

Difficulties and Solutions in Substantive Merger Bankruptcy of Affiliated Enterprises

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ABSTRACT

This paper provides an in-depth analysis of the theoretical foundation and practical implementation of the substantive merger bankruptcy system for affiliated enterprises, highlighting its significance and challenges in the contemporary economic environment. Through a comprehensive examination of the legal basis, value function, and current legal and judicial status of substantive merger bankruptcy, this study uncovers key issues in its execution while putting forward recommendations for improvement in legislation and judicial practice. The research emphasises the necessity to clarify legal standards, optimise creditor protection mechanisms, and implement appropriate commencement modes to improve efficiency, fairness, and transparency in insolvency proceedings, support the effective restructuring of complex enterprise clusters and ensure market stability.

KEYWORDS

Substantial merger bankruptcy; Legal framework; Creditor protection

1. INTRODUCTION

With the further development of economic globalisation and market integration, there is an increasingly evident trend of enterprises towards forming enterprise groups or affiliations. In this context, the substantive merger bankruptcy system for affiliated enterprises came into being, aiming to address the limitations of traditional single bankruptcy procedures in effectively handling bankruptcies of complex enterprise groups. Particularly in cases involving multinational enterprise groups, identifying and addressing the economic behaviours of each independent legal entity within the group poses a significant challenge in both theories and practices of modern bankruptcy law [1]. It is of great significance to study the substantive merger bankruptcy of affiliated enterprises to improve the bankruptcy legal system and the adaptability and effectiveness of the bankruptcy law. In practical judicial operations, such bankruptcy cases often involve complicated creditor-debtor relationships where ordinary bankruptcy procedures struggle to achieve the dual goals of economic efficiency and social equity. An in-depth analysis of the legal basis and value function of substantive merger bankruptcy of affiliated enterprises can provide theoretical support and operational guidance for legislative and judicial practices and help improve efficiency and fairness when handling complex bankruptcy cases.

This paper adopts theoretical analysis and value evaluation as research methods. First, the theoretical analysis provides an in-depth discussion on the legal principles underpinning the substantive merger bankruptcy rules so that the underlying legal foundations behind these rules are uncovered. Through elaborating on and reasoning with relevant legal theories, this paper aims to provide robust theoretical support and a solid legal basis for the provisions of substantive merger bankruptcy. This paper also employs value analysis method to examine the core values pursued by these rules and their positive impact on both the legal system and social economy to demonstrate the existence and necessity of

this mechanism and its potential legitimacy. This method facilitates a comprehensive understanding of the meaning and significance of substantive merger bankruptcy rules while providing a theoretical foundation for further legal practice and legislative reform.

2. BASIC THEORY OF RULES ON SUBSTANTIVE MERGER BANKRUPTCY OF AFFILIATED ENTERPRISES

2.1. Basic Concept of Substantive Merger Bankruptcy of Affiliated Enterprises

Substantive merger bankruptcy of affiliated enterprises refers to the legal system in which when multiple legally independent but economically closely related enterprises cannot independently repay their debts due to a financial crisis, they can be treated as an economic entity for bankruptcy liquidation [2]. This concept is based on the highly integrated economic behaviour and financial status within an enterprise group, which emphasises optimising resource allocation and satisfying creditors' interests from a holistic perspective. To deal with substantive merger bankruptcy is not only a legal form of merger but also involves a comprehensive assessment of enterprises' actual operations and financial conditions to ensure fairness and efficiency in distributing equity during the bankruptcy process.

2.2. The Legal Basis for Substantive Merger Bankruptcy of Affiliated Enterprises

The legal basis for substantive merger bankruptcy of affiliated enterprises is mainly derived from the principles of “global optimality” and “fairness”. From the “global optimality” perspective, substantive merger bankruptcy can maximise asset utilisation and facilitate the most effective repayment of debts. Through centralised management and disposal of assets of affiliated enterprises, redundant bankruptcy procedures are minimised, thereby enhancing the economic efficiency of the bankruptcy process. On the other hand, the “fairness” principle emphasises equal rights for all creditors in accessing the debtor's assets during the insolvency process, particularly when dealing with complex intra-group claims and liabilities. Substantive mergers help prevent certain creditors' unfair treatment due to the business structure's complexity.

2.3. The Value Function of Substantive Merger Bankruptcy of Affiliated Enterprises

The value function of substantive merger bankruptcy of affiliated enterprises is primarily demonstrated in three aspects: efficiency enhancement, risk management, and reinforcement of legal predictability [3]. Firstly, bankruptcy merger procedures can mitigate legal conflicts and managerial redundancies among related enterprises, thereby improving the efficiency of asset disposal. Secondly, it facilitates centralised treatment of financial risks within the group and prevents their propagation to healthy subsidiaries, thus safeguarding the stability of the economic system to a greater extent. Lastly, through standardised procedures and clear legal expectations, substantive merger bankruptcy strengthens legal predictability. It provides clearer legal guidance for business operations and financial decisions while reducing potential legal risks associated with business operations.

3. LEGISLATIVE AND JUDICIAL STATUS QUO OF SUBSTANTIVE MERGER BANKRUPTCY OF AFFILIATED ENTERPRISES

3.1. Legal Provisions on Substantive Merger Bankruptcy of Affiliated Enterprises

In order to address the guiding norms for applying substantive merger bankruptcy rules in judicial practice, the Supreme People's Court issued the Minutes of the National Court Bankruptcy Trial Work Conference (hereinafter referred to as the Minutes) [4] in 2018. The Minutes clarified the

procedures for handling bankruptcies of affiliated enterprises, principles for cautious application and exceptional conditions for applying substantive merger bankruptcy rules, review procedures, jurisdictional principles, and rights relief for interested parties. Based on the Minutes, local courts have successively issued specific operational guidelines. For instance, the Zhengzhou Intermediate People's Court and Xiamen Intermediate People's Court issued operational guidelines for substantive merger bankruptcy, respectively, in 2019 and 2020.

However, despite the frequent utilisation of substantive merger bankruptcy rules in judicial practice, the legal framework still lacks clarity. The absence of specific and explicit provisions in the current legal system to define the specific definitions, procedures, and conditions for substantive merger bankruptcy of affiliated enterprises poses challenges for courts and relevant stakeholders in understanding and applying the appropriate legal framework.

3.2. Status Quo of Judicial Practice of Substantive Merger Bankruptcy of Affiliated Enterprises

Regarding the substantive merger bankruptcy cases of affiliated enterprises, taking the issuance of the Minutes in 2018 as a benchmark, only 18 cases were reported between 2001 and 2018. However, cases surged significantly to 48 in 2019, indicating a gradual popularisation of the rule. Although the COVID-19 pandemic caused fluctuations in cases between 2020 and 2022, the overall trend remained upward. These cases were primarily distributed in economically developed regions along China's east coast, such as Shanghai.

Confusion of personality is the main criterion for determining the application of substantive merger bankruptcy. For instance, in the case of substantive merger bankruptcy involving 321 companies, including HNA Group, the Hainan High Court thoroughly examined these enterprises' organisational structure, operational management, and financial management based on Article 32 of the Minutes. Ultimately, it was found that there were instances of high confusion of legal personality, excessive costs associated with distinguishing properties of member-affiliated enterprises, and serious damage to the fair payment of creditors' interests, leading to the applicability of substantive merger bankruptcy. Similarly, in the case of the substantive merger bankruptcy of six companies, including Zongheng Group, the trial process also focused on verifying the applicability of the confusion of personality criterion. Eventually, it confirmed these companies' financial, institutional and operational confusion, which became the legal foundation for implementing substantive merger bankruptcy.

Protecting creditors' rights and interests is the key issue in substantive merger bankruptcy cases [5]. According to Article 33 of the Minutes, upon receiving an application for substantive merger bankruptcy, the People's Court shall promptly notify relevant stakeholders and organise a hearing to ensure fair protection of creditors' rights and interests. For instance, in the case of substantive merger and reorganisation involving five enterprises, including the Peking University Founder Group, Beijing First Intermediate Court first handled the Founder Group's bankruptcy request. Then, it brought the other four enterprises into the scope of merger and reorganisation based on an investigation of the administrator and consideration of the conditions for substantive merger bankruptcy. Although substantive merger bankruptcy rules have been gradually recognised and implemented in judicial practice, challenges still exist due to legal framework imperfections and operational guidelines ambiguity. Therefore, further clarifying the legal status and effect of both the Minutes and related operational guidelines in practical cases is necessary so that substantive merger bankruptcy rules can be precisely implemented to promote the efficiency and fairness of insolvency proceedings.

4. THE DILEMMA IN APPLYING RULES ON SUBSTANTIVE MERGER BANKRUPTCY OF AFFILIATED ENTERPRISES

With the increase in the number of affiliated enterprise bankruptcy cases, the application of substantive merger bankruptcy rules faces multi-faceted challenges. Despite judicial policy guidance provided by the Minutes, guidance for the application premise, legality and operation norm of the rules is still insufficient, which makes it difficult for the courts to establish a unified judgment standard during concrete implementation.

4.1. Ambiguous Application Standards

The criteria mentioned in the Minutes include the high cost of asset split, confusion of legal personality, and serious damage to the fair payment of creditors' interests. However, specific defining factors for these criteria are not clearly stated, leading to variations in interpretation and application by different courts. In a bankruptcy case involving multiple affiliated companies in Beijing, the court primarily relied on the criterion of confusion of legal personality while lacking clear guidelines for assessing asset split costs and measuring creditor's interests. In addition, when handling similar cases, courts in Shanghai and Guangzhou also have different evaluation standards concerning the "difficulty of asset split" and "confusion of legal personality", reflecting practical differences across regions.

4.2. Inconsistent Commencement Mode

The modes of commencing substantive merger bankruptcy are inconsistent in judicial practice. The main modes include "separate bankruptcy followed by merger", "partial bankruptcy followed by merger", and "merger first followed by simultaneous bankruptcy".

In a bankruptcy case involving affiliated enterprises in Guangdong province, the court adopted the mode of "merger first followed by simultaneous bankruptcy" due to these enterprises' highly centralised finance and management, making independent separation nearly impossible. In another case in Jiangsu, the court chose the mode of "separate bankruptcy followed by merger", as the involved companies, though related, maintained relatively independent financial and operational structures that necessitated separate examination of their eligibility for bankruptcy.

4.3. Imperfect Creditor Protection Mechanism

A critical concern in substantive merger bankruptcy is the protection of creditors' rights and interests. However, due to the absence of definite provisions and standards, creditors risk suffering equity losses during substantive merger bankruptcy proceedings. In certain cases, courts may fail to fully consider the interests of all creditors and solely focus on realising economic efficiency and resource maximisation of the insolvent enterprise. Furthermore, creditors often lack effective relief channels when they oppose unfair bankruptcy settlement schemes, further increasing uncertainties and creditor dissatisfaction in legal practice.

There are still numerous difficulties and challenges in applying substantive merger bankruptcy rules, including ambiguous application standards, inconsistent commencement modes, and imperfect creditor protection mechanisms. These issues impact the efficiency and fairness of courts in handling complex bankruptcy cases and undermine the transparency and predictability of legal regulations. In the future, it is necessary to clarify and refine these rules and standards to enhance the operability and fairness of substantive merger bankruptcy rules.

5. RECOMMENDATIONS FOR IMPROVING RULES ON SUBSTANTIVE MERGER BANKRUPTCY OF AFFILIATED ENTERPRISES

5.1. Improving Relevant Legislation

Improving the substantive merger bankruptcy rules requires clear legislative guidance and appropriate flexibility to respond to changing economic circumstances and complex corporate structures. To this end, legislation should specify the applicable conditions of substantive merger bankruptcy and clarify key factors such as the criteria of legal personality confusion and creditor protection measures [6]. By incorporating such provisions, courts would have a more solid foundation when adjudicating specific cases, thereby enhancing the consistency and predictability of decisions.

The legal provisions should clearly define the scope of related enterprises and the circumstances under which substantive merger bankruptcy proceedings may commence. For instance, The law should specify how to assess the presence of confusion in legal personality when assets and liabilities are highly intertwined. Furthermore, it is necessary to provide concrete creditor protection measures to fully safeguard creditors' legitimate rights and interests throughout the merger process.

Legislation should also cover the conditions for initiating substantive merger bankruptcy, legal procedures for proving legal personality confusion, and associated attribution of the burden of proof [7]. In this way, the law provides the criteria for judgment and grants courts some discretion to make appropriate rulings based on the actual circumstances in specific cases. In order to better implement these provisions, the legislation should offer specific guidance on how courts should handle substantive merger bankruptcy cases. This includes but is not limited to, trial procedures, necessary review standards, and approaches for addressing potential conflicts of interest between enterprises while ensuring the interests of creditors. As for specific creditor protection measures, the law should comprehensively outline how creditors can participate in the decision-making during the merger process, raise objections and safeguard their rights and interests from infringement [8].

5.2. Clearly Defining Applicable Standards

Clear legal standards are essential to ensure the effectiveness and fairness of substantive merger bankruptcy proceedings. Particularly, when judging the high confusion of corporate personality, the law needs to list specific judgment factors in detail, including but not limited to the interweaving of financial accounts, the sharing of management, and the interdependence of business activities. For example, situations where multiple affiliated enterprises share a financial system or where senior management professionals occupy significant roles in several enterprises, should be regarded as clear signs of corporate personality confusion.

The evaluation of asset separation costs is of equal importance. The law should specify how to measure and determine the economic costs of asset separation, including but not limited to liquidation costs, restructuring costs, and potential economic losses. These standards not only assist courts in making more accurate judgments in specific cases but also provide clarity of expectations for creditors and debtors, reducing uncertainty in legal applications. In terms of protecting the interests of creditors in fair settlement, the law also needs to clarify the conditions under which creditors' interests may be harmed and how these interests might be preserved through legal procedures [9]. For instance, there ought to be explicit legislative procedures to make amends and provide compensation when the merger of affiliated enterprises results in unjustly handling particular creditors' claims.

5.3. Determining the Starting Mode

It is recommended that the mode of "going bankrupt respectively and then starting to consolidate" be adopted as the standard procedure for substantive merger bankruptcy. This approach requires the court to conduct an independent review of each affiliated enterprise applying for bankruptcy, ensuring

that each enterprise meets independent bankruptcy conditions. This step is crucial as it ensures that only truly insolvent enterprises can enter bankruptcy proceedings, thereby upholding the fairness and seriousness of bankruptcy laws. This mode allows for merger proceedings only after confirming that all affiliated enterprises meet the bankruptcy conditions. This case-by-case review and subsequent merger process can greatly reduce legal disputes caused by improper handling and increase the transparency of the entire process. The court needs to conduct a detailed evaluation of each enterprise's financial and debt status before the merger, which is also beneficial for a more reasonable evaluation of the feasibility and effectiveness of the overall debt restructuring.

In addition, this mode greatly enhances the protection of creditors. Throughout the process, creditors can witness the progress of each step and have the opportunity to express their views and concerns before the business merger. This participation mechanism not only enhances the transparency of the procedure but also ensures that creditors' opinions can be fully heard and considered, thereby improving the fairness and efficiency of the bankruptcy proceedings.

5.4. Improving the Creditor Protection Mechanism

In the process of substantive merger bankruptcy, it is necessary to strengthen the protection of creditors' rights and interests, and specific measures include enhancing public disclosure and notification procedures. Courts and bankruptcy administrators should widely disseminate detailed information about the merger bankruptcy through multiple channels, including official websites, major media, and social media platforms, to ensure that all creditors are timely informed of relevant updates and decisions to respond appropriately. Optimising the hearing process is also the key to improving creditor protection. At every important decision-making point of bankruptcy merger, such as asset evaluation and approval of debt restructuring plans, the court should organise hearings to allow all stakeholders, especially creditors, to express their views and concerns directly. The court should fully consider these views before a final decision is made.

These measures ensure that creditors' rights are not infringed throughout the merger bankruptcy process, their voices can be heard, and they can play a role in decision-making. This increases the fairness of the process and improves the efficiency and quality of overall bankruptcy handling, ultimately promoting the stability and healthy development of the market.

6. CONCLUSION

It is crucial to establish clear and applicable legislative and judicial guiding principles on the issue of substantive merger bankruptcy. Through refining legislation and clarifying the specific application conditions and creditor protection mechanisms for substantive merger bankruptcy, the law can provide necessary guidance and flexibility to ensure fairness and efficiency in economic relations. Meanwhile, adopting the mode of "going bankrupt respectively and then start merger" and combining it with strengthened creditor protection measures will be conducive to achieving fairness and transparency in bankruptcy proceedings.

Optimising the legal framework and enhancing the fairness of procedures can protect the interests of creditors and promote market stability and healthy corporate restructuring. These improvement measures will provide a solid foundation for handling complex affiliated enterprise bankruptcies, ultimately helping create a more fair, efficient and transparent bankruptcy legal environment supporting long-term economic development.

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