarian theory first gained popularity in the early nineteenth century when operating as a corporation was truly a concession granted by the state.\(^{39}\) However, after general incorporation statutes became available, such theory ceased to conform with the reality. As a result, the contractarian theory of the firm, has thrived and lent theoretical strength in the deregulatory movement in both the UK and US.\(^{40}\)

This schism on the view of the firm also led to the divided opinions on whether directors/partners should be subject to a creditor-regarding duty. Scholars who hold the contractarian theory of the firm usually oppose imposing such duty through mandatory law, while those who believe in the communitarian theory

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find it indispensable as a means for creditor protection.\textsuperscript{41} The debates on directors’/partners’ creditor-regarding duty will be further discussed in chapter 4. Here the discussion will proceed to China where a regulatory asymmetry also exists between corporations and partnerships in terms of fiduciary duties.

3.2.2 Fiduciary Duties in Chinese Corporations and Partnerships

i. Fiduciary Duties in Chinese Corporations

(a) Legislative History of Fiduciary Duties under Chinese Company Law

The Company Law 2005 in China imposes duties of diligence\textsuperscript{42} and loyalty on directors.\textsuperscript{43} Further, shareholders are allowed to bring derivative actions against directors on behalf of the company for breach of duties.\textsuperscript{44} However, under the PEL, partners are not subject to duties of loyalty and diligence.\textsuperscript{45}

Most scholarly discussions on directors’ duties in China have regarded enactment of duties of diligence and care as an emulation of fiduciary duties in common law, however, an empirical study has found that the cases brought for directors’ breach of duty are rare and the judiciary is rather rigid in interpreting directors’ duties.\textsuperscript{46}

The debates on whether fiduciary duties can be contracted and the regulatory asymmetry between partnerships and corporations are rarely found in the Chinese context. The most critical problem regarding fiduciary duties in China is whether they can effectively emulate the fiduciary duties originated in the common law system. Here this problem will be evaluated by an examination of the legislative background of fiduciary duties in China and the judicial practice in interpreting this rule.

\textsuperscript{41} ibid., 251.
\textsuperscript{42} The equivalence of duty of care under common law.
\textsuperscript{43} Company Law 2005, articles 148-149.
\textsuperscript{44} Company Law 2005, article 152.
\textsuperscript{46} Guangdong Xu et al., “Directors’ Duties in China,” European Business Organization L. Rev. 14, no. 1 (2013): 57, 66. This will be further discussed in the following.
The Company Law 1993, which was enacted as an effort to restructure Chinese state-owned enterprises (SOEs), imposed duty of diligence, the equivalence of duty of care under common law, on directors of corporations. However, the duty of loyalty was not incorporated into Chinese company law until the Company Law 2005 was enacted.\footnote{ibid., 59.} As a general statement of duty of loyalty, the Company Law 2005 provides that “Directors, supervisors and senior managers of a company shall observe laws, administrative regulations and the company’s articles of association and shall assume the duties of loyalty and diligence to the company. Directors, supervisors and senior managers of a company shall not take advantage of their functions and powers to accept bribes or collect other illicit earnings, and shall not take illegal possession of the property of the company.”\footnote{Company Law 2005, article 148.}

Specific violations of duty of loyalty are enumerated, including: “(1) misappropriating the funds of the company; (2) opening an account in his own name or in the name of another person to deposit the funds of the company; (3) loaning the funds of the company to another person or using the property of the company to provide guarantee for another person; (4) entering into a contract or conducting transactions with the company; (5) taking advantage of his position to seek commercial opportunities, which belong to the company, for himself or for another person, or operating for himself or for another person the same kind of business as that of the company where he is holding a post; (6) taking into his own possession the commissions from transactions conducted by another person with the company; (7) disclosing secrets of the company without authorization; or (8) other acts committed in violation of the duty of loyalty to the company.”\footnote{ibid., article 149.}

In contrast to the detailed elaboration on duty of loyalty, there is no provision to clarify duty of diligence under Company Law 2005.

In the same year the new company law was promulgated, the Securities Law was also enacted in which a personal liability was imposed on directors who are in charge of information disclosure of listed companies.\footnote{Securities Law 2005, article 193. The translation of the Company Law and Securities Law is taken from the official website of National People’s Congress http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (accessed on March 3, 2013).} The China Securities
Regulatory Commission (CSRC), authorised by the Securities Law to regulate issuers, securities and market intermediaries, has issued a number of rulings against directors on the ground of breach of the obligation of information disclosure. In addition, it introduced duty of diligence and duty of loyalty into its Guidelines for Articles of Association of Listed Companies and specifies the conducts that constitute breach of fiduciary duties for directors of listed companies (Article 97 and 98). This regulation defines duty of diligence as “treating all shareholders fairly and understanding the operations and management circumstances of the company.”

(b) Judicial Rigidity in Applying Fiduciary Duties

Here a glimpse into the real operation of fiduciary duties under Chinese law will be made through the findings of an empirical study. Based on the cases concerned with duties of loyalty and diligence from 2006 to 2012, this study has found that the all of them involve limited liability companies (private companies) rather than joint stock limited companies (public companies). There are several reasons that can account for this phenomenon. First, the requirement for shareholders in public companies to bring derivative suits alleging breach of fiduciary duties against directors is much higher than those in private companies. While there is no threshold requirement for shareholders of private companies, the company law provides that only shareholders of a listed company who “alone or together hold(s) more than 1% of the shares for more than 180 consecutive days” can bring a derivative suit, an obstacle difficult for minority shareholders to overcome. Second, Chinese company law still refuses to allow for class actions as it entails political risks. Finally, most companies listed on China’s security markets are SOEs tightly controlled by the government, which does not need to resort to derivative actions. As the majority shareholder of SOEs, the state can assert its interests through shareholder meetings.

Another finding of this study is the judicial rigidity in applying fiduciary duties. It has been found that the majority of fiduciary duty cases are concerned with duty of loyalty and in most of the duty loyalty cases conflict of interests is

52 ibid., 74.
53 Company Law 2005, article 152.
alleged. This may result from the fact that conflict of interests is unequivocally provided in the Company Law 2005 and Chinese judges are more willing to apply such clear-cut rules than deducing from the general ones.

A closer examination on cases regarding duty of loyalty will further reveal the judicial rigidity. In cases concerned with directors embezzling company property or misappropriating company funds, which are explicitly categorised as breach of duty of loyalty under the company law, judges are found to apply the provisions directly without much legal reasoning. For example, the Beijing Second Intermediate People’s Court stated in its decision against a company’s director,

“As executive director and legal representative of the Zhonghui Yachuang Company, Li Jia should obey the laws and the articles of association of the company. Nevertheless, Li Jia violated the duty of diligence and the duty of loyalty to the Zhonghui Yachuang Company by depositing the company’s funds in the Saiwo Online Company, a company directly controlled by Li Jia. He should therefore bear the corresponding liability.”

As to cases concerned with non-competition, another form of breach of the duty of loyalty, courts tend to refrain from substantively examining whether there is conflict of interests and base their decision on whether a specific transaction has been approved by shareholder meeting or the board of directors, or whether it has been authorised by the company’s articles of association. For example, the Zhejiang Zhuji City People’s Court voided a transaction on the ground that the director defendant could not prove the transaction was in line with the

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55 Company Law 2005, article 149.
56 Company Law 2005, article 149.
When the cases cannot fit seamlessly with specific provisions of the statute, Chinese courts are usually unwilling to extend the application of duty of loyalty as a general principle. For example, in a case where a company’s director engaged a law firm and a human resource management company when a company was in financial difficulty, the Beijing Second Intermediate People’s Court dismissed the plaintiff’s claim that the director had breached the duty of loyalty since he should have avoided the consulting fees given the company’s financial situation. The court emphasised that “As the managing director of the company, Mr. Kang was obviously authorised to sign consulting contracts with other parties and make payments to these parties in accordance with these legally binding contracts. Mr. Kang’s activities did not breach any law, administrative regulation or article of association of the company.”

However, if the court interpreted fiduciary duties in a broader sense, the circumstances of this case could have led to the conclusion that the director had breached duty of loyalty.

Despite the general antipathy to a broader interpretation of fiduciary duties, some courts, especially those in more developed areas such as Beijing and Shanghai, have demonstrated the willingness to stretch the doctrine within the bounds of their discretion. In a case where a department manager of a company used its confidential information and ran a competing business, the court found the department manager amounted to “senior manager” under the company law, which has not been defined under the company law, and held the manager liable for breach of duty of loyalty. The court stated the reasoning of its decision,

“To judge whether or not Mr. Yu is a senior manager of the company, we should consider the scope of Mr. Yu’s power as a department manager and also the importance and influence of his work. We should ask whether or not Mr. Yu’s power includes substantially controlling the

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58 Chen Ju (陈炬) v. Orient Construction Company (东方建设公司) (Zhejiang Zhuji City Court, 2009, No. 4058), cited from ibid., 67.

59 Jishuntong Transport Company (北京极顺通运输有限公司) v. Kangmou (康某) [2011], cited from ibid., 68.
company’s business management or being authorised to make fundamental business decisions of the company or holding important confidential business information of the company. Based on the above information, we can conclude whether the duty of loyalty is applicable in this case.60

Another case concerned whether former directors are still bound by duty of loyalty. In this case, a former director of a company established a new company to develop the same product as the one he was responsible for developing before his resignation. Although there is no express provision regarding whether duty of loyalty will extend to former directors, the Shanghai Intermediate Court ruled that the duty of loyalty was still applicable to directors during a certain period after their resignation.61

Additionally, an echo of the business judgment rule has surfaced in China. The business judgment rule, developed by the US court, presumes that corporate directors have exercised due care by acting on an informed basis, in good faith and in the honest belief that their actions are in the best interests of the corporation unless a rebutting evidence can be provided. The underlying rationale for this doctrine is that the courts should not judge directors’ business decisions ex post since judges are not in a better position than corporate directors in making business decisions. Moreover, ex post examination of directors’ business decisions will harm their incentive in risk-taking and may constrain them from making right business decisions.62 Similar reasoning can be found in a decision of an Intermediate Court in Wuhan, which cautioned that a balance must be struck between constraining directors’ misbehavior and facilitating business activities. The court stated that although it was necessary to enforce duty of loyalty and diligence, directors could not be held liable for

60 Beijing Jinghua Sifang Trading Company (北京京华四方贸易有限公司) v. Yumou (余某, Beijing First Intermediate Court, 2009, No. 13800), cited from ibid., 70.


62 See 3.2.1 (i).
every loss caused by their decision. Otherwise, they would only make overly cautious decisions and cause companies to lose profitable opportunities.\(^{63}\)

Although these courts are making progress, they have not changed the overall picture in China. The judiciary as a whole seems to have played a small role in refining fiduciary duties. In contrast, the CSRC has been active in sanctioning directors of listed companies for breaching their duties, especially the duty of information disclosure.\(^{64}\) As many other Chinese government agencies, there is no specific limits to CSRC’s authority under Chinese law. The benefit of such broad discretion is that agencies can respond in a timely fashion to the changes of the society. However, a proactive and powerful agency will weaken the authority of the judiciary, making shareholders even more unwilling to litigate against directors. Moreover, unlike litigation, administrative punishment issued by the CSRC will not recover losses for the shareholders and other stakeholders. In a nutshell, fiduciary duties under the Chinese company law are still under progress and institutional changes are crucial for their further development. This will be further discussed in the following.

(c) Proposing Institutional Changes for Further Development of Fiduciary Duties

The ‘structural transplant’ theory, which has been used to explain the failure of fiduciary duties when they are transplanted into a civil law country, can offer insights for future development of fiduciary duties in China. According to this theory, when rules under common law are transplanted, the judiciary in the recipient country cannot develop and enforce these rules as effectively as their common law counterpart. Therefore, it has been proposed that the focus on substantive transplant of law must be shifted to structural transplant, namely to pay more attention to allocation of lawmaking and law enforcement powers than the contents of law.\(^{65}\) From this theory it can be concluded that a successful

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\(^{63}\) *Liquidation Committee of Wuhan Diguang Communication Company (武汉科地光通信有限责任公司清算小组)* v. *Liusheng (刘胜)* (Wuhan Intermediate Court, 2006, No. 125), cited from ibid., 72.

\(^{64}\) ibid., 77.

‘structural transplant’ of fiduciary duties to China entails a fundamental institutional change in the lawmaking.

China has a statute-based legal system in which statutes promulgated by the NPC is at the center.\textsuperscript{66} Also, the local congresses and the administrative authorities at both the state and local level are authorised to make secondary law.\textsuperscript{67} The decisions of the courts are not a formal source of law. Chinese courts are shackled in their discretion and there is no principle of \textit{stare decisis} under Chinese law. This means that fiduciary duties cannot be clarified through precedents built up by the courts.

However, despite the general lack of lawmaking power of the Chinese judiciary, the Supreme People’s Court (SPC) can shape law by issuing judicial interpretations,\textsuperscript{68} adjudicating cases and being involved in the statute-making process. In recent years, the SPC has gradually strengthened its lawmaking power by issuing cases that will guide decisions of the local courts. Since 1985, the SPC has published its decisions on its official \textit{Gazatte}, as an guidance for local courts. However, they are referred to as “example case\textit{(anli 案例)}” rather than and different from precedents under the common law and their authority is ambivalent.\textsuperscript{69} In 2005, the SPC started to establish a system of “guiding cases\textit{(zhi dao xing an li 指导性案例)} to improve consistency of judicial decisions.\textsuperscript{70} Under the Regulation on Cases Guiding issued by the SPC, it demanded that local courts should adjudicate according to the guiding cases.\textsuperscript{71} Therefore, guiding

\textsuperscript{66} Constitution (promulgated in 1982, most recently amended in 2004), article 3.

\textsuperscript{67} Legislation Law 2000, articles 56, 63, 71, 73. For detailed discussion on distribution of law-making power between central and local governments in China, see 1.3.3.

\textsuperscript{68} Organic Law of the People’s Courts, article 32: “The Supreme People’s Court gives interpretation on questions concerning specific application of laws and decrees in judicial proceedings.” The judicial interpretation discussed here is different from that in the common law context, which refers to decisions made to specific cases.\textsuperscript{69} Rather, the SPC’s judicial interpretations are the general guidance for the courts in applying vague or complex law and therefore function more like statutory law. See Wang, “Law-Making Functions of the Chinese Courts: Judicial Activism in a Country of Rapid Social Changes,” \textit{Frontiers of Law in China} 1, no. 4 (2006): 524.

\textsuperscript{69} Cited from Chao Xi, “Piercing the Corporate Veil in China: How Did We Get There?,” \textit{Journal of Business Law} no. 5 (2011): 413, 417.


\textsuperscript{71} Regulation on Cases Guiding, article 7.
cases have greater authority than example cases and will play a more important role in shaping the Chinese legal system.

The guiding case system can be seen as an extension of the SPC’s power of judicial interpretation and a tentative emulation of *stare decisis.*

Through the guiding cases, the SPC can offer detailed guidance to local courts in many vague and difficult issues. With regard to fiduciary duties, further interpretation can be made on the duty of diligence, which is yet to be specified. In addition, the SPC can absorb the interpretations of fiduciary duties by some local courts and make them binding on the whole judiciary. In a word, the SPC is making a change facilitative to the development of fiduciary duties. However, the judiciary needs to be further strengthened so that open-ended fiduciary duties can really play a part.

At the same time, the over-reliance on the CSRC to enforce fiduciary duties should be ended. It has been observed that government agencies have the combined advantages of legislatures and courts in that they can make regulations to apply to prospective situations and enforce their regulation through issuing sanctions. However, they are also criticised for abuse of power, suppressing potentially beneficial actions and engaging in rent-seeking.

In China where such problems are widespread it is imperative to curb the power of government agencies such as the CSRC.

In summary, although China has introduced fiduciary duties into its company law, the development of fiduciary duties is impeded by the lack of judicial lawmaking power. Structural reform must take place before fiduciary duties can be really play their part in the Chinese context. The next section will discuss the absence of fiduciary duties in Chinese partnerships and consider whether it is necessary to extend fiduciary duties to Chinese partnerships, especially limited partnerships which have become a popular vehicle for private equity firms.

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ii. Absence of Fiduciary Duties in Chinese Partnerships

Unlike the company law, Chinese partnership law has not introduced the general duties of loyalty and diligence. Partners’ rights and duties to each other are mostly decided by the partnership agreement. The duties of partners provided by the partnership law are duty of information disclosure and duty of avoiding conflicts of interests.

As the limited partnership has become a popular vehicle for Chinese private equity firms, the strains on internal governance of limited partnerships have come to the fore. The absence of fiduciary duties compounded by other factors has led to a singular situation where limited partners are grappling for power in Chinese limited partnerships. Many limited partners are actively involved in the decision-making process of private equity funds and effectively control the fund. For example, limited partners of Donghai Venture Capital, the first limited partnership established in the city of Wenzhou, were effectively the ultimate decision-makers of the partnership. The highest decision-making body of the partnership was the partnership’s meeting, which consisted of all partners. According to the partnership agreement, two-thirds vote was requisite for an investment decision to pass in the partnership’s meeting. As a capital contribution of 5 million RMB was entitled to one vote and the general partner had little capital contribution, the partnership’s investment strategy was effectively decided by limited partners. From the start the limited partners of Donghai had displayed great distrust to the general partner and the wariness to let others manage their money. Finally, the internal conflicts between limited partners and the general partner finally brought the partnership to a lackluster end.

74 PEL 2006, article 28: “Where partnership affairs are managed by one or more partners, the managing partner(s) shall, at regular intervals, report to the other partners the state of management and business operations and the financial status of the partnership and the incomes derived from management of partnership affairs shall belong to the partnership and the expenses or losses entailed shall be borne by the partnership.”

75 ibid., article 32: “No partner may, by himself or through cooperation with another person, engage in business in competition with the partnership in which he is a partner. No partner may conduct business transactions with the partnership in which he is a partner, unless otherwise stipulated in the partnership agreement or consented by all the partners. No person may engage in any activities that harm the interests of the partnership in which he is a partner.”

The story of Donghai has raised alarm for the whole Chinese private equity industry. Besides the absence of fiduciary duties, some other reasons have been cited to explain interference of limited partners. The first reason is that traditionally, Chinese do not have the practice to put one’s own property entirely into the care of others who are outside of the family. The absence of the “trust culture” also partly explains the ineffectuality of fiduciary duties in constraining directorial misbehaviour in the corporate context. Second, as indicated by a 2012 survey, 50.2% of Chinese limited partners are wealthy individuals and families, which tend to be more active and less risk-tolerant than institutional investors.\(^77\) China’s fast economic growth has created a new generation of super rich who are eager to diversify their investments. At the same time, institutional investors in China, for example insurance companies, were previously barred from the equity investment market. Third, the scarcity of qualified general partners in the private industry has also contributed to emergence of active limited partners.\(^78\) As China’s private equity industry is yet to mature, the lack of qualified general partners is not surprising. It has been found that few general partners in China have more than 10 years’ experience in the private equity industry. Finally, the absence of a national credit system means that reputation cannot adequately constrain general partners.\(^79\)

Active limited partners not only disrupt running of the limited partnership, but also can harm the interests of creditors. It is likely that creditors will regard active limited partners as general partners and presume them to be unlimitedly liable for the partnership’s debt. Chinese partnership prohibits limited partners from managing the affairs of the partnership, with a list of safe harbours that fall outside “managing”.\(^80\) However, this provision is unlikely to play a significant

\(^{77}\) ibid., 199.
\(^{78}\) ibid., 200.
\(^{80}\) PEL 2006, article 68:

“A limited partner of a limited liability partnership shall not manage partnership affairs or represent the partnership in its relations with people outside the partnership.

The following acts of a limited partner shall not be deemed to be management of partnership affairs:

(1) to participate in deciding on a general partner’s entering into or retiring from the partnership;
(2) to raise suggestions concerning the operation and management of the partnership;
role in constraining the activism of limited partners. First, there is no definition of “managing” and it is unclear whether the safe habour list is exhaustive. The experience of the US has demonstrated the difficulty of articulating a rule to segregate limited partners from management.\(^{81}\)

Second, the function of the “management rule” overlaps with the “estoppel rule”\(^ {82}\) provided by the Chinese partnership law, which states that limited partners holding themselves out to third parties as general partners will be liable to such third parties for the partnership’s debts.\(^ {83}\) Also, limited partners will be liable for the losses caused by unauthorised execution of the partnership’s affairs.\(^ {84}\)

Last and most importantly, rather than the “management rule, the most crucial measure to curb limited partners’ over-activism in China is to impose fiduciary duties on general partners. In this way, limited partners’ interests will be protected through fiduciary duties and they will feel less need to vie for control in the partnership. As limited partners are in a position similar to corporate directors, they should be subject to duties equivalent to duties of loyalty and care provided by the Chinese company law.

All in all, the rule that prohibits limited partners from management will not solve the internal conflicts within Chinese limited partnerships. A more

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\(^{81}\) See 1.1.1 (iii).

\(^{82}\) The estoppel rule in the limited partnership context means that if creditors of the partnership extend credit on the reasonable belief that the limited partner is in fact a general partner, the limited partner is estopped from denying personal liability to such creditors. See Carter G Bishop, “The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?,” *Suffolk UL Rev.* 37 (2004): 677.

\(^{83}\) PEL 2006, article 76.

\(^{84}\) ibid., article 98.
fundamental solution is to introduce fiduciary duties to partnership law, which can be drafted drawing the experience of the Anglo-American law. Although fiduciary duties are developed by case law in the UK and US, in both countries there are statutory provisions regarding fiduciary duties, which can be instructive for China’s codification of fiduciary duties.

**Summary of 3.2**

In the UK and US, fiduciary duties are built by accumulation of case law. The essential feature of the principle of fiduciary duties is its open-endedness and flexibility due to the wide judicial discretion. Fiduciary duties exist in both corporate and partnership law, and they have also been transported to limited partnerships, LLPs and US LLCs. However, with the prevailing contractarian theory of the firm, which strongly advocates for freedom of contract, there is a trend that partnerships with limited liability will be exempt from fiduciary duties through contractual arrangement.

In China, there is also regulatory asymmetry on fiduciary duties between corporations and partnerships. While corporate directors are subject to duties of loyalty and diligence, there are no such duties under the partnership law. Unlike the regulatory asymmetry in the US underpinned by heated theoretical debates, the regulatory asymmetry seems to be out of neglect rather than meaningful policy considerations. Due to the absence of effective mechanism for controlling general partners, limited partners in private equity partnerships in China are usually overly active, interfering with the running of the partnership. To give limited partners a sense of security, fiduciary duties should be introduced into Chinese partnership law through amendment of legislation.

It needs to be pointed out that although China can emulate the UK and US by imposing duties on directors/partners, unlike the UK and US, China is a statute-based country and the judiciary has limited discretion. Fundamental structural changes are essential for a successful emulation of UK-US law. First, the judiciary must be strengthened and given more discretion so that open-ended directorial duties can really play a part. At the same time, the rule of *stare decisis* can be emulated so that more coherent interpretation of fiduciary duties will be developed by the courts. Second, the legislature or the SPC must
formulate specific rules to guide the local courts in applying these duties. Otherwise, courts will be uncertain of their discretion and become reluctant in citing directorial duties, as demonstrated by the rarity of cases concerned duty of care, which remains unspecified under Chinese company law. Finally, the judiciary, instead of the governmental agency should be in charge of implementing fiduciary duties. The next section will move to the rule of veil-piercing, which like fiduciary duties, is also open-ended and depends largely on the competence of the judiciary.
3.3 Piercing the Entity Veil

The veil-piercing doctrine generally refers to the practice of the judiciary to disregard the separate legal personality of the corporation and hold shareholders liable for corporate debts. It becomes relevant to the discussion of creditor protection in partnerships with the introduction of limited liability into partnership law. As discussed above, limited liability encourages directors and partners to take excessive risks and behave opportunistically against creditors, particularly in private companies and partnerships which are often owner-managed.\(^1\) When all other measures of creditor protection have failed, piercing the entity veil will be the last resort for creditor protection.

Unlike the UK and US where the veil-piercing doctrine was built through case law, China introduced a veil-piercing provision into its statutory law with the enactment of the Company Law in 2005. The veil-piercing provision has played an important role in the Chinese corporate context since it was first written into statutory law. However, it is rare to see any discussion on applying veil-piercing to partnerships.

The purpose of this subchapter is to compare the UK-US veil-piercing principle with its Chinese equivalent and examine whether it is necessary and possible to extend the corporate veil-piercing rule to partnerships. In 3.3.1, the general picture of veil-piercing in the UK and US will be presented, and the theory and practice of applying veil-piercing to non-corporate entities will be discussed. In 3.3.2, the development of the veil-piercing rule in China and the role of the Chinese judiciary in shaping this doctrine will be examined. It is worth noting that although the veil-piercing doctrine was not formally established in China until it was written into statute, the judiciary has played an instrumental role in its creation and development. Also, the issue of applying the veil-piercing provision to Chinese partnerships will be explored.

\(^1\) See 2.2.2 (iii).
3.3.1 Veil Piercing in the UK and US

i. UK-US Veil Piercing in the Corporate Context

(a) Corporate Veil Piercing in the UK

The veil-piercing doctrine developed by the common law courts exemplifies the fundamental role of the judiciary in remedying wrongs unforeseeable to legislators. As the opportunistic abuse of the corporate form has become more and more sophisticated over the time, legislators cannot foresee and forestall every instance of opportunism. Therefore, the judiciary developed the rule of piercing the corporate veil to disregard the separate personality of a corporation under specific circumstances and hold its controlling shareholders or directors liable for corporate liability.

However, it is worth noting that piercing the corporate veil does not necessarily lead to piercing the limited liability shield of shareholders or directors. A British scholar has classified the common instances of piercing the corporate veil (or lifting the corporate veil, as it is called in the UK) into peeping behind the veil, penetrating the veil, extending the veil, and ignoring the veil.² Peeping behind the veil is used by the judiciary to obtain information about the controllers of the company and will not necessarily result in personal liability of shareholders or directors. Penetrating the veil, on the other hand, is the judicial practice of reaching beyond the corporate veil and imposing liability oncontrolling shareholders/directors for the company's acts. Extending the veil is when a corporate veil is extended to other corporations within a corporate group, namely, a group of companies is regarded as a single going concern. Finally, there is ignoring the veil, which is the most severe type of veil-piercing. The judiciary will ignore the corporate veil when it finds that the company is formed to defraud creditors or to circumvent law. The result is that shareholders will be liable for the company's debts. Besides these four types of veil-piercing cases, there is reverse veil piercing, a special form of veil piercing used to hold the

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company liable for debts of its shareholders.\(^3\) Related to the concerns for the risks of limited liability, the discussion on veil piercing in this article will focus on the judicial practice of stripping the corporate veil to attribute a corporation’s liabilities to its shareholders.

Although there are lots of cases compiled under the title of piercing the corporate veil, neither the UK nor the US has established an overarching theory of veil piercing, and the application remains open-ended and fact-based. This causes the veil piercing doctrine to be one of the most confusing in corporate law. Some have even commented that it “seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled.”\(^4\) The following discussion will not attempt to present a thorough explanation of the veil piercing theories in the US and the UK, but it will consider the most significant ones.

In *Salomon v A. Salomon & Co Ltd.*,\(^5\) a milestone in British company law, it was confirmed that even small businesses can take advantage of the separate personality and limited liability provided by the corporate form.\(^6\) The separate personality established by *Salomon* became so entrenched in English law that it is rare for English courts to disregard the corporate legal personality or to lift the corporate veil. Subsequent courts have shown a high deference to *Salomon* and steadfast adherence to the doctrines of separate personality and limited liability. The result is that not only can individuals shield their risks by incorporating their business but a company can also limit its liability by setting up subsidiaries.\(^7\)

However, there are exceptional situations where the courts feel compelled to disregard the separate personality of a company. The main test that the UK courts developed for piercing the corporate veil is the “façade” or “sham” test. This test is the most developed reason for veil piercing in the UK. It has been

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\(^5\) [1897] AC 22 (HL).

\(^6\) For detailed discussion on *Salomon*, see 2.1.1.

constantly reasserted that the courts will prevent the corporation from being used for purposes of fraud or evasion of contractual or other legal obligations.\(^8\) Two leading cases can give an illustration of how the courts will apply this test. In *Gilford Motor Co. Ltd v Horne*,\(^9\) the defendant set up a new company through which he solicited customers from his former employer, allegedly in contravention of his contractual obligations not to solicit customers from his former employer. Finding that the company was “formed as a device, a stratagem, in order to mask the effect carrying on of a business of Mr. EB Horne,”\(^10\) the Court of Appeal pierced the corporate veil and issued an injunction against the defendant and his company. In *Jones v. Lipman*,\(^11\) the defendant sold a property to a company he owned and controlled for the purpose of circumventing his contractual obligation to sell the property to the plaintiff. Based on the observation that the company failed to observe formalities and had no share capital or any physical premise, the court concluded that the company was “the creature of the first defendant, a device and a sham, a mask which he holds before his face in an attempt to avoid recognition by the eye of equity,”\(^12\) and then ordered specific performance against the defendant and the sham company.

Besides the façade test, the British courts have formulated some special tests in corporate group settings. The first one is the agency test articulated in *Smith, Stone & Knight Ltd v Birmingham Corp.*,\(^13\) In this case, a parent company claimed compensation for business disturbance after its subsidiary’s estate was compulsorily purchased. Judge Atkinson developed a six-prong test to determine whether the subsidiary was acting as the agent of its parent company.\(^14\) Relying on the test, the court held that the subsidiary was actually carrying on business of its parent company, and therefore the latter was the real occupier of the

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\(^9\) [1933] Ch 935 (CA).

\(^10\) ibid., 969.

\(^11\) [1962] 1 All ER 442 (Ch).

\(^12\) ibid., 445.

\(^13\) [1939] 4 All ER 116 (KB).

\(^14\) ibid., 121.
estate and had entitlement to the compensation. However, this test was rarely used by subsequent courts because of the exceptional factual circumstances of this case.\(^{15}\)

Another test invented by the UK courts to disregard the separate personality when corporate groups are concerned is the “single economic unit” theory. Decades after *Smith, Stone and Knight*, the question of whether a parent company could claim for governmental compensation for losses suffered by its subsidiary resurfaced in *DHN Food Distributors Ltd. v Tower Hamlets London Borough Council*.\(^{16}\) In this case, Lord Denning, a leading judge in the twentieth century, proposed the “single economic unit” theory to determine whether a group of companies should be treated as the same entity under the law. The gist of the theory is that the separate legal personality of subsidiaries should be ignored if they are “bound hand and foot to the parent company and must do just what the parent company says.”\(^{17}\) Despite following a different line of reasoning from *Smith, Stone and Knight*, this case also ended with a veil-piercing decision, allowing the parent company to be the appropriate claimant of governmental compensation. The “single economic theory” was subject to wide criticism because of its vagueness and a flaw in its reasoning. Under the “single economic unit” theory, all wholly owned subsidiaries will face the risk of losing their separate legal personality, since this theory identified control by the parent company as the primary ground for piercing the corporate veil of subsidiaries.\(^{18}\)

As a matter of fact, both the agency test and the single economic theory have been largely ignored since their first appearance. When considering the liability of individual shareholders as well as corporate shareholders, the UK courts usually stick to the façade test. Later in *Woolfson v. Strathclyde Regional Council*,\(^{19}\) Lord Keith observed in opposition to the reasoning in *DHN* that the

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\(^{15}\) Moore, “A Temple Built on Faulty Foundations: Piercing the Corporate Veil and the Legacy of *Salomon v Salomon*,” 183 (above note 8).

\(^{16}\) [1976] 3 All ER 462 (CA).

\(^{17}\) ibid., 467.


\(^{19}\) [1978] SC90 (HL).
corporate veil could only be pierced when the corporation was used as “a mere façade concealing the true facts.”

The authority of the façade test was further acknowledged in the leading case of Adams v. Cape Industries plc, which concerned whether a judgment relating to asbestos injuries made by a US court should be enforced against a UK company (Cape Industries plc) and its subsidiary (Capasco). The pivotal issue was whether the UK company had presence in the US through two subsidiaries (AMC and CPC). Three arguments had been considered and rejected by the court in deciding whether to pierce the corporate veil and regard the UK company and its subsidiaries as the same entity. The first was the single economic unit theory. On examination of the factual aspects of the case, the court found it indisputable that Cape and its subsidiaries were separate legal entities in law. It also distinguished the circumstances of DHN from Adams on the ground that in DHN the corporate veil was pierced so that the true owner of the company could claim for compensation. In rejecting the application of the single economic unit theory to Adams, the court stated that it would not disregard the principle in Salomon “merely because it considered it just to do so” and said that it was “concerned not with economics but with law. The distinction between the two is, in law, fundamental and cannot here be bridged.”

Next, the court moved to consider the façade test in Woolfson, which was “one well-recognised exception to the rule prohibiting the piercing of the corporate veil.” The court stated that it would only lift the veil when the defendant used the corporate structure to evade existing legal obligations or liabilities. The court found that Cape set up subsidiaries to carry out its sales in the US and concealed its connections with them. However, the arrangements did not involve any actual or potential illegality and were not intended to deprive anyone of their existing rights. The court added that it was entirely appropriate for the defendant company to use the corporate structure to limit future liability, since

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20 ibid., 96.
21 [1991] 1 All ER 929 (Ch).
22 ibid., 1020.
23 ibid., 1022.
24 ibid., 1026.
“the right to use a corporate structure in this manner is inherent in our corporate law.”

The last argument raised was agency. On this point, the court found that although CPC acted on behalf of Cape under some circumstances, it could not be established that there was an agency relationship between the two without an express agreement. The court concluded that Cape was carrying on its own businesses and Cape did not have presence in the US through it.

In distinguishing appropriate uses of the corporate form to limit potential liabilities from malicious and dishonest evasions of preexisting liabilities, the Adams case has set a high bar for piercing the corporate veil. It stresses the façade test as the only accepted test for veil piercing. Furthermore, it restricts the application of the façade test to evasion of preexisting liabilities, namely where the company is established specifically to shield shareholders from their preexisting liability, as exemplified by Gilford Motor and Jones.

The decision in Adams prohibits tort victims from reaching the parent company of the corporate tortfeasor and runs counter to intuitive notions of justice. On closer examination, it is also theoretically problematic, as it fails to specify any standards to determine what are preexisting liabilities. Although one of the subsidiaries of Cape was formed after asbestos injuries occurred, the court concluded that there were no preexisting liabilities. The court seemed to assume that a legal obligation exists only when it is established. It has been argued by a scholar that during the long lapse between occurrence and establishment of legal liabilities, many opportunistic measures can be taken to evade liabilities. Therefore, “the best rule seems to be that a legal obligation is incurred when the event that gives rise to potential liability takes place, and the

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25 ibid., 1026.
26 ibid., 1027-1030.
company knows, or has reason to know, that the event may expose it to liability.”

Following the reasoning in Adams, the UK Supreme Court distinguished pre-existing obligations from future ones in Prest v Petrodel Resources Ltd in 2013. In this case, Mrs. Prest applied to transfer several properties registered to seven offshore companies that were owned and controlled by Mr. Prest, in order to satisfy part of a divorce settlement. The Supreme Court rejected Mrs. Prest’s argument for piercing the corporate veil.

In considering the arguments for piercing the corporate veil, the Supreme Court reasserted that the veil could only be pierced in exceptional circumstances, namely, when a person was using the company under his control to evade an existing legal obligation or liability. By this standard, the principle of veil-piercing can only apply to limited circumstances because “in almost every case where the test is satisfied, the facts will in practice disclose a legal relationship between the company and its controller which will make it unnecessary to pierce the corporate veil.... If it is not necessary to pierce the corporate veil, it is not appropriate to do so....”

Based on the facts of this case, the Supreme Court found that Mr. Prest incorporated the offshore companies long before the breakdown of the marriage and that they were intended for wealth protection and tax avoidance rather than to evade Mrs. Prest’s matrimonial claims. Therefore, the court decided not to pierce the corporate veil. However, it effectively ordered the transfer of the properties by concluding that they were held in trust for Mrs. Prest. By this decision, the Supreme Court seemed to encourage courts to look for alternative

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32 ibid., at para 35.
33 ibid., at para 36. Also see Christopher Hare, “Family Division, 0; Chancery Division, 1: Piercing the Corporate Veil in the Supreme Court (Again),” The Cambridge LJ 72, no. 3 (2013): 511, 513.
34 ibid., at para 55.
solutions in other well-established principles under English law rather than to use the broad and unpredictable veil-piercing rule.  

To summarise, as the case that encapsulates the contemporary judicial stance on veil piercing in the UK, Adams has restricted the application of veil-piercing to very limited circumstances. Since Adams, the façade test, defined as using the company to evade preexisting duties, seems to have become the only ground for veil piercing in the UK. Further, as demonstrated by Prest, the courts are inclined to look for alternative solutions rather than to use the veil-piercing rule.

(b) Corporate Veil Piercing in the US as Compared with UK

In contrast to the reluctance to use the veil-piercing rule by the UK courts, the US courts seem to be more willing to exercise their discretion in veil piercing in order to achieve justice. In the US, veil piercing is the most litigated issue in corporate law.  

An empirical study carried out by Thompson in 1990 found that US courts upheld over 40% of the veil-piercing claims, and this result was confirmed by another study by Oh in 2010.  

The most cited factors by US courts in veil-piercing cases include: (1) fraud or injustice; (2) failure to comply with corporate formalities, such as failures to keep records of shareholder or director meetings; (3) undercapitalisation of a company; and (4) improper domination of an entity described by the courts as instrumentality or alter ego. This list is non-exhaustive because, as in the UK, the US judiciary has failed to develop an overarching and consistent rule of veil

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37 ibid.


piercing. The veil-piercing law in the US has been described to be “enveloped in the mists of metaphor.”

Some US courts have attempted to construct a comprehensive test for veil piercing around the notion of “instrumentality” or the “alter ego.” The instrumentality theory was first articulated by Judge Powel in 1931 to address the liability of a parent corporation for its subsidiaries, but it is also cited in cases concerned with individual shareholders. The most authoritative statement of the instrumentality test is found in Lowendahl v. Baltimore & O.R. Co., which declared that a corporation would be regarded as an instrumentality if three elements could be found: First, the corporation had no independent existence due to control of the defendant. Second, the defendant used such control to commit fraud, wrong or other breaches of the plaintiff’s legal rights. Third, the injury of the plaintiff was proximately caused by the aforesaid "control and breach of duty." Sometimes the US courts use “agency” as a synonym for instrumentality, although it does not mean the same thing as the agency relationship under the common law.

As the instrumentality test is apt to slide into vagueness and unpredictability, some US courts instead adopt a “laundry list” approach, under which they take into consideration various weighted factors. These factors include gross undercapitalisation, nonobservance of formalities, non-payment of dividends, non-functioning of other officers or directors, absence of corporate records, and “the fact that the corporation is merely a façade for the operations of the dominant stockholder or stockholders.” The laundry list approach cannot be said to be a better alternative to the instrumentality test due to the uncertainty

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43 Ottolenghi, “From Peeping Behind the Corporate Veil, to Ignoring it Completely,” 345 (above note 2).

over the weight of each factor, the variance of the list in different cases, and the absence of a principled approach to assessing the factors on the list.

Despite the apparent divergence in their approaches, courts in the UK and US have showed convergence in their reasoning and even language in cases involving veil piercing. Under the case law in both the US and UK, the concepts of façade, instrumentality, or alter ego imply not only control of a company but also using the company for an unjustified purpose. Control of the company is not adequate for piercing the veil and imposing personal liability on directors or controlling shareholders. This is reasonable because if control becomes the only condition to pierce the corporate veil, shareholders of private companies and parents of wholly owned subsidiaries, who are usually active in the management, will all be exposed to unlimited liability. Therefore, use of control for a wrongful purpose is the ultimate test for abuse of corporate form.

Furthermore, as demonstrated by empirical studies, the UK and US courts have demonstrated similar patterns in their veil piercing decisions. First, it has been found that all veil-piercing cases in both the UK and US involve private companies, and no veil of public companies has ever been pierced. This is consistent with the theory that limited liability is more justified in public companies than private companies. Second, empirical studies have also found that in both the UK and US, contractual claims are more likely to cause veil piercing than tort claims. This finding is in conflict with the theoretical analysis because compared with contractual creditors, tort creditors are more likely to

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48 See 2.2.2 (iii).

suffer from excessive risk taking and shareholder opportunism, as they cannot protect themselves by contract.\textsuperscript{50}

The major difference between veil-piercing cases in the UK and US is that veil-piercing decisions are rarer in the UK. In other words, the UK courts are more likely to adhere to the principles of separate legal personality and limited liability established by \textit{Salomon}. One implication of this is that the UK courts are more scrupulous than their US counterparts in citing the open-ended “justice” as the rationale for veil piercing. In the US, justice has been recognised by the courts as the paramount goal being considered in veil-piercing cases. For example, in \textit{Berkey v. Third Avenue Railway},\textsuperscript{51} Justice Cardozo remarked that when the degree of control failed to establish a subsidiary was the agent of its parent corporation, the court would turn to the test of justice. In contrast, the UK courts are reluctant to give justice a decisive role in veil piercing cases. Although in some cases, the UK courts have referred to “justice” in their decisions,\textsuperscript{52} the House of Lords unequivocally stated in \textit{Adams} that it would not pierce the corporate veil merely because it considered it just to do so.\textsuperscript{53}

The relative unwillingness of UK courts to strip away the corporate veil demonstrates a divergence of the judicial role in the UK and the US. While the former usually follows its tradition of judicial deference and assumes a more formalistic pattern in its decisions,\textsuperscript{54} the latter plays a more active role in shaping legal rules. Another reason that may explain the rarity of veil-piercing cases in the UK is that the UK insolvent law already provides for many circumstances under which personal liability will be imposed on directors and

\textsuperscript{50} See 2.2.2 (ii).
\textsuperscript{51} 244 N.Y. 84, 155 N.E. 58 (1926).
\textsuperscript{52} In \textit{Re A Company Ltd.} [1985] BCLC 333 (CA), the court observed that the court would pierce the corporate veil "if it is necessary to achieve justice irrespective of the legal efficiency of the corporate structure." In \textit{Creasey v. Breachwood Motors} [1993] BCLC 480 (QB), the court stated that it would exercise the power of veil-piercing to achieve justice. However, the decision in \textit{Creasey} was later overruled by \textit{Ord & Anorv. Belhaven Pubs} [1998] B.C.C. 607 (A.C.). For a discussion of these cases, see Miller, “Piercing the Corporate Veil Among Affiliated Companies in the European Community and in the US: A Comparative Analysis of US, German, and UK Veil-Piercing Approaches,” 114 (above note 45).
\textsuperscript{53} See the above section discussing \textit{Adams}.
shareholders, like the fraudulent and wrongful trading provisions that will also apply to LLP members.\textsuperscript{55}

In summary, the veil-piercing doctrine has been developed by the judiciary in both the UK and US. In order to achieve justice, judges have used their discretion to decide what constitutes the proper circumstances for veil piercing. The result is that the veil-piercing doctrine seems to be exercised in an erratic and inconsistent way. The next section will focus on the US practice of piercing the veil of partnerships, as the US courts are more willing to exercise veil piercing than their UK counterparts and have already applied it in the non-corporate context.

\textbf{ii. Extending Veil Piercing to Partnerships with Limited Liability}

In both LLPs and limited partnerships under the Anglo-American law, there are exceptions to the liability shield, which can be viewed as the functional equivalents of the veil-piercing rule in the corporate setting.\textsuperscript{56} First, in limited partnerships, limited partners will lose their liability shield if they take part in the control of the business.\textsuperscript{57} Second, a partner of an LLP will not be shielded from the liability caused by her own misconduct and neglect. In the US, LLP acts usually provide that partners are also liable for the conduct of those under their direct control or supervision.\textsuperscript{58} In the UK, the member who directly causes a debt can be held liable through a tort action,\textsuperscript{59} while other members will be required to contribute to the LLP’s assets if their withdrawal of capital has rendered the LLP insolvent.\textsuperscript{60}

Given these exceptions to limited liability in partnerships, the question arises as to whether it is necessary to introduce corporate-style veil piercing into these entities. In the UK, there are few arguments for applying veil-piercing to

\textsuperscript{55} Fraudulent and wrongful trading provisions are provided for in IA 1986, ss 213, 214. Its application to LLP is mandated by UK LLP Regulations 2001 (SI 2001/1090). For more discussion on fraudulent and wrongful trading, see 4.3.1.

\textsuperscript{56} For detailed discussion of liability rule of partnerships with limited liability, see 1.2.2 (ii).

\textsuperscript{57} LPA 1907, s 6.


\textsuperscript{59} LLP 2000, Explanatory Notes.

\textsuperscript{60} Insolvency Act 1986, s 214A.
partnerships with limited liability. It is also unlikely for the UK courts to extend veil piercing to partnerships, considering their circumspection in applying this rule. In the US, it has been argued that the liability shield of limited partnerships, LLPs, and LLCs has become similar to that of corporations. Therefore, it is necessary to extend the veil-piercing doctrine to these entities, or else there will be a great regulatory asymmetry between corporate and non-corporate entities. The counter-argument is that partnerships and LLCs are of contractarian origins and should embody freedom of contract with minimum state interference. However, on closer examination, there are valid grounds for applying veil piercing to limited partnerships, LLPs, and LLCs, and in practice, some US courts have already pierced the veil of non-corporate entities that have extensive liability shields. Here, discussions will be made on each of these entities.

In US limited partnerships, there is still the principle that limited partners will lose their liability shield if they take part in the control of the business. Although the ULPA 2001 has abolished the control rule, many states have not adopted this version of the model law. Therefore, in these states, the control rule will still be one way in which limited partners may be held liable for partnership debts. Also, the estoppel rule under the common law can continue to constrain limited partners. The estoppel rule in the limited partnership context dictates that if creditors of the partnership extend credit on the reasonable belief that the limited partner is in fact a general partner, the limited partner is estopped from denying personal liability to such creditors. While the ULPA 2001 eliminates the control rule, it does not abolish the estoppel rule.

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61 Morrissey, “Piercing All the Veils: Applying an Established Doctrine to a New Business Order” (above note 46).


Although there are already rules restricting the liability shield of limited partners, the veil-piercing doctrine is necessary for US limited partnerships. First, there are states that have abolished the control rule and give limited partners a liability shield almost equivalent to that of corporate shareholders. Second, general partners of limited partnerships should also be subject to the veil-piercing doctrine if they obtain limited liability protection. Although traditionally general partners assume unlimited liability, some US states have adopted the new form of limited liability limited partnership (LLLP), in which all partners have limited liability protection. Finally, even when state law does not provide for the LLLP, the real controller of the limited partnership can obtain limited liability by setting up a corporation to act as the general partner. In this way, the real controller is protected by the limited liability shield of the corporation. This form of arrangement is common in the private equity setting. For such limited partnerships, the veil-piercing doctrine can be used against its corporate general partner to hold the real controller, who stands behind the corporation, to be liable for the partnership debts when there are circumstances of abuse.

In the US, the scope of limited liability protection of partners of LLPs has been extended from tort liability caused by malpractice to ordinary business debts in many states. However, even under such a wide shield of liability, the liability of partners of LLPs is not unrestricted. Partners are liable for their own negligence and misconduct as well as the conduct of those under their direct control or supervision. The supervision or control exception is consistent with Rule 5.1 (c) of the Model Rules of Professional Conduct promulgated by the American Bar Association, which states that:

“A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:

65 See 1.1.1 (iii).
66 See 1.1.1 (ii).
68 Model Rules of Professional Conduct was adopted by the American Bar Association in 1983 and has been adopted by most states. It is available at http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct.html (accessed on May 3, 2013).
(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or
(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.”

Furthermore, this supervision or control exception has been confirmed by judicial practice in the US. In a New York case, Lewis v. Rosenfeld, the court confirmed that LLP partners would not be held liable just because of their membership in the LLP. The plaintiff sued the partners of a law firm on the basis that a partner’s advice induced him to make a loan to a borrower who failed to repay. The court observed that under the New York LLP statute, LLP partners were not liable for the liabilities of the partnership, including tort and contract liabilities, and the only grounds to hold individual partners liable were the liabilities incurred by themselves or those under their direct control or supervision.

In a Connecticut case, Kus v. Irving, the plaintiff attempted to sue the lawyer (Irving) who directly represented her and the two other lawyers in the LLP law firm. The court decided that the two innocent partners shared no benefit in the fee received by Irving and did not have supervision or control of Irving. Therefore, they were not responsible for the liability caused by the actions of Irving.

Besides the statutory exceptions to the liability shield, US case law has indicated that it is also possible for partners of LLPs to lose their limited liability when the court decides to apply the veil-piercing doctrine to the LLP. For example, in Middlemist v. BDO Seidman, the plaintiff sought to hold her supervisor personally liable for breach of her employment contract on the ground that her

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supervisor was responsible for the LLP’s personnel policies. The court observed that “[a] party seeking to hold a partner of a limited liability partnership personally liable for alleged improper actions of the partnership must proceed as if attempting to pierce the corporate veil.” However, the court did not articulate how to apply veil piercing to LLPs and dismissed the plaintiff’s claim on the ground the personnel policies were policies of the LLP, not of the supervisor.

Unlike limited partnership statutes and LLP statutes, most LLC statutes are silent on when the liability shield will be disregarded. The language of LLC statutes of different states vary on the liability shield. However, under all statutes, passive investors of LLCs have a liability shield similar to corporate shareholders, and active participants are shielded from liability caused by acts of others.73 As the LLC has the liability shield that most resembles that of a corporation, US courts are more ready to apply the corporate veil-piercing doctrine to LLCs than to other non-corporate entities. In a case in 1997, Ditty v. CheckRite,74 piercing the veil of an LLC was requested by a plaintiff for the first time.75 Since then until August 5, 2005, the number of rulings on LLC veil piercing has reached sixty-one.76

In Kaycee Land & Livestock v. Flahive,77 a widely-cited Wyoming case, the court considered the question whether to pierce the veil of an LLC and hold its managing member liable for environmental damage caused by the LLC. In deciding this question, the court commented: “We can discern no reason, in either law or policy, to treat LLCs differently than we treat corporations. If the members and officers of an LLC fail to treat it as a separate entity as contemplated by statute, they should not enjoy immunity from individual

76 ibid., 1608.
liability for the LLC’s acts that cause damage to third parties.” However, the court acknowledged that “the various factors which would justify piercing an LLC veil would not be identical to the corporate situation for the obvious reason that many of the organizational formalities applicable to corporations do not apply to LLCs. The LLC’s operation is intended to be much more flexible than a corporation’s.”

An empirical study in 2005 has confirmed that the veil-piercing case law of LLCs shows traits similar to that of corporations, despite the fact that the likelihood of veil-piercing is slightly lower in the LLC cases. First, all veil-piercing decisions have been made against closely held LLCs and not publicly traded LLCs. Second, it is more likely for the courts to pierce the veil of LLCs in contract cases than tort cases.

All in all, the theoretical analysis and judicial practice in the US has confirmed that the veil-piercing doctrine can be applied to partnerships with limited liability. However, as stated by the court in Kaycee Land & Livestock, the factors that lead to veil-piercing decisions should be different in the cases of corporate and non-corporate entities. Accordingly, the courts have to modify the corporate veil-piercing theory according to the characteristics of partnerships with limited liability. First, undercapitalization and non-compliance with formalities will be less relevant in the partnership context, as LLCs and partnerships are not generally subject to the stringent capital requirements and formality rules. For example, lack of legal capital should not be grounds for piercing the veil of professional firms, as they are usually thinly capitalised. Instead, lack of professional insurance can be a factor considered for veil-piercing decisions against professional firms. Second, the two basic elements of veil-piercing — control and use of control for a wrongful purpose — will have disproportionate weight in cases regarding partnerships with limited liability. As owners of LLCs and partnerships are usually involved in the management, the control element.

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78 ibid., 328.
79 ibid., 329.
81 Morrissey, “Piercing All the Veils: Applying an Established Doctrine to a New Business Order,” 559 (above note 46).
itself does not imply abuse, and veil piercing should depend on discovering of a wrongful purpose.

To summarise, in the US, the corporate veil-piercing doctrine has already been applied to partnerships with limited liability. The next section will turn to the statutory veil-piercing rule in China and compare it with the veil-piercing rule under Anglo-American law. Then it will discuss whether it is necessary and possible to apply the corporate veil-piercing rule to Chinese partnerships.

3.3.2 Veil Piercing in China

i. Judicial Role and Development of Corporate Veil-Piercing in China

The article 20 of the Chinese Company Law 2005 states: “Where the shareholder of a company abuses the independent status of the company as a legal person or the limited liability of shareholders, evades debts and thus seriously damages the interests of the creditors of the company, he shall assume joint and several liability for the debts of the company.” This provision is generally regarded as the statutory equivalent to the veil-piercing doctrine in the UK and US. To highlight the particularity of the Chinese veil-piercing rule, here a discussion will be made on its development.

(a) Judicial Interpretations Before the Promulgation of Statutory Veil Piercing

Although the veil-piercing doctrine in China is not developed through case law as in the UK and US, the judiciary, especially the SPC, has played an instrumental role in its development. Before the veil-piercing provision was written into Chinese company law, the SPC had already begun to formulate rules to curb the abuse of the corporate form. It is true that there is no system of stare decisis in China and therefore courts cannot make law by establishing precedents. However, the SPC is exceptional as it can shape law by issuing judicial interpretations, adjudicating cases, and being involved in the statute-making

82 Organic Law of the People’s Courts, article 32.
process.\textsuperscript{83} The development of the veil-piercing doctrine in China is evidence to this point.

In the case of the veil-piercing doctrine, before it was introduced into statutory law with the promulgation of the Company Law 2005, the SPC had issued three judicial interpretations that had in fact provided for circumstances of veil piercing. Under the Company Law 1993, a corporation as an autonomous legal person liable to its own debts with its own assets.\textsuperscript{84} The entity status provided by the Company Law 1993 was essential for SOEs to transform from government affiliates to modern companies. However, very soon cases of abusing the corporate form began to emerge. In response to the requests of the lower courts, the SPC issued judicial interpretations regarding the conditions under which a corporation would lose its separate personality and incur liability for its shareholders. The first one was issued in 1994\textsuperscript{85} to address the liability of a parent company that failed to meet the minimum capital requirement when setting up a new company. The capital contributed by shareholders to a company is called “registered capital” under the Company Law 1993, as shareholders must pay in full the requisite capital before they can register a company. To strengthen the minimum capital requirement, the interpretation in 1994 provided that if the parent company failed to pay in full the registered capital required of its wholly owned subsidiary, it would be liable for the shortfall between the paid-up capital and the requisite capital. Also, if the parent company did not contribute any capital to its subsidiary, the subsidiary’s separate legal personality would be disregarded, and its parent would be held liable for its debts.

In 2001, the SPC started to apply the veil-piercing rule to constrain transfers of corporate assets within a corporate group. In a judicial interpretation issued by

\textsuperscript{83} For detailed discussion on the lawmaking power of the SPC, see 3.3.2 (i).

\textsuperscript{84} Company Law 1993, article 3.

the SPC in 2001, it was stated that if the controller of a company transferred the assets of the company to itself, it would be required to return the assets to satisfy the debts of the company. Further, an SPC judicial interpretation issued in 2003 declared that in the restructuring process of SOEs, if the parent company fraudulently transferred assets of its subsidiaries to evade debts, it would be liable for the debts of the subsidiary. Noticeably, unlike the interpretation in 2001, the interpretation in 2003 did not limit the shareholder’s liability to the amount of assets that it transferred from its subsidiary.

(b) SPC’s Decisions Before the Promulgation of Statutory Veil-Piercing

Besides judicial interpretations, the SPC has also shaped the Chinese veil-piercing doctrine through its decisions. In US Minmetals Inc v Xiamen United Development (Group) Co Ltd (2004), the appellant sought to hold the defendant liable for the debts incurred by its wholly owned subsidiary, Xiamen United Development Import & Export Trading Co (U&D Trading Co). The appellant made its claim on the ground that the defendant had violated regulations by setting up U&D Trading Co as a Sino-Foreign joint venture but failing to meet certain requirements for doing so. After pointing out that there was no direct legal relation between the appellant and the defendant, the SPC identified the main purpose of the appellant was to deny the separate personality of the defendant. The SPC considered whether the defendant’s conduct would constitute abuse of the corporate personality and lead to veil-piercing. It observed that circumstances of shareholder abuse included transferring the corporate assets, evading debts by setting up a new company.

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87 Regulations on Several Issues of Adjudicating Civil Dispute Cases in Relation to Enterprise Restructuring 2003 [关于审理与企业改制相关的民事纠纷案件若干问题的规定 Guanyu Shenli yu Qiye Gaizhi Xiangguan de Minshi Jiufen Anjian Ruogan Wenti de Guiding]. See ibid.,417.

88 The intention of restructuring the SOEs is to adapt them into modern corporations as provided by the company law. See B C Reed, “Clearing Away the Mist: Suggestions for Developing a Principled Veil Piercing Doctrine in China,” Vanderbilt Journal of Transnational Law 39 (2006): 1643.

commingling the corporate and shareholder assets, or arbitrarily interfering with the corporate business to the extent that the company has no real independent operation. By such standards, the defendant, upon examination of the SPC, did not abuse the corporate personality to evade debts, despite the flaws in its establishment.

In another case, *Chengdu Municipality Jinhe Sub-Branch v Sichuan Communications Services Co, Sichuan Jinzu Industrial Co and Sichuan Financial Leasing Joint Stock Co (2003)*, the SPC applied a similar line of reasoning. In this case, the parent company was found to commingle its assets and personnel with its subsidiary and use the loans secured by the subsidiary to finance its own project. Based on the facts, the SPC decided to pierce the corporate veil and hold the parent company liable for the debts of the subsidiary.

From the above discussion, it can be observed that the SPC’s judicial interpretations on veil-piercing and its veil-piercing decisions have been confined to the corporate group context. Furthermore, the factors for veil piercing considered by the SPC, namely failure to contribute to the registered capital, transfer of assets within a corporate group, and commingling of assets and personnel between parent company and subsidiary, reflect the SPC’s concern for problems in the restructuring of large numbers of SOEs during the 1990s. When transforming from governmental affiliates to modern corporations, it was common to see insolvent SOEs set up subsidiaries in order to conceal assets from their creditors. The fundamental reason for the limited scope of the SPC’s guidance on veil piercing is that it does not have power to enact a full-fledged veil-piercing provision to override the separate legal personality provided under the company law. The following section will consider the statutory provision of veil piercing in China.

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(c) Statutory Veil Piercing in China

A fully-fledged veil-piercing doctrine did not exist in China until the Company Law was enacted in 2005. The task of drafting the new company law was assigned to the Law Affairs Office (LAO) of the State Council. During the drafting process, the LAO received many calls for adopting the veil-piercing rule into Chinese company law. One of the most vocal advocates was the SPC, which expressed the necessity of formalising such a rule, drawing on its experience with cases of shareholder opportunism. Under Chinese law, the SPC can participate in the legislative process by submitting legislative bills to the NPC and its standing committee, requesting the standing committee of the NPC to issue law interpretations, and expressing opinions regarding legislative bills under contemplation.

In response to the request for a veil-piercing doctrine, the LAO wrote in the Consultation Draft of the Amendment Bill (Draft) that a controlling shareholder would be jointly liable for the debts of its subsidiary if their personnel, finance, and business were commingled. However, this veil-piercing provision in the draft was met with strong opposition from the State-owned Assets Supervision and Administration Commission (SASAC), which supervises and represents the interests of China’s large SOEs. As a result, the proposed veil-piercing doctrine was not adopted in the end. If the proposed veil-piercing doctrine was adopted, SOEs would be exposed to high risks of veil piercing, given their common practice of commingling assets and personnel with subsidiaries.

The ultimate version of the veil-piercing doctrine, as discussed above, only vaguely states that shareholders will be liable for the company debts if they abuse “the independent status of the company as a legal person or the limited liability of shareholders.” Such vague phrasing enables courts to accommodate

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92 Chao Xi, “Piercing the Corporate Veil in China: How Did We Get There?,” 423-424 (above note 85).
93 ibid., 425.
94 Legislation Law, articles 12 and 24.
95 ibid., article 43.
96 Chao Xi, “Piercing the Corporate Veil in China: How Did We Get There?”, 426 (above note 85).
97 Company Law 2005, article 20.
veil-piercing to specific circumstances of each case. However, it also gives rise to concerns that Chinese courts will produce cases even more inconsistent than those in the UK and US, given the inherent flaws of the Chinese judicial system.

First, the open-ended nature of the veil-piercing doctrine in the Chinese Company Law 2005 means that the courts have to apply it on a case-by-case basis. Due to lack of direction and sophistication, Chinese courts often find it difficult to adapt existing law to new circumstances. It is common for Chinese courts to refuse to accept cases on the ground that they do not fall within the circumstances as prescribed by the law. The result is that cases with novel circumstances are largely ignored unless noticed by the SPC or the legislature. Lack of discretion of Chinese courts will lead to lack of flexibility of the veil-piercing doctrine and its delay in adjusting to new circumstances. In contrast, in the UK and US, although the veil-piercing doctrine has been criticised for being inconsistent and problematic, it has the advantage of being able to respond incrementally to changing social conditions, as judges can make decisions based on specific facts that will be binding on future cases. The practice of some US courts to extend veil piercing to LLCs and LLPs is evidence to the flexibility of the veil-piercing doctrine under the common law.

Second, even if a court decides to adjudicate on new circumstances, its decisions (except for decisions of the SPC) will not be followed by other courts in the absence of stare decisis. This leads to greater possibility for inconsistency of veil piercing in China than in the UK and US. Therefore, in addition to giving wider discretion to judges, China also needs to emulate stare decisis in order to increase the consistency of cases. The guiding cases of the SPC can be viewed as a good start in establishing stare decisis, and the binding effect of cases can be extended to those adjudicated by local courts.

Finally, Chinese courts are far from independent. They have to stay in line with party policy, and they are financially and politically controlled by local

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99 Thompson, “Piercing the Veil: Is the Common Law the Problem,” 624 (above note 73).
100 See 3.2.2 (i).
101 Chinese local courts are funded by local governments. However, there is reform on this under way, see Yiwei Zhang, “Judicial Reform Plan to Be ‘Released Soon’,” globaltimes.cn, March 13,
governments. In cases where veil-piercing claims are made, the local government may force the regional court not to pierce the veil if the company concerned is a major taxpayer or an SOE in which the local or central government is the principal shareholder.

In summary, China did not formally establish the veil-piercing doctrine until it was written into statutory law. Although the veil-piercing doctrine is not developed through case law as in the UK and US, the Chinese judiciary, especially the SPC, has shaped the doctrine in a significant way. Furthermore, the judiciary will continue to play an important role in the further development of veil piercing. However, the development of veil piercing is impeded by the lack of independence, lawmaking power, and professional sophistication of the Chinese judiciary. Due to lack of discretion, the judiciary is unlikely to apply veil piercing to partnerships unless it is explicitly permitted by statutory law. The next section will consider the possibility that the judiciary will extend the veil-piercing rule to partnerships, first by looking at the judicial practice of veil-piercing in China, and then by discussing whether it is necessary to apply veil piercing to Chinese partnerships.

ii. Chinese Veil Piercing in Practice and its Application to Partnerships

(a) Empirical Findings on Chinese Veil-Piercing

A review of Chinese literature reveals that the theory of veil-piercing in China has been heavily influenced by scholarly discussions in the US. Despite so many articles on how to draw on the theory and practice in the US, one has to wonder how the veil-piercing rule really works in China, given such dramatic differences between the legal systems in China and the US. An empirical study, modeled on a US veil piercing study and based on veil piercing cases in China from 2006 to

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2010, has found that the application of the veil-piercing provision under the Chinese company law shows some trends similar to veil-piercing case law in the UK and US. First, all veil-piercing cases in China involve private companies (limited liability companies), and no claim has ever been made to pierce the veil of a public company (joint stock limited company). Second, the veil piercing rate in contract cases is close to but slightly higher than that in tort cases. Third, individual shareholders are more likely to be subject to veil-piercing decisions and be exposed to corporate liability than corporations acting as shareholders of other corporations.

However, there are also dramatic singularities in the Chinese context. First, the veil piercing rate in China is 63.64%, which is much higher than those under the Anglo-American law, and there has been a steady increase in the rate every year since it was first measured in 2006. This demonstrates that Chinese courts are ready to protect creditors with the veil-piercing provision. Second, the veil piercing rate in less developed regions of China is generally higher than that in developed regions. For example, the veil piercing rate has reached 93.75% in Henan Province and 80% in Sichuan Province, while the rate is only 62.07% in Zhejiang Province and 41.67% in Guangdong Province. This may be explained by the fact that abuse of corporate form and failure to comply with corporate formalities is more prevalent in less developed regions. Third, it is very rare for the courts to disregard the separate personality of SOEs. This is consistent with the analysis above, that the local governments have strong incentives to prevent the corporate veil of SOEs from being pierced.

Finally, the factors that lead to veil-piercing decisions in China are different from those in the UK and US context. The major factors considered by Chinese

104 Hui Huang, “Piercing the Corporate Veil in China: Where is it Now and Where is it Heading,” American Journal of Comparative Law 60, no. 3 (2012): 752.
105 Ibid., 757.
106 Ibid., 749.
107 In the US, the veil piercing rate is about 40%. See 3.3.1 (i).
108 Huang, “Piercing the Corporate Veil in China: Where is it Now and Where is it Heading,” 750 (above note 104). Zhejiang and Guangzhou are China’s most developed regions, while Sichuan and Henan are relatively less developed.
109 Ibid., 773.
110 Ibid., 760.
courts include commingling of assets, business, or personnel, fraud, undue control, and undercapitalisation. Among these factors, commingling is the most common complaint alleged by plaintiffs. This can be explained by the fact that cases issued by the SPC have confirmed and stressed commingling as a valid ground for veil piercing.\textsuperscript{111} Fraud is second to commingling in the frequency of appearance, but it has the highest success rate among all the factors. Undercapitalisation only appeared in one case (which did not result in veil piercing) out of the 118 cases examined by the study.

All in all, this study has indicated an active role of veil piercing under the Chinese company law. However, it is unlikely for the courts to apply veil piercing to Chinese partnerships, as ordinary partners assume unlimited liability and the liability shield of partners in LLPs and limited partnerships is very restricted. This will be further discussed below.

(b) Applying Veil Piercing to Chinese Partnerships?

In limited partnerships, the PEL provides that a limited partner “shall not manage partnership affairs or represent the partnership in its relations with people outside the partnership.”\textsuperscript{112} Besides this management rule, the liability shield of limited partners is also restricted by the “estoppel rule” under the PEL.\textsuperscript{113} The PEL estoppel rule is similar to the estoppel rule under the common law.\textsuperscript{114} It provides that limited partners holding themselves out to third parties as general partners will be liable to such third parties for the partnership’s debts. Also, limited partners will be liable for losses caused by unauthorised execution of the partnership’s affairs.\textsuperscript{115} On the other hand, partners of SGPs are shielded from liability only when other partners incur debts by intentional acts or gross negligence in the course of business of the partnership.\textsuperscript{116} As to SGP debts incurred in other circumstances, partners still assume unlimited liability.\textsuperscript{117}

\textsuperscript{111} See previous discussion on the SPC’s veil piercing decisions 3.3.2 (i).
\textsuperscript{112} PEL 2006, article 68. See 1.1.2 (iii).
\textsuperscript{113} PEL, article 76.
\textsuperscript{114} See Chapter 1, note 115 and the accompanying texts.
\textsuperscript{115} PEL, article 98.
\textsuperscript{116} PEL, article 57.
\textsuperscript{117} For a discussion on the liability rule of Chinese limited partnerships and SGPs, see Chapter 1.
Therefore, it is currently unnecessary to apply veil piercing to SGPs and limited partnerships because partners of SGPs are liable for partnership debts under most circumstances. As to limited partnerships, if there is a need to pierce the liability shield of limited partners, courts can do so under the provisions of the “management rule” and “estoppel rule.” Due to lack of discretion, it is unlikely that Chinese courts will apply the veil-piercing doctrine to partnerships before it is extended to partnerships by statute or by SPC judicial interpretation.

However, it is not to say the veil-piercing doctrine is irrelevant for Chinese partnerships. First, the veil-piercing doctrine can be relevant for limited partnerships when its general partner is a company. A corporate general partner is usually designed to shield true controllers from unlimited liability. Many private equity partnerships are organised in this form. When the true controllers engage in fraud or other misbehaviour, courts can use the corporate veil-piercing provision to hold true controllers liable.

Second, in the future, it is possible that Chinese limited partnerships and SGPs will be given broader liability shields, and then veil piercing will be necessary to constrain abuse of those partnerships. Currently, the liability shield of these partnerships is vague and restricted. There is no provision specifying what constitutes management and triggers loss of the liability shield for limited partners, and it is also unclear whether the safe harbour list provided by the PEL is exhaustive. However, the narrow liability shield of SGPs cannot fully meet the demand of Chinese law and accounting firms, which are expanding rapidly both domestically and internationally. When a firm has operations in different cities, it is unreasonable to require a partner to be liable for the mistake of others who work far away and whom she cannot directly control or oversee. Therefore, in the future, it is possible that China will amend partnership law to clarify and provide for broader liability shields for both limited partnerships and SGPs. When the partners have acquired liability shields similar to those of corporate shareholders, as is the case in the US, it will become necessary to apply the veil-piercing doctrine to the partnership setting.
Summary of 3.3

In the UK, US, and China, veil piercing is the last resort under the corporate law after other means of creditor protection have failed. The most significant difference between the veil-piercing rule in China and in the UK and US is that while the former was formally established by statute, the latter was developed through case law. This reflects a fundamental institutional difference between China and common law jurisdictions. Based on a civil law model, China has its national legislature, the NPC, at the center of its lawmaking. Therefore, a legal rule that permits overriding the separate personality of a company is not formally established until it is promulgated by the NPC.

However, although the Chinese judiciary lacks the lawmaking power of their common law counterparts, they have nevertheless played an instrumental part in shaping the veil-piercing doctrine. Before the veil-piercing provision was written into law, the SPC had already provided for circumstances that justify piercing the corporate veil, through its judicial interpretations and guiding cases.

Since the veil-piercing provision was written into the company law, the Chinese courts have been active in using it to constrain abuses of the corporate form. It can be concluded that the Chinese courts will continue to shape the veil-piercing doctrine through their adjudication of cases. However, like fiduciary duties, the effectiveness of the veil-piercing rule depends on the competency of the Chinese judiciary due to its open-endedness. Further, owing to lack of lawmaking power, it is unlikely for Chinese courts to apply veil piercing to partnerships, due to lack of lawmaking power. It is also unnecessary for courts to pierce the veil of partnerships under current law because the liability shield of Chinese limited partnerships and SGPs is very restricted. However, as demonstrated by the practice in the US, if China gives partners a liability shield similar to that of shareholders in the future, it will become necessary for courts to apply veil piercing to partnerships.
Conclusion of Chapter 3

This Chapter has examined the measures for creditor protection that fall outside the formal insolvency procedure. It has been argued that Chinese creditors will continue to rely on mandatory rules for protection due to the existing legal and institutional obstacles to self-protection. The legal capital rule, one of the mandatory rules that are aimed at creditor protection, has found to be ineffective for this purpose and has grown out of fashion in the UK, US and China. In fact, liability insurance is a more cost-effective substitute for legal capital in order to provide compensation for creditors. Therefore, there is no reason to introduce corporate-style legal capital into partnerships with limited liability and instead, a mandatory liability insurance can be imposed. This is the practice for professional partnerships in many jurisdictions including the UK and China.

Further, fiduciary duties and the veil-piercing rule, two measures that can directly impose liabilities on directors and partners have been examined. Fiduciary duties are relevant to creditors’ protection to the extent that they reduce the internal conflicts between owners and managers of the businesses. Therefore, a minimum level of fiduciary duties should be preserved in corporations as well as in partnerships. In China, fiduciary duties in partnerships should be promulgated and clarified. As to the rule of veil-piercing, it is a drastic measure for creditor protection and should not be applied when there are alternatives. However, it can be particularly useful in China where the law always lags behind the fast-changing facts and it can be applied to partnerships when limited liability further expands into the partnerships.

Nevertheless, it needs to be stressed that the effectiveness of these open-ended rules is limited. In both the UK and US, their uncertainty and theoretical confusion has been sufficiently noticed. Due to the lack of judicial law-making power in China, the application of fiduciary duties and the veil-piercing rule is likely to be more problematic. To improve the effectiveness of fiduciary duties and veil-piercing, Chinese judiciary should be further strengthened. More importantly, open-ended rules such as fiduciary duties and veil-piercing should only assume a complementary role in creditor protection. The main task of creditor protection should be bestowed on the more specific rules in the insolvency procedure. This will be further discussed in the next chapter.
Chapter 4 Creditor Protection in Insolvency

Introduction to Chapter 4

With the promulgation of the Enterprise Bankruptcy Law (EBL) in 2006, China made another leap in its institutional transition into market economy. The law’s purpose is stated in the first article as “regulating the procedure for enterprise bankruptcy, fairly settling claims and debts, safeguarding the lawful rights and interests of creditors and debtors, and maintaining the order of the socialist market economy.”

However, the Chinese bankruptcy law still cannot accurately be described as market-oriented. It still contains inconsistent rules and sometimes sacrifices efficiency in individual cases for political considerations. Bankruptcy cases are still subject to widespread state interference.\(^1\) On the other hand, bankruptcy law in China is not fundamentally different from its counterpart in the UK and US. However, the differences in specific rules and their application in practice make bankruptcy law in the UK and US more likely to achieve a fair and efficient distribution for creditors as a whole.

This chapter will assess Chinese bankruptcy law with a comparison to its UK-US counterparts, with a focus on the partnership bankruptcy regime. In subchapter 4.1, an overall inquiry will be made into the perceived flaws of Chinese bankruptcy law, and suggestions will be made based on a comparison with the UK-US bankruptcy law. Discussions will be focused on partnerships in subchapter 4.2. Chinese partnerships are permitted to use the bankruptcy liquidation procedure as provided by the bankruptcy law. However, current rules regarding partnership bankruptcy are mostly vague, and detailed rules for applying bankruptcy law to partnerships have not been formulated. Finally, the issue of directors’/partners’ direct duties to creditors, which are enforced in the bankruptcy procedure, will be discussed in 4.3.

Before embarking on any discussion of insolvency, a clarification of the meanings of “insolvency” and “bankruptcy” needs to be made. In the US context,

\(^1\) See 4.1.3.
“insolvency” is usually used to describe a financial state and has two connotations. First, it can refer to the inability to pay debts as they fall due (equity or cash-flow insolvency). Second, it can refer to the situation where a debtor’s liabilities exceed its assets (balance sheet insolvency). The generic term for the legal procedure of being declared insolvent for both enterprises and individuals is “bankruptcy.” In the UK, the formal procedure of being declared insolvent is referred to as “insolvency” for enterprises and “bankruptcy” for individuals. It is worth noting that in Scotland, the insolvency procedure for individuals is referred to as “sequestration.” As the UK bankruptcy regime as discussed here mostly refers to the English bankruptcy regime, Scots law will only be tangentially considered.

China has used *Pochan* (*破产*) as the generic term for the legal procedure to declare insolvency and has translated it as “bankruptcy” in all legal documents. With the absence of individual bankruptcy under current Chinese law, “bankruptcy” in China refers only to enterprise bankruptcy.

### 4.1 Chinese Bankruptcy Regime and Recommendations Based on UK and US Experiences

#### 4.1.1 Introduction to Chinese Bankruptcy Law

i. From the Bankruptcy Law 1986 to the Enterprise Bankruptcy Law 2006

The current bankruptcy legislation in China, the Enterprise Bankruptcy Law (EBL), promulgated in 2006, is a statute that recognises the basic principles embodied in Anglo-American bankruptcy law and bankruptcy law in the developed world as a whole. Specifically, creditors should be treated equally, and the debtor should have a fresh start.

The predecessor of the EBL, the Interim Enterprise Bankruptcy Law 1986, was totally different. The central aim of the Bankruptcy Law 1986 was to serve the

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state policy of closing loss-making SOEs and shifting resources to the private sector. It only applied to SOEs while the bankruptcy of private and foreign-invested enterprises were subject to another set of rules. Sacrificing efficiency and fairness for political aims could be found both in the language and application of the Bankruptcy Law 1986. For example, it placed employees at the top of the creditors’ ranking as a way of maintaining social stability while and shutting down SOEs with large layoffs.

The study on bankruptcy of Chinese SOEs carried out by the World Bank in 2000 found that the bankruptcy process under the Bankruptcy Law 1986 was unfriendly to creditors and that creditor banks commonly recovered only 3-10% of their claims. Furthermore, the bankruptcy procedure seemed to fail to achieve an efficient allocation of resources, and the procedure was prone to irregularities. Finally, laid off employees of large SOEs were usually entitled to a substantial amount of compensation, which may exhaust the firm’s assets available to creditors.

With the rapid development of China’s socialist market economy, the Bankruptcy Law 1986 clearly could no longer cope with the circumstances a decade on from its enactment. The EBL 2006 came at a right time when the world was faced with a drastic economic downturn and the economic growth of China was slowing down, leading to soaring business failures and job cuts. On its face, the EBL made great progress from the Bankruptcy Law 1986. First, it unified the bankruptcy law of state-owned and private enterprises into one bankruptcy regime. Second, Under the EBL, for the first time financial institutions were permitted to go bankrupt. Third, the EBL adopted three bankruptcy procedures that corresponded to the bankruptcy procedures of sophisticated legal jurisdictions, including the UK and US. In particular, it introduced the new procedure of reorganisation. It also mandated that an independent administrator

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6 ibid.

7 ibid.

8 EBL 2006, article 134.
supervise bankruptcy procedures. The bankruptcy procedures under the EBL 2006 will be further discussed in the following subsection.

ii. The Bankruptcy Procedures under the EBL 2006

There are three bankruptcy procedures under the EBL: liquidation, reorganisation, and conciliation (or compromise). All of these can be initiated by a debtor’s voluntary filing and creditors can apply for procedures except for conciliation. Liquidation is the procedure to sell the company’s assets and distribute its proceeds to creditors. Although in China bankruptcy is usually used only by companies, partnerships are permitted to use the bankruptcy liquidation procedure. Conciliation is a voting system under which the debtor and its creditors can reach an agreement regarding restructuring of its debts. It does not require involvement of an administrator. A conciliation agreement must be accepted by a majority of creditors who are present and have the right to vote at a creditors’ meeting; such creditors must represent more than two-thirds of the total unsecured debt, and the agreement must subsequently be approved by the court.

Reorganisation is a process designed to restructure the debtor’s debt under the control of an administrator. The debtor may manage its property by itself under the supervision of an administrator upon approval by the court. The central document of the reorganisation procedure is the reorganisation plan. The reorganisation plan must include: (1) the debtor’s plan for business operations; (2) classification of the creditors’ claims; (3) the plan for the adjustment of the claims; (4) the plan for payment of the claims; (5) the period of time for implementing the reorganization plan; (6) the period of time for supervising the implementation of the reorganization plan; and (7) other plans conducive to the

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9 However, as discussed later, officials are still in control of the bankruptcy process.
10 EBL 2006, article 7.
11 PEL 2006, article 92, see 5.2.
12 EBL 2006, articles 97, 100.
14 ibid., article 73.
debtor’s reorganization. Debts are classified into secured debts, employee claims, taxes, and common claims. Creditors are classified into different groups based on their type of debt. The reorganisation plan must be approved by a majority of each of the voting groups attending the creditors’ meeting, and they must represent more than two-thirds of the total amount of each category of debt. Upon passing the creditors’ meeting, the reorganisation plan must be approved by the court. The court can approve the plan even if not all voting groups accept the plan, if the plan meets following conditions: (1) secured creditors, employees, and taxes will be fully paid; (2) unsecured creditors will be paid at a ratio not lower than what they would have been paid in a liquidation procedure; (3) the interests of capital contributors are adjusted in a fair manner; (4) creditors of the same voting group are treated equally, and creditors are paid in accordance with the priority rank as provided by Article 113; and (5) the plan of business operation is practicable. As will be discussed in the following subsection, the procedures under the Chinese bankruptcy law are similar to those in the UK and US.

iii. The Convergence of Chinese Bankruptcy Procedure

The bankruptcy procedures under the Chinese bankruptcy law are similar to those under the US Bankruptcy Code (BC) 1978. The main provisions for bankruptcy procedures of companies, non-farming partnerships, and LLCs are contained in Chapter 7 and Chapter 11 of the BC. Chapter 7 provides for the liquidation procedure, which is overseen by a court-appointed trustee. Under Chapter 7, the debtor firm will be closed and its management displaced. The trustee will sell the debtor’s assets and distribute the proceeds to creditors. Chapter 11 provides for the reorganisation procedure, and it does not require firms to be insolvent to use the procedure. Unlike under Chinese reorganisation, which is largely controlled by the administrator, Chapter 11 permits a firm to work out a reorganisation plan with creditors and remain in operation. During this process, directors will remain in control and the firm will be referred to as

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15 ibid., article 81.
16 ibid., article 82.
17 ibid., article 84.
18 ibid., article 87.
20 ibid., p 9.
the debtor-in-possession (DIP). The DIP will pay its pre-bankruptcy debt with post-bankruptcy income.\textsuperscript{21} The purpose of Chapter 11 is to rescue businesses that are worth more as a going concern than being liquidated.\textsuperscript{22}

The UK bankruptcy procedures are also similar to those provided by the Chinese bankruptcy law. In the UK, the key statutes for bankruptcy are the Insolvency Act (IA) 1986, Enterprise Act (EA) 2002, and Companies Act (CA) 2006. Under these laws, there are five forms of insolvency procedure available to insolvent companies: (1) liquidation, (2) administration, (3) administrative receivership (receivership), (4) company voluntary arrangement (CVA), and (5) scheme of arrangement (scheme).\textsuperscript{23} Partnerships, including limited partnerships and general partners, can choose among liquidation, administration, and partnership voluntary arrangement (PVA). The UK LLP has an additional option of receivership, since the corporate insolvency regime applies to LLPs.

Similar to the Chinese conciliation procedure, voluntary arrangements and schemes are two voting systems aimed at facilitating out-of-court negotiation.\textsuperscript{24} These two mechanisms are used to restructure a company’s debts with the favorable vote from the majority of the creditors and the court approval. Both administration and receivership are formal rescue procedures that can achieve reorganisation and are controlled by a licensed insolvency practitioner (either an administrator or receiver). However, these two procedures are fundamentally different due to the fact that receivers and administrators are in different legal positions with different duties. An administrator “must perform his functions in the interests of the company’s creditors as a whole”\textsuperscript{25} and “must perform his functions as quickly and efficiently as is reasonably practicable.”\textsuperscript{26} In contrast, the primary duty of a receiver, appointed by floating charge holders, is to

\textsuperscript{21} ibid., p 12-13.


\textsuperscript{24} ibid., 157.

\textsuperscript{25} IA 1986, Sch B1, paras 3.

\textsuperscript{26} ibid., para 4.
recover the debt for her appointing creditor. The corollary of this is that receivership tends to lead to piecemeal liquidation and high administrative costs, as receivers have few incentives to pursue a going concern sale or reduce costs as long as their appointing creditors are repaid. The limitation placed on secured creditors’ rights to initiate a receivership by the EA has greatly strengthened UK bankruptcy law as a collective procedure for the interests of all creditors.

Summary of 4.1.1

In summary, the Chinese EBL is a sophisticated statute that embodies the basic principles of modern bankruptcy law, that creditors should be treated equally and that debtors should have a fresh start. It has provided for procedures similar to those under UK and US bankruptcy law. The following section will describe the central rules of the Chinese bankruptcy law so that there will be a basis for further discussion.

4.1.2 Central Rules of the Chinese Bankruptcy Law

i. Financial Standard for Applying For Bankruptcy

The EBL provides two circumstances under which companies can voluntarily file for bankruptcy. First, when a debtor is unable to pay off debts that fall due (cash flow insolvency) and lacks the assets to meet debts (balance sheet insolvency), the debtor can choose among the liquidation, reorganisation, or conciliation procedures. Second, when a debtor clearly lacks the ability to pay off debts, it can file for reorganisation. The first option, the simultaneous

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27 Goode, Goode on Principles of Corporate Insolvency Law, 282 (above note 3).
29 The EA limits the secured creditor’s right to appoint a receiver to a few exceptional cases. See IA 1986, s 72.
30 EBL 2006, Article 2: “Where an enterprise legal person cannot pay off his debts due and his assets are not enough for paying off all the debts, or he apparently lacks the ability to pay off his debts, the debts shall be liquidated according to the provisions of this Law. Where an enterprise legal person is under the circumstances as specified in the preceding paragraph or he has clearly lost the ability to pay off his debts, he may undergo reorganization according to the provisions of this Law.” An enterprise legal person refers to a corporation under current Chinese law.
satisfaction of both cash flow insolvency and balance sheet insolvency, is relatively stringent. Perhaps to encourage firms to use the reorganisation procedure to revive before they fall into insolvency, the EBL adds a second option for companies to use the reorganisation procedure. However, it is unclear what it really means by “clearly lost the ability to pay off debts.” As to involuntary bankruptcies filed by creditors, only the cash-flow standard is required. The EBL provides that creditors can file for reorganisation or liquidation when the debtor cannot pay debts due.\textsuperscript{31}

Compared with company bankruptcy, partnership bankruptcy is more straightforward. The partnership law stipulates that the condition for a partnership to file for bankruptcy is its inability to pay off the debts due.\textsuperscript{32} While both creditors and the debtor company can file for company bankruptcy, only creditors can file for partnership bankruptcy.

\textbf{ii. Start of Bankruptcy Case and Automatic Stay}

Under the EBL, a bankruptcy case commences only when the court accepts it. The court will have fifteen days to decide whether to accept a bankruptcy application and can extend the time for another fifteen days under special circumstances upon approval by the court at the next higher level.\textsuperscript{33} The acceptance of a bankruptcy case will trigger a stay on creditors’ actions against the debtor started before the commencement of the bankruptcy case and execution of the debtor’s property.\textsuperscript{34} Payments to individual creditors after the commencement of the bankruptcy case are invalid.\textsuperscript{35} However, the stay has only limited effects. When the administrator takes over the bankruptcy estate, actions against the debtor will continue. Also, new actions filed against the

\begin{itemize}
\item \textsuperscript{31} EBL 2006, article 7.
\item \textsuperscript{32} PEL 2006, article 92: “Where a partnership is unable to pay off the debts due, its creditors may, according to law, apply to a people’s court for bankruptcy liquidation of the partnership, or demand that the general partners pay off such debts.”
\item \textsuperscript{33} ibid., article 10.
\item \textsuperscript{34} ibid., article 20.
\item \textsuperscript{35} ibid., article 19.
\item \textsuperscript{36} ibid., article 16.
\end{itemize}
debtor after commencement of the bankruptcy are permitted as long as they are filed with the court that accepts the bankruptcy case.37

iii. Control of the Bankruptcy Procedure

Under the EBL, the court-appointed administrator is in control of the bankruptcy process.38 The exception is that in the reorganisation process, the debtor may manage its property by itself under the supervision of an administrator upon approval by the court.39

The administrator may be a professional selected from qualified law firms or accounting firms or an interim liquidation committee usually consisting of government officials.40 The administrator has a wide range of powers to manage and recover the bankruptcy estate of the debtor company.41 The administrator is subject to duties of diligence and loyalty.42 If the administrator fails to fulfill these duties and causes losses to a creditor, the debtor, or a third party, the administrator is liable for compensation.43

The administrator will report to the court and is supervised by the creditors’ meeting and the creditors’ committee.44 Creditors whose debts have been declared have the right to attend creditors’ meetings and are entitled to vote.45 Besides supervising the administrator, creditors’ meetings will resolve on the reorganisation plan, conciliation agreement, management plan of the debtor’s assets, and distribution plan of assets, among other issues.46 The creditors’ meeting can decide to establish a creditors’ committee, which must include a

37 ibid., article 21.
38 ibid., article 24.
39 ibid., article 73.
40 ibid., article 24.
41 ibid., article 25.
42 ibid., chapter four.
43 ibid., article 27.
44 ibid., article 130.
45 ibid., article 23.
46 ibid., article 59.
47 ibid., article 61.
representative of employees and has no more than nine persons. The creditors’ committee will monitor the management and distribution of the debtor’s assets, propose to convene a creditors’ meeting, and exercise other powers delegated by the creditors’ meeting. The administrator must report to the creditors’ committee for important actions of disposing the debtor’s assets. In the absence of a creditor’ committee, the administrator must report these actions to the court.

iv. Void and Voidable Actions

To preserve the debtor’s assets available to creditors, the EBL has introduced concepts of voidable and void transactions. Article 31 states that an administrator shall have the right to request the court to void the following actions taken by the debtor within one year before the court accepts the application for bankruptcy: (1) transferring assets for no consideration; (2) trading at an obviously unreasonable price; (3) setting a charge on its assets for an unsecured creditor; and (4) abandoning claims. Further, article 32 provides that payments to creditors within six months before the court accepts the application for bankruptcy and when the debtor is insolvent are also voidable. Two actions that can severely undermine interests of creditors are deemed as void under the Article 33: (1) concealing or transferring assets to evade payment of debts and (2) fabricating debts or acknowledging debts that do not exist. It is necessary to distinguish between voidable and void actions, although both can nullify actions of the debtor and restore its property. The most important difference is that voidable actions are binding unless voided by the court while void actions are deemed to have no legal effects from the start. In addition, voidable actions must be challenged within a time limitation, while void actions have no such limitation.

\[48\] ibid., article 67.
\[49\] ibid., article 68.
\[50\] ibid., article 69.
v. Executory Contracts

Under the EBL, the administrator can decide whether to terminate or perform a contract that contains obligations that remain to be fulfilled by the debtor and the other contracting party.\(^{52}\) The administrator is required to notify the other party of the decision within two months from the date when the bankruptcy application is accepted or 30 days from the date when the other party requests a reply. The contract shall also be deemed terminated when the administrator fails to provide guarantee for the continued performance of the contract at the request of the other party.

vi. Priority

Under the EBL, secured creditors will be paid first, to the extent of the value of their security.\(^{53}\) Then come creditors who are granted priority by law. The order of priority claims under the EBL is: administrative costs, debts incurred after commencement of the bankruptcy procedure for the common benefit of creditors, claims of employees, and tax claims.\(^{54}\) Other unsecured creditors will only be paid after secured creditors and priority creditors are paid. However, article 132 provides that employees’ claims that occurred prior to the promulgation of the EBL in 2006 and existed until the EBL went into effect in 2007 shall be paid from the specific assets in priority to creditors that are secured by those assets.\(^{55}\)

Summary of 4.1.2

In summary, the EBL contains rules that are essential to a modern bankruptcy statute. Similar provisions can also be found in the UK and US bankruptcy law.

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\(^{51}\) An executory contract is “a contract that remains wholly unperfomed or for which there remains something still to be done on both sides.” See Garner, *Black's Law Dictionary*, 977 (above note 2).

\(^{52}\) EBL 2006, article 18.

\(^{53}\) EBL 2006, article 109.

\(^{54}\) EBL 2006, articles 41, 42, 43 and 82.

However, as will be discussed below, its operation in reality sets it far apart from the UK and US bankruptcy law.

4.1.3 Assessment of Chinese Bankruptcy Law and Lessons from the UK and US

i. The Aims and Objectives of Bankruptcy Law

Formal bankruptcy procedure in essence is a collective mechanism for individual creditors to collect their debts. Without such mechanism, individual creditors will pursue their debts on their own, and they will cause damages to the value of the debtor firm and consequently their own interests.

Bankruptcy law can produce extra value for creditors in three ways. First, it can reduce the strategic costs of individual creditors pursuing their debts. When creditors cannot reach a collective solution, they will race to the courthouse and attempt to beat others in order to be repaid. This will not only result in costs for individual creditors but also may cause the firm to liquidate prematurely. Second, bankruptcy law can increase the aggregate pool of assets. Individual collection of debts may cause the firm to sell its assets piecemeal and reduce the value of the firm's assets. In comparison, a statutory procedure that ensures organised collection of debts is more likely to keep the firm's assets together and get a higher value for the firm's assets. Third, bankruptcy law can improve administrative efficiencies by determining the amount of the debtor's assets and claims on its assets in a collective way. Without the bankruptcy law, every creditor trying to collect her debts will need to investigate these issues.

The role of bankruptcy law as a collective mechanism for debt collection has been recognised internationally. For example, with the aim to foster effective and efficient bankruptcy law, the Legislative Guide to Insolvency Law promulgated by the United Nations Commission on International Trade Law (UNCITRAL) in 2004 has stressed the aims of bankruptcy law to maximise the

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value of assets available to creditors and to achieve an efficient and equitable distribution of assets.\textsuperscript{57}

Promulgated after the UNCITRAL guide, the Chinese EBL 2006 has assimilated the notion that bankruptcy law is a collective procedure to settle debts fairly and to protect the rights and interests of both creditors and debtors.\textsuperscript{58} With the advent of the EBL, Chinese bankruptcy law no longer serves only political goals. This is a milestone in China’s market-oriented legal reform. However, the Chinese bankruptcy law is still far from the “efficient and effective” bankruptcy regime envisaged by the UNCITRAL guide.

As China is moving into a market-based economy, it is imperative to establish a bankruptcy regime that defers to efficiency, private interests, and the law of the market. Here, an assessment will be made on the Chinese EBL against the standards of efficient and effective bankruptcy law proposed by the UNCITRAL guide. At the same time, the bankruptcy rules in the UK and US that can be drawn on by Chinese bankruptcy law will be discussed.

\textbf{ii. Assessment of Chinese Bankruptcy Law Against the UNCITRAL Guide}

\textbf{(a) Timely, Efficient, and Impartial Resolution of Insolvency}

The most basic requirement for timely and efficient insolvency law is a clear and objective criterion of insolvency, so that non-viable and inefficient businesses can be liquidated in time and viable businesses can be saved.\textsuperscript{59} However, the financial standard for initiating the bankruptcy procedure is confusing under Chinese bankruptcy law. While voluntary filing for bankruptcy requires passing both the balance sheet and cash flow standards, involuntary filing only requires the debtor to be unable to pay its debts. At the same time, the law provides that the debtor can file for reorganisation when it “clearly lacks the ability to pay off debts.”\textsuperscript{60} Clearly, these rules need to be clarified and simplified.


\textsuperscript{58} EBL 2006, article 1.

\textsuperscript{59} “UNCITRAL Legislative Guide on Insolvency Law” (above note 57).

\textsuperscript{60} See 4.1.2 (i).
Bankruptcy statutes in the US and UK provide good examples when it comes to defining the financial standard for entering the bankruptcy process. Under the US Bankruptcy Code, the concept of insolvency is defined in terms of balance sheet insolvency. It refers to the financial condition that the sum of an entity’s debts is greater than all of its property. Under the UK insolvency law, insolvency is defined both in the sense of cash flow insolvency and balance sheet insolvency. A company is deemed to be insolvent if it is unable to pay its debts when the debts fall due or if its liabilities exceed its assets. Either the US or the UK criterion of insolvency would be more reasonable than the current insolvency criterion in China.

Another flaw that undermines the timeliness of Chinese bankruptcy procedure is that a court will refuse to contemplate a bankruptcy case if it finds that the case cannot be accepted. Unlike in the US and UK where a bankruptcy case formally starts upon filing with the court, in China a bankruptcy case commences only when the court decides to accept it. The court has fifteen days to decide whether to accept the bankruptcy case and can prolong the time for decision.

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61 BC § 101 (32):

“The term 'insolvent' means—

(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation, exclusive of—

(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and

(ii) property that may be exempted from property of the estate under section 522 of this title;

(B) with reference to a partnership, financial condition such that the sum of such partnership’s debts is greater than the aggregate of, at a fair valuation—

(i) all of such partnership’s property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and

(ii) the sum of the excess of the value of each general partner’s non-partnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner’s non-partnership debts....”

62 IA 1986 s 123:

“(1) A company is deemed unable to pay its debts—(a) if a creditor (by assignment or otherwise) to whom the company is indebted in a sum exceeding £750 then due has served on the company, by leaving it at the company’s registered office, a written demand (in the prescribed form) requiring the company to pay the sum so due and the company has for 3 weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor ....

(2) A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company’s assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.”

63 EBL 2006, article 10. See 4.1.2 (ii).
upon approval of the court on a higher level. During the time when the court is considering whether to accept the case, new transactions may be created between the debtor and third parties and there are also chances for the debtor to hide or fraudulently transfer its assets. To preserve the bankruptcy estate in the interests of creditors, the start of a bankruptcy procedure should have retrospective effects to the date that the petition of bankruptcy is filed. To be specific, provisions such as automatic stay and voidable transactions should be applied retrospectively to transactions after the petition for bankruptcy is filed and before it is accepted. However, the retrospectivity of the bankruptcy procedure will be unfair to third parties who enter into transactions with the debtor without knowledge of the bankruptcy petition. To balance the interests between creditors and third parties, a petition for bankruptcy should be registered in a publicly-accessible registry once it is filed. In this way, third parties will be able to make an informed decision on whether to take risks with a potential bankruptcy debtor.

Finally, the criteria for the court to decide whether to accept a bankruptcy application are unclear. Only one thing is certain: the government has great influence on the court’s decision whether to accept the bankruptcy case. First, bankruptcies of listed companies need to be approved by related provincial governments and the China Securities Regulatory Commission (CSRC) prior to acceptance by the courts. Second, bankruptcy cases are governed by the court at the place where the debtor resides. As local governments are often unwilling to see enterprises within their jurisdiction going to bankruptcy, they will try to influence the courts, which are financially and politically controlled.

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64 EBL 2006, article 10.
65 Provisions of automatic stay and voidable actions will be further considered in the next section.
66 In the UK, the public can already check if a company is in the insolvency procedure online. See https://www.gov.uk/find-out-if-a-company-is-in-financial-trouble; https://roi.aib.gov.uk/roi.
68 EBL 2006, article 3
69 Chinese local courts are funded by local governments, however, there are reform on this under way. See Yiwei Zhang, “Judicial Reform Plan to Be 'Released Soon',' globaltimes.cn, March 13, 2014, http://www.globaltimes.cn/content/848083.shtml#.UynDuK1_s2U (accessed on March 29, 2014).
by local governments. Therefore, Chinese courts may reject bankruptcy cases simply because of the influence of the local government.

Besides control over the start of bankruptcy, the state also has a strong presence in the process of bankruptcy cases, which undermines the impartiality and efficiency of the bankruptcy procedure. In the case of state-owned or state-controlled companies, local governments of the region where the debtor company is located usually organise liquidation committees to act as administrators. The government can also be involved in an insidious way by organising interim working teams to interfere with the work of court-appointed administrators. In many cases, the interim working teams, rather than the administrators, are actually in control of the bankruptcy cases. Even bankruptcies of private companies may be subject to governmental interference if they are regarded critical to the local economy. In practice, an interim liquidation committee consisting of governmental officials is often in charge of bankruptcy cases.

To sum up, the Chinese bankruptcy law has failed to meet the standard of “timely, efficient, and impartial” due to the lack of reasonable rules on initiating the bankruptcy procedure and the state interference with bankruptcy cases. It is necessary for China to provide for simpler and clearer requirements for entering into the bankruptcy procedure, following the example of Anglo-American bankruptcy law. Further, the state should gradually retreat from the bankruptcy process and let the courts adjudicate bankruptcy cases based on efficiency and fairness, rather than on political considerations. Finally, China should devote more resources to the cultivation of insolvency practitioners, who can supervise bankruptcy cases professionally and independently. The problem of state interference and the lack involvement of professional administrators will be further considered in 4.1.4.

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(b) Preservation of Bankruptcy Estate and Equitable Treatment of Creditors

A key function of bankruptcy law is to preserve the debtor’s estate and ensure equitable distributions to creditors. Two mechanisms in bankruptcy law are essential to the preservation of the debtor’s assets. First, a stay on creditors’ individual actions against the debtor can allow breathing space for the debtor and ensure equitable distribution to creditors. Second, avoidance of actions such as fraudulent transfers and preferences that are aimed at fraud and favoritism can recover assets for the benefit of all creditors.

Under Chinese bankruptcy law, a stay on creditors’ actions against the debtor will only be triggered by acceptance of the court. As the court has fifteen days to decide whether to accept the bankruptcy case and can prolong the time for decision upon approval of the court on a higher level, creditors may act individually to seize the debtor’s assets when the decision of the court is still pending. The fifteen-day interval may also allow the management to behave opportunistically against creditors, for example, concealing assets or fleeing. Further, the stay has only limited effects. When the administrator takes over the bankruptcy estate, actions against the debtor will continue. Also, new actions filed against the debtor after commencement of the bankruptcy are permitted as long as they are filed with the court that accepts the bankruptcy case.

A more effective automatic stay provision should be introduced into the Chinese bankruptcy law. One example of a powerful automatic stay provision can be found in the US BC. Under the BC, a petition for bankruptcy will trigger an automatic stay on claims of creditors. The automatic stay will stay all litigation and enforcement of judgments and security. The stay is effective during the time the case is pending, except for limited cases where the court allows to lift the stay.

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72 “UNCITRAL Legislative Guide on Insolvency Law” (above note 57).
73 EBL 2006, article 10.
75 EBL 2006, article 21.
76 BC §362.
Under the Chinese bankruptcy law, the function of preventing concealment of assets and favoritism is performed by the provisions of voidable and void transactions.\textsuperscript{77} However, the list of voidable transactions is rather limited and cannot encompass all the situations of fraud and favouritism. In comparison, the provisions that are designed to address fraud and favouritism under the Anglo-American bankruptcy law are more powerful.

In the US, section 547 of the BC states that the trustee may void any transfer of an interest of the debtor in property that constitutes a preference. The preference provision is aimed at the problem of favouritism, namely, that a debtor firm can selectively pay some of its creditors, including directors or shareholders who are creditors, to the detriment of other creditors. The purpose of the preference provision is to ensure the equal distribution to creditors and prevent creditors racing to the courthouse to collect their debts.\textsuperscript{78} A transfer is deemed as a preference if it is: (1) to the benefit or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the filing of the petition or between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; (5) a transfer that enables the creditors to receive more than they would otherwise receive in a Chapter 7 liquidation.\textsuperscript{79} The debtor’s insolvency is presumed during the ninety days preceding filing of the petition, while in the case of insider transactions, although the debtor’s insolvency is not presumed, the retrospective period is between ninety days and one year before the date of the filing of the petition.\textsuperscript{80} As an attempt to balance the interests of transferees and of the trustee acting on behalf of all the creditors, transfers that are not actually made on account of

\textsuperscript{77} See 4.1.2 (iv).
\textsuperscript{78} Baird, \textit{The Elements of Bankruptcy}, 180-181 (above note 19).
\textsuperscript{80} BC § 547 (f), also see ibid., 108.
an antecedent debt are not regarded as preferences.\textsuperscript{81} A list of specific exceptions has been provided by the BC.\textsuperscript{82}

When a firm is approaching insolvency, sometimes its directors or shareholders will transfer or conceal its assets before entering the formal bankruptcy procedure so that not all assets will go to the creditors. To constrain such opportunism, the fraudulent transfer provision under the BC\textsuperscript{83} provides that the trustee can avoid any transfer of property or obligations incurred that constitutes fraudulent transfer and is made or incurred on or within 2 years before the date of the filing of the petition.\textsuperscript{84} A transfer will be deemed as fraudulent if it is made with actual intent to hinder, delay, or defraud any creditor or without receiving reasonably equivalent value in return.\textsuperscript{85} Absent the “actual intent” element, a transaction can also be deemed as “constructive fraud” when the debtor transfers an asset or incurs an obligation without receiving a reasonably equivalent value in exchange and thus the debtor is rendered insolvent or left with unreasonably small capital.\textsuperscript{86} The fraudulent transfer provision differs from the preference provision in that it is not restricted to transfer to creditors. It applies to any transaction in which debtors intentionally hide their assets to evade liability or transfer assets for less than reasonable consideration, resulting in a decrease in the value of the bankruptcy estate.

Similar provisions of preference and fraudulent transfer can also be found in the UK context. The preference provision is stipulated in section 239 of the UK IA, which defines preference as anything the debtor does or suffers to put a creditor into a position that, in the event of the debtor going into insolvent liquidation, is better than the position he would have been in if that thing had not been

\textsuperscript{81} Morris W Macey, “Preferences and Fraudulent Transfers under the Bankruptcy Reform Act of 1978,” Emory LJ 28 (1979): 685, 691.
\textsuperscript{82} BC § 547 (c).
\textsuperscript{83} BC § 548; In the US, fraudulent transfer law also exists at the state level. The state law on fraudulent transfer is similar to that under the Bankruptcy Code and is usually modelled on the model uniform law.
\textsuperscript{84} BC § 548 (a)(1).
\textsuperscript{85} BC § 548 (a)(1)(A).
\textsuperscript{86} BC § 548(a)(1)(B).
If the court finds a preference, it will make an order as it thinks fit to restore the position to what it would have been if the preference had not been given.

The difference of the UK preference provision from its counterpart under the US Bankruptcy Code is that it requires a subjective element, that the debtor was influenced by a desire to put a creditor in a better position. However, if the preference is given to a person connected with the debtor at the time the preference was given, the debtor is presumed to have been so influenced. A preference must occur within relevant time to be challenged, namely, six months from the onset of insolvency, or two years prior to the onset of insolvency when the beneficiary of the preference is a connected party. Further, it must be proved that the debtor must be insolvent at the time when a preference was made or become insolvent as a result of the preference.

The equivalents of the US fraudulent transfer law can be found in sections 238 and 423 of the UK IA. The function of section 238 is similar to the constructive fraud provision in the US BC. It allows a transaction to be challenged in which a debtor receives no consideration or a consideration of significantly less than market value. An undervalued transaction must take place within relevant time to be challenged, namely two years before the onset of insolvency. Further, the debtor must be insolvent at the time of the transaction or as a result of it. However, in the case of persons connected with the company, insolvency is presumed.

Section 423 functions in a way similar to the actual fraud provision under the US BC. Its primary difference from section 238 is that it requires proving an intent to defraud creditors. As the intent element is difficult to prove, this provision is

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87 IA 1986, s 239 (4).
88 ibid., s 239 (3).
89 ibid., s 239 (5). See Goode, *Goode on Principles of Corporate Insolvency Law*, 472 (above note 3).
90 ibid., s 239 (6).
91 ibid., s 240.
rarely used in the UK. However, it also has some advantages over section 238. First, it does not have the time limits applied to section 238. Second, it does not require proving that the debtor was insolvent.

The preference and fraudulent transfer provisions in the UK and US provide good examples for China to amend its current provisions of voidable and void transactions and to stipulate a formula for determining fraud and favouritism. First, the Chinese law should stipulate preference and fraudulent transfer in separate provisions. It should be set out that the preference provision is aimed at restoring a creditor to the position what it would have been in without a preference given by the debtor, while the fraudulent transfer provision is intended to address concealing of assets by the debtor. Second, both actual fraud and constructive fraud should be provided. While actual fraud needs a subjective intent to defraud, it does not require proving that the debtor is insolvent when the transaction is made or is rendered insolvent by the transaction. These two types of fraud complement each other, and both are necessary to preserve the assets available to creditors. Third, as shown by the bankruptcy law in the US and UK, actions against preference and fraudulent transfer that benefit “insiders” should have a longer retrospective period and have a lower standard of proof.

(c) Transparency of Bankruptcy Procedure

In China, as government officials are usually in control of the bankruptcy procedure, the transparency of the procedure has become a source of concern for creditors. Under the EBL, the administrator reports to the court and is supervised by the creditors’ meeting or the creditors’ committee. However, the administrator has wide powers in managing the bankruptcy estate and only needs to report to the creditors’ committee or court for a limited list of important disposals. This leaves much room for manipulation, to the detriment of creditors.

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93 EBL 2006, article 23. See 4.1.2 (iii).
94 ibid., article 69.
Further, the judicial records of bankruptcy cases, like those of other court cases, are only partly disclosed in China. It is difficult for creditors as well as the general public to access information on bankruptcy cases. In contrast, in the US, most important decisions in disposing a bankruptcy estate need to be approved by the court.\(^95\) Also, the public’s right to access information on bankruptcy cases is substantiated by section 107 of the BC.

To increase the transparency of bankruptcy procedure, China should expand the scope of information that an administrator needs to disclose to the court and to creditors. Moreover, a record of court cases should be available to creditors as well as to the public.

(d) Maximising the Value of Assets

In recent years, the rescue culture, which emphasizes that a firm is often worth more as a going concern than being sold piecemeal,\(^96\) has been the theme of bankruptcy law in Britain,\(^97\) and jurisdictions across the globe. China has also recognised the importance of rescue and introduced the reorganisation procedure, aimed at maximising the value of assets available to creditors.

However, the reorganisation procedure in China has flaws that may compromise the goal of maximising the value of the bankruptcy estate. First, although the EBL allows the administrator to decide to terminate or perform any outstanding contract that contains obligations of the debtor,\(^98\) it fails to specify the consequences of terminating the executory contract. Second, there is no provision in the EBL providing whether new financing to a debtor under the reorganisation procedure can obtain a super priority status. Due to such uncertainty, it is difficult for companies in reorganisation to raise new funds.

In contrast to the vague phrasing of the EBL, the US BC contains specific provisions on executory contract and refinancing. Under the US BC, the trustee

\(^{95}\) Rapisardi and Zhao, “A Legal Analysis and Practical Application of the PRC Enterprise Bankruptcy Law,” 53 (above note 4).

\(^{96}\) “UNCITRAL Legislative Guide on Insolvency Law” (above note 57).

\(^{97}\) Goode, Goode on Principles of Corporate Insolvency Law, 314 (above note 3).

\(^{98}\) EBL 2006, article 18.
or DIP can choose to assume or reject executory contracts. Rejecting the contract amounts to a breach of the contract and will result in damages payable to the other party to the contract.\textsuperscript{99} This allows the debtor to weigh between the benefits of assuming the contract and the costs of rejecting it. As the claim for damages is regarded as unsecured and ranks \textit{pari passu} with other unsecured claims under the US BC, many debtors choose to default in order to avoid contracts that are no longer beneficial.\textsuperscript{100} Further, the US BC provides that new borrowings incurred by the debtor-in-possession (DIP)\textsuperscript{101} in the reorganisation procedure are superior to existing debts.\textsuperscript{102} This provision can facilitate the refinancing of the debtor firm and improve the chances of its revival. In order to facilitate the rescue function of reorganisation and maximise the assets available to creditors, China can introduce US-style provisions to provide consequences for rejection of executory contracts and the super priority of new borrowings.

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\textbf{(e) Priority Rule}
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If the priority rule in bankruptcy is decided by social and political considerations rather than the commercial bargains between creditors and the debtor, creditors will feel uncertain about their rights, and consequently they will be less willing to offer credit. Therefore, clear priority rules based on commercial bargains should be promulgated, and the influence of other considerations should be minimised.\textsuperscript{103}

However, in China political and social considerations supersede commercial bargains in many aspects of law. This has been reflected in the priority rule in bankruptcy law. Although the EBL has amended the rule under the Interim Enterprise Bankruptcy Law 1986 so that employees are paid before secured

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\textsuperscript{99} BC § 365.
\textsuperscript{101} During the reorganisation process provided by the Chapter 11 of the US BC, directors will remain in control and the company will be referred to as the debtor-in-possession (DIP). See Ware, “An Overview of Bankruptcy Law in the United States,” 320 (above note 22).
\textsuperscript{102} BC § 364 (c)(1).
\textsuperscript{103} “UNCITRAL Legislative Guide on Insolvency Law” (above note 57).
\end{flushleft}
creditors, Chinese bankruptcy law is still subject to the government’s fear of large layoffs, due to their disruptive effects to the society. First, article 6 of the bankruptcy law provides that the court shall protect the legitimate rights and interests of the employees of the enterprise and hold managers accountable for legal liabilities. Second, article 132 provides that employees’ claims that have occurred prior to the promulgation of the EBL in 2006 and exist until the EBL goes into effect in 2007 shall be paid from specific assets in priority to creditors that are secured by those assets. Finally, local governments usually interfere with the payment arrangement of bankrupt enterprises, leading to deviation from the priority rule, as local governments represent the state interests in SOEs and are willing to “buy social stability.”

In the US, the priority rule is based on commercial bargains rather than political considerations. Creditors will be paid in accordance with the rank of their priority. The first in rank are creditors with a lien. Among holders of different liens, secured creditors rank highest. The second in priority are holders of priority claims, which are unsecured claims but granted priority due to policy considerations. Priority claims come in the following order: (1) administrative expenses, (2) claims that have arisen between the filing and the order for relief, (3) wage claims, (4) employee benefit claims, and (5) tax claims. The third in rank are ordinary unsecured creditors. And last, shareholders will be paid only if there is a surplus after creditors are paid.

In the UK, creditors with a fixed charge over the firm’s assets will be paid first out of the sale proceeds of those assets. The remaining assets will be distributed in the following order: (1) expenses of the liquidation, (2) preferential debts, including employees’ remuneration and social security contributions, (3) the part of assets subject to a floating charge, (4) ordinary unsecured creditors, and (5) deferred creditors.

The priority rule in both the US and UK reflects a concern for the interests of employees. However, it accords the highest priority to secured creditors who

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105 BC § 507(a); see also Baird, The Elements of Bankruptcy, p 98 (above note 19).
106 Goode, Goode on Principles of Corporate Insolvency Law, 212 (above note 3).
have negotiated such status by contracts. It is true that bankruptcy law should consider and balance the interests of all parties, including employees. However, if secured assets go to employees, secured creditors may increase their interest rates and tighten the conditions of loans. This is counteractive to the financing of enterprises, especially of small and private enterprises.

In China, although secured creditors rank highest in the claims on the bankruptcy estate under the EBL 2006, it is possible that the court will distribute a large amount of assets to employees, to the detriment of other creditors, if such distribution can suppress social unrest. Compared with this approach, a better solution to ameliorate the effects of layoffs is to establish a social security scheme for employees. And at the same time, commercial bargains should be respected and security creditors should get what they have bargained for.

(f) Private Negotiation

As formal bankruptcy procedure may be lengthy and involve high costs, in the US and UK, creditors usually attempt private negotiation outside the formal insolvency procedure and only use the formal insolvency procedure as the last resort.

In the US, an out-of-court workout come in the forms of an exchange offer for outstanding debts, renegotiation of bond covenants, or the negotiation of a reduction in interest payment and an extension of loan maturities. Reorganisations through workouts generally involve shorter time spans and lower direct costs than reorganisations under Chapter 11 of the BC. In addition, in a workout, the court does not supervise the affairs of the distressed firm, unlike Chapter 11, under which the firm’s affairs are under the scrutiny of its creditors and the court. Companies can also combine a workout with Chapter 11 by negotiating a reorganisation plan with creditors before entering into the formal reorganisation process. This is called a pre-packaged bankruptcy (pre-pack).

Similarly, UK creditors will also attempt negotiation outside the formal insolvency procedure and only use the formal insolvency procedure failing such attempt.\textsuperscript{108} Usually, UK banks will rescue their borrowers outside the formal procedure whenever possible. This is because banks want to preserve the customer relationship with their borrowers. Also, when a firm enters into a formal insolvency procedure, the value of its business is bound to plunge when its financial difficulty is known to the public. There is also a “pre-pack” in the UK context. A pre-pack in the UK refers to a pre-packaged administration, which usually involves an agreement of sale of the company’s assets before entering insolvency.\textsuperscript{109} In the UK, private negotiation between the debtor and creditors can also be achieved through a corporate voluntary arrangement (CVA) or scheme of arrangement (scheme), two voting systems aimed at facilitating out-of-court negotiation.\textsuperscript{110} These two mechanisms are used to restructure a company’s debts with favorable votes from the majority of the creditors and with court approval. Although voluntary arrangements and schemes may have the advantage of avoiding costs of going through the court procedure, they also have the downside of lack of stay or moratorium, which is provided in the liquidation and administration procedure.\textsuperscript{111} The exception is that a small company may obtain a moratorium when a CVA is proposed.\textsuperscript{112}

The Chinese EBL also provides for a voting system aimed at facilitating private negotiation, namely, the conciliation procedure. The debtor may apply for the commencement of a conciliation procedure with the court and propose a conciliation agreement to settle its debts with creditors.\textsuperscript{113} A conciliation agreement must be accepted by a majority of creditors who are present at the meeting and have the right to vote; such creditors must represent more than two-thirds of the total unsecured debt, and the agreement must subsequently be

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\textsuperscript{110} Armour, Hsu, and Walters, “Corporate Insolvency in the United Kingdom: The Impact of the Enterprise Act 2002,” 156 (above note 23). See also 4.1.1 (iii), discussing the UK insolvency procedures.

\textsuperscript{111} Goode, \textit{Goode on Principles of Corporate Insolvency Law}, 348 (above note 3).

\textsuperscript{112} IA 1986, Schedule A1.

\textsuperscript{113} EBL 2006, article 95.
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approved by the court. Failing this, the court will declare the debtor to be bankrupt and initiate liquidation.\textsuperscript{114} The main difference of conciliation from reorganisation is that it requires no administrator and involves less interference from the court. The court cannot force a conciliation agreement to pass, and its scrutiny of the agreement is restricted to fraud and unlawful behaviour.\textsuperscript{115} It has been found that conciliation under the old bankruptcy law was rarely used and it does not become more popular under the EBL 2006. The conciliation procedure should be further developed and promoted in China, as it can save time and resources for both the courts and private parties. This will be further discussed in 4.1.4.

Summary of 4.1.3

In summary, this section has evaluated the basic principles of the Chinese bankruptcy law against the criteria proposed by the UNCITRAL for “efficient and effective” bankruptcy law. Although the EBL 2006 is more sophisticated and market-oriented than its predecessor, it contains many flawed provisions, and some stipulations still reflect a priority on political considerations at the cost of efficiency and fairness. Further, the bankruptcy procedure is still permeated with state interference that undermines transparency and equality of the procedure. This section has also discussed how to draw on the experience of the UK and US to further improve the Chinese bankruptcy law. The focus in the next section will turn to the problems of Chinese bankruptcy law in practice, which are likely to be more detrimental to creditors’ interests than the flaws of its formulation.

4.1.4 Persisting Problems in Practice

i. Underuse of Bankruptcy Procedures

Almost a decade has elapsed since the Chinese EBL was promulgated. However, bankruptcy application is still a rare option for businesses to exit the market.

\textsuperscript{114} EBL 2006, articles 97—99.

\textsuperscript{115} ibid., article 103.
According to a research, there are only 2,955 bankruptcy cases going through the court bankruptcy procedure in the 2008 while the total number of corporate dissolution is about 800,000 in that year. This means that bankruptcy cases considered by courts only account for approximately 0.37% of all company dissolutions in China in 2008. In contrast, in the same year, court-based bankruptcy cases account for 8.17% of all company dissolutions in the US and 10.16% in the UK. In addition, there were only 23 the reorganisation cases accepted by Chinese courts in 2008 and this amounts to 0.78% of all in-court bankruptcy cases. (see Table 1)

Table 1: Chinese Corporate Bankruptcy Statistics in 2008

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of companies (million)</th>
<th>Corporate Dissolutions</th>
<th>Court-Based Bankruptcy Cases</th>
<th>Reorganisation Cases</th>
<th>Dissolution rate (%)</th>
<th>Ratio of Bankruptcy Cases to Corporate Dissolutions (%)</th>
<th>Ratio of Rescue Cases to Bankruptcy Cases (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>2.41</td>
<td>288,900</td>
<td>29,338</td>
<td>5,873</td>
<td>11.36</td>
<td>10.16</td>
<td>20.03</td>
</tr>
<tr>
<td>US</td>
<td>5.08</td>
<td>600,109</td>
<td>49,091</td>
<td>10,846</td>
<td>11.8</td>
<td>8.17</td>
<td>22.09</td>
</tr>
<tr>
<td>China</td>
<td>9.7</td>
<td>800,000</td>
<td>2,955</td>
<td>23</td>
<td>8.24</td>
<td>0.37</td>
<td>0.78</td>
</tr>
</tbody>
</table>

116 Tomasic and Zhang, ‘From global convergence in china’s enterprise bankruptcy law 2006 to divergent implementation: Corporate reorganisation in China’, 304 (see above note 67).

117 The statistics are cited from ibid., 304-308.
The rarity of reorganisation cases in China has also been indicated by the White Paper on Bankruptcy Cases issued by the Intermediate Court of Shenzhen in 2011.\textsuperscript{118} The Paper states that from 2006 to June 2011, the court has accepted 172 bankruptcy liquidation cases compared to only eight reorganisation cases. However, the Paper has shown some promising trends in Shenzhen, the front of economic reform in China. First, it stresses that the reorganisation procedure is preferred if it is possible to rescue enterprises that are financially distressed. Second, as indicated by the Paper, the proportion of SOEs in bankruptcy cases is decreasing. From 1993 to 2006, the Court has accepted 167 bankruptcy cases concerned SOEs. However, only seven SOE bankruptcy cases have been accepted from 2006 to June 2011. The Paper points out that the reason for this is deepened reform of SOEs, reduced special favours to SOEs and gradual withdrawal of governmental intervention. The Paper also identifies the trend of diversified types of enterprises going into the bankruptcy procedure, especially the increase in the number of small and medium enterprises.

Two reasons can account for the overall underuse of bankruptcy procedures. First, the financial standards for initiating bankruptcy procedures in China are demanding and confusing.\textsuperscript{119} Second, bankruptcy cases will only start when accepted by the courts, which are subject to governmental influence.\textsuperscript{120} The infrequent use of reorganisation can be attributed to the problematic phrasing of the financial standards of initiation. On its appearance, the financial standard for applying for reorganisation is lower than liquidation and conciliation, as a debtor can file for reorganisation when it “clearly lacks the liability to pay off debts.”\textsuperscript{121} However, there is no clear definition of this phrase. As the court has a broad discretion regarding whether to accept a bankruptcy case, it can reject the application for reorganisation based its interpretation of the phrase. Additionally, under the EBL 2006, it is unclear how liquidation can be converted to reorganisation. It is not uncommon for creditors to reach an understanding


\textsuperscript{119} See 4.1.3 (ii).

\textsuperscript{120} ibid.

\textsuperscript{121} EBL 2006, articles 2 and 7. Also see 4.1.3 (ii).
with the debtor in the process of liquidation and want to revive the company. Therefore, bankruptcy law usually contains rules for converting liquidation to reorganisation.\textsuperscript{122} According to article 70 of the EBL 2006, “a debtor or creditor may, according to the provisions of this Law, directly apply with the people’s court for having the debtor reorganised. Where a creditor applies for putting his debtor into bankruptcy liquidation, the debtor or his capital contributors whose capital contribution makes up one-tenth or more of the debtor’s registered capital may, after the people’s court accepts the application for bankruptcy and before it declares the debtor bankrupt, apply with the people’s court for reorganisation”. However, there are no clear rules regarding how to convert liquidation into reorganisation and in some cases, for example East Star Airline,\textsuperscript{123} the court has declined to allow the conversion of liquidation into reorganisation on application of a creditor.

Compared with reorganisation, conciliation is even more of a rarity. It has been found that the conciliation procedure provided by the old bankruptcy law had almost never been used.\textsuperscript{124} An empirical study conducted in 2011 found that there had not been a single case of conciliation since the EBL 2006 was promulgated.\textsuperscript{125} Although conciliation is intended for restructuring of a company’s debt, this is usually achieved through reorganisation in China.\textsuperscript{126}

The underuse of the conciliation procedure can be attributed to an array of defaults in its design. First, the initiation of conciliation requires the same financial standards as liquidation.\textsuperscript{127} This is unreasonable since conciliation is a contractual arrangement between the debtor and creditors and usually involves restructuring of debts such as writing off the debts or postponement of payment.

\begin{itemize}
\item \textsuperscript{123} See the following 4.1.4 (ii).
\item \textsuperscript{126} ibid., 65.
\item \textsuperscript{127} EBL 2006, articles 2 and 7.
\end{itemize}
It can be more instrumental before the company becomes insolvent in the eyes of the bankruptcy law. When the company has reached the state of insolvent in the legal sense, reorganisation is usually more useful for the company’s rescue. Second, compared with reorganisation, the effects of conciliation are limited. The conciliation procedure does not stay execution of claims by secured creditors, and the conciliation agreement is only binding on unsecured creditors. Third, the conciliation procedure excludes the participation of an administrator and requires minimum judicial involvement. Without adequate monitoring, creditors are vulnerable to the opportunism of the debtor, such as preference payments and transfer of assets. To safeguard the interests of creditors, the creditors’ committee can be vested the with power to monitor the debtor in the conciliation procedure; however, such rules are absent in the EBL 2006. Also, there are no rules for dissented creditors to challenge the conciliation agreement. Fourth, once the conciliation procedure is initiated, there is no provision in the bankruptcy law regarding the conversion of conciliation to reorganisation and this remains a controversial issue. This means when creditors find reorganisation a better way of saving the company in the process of negotiating a conciliation agreement, they may not be able to transfer into a reorganisation procedure and the failure of reach a conciliation agreement will result in a bankruptcy liquidation.

Given the lack of utilisation of the conciliation procedure, some scholars have argued for its eradication. However, as demonstrated by the experience in both the UK and US, voluntary arrangements between the debtor and creditors can be a cost-effective way of saving a company. The conciliation procedure

128 ibid., article 96.
129 ibid., article 100.
131 EBL 2006, article 99.
should be preserved and further improved to facilitate the out-of-court negotiation between the debtor and creditors.

ii. Prevalent State Interference

As many bankruptcy cases are administered by liquidation committees consisting of governmental officials, the state can directly interfere with the bankruptcy procedure. It has been estimated that 45% of administrators are liquidation committees.134 Further, one study has found that out of twenty-five reorganisation cases of special treatment (ST) listed companies,135 twenty-four cases are found to have liquidation committee serving as the administrator and only one case a professional administrator.136 Also, all the liquidation committees are exclusively comprised of governmental officials without professionals and are usually headed by a vice major or other senior official.

There are many reasons for the active governmental involvement in bankruptcy cases. First, local governments are concerned with social and political repercussions in the local community caused by bankruptcy of large enterprises, especially SOEs. In the past, SOEs not only were the main employers in the country, but they also provided a bundle of housing and welfare services to its employees.137 For employees in the SOEs, unemployment is not just loss of job, rather, it is loss of a status and the security associated with such status.138 Therefore, shutting down of SOEs can result in violent protests of workers.139

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134 ibid.
135 These refer to Chinese listed companies that receive special treatment because of abnormal financial conditions. See http://my.safaribooksonline.com/book/international-business-globalization/9781602670068/key-concept-of-china-stock-markets/par01ch04sec04
Second, although private investors have acquired ownership in the process of restructuring of SOEs, the central or local government remains the major shareholder of SOEs. Therefore, the state has a critical interest to protect in the bankruptcy procedure. Finally, closure of a large SOE or an important private enterprise will lead to disturbances of the local economy. As Chinese officials are gauged according to their caliber in promoting economic development and stability, bankruptcies can lead to negative appraisal of their work if not handled delicately.

Governmental involvement in the bankruptcy process can be instrumental in the bankruptcy process. Local governments of the region where the debtor is located can take action to protect a debtor’s assets from creditors including unpaid employees who would seize anything valuable when the business is closed. In some cases, the local governments even paid outstanding wages in order to suppress potential upheavals. Also, local governments can introduce new investors into the distressed business.\footnote{140}

An example that can illustrate the positive effects of governmental involvement is the reorganisation of five subsidiaries of FerroChina Lt, one of the largest bankruptcy cases in China with more than 1400 creditors from both within and outside of the country and the debt claimed by creditors amounting to 11 billion.\footnote{141}

In 2008, hit by the global economic meltdown, five subsidiaries of the Singapore-listed steel make, FerroChina Lt, slumped into dire situation. On October 7th 2008, directors of all of these subsidiaries suddenly left for their native Taiwan, leaving creditors and employees in anxiety and bewilderment. In order to prevent creditors from grabbing the assets and causing instability to the local community, Changshu people’s court, the local court in the place where the five subsidiaries were based, established an ad hoc group to handle the case and

\footnote{140} Tomasic and Zhang, “From Global Convergence in China’s Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China”, (see above note 67).

took immediate action to preserve the corporate assets on October 8th 2008 with the assistance of the local government officials.\textsuperscript{142} The local government of Changshu and governments on higher level have been instrumental in this bankruptcy case. Although the court appointed a law firm as the administrator, government officials were actively involved in the process in the form of a working team. In 2009, with the joint efforts of the court, administrator and governmental officials, the two biggest creditors of the FerroChina subsidiaries, the China Minmetals Corp. and Zhejiang Materials Industry Group were persuaded to inject 1 billion to the subsidiaries in exchange for shareholding to facilitate their reorganisation. Under the reorganisation plan, the money injected to the subsidiaries would be used to repay part of debts and restart the manufacturing operations. The rest of the debts will be paid in installments from 2010 to 2013.\textsuperscript{143}

At the end of 2013, the Changshu court declared the end of the FerroChina reorganisation case. The case has been remarked to be an example of successful collaboration of administrator, the court, and the government, with enterprises remaining going concerns, employees retaining their jobs and creditors getting back their money.\textsuperscript{144}

However, although the governmental involvement can be positive in some bankruptcy cases, it disrupts the functioning of the market mechanism and can conflict with the principle of fairness and equality enshrined by the bankruptcy law. First, governmental interference encourages excessive risk taking and can lead to overcapacity of policy-supported industries. As the state backing is always presumed, there will be the moral hazard of excessive risk-taking on the part of both enterprises and their creditors. For enterprises, they will take excessive risks, for example expanding ambitiously with high leverage, and they will rip the benefits once they succeed. If they fail, they expect the government

\textsuperscript{142} ibid.


\textsuperscript{144} "The Largest Bankruptcy Case That Spanned Five Years and Involved 11 Billion Debts[最大破产重整案历时五年终 结 债务记录达 110 亿. Zuida Pochan Chongzhenan Lishi Wunian Zhongjie Zhaiwu Jilu Da Yibaiyishi Yi]," (above note 141).
Chapter 4 Creditor Protection in Insolvency

to bail them out and pacify angry creditor and employees. For creditors, they may lend to highly risky enterprises, especially SOEs, just because they assume them to be implicitly guaranteed by the government. The example of the solar panel manufacturer, Suntech, is evidence to such problem.\textsuperscript{145}

Chinese solar industry is heavily supported and encouraged by the government with generous subsidy and bank loans. As the first Chinese solar enterprise to go public in 2005, the Wuxi-based Suntech once was regarded as a one of the most sterling achievements on the record of the Wuxi Government.\textsuperscript{146} However, the successful story of Suntech did not last long and soon its problems of over-expansion surfaced as the solar industry was experiencing the dual predicaments of overcapacity and anti-dumping sanctions of EU and US. Finally, in 2013, it declared bankrupt with debts estimated to be as high as 9.5 billion RMB and most of its creditors are banks which would lose six billion under the reorganisation plan.\textsuperscript{147} As demonstrated by the Suntech case, the governmental interference not only encourages excessive risk taking, it can also lead to overcapacity, which has already become evident in the solar industry.

Second, the government may sacrifice the interests of creditors in order to preserve the government’s interests as the major shareholder of SOEs, or just to prevent a large enterprise from falling apart and causing disruptions to the local society. A common scenario is the local government forces creditors to accept an unfair organisation plan through its influence on the court. Under the EBL, the reorganisation plan must be approved by the creditor meeting and then approved by the court.\textsuperscript{148} If the reorganisation plan is opposed by some class of creditors, the court can force through the plan,\textsuperscript{149} namely “cram down” the plan


\textsuperscript{148} EBL 2006, article 86.

\textsuperscript{149} EBL 2006, article 87
using the expression in the US context. Several conditions must be met if the court wants to approve the reorganisation plan without consent of all classes of creditors: (1) under the plan, secured creditors must be fully paid to the extent of the value of their security (2) employees and tax claims must be fully paid (3) the rate of repayment for common creditors must not be lower than what they would obtain in the liquidation procedure (4) the plan is fair to capital contributors (namely, shareholders) (5) the plan has treated creditors of the same voting group (namely, has the same ranking) in a fair way and does not conflict with the priority rule under the article 113 of the EBL (6) the plan for business operations is feasible.

However, in reality creditors’ interests are often sacrificed. It has been found that the use of cram-down in the reorganisation procedure is relatively common in China and the reorganisation cases usually involve a high reduction of creditors’ claims to the benefit of shareholders. One case in example involves the reorganisation of Tianyi, a large producer of vegetable oil based in Jinzhou, Hubei province. In this case, the court approved the reorganisation plan despite of the opposition from the unsecured creditors. The reorganisation plan successfully restored the debtor, however, the rate of repayment for unsecured creditors was only 10.07%, not higher than the estimated repayment rate under the liquidation procedure, which was between 8.62% and 12.62%.

Finally, in contrast to the governmental efforts of withholding some enterprises from exiting, the government can also prompt the early death of others. East Star Airline, a private regional carrier based in Wuhan, was one of the few private players in the Chinese airline industry and the only airline company that has been declared bankrupt in China. The airline became cash-strapped in 2008 and was suspended from operations on March 15, 2009, the day after it announced its refusal to the takeover bid from the state-owned giant, Air China.

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150 The “cram down clause” is provided in 11 USC § 1129.
151 EBL 2006, article 87
152 Tomasic and Zhang, “From Global Convergence in China’s Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China,” 315 (see above note 67).
The chairman of East Star, Lan Shili, was then detained on March 17. On March 30, 2009, the Wuhan intermediate court accepted the involuntary bankruptcy application filed by the airline's creditors including GECAS (GE Capital Aviation Services).¹⁵⁴

Instead of a professional administrator, the court appointed a liquidation team to be the administrator, which consisted of various governmental authorities, including the Wuhan Transportation Commission, the Legislative Affairs Bureau, the Wuhan Labor Union, and the Public Safety Bureau.¹⁵⁵ On June 12, the Wuhan Intermediate Court denied the application for reorganisation of East Star filed by China Aviation Oil Group (CAOG), one of its largest creditors. The court stated that based on examination of facts, there was no possibility for Eastern Airline to resume operations. Moreover, there was no legal ground for CAOG to apply for reorganisation after other creditors, including GECAS had applied for bankruptcy liquidation. In its appeal with the Wuhan High Court, the provincial level of court, CAOG cited article 70 of the EBL as its legal ground for applying for reorganisation, which permits creditors to apply for reorganisation during the liquidation procedure before the bankruptcy of the debtor is formally declared. However, CAOG’s appeal was not supported.¹⁵⁶

In August 2009, China Equity Group, an investment company proposed a reorganisation plan in which the company would offer funds to East Star in exchange for 70%-80% of the equity shares of the airline and its creditors would convert their debt into 20%-30% of the shareholding.¹⁵⁷ This reorganisation plan was also rejected by the Wuhan intermediate court. Throughout the whole process, although the airline, and some of its major creditors made repeated efforts to revive the company, however, the liquidation team had always been of the opinion that the company could not be reorganised and liquidation was the only option. Finally, the Wuhan intermediate court announced bankruptcy


¹⁵⁶ “Bankruptcy of East Airline[东星航空破产] Dongxin Hangkong Pochan]”(above note 154)

liquidation of East Star Airline in August 27, 2009, only five months after the initiation of the bankruptcy case. Lan Shili, the chairman of the airline was convicted of tax evasion and sentenced to four years in prison.¹⁵⁸

The effects of the East Star Airline case are far-reaching. It chills private investors' ambition to go into the airline business and gives rise to the criticism of “advancement of the state and retreat of the private sector”.¹⁵⁹ It is hard to determine whether the Wuhan government, represented by the liquidation team, and supported by the court, had the intention to force the liquidation of East Star and let its business gobbled by its state-owned competitors. However, the result is that Air China acquired the assets of Easter Star, took over its flight routes in Wuhan and recruited 600 of its employees. In many industries in China, private companies are squeezed out because their state competitors are backed by generous state subsidies and easy credit from state-owned banks. The downfall of East Star demonstrates yet another treat: a forced liquidation.

iii. Muddled Role of Administrator

From the above discussion, it can be observed that bankruptcy procedures are frequently interfered by governmental officials by acting as the administrator. To exacerbate this problem, the role of administrator is ill-defined under Chinese bankruptcy law and there is a shortage of professionals to act as administrators. This will be further explained in the following.

The court will appoint an administrator at the same time that it accepts a bankruptcy case.¹⁶⁰ An administrator can be a person “who has the necessary professional knowledge and has obtained the qualifications for the practice to serve as an administrator”.¹⁶¹ Alternatively, it can be a liquidation team of persons from governmental authorities, “a certified public accountant firm, a bankruptcy liquidation firm or any other public intermediary agency that is


¹⁵⁹ ibid., 186.

¹⁶⁰ EBL 2006, article 13.

¹⁶¹ EBL 2006, article 24.
established according to law may serve as an administrator”. There is also a list of people who are prohibited from acting as administrators. The administrator is usually randomly selected from a roster of eligible administrators. However, the court may make an open invitation to compete for the position of administrator when financial institutions or important enterprises are involved.

The administrator has wide powers under Chinese bankruptcy law is responsible for the management of the debtor’s property and recovery of the bankruptcy estate. Even in the reorganisation procedure, the administrator is usually in charge of the management although the EBL has provided that the debtor may manage its property by itself under the supervision of the administrator upon approval of the court. Given this, it is highly inaccurate when some scholars refer to reorganisation under the EBL as a “modified debtor-in-possession” approach. As demonstrated by the discussion in the last section, reorganisation of companies is usually dominated by the administrator, which is often assumed by governmental officials and as a result, reorganisation has frequently deviated from its essential purpose of rescue.

The administrator’s broad power is only checked by the court and the creditors’ meeting or creditors’ committee. However, as there are no detailed rules regarding administrator’s duty, the debtor and its creditors are vulnerable to neglects or misbehaviours of the administrator. Article 25 of the EBL has listed a range of things that falls within the administrators’ duties, including the duty to dispose and manage the property of the debtor. However, it describes the function and power, rather than the duties of an administrator. A more hopeful

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162 ibid.
163 ibid.
164 Provisions of the SPC on Designating the Administrator during the Trial of Enterprise Bankruptcy Cases [最高人民法院关于审理企业破产案件指定管理人的规定] 2007, article 20.
165 ibid., article 21.
166 EBL 2006, article 25 and Chapter 5.
167 EBL 2006, article 73.
168 Jiang, “The Curious Case of Inactive Bankruptcy Practice in China: a Comparative Study of US and Chinese Bankruptcy Law,” 575 (above note 155). See the discussion on the difference between reorganisation under the EBL and Chapter 11 of the US BC which allows the debtor to be in control of the reorganisation and can run the business in the “ordinary course” as it sees fit.
169 EBL, article 27.
recourse against the administrator can be found in article 27 which provides that
the administrator is subject to duty of diligence and loyalty, which are the same
language used to describe fiduciary duties of corporate directors in the Company
Law 2005. Further, article 130 provides that if the administrator fails to fulfill
these duties and causes losses to creditors, the debtor or a third party, the
administrator is liable for compensation. However, as demonstrated by the case
law of fiduciary duties in the Chinese company law, the courts are unlikely to
apply these vague provisions or to interpret them further. It is even more
unlikely for the debtor or its creditors to litigate against officials who act as the
administrator and causes losses to them.

Noticeably, the EBL contains a requirement for an individual person, who serves
as the administrator, to purchase liability insurance. Liability insurance can
provide compensation for the debtor, its creditors or third parties who have
suffered losses from the neglect or misbehavior of a administrator. Further,
insurance companies can play an instrumental role in monitoring the
administrator. However, as there are no clear rules in implementing
mandatory liability insurance for administrators and there seems to be no
company offering such insurance, the effects of the liability insurance for
administrators are questionable.

The unclear scope of duty and liability for administrators has undermined the
incentive for professionals to be enrolled as potential administrators and
contributed to the shortage of professional administrators. To make things worse,
there is great uncertainty over how much administrators should be paid. According to the judicial interpretation issued by the SPC, the court shall decide the compensation for administrators on a sliding scale depending on the value of

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170 Company Law 2005, articles 148-149.
171 See 3.2.2.
172 EBL 2006, article 24.
173 See 3.1.3.
the bankruptcy estate. In reality, administrators are usually underpaid. These factors together have discouraged skilled professionals from acting as bankruptcy administrators, and thus further exacerbate the problem of state intervention in bankruptcy cases, as officials are more likely to assume the role of administrator.

Summary of 4.4.1

In summary, several problems have been identified in the Chinese bankruptcy law in practice: First, bankruptcy procedures, particularly reorganisation and conciliation, are underused for dissolution of companies in China. Second, the bankruptcy procedure is still permeated with state interference that undermines the efficiency and fairness of the procedure. Third, the role of administrators in the bankruptcy procedure is ill-defined and professionals are discouraged from acting as administrators by the uncertainty over their liability and remuneration. This further exacerbates the problem of state intervention by increasing the likelihood for officials to act as administrators. These problems in the implementation of Chinese bankruptcy law are likely to have more deleterious effects on creditors than the defaults in its formulation. The following sections of this chapter will be focused on partnerships and a partnership bankruptcy regime will be proposed based on the experience of the UK and US.


4.2 Partnership Bankruptcy and Partner Bankruptcy

4.2.1 Establishing a Partnership Bankruptcy Regime in China

i. Absence of Partnership Bankruptcy Regime in China

According to the Partnership Enterprise Law 2006, “Where a partnership is unable to pay off the debts due, its creditors may, according to law, apply to a people’s court for bankruptcy liquidation of the partnership, or demand that the general partners pay off such debts.”¹ Further, the EBL provides that the bankruptcy liquidation of organisations other than corporations, if permitted by other laws, shall be governed, mutatis mutandis, by the procedure as prescribed by the EBL.² Read together, these provisions mean that partnerships can apply for bankruptcy liquidation but cannot apply for reorganisation or conciliation. However, in reality, it is unlikely to see filings of partnership bankruptcy in the absence of detailed rules for applying bankruptcy law to partnerships. With the increasing number of limited partnerships and professional SGPs, it has become imperative to promulgate a sound partnership bankruptcy regime.

First, as discussed above, a bankruptcy regime can prevent creditors from acting individually and grabbing the assets of the debtor. In this way, it saves costs for individual creditors and preserves the aggregate value of the debtor’s assets.³ The automatic stay on creditors’ individual actions can allow breathing space for the debtor and ensure equitable and orderly distribution for creditors. In addition, avoidance of fraudulent transfers and preferences can recover assets for the benefit of all creditors.⁴ However, it must be admitted that for professional partnerships, these benefits of bankruptcy are limited as professional partnerships are relatively thinly capitalized and do not have many physical assets for creditors to grab. The most valuable asset in professional partnerships is the human capital of each partner, which cannot be seized by

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¹ PEL 2006, article 92.
² EBL 2006, article 135.
³ See 4.1.3 (i).
⁴ See 4.1.3 (ii).
creditors. Therefore, for professional partnerships, the major benefit of bankruptcy lies in a reorganisation procedure that allows partners to continue their business and pay the creditors with their revenue. A reorganisation procedure for partnerships, as demonstrated by the US case law, can be instrumental in maximising the value of a partnership as a going concern and increase the chance of repayment for its creditors.

Second, a partnership bankruptcy regime can designate the assets of partnerships and facilitates the rule that partnership’s debts will first be paid off with its own assets. Chinese partnership law provides that a partnership shall first pay off its debts with all of its property, and then the partners shall bear unlimited joint and several liability for the unpaid part of the partnership debts. This provision is the equivalence to the “exhaustion rule” in the US partnership law and is consistent with the de facto entity status of Chinese partnerships. However, it is in conflict with the provision that allows creditors to directly apply for bankruptcy or demand general partners to pay off debts when the partnership cannot pay off its debts. To implement the “exhaustion rule” in Chinese partnership law, a partnership bankruptcy regime should be established and the provision that allows creditors to go after partners directly should be abolished.

Third, consistent with the reasoning above, a partnership bankruptcy regime can reinforce the limited liability rule that has been introduced into Chinese partnership law. Although the limited liability rule has been established in limited partnerships and SGPs, it is difficult to distinguish the assets of a partnership from personal assets of its partners without a formal bankruptcy procedure to determine the assets owned by a partnership. Even with a limited

7 PEL, article 38.
8 ibid., article 39.
10 See 4.2.1(ii).
11 PEL 2006, article 92.
liability protection, partners can find their own assets grabbed by creditors when the partnership comes to a chaotic ending. As limited partnerships have become a popular choice for private equity firms, and SGPs for professional firms, it has become increasingly important to promulgate a partnership bankruptcy regime in order to effectively implement the limited liability rule. Particularly, the fragility of limited liability for limited partner in private equity partnerships can send ripples to the entire society with the soaring amount of private equity investments and an ever-wider range of participants including the Chinese National Pension Fund. In a word, a partnership bankruptcy regime is becoming increasingly indispensible in China. In the following, detailed rules for partnership bankruptcy in China will be proposed based on examples of the UK and US.

ii. Available Procedures for Partnership Bankruptcy

As a matter of policy, partnerships should have access to all bankruptcy procedures as provided by the partnership bankruptcy law. In contrast to China, where partnerships are only permitted to use the liquidation procedure, both the UK and US allow partnerships to access all bankruptcy procedures. In the US, partnerships and LLCs can apply for both the liquidation procedure and the reorganisation procedure provided by the BC. Since LLCs are not directly mentioned in the BC, courts deal with LLCs by making analogies to both corporations and partnerships. In the UK, partnerships, including limited partnerships and general partnerships, can choose among liquidation, administration, and partnership voluntary arrangement (PVA). Since the corporate insolvency regime applies to the UK LLP, the LLP has an additional option of receivership. In a word, there seems to be no ground for denying

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14 As partnerships, including limited partnerships, lack separate legal personality under English law, they cannot create a floating charge over their assets and therefore cannot enter the insolvency procedure of receivership. In contrast, as a body corporate, an LLP has separate personality and can grant a floating charge. Therefore, an LLP can use the procedure of insolvency. See David Gibson, “Insolvent Partnerships,” Corporate Rescue and Insolvency no. 2 (April 1, 2012): 35.
partnerships procedures that can facilitate their rescue. Like companies, partnerships can also become insolvent while having the potential to be rescued. It is only reasonable to allow Chinese partnerships to have access to reorganisation and conciliation procedures.

iii. Who Can File for Partnership Bankruptcy?

Partners should be allowed to file for bankruptcy of partnerships. Both creditors and partners can apply for bankruptcy under the US bankruptcy law.\textsuperscript{15} Similarly, in the UK, ordinary and limited partnerships can be wound up as an unregistered company with or without any petitions against partners or formal partners on petition of creditors or partners.\textsuperscript{16} As an LLP is wound up as a company, both its members and creditors can apply for insolvency.\textsuperscript{17} However, under the PEL, only creditors can file for bankruptcy liquidation of partnerships. This ignores the fact that partners are more privy to the financial information of the partnership. Therefore, partners should be allowed to file for partnership bankruptcy, but there should be some limitation on bankruptcy petitions filed without agreement of all partners. For example, the US BC provides that a general partner that did not join in the bankruptcy petition may file an answer to the petition to prevent the partnership from going into bankruptcy.\textsuperscript{18} Without such restriction, some partners may file for partnership bankruptcy as a way of exiting the partnership. This would destroy a partnership’s going concern value, to the detriment of creditors and other partners.

iv. The Standard for Partnership Bankruptcy

The test of partnership insolvency should take into account the assets of the general partner, who assumes unlimited liability for the partnership’s debts. Under the US BC, insolvency of partnerships refers to the financial condition that the sum of its debts is greater than the sum of its property plus the excess of

\begin{footnotesize}
\begin{enumerate}
\item USC § 303 (b)(3).
\item Insolvent Partnership Order 1994 (SI 1994/2421), articles 7-10. It is worth noting a petition for winding up a partnership as an registered company without any petition against the members or former members can also be filed by a responsible insolvency practitioner or the Secretary of the state.
\item UK LLP Regulations 2001 (SI 2001/1090).
\item USC § 303 (d).
\end{enumerate}
\end{footnotesize}
each general partner’s non-partnership property over such partner’s non-partnership debts. The reason for considering assets of general partners is that they are vicariously liable for the partnership’s debts. As limited partners and partners of LLPs are only liable to the extent of their contributions, their assets will not be considered for the purpose of determining the financial situation of the partnership. Under the Chinese PEL, the insolvency of a partnership is defined as when “a partnership is unable to pay off the debts due.” To reinforce the unlimited liability of general partners, the law should provide that the financial situation of general partners also be considered to determine the insolvency of partnerships.

Furthermore, when a partnership becomes insolvent, creditors should be able to apply for its bankruptcy. However, creditors should not be given the alternative to go directly after the general partners, as provided by the Chinese PEL. In the US, creditors can only demand partners to pay off partnership debts after the partnership assets are exhausted. This protects partners’ assets from direct claims of partnership creditors and reflects the entity view of partnerships.

Chinese partnership law also contains a similar rule, which states that a partnership shall first pay off its debts with all of its property, and then the partners shall bear unlimited joint and several liability for the unpaid part of the partnership debts. However, this is actually compromised by the provision that allows creditors to directly apply for bankruptcy or demand general partners to pay off debts when the partnership cannot pay off its debts. Such inconsistency reflects the confusion over the nature of partnership under Chinese law.

Although Chinese law fails to clearly define a partnership as a legal entity, it in fact treats a partnership like a legal entity in many ways. For example, it allows a partnership to own assets and to sue and be sued in its own name. Therefore, to be consistent with the de facto entity status of the partnership, partnership

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20 PEL 2006, article 92.
21 ibid., article 92.
23 PEL, article 38.
24 ibid., article 39.
25 See 1.1.2.
bankruptcy law should require partnership creditors to claim directly against the partnership and only go to partners after the partnership assets are exhausted.

v. Contribution of General Partners to The Partnership Estate

General partners with unlimited liability for the partnership’s debts should be required to contribute to the bankruptcy estate of partnership. Under the US BC, a petition for bankruptcy starts the bankruptcy procedure and creates a bankruptcy estate, which consists of all of the equitable and legal interests that the debtor has or can claim, including property rights, contractual rights, and causes of action. Partnership creditors should be required to claim directly against the partnership and only go to partners after the partnership assets are exhausted.

vi. Preference Transaction and Fraudulent Transfer by Partners

Specific rules should be formulated to restrain partners from transferring partnership assets. In the UK, legal rules against preference and fraudulent transfer also apply to partnerships which are wound up as unregistered companies in accordance with the IA 1986. For UK LLPs, there is an additional provision that distributions made to members in the two years before insolvency will be clawed back if the member "knew or ought to have realised" at the time of the withdrawal that there was no reasonable prospect of avoiding an insolvent winding up. Under US bankruptcy law, a partner is an insider of the partnership, and therefore a transfer by the partnership to a partner within one year of the bankruptcy can be voided under the preference provision. Further, transfer by the partnership to a general partner while the partnership is insolvent or which

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26 BC § 541. See also Wright, “Bankruptcy Issues in Partnership and Limited Liability Company Cases,” 1 (above note 13).

27 BC § 723.

28 IA 1986, s 221.

29 ibid., s 214 A, inserted by UK LLP Regulations 2001 (SI 2001/1090).

renders the partnership insolvent will be deemed as fraudulent transfer.\footnote{BC § 548 (b).} To constrain partners’ opportunism against partnership creditors, similar rules should also be provided by the Chinese law.

**Summary of 4.2.1**

In summary, to establish a bankruptcy regime for partnerships, China can emulate the bankruptcy law in the UK and US. Detailed rules should be designed in order to give equal treatment to creditors and give the debtor a fresh start, in accordance with the basic principles of bankruptcy law.\footnote{See 4.1.} The next section will consider the situation where both the partnership and one or more partners are in bankruptcy and the concomitant conflicts between creditors of the partnership and those of the partners.

**4.2.2 When Partnership and Partners are both Bankrupt**

As general partners assume unlimited liability for the partnership debts, partnership bankruptcy is often accompanied by bankruptcy of general partners. In those situations, problems arise as to the ranking of partnership creditors and partners’ personal creditors. It is clear that partnership creditors should go after the partnership assets first. However, when personal creditors claim against the partnership’s estate, or when partnership creditors claim against personal assets, what is the order of priority between partnership creditors and personal creditors?

Chinese law is silent on these issues. To solve the conflicts between partnership creditors and personal creditors, many scholarly articles have argued for adopting the “dual priorities rule” from the Anglo-American legal system.\footnote{See, for example, "Using Partnership Bankruptcy to Resolve Debt Disputes [论合伙企业适用破产程序处理债务纠纷 Lun Hehuo Qiye Shiyong Pochan Chengxu Chuli Zhaiwu Jiufen],” *China.Findlaw.Cn*, March 6, 2010, http://china.findlaw.cn/gongsifalv/hhqyf/qyzs/qyzw/16205_2.html#p2 (accessed on September 1, 2013).} However, these articles fail to examine the underlying reasoning of the dual priorities rule and ignore the fact it has been partly abolished in both the US and…
UK. An examination of the history and theory of the dual priorities rule will demonstrate that it may not be the perfect solution to the conflicts between personal creditors and partnership creditors.

i. Origins of the Dual Priorities Rule under Anglo-American Law

The dual priorities rule states that partnership creditors have priority over personal creditors of partners with respect to the partnership estate, while personal creditors have priority over partnership creditors with respect to personal assets. In the US, the dual priorities rule has also been dubbed as the “jingle rule” for its resonance and superficial symmetry.34

The dual priorities rule has a long history under the common law. It was established in England by the Court of Chancery.35 In a 1683 case, Craven v. Knight,36 the court held that the creditors of a partnership enjoy priority over partnership assets, i.e. they can claim partnership assets before personal creditors of the owners of the partnership. Another case, in 1715, Ex parte Crowder,37 established the parallel rule that personal creditors have priority over partnership creditors over the person’s private estate. In 1728, a classic statement of the dual priorities rule was made in Ex Parte Cook.38

“[I] t is settled, and a resolution of convenience, that joint creditors shall first be paid out of the partnership or joint estate, and the separate creditors out of the separate estate of each partner; and if there be a surplus of the joint estate, besides what will pay the joint creditors, the same shall be applied to pay separate creditors; and if there be, on the other hand, a surplus of the separate estate beyond what will satisfy the separate creditors, it shall go to supply any deficiency that may remain as the joint creditors.”

36 [1683] 21 ER 664 (Ct of Chancery).
37 [1715] 23 ER 1064 (Ct of Chancery).
38 [1728] 24 ER 834 (Ct of Chancery) 835.
ii. Reform of the Dual Priorities Rule in the UK and US

The dual priorities rule was enshrined by English and US legislation well into the twentieth century. The first part of the rule - that partnership creditors have priority over partnership assets - still exists in the Anglo-American law and can also be found in many continental jurisdictions. Partnership creditors’ priority over partnership assets is justified. A partner can only get her share of surplus after the partnership creditors have been paid, so it is logical that her personal creditors should not rank higher.

On the other hand, the second part of the dual priorities rule - that personal creditors have priority over personal assets - has been abolished in both England and the US. It has been argued that this part of the rule was developed only as a matter of convenience and its logical unsoundness was veiled by its superficial symmetry and resonance with the first part of the rule. The main criticism against the priority of personal creditors over personal assets is that it contravenes the unlimited liability of general partners, which is a core principle of the partnership law. General partners assume unlimited liability for partnership debts. Postponing claims of partnership creditors will obstruct them from claiming on personal assets of general partners. After personal creditors are paid, partnership creditors usually get little, especially when the partnership is operated on partners’ assets and has few assets in its own name. Thus, the priority of personal creditors over partners’ personal assets compromises the unlimited liability rule and severely undermines the creditworthiness of partnerships.

A more reasonable approach regarding partners’ personal assets can be found in Scotland, where the second part of the dual priorities rule has never been adopted. Under Scots law, partnership creditors rank in priority to personal

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40 ibid., 312.
41 ibid., 307.
42 ibid., 312.
43 ibid., 309.
creditors over the partnership estate and *pari passu* with personal creditors on separate estates for any unpaid balance.  

The Scottish Bankruptcy Act 1985 provides that where a partnership creditor claims against the estate of one of the partners, she has to estimate the value of (1) the debt to the creditor from the partnership estate where that estate has not been sequestrated or (2) the creditor's claim against the partnership estate where the estate has been sequestrated, and then deduct such value from her claim against the partner's separate estate. She can claim against the partner's separate estate for the balance after the deduction has been made, and this claim rank *pari passu* with those of the partner's personal creditors.

In Britain, the problem of the second part of the dual priorities rule was addressed in the *Report of the Review Committee: Insolvency Law and Practice* (Cork Report) in 1982. The report proposed to eliminate the dual priorities rule and bring it in line with the Scottish model. Although it reckons that priority of partnership creditors is correct, it finds priority of personal creditors to be unjustified. However, the Insolvent Partnership Order 1986 still retained the dual priorities rule and did not incorporate the reform proposed by the Cork Report. The dual priority rule lingered on until the Insolvent Partnership Order 1994 came into effect. This order abolished the priority of personal creditors of partners and provides that when the partnership assets are not sufficient to pay its debts, the partnership creditors can claim the balance of the debts against each partner's separate estate and will rank *pari passu* with separate creditors.

In the US, the proposal to abolish the dual priorities rule was made by the Commission on Bankruptcy Laws in 1973. The Bankruptcy Code 1978 adopted this proposal and states in section 723(a) that the trustee of a partnership in bankruptcy has a claim against any general partner for the deficiency of the partnership estate to pay in full the claims against the partnership. Further,

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44 ibid., 309.
45 Scottish Bankruptcy Act 1985, Schedule 1, s 6.
47 See IA 1986, s 175A. S 175A was inserted by the Insolvent Partnership Order 1994 (SI 1994/2421), Sched 4, para 23.
section 723(b) provides that the trustee shall first seek recovery of such deficiency from any general partner in such partnership that is not a debtor in a bankruptcy case. Section 723(c) states that the trustee has a claim against the estate of each general partner that is a debtor in a bankruptcy case, and ranks equally with personal creditors of partners in distribution of their individual estates. Section 723(d) provides that if the trustee's recovery from the estates of general partners is greater than the deficiency of partnership debts, the court shall determine an equitable distribution of the surplus of the recovery. The Uniform Partnership Act (UPA) 1994 and 1997 reinforced this position in the Bankruptcy Code by providing that partnership creditors share pro rata with the personal creditors of partners in partners' separate estates.\(^49\)

The abrogation of the dual priorities rule is incomplete in the US, since it only applies to cases where both a partnership and one of its general partners are “Chapter 7 debtors”. It has been proposed that equal priority should be given to partnership creditors and separate creditors, regardless of whether the partnership is a debtor under the BC, and this should apply to cases under all chapters of the BC.\(^50\)

**Summary of 4.2.2**

In summary, rather than copying the dual priorities rule under the common law, China should adopt the current stance of the partnership law in the UK and US by granting priority on partnership assets to partnership creditors while allowing them to rank pari passu to personal creditors over partners' personal assets.

**4.2.3 Partner Bankruptcy without Bankruptcy of the Partnership**

**i. Enforcement of Partners’ Interests and Charging Order**

When a partner is bankrupt while the partnership is still economically viable, her creditors may seek to enforce her interests upon the partnership. However, such enforcement may harm the interests of other partners and partnership creditors.

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\(^49\) ibid., 324.
\(^50\) ibid., 323.
To prevent this, the Chinese partnership law states that where a partner’s personal creditor owes debts to the partnership, she cannot use her claim against the partner to offset her debts owed to the partnership. Further, a partner’s personal creditor cannot subrogate the rights of the partner and exercise the partner’s rights in the partnership. This rule emanates from the recognition of the consensual nature of the partnership, which demands that no one shall become a partner or exercise partners’ management rights without consent of other partners.

The Chinese partnership law also provides for how a partner’s personal creditors can enforce that partner’s interests in the partnership. It provides that a partner can use the proceeds distributed to her by the partnership to pay off her debts where her personal assets are insufficient to pay off her personal debts. However, her creditors can apply to the court to execute her share of property in the partnership to collect the debts. Other partners will have a priority in purchasing the partnership share. This means that when other partners offer to buy the partner’s share under similar terms as offered by non-partners, the partner must sell her share to other partners. The gist of this provision is that personal creditors of partners can force partners to transfer their share by a court order. This may lead to reduction of partnership assets, unless other partners offer to purchase the debtor partner’s share.

In contrast, in the Anglo-American context, personal creditors of partners cannot directly demand a sale of the debtor partner’s share. Instead, the “charging order” can be used by partners’ judgment creditors to enforce their claims against partners and receive the distributions that should have been received by the debtor partner.

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51 PEL, article 41.
52 ibid., article 43.
53 ibid., articles 42, 74.
54 ibid., article 42.
55 Partnership Act 1890, s 23 and UPA § 504. See discussion below for specific contents.
The charging order is “a statutory procedure whereby an individual partner’s creditor can satisfy its claim from the partner’s interest in the partnership.” The English Partnership Act 1890 is the first statute to promulgate a charging order provision. In the US, the charging order has been a feature of the partnership law since the Uniform Partnership Act 1914 and Uniform Limited Partnership Act 1916. It has also been absorbed into LLC statutes.

Without the existence of the charging order, actions taken by a judgment creditor of a partner can be destructive for the operation of a partnership. As stated by an English court in 1895, “When a creditor obtained a judgment against one partner and he wanted to obtain the benefit of that judgment against the share of that partner in the firm, the first thing was to issue a [writ of execution], and the sheriff went down to the partnership business, seized everything, stopped the business, drove the solvent partners wild, and caused the execution [judgment] creditor to bring an action in Chancery in order to get an injunction to take into account and pay over that which was due by the execution debtor. A more clumsy method of proceeding could hardly have grown up.”

As the Anglo-American view of partnership was changing from an aggregate of partners to an independent entity, more protection was given to partnership assets. The charging order is designed to partition partnership assets from partners, prevent creditors directly seizing the partnership assets and at the same time satisfy partners’ creditors with the interests in the partnership. To achieve this, the charging order regime allows judgment creditors to apply to the court for an order to charge the share of the debtor partner. In the following

59 See 1.2.2 (i).
paragraphs, specific formulations of the charging order under the UK and US partnership law will be discussed.

In the UK, section 23 of the Partnership Act 1890 provides that only partnership debts can be enforced against the partnership assets, and a judgment creditor of a partner can only enforce her claim against the partner’s interests in the partnership through a charging order. The holder of a charging order will also acquire a position of an assignee of the economic right of a partner. This means that she can receive interests distributed to the debtor, but she cannot participate in the management of the partnership.

In the US, although state laws vary on the specific language regarding charging orders, a basic formula can be found in the UPA 1997. The UPA 1997 states, “A charging order constitutes a lien on the judgment debtor’s transferable interest in the partnership.” Namely, the holder of charging order is entitled to the distributions that the debtor partner would have received. However, the holder has no other right that is associated with the status of a partner. She cannot participate in the management of the partnership and has no interest in the partnership property. She has no rights to information from the partnership and is not owed fiduciary duties or the obligation of good faith and fair dealing by other partners or the partnership. As in the UK context, the holder of a charging order is in a similar position to a transferee (assignee). The difference between a charging order holder and a transferee is that the debtor partner’s interests are not directly transferred to the charging order holder. The interest subject to the charging order can be transferred to the charging order holder through a foreclosure order issued by the court. However, the foreclosure will not take place if the debtor partner, the partnership, or the other partners redeem the debtor partner’s interest.

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61 G Morse, Partnership Law, (OUP, 2010), 204.
62 UPA 1997 § 504 (a) (b).
63 ibid.
65 UPA 1997 § 504 (b).
66 UPA 1997 § 504 (c).
Chinese partnership law may introduce the charging order regime so that partnership assets will not be reduced because of actions taken by personal creditors of partners. Under the current Chinese partnership law, personal creditors can force partners to transfer their share by a court order. This may be advantageous to the personal creditors of partners, but it is unfair to other partners and creditors of the partnership. Similarly, it is also detrimental to the interests of creditors and debtor partners to have a partner’s bankruptcy automatically lead to dissolution of the partnership. This will be further discussed in the following subsections.

ii. Partner Bankruptcy and Partnership Continuity

The Chinese PEL provides that bankruptcy or an individual’s inability to pay off debts\(^{67}\) will lead to automatic withdrawal of the partner instead of partnership dissolution.\(^{68}\) The exception is that a limited partner who is an individual will not automatically withdraw from the partnership, even if she loses the ability to pay off debts.\(^{69}\) The consequence of a general partner’s withdrawal is that other partners will return the partner her share of property, with deductions for the losses she caused to the partnership.\(^{70}\) The partner continues to assume unlimited liability for the partnership debts that occurred before the withdrawal.\(^{71}\) As to withdrawal of a limited partner, the limited partner will only be liable for the partnership debts that occurred before withdrawal, to the extent of the property that has been returned to her.\(^{72}\)

That a partnership will continue to exist despite the bankruptcy of a partner is reasonable in the economic sense. If a partner’s bankruptcy leads to dissolution of the partnership, the going concern value of the partnership will be undermined. It is true that partnerships can change such default rule by contractual provisions. However, as many small partnerships may not be

\(^{67}\) Individuals cannot become bankrupt under Chinese law. Therefore bankruptcy of a partner here refers to bankruptcy of a corporate partner, and the equivalent circumstance for an individual is the inability to pay off debts.

\(^{68}\) PEL 2006, article 46.

\(^{69}\) ibid., article 78.

\(^{70}\) ibid., article 51.

\(^{71}\) ibid., article 53.

\(^{72}\) ibid., article 81.
sophisticated enough to devise such provisions, it is more reasonable to give partnerships greater continuity by default.

The continuity of partnerships reflects the view of the nature of partnerships in a given jurisdiction. Traditionally, partnerships are regarded as aggregates rather than independent entities under the Anglo-American law and will dissolve upon bankruptcy of a partner. The English partnership law retains this rule for general and limited partnerships, as they still lack separate legal personality under English law. On the other hand, a UK LLP, which is a body corporate, will continue to exist despite bankruptcy of its members.

In the US, the UPA 1997 recognises partnerships as legal entities and gives them greater continuity than traditionally under the common law. It provides that bankruptcy and other circumstances that would otherwise cause dissolution of the partnership under previous versions of UPA will only lead to dissociation of the partner. As long as other partners buy out the interests of the dissociated partner, the partnership will continue to exist as the same entity. In a word, a partner’s dissociation under the UPA 1997 can result in either a buyout of the dissociated partner’s interests by the partnership or a dissolution of the partnership.

These provisions are basically replicated by the ULPA 2001. However, the ULPA specifies that bankruptcy is not a circumstance for dissociation of a limited partner, although it will lead to dissociation of a general partner. The Uniform Limited Liability Company Act (ULLCA) 2006 contains a rule similar to that under the UPA, which states that bankrupt members of member-managed LLCs are regarded as dissociated from the LLC. However, it provides no obligation to

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73 Partnership Act 1890, s 33. It is worth noting that although this provision applies to a Scottish partnership as well, a Scottish partnership has separate legal personality. See section 1.1.2.

74 UPA 1997 § 601.

75 UPA 1997 § 603.

76 This is confirmed by the summary of the UPA, which can be found at http://www.uniformlaws.org/ActSummary.aspx?title=Partnership%20Act (accessed on November 1, 2013).

77 ULPA 2001 § 603.

78 ULLCA 2006 § 602.
buy out a dissociating member and gives greater protection to the continuity of an LLC.\textsuperscript{79}  

From the above discussion, it can be concluded that greater continuity of a business organisation usually suggests an independent entity status under the law. Although Chinese law does not explicitly recognise partnerships as legal entities independent from their partners, it has adopted a stance similar to the US partnership law regarding the continuity of partnerships when one or more partners are bankrupt. This provides further evidence for the \textit{de facto} entity status of partnerships under Chinese law.

Another noticeable trait of the US partnership law is that a limited partner will not dissociate from the partnership upon bankruptcy but a general partner will. In contrast, the Chinese PEL provides that limited partners will withdraw upon bankruptcy. This is unreasonable since the bankruptcy of limited partners does not have much effect on the limited partnership as they usually do not participate in the management.

If limited partners withdraw from the partnership upon bankruptcy, their share of property will be returned, and this will undermine the operation of the limited partnership. It is also not beneficial to the personal creditors of the bankrupt partner if the partner is forced to withdraw from a partnership that can produce profits in the long run. Therefore, the more sensible approach is to follow the US example and provide that general partners will withdraw upon bankruptcy but limited partners will not.

\textbf{Summary of 4.2.3}

When one partner of a partnership is bankrupt, the partnership should be protected from the direct claims of personal creditors of the bankrupt partner. Otherwise, it is not fair to non-debtor partners or to creditors of the partnership. Further, a partnership should continue to operate despite a partner’s bankruptcy

\textsuperscript{79} For more information, see the summary of the ULLCA at http://uniformlaws.org/ActSummary.aspx?title=Limited%20Liability%20Company%20(Revised) (accessed on September 1, 2014).
as long as it is financially sound and other partners with unlimited liability have no financial difficulty. Given such considerations for the interests of the partnership’s creditors and non-debtor partners, the current Chinese partnership law needs to embrace some changes. First, it can introduce the charging order regime developed under Anglo-American law, which permits a personal creditor of a partner to receive her interests in the partnership without allowing the creditor to seize upon the partnership assets. It recognises the going concern value of partnerships and embodies a balance between the interest of personal creditors, non-debtor partners, and creditors of the partnership. Second, the Chinese partnership law should formally acknowledge the partnership as an independent legal entity. A clarification of the entity status of partnerships is important for strengthening the continuity of partnerships and improving the consistency of partnership law. Finally, as limited partners do not participate in the management of a partnership and do not assume unlimited liability for partnership debts, limited partners should not be required to withdraw upon bankruptcy. The next section will proceed to examine the theoretical foundation of directors’/partners’ duties to creditors and propose a modification of such duties into Chinese law from a comparative perspective.
4.3 Directors’/Partners’ Duties to Creditors

4.3.1 Directors’/Partners’ Duties to Creditors in the UK and US

i. Overview

When a company is insolvent, creditors will replace shareholders as the residual claimants of the company’s value.¹ As a result, directors’ decisions directly affect creditors’ interests when the company is insolvent or approaching insolvency. Since creditors will bear the ultimate costs, directors have the moral hazard to take more risks when approaching insolvency. This is especially true in private companies where the gains of risk-taking will directly accrue to the director-owner. Problems of excessive risk taking may also arise in partnerships with limited liability, which are similar to private companies in that ownership overlaps with management and owners are shielded from creditors’ claims by the limited liability institution.² Therefore, personal liability should be imposed on directors, including shareholders who act as directors, and managing partners to constrain the problem of excessive risk-taking.

To protect creditors, the common law system has developed the doctrine that directors must take into consideration of the interests of the creditors of the company as part of their duties to the company in the event of financial difficulty.³ The UK Companies Act 2006 imposes on directors a statutory duty to consider the interests of creditors as part of the duty to promote the success of the company.⁴ Additionally, such duty is reflected in the fraudulent and wrongful trading clauses of the insolvency law. The fraudulent trading provision in the UK insolvency law provides that directors are liable to contribute to the corporate assets as the court thinks fit if they defraud creditors intentionally in the course of winding up.⁵ The wrongful trading clause, on the other hand, requires the directors to take “every step with a view to minimising the potential

² See 2.2.2 (ii).
³ Keay, “Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over Protection of Creditors,” 666 (above note 1).
⁴ CA 2006, s 172.
⁵ IA 1986, s 213.
loss to the company’s creditors” when they know that “there was no reasonable prospect that the company would avoid going into insolvent liquidation”.\(^6\) The result of failure to comply with this provision is also a contribution set by the courts. The major difference between fraudulent trading and wrongful trading is that the former requires proving an element of fraud and thus it is harder to establish than wrongful trading.\(^7\) In reality, it is wrongful trading which plays a primary role in constraining directors from taking excessive risks. More discussion on the UK wrongful trading provision will be made in the final section, which considers the possibility to emulate such provision under Chinese law.

Although a directorial creditor-regarding duty has been established for years in the corporate context under the common law, when it comes to partnerships with limited liability, it is unclear whether there is such duty. Theoretically, partners or managers of limited partnerships, LLPs and LLCs will also have the incentive to engage in excessive risk-taking in the event of insolvency and should be subject to a creditor-regarding duty.

The UK LLP seems to have embraced such theory. The duties of directors under the fraudulent and wrongful trading provisions are extended to members of UK LLPs.\(^8\) Additionally, by inserting 214A into the Insolvency Act 1986, the UK LLP Regulations 2001 provides that distributions made to members in the two years before insolvency will be clawed back if the member “knew or ought to have realised” at the time of the withdrawal that there was no reasonable prospect of avoiding an insolvent winding up.\(^9\)

However, in the US Delaware where the contractarian theory of LLCs and limited partnerships prevails, courts are reluctant to impose any mandatory duty on directors/partners of LLCs and limited partnerships as these business entities are considered to enshrine the maximum of freedom of contract. In a recent Delaware case, the court has declined to allow creditors of an LLC to claim

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\(^6\) ibid., s 214.


\(^8\) Fraudulent and wrongful trading provisions are provided for in IA 1986, ss 213, 214. Their application to LLP is mandated by UK LLP Regulations 2001 (SI 2001/1090).

\(^9\) UK LLP Regulations 2001 (SI 2001/1090).
against directors’ breach of fiduciary duties on behalf of the LLC. To determine whether it is necessary to impose a creditor-regarding duty on directors/partners, the following part will consider the theoretical debates surrounding such duty.

ii. Theoretical Debates on a Creditor-Regarding Duty

Except for its uncertainty, the directorial duty to creditors under the Anglo-American legal system has also attracted criticism on the ground that it will undermine efficiency. One argument claims that forcing directors’ to factor creditors’ interests into their decision-making will reduce directors’ incentive of risk-taking and as a result companies will miss profitable business opportunities and efficiency will be reduced.11

It is true that when directors become concerned with their own position rather than the goal of wealth-maximisation for shareholders, they tend to make more risk-averse decisions and even apply for premature liquidation.12 However, even if a creditor-regarding duty will reduce directors’ incentive of risk taking, it will not eliminate it. In addition, although an appropriate level of risk-taking spirit will stimulate the growth of the company, excessive risk-taking will lead to its downfall. When the company is on the edge of insolvency, directors and shareholders may gamble everything since it is creditors, not them, that will bear the ultimate costs. Under such circumstances, a creditor-regarding duty is indispensable in constraining shareholders and directors from risk-taking.

Further, the risks to directors posed by a creditor-regarding duty can be reduced by other mechanisms. The business judgment rule can prevent the courts from second-guessing directors’ business decisions and increase their incentive in risk-

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In this case, a creditor of an LLC filed derivative claims against the board of the LLC for breach of fiduciary duties of care and loyalty. Although admitting creditors of the corporation had a right to make a derivative action against breach of duty to the corporation under the Delaware law, the court denied that creditors of the LLC had the derivative standing to sue on behalf of the LLC principally on the basis of the principle of freedom of contract underpinning the LLC statute.

11 Keay, “Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors,” 682 (above note 1).

12 ibid., 683.
taking. The business judgment rule under the US corporate law presumes that corporate directors have exercised due care by acting on an informed basis, in good faith and in the honest belief that their actions are in the best interests of the corporation unless a rebutting evidence can be provided. Given the constraints of the business judgment rule, it is rare for the US courts to hold directors liable for breach of duty of care.\(^\text{13}\)

Also, liability insurance for directors is likely to foster their risk-taking incentive and neutralise the effects of a creditor-regarding duty. In the UK, under Section 233 of Companies Act 2006, companies are permitted to insure their directors against liability for breach of duty. Such insurance is also available in the US, but generally at a much higher price.\(^\text{14}\)

Another efficiency-based argument against a creditor-regarding duty is that such duty will increase directorial-monitoring and agency costs.\(^\text{15}\) Admittedly, once directors are charged with a duty to creditors triggered by deterioration of the company’s financial health, they have to engage in constant checking of the companies' financial situation and consult legal and financial experts for this purpose. Such evaluations will cost time and money and the losses will ultimately accrue to the company. However, even without a creditor-regarding duty, responsible corporate governance requires directors to closely monitor the financial situation of the company. Moreover, as directors' monitoring may identify and solve the problems in the management of the company, the costs of directors' monitoring increased by a creditor-regarding duty are likely to be offset by improvement of the company's financial health.

Finally, it has been argued that creditors can protect themselves by charging compensation for higher risks or inserting contractual terms to constrain directorial behaviour. Admittedly, adjusting creditors such as banks and institutional lenders usually condition loans on security or personal guarantee from directors and adjust interests to the risks associated with the company.


\(^{14}\) Keay, “Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over Protection of Creditors,” 685 (above note 1).

\(^{15}\) ibid., 685-686.
However, most creditors are non-adjusting creditors who cannot match their contractual terms to the risks posed by the company, including tort creditors who have no opportunity to negotiate with the company before the damage is caused. In addition, even for adjusting creditors, it is difficult for them to assess the risks ex ante and prevent directors behaving opportunistically simply by contracting.\textsuperscript{16} Creditors cannot charge compensation ex ante based on unpredictable risks. Even if creditors have carefully crafted contractual terms ex ante, such terms may not be fulfilled in the event of insolvency. Under such circumstances, creditor-regarding duties are indispensable for restraining directors from single-mindedly pursuing wealth-maximisation for the firm. Such duty also allows directors to take into account creditors' interests without being exposed to the claim of not acting in the best interests of shareholders.\textsuperscript{17}

To summarise, the arguments against the efficiency of the directorial creditor-regarding duty are questionable. It is necessary to impose on directors a duty to creditors when a firm is in financial difficulty in order to constrain directors from engaging in excessive risk-taking. The above analysis also holds true in the context of partnerships with limited liability, where partners are incentivised to take excessive risks by the limited liability protection. Drawing on the theory and practice in the UK and US, the remaining sections will turn to the absence of a directors'/partners' duty to creditors under Chinese law.

4.3.2 Directors'/Partners’ Duty to Creditors in China

i. Directors’ Duty to Creditors under Chinese Law

(a) Overview

Under Chinese law, there is no express provision that directors/partners owe a duty to creditors. Nor it is likely that such duty will be developed within the current framework of duties of directors/partners given the judicial rigidity in interpreting fiduciary duties.\textsuperscript{18}

\textsuperscript{16} See 3.1.1.
\textsuperscript{17} ibid., 670.
\textsuperscript{18} See 3.2.2(i).
However, Chinese company law and bankruptcy law actually leaves the possibility for creditors to claim against directors. Under the Company Law 2005, one of the circumstances that disqualify a personal as a corporate director is being a director of a company and was personally liable for the bankruptcy of the company.\(^\text{19}\) Within three years from the liquidation of the company, the said person shall not serve as a director of another company. This stance is confirmed by the EBL, which further provides that a director shall bear civil liability according to law when her failure to comply with duties of loyalty and diligence leads to bankruptcy of a company.\(^\text{20}\) This means directors may bear civil liability for causing damage to creditors when they breach their duties under the law. Another provision in the EBL that may be the ground for creditors to claim against directors states that the legal representative\(^\text{21}\) of the debtor company and the person who is directly responsible will bear the liability for compensation if the debtor company commits an act that constitute void or voidable actions to the detriment of creditors.\(^\text{22}\)

Nevertheless, the above provisions are too general to be functional. In practice, directors and shareholders are usually held liable to creditors for breaching their “liquidation obligation” as provided by the Company Law 2005 and the relevant judicial interpretation issued by the SPC. The “liquidation obligation” is designed to ensure timely and lawful liquidation and is imposed on shareholders of a limited liability company (private company) or the directors and controlling shareholders of a joint stock company (public company). The contents of the liquidation obligation are two-folds. First, the Company Law 2005 provides that a liquidation committee must be set up within 15 days from the date when the circumstances for dissolution arise,\(^\text{23}\) including: (1) the term of business operation as specified in the company’s articles of association expires or other causes for dissolution as specified in the articles of association occur; (2) a resolution on dissolution is passed by the shareholders assembly; (3) merger or

\(^{\text{19}}\) Company Law 2005, article 147.

\(^{\text{20}}\) EBL 2006, article 125.

\(^{\text{21}}\) Legal representative under Chinese law is a person who represents the company to outsider and has power to bind the company. It can be assumed by executive director, the chairman of the board of directors or manager of a company, see Company Law 2005, article 13.

\(^{\text{22}}\) EBL 2006, article 128. What constitutes void and voidable actions are provided by articles 32 and 33 of the EBL 2006. For more discussion of void and voidable actions, see 4.1.2.

\(^{\text{23}}\) Company Law 2006, article 183.
division of the company necessitates its dissolution; (4) the business licence is revoked, the company is ordered to close down, or the registration of the company is revoked according to law;\textsuperscript{24} (5) the court dissolves the company upon demand of shareholders when the company was in great difficulty in operation and management and its continuing operation will incur great losses to shareholders.\textsuperscript{25}

The consequence of failure to set up a liquidation committee in time is provided in a judicial interpretation issued by the SPC,\textsuperscript{26} which states that creditors can sue shareholders of an limited liability company or the directors and controlling shareholders of a JSC for compensation for the debts of the company to the extent of the losses caused by their failure to form a liquidation committee and commence liquidation within the statutory time limit. Further, if their neglect to perform their liquidation duty leads to loss of the primary properties, account books, and important documents of the company and renders it impossible to carry out liquidation, creditors can demand them to bear joint and several liability for the debts of the company.

Second, directors and controlling shareholders must refrain from misbehaviour that disrupt a fair and timely liquidation. As provided by the relevant judicial interpretation, directors and controlling shareholders can be held liable to creditors for maliciously disposing of the corporate assets after the company is dissolved, deregistering the company with a false liquidation statement\textsuperscript{27} or deregistering the company without liquidation.\textsuperscript{28}

\textsuperscript{24} Business license can be revoked for fabricating statement of registered capital, having no operations within six months after the registration or stopping trading for six months after starting business and so forth. See Regulations on the Administration of Company Registration [公司登记管理条例 Gongsi Dengji Guanli Tiaoli], an English translation is available on http://vip.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=66585 (accessed on May 5, 2013).

\textsuperscript{25} Company Law 2006, article 180.


\textsuperscript{27} ibid., article 19

\textsuperscript{28} ibid., article 20
The main purpose of the liquidation obligation is to constrain widespread neglect and abuse in the liquidation procedure. To illustrate this point, typical cases on liquidation obligation will be discussed here.

(b) Cases on Directors’ Liquidation Obligation

In *Shanghai Cunliang Commercial Limited Liability Company (Cunliang) vs. Jiang Weidong & Wang Weiming etc.*, the ninth guiding case issued by the SPC in 2012, the issue of failure to liquidate a company in time was discussed. In this case, Cunliang was owed the payments for steel it delivered to Changzhou Tuoheng Machinery Limited Liability Company (Tuoheng). Cunliang sued shareholders of Tuoheng for delay in liquidating the company after its license was revoked and demanded them to be jointly liable for the debts of Tuoheng. The court found that shareholders of Tuoheng had the liquidation obligation and their delay in liquidation had led to loss of the main assets and accounts of the company; therefore, they should be jointly liable for the debts of the company in accordance with the company law and the relevant judicial interpretation. The court also dismissed two shareholders’ claims that they were not involved in the management of Tuoheng on the ground that as Tuoheng was a limited liability company, so its shareholders as a whole should be treated as the liquidation obligator under the company law and all of them have the obligation to liquidate the company in time regardless the number of shares and the extent of involvement in the management.

The Cunliang case is concerned with the inaction of shareholders when the company should be put into liquidation. There are other cases concerned with the malicious behaviour against creditors committed by directors and controlling shareholders. For example, in a case published by the judiciary in the city of Qingdao, a company was deregistered without giving notice to its creditor,

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29 See previous discussion on the lawmaking power of the SPC.
30 The official report of this case can be found on the website of the SPC: [http://rmfyb.chinacourt.org/paper/html/2012-09/26/content_51507.htm](http://rmfyb.chinacourt.org/paper/html/2012-09/26/content_51507.htm).
leaving its creditor unable to collect its debts. The creditor alleged that shareholders of the debtor company had maliciously deregistered the company to escape debt, as they did not give notice to the creditor during the liquidation procedure as required by law. This case resulted in conciliation between the two parties with the shareholders paying part of the corporate debt to the creditor.

In another case also published by the Qingdao judiciary, shareholders of a LLC deregistered the company with liquidation statement, which showed that the company had completed the liquidation procedure and paid all the debts. The appellate court found that the liquidation statement was fabricated and the shareholders’ intent in deregistering the company was to avoid payment to a creditor. Therefore, it concluded that shareholders should be jointly liable to the creditor.

From the above cases it can be concluded that the liquidation obligation under Chinese law is designed to ensure that creditors’ interests will not be hampered by delay or irregularities in the liquidation procedure. However, an analysis of the statutes and cases will reveal that the liquidation obligation is not intended to constrain directors’ excessive risk taking problem and new provisions should be devised. The discussion below will compare liquidation obligation with the UK wrongful trading clause to demonstrate this point and consider the possibility to introduce a wrongful trading provision into Chinese law.

ii. Revising Directors’/Partners’ Duty to Creditors under Chinese Law

(a) Comparative Analysis of Wrongful Trading and Liquidation Obligation

Under the UK wrongful trading provision, directors or controlling shareholders can be held liable to creditors if they fail to take the steps they ought to have taken to minimise the loss to creditors when they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. To determine whether directors know or ought to have known the prospect of an insolvent liquidation and whether they have taken necessary steps to reduce losses, the courts have to refer to the test

\[ \text{ia 1986, s 214.} \]

\[ \text{ibid.} \]
of directors’ knowledge, skill and experience.\(^{34}\) If a director fails to live up to his duty under the wrongful trading provision, upon application of the liquidator, the court will mandate her to contribute to the company’s assets an amount as it sees fit.\(^{35}\)

The function of liquidation obligation under the Chinese law sometimes looks similar to that of the UK wrongful trading provision. For example, when a company is in a dire financial situation and its business licence was revoked for stopping trading for more than six months,\(^ {36}\) its directors and controlling shareholders are obligated to liquidate it timely and lawfully. Delay in liquidation or maliciously disposing the company’s assets will result in a liability for the company’s debts.\(^ {37}\)

Similar behaviour could also be caught by the UK wrongful trading provision, which requires directors to take necessary measures to reduce losses to creditors. To the extent that the liquidation obligation reduces losses to creditors when a company is in financial difficulty, its function seems similar to that of wrongful trading. However, a closer examination of the two will reveal that they are fundamentally different.

First, the fundamental distinction between the liquidation obligation under Chinese law and the UK wrongful trading provision lies in their purpose. While the former compels directors to liquidate timely and lawfully when circumstances for dissolution have arisen, the latter is designed to constrain directors’ excessive risk taking by requiring them to reduce losses to creditors when they know or ought to have known there is no reasonable prospect of avoiding an insolvent liquidation.\(^ {38}\) Under the liquidation obligation, directors’ interests are not aligned with creditors and they do not have much incentive to take necessary steps to reduce losses to creditors.


\(^{35}\) Ibid., s 214 (1).

\(^{36}\) Business license can be revoked for fabricating statement of registered capital, no operations within six months after the registration or stop trading for six months after starting business and so forth. See Regulations on the Administration of Company Registration (above note 24).

\(^{37}\) Company Law 2006, article 184; Provisions of the Supreme People’s Court on Some Issues about the Application of the Company Law (II), articles 18-20 (above note 26)

\(^{38}\) See 4.3.1.
Second, due to the divergent policies behind them, the liquidation obligation and the UK wrongful trading have different, although sometimes overlapping, scope of application. For example, deregistering the company without liquidation does not lead to a breach of the UK wrongful trading provision since this provision only bites when directors plunge the company into insolvency by taking excessive risks. However, the liquidation obligation will be breached if directors deregister the company without liquidation and this is one of the typical misdeeds targeted by the liquidation obligation provisions. Another example is that liquidation obligation will not prevent directors from liquidating the company prematurely and causing losses to creditors. In contrast, this is caught under the UK wrongful trading provision.\(^{39}\)

Third, the triggering point of the liquidation obligation and directors’ duty under the UK wrongful trading provision is different. The liquidation obligation is not defined by reference to a company’s financial situation and is triggered by the circumstances for dissolution, including revocation of business licence, non-trading for more than six months, and shareholders’ application for judicial dissolution etc. These circumstances may occur before or after a company is in financial difficulty. In contrast, the wrongful trading provision will only be triggered when a company is in financial difficulty. To be specific, under the UK wrongful trading provision, directors’ duty arises when there is no reasonable chance of avoiding an insolvent liquidation, a point earlier than the onset of formal liquidation procedure.\(^{40}\)

Fourth, it is creditors who have the standing to sue against breach of the liquidation obligation. This is because in China breach of the liquidation obligation is usually viewed as a tort committed against creditors. Thus, by the principle of tort law, the right to claim against breach of liquidation obligation is conferred on creditors.\(^{41}\) In contrast, in the UK, the right to claim against

\(^{39}\) See Goode, *Goode on Principles of Corporate Insolvency Law*, 532 (above note 34).


wrongful trading is conferred on the liquidator, rather than individual creditors, in the insolvency proceeding. This derives from the common law principle that directors’ duty to creditors are part of their duty to the company and is not owed to individual creditors.\textsuperscript{42}

To summarise, the liquidation obligation under the Chinese law diverges greatly from the UK wrongful trading provision. It is not intended to constrain directors’ excessive risk taking behaviour although it sometimes can catch these behaviour. Therefore, China needs to introduce a directorial duty to creditors, specifically designed to mitigate excessive risk taking. As will be further discussed, directors’ duty under the UK wrongful trading provision can be a viable model for China.

(b) Introducing Wrongful Trading into Chinese Law

With the abolition of the paid-in minimum capital regime in China, creditors are faced with more risks of directors’ unreasonable trading. In order to curb the excessive risk-taking problem, China needs to introduce a directorial duty to creditors in financial difficulty. The UK wrongful trading provision can be a promising model for China to emulate, however, some cautions must be made:

First, directors’ duty under the wrongful trading provision should be triggered when there is no reasonable prospect of paying off debts that fall due, rather than when the company meets the legal definition of bankruptcy under Chinese law. The financial standard for bankruptcy under Chinese law is relatively stringent and requires both cash flow insolvency and balance sheet insolvency.\textsuperscript{43}

Further, the application of wrongful trading should not be restricted to the insolvent liquidation. In China, the formal bankruptcy procedure is rarely used and often delayed due to the stringent financial standard for starting the procedure and the interference of the government.\textsuperscript{44}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{42} Keay, “Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors,” 670 (above note 1).
\item \textsuperscript{43} EBL 2006, article 2. See 4.1.2 (i).
\item \textsuperscript{44} Roman Tomasic and Zinian Zhang, “From Global Convergence in China’s Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China,” \textit{Journal of Corporate Law Studies} 12, no. 2 (2012): 295.. Also see 4.1.3 (ii).
\end{itemize}
\end{footnotesize}
Second, as directors are most familiar with the state of the business, the Chinese wrongful trading rule should not force the directors to liquidate the company when it is in financial difficulty. Rather, they should be allowed to decide whether to continue trading, rescue company or put the company into insolvent liquidation as long as they honestly believe doing so can reduce losses to creditors. This can encourage an increasing use of out-of-court workouts with creditors and the reorganisation procedure provided by the Chinese bankruptcy law. Currently, it is rare for bankrupt enterprises to take advantage of the reorganisation procedure in China. Promoting rescue of businesses not only gives them a second chance, but it is also beneficial for their creditors when a business is worth more as a going concern than being sold piecemeal.

Third, a wrongful trading rule in China should be formulated with more certainty. With the absence of stare decisis and limited judicial discretion, judges in China do not have the power to establish law through their decisions in individual cases. Therefore, the task of fine-tuning a wrongful trading provision should not be left to the Chinese judiciary. Rather, the legislature should formulate the wrongful trading provision in a more definite way. To begin with, a non-exhaustive list of behaviour that constitute wrongful trading can be added to the Chinese wrongful trading clause and further expanded through the judicial interpretation of the SPC. For example, the list can include premature liquidation that causes losses to creditors, excessive compensation to creditors when the company is in financial difficulty, and failure to preserve the company’s assets and collect the company’s debts. Further, besides the general language of “take every step to minimise losses to creditors”, a list of specific defenses for directors should be provided. Common practices of rescuing the company should be recognised as defenses for directors. For example, introducing “strategic investors” to purchase the shareholding of the company, a common method for directors in China to rescue the company, should be an adequate ground of defense if properly conducted. Finally, the method for calculating the compensation should

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45 According to a research, in 2008 there were only 23 reorganisation cases accepted by Chinese courts and this amounts to 0.78% of all in-court bankruptcy cases. See ibid., 304.; also 4.1.4.


47 Tomasic and Zhang, “From Global Convergence in China’s Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China,” 314 (see above note 44).
be specified. As the purpose of wrongful trading is to limit and reduce the losses of creditors, the amount of compensation should be limited to the losses of corporate assets caused by directors’ wrongful trading.

Summary of 4.3

The common law system has established the principle for years that directors must take into consideration of the interests of the creditors of the company as part of their duties to the company in the event of financial difficulty. However, it is still unclear whether such duty will apply to partnerships with limited liability. On examination of theoretical debates on this issue, it can be concluded that directors should be subject to a creditor-regarding duty when the firm is in financial difficulty in order to constrain directors from taking excessive risks to the detriment of creditors. As the excessive-risk taking problem caused by limited liability also exists in partnerships with limited liability, partners in these entities should also be subject to creditors in the event of financial difficulty.

In China, directors and shareholders are usually held liable to creditors for breaching their ‘liquidation obligation’ in accordance with the Company Law 2005 and the relevant judicial interpretation issued by the SPC. The liquidation obligation may constrain excessive risk-taking in some cases, however, it is not designed for this purpose and its main function is to ensure that creditors’ interests will not be hampered by delay in liquidation or irregularities in the liquidation procedure. Therefore, it is necessary to introduce a wrongful trading rule into China based on the UK model, although some modifications must be made.

Conclusion of Chapter 4

The Chinese EBL 2006 has made great progress compared with the previous Chinese bankruptcy law. Against the background of deepening market-oriented reform, Chinese bankruptcy law is evolving from a public policy tool to a formalised mechanism for debt collection. However, it is still far from the “efficient and effective” bankruptcy law as envisioned by the UNCITRAL legislative guide, principally because the state still interferes with the
bankruptcy procedure. Further, the EBL has failed to provide detailed rules for partnership bankruptcy, although partnerships are explicitly permitted to apply for the liquidation procedure. Partnership bankruptcy is a subject rarely discussed in China. This is partly because partnerships are mostly small businesses, which are usually eclipsed by corporations, especially SOEs. However, with the introduction of limited partnerships and SGPs, partnerships will assume a bigger role in the economy, and more cases of partnership insolvency are likely to emerge. In time, partnership bankruptcy will become a problem that must be dealt with. Finally, directors’/partners’ direct duty should be introduced into Chinese bankruptcy law to constrain the problem of excessive risk taking. If China is going to reform its bankruptcy in the future, it can emulate the bankruptcy law in the UK and US, especially bankruptcy rules for partnerships.

However, emulating legal rules of other countries entails potential pitfalls. One of them is lack of thorough study of the foreign laws, which will lead to flawed legislation. Another more critical problem is poor implementation of the law. In China, a major obstacle to implementation of law is the unwillingness of the government to change its role and let the market function under the rule of law. This has been shown by the ubiquitous state involvement in bankruptcy cases, which has led to subordination of efficiency to political goals. Implementation of law also depends on the establishment of supporting institutions. For example, with the absence of a registry system of personal assets, it is difficult to distinguish partners’ personal assets from partnership assets. This has also obstructed the establishment of a personal bankruptcy regime in China.\(^{48}\) In a nutshell, formulation of rules is only the first step. A successful emulation ultimately turns on the implementation of law.

Chapter 5 Conclusion

5.1 Extending Creditor Protection Rules to Partnerships with Limited Liability

Limited liability is usually viewed as a feature of corporations, but this thesis has identified a trend of expansion of limited liability into partnerships.\(^1\) In fact, this trend already began to emerge in the US as early as the 1970s, when LLCs were created with limited liability despite their resemblance to partnerships. Then, in the 1990s, LLPs were established in the US to protect professionals from the liability arising from the negligence or misconducts of other partners. Finally, the limited partnership, which had been neglected in the US when it was first created, was revived as the form of choice for private equity firms. A similar pattern can also be found in Britain, which has also enacted an LLP statute in 2000 and seen limited partnerships become a major form for private equity firms. China has also embraced this trend by introducing limited partnerships and SGPs with the promulgation of a new partnership law in 2006.

While limited liability can be instrumental in amassing large amounts of capital and encouraging entrepreneurialism, many scholars in the UK and US have questioned its theoretical justification.\(^2\) Based on a review of the literature discussing limited liability, this thesis concludes that limited liability cannot be fully justified by efficiency and entails huge risks for creditors, especially those of private companies and partnerships with limited liability. Hence, limited liability should be constrained with various legal devices, and creditor protection should be strengthened when business owners are shielded from personal liability.

In reality, the expansion of limited liability is accompanied by a deregulatory trend in corporate law and relaxation of creditor protection rules in the UK, US, and China. For example, most US states require no minimum capital, and the UK has abolished the minimum capital requirement for private companies.\(^3\) Very recently, China also abolished its minimum capital requirement for companies in

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1 See Chapter 1.
2 See Chapter 2.
3 See 3.1.2.
2014. Further, although in the US partnerships with limited liability closely resemble corporations in terms of entity status and liability shield, they are subject to less regulation than corporations. In China, there is also a regulatory asymmetry between corporations and partnerships. While the regulatory asymmetry in the US reflects a division between the contractarian and communitarian theories of the firm, such asymmetry in China seems to be out of neglect rather than deliberate policy considerations.

The regulatory asymmetry between corporations and partnerships with limited liability in terms of creditor protection is questionable. Traditionally, partners undertake unlimited liability for the debts of the partnership. Therefore, unlike creditors of corporations, creditors of partnerships are not protected by stringent legal rules. However, with unlimited liability being replaced with limited liability in partnerships, the absence of creditor protection rules under partnership law is no longer justifiable.

This thesis has examined the essential creditor protection rules under corporate law in the UK, US, and China and considered whether they should be transposed into partnership law. The findings are as follows: first, the legal capital rule, including minimum capital and capital maintenance, is redundant and ineffective for creditor protection; it has seen its decline in UK, US, and China. Therefore, there is no reason to extend legal capital to partnerships. Second, compared with the legal capital rule, mandatory liability insurance is a better safeguard for tort creditors; liability insurance can ensure compensation for tort creditors and have a regulatory function on insured businesses. In practice, professional partnerships are usually required to purchase liability insurance. Third, managing partners in partnerships with limited liability should be subject to a minimum level mandatory fiduciary duties as directors in corporations. This is because fiduciary duties are indispensible for the internal governance of partnerships. Fourth, when the limited liability shield in non-corporate entities has evolved to be like that in corporations, they should also be subject to the veil-piercing rule, which is a final resort for creditor protection. In the US, the judiciary has already started to apply veil-piercing to non-corporate entities.

\[^4\] See 3.1.3.
Last and most importantly, the limitations of these measures for creditor protection have been well noted in this thesis. It has found specific rules in the insolvency protection are more meaningful for creditor protection. This is true for both corporations and partnerships. Insolvency procedure is a collective procedure for creditors to collect their debts. A sound insolvency regime can prevent creditors from acting individually and grabbing the assets of the debtor. In this way, it saves costs for individual creditors and preserves the aggregate value of the debtor’s assets. The automatic stay on creditors’ individual actions can allow breathing space for the debtor and ensure equitable and orderly distribution for creditors. In addition, avoidance of fraudulent transfers and preferences can recover assets for the benefit of all creditors. Further, as in the corporate context, a reorganisation procedure for partnerships can be instrumental in maximising the value of a partnership as a going concern and increase the chance of repayment for its creditors.

In a nutshell, as partnerships go from unlimited liability to limited liability, their creditors start to face the risks of limited liability, no less than creditors of corporations. Therefore, corporate rules for creditor protection should be adapted to the context of partnerships with limited liability. Most importantly, a formal insolvency procedure for partnerships should be established by analogy to that of corporations. The regulatory asymmetry in creditor protection between partnership law and corporate law should be closed up to prevent directors and business owners from engaging in “regulatory arbitrage,” namely to circumvent regulation of corporate law by registering as alternative entities that can also provide limited liability. In considering whether to extend corporate rules for creditor protection into partnerships, this thesis has also made an overall evaluation of the creditor protection regime in China, based on a comparison with its UK and US equivalents. The next section will make a summary of findings and recommendations on the Chinese creditor protection regime.

5.2 Recommendations for Strengthening the Creditor Protection Regime in China

Since the launch of economic reform in the 1980s, China has been making substantial changes on its legal infrastructure to bring it into line with its
booming market economy. In today’s China, a modern legal framework, essential for a market economy, is already taking shape. The creditor protection regime under Chinese law resembles that in the UK and US in terms of basic principles. However, it still has its unique features and problems that are associated with a society in transition. Based on a comparison with UK and US law, this thesis has made an overall evaluation of the creditor protection regime in China and propounded several recommendations.

First, the legal and institutional environment for creditor self-protection in China should be improved. If sophisticated creditors can effectively protect themselves by adjusting interest rates and designing complex covenants, the costs of going through the legal process will be saved. However, currently, creditors in China, including banks, are still impeded from self-protection by factors such as lack of information of borrowers, difficulty in enforcing contracts, and flaws in the security law.

Second, China should further reform the legal capital rule under its company law. In 2014, China abolished the minimum capital requirement for limited liability companies (private companies) and joint stock companies (public companies). However, its rigorous capital maintenance regime remains intact. To encourage investment and entrepreneurialism, China should gradually relax the capital maintenance regime and supersede it with more effective rules for creditor protection.

Third, China should encourage the development of liability insurance. Compared with legal capital, mandatory liability insurance is a better safeguard for tort creditors. It ameliorates businesses’ exposure to escalating legal liability and at the same time ensures compensation for tort victims. Moreover, insurance companies can play an important role in monitoring insured companies for compliance with laws and regulations. Although the liability insurance industry is growing in China, it still has a long way to go. Particularly, insurance companies need to strengthen their expertise in monitoring insureds. Otherwise insureds will lack the incentive to prevent the occurrence of liability. This is not only detrimental to the insurance industry but also to the society as a whole.
Fourth, to improve the flexibility and effectiveness of fiduciary duties and the veil-piercing rule, the Chinese judiciary should be strengthened. As China has a statute-based legal system with the legislature at the centre, the judiciary in fact has no law-making power and is shackled in its discretion. Therefore, unlike in the UK and US where fiduciary duties and veil-piercing are developed by judges and being continually shaped by judicial interpretation, fiduciary duties and veil-piercing rule are promulgated in Company Law 2005 by the legislature.

The lack of law-making power of the Chinese judiciary has weakened the efficacy of fiduciary duties and the veil-piercing rule, as their main force comes from allowing the judiciary to impose liability on directors or controlling shareholders on a case-by-case basis. To improve the coherency and flexibility of fiduciary duties and veil-piercing rule under Chinese law, the Chinese court should be given more discretion, and at the same time an equivalent to the rule of *stare decisis* should be established. However, as the Chinese legislature will still be the main force of lawmaking, it is still incumbent upon the legislature to promulgate specific rules to clarify many issues regarding fiduciary duties and veil-piercing. Further, it is impossible for the Chinese judiciary to develop a creditor-regarding duty, following their counterparts in the UK and US, and therefore the legislature should provide for such duty in statutory law. One example for emulation is the UK wrongful trading clause.

Fifth, Chinese bankruptcy law needs to be revamped to achieve fair and efficient distributions for creditors. In principle, Chinese bankruptcy law resembles those in both the UK and US. To facilitate creditor protection through the bankruptcy law, this thesis has proposed modifications of Chinese bankruptcy law drawing on the legal rules in both the UK and US. For example, a directors’/partners’ duty to creditor has been proposed based on the example of the UK wrongful trading provision. However, the most worrying problem of Chinese bankruptcy does not lie in its flaws of formulation. Rather, it is the state interference that runs through most bankruptcy cases. To be specific, local governments can influence bankruptcy cases handled by the courts under their purview by preventing them from accepting bankruptcy cases and controlling the bankruptcy procedure through liquidation committees or interim working committees. Thus, the efficacy of Chinese bankruptcy law ultimately turns on
the governmental willingness to retreat from the stage and unleash the power of the market. Moreover, China should devote more resources to the cultivation of insolvency practitioners who can supervise bankruptcy cases professionally and independently.

Finally, the creditor protection regime in Chinese partnership law should be reinforced. Most importantly, a partnership bankruptcy regime should be established. This thesis has made proposals for establishing a partnership bankruptcy regime based on the experience of the UK and US. As their experience demonstrates, most rules for partnership bankruptcy should be designed by analogy to those for corporations. However, special consideration should be given to the characteristics of partnerships, such as unlimited liability of general partners and lack of separation of management from ownership. In addition, as partnership bankruptcy may lead to partner bankruptcy and vice versa, conflicts between partnership creditors and partners’ personal creditors must be considered.

To summarise, this thesis has made an overall evaluation of the creditor protection regime in China and found that it has already incorporated legal rules essential for counteracting the risks of limited liability and thus balanced the interests of business entities and their creditors. However, the creditor protection regime in China is still a work in progress and needs to borrow from the theory and practice of other countries.

This thesis has relied on the theory and practice in the UK and US to inform the evaluation of Chinese law, not because the legal rules in these two countries are perfect but because of the constant exposure of their imperfections and their fast responsiveness to new realities. As a country in the midst of rapid changes, China can not only emulate specific legal rules in the UK and US but can also assimilate the rationality and pragmatism of their legal theory. A caution must be made when China is emulating legal rules of the UK and US. As China has a statute-based legal system with the legislature at the center, importation of judge-made law from the UK and US is unwise without a transformation of the judicial role in China, which is going through a progressive change and needs to be closely observed by the legal scholarship.
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