

GARNISHMENT OF RECEIVABLES IN CHINESE LAW

The sign over the cash register at Shakey's Pizza Parlor reads, "We made a deal with the bank. We don't cash checks, and the bank doesn't make pizza."

The unarticulated premise—banks, not businesses, provide financial services—seems sound. In reality, however, trade credit is an important source of financing for businesses and their customers. It is sometimes used even when bank credit is available.¹ In China eighty percent of businesses extend some form of trade credit.²

Trade credit creates a hazard for lenders to businesses who are themselves extending unsecured credit. Debtors who appear solvent may fail to collect debts owed to them by third parties. Yet for a long time receivables remained beyond the reach of creditors to Chinese companies.³

Recently, China changed its laws to allow creditors to execute against receivables.⁴ Ostensibly aimed at easing the problem of debts between State-owned Enterprises,⁵ these measures also help fill in the detail of pre-bankruptcy debtor-creditor law. After all, once a debtor has lost or encumbered all its real and movable assets, the receivables could be the final straw before the debtor goes bankrupt.

Trade credit is only efficient if the risk-adjusted cost of lending is lower than the cost of replacing the customer of suffering breach of contract. Difficulty proving a prima facie case, lax enforcement, and local protectionism will make garnishment orders difficult to obtain and execute. Asymmetries between pre-bankruptcy and bankruptcy priorities will limit the provision's practical benefit. It is also too easy for other creditors to intervene in a debt collection action. Each of these difficulties

1. See Vicente Cuñat, *Trade Credit: Suppliers as Debt Collectors and Insurance Providers* (LSE Financial Markets Group Discussion Paper Series, No. 365) (2000) (on file with WASH. U. GLOBAL STUD. L. REV.), available at <http://rlab.lse.90UC/opening/papers/cunat.pdf> (last visited Oct. 27, 2003).

2. State Council Development Research Center, *Discussion of Several Problems of Safeguarding Societal Credit Order*, Jan. 22, 2002 (on file with WASH. U. GLOBAL STUD. L. REV.). National triangular debt was ¥124 billion in 1989, ¥700 billion in 1994, and ¥1.1 trillion (US\$132 billion) in 1998. *Id.*

3. A receivable is "a balance owed by a debtor; a debt owed by a customer to an enterprise for goods or services." BLACK'S LAW DICTIONARY 13-14 (Abridged 7th ed. 1999).

4. See *infra* notes 39, 41 and accompanying text.

5. See, e.g., *Woguo daiwuquan zhidu shen zhi* [Analysis of Our Country's Subrogation Rights System], RENMIN FAYUAN BAO [PEOPLE'S COURT REPORTS] Dec. 5, 2001 (describing inter-enterprise debt as "an important aim" of the contract law provisions).

will increase costs and risks for trade creditors who seek to exercise their rights under the new garnishment provisions.

Part I of this Note introduces a framework for evaluating distributional rules.⁶ Part II describes the status quo in China: trade debt, creditors' rights over receivables, and bankruptcy. Part III considers why judgments are difficult to enforce in China. Part IV examines how well the system functions as a whole, particularly whether the debt collection regime suits the needs of debtors, creditors, and other constituencies. Part V makes several proposals for procedural and substantive changes to China's garnishment regime.

I. THE CHALLENGE OF CREATING EFFECTIVE PRE-BANKRUPTCY DEBT COLLECTION RULES

The debt collection system can create incentives for transactions by generating predictable outcomes. Canny investors and traders seeking to participate in the market will look to the enforceability of rights.⁷ Unexpected risk causes creditors to lose in the short-term,⁸ but credit terms eventually reflect the risk of default.⁹ Anything causing uncertainty of

6. "Distributional rule" means a rule that determines which of a debtor's several creditors will be entitled to repayment, and the relative amounts of repayment. It does not include rules defining the substantive rights that gave rise to a debt.

7. For a discussion of the effect of legal certainty on investment decisions, see the comments of an attorney handling energy contracts for Allen & Overy (A&O) in *Global Overview: The Lawyers, PETROLEUM ECONOMIST*, June 18, 1998.

The lawyer's primary role is to establish what the current legal system is and to try to structure the transaction to ensure the likelihood of success if rights have to be enforced or preserved. A&O practice is to structure the transaction initially having regard to international practice, and then to test the local legal system's approach to key areas, for example, the taking and enforcement of security, and insolvency procedures generally.

Id.

8. The best-known clash of foreign creditors and Chinese debtors took place in 1998, when the Guangdong International and Trust Investment Corporation (GITIC) went bankrupt, leaving RMB¥26.14 billion (US\$3.1 billion) in debts owed to domestic and foreign entities. See Mitchell Silk, Michael Openshaw, and Virginia Hulme, *The Lessons of GITIC: Bankruptcy Proceeds as Scheduled*, CHINA BUS. REV., May 1, 1999, at 36-37.

GITIC was established in 1980 as a window for foreign currency borrowing by provincial enterprises. *Id.* at 37. It eventually became the second largest "ITIC" in China. *Id.* at 36. Although GITIC was originally open only to foreign lenders, it eventually borrowed from domestic entities directly and through overseas branches. *Id.* at 37. It also had more than 20,000 individual creditors. *China: GITIC Creditors Seen Facing Long Wait*, CHINA BUS. INFORMATION NETWORK, Jan. 14, 1999, 1999 WL 5617894.

In the bankruptcy proceedings, individual creditors were paid 100%. *Id.* Other creditors' average recovery rate as of February 2000 was 3.836%, but significant assets, including a hotel valued at up to RMB¥2.1 billion (US\$253 million), remained to be liquidated. *Guangdong High Court Aims to Complete GITIC Liquidation by Year-end*, AFX NEWS, Feb. 14, 2001 (available on Lexis).

9. This effect may be observed in the wide disparity among credit terms offered to United States

repayment should inflate credit rates or result in credit denials. In this predictable enforcement of debt contracts will encourage the increased foreign and domestic investment that China's leaders see as necessary for job creation.¹⁰

To fulfill its basic purpose, a debt collection system must provide a mechanism for paying claims. When a debtor has more assets than liabilities, the distribution rule is simple: pay all debts when due. If a debtor has liabilities greater than assets, however, allowing debt collection impairs business operation, and can drive it to the point of collapse. Thus, in addition to providing for distribution, the law must intervene occasionally to prevent debt collection from pushing a company into premature bankruptcy.

These two goals, conserving the debtor's assets and satisfying the creditors' claims, appear at first to stand in opposition to one another. The reality is to the contrary. If a company has liquidity problems, allowing creditors to garnish receivables may be the best way to ensure that the debtor (and its assets) survive to pay further debts.

A. *Conservation of the Debtor's Assets*

One function of debt collection law is to conserve the assets from which debts may be settled. From a creditor's perspective, the debtor's assets are a pool of funds for settlement of debts, and conservation measures protect the pool. An effective debtor-creditor law will seek to preserve the maximum value of the debtor's assets, so the maximum amount remains to satisfy creditors' claims. Preservation of assets may require halting other proceedings, including execution of judgments in order to preserve the business as a going concern.

Creditors have a divided loyalty with respect to conservation. An individual creditor's primary interest is receiving payment. Thus, the

consumers. See, e.g., *New Assault on Your Credit Rating*, CONSUMER REPORTS, Jan. 2001, at 20. A scholar who analyzed lenders' public filings estimated that, between 1995 and 1999, subprime borrowers paid median rates 2.2% to 4.06% higher than prime borrowers. Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 537 (2000). The main determinants of subprime status are previous payment behavior and current level of indebtedness. *New Assault on Your Credit Rating*, *supra*.

10. Last year, Zhu Rongji told the National People's Congress of the need to "continue improving the investment environment and the legal system. We need to do everything in accordance with the law, render better services to investors, improve our efficiency, and standardize our work related to attracting foreign businesses and investment." *Chinese Premier's Government Work Report at National People's Congress*, BBC MONITORING, Mar. 5, 2002, 2002 WL 15936547.

individual creditor has an incentive to maximize the value of only the assets subject to execution, and then only to the extent proceeds do not exceed the amount of that creditor's debt. As a group, creditors have an interest in maximizing the value not just of any single asset subject to levy, but of the debtor's property as a whole.

Preventing a single creditor from taking the debtor's property is sometimes necessary. For example, seizing inventory may result in immediate loss of goodwill for the debtor company and harm valuable trading relationships.¹¹ This result would be contrary to the best interests of the creditors as a group. The risk may be at its highest when the debtor's inability to pay arises solely from liquidity woes.¹² If a single creditor's action will push the debtor closer to insolvency, other creditors may hasten to file actions against the troubled debtor.¹³

Individual creditors' self-serving actions are not inherently inimical to conservation. Active monitoring by creditors may also help to ensure that the debtor does not dissipate or consume assets needed for debt repayment.¹⁴ If a creditor believes the debtor will soon lack funds to pay a debt, she may seek a court order preventing liquidation of the debtor's assets.¹⁵ Receivables may require the same urgent attention if the debtor's debtors are failing businesses as well.¹⁶ Creditor actions may also spur the debtor into action; once compulsory execution becomes imminent, the

11. Some of this lost goodwill will be illicit, reflecting the secondary creditor's desire to avoid paying its debts and expectations of further, easy credit.

12. Ex post efficiencies of responses to various business scenarios are explored in Clas Wihlborg & Shubhashis Gangopadhyay, *Infrastructure Requirements in the Area of Bankruptcy Law*, BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES: 2001, 286-87 (2001). Wihlborg and Shubhashis compare economic distress, in which the net present value of a company's cash flow is negative, with financial distress, in which liquidity is a problem or the net present value of cash flow is insufficient to service debt. *Id.* They argue piecemeal liquidation will maximize the value of a business where it is in economic distress and even improved management would not yield a positive net cash flow value. Other scenarios would favor a change of management, debt-equity swaps, or restructuring of debt. *Id.*

13. R.M. GOODE, *PRINCIPLES OF CORPORATE INSOLVENCY LAW* 17-24 (1990).

14. See Thomas Jackson, *Fraudulent Conveyance Law and its Proper Domain*, 36 VANDERBILT L. REV. 829, 835 (1985). Professor Jackson describes how action by a few creditors can benefit the debtor pool as a whole by controlling debtors' risky or inequitable behavior. If a few large creditors insist on contractual terms prohibiting certain acts, "[o]ther creditors (including nonconsensual creditors) may be able to profit by the monitoring of the debtor undertaken by those whose contracts do prohibit such activity." *Id.*

15. In China, if a debt will be difficult or impossible to collect, the court may issue an order to preserve property relevant to the dispute, either on its own initiative, or on the request of a party in interest. Zhonghua renmin gongheguo minshi susong fa [PRC Civil Procedure Law], arts. 92, 94, ZHONGHUA RENMIN GONGHEGUO FAGUI HUIBIAN (1991), at 28 [hereinafter Civil Procedure Law].

16. This assumes that the secondary debtor is in economic distress. See *Analysis of Our Country's Subrogation Rights System*, *supra* note 5. Postponed collection forces the primary creditor to underwrite the risk that the secondary creditor will go bankrupt.

debtor is forced to surrender property, collect its own outstanding debts, or file for bankruptcy.¹⁷

B. Satisfaction of Claims

The system also requires a mechanism to distribute proceeds to creditors. A well-designed system will have distributional rules to determine, for example, what part of the proceeds from any seizure of assets must be paid to the creditors, the share that each litigant receives, and the allocation of collection costs.

Maximizing the litigating creditor's share of a successful levy and sale will reward the creditor who actively monitors his debtors. Creditors' incentives to bring suit will vary depending on which distributional rule applies. As the creditor's perceived risk of non-collection rises, so rises the risk that the creditor will decide that the costs and risks are too great, and simply write off the debt.¹⁸

Most systems, including the Chinese system, rely on creditors to act. The size of a creditor's expected share may be a significant factor in its decision to bring a debt collection action. A debtor in default is unlikely to have but a single creditor, and each additional creditor puts an additional demand on the asset pool. A debtor unable, or unwilling, to pay its debts may declare bankruptcy up to the time of execution.¹⁹ If it does, the primary creditor will end up one of many picking at the carcass.²⁰

17. Professor Elizabeth Warren, describing the U.S. system, remarks that "[s]tate law promises that if the creditor is persistent, the corporate debtor can escape payment only through death: the corporation must cease operations and return its charter to the state. Nothing in state law allows a corporation to continue to operate while denying the enforceability of a lawful debt." Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785 (1987).

18. A thumbnail sketch of law and economics as applied to the debt collection decision can be found in David G. Carlson, *Debt Collection as Rent Seeking*, 79 MINN. L. REV. 817, 820-21 (1995).

For a discussion of the effect of predictability of judgments on litigation decisions, see generally RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* (5th ed. 1998). See also J. Mark Ramseyer & Minoru Nakazato, *The Rational Litigant: Settlement Amounts and Verdict Rates in Japan*, 18 J. LEGAL STUD. 263 (1989) (arguing that highly predictable verdicts in traffic accident cases in Japan have resulted in a high proportion of settlements; settlement amounts closely track historical verdict amounts).

19. See *infra* notes 55-60 and accompanying text.

20. In the Serengeti, after a dog pack attacks a prey, spotted hyenas (the kleptoparasites) arrive to join in the frenzy. See generally C. Carbone et al., *Feeding Success in African Wild Dogs: Does Kleptoparasitism by Spotted Hyenas Influence Hunting Group Size?*, 66 J. ANIMAL ECOLOGY 318, 319 (1997). The dogs' likelihood of feeding to satiation or carcass depletion is directly proportional to the dog to hyena ratio at the kill site. *Id.* at 320. Successful hunting and feeding thus requires the dog pack be strong enough to bring down an animal of sufficient size to satisfy both dogs and hyenas, but not so large that intra-pack competition depletes the carcass.

This analogy must not be taken too far, but it does suggest two conclusions. First, a lone creditor

Professor Elizabeth Warren has identified a set of policy concerns underlying distributional priorities of the United States bankruptcy system.²¹ Of note here are the creditors' relative abilities to bear the cost of default, similarities among creditors, and the incentive effects on pre-bankruptcy transactions.²² Pre-bankruptcy, however, it is also appropriate to consider differences among creditors, which arise from the contracts themselves, and from creditors' relative diligence.

II. GARNISHMENT IN CHINA

A. *Inter-Enterprise Debt in China*

Chinese government estimates show inter-enterprise debt of almost US\$132 billion and growing.²³ A recent investigation of 342 small and medium sized enterprises in Hebei Province found, on average, receivables of RMB¥10 million (US\$1.2m).²⁴

Inter-enterprise debt in China has often been called "triangular debt." The term was coined to describe unpaid bills among groups of creditors that accumulated when the government restricted credit growth in the late 1980s and early 1990s.²⁵ State-owned firms unable to borrow funds to pay for their inputs simply postponed paying their suppliers.²⁶ It is possible that at least some of these debt chains may have been linear.²⁷

Non-State actors, while not as severely affected by central bank credit tightening, use trade credit as a flexible financing source available when

hunting down assets of a company indebted to a large number of potentially kleptoparasitic creditors is unlikely to have its full claim satisfied. Second, there may be some benefit to allowing voluntary joinder of creditors claims because the litigation costs would be spread amongst them. To the extent that protections are nominally provided against other creditors' late joinder, the pack will be better equipped to withstand the collateral attack.

21. These are: (1) creditors' relative ability to bear the cost of default; (2) incentive effects on pre-bankruptcy transactions; (3) similarities among creditors; (4) equity owners as residual creditors; and (5) benefits to the bankruptcy estate. Warren, *supra* note 17, at 790-92.

22. *Id.*

23. State Council DRC Paper, *supra* note 2. The exchange rate used throughout this paper is the official US Dollar-peg rate of RMB¥8.3 to US\$1. The Bank of China mid-rate on March 16, 2003 was ¥8.28/\$1. *Waihui paijia* [*Foreign Exchange Posted Rates*], at <http://www.bank-of-china.com/info/qpindex.shtml> (last visited Mar. 16, 2003).

24. State Council Development Research Center, *Hebei: Small and Medium Enterprise Triangular Debt Worsens*, July 10, 2001 (on file with WASH. U. GLOBAL STUD. L. REV.).

25. See LI KWOK-SING, A GLOSSARY OF CHINESE POLITICAL TERMS 369-70 (Mary Lok trans., 1995) (citing Zhong Pengrong, *Triangular and Linear Debt Chains*, ECON. DAILY, Apr. 10, 1990).

26. NICHOLAS LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION 40-41 (1998).

27. *Id.* Triangular debt exists when A owes B money, B owes C, and C owes A. In this situation at least some of the debts cancel out others. Linear debt describes a situation where only the A - B and B - C debts exist.

bank credit or private investment are unavailable.²⁸ A 1997 survey of American Chamber of Commerce members showed that forty-four percent sometimes extended trade credit, and that twenty-one percent used trade credit exclusively.²⁹

The Chinese experience does not appear to differ significantly from Western economies. One study reported that trade credit in the United Kingdom and China was twenty percent and twenty-two percent of gross domestic product (GDP), respectively.³⁰ The debts were cleared at similar rates, with payment periods of 2.6 months in China and 2.1 months in the United Kingdom.³¹ On the other hand, inter-enterprise debt is increasing, both in real terms and as a percentage of GDP, and debts are being cleared more slowly (see Table 1).

Year	1990	1994	1996	1998
Receivables in RMB¥ Billion	90.1	631.4	927	992.2
As % of GDP	7.7	21.5	22	12.7
Average Payment Period in Months	0.6	1.9	2.1	-----

China's credit screening systems remain inadequate. In recent years, the Government helped establish two credit bureaus in Beijing and Shanghai in recent years, with mixed results.³³ A report by one business

28. See Cuñat, *supra* note 1.

29. Companies report using "open account" practices. *Credit Control: Better Late Than Never*, CHINA ECON. REV., Feb. 1, 1997, at 31. Survey subjects included members of the Beijing, Shanghai, and Guangzhou American Chambers of Commerce. *Id.* "Open account" practice carries debts and credits forward, with no fixed date for settlement. See BLACKS LAW DICTIONARY 19 (Abridged 7th ed. 2000). There may be variances between the behavior of foreign and domestic firms. *Id.*

30. GAO SHUMEI & MARK SCHAFFER, FINANCIAL DISCIPLINE IN THE ENTERPRISE SECTOR IN TRANSITION COUNTRIES: HOW DOES CHINA COMPARE? 5, 7 (William Davidson Inst., Working Paper No. 124, 1998). In the United States, nearly sixteen percent of all small business debt is trade credit. Allen Berger & Gregory Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22 J. BANKING & FIN. 613, 620 (1998) (non-farm, non-financial, non-real estate, small businesses).

31. SHUMEI & SCHAFFER, *supra* note 30, at 5, 7. The payment period is calculated as the ratio of end of year receivables to average monthly sales. *Id.*

32. *Id.* Figures for 1998 were derived from the State Council Research Paper, *supra* note 2. In 1998, China's GDP was RMB¥7.854 trillion (US\$946.3 billion). World Bank, available at <http://devdata.worldbank.org/data-query> (last visited Mar. 16, 2003). To compensate for the inclusion of non-industrial firms in the 1998 figure, the receivables have been multiplied by .902. The multiplier represents the ratio of 1994 industrial firm receivables to all receivables: 631.4/700. Without the adjustment, inter-enterprise debt is fourteen percent of GDP.

33. The Beijing Credit Bureau, established in 2002 with investment from government-controlled internet provider Capinfo, has sustained large losses over the past year. *Capinfo Profit Dips as Affiliates in Red*, HONG KONG IMAIL, Aug. 12, 2003 (available on Lexis); Sidney Luk, *Mainland Internet Solutions Provider Capinfo Is Back in the Black*, SOUTH CHINA MORNING POST, Mar. 22,

credit reporting service identified a number of shortcomings with the bureaus, such as: backwardness in communications and transportation that prevent creditors from investigating debtors, lack of disclosure of civil litigation records, inaccurate company registrations, and negative attitudes towards requests for credit information disclosures by debtor management.³⁴ China recently announced that it was postponing compliance with credit screening standards in an international banking standards accord.³⁵

B. Legal Framework for Garnishment of Receivables

Traditionally in China, as in other civil law systems, a creditor holding a valid judgment has been able to execute against bank accounts, wages, real and movable property, or negotiable instruments.³⁶ This framework created a dilemma for the creditor to a business, which had few tangible assets, but which held receivables sufficient to pay the debt. Receivables are choses in action³⁷ and thus not clearly subject to execution under the Civil Procedure Law, which lists only real and movable property.³⁸

2003, at 3, 2003 WL 14054382. Shanghai Municipal Government-owned Shanghai Credit Information Service claims to have credit information on one in four Shanghai residents. *Shanghai Issues Action Agenda for Social Credit System*, XINHUA NEWS AGENCY, Aug. 21, 2003. A recently-released Shanghai Municipal Government agenda calls for Shanghai to become a “metropolis of credit,” establishing a joint individual and corporate credit rating system by 2005. *Id.* Over 3,000 Shanghai businesses had received credit ratings by early 2002. *China to Create Corporate Credit-Rating Regime*, INT’L FIN. L. REV., Mar. 1, 2002. It is unclear whether Shanghai Credit Information Services was responsible for all of these ratings. *Id.*

34. *Credit Control*, *supra* note 29. The report identified six areas in need of improvement. *Id.* The other two areas were: (1) extraneous political factors affecting companies’ stability; and (2) confusing and improperly implemented legal rules. *Id.*

35. Zhao Renfeng, *China Not Ready for Basel II*, CHINA DAILY, Sept. 18, 2003. The agreement, formally known as the New Basel Capital Accord, requires all countries to establish standards for credit rating and reporting. Bank for International Settlements, *New Basel Capital Accord*, at <http://www.bis.org/publ/bcbsca03.pdf> (last visited Oct. 12, 2003). See generally Michael Imeson, *Striking a New Accord—Basel II Has Already Been Delayed Until 2006. Can It Overcome the Difficulties In Time?*, THE BANKER, July 1, 2002.

36. See PRC Civil Procedure Law, arts. 221, 222, 223, 228. Compare Zhonghua renmin gongheguo minshi susong fa (Shixing) [PRC Civil Procedure law (for trial use)], arts. 171-79, ZHONGHUA RENMIN GONGHEGUO FAGUI HUIBIAN (1982), at 133, translated in CHINALAW No. 119, available at <http://www.gis.net/chinalaw/prelaw34.htm> (last visited Oct. 26, 2003) (allowing execution against property, bank accounts, negotiable instruments, wages, other specific performance). Execution is limited to the amount of property necessary to satisfy the debt, and may not deprive the executee of items necessary for living (*shenghuo bixu pin*). PRC Civil Procedure Law, art. 223.

37. A “chose in action” is a personal right to recover a debt, sum of money, or a thing. See BLACK’S LAW DICTIONARY 219 (Abridged 7th ed. 2000).

38. PRC Civil Procedure Law, art. 223.

In 1998, the Supreme People's Court interpreted the Civil Procedure Law to permit garnishment of receivables.³⁹ Article 73 of the 1999 Unified Contract Law codifies the Court's interpretation with respect to garnishment of contracts with only minor changes.⁴⁰ Both permit a primary creditor to collect money from the secondary debtor if the debtor's failure to collect the debt has made the creditor's claim uncollectible.⁴¹

39. Zuigao Renmin Fayuan: Guanyu Renmin Fayuan Zhixing Gongzuo Ruogan Wenti de Guiding (Shixing) [Supreme People's Court Regulations Regarding Issues of Court Execution (for Trial Use)] art. 61, Zhonghua Renmin Gongheguo Zuigao Renmin Fayuan Gongbao [Gazette of the Supreme People's Court of the People's Republic of China] (1998 No. 3) at 91 [hereinafter Execution Regulations].

In this Note, the term "garnishment" refers to execution against a primary debtor's receivables. Other authors have used the term "subrogation" or "right of subrogation" to describe the operation of Article 73. See, e.g., Zhong Guanhua & Yu Guanhua, *China's Uniform Contract Law: Progress and Problems*, 17 UCLA PAC. BASIN L.J. 1, 22 (1999). These are more direct translations of the term *daiwei quan*. XIN HAN YING FAXUE CIDIAN [NEW CHINESE-ENGLISH LEGAL DICTIONARY] 127 (3d ed. 2000).

Traditional forms of subrogation do not require court intervention. Conventional subrogation is an express assignment of rights, as when an insurance company pays a policyholder contingent upon an express assignment of rights to sue an at-fault third party and receive proceeds up to the amount of its payments. See, e.g., French C. CIV 1250. Legal subrogation is an equitable lien over the collateral of the primary debt, that vests in a suretor or one who voluntarily pays the secured debt of another. See, e.g., French C. CIV 1251.

The Chinese garnishment law has different civil law roots. According to the French Civil Code, "whoever obligates himself personally is required to fulfill his engagement through all his personal and real property, present and to come." C. Civ Art. 2092 (translated in John Crabb, THE FRENCH CIVIL CODE (Revised ed. 1995)). "Personal and real property" does not include choses in action. Thus, to protect the creditor's future interest from the prejudice that would inevitably flow from uncollected debt, the French developed the *action oblique*, a creditor's right to exercise the rights of the debtor in default. C. CIV. art. 1166 (Fr.). The Japanese *dai-i soken*, which is in most respects identical to the Chinese *daiwei zhixing*, rests on similar logic. J.E. DEBECKER, THE PRINCIPLES AND PRACTICE OF THE CIVIL CODE OF JAPAN 277-78 (1921).

40. Zhonghua renmin gongheguo hetong ffa [People's Republic of China Contract Law] arts. 73-74, ZHONGHUA RENMIN GONGHEGUO XIN FAGUI HUIBIAN (1999, No. 1), at 16.

41. Zuigao Renmin Fayuan: Guanyu Shiyong Zhonghua Renmin Gongheguo Hetongfa Ruogan Wenti de Jieshi [Supreme People's Court's Interpretation of Certain Issues Concerning the Application of the Contract Law of the People's Republic of China], Zhonghua Renmin Gongheguo Zuigao Renmin Fayuan Gongbao [Gazette of the Supreme People's Court of the People's Republic of China] (1999, No. 9) art. 13(2) [hereinafter "SPC Contract Law Interpretation"]. There are actually two types of garnishment in China. For simplicity, this Note examines only actions brought under the Uniform Contract Law. A judgment creditor can also execute against receivables under supplemental regulations to the PRC Civil Procedure Law. Execution Regulations, *supra* note 39, art. 61. The key differences are that the Execution Regulations require a separately obtained enforceable judgment and lower the secondary debtor's burden of proof.

The procedure is straightforward. Upon proof of a valid debt owed by the secondary debtor to the primary debtor, the court issues a demand that the secondary debtor discharge his debt to the creditor rather than the primary debtor. *Id.* Within fifteen days the secondary debtor must raise a defense or pay the primary debtor. *Id.* art. 61(2). During the fifteen days, the regulations bar the primary debtor from waiving or extending the debt. *Id.* art. 66. If, after receiving the court's notice, the secondary debtor pays the debt directly to the primary debtor, the secondary debtor becomes jointly and severally liable

Garnishment satisfies the creditor's claim by allowing the creditor to enforce the primary debtor's rights against the secondary debtor. If the garnishment action succeeds, the secondary debtor pays the primary creditor directly. The respective debt obligations between primary creditor and primary debtor, and between primary debtor and secondary debtor are cancelled.⁴²

The garnishment action has three elements: validity, non-exemption, and actual harm.⁴³ Validity requires: that the primary debtor owe a lawful

for any resulting shortfall, along with the primary debtor. *Id.* art. 67. For a detailed explanation of the Execution Regulations, see FAYUAN ZHIXING YUNZUO SHIWU [COURT EXECUTION PROCEDURES] (Dai Jianzhi ed., 1999).

42. SPC Contract Law Interpretation, *supra* note 41, art. 20. Bing Ling interprets this provision to extinguish the prior debts only once the secondary debtor actually pays the debt. Bing, *infra* note 47, at 284. This conclusion is supported, but not dictated, by the commentary text. Compare the following two translations:

If, having tried a subrogation action brought against the secondary obligor by the obligee, the people's court determines that the obligee does have a right of subrogation, the secondary obligor shall perform the obligation of payment towards the obligee, and the corresponding claim-debt relationships between the obligee and the obligor and between the obligor and the secondary obligor shall be extinguished as *at that time*."

SPC Contract Law Interpretation, *supra* note 41, art. 20, translated in CHINA L. & PRAC. 43, Mar., 2000, at 43, 47 (emphasis added).

Where an obligee brings a suit of subrogation against a secondary obligor, and the People's Court affirms the subrogation, the secondary obligor shall perform the payment obligation, *whereupon* the respective obligee-obligor relationships between the obligee and the obligor, and between the obligor and the secondary obligor, are discharged accordingly.

SPC Contract Law Interpretation, *supra* note 41, art. 20, translated in cclaw.net at http://www.cclaw.net/download/SPC_Interpretation1.asp (emphasis added).

Without commenting on the correctness of either translation, note that Bing's translation creates an interim period between judgment and payment, in which the secondary debtor has an obligation to pay the primary creditor, but the primary debtor remains conditionally liable if the obligation is not fulfilled. This should increase the likelihood of loss of rights in the event of a post-judgment bankruptcy.

In France, the *saisie attribution* (seizure and attribution) procedure provides that, after a brief injunction on direct payment, the secondary debtor is obliged to pay the first party creditor directly. *Loi Portant Réforme des Procédures Civiles d'Execution* (Law Reforming Civil Execution Procedures), Law No. 91-650, as amended (July 9, 1991). See also Jacqueline Jaeger & Simon Lowe, *Protection and Enforcement of Creditors' Rights Under French Law*, INT'L COMPANY & COMM. L. REV. 1993, 4(7), 255-58. The first party creditor must hold a valid judgment over first party debtor, and the debt may not be for back wages. Case No. 97-19732, Bulletin 1999 II No. 147, P. 105 (noting that Labor Code provides adequate remedies for garnishment of wages).

As a separate matter, it is unclear from the statutory language that a single creditor may pursue multiple secondary debtors. The primary creditor's recovery from the secondary debtor is limited to the amount of the primary debt, plus costs. SPC Contract Law Interpretation, *supra* note 41, art. 21. The Supreme People's Court has not addressed the situation in which the secondary debt has a lower face value than the primary debt. A literal application of the Court's Interpretation would lead to the absurd result that a RMB¥10 million primary debt could be extinguished upon the successful prosecution of a single garnishment action over a RMB¥100,000 secondary debt. A better approach might discharge the primary debt only to the extent of the secondary debt.

43. PRC Contract Law, arts. 73-74.

debt to the primary creditor, that the secondary debtor owe a lawful debt to the primary debtor, and that both debts be due.⁴⁴ Non-exemption requires that secondary debt not be exempt from garnishment.⁴⁵

Actual harm requires that the primary debtor's failure both to perform its obligation to the primary creditor and to exercise its rights against the secondary debtor have caused the primary creditor's claim incapable of realization (*weineng shixian*).⁴⁶ The debtor de facto must have insufficient real or movable assets to satisfy the primary creditor's claim.⁴⁷ Actual harm is not, however, an insolvency standard. We can infer that actual harm is possible even with a primary debtor who is legally solvent.⁴⁸

The law provides a mechanism for obtaining a protective order over property pending litigation.⁴⁹ However, courts have reached opposite conclusions regarding whether they may grant such protective orders over the secondary debtor's receivables.⁵⁰

If two or more primary creditors bring action against the same secondary debtor, the court may (*keyi*) consolidate the two suits.⁵¹ The Civil Procedure Law provides that intervention in a civil suit may not take

44. SPC Contract Law Interpretation, *supra* note 41, arts. 11(1), (3).

45. *Id.* art. 11(4). Exempt rights are those that are "exclusively personal," including alimony, child support, wages, pensions, life insurance, and personal injury claims. *Id.* art. 12.

46. *Id.* art. 13(2). The exercise of rights must be by either judicial or arbitral proceedings. *Id.* art. 13(1).

47. BING LING, CONTRACT LAW IN CHINA 281 (2002).

48. SPC Contract Law Commentary, *supra* note 41, art. 21. Recoveries in excess of those necessary to satisfy the primary creditor's claim must returned to the primary debtor's asset pool; the law contemplates a debtor with assets greater than liabilities.

Legal insolvency occurs when the debtor's balance sheet indicates liabilities exceeding assets. *Jackson v. Farmers State Bank*, 481 N.E.2d 395, 403 n.7 (Ind.App. 1 Dist. 1985). Equity insolvency occurs when a debtor is unable "to pay his debts as they come due in the ordinary course of business." *Id.*

49. PRC Civil Procedure Law, art. 92. If a judgment is difficult or impossible to execute, a court may issue an order to preserve property relevant to the dispute, either sua sponte or on the request of a party in interest. *Id.* arts. 92, 94. A creditor garnishing receivables must post a security deposit over the secondary debtor's assets. Contract Law Interpretation, *supra* note 41, art. 17.

50. Randall Peerenboom & Zhang Dacai, *Preservation of Assets in China: Law and Reality*, CHINA L. & PRAC. (Feb. 2000), at 44. The law only allows such orders over property (*zechan*), and although the trend has been toward recognition of receivables as a form of property, this is an as-yet unsettled point of law. *Id.* The Supreme People's Court appears to favor treating debts as a type of property; the Court's most recent bankruptcy regulations describe the estate as including "articles, debts, intellectual property, and other property and property rights." Zuigao Renmin Fayuan: Guanyu Shenli qiye pochuan anjian ruogan wentideguiding [Supreme People's Court Regulations Regarding Trial of Enterprise Bankruptcy Cases], *Zhonghua renmin gongheguo zuigao renmin fayuan gong bao* [Gazette of the Supreme People's Court of the People's Court of the People's Republic of China] (2002) [hereinafter SPC Bankruptcy Regulations].

51. SPC Contract Law Interpretation, *supra* note 41, art. 16. The court may also join the primary debtor as a necessary party; this may be essential if the secondary debtor raises affirmative defenses. *Id.*; see also Bing, *supra* note 30, at 282.

place after the entry of judgment.⁵² Before judgment is entered, however, there appears to be no limit on a court's power to allow joinder of claims. Neither the legislature nor the court have specified how the proceeds of a joined action are to be shared.⁵³

C. *The Fate of Receivables in Bankruptcy*

Because garnishment of receivables is conditioned on actual harm to the creditor, and not just acts which render the debt uncollectible, its greatest utility will be against failing companies.⁵⁴ In that context, a creditor's "right" to these measures attaches when the debtor would be unable to raise cash to pay its obligations without the receivable. The right is extinguished when a bankruptcy petition is filed on the debtor's behalf.⁵⁵

Generally speaking, China's bankruptcy "law" is a patchwork of laws, regulations, and pronouncements.⁵⁶ A new bankruptcy law has been

52. A third party whose claim has a separate basis but whose interests will be affected by the outcome of the action may file a request to intervene. PRC Civil Procedure Law, *supra* note 15, at 56. The court can also give notice to third parties whose rights may be affected. *Id.* At least one treatise views potential prejudice to a third party from another creditor bringing a claim likely to render the debtor insolvent as adequate grounds for joinder. See MINSHI SUSONG FA [CIVIL PROCEDURE LAW] 124-25 (Jiang Wei ed., 2000).

53. In an article contemporaneous with the passage of the Unified Contract Law, Professor Wang Liming proposes pro-rata sharing. Wang Liming, *An Inquiry into Several Difficult Problems in Enacting China's Uniform Contract Law*, 8 PAC. RIM L. & POL'Y J. 351, 388 (Keith Hand trans.). It may be inferred from his proposal that the matter had not yet been settled at the time of enactment. Sharing of proceeds has not been the subject of subsequent clarification by the court.

54. There will be situations in which the debtor is not a failing company but nevertheless causes actual harm, such as by failing to pursue a debt or gratuitously transferring property. Such a situation should arise infrequently because the challenged action would be contrary to both the primary creditor's interest in prompt repayment and the primary debtor's interest in conserving its capital.

55. Chinese law provides for both voluntary and involuntary bankruptcy petitions. SPC Bankruptcy Regulations, *supra* note 50, arts. 6-7.

56. China's first Bankruptcy Law was passed in 1986. Zhonghua renmin gongheguo qiye pochan fa [Bankruptcy Law of the People's Republic of China (for Trial Use)] FAGUI HUIBIAN (1986), at 58; Henry Zheng, *The Enterprise Bankruptcy Law of the People's Republic of China (for Trial Use): A Translation*, 4 VAND. J. TRANSNAT'L L. 733, 733 n.1 (1986) [hereinafter Bankruptcy Law].

The Law is simple, with just forty-three articles, and applies only to state-owned enterprises. *Id.* It provides for handling of petitions, creditors meeting, mandatory conciliation, optional attempts at reorganization, conservation and liquidation of the estate, and distribution of the estate proceeds. *Id.* The 1991 Civil Procedure Law included a chapter running just seven articles addressing the bankruptcy of private enterprises, or "enterprise legal persons" (qiyefaren). PRC Civil Procedure Law, arts. 199-206. The Company Law made the Bankruptcy Law's provisions applicable to non-State Owned Enterprise bankruptcies. Zhonghua renmin gongheguo gongcifa [Company Law of the People's Republic of China], arts. 189-94, translated in CHINA L. & PRAC., Mar., 1994, at 7, 47-48.

In July 2002, the Supreme People's Court issued detailed bankruptcy regulations, giving scope and depth to the bankruptcy regime. Zuigao renmin fayuan: Guanyu shenli qiye pochan anjian ruogan wenti de guiding [Supreme People's Court Regulations Regarding Trial of Enterprise Bankruptcy

circulated in draft form since 1995, but it is not expected to pass for several years.⁵⁷ Institutions—financial institutions, trustees, and courts—lack technical skills and training capacity,⁵⁸ and ordinary creditors often lack effective representation.⁵⁹

Five features of China's bankruptcy law are of interest for the present inquiry: (1) an enterprise may only declare bankruptcy when it is "unable to pay its debts when they fall due";⁶⁰ (2) a creditor may bring an involuntary petition;⁶¹ (3) a debtor's receivables pass into the bankruptcy estate;⁶² (4) execution of judgments is frozen at the start of the bankruptcy

Cases], *Zhonghua Renmin Gongheguo Zuigao Renmin Fayuan Gongbao* [Gazette of the Supreme People's Court of the People's Republic of China] (2002 No. 5), at 155 [hereinafter SPC Bankruptcy Regulations]. These derive statutory authority from the Bankruptcy Law and Civil Procedure Law provisions.

For an enlightening discussion of the current debates surrounding the Bankruptcy Law, including factors favoring and preventing passage, see Gebhardt & Olbrich, *New Developments in the Reform of Chinese Bankruptcy Law*, 12 AUSTL. J. CORP. L. 1, 6-7 (2000). Obstacles cited include opposition by banks unwilling to allow the extent of their bad loan exposure to be revealed and fear of widespread unemployment and pension loss. *Id.* Factors favoring passage include the problems encountered in administering the GITIC bankruptcy. For information about GITIC, see *supra* note 8. *Id.*

57. NPC Standing Committee vice-Chairman Cheng Siwei has said the law might not pass until 2008. Guy de Jonquieres, *China Bankruptcy Law Faces Further Delays*, FIN. TIMES, Jan. 27, 2003, at 8.

58. See World Bank, *Bankruptcy of State Enterprises in China: A Case and Agenda for Reforming the Insolvency System*, Sept. 20, 2000, at 43-44, at <http://www.worldbank.org/en/English/content/bankruptcy.pdf>. The report states that bankruptcies did not treat claims in a consistent manner; some merged enterprises assumed only the bank debts and not any trade debts. *Id.* at v, vi. These practices may have been abated. *Id.*

Courts handling private sector bankruptcies have used provisions intended to apply only to State-owned Enterprise bankruptcies as a justification for abrogating creditor rights. Zhang Weimin, *Report Says Half of Restructured PRC Enterprises Evade Payment of Financial Debts*, XINHUA DOMESTIC SERVICE, Aug. 17, 2001, FBIS-CHI-2001-0817. Some enterprises, "without the approval of high authorities," made resettlement payments from funds that should have been used to pay debt. *Id.*

59. According to the World Bank study, the Liquidation Committee "consists usually of representatives from various municipal agencies (for economy & trade, labor, land, finance, etc.) and the central bank branch." *Id.* Senior officials are often left in control of the enterprise during liquidation. *Id.* The only creditor in a State-owned Enterprise's liquidation committee may be the central bank. *Id.*

60. Bankruptcy Law, art. 3. Under the Bankruptcy Regulations, the term "unable to repay debts when they fall due" means that the debts are due for payment and the debtor obviously cannot repay them. Bankruptcy Regulations, art. 31. The same term is used in both the Bankruptcy Law and the Civil Procedure Law, but the Bankruptcy Regulations define the term with reference only to the former. See Joseph Lam & James Wong, *Bankrupt in China*, at <http://www.hk-lawyer.com/2002-11/Nov02-china.htm> (last visited Jan. 21, 2003). It is thus unclear whether the Bankruptcy Regulations' definition applies to non-State-owned Enterprise bankruptcies arising under the Civil Procedure Law. *Id.* For the purpose of the present discussion, it is assumed that the issue would be decided in a similar manner for both State-owned Enterprise and non-State-owned Enterprise bankruptcies.

61. Bankruptcy Law, art. 7.

62. *Id.* art. 3.

case;⁶³ (5) priority of payments is as follows: secured debts, administration expenses of the estate, wage and pension debts, taxes, and finally unsecured debts.⁶⁴

D. Prospects for Enforcement

A judgment is of little value without enforcement, or the threat of enforcement. China's enforcement problems (*zhixing nan*) have long been a source of uncertainty about the value of recourse to the courts. Indeed, as of January 2000, 850,000 judgments totaling RMB¥259 billion (US\$31.2 billion) remained unexecuted.⁶⁵

Non-enforcement commonly results from local protectionism (*difang baohu zhuyi*), corruption, or co-optation of courts by local elites.⁶⁶ Former President Jiang Zemin,⁶⁷ former Premier Zhu Rongji,⁶⁸ and Supreme People's Court President Xiao Yang⁶⁹ have all identified local protectionism as a major obstacle to fair case administration. Judges are subject to local political pressures because they are locally appointed and lack the security of tenure.⁷⁰ As such, judges may find it difficult to withstand pressure from officials who have financial or political interest in the disputes before them.

Inadequate court resources also contribute to non-enforcement. Execution officers may lack the training, funding, or legal authority to

63. Bankruptcy Regulations, art. 65.

64. *Id.* art. 58. The priorities are not specified in the Regulations, but are incorporated from Bankruptcy Law, art. 37 by reference. *But see infra* note 103 and accompanying text, describing super-priority given to employee resettlement schemes.

65. *PRC Supreme Court Issues Regulations on Enforcing Orders*, Jan. 28, 2000, FBIS-CHI-2000-0128.

66. See Donald C. Clarke, *Power and Politics in the Chinese Court System: The Enforcement of Civil Judgments*, 10 COLUM. J. ASIAN L. 1, 44 (1996) [hereinafter *Power and Politics*]. Local protectionism is probably best understood not as a geographic bias, but as a tendency by actors to favor other actors inside one's own network. Such networks could be a geographic subdivision, the actor's *guanxi* (personal connections) web, ancestral ties or a county or village. Whether one is "local" enough to garner protection is left to the subjective view of the decision maker. For a discussion of the role of networking in the context of planning China ventures, see Peter L.K. Wong & Paul Ellis, *Social Ties and Partner Identification in Sino-Hong Kong International Joint Ventures*, 33 J. INT'L BUS. STUD. 267 (2002).

67. Shao Zongwei, *Judicial Reform Prudent*, CHINA DAILY, Mar. 22, 2002, 2002 WL 7167753.

68. Erik Eckholm, *Chinese Hear From Premier On Threats To Economy*, N.Y. TIMES, Mar. 6, 2002, at A5.

69. Lu Guoqing, *Supreme Court's Xiao Yang Conducts Investigation in Hebei*, Aug. 27, 1999, FBIS-CHI-1999-0914.

70. Basic Level People's Court judges are appointed by local officials. *Power and Politics*, *supra* note 66, at 8-10. Higher Level People's Court judges are appointed by provincial officials. *Id.*

effectively execute judgments.⁷¹ Unsatisfactory discovery provisions may hamper litigation, and creditors may find themselves unable to compel banks or other third parties to disclose debtors' assets.⁷² Professor Donald Clarke has argued that the internal organization of the courts reflects a lack of emphasis upon enforcement.⁷³ As a result, basic courts give priority to criminal adjudication and sentencing, rather than execution of civil judgments.⁷⁴

Courts employ a variety of tactics to help debtors avoid execution. They may delay proceedings to allow debtors to freeze or transfer assets.⁷⁵ Another delay tactic is to demand to examine the records giving rise to the judgment.⁷⁶ Although courts must respect judgments issued by courts in other jurisdictions, in practice the executing court may attempt to review the substance of the judgment.⁷⁷ A local court may refuse to execute a judgment obtained in another jurisdiction without concessions from the judgment creditor, or may demand that the issuing court pay the costs of execution.⁷⁸

Sometimes the delay mechanism is simply heavy-handed obstructionism. In 1998, for example, creditors to Chongqing Special Steel Corp. obtained RMB¥700 million (US\$84.3 million) in judgments. After

71. See generally *Power and Politics*, *supra* note 66; Randall Peerenboom, *Seek Truth from Facts: An Empirical Study of Enforcement of Arbitral Awards in the PRC*, 49 AM. J. COMP. L. 249 (2001) [hereinafter *Seek Truth from Facts*]. Peerenboom cites instances of judges being physically threatened or abused by parties who resist compulsory execution. *Id.* at 295. The Supreme People's Court staff have been quoted as saying it was "not uncommon for criminals who resist court enforcement efforts . . . to become violent." *PRC Supreme Court Issues Regulations on Enforcing Orders*, *supra* note 65.

72. There is no right to discovery of evidence, although the People's Court may have a duty to collect it and the power to demand it from defendant and others. Civil Procedure Law, arts. 54, 65. The Court may compel a debtor to provide information about its assets. See *Seek Truth from Facts*, *supra* note 71, at 292. Despite this sweeping power, courts generally expect a litigant to provide details of a party's assets. *Id.*

73. *Power and Politics*, *supra* note 66, at 37-38. The president of a court is in charge of criminal adjudication, and the vice president of civil adjudication. *Id.* The vice president's assistant is in charge of civil execution. *Id.* at 37.

74. *Id.* at 37-38.

75. *Seek Truth from Facts*, *supra* note 71, at 287. Peerenboom describes a case in which a party holding an arbitral award went to the bank with enforcement personnel, only to be told the bank president was away and his approval was necessary. Upon returning the next day, the creditor discovered that a higher level court in the same city froze the bank account, depriving the creditor of the single identified asset against which it could execute. *Id.* at 278.

76. *Power and Politics*, *supra* note 66, at 46. The requesting court would lack power to dispute the judgment based on anything it found in those records. *Id.* at 43.

77. *Id.* at 44.

78. *Id.* at 44, 46. In one case a Basic Level court demanded a waiver of fifty percent of the amount before it would enforce a judgment obtained from another region's Intermediate Level court. *Id.* at 44.

the local court executed against RMB¥92 million (US\$11.1 million) in bank accounts, the Chongqing government “halted execution.”⁷⁹ Lawyers working in China have also cited instances of court officials helping debtors hide assets.⁸⁰

Uncertainty increases risk of non-recovery, and inefficiency increases costs; together these risks create opportunities for coercion. In one instance a foreign party settled an arbitral award for half its face value, although the debtor held ten separate debts, which totaled more than the entire debt.⁸¹

Foreign creditors have one advantage in ensuring the preservation of assets once litigation commences. A foreign party’s request for a protective order falls under the jurisdiction of the relevant Intermediate People’s Court.⁸² This factor may help foreign parties avoid conflicted Basic Level People’s Courts, but may prove cold comfort for a foreign party involved in a dispute with a debtor whose business is provincial or national in scope.

III. ANALYSIS

Should China promote trade credit? Much of the literature on inter-enterprise debt in China answers in the negative, focusing on the State sector and soft budget constraints.⁸³ This species of inter-enterprise debt did distort the State plan, since later extensions of bank credit went toward inter-enterprise arrears and trade debts recurred when credit was tightened.⁸⁴ But as the proportion of enterprises subject to hard budget constraints increases, the law should presume that debtors and creditors

79. *China: Courts Face Hurdles in Backlog*, CHINA DAILY, Nov. 30, 1998, 1998 WL 20479546. The article does not explain the methods used to halt execution, only that the local government refused to allow the company “to be treated like a bankrupt business.” *Id.* During a period of unrest due to unpaid pensions, the company eventually merged with five other State Owned steelmakers. *Firm-Action Steel-2*, XINHUA NEWS AGENCY, Nov. 15, 1999, 1999 WL 7309215; *Worker Unrest Erupts in Cities*, SOUTH CHINA MORNING POST, Dec. 29, 2000, at 8, 2000 WL 30925626.

80. *Seek Truth from Facts*, *supra* note 71, at 287. *See also PRC Supreme Court Issues Regulations on Enforcing Orders*, *supra* note 65. The report quotes Supreme People’s Court sources as saying that some “local and department leaders have been found illegally meddling in the enforcement of court orders to protect their vested local and departmental economic interests.” *Id.*

81. *See Seek Truth From Facts*, *supra* note 71, at 275. The debts had already been reduced to judgment, but the creditor settled rather than pursue the ten separate enforcement actions necessary to exercise its right to garnish. *Id.*

82. Enforcement Regulations, art. 12.

83. *See Ou Jiawa, Policy Choices of the Central Bank: Goals, Instruments and Effects of Central Bank Controls in FINANCIAL REFORM IN CHINA* (On Kit Tam ed., 1995).

84. *Id.*

are doing business on commercial terms and protect their mutual rights and obligations.

Inter-enterprise debt is not an inherently unhealthy phenomenon. First, trade credit tends to be more flexible than bank credit, more available to start-up companies than bank credit, and more readily available in the presence of informational opacities that deter banks from lending.⁸⁵ In addition, extensions of trade credit are frequently premised on business transactions, and therefore on increased output for both the borrower and lender.⁸⁶

Unfortunately, China developed a system, which puts a creditor in a position to act only when the debtor is uncomfortably close to bankruptcy. A creditor is required to pursue real and movable property before bringing a garnishment action.⁸⁷ The creditor must expend resources to prove the debtor's insolvency. As time passes, and the value of the failing debtor's assets dips below its liabilities, so increases the risk some creditor will remove the final support and the debtor (or another creditor) will file a bankruptcy petition.⁸⁸ A creditor contemplating garnishment must therefore consider whether she is likely to be the recipient of the *res*, or merely an unsecured claimant in the primary debtor's bankruptcy.

Rules that generate optimal outcomes in the pre-bankruptcy debt collection system will not necessarily generate optimal outcomes in bankruptcy.⁸⁹ In pre-bankruptcy, the debtor is presumed master of her affairs even as fleet-of-foot creditors strip away necessary assets. Satisfaction is paramount—a creditor is entitled to payment, and the system uses all the debtor's available property to satisfy the debtor's obligation.⁹⁰

85. See Cuñat, *supra* note 1; Allen N. Berger, Leora F. Klapper & Gregory F. Udell, *The Ability of Banks to Lend to Informationally Opaque Small Businesses*, 25 J. BANKING & FINANCE 2127 (2001).

86. Cuñat, *supra* note 1. By way of illustration, Cuñat describes how Alcatel extended financial support to its customer, a Brazilian long-distance provider. *Id.* at 36. Alcatel's annual report described how it sought "to support certain customers at a financial level through flexible credit systems before the bank system takes over financing." *Id.* This shows, Cuñat argues, how suppliers use credit extensions to help customers with liquidity problems. *Id.*

87. This is an inference from the actual harm requirement—if the debtor had other valuable assets, then the primary debtor's failure to collect the secondary debt can not cause the harm required by the SPC. See *supra* note 41 and accompanying text.

88. Bankruptcy, once a rarity in China, is increasing. From 1989 to 1993 there was an average of 277 bankruptcies per year. *Bankruptcy of State Enterprises in China*, *supra* note 58, at iv. In 1994–1995, there were 2,100 bankruptcies. *Id.* In 1996–1997, there were 5,640 cases; more than half of these were State-owned Enterprises. *Id.*

89. See *Bankruptcy Policy*, *supra* note 17, at 784.

90. See *id.* (discussing U.S. state-law remedies). The term "available" is used to distinguish between assets which are amenable to execution and encumbered or exempt assets.

In bankruptcy, the debtor's ability to manage its affairs is severely constrained. There is a presumption that creditors will not receive full payment.⁹¹ Instead, the goal is to create a safe harbor for conservation activities,⁹² and then to distribute the proceeds according to set priorities. Creditors are divided into classes according to their interests as of the date of the petition. They are barred from taking any action against the debtor without permission, and must wait in line for whatever payment they receive. The equities of handling a particular claim under pre-bankruptcy or post-bankruptcy rules are thus not easily discernible. It cannot be simply a measure of legal insolvency,⁹³ because conserving the going-concern value of a business may benefit all debtors.

Other constituencies will suffer as well if the company goes bankrupt.⁹⁴ Local protectionism may have acted as an informal mechanism to protect these local constituencies. Consider the *Chongqing Special Steel* case.⁹⁵ The local government ostensibly adjudged the company's going concern value as greater than the liquidation value of the assets levied upon, and called an end to the proceedings. This *ad hoc* valuation undoubtedly included the cost of bankruptcy to non-creditor constituencies. Unfortunately, because extralegal methods were employed, the Case provides creditors without a discernible principle to guide subsequent action.⁹⁶

Rules that favor diligent creditors may help keep recovered amounts within local economies.⁹⁷ Strategic, informational, and political advantages may give local creditors greater chances of receiving payment in pre-bankruptcy debt collection.⁹⁸ If, as in China, jurisdiction over debt

91. *See id.* (discussing U.S. bankruptcy law).

92. Acceptance of the bankruptcy case, halts payment of debts, disposal of property, set-off, and execution. Bankruptcy Regulations, art. 15. Property and claims are cataloged and verified. *Id.* art. 18. Certain property transfers within the six months prior to bankruptcy are also void. Bankruptcy Law, art. 35. These are: concealment, secret distribution, or donative transfers of property; sale of property at a low price and not in the ordinary course of business; creation of a security interest in the debtor's property where no prior lien existed; accelerated payment of debts; or waiver of the debtor's own creditor's rights. *Id.* art. 15. However, a World Bank study of 222 State Owned Enterprise bankruptcies between 1995 and 1998 found no voided preferences. *Bankruptcy of State Enterprises in China*, *supra* note 58, at 5.

93. *See supra* note 48.

94. Professor Warren identifies the following constituencies: older workers who can not retrain for other jobs, customers who will have to switch to less attractive suppliers, suppliers who will lose customers, property owners who suffer from declining property values, states and municipalities which must forego taxes. *See Bankruptcy Policy*, *supra* note 17, at 787-88.

95. *See supra* note 79 and accompanying text.

96. *See Debt Collection as Rent Seeking*, *supra* note 18, at 828-29.

97. *Id.*

98. *See id.* at 827.

actions lays where either the debtor or the debtor's customer reside, the local creditor will have a strategic advantage in planning and pursuing the litigation.⁹⁹ Local creditors are likely to have superior information, and to the extent that information has costs, receive a competitive advantage. As the trade creditors—State-owned, township, and private sector—are faced with increasingly hard budget constraints, it is reasonable to expect they will take legal measures to protect themselves, and thus become less reliant on local patrons.

Valid public policy justifications exist for barring a creditor from intermeddling in a primary debtor's business relationships. A creditor hassling a customer for payment threatens the debtor's relations with that customer. While unfair, the debtor is hardly in a position to complain after breaking its promise to repay the creditor.¹⁰⁰ The better answer is that unwarranted assaults on the primary debtor's customers are inimical to conservation of the debtor's asset pool. Trade debt is interwoven with the goodwill of business; it may provide significant competitive advantages to a company.¹⁰¹ Business goodwill could be the most valuable asset of a debtor experiencing a liquidity crisis.

Incentive effects are more difficult to identify. It can be said with some certainty that a creditor will only lend when it expects to make a profit.¹⁰² When a business decides to extend unsecured credit, it must account for the risk that when the debt comes due, the debtor will be unwilling or unable to pay. For example, trade creditors are likely to have mixed motivations for lending. Sales and foregone customer acquisition costs can subsidize their cost of extending credit.

Finally, creditors' interests are divergent. Trade creditors' anticipated rate of recovery is much higher outside of bankruptcy. Wage, pension, and tax arrears receive a priority in bankruptcy. Secured creditors receive priority payment up to the value of their security.¹⁰³ Even if piecemeal

99. Jurisdiction is where the "defendant" (beigao), either the primary debtor or secondary debtor, is domiciled. Contract Law Interpretation, *supra* note 41, art. 14.

100. This is a variation of the "clean hands" doctrine, whereby a litigant in equity is examined as to "whether he comes into Court with clean hands, and can justly reproach [the counterparty] with bad faith and unfairness towards him." *Tompkins v. Wheeler*, 41 U.S. 106, 117 (1842). In this case, the bad faith would be granting credit extensions to one's customers while not paying a debt owed to the primary creditor.

101. *See generally Financial Discipline*, *supra* note 30.

102. This profit need not come from debt payments. As Cuñat points out, a trade creditor is likely to expect other benefits, such as deepening business relationships with the debtor. *See supra* note 1.

103. Special rules for State Owned Enterprise bankruptcy give super-priority status to worker re-employment schemes that trumps secured creditors' rights. *Guowuyuan guan yu zai ruogan chengshi shixing quoyou qiye jianbing pochan he zhigong zaijiuye youguan wenti de buchong tongzhi* [Supplementary Notice Issued by the State Council Regarding Problems Pertaining to the Trial

liquidation yields less than bankruptcy liquidation, trade creditors will tend to oppose bankruptcy. Therefore, a trade creditor is uniquely exposed to the risk that an involuntary petition will force a halt to its collection activities.

Without the threat of a creditor-led bankruptcy, the debtor's incentives to engage in conservation activities diminish.¹⁰⁴ In theory, the debtor and all creditors share an interest in maximizing the proceeds from a garnishment. Greater symmetry between the handling of trade debts pre-bankruptcy and during bankruptcy would give the creditors meaningful leverage against a creditor who threatens action that will too-far deplete the asset pool.

The Chinese system imposes heavy procedural burdens on creditors while exposing them to an enforcement system that is unpredictable at best. Even after creditors satisfy their burdens of proof, they remain exposed to joinder by other creditors, and loss of right even if the debtor files a bankruptcy after judgment is rendered. The next section makes several modest proposals, which the Author believes will improve the balance for creditors with effective monitoring to help healthy debtors remain in business and sick debtors to be liquidated in bankruptcy.

IV. PROPOSALS

A. Procedural Change

1. *The Law Should Force Primary Creditors to Bring Suit Against the Primary Debtor, Not the Secondary Debtor*

In China, garnishment actions are brought against the secondary debtor.¹⁰⁵ The court may, but need not require that the primary debtor be named as a joint defendant. Primary creditors should be required to sue the primary debtor, to the extent practical.

Implementation of State-Owned Enterprise Merger & Bankruptcy and Re-employment in Certain Cities], Zhonghua Renmin Gongheguo Guowuyuan Gongbao (1998, No. 8), at 312. See generally Donald Clarke, *State Council Notice Nullifies Statutory Rights of Creditors*, 19 No. 4 E. ASIAN EXEC. REP. 9, 9 (Apr. 15, 1997). Clarke describes the regulations as effectively "staking a claim to all valuable assets connected with the enterprise, regardless of the rights of creditors, in order to fund worker resettlement." *Id.*

104. Amounts in excess of those required to satisfy the garnishment order will remain in the hands of the secondary debtor. Contract Law Interpretation, *supra* note 41, art. 21. The primary debtor or one of its other creditors can bring suit against the secondary debtor for the remainder. *Id.* art. 22. The primary creditor also retains an unsecured claim if there is any shortfall—anything that decreases this deficiency inures to the benefit of the non-litigating creditors as a group.

105. See *supra* notes 41–42 and accompanying text.

From a formal standpoint, it was the default by the primary debtor, not the secondary debtor, that led to the cause of action. From a practical standpoint, the primary debtor has the most at stake. It stands to lose not only goodwill, but also the privilege of contract privity it once enjoyed with its trading partner. This privilege should not be stripped away without notice and an opportunity to be heard.

Allowing the primary creditor to sue the secondary debtor will tend to increase pre-adjudication harm and hamper efforts to mitigate the effect of erroneous or bad faith filings. There is a likelihood of irreparable harm before the primary debtor can act. It is also likely that the court will find helpful the primary debtor's testimony regarding the primary debt, or efforts to collect the secondary debt. Thus, the law should presume that the proper defendant is the primary debtor.

2. *Non-payment of a Debt Should Suffice to Show Actual Harm*

The law should allow the creditor's showing that the debtor is not paying its debts to create a presumption of actual harm.¹⁰⁶ A debtor could rebut the presumption by showing the existence of real and movable assets in excess of liabilities. The inquiry should consider whether the debtor was likely to become able to pay its debts in the ordinary course of business.¹⁰⁷

This rule balances the creditor's difficulty in proving the insufficiency of assets with the debtor's need for protection from unmeritorious litigation. The well-informed creditor will know about a debtor's financial health but likely will lack detailed information about the debtor's property or bank accounts. Weak discovery privileges in China further hamper the creditor's showing.¹⁰⁸

The debtor should be able to offer proof that it is likely to be able to pay the debt in the ordinary course of business. To take a simple case, assume D buys goods from C for 100 and resells them to his longtime customer, T, for 200. Sixty days pass. T has not paid D, and D has not paid

106. This is modeled on the United States Uniform Fraudulent Transfer Act, in which a creditor can create a presumption of insolvency by showing that the debtor is not paying its debts as they come due. See Uniform Fraudulent Transfer Act (U.F.T.A.) § 2(b).

107. See, e.g., *Lerner v. Lerner Corp.*, 711 A.2d 233, 241 (Md. App. 1998) (stating that in considering whether a shareholder distribution was likely to render the company insolvent, directors were entitled to consider the corporation's future sources of cash).

108. Although there is no right to discovery of evidence, the People's Court may have a duty to collect evidence, and the Court has the power to demand evidence from the defendant and others. Civil Procedure Law, arts. 54, 65. The court may compel a debtor to provide information about its assets. See *Seek Truth From Facts*, *supra* note 71, at 292. Despite this sweeping power, courts generally expect a litigant to provide details of a party's assets. *Id.*

C. D has 500 in other liabilities. D also owns some movable property that would sell for 500 immediately, but in six months will be worth 1000. C threatens to bring a collection action. D calls T, who says he will pay “soon.”

It could be that T is waiting for a bank transfer that has gotten lost somewhere between Lahore and Chengdu. In fifteen days, T will receive the money and pay D with apologies. D will pay C. If C is allowed to bring a garnishment action, C gains nothing, and D loses the goodwill of his customer.¹⁰⁹ Preventing C from garnishing the D-T receivable would benefit D and hurt no one.

Of course, it is possible that T is just dodging its creditors because it already resold the goods and spent the proceeds. Here, quick action by someone, either C or D, is critical. D lacks incentives to collect the debt—if he collects, the proceeds will go to C, and D loses goodwill from T. If C is confident that a garnishment action will bear fruit, C should take action. If C is unable to state a prima facie case, and D is unwilling to collect the debt, no one wins. T can spend the money, and the value of D’s assets will decline, increasing the likelihood of default and bankruptcy.

Either way, the issue is not the fairness of allowing a creditor to intermeddle, but whether a debtor who is not paying his bills is presumed nevertheless to have sufficient available assets to pay its creditors. The debtor, with its unique access to information about its own financial health, is in the best position to answer this question. If the primary debtor were able to rebut the presumption, the creditor would receive useful evidence of valuable assets amenable to execution for its efforts.¹¹⁰

Even if a presumption of actual harm would put an additional burden on debtors, there is no unfairness; a dilatory debtor is hardly in a position to complain after breaking its promise to repay. The law already provides robust protections against bad faith creditor filings. This is a conservation measure, helping maintain the value of the debtor’s business and providing relief from the expense of litigation. The Chinese system fulfills this requirement by placing the burdens of proof on the litigating creditor, by commanding the court to consider any objections by the secondary debtor or transferee, and by allowing a court to join the primary debtor as necessary. Creditors seeking protective orders must post bond.¹¹¹ Case

109. This loss can be seen as goodwill value, but can also be represented by the cost of acquiring a new customer.

110. Bing, *supra* note 47, at 281.

111. Contract Law Interpretation, *supra* note 41, at art. 17.

acceptance fees are borne by the losing party.¹¹² If these measures prove insufficient, punitive damages could be imposed for bad faith. For example, failure to investigate the debtor's true state of affairs could result in a punitive damages award.

B. Substantive Change

1. China Should Grant First-to-File Priority to Pre-Bankruptcy Claims

Chinese law seems to allow intervention in a garnishment action up to the time the court passes judgment. It is possible that the proceeds would be divided pro rata among the litigants in a sort of non-bankruptcy collective proceeding. A first-in-time regime would provide maximum payment for the first movant, but at the expense of conservation because a creditor might act strategically to obtain payment before the debtor declares bankruptcy.¹¹³

The Japanese Supreme Court, interpreting Japan's fraudulent conveyance statute,¹¹⁴ addressed precisely this issue.¹¹⁵ Although the Japanese statute provides that avoidance inures to the benefit of all creditors as a group,¹¹⁶ the Court nevertheless held that *pro rata* distribution was not required.¹¹⁷ The Court noted the statute's silence on the mechanism for apportioning the proceeds.¹¹⁸ Because Chinese law is silent as to the method of apportionment, a similar interpretation may not be barred.

For these reasons, the garnished amounts should be distributed first to the litigating creditor, to the full amount of its claim, then to any remaining creditors. Any resulting remainder should be paid to the debtor. This method would correspond to the American rule that "[e]very attachment takes precedence over a subsequent attachment," and that the

112. See MINSHI SUSONG FA [CIVIL PROCEDURE LAW] 124-25 (Jiang Wei ed., 2000). Case fees are calculated as a percentage of the damages sought. *Id.*

113. In the United States, for example, most levying creditors are immune from challenge 90 days after the levy takes place. See 11 U.S.C. § 547 (2002). Most transfers to a pre-petition creditor within 90 days of the bankruptcy petition can be voided. *Id.*

114. MINPO [C. CODE], art. 425 (Japan) [hereinafter Japan Civil Code].

115. See Frank Bennett, *Preference Rules in Japanese Bankruptcy Law*, in JAPANESE COMMERCIAL LAW IN AN ERA OF INTERNATIONALIZATION 222 n.8 (Hiroshi Oda ed., 1994) (citing Supreme Court, Oct. 9, 1962, *Minji Hanreishā* Vol 16, No. 10, p. 2070; Supreme Court, 19 Nov. 19, 1971, *Minji Hanreishā* Vol 25, No. 8, p. 1321).

116. Japan Civil Code, art. 425.

117. See *supra* note 115.

118. *Id.*

first-in-time creditor has priority in payment up to the full amount of its claim.¹¹⁹ Although there is certainly a risk of lost value, as long as safeguards are in place to weed out unmeritorious claims, responsibility for risk belongs on the debtor's account. This approach would increase the debtor's incentive to either collect the debt or negotiate with the primary creditor.

Would such a rule be fair and effective? On one hand, allowing a second creditor to join a suit after another has borne the risk and completed the work necessary to bring suit hardly seems equitable. Liberal joinder rules could also tempt a debtor to act strategically to join a favored creditor, perhaps in hopes of dissuading the litigating creditor from prosecuting the action, or to keep the proceeds in the local economy.

On the other hand, creditors would need to be constrained in their ability to use the threat of garnishment actions as a lever to extract unjustified payments in exchange for credit extensions. The Bankruptcy Law provides a six month window to reverse pre-petition grants of security interests, but not necessarily payments for value.¹²⁰

The rule would have to be applied uniformly. Tax collection laws now provide garnishment and avoidance rights against tax debtors via reference to Articles 73 and 74.¹²¹ This may make the State Tax Bureau a weighty competitor indeed; the Bureau likely would expect priority in garnishment and avoidance actions whenever its interests conflict with those of a trade creditor. The Labor Department might also use a strengthened creditor rights regime to bring claims for wage and pension arrearages.

These concerns militate not for liberal joinder rules, but for strengthening the involuntary bankruptcy remedy and harmonizing pre- and post-bankruptcy distributional rules for non-tax, non-labor creditors. If bankruptcy is a viable alternative for the creditor group, then all creditors similarly situated to an insolvent enterprise would have similar incentives to act.¹²²

119. 6 AM. JUR. 2D *Attachment and Garnishment* § 492 (2003). Under state law such as under the Civil Procedure Law, the creditor may be required to forego some portion of the debtor's property, such as where the secondary debt is for wages. 31 AM. JUR. 2D *Exemptions* § 1 (2003).

120. See Bankruptcy Law, art. 35.

121. The Law of the People's Republic of China to Administer the Levying and Collection of Taxes, art. 50 *translated in* PRC Tax Collection, MANAGEMENT LAW, FBIS-CHI-2001-0429, Apr. 28, 2001. Article 74 deals with fraudulent conveyances. Contract Law, art. 74.

122. The ability of a single creditor to obtain full satisfaction is counterbalanced by the right of other creditors, either singularly or in coalition, to file an involuntary bankruptcy petition. Any attempt to take too much out of the debtor's asset pool, assuming the other creditors are sufficiently engaged to notice, would trigger bankruptcy. Rather than a winner-takes-all approach, the other creditors can force everyone into pro-rata sharing.

Pro-rata sharing may lead to an increased risk of bankruptcy. Consider again the Serengeti dogs.¹²³ To overcome the loss to theft by hyenas, who neither hunt nor kill their own prey, the dogs are forced to hunt larger animals. In the same way, liberal joinder rules may force a creditor to go after more and larger assets.

Assume D owes 200 to C. D also owes 300 each to E and F. T owes 500 to D. C brings a garnishment suit against T for 100. Table 2 illustrates possible outcomes under various distributional schemes.

Case	Rule	Creditor	Payment
C files a garnishment suit. E and F do not join. E and F file sequential suits.	Pro-rata	C	200.00
		E	300.00
		F	0.00
C files a garnishment suit. E and F join.	Pro-rata	C	125.00
		E	187.50
		F	187.50
C files a garnishment suit. E and F do not join. E and F file sequential suits.	First-to-file	C	200.00
		E	300.00
		F	0.00
C files a garnishment suit. E and F join.	First-to-file	C	200.00
		E	300.00
		F	0.00

The pro-rata rule creates a strategic advantage to intervention, because sequential filing yields no payment for the third creditor. Some creditors to a primary debtor will share the primary debtor's motivations: to continue the business as a going-concern. Those creditors will not act unless the system clearly disadvantages them for failure to do so. Furthermore, if the three creditors join the suit, our protagonist, C, receives only partial payment and must go after additional receivables, further decreasing D's goodwill of business and increasing the likelihood of bankruptcy. This result is a variation on the tragedy of the commons, or "common pool," and has been described by a number of bankruptcy theorists.¹²⁴

This result is only effective if there is rough symmetry in the treatment of particular classes of creditors pre- and post-bankruptcy. For example, an unsecured creditor to a Chinese firm with significant tax arrears might receive a small payout if it must jointly prosecute its claim along with the State Tax Bureau, but receive nothing post-bankruptcy. In this situation, calling for involuntary bankruptcy would be futile because the other creditors would receive no reward.

Such a rule would not necessarily accelerate bankruptcies because it would provide the competing creditors with a strong coercive tool with which a non-bankruptcy solution can be fashioned.

123. See *supra* note 20 and accompanying text.

124. See, e.g., Michael S. Quinn & Brian S. Martin, *Insurance and Bankruptcy*, 36 TORT & INS. L.J. 1025 ("Because creditors have conflicting rights, their debt-collection efforts tend to make a bad

Failing to protect creditors whole bargain could create *ex ante* costs. Creditors could create a chilling effect on transactions generally, by refusing to extend credit where there is not real or movable property against which a lien can be recorded.¹²⁵ Moreover, transaction costs could increase as creditors seek to create and record security interests rather than face the uncertainty of execution in a first-to-file environment.

2. *Successful Litigation Should Result in Immediate Assignment of the Underlying Debt Obligations*

Securing a judgment should entitle the creditor to satisfaction of some portion of his claim. Under the Bankruptcy Regulations, upon acceptance of a bankruptcy case any debts owed to the insolvent enterprise pass to the estate.¹²⁶ Thus, unless the debtor's rights are assigned immediately to the litigating creditor, the proceeds are likely to be lost to the bankruptcy estate.¹²⁷

China should clarify the new rights created by a successful garnishment or avoidance action. A primary creditor who prevails in a garnishment action should immediately become the obligee, with payment owed directly by the secondary debtor to the primary creditor.¹²⁸ The debt between the primary debtor and secondary debtor should be cancelled. This way, should the primary debtor file bankruptcy, the debt will not pass into the bankruptcy estate.

This rule would create certainty. It would also force the debtor whose receivables are subjected to a garnishment action to choose between fighting the pre-bankruptcy case and declaring bankruptcy. Allowing a debtor to fight the judgment only to declare bankruptcy once a court has

situation worse") (2001); Thomas P. Jackson & Robert E. Scott, *On the Nature of Bankruptcy Sharing and the Creditor's Bargain*, 75 VA. L. REV. 155 (1989) ("Bankruptcy sharing rules that apply only in particular cases [create] an incentive to expand resources to minimize the [cost to] them as individuals, thus reducing the wealth of the claimants as a group."); James O. Johnston, Jr., *The Inequitable Machinations of Section 362(a)(3): Rethinking Bankruptcy's Automatic Stay Over Intangible Property Rights*, 66 SO. CAL. L. REV. 659 (1992). Johnson describes the dilemma, where "each creditor has an incentive to act quickly in order to collect claims before others do. Although all may be better off in a [reorganization] proceeding . . . none have any incentive to delay a collection action." *Id.* at 663 n.19.

125. Security interests can not be registered against receivables. Security Law art. 34 (stating what property can be the subject of a mortgage).

126. Bankruptcy Law, art. 3.

127. *See supra* note 50.

128. An opposing view was articulated by Wang Liming in *An Inquiry into Several Difficult Problems in Enacting China's Uniform Contract Law*, *supra* note 53. Professor Wang's view is that assigning the debt obligation not only violates contract relativity (similar to the common law concept of privity), but harms the interests of other creditors of the primary debtor. *Id.*

rendered judgment against him, serves little purpose except to deter collection activity and to allow debtors' assets to be further depleted by litigation.

At least one commentator has proposed imposing joint and several liability on the primary debtor and the secondary debtor.¹²⁹ If recovery from the secondary debtor proved elusive, and assuming the primary debtor's fortunes improved in the interim, the primary creditor would be paid despite having bet on the wrong horse. In effect, this result would turn the primary debtor into a guarantor.

V. CONCLUSION

China has created a system for garnishment of receivables, which includes most of the formal institutions found in mature systems. A creditor must first show that there are no real or movable assets against which to execute, and upon proof that the creditor is owed money, and proof that the debtor is holding valuable, mature debt from a third party, the court will allow the proven debts to be collected from the third party.

However, China's legal system imposes unreasonably high costs and risks on the litigating creditor. The litigation burdens are high, and problems associated with securing and executing judgments prevent parties from accurately assessing their chances of recovery. This uncertainty creates *ex ante* costs as potential creditors adopt risk reduction strategies and *ex post* costs as creditors are deprived of capital. Tomorrow's trade debtors are punished for their predecessors' improvidence.

China's laws should reward creditors fully for monitoring debtors' stewardship of their assets and for stepping forward when necessary to prevent their waste. They should shift the burden of proving insolvency back to the debtor in default, the party who is best able to prove financial well-being. Non-payment of a debt should create a presumption of actual harm. Creditors should receive first-to-file priority for claims. Finally, a creditor who prevails in a garnishment action should receive protections against loss of right.

Most of the issues highlighted in this Note are not dictated by the statutory language. The recently promulgated bankruptcy regulations show the Supreme People's Court as a vital institution of legal change even in the face of legislative inertia. Many of the problems identified in this Note

129. Chen Yunfei, *Interpreting the PRC, Contract Law*, 14 CHINA L. & PRAC. 40, 44 (Mar. 2000).

derive from the Court's prior gap-filling efforts, thus the Court is uniquely positioned to provide solutions.

These issues are not trivial, and prospects for timely legislative change are far from sanguine. However, the issues highlighted here should not be viewed as overshadowing the tremendous strides China has made in giving creditors a range of options to protect the benefit of their bargains.

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