

# The Protection of the Right and Interests of Small and Medium-sized Creditors in Corporate Bankruptcy under the Framework of Chinese Bankruptcy Law

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**Abstract:** Protecting the interests of creditors is the key to improve the business environment of our country. However, the current law of our country is weak to protect the creditors. When an enterprise enters bankruptcy procedures, the game between creditors and enterprises exists at various stages of bankruptcy. However, the small creditors often have less voice in the creditors' meeting, and the large creditors have more decision-making power in the meeting, making the interests of the large creditors as the core in the meeting and causing serious damage to the interests of the small creditors. Based on the process of corporate bankruptcy, this paper analyzes the inadequacy of the protection of small creditors in each stage after corporate bankruptcy, and puts forward some suggestions for future amendment.

**Keywords:** Company law, Bankruptcy law, Forced liquidation, Bankruptcy reorganization, Creditor, Interest protection.

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## 1. Introduction

In the current law of our country, Enterprise Bankruptcy Law provides guarantee for standardizing enterprise bankruptcy procedure, settling creditor's rights and debts fairly and protecting the legal rights of creditor and debtor. After the creditors declare for bankruptcy, no matter whether the reorganization is successful or not, the game between the creditors of large and small size also exists. When the enterprises discuss the reorganization plan, the investors are unwilling to pay off in full, which will certainly cause damage to the interests of the creditors; and when the reorganization failure enters into the liquidation procedure, the protection of the interests of the small creditors shall be emphasized even more at this time. The liquidation procedure of the company must mean that the company is insolvent and needs to pay off the debts in proportion. However, there are few provisions on how to protect the interests of small creditors in the process of corporate bankruptcy, which leads to the situation that the rights and interests of the minority creditors are easy to be damaged in the process of corporate bankruptcy, reorganization and liquidation and is not conducive to maintaining the order of economy. Existing research mainly focus on a certain stage of bankruptcy. For example, Fu Xin takes the company's bankruptcy status as the perspective[1], while He Jinling analyze the insufficiency of creditor protection in the process of bankruptcy reorganization[2], and Yin Yan analyze the drawback in the process of bankruptcy liquidation[3]. This article will figure out the deficiencies of Chinese laws at various stages of bankruptcy, comparing Chinese law with that of Japan and the United States and increases the drawbacks of existing laws in the process of companies from registration to operation to bankruptcy.

## 2. Necessity and Emphasis of Protecting Small Creditors in the Case of Company Bankruptcy

Creditors in bankruptcy reorganization procedures are divided into general creditors, secured creditors, petty creditors, employee creditors and tax creditors. Petty creditors have less say and decision-making power in creditors' meetings, and it is often difficult to safeguard their own interests. So it is necessary to improve relevant laws and regulations. "The key point of protecting ordinary creditors and petty creditors is to set up a reasonable amount standard to distinguish ordinary creditors and petty creditors. For petty creditors, if they follow the order of repayment strictly, they will not be repaid basically. Therefore, the key point of protecting the interests of petty creditors is how to establish a targeted repayment scheme[2]".

## 3. Issues Concerning the Protection of Small and Medium Creditors in The Existing System

### 3.1. Absence of a small creditor protection system

Although the system of China's bankruptcy reorganization procedure is complete, there are still some problems on the specific protection measures for small creditors. For example, China still insists on the principle of specific voting group rather than individual creditors in the voting of compulsorily approving the reorganization plan. As for the small creditors, there is no special protection policy in the Bankruptcy Law.

### 3.2. Absence of fiduciary obligations of directors to shareholders and creditors

At the time of company registration, the person-in-charge of the company may exaggerate the registered capital for the purpose of highlighting the company's strength, fill in the registered capital and payment period arbitrarily, and change

the company's articles of association before expiry of the payment period to move the period later or not pay the registered capital. The registered capital shall be linked up with the credit of the enterprise. Shareholders are required to be liable to the company to the extent of the company's registered capital, and a creditor shall require the shareholder to bear compensation liability for the portion of the company's debts which cannot be repaid within the scope of unpaid principal and interest. If the registered capital is not actually paid, the company is actually burdened with debts equal to the registered capital. If the company enters into the liquidation procedure due to poor management, the company will be insolvent, but at the same time bears debts equal to the registered capital, so it is difficult for shareholders and creditors to obtain funds.

After the company goes into bankruptcy, due to the deterioration of financial status, the management of the company may make a lot of high-risk investments for profit so as to fill up the fund loopholes of the company. "The creditors take the ownership role of the shareholders and become the actual owners of the remaining assets of the company. The risk of capital impairment that should have been borne by the shareholders is transferred to the creditors. In all the legal articles of the Enterprise Bankruptcy Law, there are almost no articles in which directors bear fiduciary obligations to the creditors[1]"

### **3.3. The regulations do not provide for the ability of the enterprise to restructure**

The reorganization procedure is actually a game between the interests of the creditors and the enterprises. When the enterprises apply for reorganization, some enterprises only want to prolong the time and evade debts through reorganization; some enterprises have no possibility of successful reorganization, but entering into the liquidation procedure after the failure of reorganization will lead to the depreciation of the assets of the enterprises, which is even more unfavorable for the creditors to obtain effective repayment. For those enterprises that do not have the ability to carry out reorganization, the reorganization procedure is no doubt to shift the risks borne by the enterprises to the creditors, while China does not impose restrictions on the ability to carry out reorganization. The examination standards of the courts are relatively loose after the receipt of the reorganization application, and the ability of the enterprises to carry out reorganization is not clearly limited. Article 31 of the Bankruptcy Law only provides the reasons for reorganization, but does not restrict the ability to carry out reorganization, which increases the risks borne by the creditors when the companies go bankrupt.

### **3.4. There are problems in the creditors' committee system**

The creditors' committee should protect the rights and interests of creditors in the bankruptcy reorganization procedure, but there are some defects in the system of creditors' committee in our country. While small creditors have less voice among creditors due to lower social status and are difficult to enter the creditors' committee to safeguard their own rights and interests, and may even sacrifice the interests of small creditors with less claims for the sake of most creditors' rights and interests when necessary. Unfortunately, the laws of our country have not responded to such problems, which leads to the lack of channels for small

creditors to voice their opinions and to safeguard their rights.

### **3.5. There are deficiencies in compulsory liquidation rules**

When a company is ordered by the authorities in charge to close down pursuant to the law for committing an illegal act and is required to carry out compulsory liquidation, due to the fact that the interests of the People's Court and the interests of groups such as creditors and shareholders are different, it is unrealistic for the liquidation procedures to be completed by the People's Court, and the Company Law stipulates that although the time limit for compulsory liquidation is generally six months, an application for extension of time may be made to the People's Court under special circumstances, and there is no limit on the length of extension of time, which undoubtedly increases the risks borne by the creditors and prolongs the time for repayment by the creditors.

With regard to the relevant provisions on compulsory liquidation groups, according to Articles 8 and 9 of the Judicial Interpretation II on the Company Law of China and Article 10 of the Minutes of the Strong Liquidation Meeting of the Supreme People's Court, it can be seen that creditors, who should focus on protecting their interests in liquidation proceedings, have no legal basis to become members of the liquidation group. "It is clear that there is no regular channel for creditors to obtain timely information on liquidation matters and to express their opinions[3]". As the group that should be protected most in the process of liquidation, this deprives their right to know in the process of liquidation. Therefore, creditors' distrust and insecurity towards the liquidation group are often caused.

## **4. Suggestions on Perfecting China's Small and Medium Creditors Protection System**

### **4.1. Refinement of legislative mechanisms for small creditors**

China's "Bankruptcy Law" does not set up a special group of small creditors for the protection of provisions and strict provisions on the order of repayment, and Japan in this regard has some merits. For example, according to Paragraph 4 of Article 112 of the Japanese Corporate Renewal Law, "if the early repayment of small claims is successful, the court may, even before deciding to approve the renewal plan, allow the property administrator to pay upon application". Compared with China, Japan clearly stipulates that small claims can be applied for repayment in advance, which helps to reduce the number of creditors, promote the smooth launch of the regeneration process and ensure the priority of small creditors.

### **4.2. Constructing the fiduciary duty system of directors**

After the company is in bankruptcy, directors and shareholders engage in high-risk activities for their own interests and transfer the high-risk to creditors, which damages creditors' vital interests. Therefore, it is necessary to construct the fiduciary duty system of directors, which should be strictly restricted after the company enters into the state of de facto bankruptcy, so as to ensure that the company will not continue to suffer losses due to high-risk activities, and finally, there will be no sufficient fund for repayment after the company enters into the liquidation procedure. The fiduciary

duty system of directors can restrict the rights of directors, so as to protect the interests of creditors and the order of market economy.

### **4.3. The object of reorganization should be explicitly restricted by law**

Because China's Bankruptcy Law does not stipulate the reorganization ability of enterprises, which makes the court's efficiency too low in practice, increases the risk of reorganization failure and damages the interests of all creditors. Therefore, the provisions restricting reorganization objects are the key to enhance the reorganization efficiency and increase the probability of reorganization success. For example, the first article of Japan's "Company Renewal Law" stipulates that "Company Renewal" is applicable to joint stock companies which are in trouble and have the hope of rebuilding. But our country "the bankruptcy law" has no any restriction to the reorganization object, therefore should reconstruct the regeneration hope to the enterprise to take the essential document to stipulate.

### **4.4. There should be small creditor representatives on the creditors' committee**

Small and medium creditors are often in a weak position in the process of bankruptcy reorganization, and the creditors' committee is composed of the creditors who hold most of the creditor's rights. Therefore, small and medium creditors should actively negotiate with the debtor on behalf of the interests of small and medium creditors as a member of the creditors' committee. Legislation stipulates that the existence of small creditors in the creditors' committee can provide effective channels for small creditors to express their opinions, effectively protect their interests and avoid unfair treatment. This is a protection for small and medium creditors, and also to some extent to avoid the formation of homogenization of the idea[4].

### **4.5. Improving the rules of procedure of the liquidation group**

In order to safeguard the creditors' right to know and provide a platform for them to express their opinions, the

creditors shall join the liquidation group to represent the interests of the creditors and communicate with various parties, determine the status of the creditors in the liquidation group in the form of legislation, and protect the creditors' rights and interests in the liquidation group.

In addition, the introduction of necessary liquidation rules can shorten the liquidation time and complete liquidation as soon as possible to protect the interests of small creditors. According to C. J. Tabb, many bankruptcy courts invoke the residual "equity" right to the early repayment of unsecured claims based on the necessity, and issue the "first day of repayment order"[5]. This can make up for the shortcomings of the current system and shorten the time of liquidation.

## **5. Conclusion**

The protection of debtors and creditors has always been endowed with great significance in the process of enterprise bankruptcy. This paper first analyzes the necessity of the protection of small creditors when the company goes bankrupt, and analyzes the deficiencies of the protection of small creditors in different states.

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