

# Research on the Construction of China's Pre-reorganization System

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## Abstract

**Pre-reorganization is an effective mechanism to realize the connection between out-of-court debt restructuring and in-court reorganization. In practice, both the reorganization system and the out-of-court debt restructuring have defects. Pre-reorganization can overcome the drawbacks of the existing dual mechanism. Therefore, it is necessary to establish a pre-reorganization system. The reorganization system and out-of-court debt restructuring can be used as the institutional basis for the construction of the pre-reorganization system, and judicial practice has also carried out a corresponding exploration of the pre-reorganization system, which provides feasibility for the construction of the pre-reorganization system. In the specific construction of the pre-reorganization system, it should be carried out from the scope of application of the pre-reorganization, the start of the pre-reorganization, the setting of the administrator, the voting of the pre-reorganization plan, and the approval of the pre-reorganization plan, So as to escort the regeneration of distressed enterprises.**

## Keywords

**Pre-reorganization; Out-of-court Debt Restructuring; In-Court Reorganization.**

## 1. The Connotation of Pre-reorganization

In the early stage of bankruptcy laws of various countries, there is no relevant setting for pre-reorganization. Pre-reorganization originated in the United States and are the product of the continuous development of bankruptcy practice. The core of the pre-reorganization system is to carry out the relevant reorganization matters outside the court in advance with the final orientation of the in-court reorganization. The pre-reorganization is a development product that meets the needs of bankruptcy practice. The design of the pre-reorganization system is to provide coercive guarantee for the execution of the out-of-court debt restructuring plan, and to prevent the situation of "clamping" between interested parties due to autonomy of will. The pre-reorganization system has a connection function and an efficiency promotion function, which can overcome the inherent drawbacks of in-court reorganization and out-of-court debt restructuring, and realize the efficient connection from out-of-court debt restructuring to in-court reorganization. Its specific manifestation is that before applying for reorganization, the debtor and creditors formulate a reorganization plan through free negotiation and negotiation. After the plan is approved by the majority of creditors, the reorganization procedure makes it coercive and enforceable, so as to realize the debtor's revival as soon as possible. Compared with the formal reorganization procedure, pre-reorganization is more flexible and convenient, and can quickly and efficiently carry out the rescue of distressed enterprises. The revision of Law of the People's Republic of China on Enterprise Bankruptcy (hereinafter referred to as the Bankruptcy Law )in 2021 is listed as a key legislative work, and the pre-reorganization system is the key content that should be paid attention to. Since the implementation of the Bankruptcy Law in 2006, with the development of economy and society, the problem of rebirth of difficult enterprises urgently needs to be dealt with by a new bankruptcy model. The establishment of a pre-reorganization system can enrich the corporate bankruptcy system,

realize the effective combination of independent negotiation between the parties and judicial procedures, and thus protect the legitimate rights and interests of relevant stakeholders. To promote the vigorous development of the market economy. Therefore, the targeted research on the construction of the pre-reorganization system is very important. In the existing local judicial practice, pre-reorganization can be divided into two types: out-of-court pre-reorganization and in-court pre-reorganization, according to the different leading subjects. The pre-reorganization plan in the out-of-court pre-reorganization is reached by the interested parties, while the pre-reorganization plan in the court is led by the court to formulate the pre-reorganization plan.

## **2. The Necessity of Pre-reorganization System Construction**

### **2.1. The Flaws of the Reorganization System and Out-Of-Court Restructuring**

For the regeneration of enterprises in difficulty, China has comprehensively used judicial and non-judicial remedies to establish in-court bankruptcy reorganization and out-of-court debt reorganization systems. However, this rescue mechanism has many shortcomings in practice and cannot meet the current economic and social development requirements. need. On the one hand, the reorganization procedure is formally established by the Bankruptcy Law, and the relevant matters are strictly carried out in accordance with the law. The applicable threshold of the reorganization procedure is relatively high, and it is difficult for many enterprises to obtain effective relief from the reorganization procedure. According to Article 2 of the Bankruptcy Law, distressed enterprises need to meet the requirements of being unable to pay off their due debts and insolvent, unable to pay off their due debts and obviously insolvent or obviously insolvent and may be eligible for reorganization procedures. The traditional bankruptcy reorganization system has a long time and high cost. Since the establishment of the reorganization system, the success rate of reorganization cases has not been high. In addition, the progress of the reorganization procedure will be affected by the work efficiency of the court, and the rights and interests of creditors are at risk of being damaged. On the other hand, traditional out-of-court debt restructuring also has many imperfections. Under the autonomy of the parties, if there are parties who do not cooperate, it will be difficult to negotiate and the process of debt restructuring will be blocked. At the same time, out-of-court debt restructuring is not guaranteed by public power, which will bring more difficulties to the implementation of the restructuring plan.

### **2.2. Pre-Reorganization can Overcome the Shortcomings of the Existing System**

The pre-reorganization system is a new type of rescue procedure for distressed enterprises that has been explored to make up for the insufficiency of the connection mechanism between out-of-court debt restructuring and in-court reorganization. . As mentioned above, in-court restructuring procedures are complex and costly, and out-of-court debt restructuring cannot be widely used due to issues such as "clamping". Enterprises applying pre-reorganization must conduct information disclosure, negotiation and other matters out of court in accordance with the requirements of the bankruptcy legal system. Pre-reorganization puts the negotiation stage between debtors and creditors before bankruptcy reorganization. There is sufficient time for free negotiation. Therefore, it is possible to speed up the progress of reorganization cases, effectively reduce the loss of assets of reorganization enterprises and save judicial resources. At the same time, the establishment of the pre-reorganization procedure is a manifestation of the intervention of public power, which can make the out-of-court debt restructuring more orderly and efficient, and change the previous situation that the out-of-court restructuring agreement lacked execution guarantees. The intervention of public power in the pre-reorganization procedure is limited, and it will not cause excessive interference with the autonomy of the parties. The specific manifestation is that the out-of-court debt restructuring

agreement obtains enforceability through the pre-restructuring procedure, thereby effectively solving the restraint problem caused by the parties' non-cooperation.

### **3. Feasibility of Pre-reorganization System Construction**

#### **3.1. The Existing of System Basis**

The pre-reorganization system is a new system based on the reorganization system and the out-of-court restructuring system. Although the reorganization system and the out-of-court restructuring system have their own limitations, they are the basis for the construction of the pre-reorganization system. In-court reorganization is one of the statutory bankruptcy procedures of the Bankruptcy Law. The court intervenes in a troubled enterprise to revitalize its operating assets and promote its economic regeneration through judicial means. Judicial intervention is a prominent feature of in-court reorganization, and the adjustment of the relationship between debtors and creditors must be carried out under the leadership of the court in accordance with the Bankruptcy Law and relevant judicial documents. Compared with in-court reorganization, which is constrained by the Bankruptcy Law, out-of-court debt restructuring guarantees the parties' freedom of expression and avoids judicial intervention by the court. The out-of-court debt restructuring agreement is freely reached by the parties, and the agreement is not legally binding, and is a manifestation of the parties' autonomy.

#### **3.2. Relevant Exploration of Judicial Practice**

Although the pre-reorganization system has not been formally established, the relevant exploration of judicial practice can provide a feasible basis for the establishment of the pre-reorganization system. In 2018, the "Minutes of the National Court Bankruptcy Trial Work Conference" proposed to explore the connection between out-of-court debt restructuring and in-court reorganization; In 2019, the "Minutes of the National Courts' Civil and Commercial Trial Work Conference" proposed to continue to improve the connection mechanism between out-of-court debt restructuring and in-court reorganization, reduce institutional costs, and improve the efficiency of the bankruptcy system. At present, many courts have made operational guidelines for the pre-reorganization procedure, and pre-reorganization has shown different forms in different regions, such as the Wenzhou model, the Shenzhen model and the Chongqing model. Although the pre-reorganization models in different regions are quite different in the aspects of pre-reorganization initiation, determination of pre-reorganization plans, and approval of pre-reorganization, they are all in-depth explorations of the application of the pre-reorganization system in China. The pre-reorganization procedure has also achieved good results in specific judicial practice. For example, in the early stage of the Yifengcheng bankruptcy reorganization case, the company carried out a series of tasks such as clarifying the relationship between creditor's rights and debts, introducing investors, formulating a draft reorganization plan, and calling creditors to vote on the draft, which effectively reduced the cost of in-court reorganization procedures. While reducing costs, the pre-reorganization practice finally achieved good results, and rescued a distressed enterprise with a debt of 1.8 billion yuan through financing of 20 million yuan.

### **4. Concrete Construction of Pre-reorganization System**

A successful legal system of market economy must take bankruptcy law as an important guarantee for purifying market entities and enhancing their vitality[3]. As an effective new rescue model for distressed enterprises, the pre-reorganization system can overcome the deficiencies of in-court reorganization and out-of-court debt restructuring, and optimize the existing bankruptcy legal system. Through in-depth domestic research and active exploration of judicial practice, the establishment of a pre-reorganization system in China can make up for

the insufficiency of the existing dual rescue mechanism and enrich China's bankruptcy relief system. For the construction of the pre-reorganization system in the future, the legal status of pre-reorganization should be clarified, the procedural arrangements of the system should be determined, and the auxiliary mechanism of pre-reorganization should be established, so as to promote the further improvement of the bankruptcy mechanism of enterprises in China.

#### **4.1. Scope of Application of Pre-reorganization**

Pre-restructuring is a choice made by debt restructuring companies to obtain the enforceability of the restructuring agreement. However, because the company will enter the restructuring process after the general pre-restructuring process, not all debt restructuring companies are suitable for pre-restructuring. The scope of application of the pre-reorganization system should be clarified first, and the identification mechanism for the pre-reorganization value of distressed enterprises should be strengthened. The rescue of distressed enterprises should be feasible and necessary. When applying pre-reorganization or not, creditors' consent should be taken as the precondition for applying pre-reorganization. The external standards of the target enterprise of the pre-reorganization procedure should be specified, such as the minimum standardized provisions for the size of the enterprise, the number of employees, the number of affiliated enterprises and cooperative enterprises, and the purpose is to objectively and accurately identify the qualified enterprises in distress. For enterprises whose direct reorganization will have a significant impact on the production and operation of the enterprise or society, the pre-reorganization procedure should also be applied first.

#### **4.2. The Starting of Pre-reorganization**

As a pre-reorganization procedure for bankruptcy reorganization, the criteria for commencement should be consistent with the criteria for bankruptcy reorganization, so as to facilitate its connection with bankruptcy reorganization. The commencement of pre-reorganization requires an application by an interested party, and the subject of the application for pre-reorganization proposed in the Legislative Guide to the Bankruptcy Law should be the debtor, and the design of the applicant subject for pre-reorganization procedures in China should not be limited to this. The applicant may include the debtor, creditor, investor or other interested parties, etc., and the government may also act as the applicant for pre-reorganization, for example, in the practice of wenzhou pre-reorganization, the government is a typical representative of the applicant subject. As the applicant body, the government can give full play to the guiding role of the government in the pre-reorganization, which is an in-depth attempt to give full play to the advantages of linkage. Multiple applicants can quickly and fairly initiate the pre-reorganization procedure, and realize the timely transition from out-of-court debt restructuring to in-court reorganization, which is conducive to the normal operation of enterprises and the preservation of property. As a judicial organ, the court is not suitable to directly intervene in the pre-reorganization procedure as the initiating entity, and the initiation of the pre-reorganization shall fully reflect the party's autonomy of will. Placing the pre-reorganization under the leadership of the court will easily lead to the pre-reorganization becoming a tool to avoid the time limit for submitting the draft reorganization plan in the bankruptcy law[5].

#### **4.3. The Setting of Administrator**

As an important subject in bankruptcy proceedings, the administrator has the characteristics of professionalism, independence and impartiality. The orderly advancement of bankruptcy proceedings is inseparable from the performance of the functions of the administrator, and the administrator is also indispensable in the pre-reorganization procedure. The administrator shall investigate the relevant information of the debtor during the pre-reorganization, and is the main body of the information reception and transformation, and shall also play a

supervisory function to supervise the progress of the pre-reorganization procedure. During the pre-reorganization, the formulation and voting of the pre-reorganization plan shall be carried out, and the administrator shall play a coordinating and guiding role here to promote the smooth coordination of the parties. Whether the selection of managers is appropriate or not depends on the performance of the aforementioned functions of the managers. Therefore, when selecting managers, it is necessary to make up for the shortcomings of the traditional court designation methods such as direct designation, lottery, and competition, and innovate the selection method.

#### **4.4. Voting on the Pre-reorganization Plan**

The pre-reorganization plan is the result of the game of interests of the debtors, creditors and investors under the guidance of the pre-reorganization auxiliary agencies or managers. Due to time and cost considerations, the pre-reorganization plan is a foreshadowing of the formal reorganization plan in the courtroom. In essence, pre-reorganization is to advance some procedures in the reformation procedure, and the pre-reorganization plan is transformed into a draft reformation plan, which is a natural extension of the effectiveness of the pre-reorganization plan[6]. Therefore, its design content should be consistent with the main content of the reorganization plan. The Bankruptcy Law clearly stipulates the contents of the draft reorganization plan, such as the business plan, the classification and adjustment of creditor's rights, the payment of creditor's rights, the execution and supervision period, etc., and provides a model for the specific content and framework of the pre-reorganization plan. In order to ensure the fairness of the voting process, creditors shall vote on the pre-reorganization plan according to the nature of the claims and the types of creditors. For the behavior that the debtor may secretly collude with some creditors and damage other creditors in the pre-reorganization, the right of objection may be granted to the creditors whose interests are damaged[7].

#### **4.5. Approval of the Pre-reorganization Plan**

The pre-reorganization plan does not need to be voted again after entering the formal reorganization process, and the court can directly review and approve it in accordance with statutory conditions. The pre-reorganization plan can only be extended to the reorganization procedure and become compulsory if it is approved by the court. Therefore, the court's approval of the pre-reorganization plan is a key part of the design of the pre-reorganization program. It is necessary to clarify the conditions for the court's approval. When certain conditions are met, the court can directly approve the pre-reorganization plan as a reorganization plan. For defective or unapproved pre-reorganization plans, the court may arrange for another consultation and voting, and then re-enter the approval process. The court shall decide whether to accept the reorganization application in a timely manner after receiving the pre-reorganization work report. When the court's examination and approval result is that it does not rule to enter the reorganization procedure, it may transfer to the bankruptcy liquidation procedure or rule not to accept the application.

### **5. Conclusion**

The separation of out-of-court debt restructuring and in-court reorganization system has been unable to meet the practical needs of rescue of distressed companies, and is not conducive to the sound development of the economic market. As a new type of procedure to rescue distressed enterprises, pre-reorganization has been reflected in extraterritorial bankruptcy legislation and China's local judiciary. It can effectively connect out-of-court debt restructuring and in-court reorganization, and is a supplement and optimization to the existing bankruptcy mechanism. In order to establish a diversified bankruptcy mechanism, the targeted

research on the pre-reorganization system is a useful exploration for the revision of China's bankruptcy law. The specific construction of the pre-reorganization system should be carried out in terms of the scope of application of the pre-reorganization, the start of the pre-reorganization, the voting of the pre-reorganization plan, and the approval of the pre-reorganization plan, so as to improve the success rate of saving the troubled enterprises.

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