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articles...

Dr Melis Özdel — **UNITED KINGDOM**
The Receipt Function of the Bill of Lading: New Challenges

Liu Mingkang and Chuyi Wei — **INTERNATIONAL**
Towards a Better Future for Chinese Bankruptcy Law: Problems and Potential

Dr Edoardo Muratori — **EUROPEAN UNION**
Emergency Liquidity Assistance under the EU Legal Framework

Dr Ali Khaled Qtaishat — **UNITED KINGDOM**
The Rule of Ultra Vires in Company Law: Understanding English Perspectives and Legal Issues

book reviews...

news...

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International Company and Commercial Law Review

Table of Contents

Articles

DR MELIS ÖZDEL

The Receipt Function of the Bill of Lading: New Challenges 435

Shipping practice is an evolving landscape and the diversity of transport documents has been a source of confusion among shippers, bankers, carriers and cargo receivers. With the rise of containerisation, it is not uncommon for goods to be covered by multimodal transport documents. Can a shipper or consignee named as such in a multimodal transport document covering goods carried partly by sea make use of the statutory provisions on the receipt function of bills of lading? Ever-changing shipping practice has also left us with redocumentation for cargoes commingled/blended aboard a vessel. For present purposes, this practice raises an important question: where different parcels of cargo are loaded at different locations, what particulars in relation to such goods must be provided in the consolidated bill of lading and what evidential effects do they have? Another contemporary problem is the common presence of defects in cargoes such as rice, grain and steel. Where the degree of imperfection can vary considerably and where views of masters may honestly differ, how are carriers to protect themselves against the risk of such misdescriptions?

LIU MINGKANG AND CHUYI WEI

Towards a Better Future for Chinese Bankruptcy Law: Problems and Potential 443

In the past, Chinese bankruptcy law has been under-used: companies are usually dissolved without going through the bankruptcy procedure. However, since 2014, the number of bankruptcy cases in China has surged, with bankruptcy law being used to facilitate supply-side reforms that aim to cut over-capacity and close down "zombie companies" in the country. Against such a backdrop, this article will evaluate Chinese bankruptcy law and propose reforms in governmental intervention, debt evasion in bankruptcy and cross-border insolvency. We argue that, despite all its problems, Chinese bankruptcy law is potentially effective if enforced properly and can be made more so if further reforms are carried out. The laws in this article are up to date at 10 May 2017.

DR EDOARDO MURATORI

Emergency Liquidity Assistance under the EU Legal Framework 453

This article analyses the main procedural and substantial legal issues related to the emergency liquidity assistance as envisaged under the EU's system. The objective of this article is to provide the reader with a concise, pointed and thorough overview of the relevant legal framework.

DR ALI KHALED QTAISHAT

The Rule of Ultra Vires in Company Law: Understanding English Perspectives and Legal Issues 457

The rule of ultra vires has, over the years since its inception, presented many complications in the conduct of a company's affairs. The earliest developments in this area in the English legal system have had tremendous implications for common law jurisdictions around the world and still have a profound impact on their applications in foreign jurisdictions. The present article attempts to find out the basis of the rule of ultra vires, its chequered past and its contemporary status under English company law. To this end, this article will analyse and discuss the key provisions of English company law underlining the rule of ultra vires. It will thus try to see whether the said rule is headed for its demise or whether it still exists in some form or other.

Book Reviews

EUGENIO VACCARI

The Framework of Corporate Insolvency Law 464

DR FANG MA

Derivative Actions in Chinese Company Law 465

News Section

Cyprus

COMPANY LAW
Transparency on environmental and social matters N-79

Czech Republic

INSOLVENCY
Legislative reforms N-80

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The Receipt Function of the Bill of Lading: New Challenges

Dr Melis Özdel*

Bills of lading; Cargo; Carriers' liabilities; Carriers' powers and duties; Defects; International carriage by sea; Multimodal transport documents; Shipmasters' powers and duties

The bill of lading originally started life as a receipt for the goods shipped aboard a vessel. This long-lived function of the bill of lading has always been and still is crucial to the main players in international trade, namely buyers, sellers and bankers. The main reason behind this is the nature of the international sale of goods, where the agreed place of delivery is usually some distance from the agreed destination. This peculiar nature of international sales is seen particularly in sale contracts on shipment terms (namely on CIF (Cost, Insurance and Freight), CFR (Cost and Freight) and FOB (Free on Board) terms). In such sales, the delivery of goods generally[1] takes place on shipment. Aware that the risk of loss of or damage to goods during transit lies with them, buyers naturally wish to part with their money against the tender of a "conforming" receipt: a receipt covering the contract goods and showing that the goods were in apparent good order and condition at the time of their shipment.[2] In the case of damaged and/or short-delivered goods, a "conforming" receipt can help buyers establish the carrier's liability.[3] Such a receipt makes it possible to prove that the apparent condition and/or quantity of the goods shipped are different from what has actually been delivered by the carrier.

Given that buyers part with their money in reliance on the particulars of the goods specified in the bill of lading, sellers naturally wish to be sure of getting from the carrier a "conforming" receipt. Most bills of lading are now governed either by the Hague Rules (1924) or the Hague-Visby Rules (1968), and this allows shippers to demand from the carrier a bill of lading containing the particulars stated in art.III(3)(a)–(c) of the Hague and Hague-Visby Rules.[4] This is, however, subject to three main conditions. First, the contract of carriage between the shipper and the carrier must expressly or by implication provide for the issue of a bill of lading or any similar document of title.[5] Secondly, the shipper must "demand" from the carrier a bill of lading containing these particulars. Thirdly, despite the demand of the shipper, the carrier[6] can refrain from acknowledging the marks, number, quantity or weight of the goods furnished by the shipper. By the same article, the carrier is permitted to make reservations as to these furnished particulars, where he/she has reasonable grounds for suspecting their accuracy or where there is no reasonable opportunity to check the figures.[7] However, the same is not true in respect of the statements as to the apparent condition of the goods. When demanded by the shipper, the carrier is required to state in the bill of lading the apparent order and condition of the cargo being shipped.[8]

From the perspective of the banks financing the sale of goods under letters of credit, the evidentiary function of the bill of lading is also important. The banks need to

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1 It is possible for parties to change this default rule and agree that risk will pass before or after shipment. Where parties can be said, even by implication, to have intended to change the default rule, an English court may give effect to the parties' intention to that effect. However, under the Incoterms 2010 rules, parties must have an express and clear agreement to change the default rule on the passing of risk.

2 Under English law, a claused bill of lading is considered to be a bad tender even in cases where the sale contract is silent on this matter. However, if a bill of lading records a post-shipment damage, it has to be treated as a "clean bill of lading" and be accepted. See the decision in *The Galatia* [1980] 1 W.L.R. 495; [1980] 1 Lloyd's Rep. 453; (1980) 124 S.J. 201 CA (Civ Div). The situation is different in cases where the payment is agreed to be made through a letter of credit and where the letter of credit incorporates the UCP 600. Article 27 of the UCP 600 makes no difference between pre-shipment and post-shipment damages. Consequently, if a bill of lading contains a statement that negatives the pre-printed words "shipped in apparent good order and condition", it will not be a good tender, unless the letter of credit contracts out of art.27.

3 For a cargo claim in bailment, see the decision in *Elder Dempster & Co Ltd v Paterson Zochonis & Co Ltd* [1924] A.C. 522; (1924) 18 Ll. L. Rep. 319 HL. Where the buyer has a charterparty with the shipowner who is also the contractual carrier under the bill of lading covering the relevant goods, the bill of lading will not function as a contract of carriage but will still have a receipt function. For this reason, the evidential power of such a bill of lading will not be drawn from the Carriage of Goods by Sea Act 1971, which applies to "contracts of carriage" covered by a bill of lading or a similar document of title; see s.1(4) of the Act and art.I(b) of the Hague-Visby Rules 1968 scheduled to the Act. In such cases, the evidential power cannot also be drawn from s.4 of the Carriage of Goods by Sea Act 1992, given that a buyer in such cases does not "become" a lawful bill of lading holder within the meaning of the latter Act; see s.5(1)–(2) of the Carriage of Goods by Sea Act 1992.

4 These provisions cover three main particulars: the leading marks necessary for the identification of the goods; either the number of packages or pieces, the quantity, or weight; and the apparent order and condition of the goods. Under the Hamburg Rules 1978, art.15(1)(a) and (b) requires bills of lading to record the "apparent condition of the goods" and the "number of packages or pieces *and* weight of the goods or their quantity" (emphasis added). In addition, where applicable, the same provision also requires the dangerous nature of a cargo to be recorded in the bill of lading. With respect to the position under the Rotterdam Rules 2008, see art.36.

5 See English Carriage of Goods by Sea Act 1971 s.1(4). Some scholars, including Tetley, take the view that carriers should not have the liberty to issue a sea waybill or other non-negotiable receipt in the case of ordinary shipments. According to this view, the liberty to issue a sea waybill or other non-negotiable receipt enables the carrier to effectively avoid the application of the Hague and the Hague-Visby Rules. See S. Baughen, *Shipping Law*, 5th edn (Abingdon: Routledge, 2009), p.100. On this issue, see also Steyn J in *The European Enterprise* [1989] 2 Lloyd's Rep. 185 QBD (Comm) at 188, where he said: "It follows that shipowners, if they are in a strong enough bargaining position, can escape the application of the rules by issuing a notice to shippers that no bills of lading will be issued by them in a particular trade."

6 Given that most carriers are corporations, the reference to "carrier" should be taken to mean either the master or the person who has the express, implied or apparent authority of the carrier to sign bills of lading.

7 The restrictions as to the carrier's right to make reservations are tighter in the Hamburg Rules (art.16(1)) and the Rotterdam Rules (art.40(2)). Under English law, there seems to be no effective restriction on the carrier's right to qualify the statement of the shipper as to the weight and quantity of the goods with a "weight and quantity unknown" or a similar clause. See the decisions in *The Atlas* [1996] 1 Lloyd's Rep. 642; [1996] C.L.C. 1148 QBD (Comm) and *The Mata K* [1998] 2 Lloyd's Rep. 614; [1998] C.L.C. 1300 QBD (Comm), where the courts firmly held that such clauses were valid and could not be invalidated by art.III/8 of the Hague and the Hague-Visby Rules.

8 *The David Agmashenebeli* [2002] EWHC 104 (Admlty); [2003] 1 Lloyd's Rep. 92; [2003] 1 C.L.C. 714.

pay against a "clean" bill of lading[9] covering the contract goods in order to have a proper claim against the applicant buyer for reimbursement. Furthermore, against the risk of non-payment by the applicant buyer, the banks would wish to pledge over a bill of lading covering goods that are not apparently defective and/or damaged at the time of their shipment. Undoubtedly, to pledge over a clean bill of lading provides a better security for their credit exposure.

To have a "reasonably accurate"[10] snapshot of the particulars of the goods actually loaded is important to the carrier under the bill of lading.[11] A carrier under a bill of lading may be liable at common law for damages arising from false statements in the bill of lading about the goods.[12] In particular, where a master or other agent of the carrier recklessly or deliberately[13] makes false statements about the goods in the course of his employment or within the scope of his authority, the carrier and the issuer of the bill of lading[14] will be liable in the tort of deceit.[15] In such cases, they will be liable to those who have been induced into accepting the bill of lading and thereby suffered a loss.[16] An over-zealous master who has negligently claused a bill of lading for goods that were apparently in good order and condition will also expose the carrier to liability.[17]

The duty not to make any false representations in the bill of lading is generally considered to be a duty towards the transferees of bills of lading, even in cases where the vessel is subject to at least one charterparty. For this reason, a charterparty provision requiring the master to sign the bill of lading "as presented" by the charterer is not interpreted as an obligation on the part of the master to issue a clean bill of lading irrespective of the apparent condition of the goods.[18] Consequently, the shipowner does not have any remedies against the charterer in damages or under an implied or express indemnity, where it suffers a loss as a result of the false representations in the bill of lading as to the apparent condition of the goods.[19] This well-established rule is consistent with the courts' refusal to enforce letters of indemnity provided to the carrier in consideration for the issue of a clean bill of lading covering apparently defective goods.[20] Against this background, it is timely to consider first the evidentiary effect of multimodal transport documents.

The evidentiary effect of multimodal transport documents

Since the decision in *Naviera Vasconzada*, it has been clear that the statements in the bill of lading as to the goods are only representations of fact,[21] not contractual promises.[22] They can amount to prima facie evidence as to the state of the goods at the time of their shipment.[23] Provided that the elements of common law estoppel are established,[24] these representations may become conclusive evidence as against the carrier.[25] On the construction of the bill of lading as a whole, the statements in the bill of lading as to the goods may not

[9] See fn.2 above. Although the decision in *The David Agmashenebeli* [2003] 1 Lloyd's Rep. 101 governs the issue of the carrier's standard of duty towards the shipper, the required standard of duty established in this decision can equally be applied to a dispute between the carrier and the transferees of bills of lading. See, for instance, the decision in *The Saga Explorer* [2012] EWHC 3124 (Comm); [2013] 1 Lloyd's Rep. 401.

[10] See the decision in *The David Agmashenebeli* [2003] 1 Lloyd's Rep. 101, where Colman J took the view that art.III(3) did not require the carrier to state the apparent order and condition of the goods with absolute accuracy. The master is required to express his opinion that reasonably reflects the apparent order and condition of the cargo, considering the extent of any defect in the cargo. Thus, there will be no breach of art.III(3) , as long as his view on the apparent order and condition of the cargo can properly be taken by a "reasonably observant" master. A somewhat contrary view was expressed by Evans LJ in *The Arctic Trader* [1996] 2 Lloyd's Rep. 449; [1997] C.L.C. 174 CA (Civ Div) at 458.

[11] It must be noted that a shipowner can in some cases be subject to a cargo claim by the bill of lading holders in bailment. For this reason, the stated particulars in relation to the goods may be important to a shipowner, even in cases where the bill of lading is a charterer's bill of lading; see fn.3 above. For present purposes, an important limitation to an action in bailment is that the bailment relationship usually arises between the shipper and carrier; see *The Aliakmon* [1986] A.C. 785; [1986] 2 W.L.R. 902; [1986] 2 Lloyd's Rep. 1 HL at 818. Where a shipper may be regarded as agent of a named consignee in making the contract covered by the bill of lading, the consignee can be the bailor; see *East West Corp v DKBS 1912* [2003] EWCA Civ 83; [2003] Q.B. 1509; [2003] 3 W.L.R. 916 at [34].

[12] Where a shipped bill of lading is issued for unshipped goods, the carrier can be protected by the rule established in *Grant v Norway* 138 E.R. 263; (1851) 10 C.B. 665 CCP. Although the signer of the bill of lading can be held liable for breach of warranty of authority, see *Rasnoimport V/O v Guthrie & Co Ltd* [1966] 1 Lloyd's Rep 1 QBD (Comm). Alternatively, it may be possible to hold the signer liable for the tort of deceit; see *Standard Chartered Bank v Pakistan National Shipping Corp (No.2)* [2002] UKHL 43; [2003] 1 A.C. 959; [2002] 3 W.L.R. 1547.

[13] It may also be possible for the carrier to be liable for negligent mis-statement in the bill of lading, although this option has not been judicially explored. Colman J in *The David Agmashenebeli* [2003] 1 Lloyd's Rep. 101 took the view that the carrier's obligation to issue a bill of lading cannot concurrently be based on art.III(3) and on tort. Where the Hague-Visby Rules do not govern the issue of mis-statement, the carrier will be held liable in tort of negligence; see *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] A.C. 465; [1963] 3 W.L.R. 101; [1963] 1 Lloyd's Rep. 485 HL at 517 per Lord Devlin. However, it is unlikely for the signer to be held liable for negligent mis-statement without the proof of duty of care between the signer and the representee; see the decision in *Williams v Natural Life Health Foods Ltd* [1998] 1 W.L.R. 830; [1998] B.C.C. 428; [1998] 1 B.C.L.C. 689 HL.

[14] See *Standard Chartered Bank* [2002] UKHL 43, where the House of Lords held that other persons involved in the making of false statements. For this reason, the seller's managing director in this case was also held to be liable in deceit.

[15] See *Standard Chartered Bank* [2002] UKHL 43.

[16] In *Standard Chartered Bank* [2002] UKHL 43, the persons who joined in issuing a falsely dated bill of lading were liable towards the bank that was induced into making payment under the letter of credit.

[17] *The David Agmashenebeli* [2003] 1 Lloyd's Rep. 101; and *Standard Chartered Bank* [2002] UKHL 43.

[18] *The Nogar Marin* [1988] 1 Lloyd's Rep. 412; [1988] 1 F.T.L.R. 349; Times, 22 January 1988 CA (Civ Div). Where the charterers have the right to issue a bill of lading on behalf of the master and where they issue a clean bill of lading for apparently defective goods, no term will be implied into the charterparty to allow the charterers to recover their losses arising from such a bill of lading, see *The Arctic Trader* [1996] 2 Lloyd's Rep. 449.

[19] See the decision in *The Nogar Marin* [1988] 1 Lloyd's Rep. 412. This rule should equally apply in relation to false statements as to the quantity of goods shipped in cases where the master knew or ought to have known the actual quantity of the cargo shipped.

[20] *Brown Jenkinson & Co Ltd v Percy Dalton (London) Ltd* [1957] 2 Q.B. 621; [1957] 3 W.L.R. 403; [1957] 2 Lloyd's Rep. 1 CA. From this case, it appears that a letter of indemnity will be unenforceable, even in cases where the master was not actually dishonest when issuing a clean bill of lading in consideration for a letter of indemnity. For a brief discussion as to all the ingredients of deceit, see *Derry v Peek* (1889) 14 App. Cas. 337; (1889) 5 T.L.R. 625 HL at 374.

[21] *Compania Naviera Vasconzada v Churchill & Sim* [1906] 1 K.B. 237 KBD.

[22] *Naviera Vasconzada* [1906] 1 K.B. 237. See also *The Mata K* [1998] 2 Lloyd's Rep. 614.

[23] *Henry Smith & Co v Bedouin Navigation Co Ltd* [1896] A.C. 70; (1895) 23 R. (H.L.) 1; (1895) 3 S.L.T. 184 HL.

[24] The representations contained in a bill of lading can give rise to an estoppel in favour of a transferee of the bill of lading where the transferee relied to his detriment upon the representations therein and where it would be inequitable to allow the carrier to resile from the representations; see *Naviera Vasconzada* [1906] 1 K.B. 237.

[25] *Naviera Vasconzada* [1906] 1 K.B. 237.

be sufficiently clear and unqualified to give rise to estoppel. Hence, there is no estoppel in relation to the weight and quantity of the goods shipped where the bill of lading contains a "weight and quantity unknown" or a similar clause.[26] In *Canada and Dominion Sugar*, a stamped endorsement in a received for shipment bill of lading that read "signed under guarantee to produce ship's clean receipt" was held to qualify the words "shipped in apparent good order and condition".[27] Thus, the carrier was not estopped from showing that the goods were shipped in other than apparent good order and condition.

The Grant v Norway case

At English common law, representations in a bill of lading have no evidentiary effect where in fact no goods have been shipped.[28] In *Grant v Norway*,[29] it was held that the master had no apparent authority to sign a bill of lading for goods that had not been put on board.[30] This rule was extended also to cases where a bill of lading indicated a larger quantity of goods than the quantity of goods actually shipped.[31] This undesirable result arising from the application of *Grant v Norway* has been greatly diminished through the enactment of the Carriage of Goods by Sea Act (COGSA) 1992. Pursuant to s.4 of that Act, the carrier is estopped from denying, as against the lawful holder of the bill of lading, the shipment of the goods or their receipt for shipment.

Provided that a multimodal transport document purports to be a receipt, the representations as to the goods made thereunder can give rise to prima facie evidence or conclusive evidence at common law. Just as with the representations made in bills of lading, the question of estoppel in this context must also be decided "on ordinary law principles of construction and of what is reasonable, without fine distinctions or technicalities".[32] If the common law reasoning is adopted, unequivocal representations about the goods, such as the quantity of the goods shipped, their apparent order and condition and the date of shipment, will normally be binding upon the carrier as against the cargo receiver. However, where an agent for the carrier issues a multimodal transport document for goods that he has not actually received, does the rule in *Grant v Norway* apply?

If a master or other agent of the carrier has no apparent authority to sign a bill of lading for unshipped goods, then it seems to follow that an agent acting for the carrier cannot also have an apparent authority to issue a multimodal transport document for goods that he has not received. In order to decide if the rule can equally apply to multimodal transport documents covering non-existing goods, it is important to discuss the rule in more detail. The rule in *Grant v Norway* relieves the carrier from liability in contract, or by way of estoppel, for an unauthorised statement that is false. Despite the attempts at extending the application of the rule to other statements,[33] the rule only bites against statements as to the shipment of the goods and their receipt for shipment. What makes the fact of shipment (or receipt for shipment) different from others?

Devlin J in *Heskell* said that "in many cases … no contract [of carriage] is concluded until the goods are loaded or accepted for loading".[34] In respect of a bill of lading covering goods that have not been received, Lord Esher in *Leduc v Ward* took the obiter view that the master had

> "no authority to make a contract of carriage to bind the shipowner, except in respect of goods received by him. If the goods have not been received, the bill of lading cannot contain the terms of a contract of carriage with respect to them as against the ship owner".[35]

These dicta clearly show that, when these cases were brought, the fact of non-shipment (or non-receipt of goods) was an important factor for finding against a valid and binding contract of carriage.

The question of whether there is a valid and binding contract between the parties depends on the facts of each case,[36] and much turns on at what point in time the parties had a mutual intention to enter into a binding contract.[37] It may well be possible for parties to have intended to enter into a contract of carriage when the goods are shipped or received for shipment. Thus, the shipment of the goods or their receipt may well be a condition precedent to the making of a contract of carriage.[38] The application of the rule in *Grant v Norway* does make sense where there is no mutual intention to enter into a contract unless the goods are actually shipped or received for shipment.

In modern circumstances, contracts of carriage by sea are in almost all cases entered into before the shipment of the goods or their receipt for shipment. The terms of these antecedent contracts are in almost all cases found

[26] *The Mata K* [1998] 2 Lloyd's Rep. 614; and *The Atlas* [1996] 1 Lloyd's Rep. 642.
[27] *Canada and Dominion Sugar Co Ltd v Canadian National (West Indies) Steamships Co Ltd* [1947] A.C. 46; (1947) 80 Ll. L. Rep. 13; 62 T.L.R. 666 PC (Canada).
[28] *Grant v Norway* (1851) 10 C.B. 665.
[29] *Grant v Norway* (1851) 10 C.B. 665.
[30] The carrier will obviously not be able to make use of this rule if he is also the signer of the bill of lading covering unshipped goods.
[31] *Rasnoimport v Gutherie* [1966] 1 Lloyd's Rep. 1.
[32] *Canada and Dominion Sugar* [1947] A.C. 46 at 55.
[33] The application of the rule is not extended to statements as to the date of shipment (*The Saudi Crown* [1986] 1 Lloyd's Rep. 261 QBD (Admlty)), deck carriage (*The Nea Tyhi* [1982] 1 Lloyd's Rep. 606; [1982] Com. L.R. 9 QBD (Admlty)), or the apparent order and condition of the goods (*Naviera Vasconzada* [1906] 1 K.B. 237).
[34] *Heskell v Continental Express Ltd* [1950] 1 All E.R. 1033 at 1037; (1949–50) 83 Ll. L. Rep. 438; [1950] W.N. 210 KBD.
[35] *Leduc & Co v Ward* (1888) 20 Q.B.D. 475 CA at 479.
[36] *The Pacific Champ* [2013] EWHC 470 (Comm); [2013] 2 Lloyd's Rep. 320.
[37] *Pagnan SpA v Feed Products Ltd* [1987] 2 Lloyd's Rep. 601 CA (Civ Div).
[38] *UR Power GmbH v Kuok Oils and Grains PTE Ltd* [2009] EWHC 1940 (Comm); [2009] 2 Lloyd's Rep. 495; [2009] 2 C.L.C. 386, which was concerned with the question of whether the obligation to open a letter of credit was condition precedent to the making of a contract of sale.

in booking notes.[39] In the case of multimodal carriage of goods partly by sea, there is also usually an antecedent contract stage, at which a contract of carriage is entered into before the receipt of the goods by the freight forwarder. For this reason, it would appear that the rule in *Grant v Norway* is normally not applicable to goods covered by a multimodal transport document. This approach can even more readily be followed in cases where the goods are covered by a multimodal transport document in the standard FIATA Multimodal Bill of Lading form. In this form, it is stated that the goods are "taken in charge" while other standard forms only provide that the goods have been "received".[40] In the former phrase, the emphasis is placed on the assumption of responsibility and this makes it more justifiable to rule out the application of the rule in *Grant v Norway* to the goods covered by a FIATA Multimodal Bill of Lading.

Carriage of Goods by Sea Act 1992

A more straightforward, if not alternative, way to avoid the application of the rule in *Grant v Norway* is to bring the multimodal transport documents within COGSA 1992. Effectively reversing the *result* of the rule,[41] s.4 of the Act provides:

> "A bill of lading which—
> (a) represents goods to have been shipped on board a vessel or to have been received for shipment on board a vessel; and
> (b) has been signed by the master of the vessel or by a person who was not the master but had the express, implied or apparent authority of the carrier to sign bills of lading
>
> shall, in favour of a person who has become the lawful holder of the bill of lading, be conclusive evidence against the carrier of the shipment of the goods or, as the case may be, of their receipt for shipment."

As is clear from the wording, s.4 purports to prevent the carrier from denying that the goods have been shipped or have been received for shipment. In so doing, it rules out the application of the rule in *Grant v Norway*. Nonetheless, there are limits to its application. The section applies to lawful bill of lading holders only. The consignees named as such in sea waybills, ship's delivery orders and straight bills of lading cannot make use of the statutory estoppel created by this section. Moreover, the section only bites against the statements as to the shipment of the goods and their receipt for shipment. Any other statements as to goods, such as their apparent order and condition, cannot be brought within it.[42]

Given that the definition of the "bill of lading" in the Act includes received for shipment bills of lading, the question arises as to whether multimodal transport documents can be treated as received for shipment bills of lading. If they can be treated as such, the rule in *Grant v Norway* can effectively be avoided in the context of multimodal transport documents. All multimodal transport documents have two key features in common, making them distinctive instruments: they show inland points as the place of receipt and/or delivery of goods; and they cover more than one mode of transportation. Where only these features make a multimodal transport document distinct from transferable shipped bills of lading, there is a compelling suggestion that such a document should be treated as a "received for shipment bill of lading" under COGSA 1992.

If this suggestion is accepted, many different types of multimodal transport documents, such as the Combined Transport Bill of Lading (Combiconbill 1995), the FIATA Multimodal Transport Bill of Lading and the Multimodal Transport Bill of Lading (Multidoc 95), will readily come within the sphere of COGSA 1992. This will also bring more certainty to multi-purpose bills of lading that can operate as a port-to-port or a combined transport bill of lading, depending on whether any inland movement prior or subsequent to sea carriage is indicated therein. Irrespective of any indication of an inland movement in these transport documents, COGSA 1992 will in any case be applicable to them.

At this juncture, it is important to note that not all types of multimodal transport documents can come within COGSA 1992. Caution must be exercised in not calling all multimodal transport documents "bills of lading". By the definition of "bill of lading" in the Act, straight bills of lading are excluded from the scope of the bill of lading.[43] For this reason, a multimodal transport document that is not transferable cannot be brought within s.4 of the Act. For the purposes of deciding which types of multimodal transport document can be brought within the purview of the Act, we should focus on the content of the document as opposed to its heading.[44] That said, a multimodal transport document, however named, is not a bill of lading if it is issued by a freight forwarder who assumes liability for the entire carriage as agent only.[45] Such a document is naturally taken as a contract of agency, not as a contract of carriage, and hence it lacks one of the key attributes of bills of lading.[46]

Can a multimodal bill of lading covering carriage partly by sea be taken as a "bill of lading" within the meaning of COGSA 1992? Where the sea leg is the significant component of a multimodal transportation, we may well be more inclined to answer this question in the

[39] See *Carver on Bills of Lading*, edited by F. Reynolds and G. Treitel, 3rd edn (London: Sweet & Maxwell, 2011), para.2-008.
[40] See the standard Combiconwaybill 2016, Combiconbill forms.
[41] See *Carver on Bills of Lading* (2011), para.2-017, where the learned editors emphasised the fact that s.4 of the Act does not override the *reasoning* in *Grant v Norway*.
[42] *Carver on Bills of Lading* (2011), para.2-028.
[43] See COGSA 1992 s.1(2)(a).
[44] *Comalco Aluminium Ltd v Mogal Freight Services* (1993) 113 A.L.R. 677.
[45] *The Maheno* [1977] 1 Lloyd's Rep. 81 SC (New Zealand).
[46] See also *Benjamin's Sale of Goods*, edited by M.G. Bridge, 8th edn (London: Sweet & Maxwell, 2010), para.21-083.

affirmative. Nonetheless, determining the application of COGSA 1992 on the basis of the magnitude of sea carriage in a multi-stage transport operation presents an unattractive prospect of uncertainty over the legal force of multimodal transport documents. Thus, balance comes down heavily in favour of bringing multimodal transport documents within the definition of "bills of lading" under COGSA 1992, and one further point must be made in support of this. By including "received for shipment" bills of lading within its scope, the Act naturally implies that a transport document indicating an inland movement prior or subsequent to sea carriage is to be considered as a "bill of lading", regardless of the proportion of the sea carriage involved. Hence, as long as the multimodal carriage contains a sea leg and is covered by a multimodal transport document that carries the key attributes of a "received for shipment" bill of lading, COGSA 1992 must be applicable.[47]

On the application of s.4 to such multimodal transport documents, there is one further issue to be discussed. Given the express reference to receipt of goods for shipment on board "a vessel" in s.4(a) of the Act, should the multimodal transport document identify the vessel on which the goods are to be shipped? In other words, should the express reference be taken to mean that the goods have been received for shipment on a "named" vessel? It would appear that the provision requires for the transport document to provide at least the name of the proposed vessel.[48] Hence, a transport document providing that the goods have been received for shipment on board a named vessel or an alternative should qualify for this purpose.[49]

The Hague-Visby Rules

Article III(4) of the Hague-Visby Rules (the Rules) provides that the statements as to the leading marks, weight/quantity of the goods and their apparent order and condition will be conclusive evidence as against the transferee of the bill of lading acting in good faith. Given that the provision makes no reference to statements as to the fact of shipment or receipt of goods for shipment, it can be argued that the rule in *Grant v Norway* survives the Rules.[50] This seems to be an overly technical reading of art.III(4). Where a transferee of a "shipped" bill of lading relies in good faith on a statement as to the weight/quantity of the goods, that statement will be conclusive evidence as regards the weight/quantity of the goods "shipped". Thus, the rule in *Grant v Norway* should not have any role to play where the transport document is mandatorily governed by the Rules.[51]

The next step is then to ask whether multimodal transport documents fall within the definition of "a bill of lading or a similar document of title" under art.I(b) of the Rules. It is suggested that these transport documents must be governed by the Rules insofar as they relate to carriage of goods by sea and provided that the entire carriage covered by the document is not wholly regulated by another international convention. The main underpinnings of this suggestion are both literal and purposive. In the absence of a special provision in the article excluding some particular types of bill of lading from the scope of the Rules and given the expansive wording used in the article, it is clear that the range of bills of lading to which the Rules apply is intended to be wide.[52] This is also supported by the unequivocal and indisputable policy reason behind the Rules, which was to afford protection to cargo interests against "unduly onerous terms in the contract of carriage".[53] Viewed in that light, art.I(b) of the Rules must be interpreted broadly and thus in line with their international spirit, instead of by reference to restrictive English common law or statutory definitions on "bills of lading" and "document of title".

At this juncture, it is important to note that English courts to date have demonstrated an overwhelming tendency towards interpreting international conventions in a purposeful and internationally accepted manner.[54] Notably, art.I(b) of the Rules was read in that spirit by the House of Lords in *The Rafaela S*,[55] where their Lordships held that straight bills of lading fall under the article and hence under the Rules. In this context, their Lordships cautiously referred to the *travaux préparatoires* of the Hague Rules , acknowledging that straight bills of lading were not intended to be ousted from the Rules.[56]

Could the reasoning of the House of Lords in *The Rafaela S* be followed in support of the argument that multimodal bills of lading must come within the sphere of the Rules? Unlike straight bills of lading, multimodal transport documents were not widely used mercantile instruments when the discussions on the adoption of the Hague Rules were taking place in the early 1920s. Nonetheless, the *travaux préparatoires* lend some support to the suggested construction of art.I(b) of the Hague-Visby Rules for two reasons. First, the *travaux préparatoires* demonstrate the legislators' awareness of

[47] However, this should be subject to the overarching condition that the application of COGSA 1992 does not run counter to any international transport convention that may wholly or partly govern the multimodal transportation of goods covered by such documents.
[48] For a similar view, see *Carver on Bills of Lading* (2011), para.2-025.
[49] See the received for shipment bill of lading in *The Marlborough Hill* [1921] 1 A.C. 444; (1920) 5 Ll. L. Rep. 362 PC (Australia), which stated that the goods were received for shipment on board *The Marlborough Hill* or an alternative. A multimodal transport document containing a similar statement should qualify for the purposes of application of s.4 of the Act.
[50] *Carver on Bills of Lading* (2011), para.2-041.
[51] However, where a sea waybill is mandatorily governed by the Rules through incorporation pursuant to s.1(6)(b) of the Carriage of Goods by Sea Act 1971, art.III(4) does not apply to such a sea waybill despite the incorporation; see the last paragraph of s.1(6).
[52] *The Rafaela S* [2005] UKHL 11; [2005] 2 A.C. 423; [2005] 2 W.L.R. 554 at [53]–[58] per Lord Rodger.
[53] *The Rafaela S* [2005] UKHL 11 at [70] per Lord Rodger.
[54] *El Greco (Australia) Pty Ltd v Mediterranean Shipping Co SA* [2004] FCAFC 202; [2004] 2 Lloyd's Rep. 537 Fed Ct (Aus) (Full Ct) at 559.
[55] *The Rafaela S* [2005] UKHL 11; [2005] 2 A.C. 423; [2005] 2 W.L.R. 554.
[56] *The Rafaela S* [2005] UKHL 11 at [17] per Lord Bingham.

those transport documents relating to carriage of goods partly by sea.[57] Secondly, there is nothing in the *travaux préparatoires* indicating a definite intention to oust such transport documents from the purview of the Rules. Instead, the *travaux préparatoires* evidence the drafters' views favouring the application of the Rules to the sea leg of a multimodal carriage covered by a multimodal bill of lading (however defined).[58]

It would be going too far to treat the *travaux préparatoires* as conclusive for present purposes, given that they do not "clearly and indisputably" point to a "definite" intention as required by *Fothergill*.[59] It is thus fair to say that, while not being determinative, the *travaux préparatoires* supplement the underpinnings of the suggestion that multimodal transport documents that carry the key characteristics of bills of lading must qualify for application of art.I(b) of the Rules.[60]

Consolidated bills of lading covering blended/commingled goods

Just as with multimodal transport documents, consolidated bills of lading covering blended/commingled goods also raise particular challenges. It is common for carriers to be asked to commingle or blend cargoes shipped aboard their vessels. A number of risks are involved in this practice. In most cases, the commingling/blending of cargoes naturally affects the specification of each cargo commingled/blended with others. Moreover, the apparent order and condition of each cargo also changes with the commingling/blending process. Since this process usually takes place after a bill of lading has been issued for each cargo, it exposes carriers to potential liabilities under the bills of lading covering the commingled/blended cargoes. To avoid liability, they may well consider alerting the holders with an express statement in the bill of lading that the cargo may be commingled/blended. There may be complications in cases where a cargo that has been shipped in other than apparent good order and condition is to be treated during transit. Should the bill of lading covering this cargo be claused? Despite the planned treatment of the cargo during transit, if the cargo is not properly treated, the carrier will be exposed to liability under a bill of lading that is not claused.[61] Nonetheless, considering the planned treatment of the cargo, the carrier is expected to issue a clean bill of lading in consideration for a letter of indemnity. A letter of indemnity provided in such cases should be enforceable since the issue of a clean bill of lading in such cases does not amount to fraudulent or reckless misrepresentation.[62]

Another important complication arises in relation to the dates and places of shipment to be stated in the bills of lading covering the commingled/blended cargoes. If each cargo commingled/blended with others has been shipped by different shippers, in different places and/or at different times, should a single bill of lading covering each cargo be issued? Where the individual bills of lading are surrendered to the carrier in exchange for one consolidated bill of lading, what should the consolidated bill of lading provide as the date and place of shipment and who should be named as the shipper?

As is clear from the decision in *Mitchel v Ede*, when the bill of lading remains in the hands of the shipper, the shipper has the right to redirect the goods to a different consignee "before the delivery of the goods themselves or of the bill of lading to the party named in it".[63] This rule, established in *Mitchel v Ede*, is normally taken to apply to straight bills of lading.[64] In *Moller-Maersk*,[65] the rights of the original consignee under a straight bill of lading were lost when that bill of lading was cancelled by the carrier upon the request of the shipper and when it was replaced with a new straight bill of lading requiring the carrier to deliver the goods to a different consignee.[66] The case clearly suggests that the original parties can properly terminate their contract of carriage covered by a bill of lading and substitute it with a new contract by the issue of a new bill of lading.

In light of the explanations above, it is clear that a new set of consolidated bills of lading can properly be issued for commingled/blended cargoes, where the carrier and all the shippers of the relevant cargoes agree. What is not so clear is how the date and place of shipment and the identity of the shipper should be provided in a consolidated bill of lading. Given the carrier's obligation to give a "reasonably accurate" snapshot of the goods covered by the bill of lading, the consolidated bills of lading should fully provide all the details in relation to each cargo commingled/blended aboard the vessel.[67] If this approach is followed, then many sets of consolidated bills of lading will provide more than one date of shipment, place of shipment and shipper. This will have further implications as between the buyers and sellers in the context of the international sale of goods.

[57] M.F. Sturley, *The Legislative History of the Carriage of Goods by Sea and the Travaux Préparatoires of the Hague Rules* (Littleton: F.B. Rothman, 1990), p.91.
[58] Sturley, *The Legislative History of the Carriage of Goods by Sea* (1990), p.92.
[59] *Fothergill v Monarch Airlines Ltd* [1981] A.C. 251 at 278; [1980] 3 W.L.R. 209; [1980] 2 Lloyd's Rep. 295 HL, where Lord Wilberforce stated that *travaux préparatoires* can be used as an aid to construction only where they are "public and accessible" and where they "indisputably" demonstrate a "definite" legislative intention.
[60] For a contrary view, see the decision in *Bhatia Shipping & Agencies Pvt Ltd v Alcobex Metals Ltd* [2004] EWHC 2323 (Comm); [2005] 2 Lloyd's Rep. 336.
[61] R. Lord et al, *Bills of Lading* (Abingdon: Routledge, Informa Law, 2005), para.3.94.
[62] Consider the facts in *Brown Jenkinson & Co Ltd v Percy Dalton (London) Ltd* [1957] 2 Q.B. 621; [1957] 3 W.L.R. 403; [1957] 2 Lloyd's Rep. 1 CA.
[63] See *Mitchel v Ede* 113 E.R. 651; (1840) 11 Ad. & El. 888 at 903. The main rationale behind this rule is that the consignee in a bill of lading does not acquire any right under the bill of lading by merely being named as a consignee in that bill of lading.
[64] G.H. Treitel, "The Legal Status of Straight Bills of Lading" (2003) 119 *Law Quarterly Review* 608, fn.25.
[65] *AP Moller-Maersk A/S (t/a Maersk Line) v Sonaec Villas Cen Sad Fadoul* [2010] EWHC 355 (Comm); [2011] 1 Lloyd's Rep. 1; [2010] I.L.Pr. 32.
[66] It should be noted that both the shipper and the original consignee had in fact the right to exercise control over the goods covered by the straight bill of lading, see ss.1(3)(b), 2(1)(b) and 5(3) of COGSA 1992. However, the decision now suggests that the original consignee's right is in any case subject to the shipper's right to redirect the goods.
[67] Bengt E. Nergaard, "Redocumentation of Cargoes in Tanker Trade", Paper delivered at the 19th International Congress of Maritime Arbitrators (11–15 May 2015).

Where parties to a sale contract agree that the payment is to be made through a letter of credit incorporating UCP 600, such a bill of lading will not be acceptable pursuant to art.20 of UCP 600. Given that the provisions in the UCP 600 are not mandatory, it will be for the parties to agree on the terms of the letter of credit to be opened for payment. A further complication, of even more relevance, is the applicability of the Rules to consolidated bills of lading. Where only some part of the commingled/blended goods was shipped from a Hague-Visby state, can the consolidated bill of lading be governed by the Rules pursuant to art.X(b) of the Rules? The answer to this question has a great impact on the evidential value of such consolidated bills of lading owing to art.III(4) of the rules, but currently no definitive answer can be given to this question.

To clause or not to clause?

The final point to discuss is the increasing sophistication surrounding the master's duty to give a reasonably accurate snapshot of the goods. Most types of goods invariably display some defect/damage and the degree of such imperfections varies considerably. On the question of what degree of defect/damage justifies clausing the bill of lading, Colman J in the English case of *The David Agmashenebeli* said[68]:

> "[T]he law does not cast upon the master the role of an expert surveyor. He need not possess any greater knowledge or experience of the cargo in question than any other reasonably careful master. What he is required to do is to exercise his own judgment on the appearance of the cargo being loaded. If he honestly takes the view that it is not or not all in apparent good order and condition and that is a view that could properly be held by a reasonably observant master, then, even if not all or even most such masters would necessarily agree with him, he is entitled to qualify to that effect the statement in the bill of lading."

With this guidance, due performance of this duty under English law can seem attainable, although not free from challenges. Where a small portion of the goods contains foreign materials, rust, moisture or discoloration, should carriers clause the bill of lading covering such goods? Imagine the surface of a cargo which is contaminated by coal dust dropped from hatch covers or a cargo of steel which is slightly scratched on its surface. Would such minor defects justify the issue of a claused bill of lading? In *The David Agmashenebeli*, Colman J took the view that "the presence of a miniscule quantity of contaminants does not render the cargo otherwise than in good order and condition".[69] This view has much to commend it, when the drastic consequences flowing from a claused bill of lading are considered: a claused bill of lading is not fit to pass through the hands of traders and is thus not ordinarily accepted as good tender for payment in international trade.[70]

On considering whether or not to clause the bill of lading, the master's dilemma is obvious: on the one hand, to inaccurately clause the bill of lading would give rise to damages arising from non-compliance with art.III(3).[71] On the other hand, not to clause the bill of lading in respect of goods otherwise than in apparent good order and condition would expose the carrier to a considerably high risk of liability vis-à-vis the cargo receiver. It is true that some visible, but minor, contamination, moisture, discoloration or some other imperfections can be expected of some particular types of cargo. However, where the degree of imperfection can vary considerably and where views of masters may honestly differ as to the identification of the correct degree when looking at the goods, how are carriers to protect themselves against the risks of misdescriptions? The practical attempt at avoiding this dilemma has been to introduce "RETLA clauses" into bills of lading. In essence, these clauses are designed to redefine the pre-printed words "shipped in apparent good order and condition". To this end, RETLA clauses purport not to qualify but to redefine these words, with a view to keeping the bill of lading fit to pass through the hands of traders.[72] With a RETLA clause introduced into a bill of lading, the words "shipped in apparent good order and condition" no longer bear the meaning that the goods are free from any of the visible defects listed therein, such as rust, decay and discoloration. From the perspective of a cargo receiver, who is also generally the buyer of goods under a sale contract, this effect of RETLA clauses may raise eyebrows. The cargo interest places heavy reliance on the words "shipped in apparent good order and condition" when it intends to part with its money only against a clean receipt. When viewed from this perspective, RETLA clauses would appear to render the words "shipped in apparent good order and condition" meaningless, to the detriment of the cargo receiver. However, it is possible for the cargo receiver to avoid this by simply asking the seller under the sale contract to tender a bill of lading without a RETLA clause.[73]

[68] *The David Agmashenebeli* [2003] 1 Lloyd's Rep. 101 at 105 per Colman J.
[69] *The David Agmashenebeli* [2003] 1 Lloyd's Rep. 101 at 115.
[70] For letters of credit sales, see UCP 600 art.27. For cash-against-documents sales, see *Benjamin's Sale of Goods* (2010), para.19-126. See also *The Galatia* [1980] 1 W.L.R. 495, where the court took the view that a bill of lading that contained a notation indicating that the goods had been damaged during loading should be treated as a clean bill of lading and be accepted by the buyer for payment. The damage to which the notation referred was a post-shipment damage which had to be borne by the buyer. The decision cannot find room for application in the case of a letter of credit incorporating UCP 600 by reason of its art.27.
[71] This will be the case where the Rules are applicable to the contract of carriage.
[72] In the meantime, RETLA clauses also typically confer upon shippers a "notional" right to request a substitute bill of lading setting out the defects—a right that is unlikely to be exercised by shippers, who would naturally wish to receive payment under a sale contract or a letter of credit.
[73] Difficulties may arise, however, where a letter of credit is in place and where the RETLA clause appears on the reverse side of the bill of lading. In such circumstances, the bank is likely to accept such a bill of lading contrary to the buyer's intention: see UCP 600 art.14, which provides that the bank will accept documents that appear on their face in compliance with the requirements in the letter of credit. See the English case of *The Starsin* [2003] UKHL 12; [2004] 1 A.C. 715; [2003] 2 W.L.R. 711 HL.

Leaving this practical solution to one side, the alternative would be a judicial solution, which, if preferred, may lead to two possible routes of judicial approach. The first approach, the "trade approach", would be to give the RETLA clause full effect, with the result that the carrier would be able to avoid claims arising from pre-shipment damage to goods. If this approach were followed, the cargo receiver would be urged to seek redress against the seller. In the absence of a provision in the sale contract requiring the tender of a bill of lading without a RETLA clause, the cargo receiver would be left with a highly risky option, which it may not wish to take: to reject the bill of lading tendered by the seller on the grounds that the bill of lading contains a RETLA clause. This would possibly trigger an action by the seller for wrongful rejection. In such an action, the cargo receiver would have to navigate in uncharted waters, trying the plea before a court or an arbitral tribunal that such a bill of lading was not clean and was therefore a bad tender. The second approach, the "carriage approach", would be to give no effect[74] or only limited effect to RETLA clauses. To follow this approach would have the effect of putting carriers at risk in relation to claims arising from pre-shipment damage and thereby giving cargo receivers enough incentive to seek redress against the carrier. Recently, Simon J in *The Saga Explorer* opted for the "carriage approach" when he said[75]:

> "The Retla clause can and should be construed as a legitimate clarification of what was to be understood by the representation as to the appearance of the steel cargo upon shipment. It should not be construed as a contradiction of the representation as to the cargo's good order and condition, but as a qualification that there was an appearance of rust and moisture of a type which may be expected to appear on any cargo of steel: superficial oxidation caused by atmospheric conditions. The exclusion of 'visible rust or moisture' from the representation as to the good order and condition is thus directed to superficial appearance of a cargo which is difficult, if not impossible, to avoid."

The combined effect of Colman J's approach in *The David Agmashenebeli*[76] and that of Simon J in *The Saga Explorer* is that RETLA clauses have now been rendered redundant. The net result is that, in the case of any defect that is more than minimal, carriers are now expected to clause the bill of lading, whether or not the bill of lading contains a RETLA clause. When holding that the bill of lading should have been claused in that case, Simon J's second reasoning also suggests that the RETLA clauses may now be invalidated by art.III(8) of the Hague and Hague-Visby Rules.

With respect, there is insufficient legal basis for upholding this reasoning. Given that statements as to the goods are only representations of fact, but not contractual promises, these statements cannot in fact be struck down by art.III(8).[77] If Simon J's approach is endorsed by other courts and higher courts, this will surely create a platform for cargo receivers to challenge the well-established validity of the weight and quantity unknown and similar clauses. Another important point with respect to the decision in *The Saga Explorer* is this: in that case, the master/carrier agreed to issue a clean bill of lading in consideration of a letter of indemnity. On the master's/carrier's decision to issue a clean bill of lading, Simon J said:

> "What occurred was not an 'honest and reasonable non-expert view of the cargo as it appeared' but a deceitful calculation made on behalf of the owners by their authorised agent at the request of the shippers and to the prejudice of those who would rely on the contents of the bills of lading … ."[78]

Owing to Simon J's finding of dishonesty on the part of the carrier, the validity of the letter of indemnity given to the carrier in exchange for a clean bill of lading would naturally be tainted with this dishonesty. It is important to highlight the fact that the letter of indemnity was accepted in a situation where the legal effect of the RETLA clause in the bill of lading had not been tested by English courts. Consequently, the decision suggests that a letter of indemnity provided in exchange for a clean bill of lading is enforceable only in cases where the master has a genuine doubt about the apparent condition of the "goods", not about the law.[79] Should this be the way forward?

Conclusion

The specific issues discussed here in relation to the receipt function of the bill of lading and indemnities will no doubt attract more judicial scrutiny in the future. Until the law in respect of these issues is further clarified by the courts, these issues will remain as a challenge for all the main players in shipping and trade markets.

[74] Under English law, as with weight and quantity unknown clauses, RETLA clauses should not offend against art.III(8), which has no teeth to bite representations made in the bill of lading.
[75] *The Saga Explorer* [2012] EWHC 3124 (Comm) at [44].
[76] See *The David Agmashenebeli* [2003] 1 Lloyd's Rep. 101 at 105.
[77] *The Mata K* [1998] 2 Lloyd's Rep. 614 at 620 per Clarke J. See also *The Atlas* [1996] 1 Lloyd's Rep. 642.
[78] *The Saga Explorer* [2012] EWHC 3124 (Comm) at [55].
[79] See also *Scrutton on Charterparties and Bills of Lading*, edited by B. Eder, 22nd edn (London: Sweet & Maxwell, 2011), para.8-018.

Towards a Better Future for Chinese Bankruptcy Law: Problems and Potential

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China; Comparative law; Corporate insolvency; Cross-border insolvency; United States

Introduction[1]

To counter declining economic growth, the Chinese Government initiated a "supply-side reform" in 2015, which aims at reducing industrial overcapacity and closing down "zombie companies".[2] According to the Government, bankruptcy law will be essential for carrying out the supply-side reform. In November 2013, the Central Committee of the Communist Party of China (CCCPC) adopted the Decision on Some Major Issues Concerning Comprehensively Deepening the Reform, which states: "we will improve the market exit system in which the good eliminates the bad, and perfect the enterprise bankruptcy system".[3] In 2015, the State Council also stressed in the Opinions on Developing Mixed Ownership Economy by State-owned Enterprises that it is imperative to conduct research on the bankruptcy law so as to make amendments.[4] The State Council further pointed out in the *Government Work Report* in 2016 that the Government would reduce capacity and address the issue of "zombie companies" using measures such as mergers, reorganisations, debt restructuring and bankruptcy liquidations.[5]

All these mark a new era for Chinese bankruptcy law, which was largely unused in the 20 years following its original passage in 1986 and the seven years after its replacement with a new law in 2006. Since 2014, however, the number of bankruptcy cases in China has surged and various efforts have been taken to improve the implementation of the bankruptcy law. For example, in June 2016, the Supreme People's Court (SPC) issued 10 example cases on bankruptcy to guide the adjudication and stated that bankruptcy law should be used to facilitate the supply-side reform.[6] However, despite such efforts, Chinese bankruptcy law still has many problems that remain to be solved. On the one hand, the legislation has left gaps on important fronts including financial institution insolvency and cross-border insolvency. On the other hand, local governments have widely intervened in the bankruptcy procedure and shielded many insolvent companies from the formal bankruptcy. Local protectionism and governmental intervention have also contributed to massive debt evasion on the pretext of bankruptcy. Additionally, in recent years, it has become increasingly popular for Chinese companies to issue bonds to overseas investors. When some of them slipped into insolvency, problems arose as to the co-ordination of the bankruptcy procedures across borders and the balance of interests between domestic and foreign creditors.

Focusing on these conundrums, this article will evaluate Chinese bankruptcy law and propose future reforms. It begins with a comparison of the US and Chinese bankruptcy law, proceeds to discuss problems in the practice of Chinese bankruptcy law and concludes with possible solutions to those problems.

A comparative review of US and Chinese bankruptcy law

The current bankruptcy legislation in China, the Enterprise Bankruptcy Law (EBL), was promulgated in 2006. It replaced the Interim Enterprise Bankruptcy Law of 1986, which only applied to state-owned enterprises (SOEs). The EBL provides for three bankruptcy procedures—liquidation, reorganisation and conciliation. Its provisions on liquidation and reorganisation are analogous to those in Chs 7 and 11 of the US Bankruptcy Code of 1978 (USBC). However, although the EBL resembles the USBC in terms of the basic framework, they diverge on specific issues. Here, a brief analysis will be made to illustrate the point.

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[2] "China to Press Ahead with Supply-Side Reform" (27 December 2016), *China Daily* available at: *http://www.chinadaily.com.cn/business/2016-12/27/content_27784692.htm* [Accessed 4 October 2017].

[3] Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform (17 January 2014) available at: *http://www.china.org.cn/chinese/2014-01/17/content_31226494.htm* [Accessed 5 October 2017].

[4] Opinions on Developing Mixed Ownership Economy by State-Owned Enterprises (September 2015) available at: *http://www.gov.cn/zhengce/content/2015-09/24/content_10177.htm* [Accessed 5 October 2017].

[5] *Government Work Report* (24 March 2016) available at: *http://www.mofcom.gov.cn/article/i/jyjl/l/201603/20160301282908.shtml* [Accessed 5 October 2017].

[6] SPC, "SPC Example Cases on Adjudicating Bankruptcy Cases and Facilitating Supply-Side Reform" (June 2016) available at: *http://www.court.gov.cn/zixun-xiangqing-22051.html* [Accessed 29 November 2016].

Financial standards for entering bankruptcy

The USBC defines "insolvency" by reference to the balance sheet. It states that insolvency under the code refers to the financial condition that the sum of an entity's debts is greater than all of its property.[7] If a company is insolvent, it can apply for Ch.7 liquidation. However, a company does not need to be insolvent to apply for USBC Ch.11 reorganisation: simply being unable to service its debts is sufficient.[8] The threshold for entering the bankruptcy procedure under the EBL in China is much higher than under the USBC in the US. In order to apply for voluntary bankruptcy, the debtor must both be unable to service debts and to have the value of its debts exceed the value of its assets. In other words, the debtor must be both illiquid *and* insolvent, lacking both the cash to service debts and failing the balance sheet test. In an involuntary EBL bankruptcy filed by a creditor, however, only the cash-flow standard is used. If the debtor chooses to apply for reorganisation, then an additional circumstance can be considered: that the debtor "clearly lacks the ability to pay off debts".[9] The guidance book on adjudicating bankruptcy cases edited by the SPC explains that if the court is unable to ascertain the financial situation of the debtor based on formal evidence (e.g. the balance sheet), it may accept the petition concerning debtors that "clearly lack the ability to pay off debts".[10]

Stringent financial standards for entering bankruptcy can constrain the abuse of the bankruptcy protection; however, such benefits may be outweighed by the downside that they cause delays in liquidating or restructuring distressed companies. The EBL standard for applying for reorganisation is problematic as it gives the courts too much discretion over whether or not to accept the application for both voluntary and involuntary bankruptcy.

The automatic stay

The automatic stay (or moratorium) is the central provision of bankruptcy law as it stays claims of all creditors and forces them to pursue their claims through the bankruptcy procedure. It gives a breathing space for the debtor while striving to ensure equitable distribution for creditors.[11] Under the USBC, a petition for bankruptcy will trigger an automatic stay on claims of creditors. In contrast, under the EBL, a stay on creditors' actions against the debtor will only be triggered by acceptance of the court. As the court has 15 days to decide whether to accept the bankruptcy case,[12] when the decision of the court is still pending, creditors may act individually to seize the debtor's assets. The 15-day interval may also allow the management to behave opportunistically against creditors by diverting assets—i.e. fraudulent transfer or fraudulent conveyance.

Further, the effects of the automatic stay are different under US and Chinese bankruptcy laws. The automatic stay under the USBC will stay all litigation and enforcement of judgments and security. The stay is effective during the time the case is pending except for limited cases where the court allows creditors to lift the stay.[13] By comparison, the stay under the EBL has only limited effect in that actions or arbitrations are only suspended and can continue when the administrator takes over the bankrupt estate. Also, new actions filed against the debtor after the commencement of the bankruptcy are permitted as long as they are filed with the court that accepts the bankruptcy case.[14] This means that, alongside the bankruptcy procedure, creditors may pursue the debtor through the court actions and arbitrations that have started before the initiation of the bankruptcy procedure, possibly reaching conflicting judgments.

Avoidance actions

Creditors pursuing claims against a debtor in an ELB bankruptcy cannot confidently rely on the automatic stay provision: they should take avoidance actions against fraudulent transfer and preference to constrain irregularities in asset distribution and to recover transferred assets for the benefit of all creditors. Under the USBC, the trustee is empowered to avoid any transfer of an interest of the debtor in property that constitutes a preference.[15] This is intended to address the problem that a debtor can selectively pay some of its creditors to the detriment of the interests of other creditors, for example, repaying connected persons before other creditors.

[7] 11 USC s.101(32): "The term 'insolvent' means—

(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of this title."

[8] D.G. Baird, *The Elements of Bankruptcy*, 4th edn (New York: Foundation Press, 2006), p.65.

[9] SPC (ed.), *Judicial Guidance on Enterprise Restructuring, Bankruptcy and Reorganisation Cases* (Beijing: Law Press China, 2015), p.80.

[10] SPC, *Judicial Guidance on Enterprise Restructuring, Bankruptcy and Reorganisation Cases* (2015), p.80.

[11] UNCITRAL, *Legislative Guide on Insolvency Law* (2005) available at: *http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf* [Accessed 5 October 2017].

[12] EBL 2006 art.10.

[13] 11 USC s.362.

[14] EBL 2006 art.21.

[15] 11 USC s.547(b) provides that a transfer is deemed as a preference if it is: (1) to the benefit or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the filing of the petition, or between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and/or (5) a transfer that enables the creditors to receive more than it would otherwise receive in a Ch.7 liquidation.

In addition, the USBC has promulgated the fraudulent transfer provision to constrain directors or shareholders from transferring or concealing corporate assets. The difference between the fraudulent transfer provision and the preference provision is that the former applies to any transaction that will unfairly reduce corporate assets available to creditors, while the latter is aimed at preventing unfair treatment among creditors.[16] There are two categories of fraudulent transfers under the USBC. One is "actual fraud", which means that the transfer is made with actual intent to hinder, delay or defraud any creditor.[17] If the intent to defraud cannot be proved, a transaction can also be deemed as "constructive fraud" when the debtor transfers an asset or incurs an obligation without receiving a reasonably equivalent value in exchange and at the time when the transferor was rendered insolvent or left with unreasonably small capital.[18]

In contrast to the detailed provisions under the USBC, the EBL contains crude provisions for void and voidable transactions without differentiating between fraudulent transfer and preference payment.[19] The provisions on void and voidable transactions under the Chinese bankruptcy law derive from Chinese contract law. Also, the EBL fails to provide for "constructive fraud", which is easier for creditors to claim, as it does not require the proof of the intent to defraud.

The reorganisation procedure

The major difference between the US and Chinese reorganisation procedure is that the former allows directors to continue to be in charge (debtor-in-possession),[20] while the latter generally requires a court-appointed administrator to take over as soon as the bankruptcy case is accepted by the court.[21] The exception is that, in the reorganisation process, the debtor may manage its property by itself under the supervision of an administrator upon approval by the court.[22] However, in practice, the reorganisation is almost always managed by the administrator and, as will be discussed later, the role of an administrator is usually assumed by officials of the local governments.

The administrator-dominated reorganisation is justified insofar as most companies in China have concentrated ownership[23] and therefore directors' interests are likely to be aligned with shareholders' and against creditors' in a reorganisation procedure.[24] The unique circumstances in Chinese SOEs, the major listed companies in the country, make this even more likely. Creditors of SOEs are frequently forced to relinquish their interests for the sake of social stability. Moreover, directors of SOEs are not sufficiently monitored and asset diversion is prevalent.[25] Before the shareholder value is depleted, the state shareholder is the principal victim of asset diversion by directors. If, when a company is insolvent, the directors continued to be in control, its creditors, who typically lack the resources to monitor effectively the directors, would become the victims of the directors' misbehaviour.

Priority rule

As in the US,[26] secured creditors rank highest in priority of repayment under the EBL, followed by holders of priority claims including administrative expenses, employees' compensation and tax claims (from high to low).[27] The rest of the bankrupt estate would go to the unsecured creditors. The EBL, however, makes an exception to this order of seniority for employees' claims that occurred before 2006, the year that the EBL replaced the Interim Bankruptcy Law of 1986. Reflecting the Government's concern that social instability might be caused by unemployment that followed bankruptcy, employee claims incurred before 2006 are grandfathered to rank above secured creditors.[28]

Bankruptcy for financial institutions

The bankruptcy of financial institutions in the US is governed by specialised laws such as the Federal Deposit Insurance Act 1950 (FDIA), the Federal Deposit Insurance Corporation Improvement Act 1991 (FDICIA)

[16] 11 USC s.548 provides that the trustee can void any transfer of an interest of the debtor in property or any obligation incurred by the debtor that constitutes fraudulent transfer and was made or incurred on or within two years before the date of the filing of the petition. In the US, fraudulent transfer law also exists at the state level. The state law on fraudulent transfer is similar to that under the Bankruptcy Code and usually modelled on the model uniform law.
[17] 11 USC s.548(a)(1)(A).
[18] 11 USC s.548(a)(1)(B).
[19] EBL 2006 arts 31 and 32. Article 31 states that an administrator shall have the right to request the court to avoid the following actions taken by the debtor within one year before the people's court accepts the application for bankruptcy: (1) transferring assets for no consideration; (2) trading at an obviously unreasonable price; (3) set a charge on its assets for an unsecured creditor; and/or (4) abandoning claims. Further, art.32 provides that payments to creditors within six months before the people's court accepts the application for bankruptcy and when the debtor was insolvent are also voidable. Two actions that can severely undermine interests of creditors are deemed as void under art.33: (1) concealing or transferring assets to evade payment of debts; and (2) fabricating a debtor or acknowledging debts that do not exist. It is necessary to distinguish the voidable and void actions, although both can nullify actions of the debtor and restore its property. The most important difference is that the voidable actions are binding unless being voided by the court while the void actions are deemed to have no legal effects from the start. In addition, voidable actions must be challenged within a time limitation, while void actions have no such limitation.
[20] During the reorganisation process provided by the Ch.11 of the USBC, directors will remain in control and the firm will be referred to as the debtor-in-possession (DIP).
[21] EBL 2006 art.24.
[22] EBL 2006 art.73.
[23] F. Jiang and K.A. Kim, "Corporate Governance in China: a Modern Perspective" (2015) 32 *Journal of Corporate Finance* 190. This article has found that, on average, the largest shareholder of Chinese listed companies owns one-third of the shareholding, while the largest five shareholders together own more than half.
[24] D. Hahn, "Concentrated Ownership and Control of Corporate Reorganisations" (2004) 4 *Journal of Corporate Law Studies* 117.
[25] The National Audit Department conducted an audit on 1290 key enterprises in 2000 and found that losses of state assets arising from escaping bank debts and irregularities in reform amounted to CNY 29 billion. See M. Li, "On Supervisory Committee in SOEs" (2005) 27 *Review of Shanxi Caijing University* 89. See also W. Zhang, "China's SOE reform: A corporate governance perspective" (2006) 3 *Corporate Ownership and Control* 132.
[26] 11 USC s.507(a).
[27] EBL 2006 art.113.
[28] EBL 2006 art.132.

and the Securities Investor Protection Act 1970 (SIPA). These statutes lay down the framework for financial institutions, and particularly banks, to be handled outside of the USBC.

Given the externalities of bank insolvency, bank resolution is initiated by the chartering agency or the institution's primary federal regulatory agency, or the Federal Deposit Insurance Corporation (FDIC), unlike corporate bankruptcies that are filed by the debtor or its creditors. Further, the grounds for initiating bank resolution are distinct; for example, if the relevant authority believes that the bank is not being operated in a safe and sound manner or that the bank is unlikely to meet its deposit obligations. Bank resolution can also be initiated if the bank is becoming "critically undercapitalised", defined as a minimum of 2% of equity capital to total assets under the FDICIA. Moreover, the FDIC will be in charge of the bank resolution procedure as the receiver or conservator.[29]

The Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank Act) in response to the latest financial crisis has reshaped the process to resolve large, complex financial companies, especially those systemically important financial institutions (SIFIs) as defined by Title I of the Dodd-Frank Act. Such institutions are required to develop a resolution plan that explains how a company would conduct a rapid and orderly resolution in case of financial distress or failure. Further, Title II of the Dodd-Frank Act provides for an alternative to bankruptcy for resolving financial companies, in which the FDIC will act as a receiver and liquidate the company.[30]

Compared with the complex legal apparatus in the US, the bankruptcy law for financial institutions in China is still nascent. In the past, resolution of financial institutions was usually carried out by regulatory authorities on an ad hoc basis rather than on clearly based laws and regulations.[31] The EBL provides that upon the application of regulatory authorities, financial institutions can enter the bankruptcy procedure.[32] Also, China has paved the way for bank bankruptcy by passing the Deposit Insurance Regulation in 2015, which requires deposit-taking institutions to insure all account for up to CNY 500,000 (USD 725.74).[33] Further, the big four commercial banks in China have been identified as global SIFIs by the Financial Stability Board (FSB) and have promulgated the rescue resolution plan (RRP) in compliance with the requirements of the China Banking Regulatory Commission (CRBC).[34]

Cross-border insolvency

The US has incorporated the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency (UNCITRAL Model Law) through the enactment of Ch.15 of the USBC in 2005. Upon application by a foreign representative, the US court will recognise a foreign proceeding as a foreign main or a foreign non-main proceeding if certain requirements are met.[35] The recognition of a foreign main proceeding will trigger an automatic stay on the debtor and its property within the US, while the relief for non-main proceeding is much more limited.[36] A foreign main proceeding is one pending in a country where the debtor has the centre of its main interests (COMI). The analysis of COMI by the US court is flexible and involves much controversy.[37]

In contrast, the jurisprudence of cross-border insolvency in China is just starting to develop. For the first time, the EBL has dealt with the extraterritorial application of Chinese bankruptcy law and recognition of foreign bankruptcy judgments. It provides that bankruptcy proceedings made under the EBL are binding on the debtor's property situated outside China. Also, the EBL provides that Chinese courts shall recognise and enforce judgments or rulings made by foreign courts on the basis of applicable international treaties or the principle of reciprocity. The precondition is that such judgments or rulings do not violate the basic legal principles of China, do not jeopardise the sovereignty, security or public interests of the country, and do not undermine the legitimate rights and interests of the creditors within the country.[38]

Although the EBL has made a significant step forward, it remains vague on the enforceability of foreign bankruptcy judgments in China. In addition, it fails to incorporate the UNCITRAL Model Law, which provides a framework for international co-operation in insolvency proceedings and has been adopted by many countries including the US. The uncertainty on cross-border insolvency under Chinese bankruptcy law has adverse effects on both inbound foreign investments and Chinese companies that are expanding overseas. The following section will discuss cross-borders insolvency cases after considering governmental intervention and debt evasion, which are major implementing problems of Chinese bankruptcy law.

[29] R.R. Bliss and G.G. Kaufman, "U.S. Corporate and Bank Insolvency Regimes: an Economic Comparison and Evaluation" available at: *http://users.wfu.edu/blissrr/PDFs/Bliss-Kaufman%20-%202005%20-%20Insolvency%20Declaration%20and%20Resolution.pdf* [Accessed 5 October 2017].
[30] D.A. Skeel, "The New Synthesis of Bank Regulation and Bankruptcy in the Dodd-Frank Era" (10 July 2015), *SSRN* available at: *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2628694* [Accessed 5 October 2017].
[31] T. Huang, "The Power Struggle of the Exit Mechanism for Financial Institutions" [2009] *Peking Law Review* 867.
[32] EBL 2006 art.134.
[33] Deposit Insurance Regulation 2015 available at: *http://lawinfochina.com/display.aspx?id=19762&lib=law* [Accessed 30 March 2016].
[34] "China's Banks Adopt 'Living Wills' to Plan for Less Predictable Future" (1 January 2014) available at: *https://blogs.wsj.com/chinarealtime/2014/01/01/chinas-banks-adopt-living-wills-to-plan-for-less-predictable-future/* [Accessed 5 October 2017].
[35] 11 USC s.1517.
[36] 11 USC s.1520.
[37] J. Luna, "Thinking Globally, Filing Locally: the Effects of the New Chapter 15 on Business Entity Cross-Border Insolvency Cases" (2007) 19 Fl. J. Int'l L. 671.
[38] EBL 2006 art.5.

Problems of Chinese bankruptcy law in practice

Governmental intervention

The annual number of bankruptcies in China peaked at 8,900 in 2001 during the restructuring of SOEs.[39] In the years following the passage of the EBL in 2007, annual bankruptcies substantially declined to 1,998 in 2013.[40] A report by the SPC pointed out that from 2003–12, the total number of bankruptcy cases amounted to around 4,000, with SOEs accounting for 80% of the total.[41]

Court-based bankruptcy cases continued to account for a very small proportion of all company dissolutions in China prior to 2014.[42] From 2014, however, the number of bankruptcy cases has risen sharply as economic growth slowed in China.[43] In 2016, the bankruptcy cases accepted by the Chinese courts surged to 5,665, a 53.8% year-on-year increase.[44]

The main difficulty for companies in accessing the bankruptcy procedure is the intervention by local governments. As local governments have the dual objectives of maintaining social stability and driving economic growth,[45] they are unwilling to let local SOEs or large private companies go bust. Bankruptcy cases are governed by the court at the place where the debtor resides.[46] A local court is often subject to the influence of the local governments[47] and may reject a bankruptcy case owing to the opposition of the local government.

Besides influencing the initiation of bankruptcy cases, a local government can also dominate the bankruptcy process by assuming the role of the administrator. The EBL provides that role of administrator can be assumed by a liquidation team, a law firm, an accountancy firm, a bankruptcy firm or any other public intermediary agency.[48] Liquidation teams consist mostly of governmental officials because a court is required to choose members of the liquidation team from the standing, regional "interim emergency team" established by the local government to deal with distressed companies.[49] It has been estimated that 45% of administrators are liquidation teams.[50] Further, one study has found that, out of 25 reorganisation cases of special treatment (ST) listed companies,[51] 24 cases were found to have liquidation teams serving as the administrator and only one case was administrated by a professional firm.[52] These liquidation teams are exclusively composed of governmental officials, not professionals, and are usually headed by a vice-major or other senior official.

Admittedly, governmental involvement can stabilise the situation after a large company collapses and can facilitate the bankruptcy process to an extent. Local governments can take action to protect a debtor's assets from creditors. In some cases, the local governments have even paid outstanding wages in order to suppress potential upheavals. Also, local governments can introduce new investors into the distressed business. For example, the local government of Changshu city, as well as the government on the provincial level, played an instrumental role in the reorganisation of the subsidiaries of FerroChina Ltd, after directors of these companies had fled. This was one of the largest bankruptcy cases in China with more than 1,400 creditors and the debt claimed by creditors amounting to CNY 11 billion. The local government established an ad hoc team to handle the case and took immediate actions to preserve the corporate assets and pacify the angry creditors. It also paid for part of the workers' salaries. In the end, China Minmetals Corp and Zhejiang Materials Industry Groups, the two major creditors, injected CNY 1 billion into the distressed companies through a debt-for-equity swap. Under the reorganisation plan, the funds would be used to pay off part of debts and restart the manufacturing operations. The rest of the debts would be paid in instalments from 2010–13. At the end of 2013, the Changshu court approved the reorganisation plan and declared the end of the FerroChina reorganisation procedure.[53]

However, although the governmental involvement can have positive effects on social stability, it has undermined the functioning of the market mechanism and conflicts with the rule of law. First, in the absence of bankruptcy

[39] R. Tomasic and Z. Zhang, "From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China" (2012) 12 *Journal of Corporate Law Studies* 295, 308. The restructuring of SOEs will be further discussed.

[40] 21 Century News, "SPC Report Claims That SOEs Account for 80% of the 40,000 Bankruptcy Cases" (4 September 2014) available at: *http://finance.sina.com.cn/china/20140904/030720206424.shtml* [Accessed 5 October 2017].

[41] 21 Century News, "SPC Report Claims That SOEs Account for 80% of the 40,000 Bankruptcy Cases" (2014).

[42] For example, in 2008, the ratio of court-based bankruptcy cases to all company dissolutions was only 0.37%, much lower than that in the UK (8.17%) and US (10.16%) in the same year. See Tomasic and Zhang, "From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation" (2012) 12 *Journal of Corporate Law Studies* 295.

[43] Tsinghua PBCSF, *Report on Improvement of Bankruptcy Law and Market Exit by Law* (23 June 2016) available at: *http://www.pbcsf.tsinghua.edu.cn/content/details226_12442.html* [Accessed 5 October 2017].

[44] "SPC: Putting Employees' Rights First in Bankruptcy Cases" (15 June 2016) available at: *http://news.xinhuanet.com/politics/2016-06/15/c_129064782.htm#pinglun* [Accessed 5 October 2017].

[45] IMF, "Resolving China's Corporate Debt Problem" (October 2016) available at: *https://www.imf.org/external/pubs/ft/wp/2016/wp16203.pdf* [Accessed 5 October 2017].

[46] EBL 2006 art.3.

[47] R. Peerenboom, "Judicial Independence in China: Common Myths and Unfounded Assumptions", La Trobe Law School Legal Studies Research Paper No.2008 (2008), p.17.

[48] EBL 2006 art.24.

[49] SPC, *Judicial Guidance on Enterprise Restructuring, Bankruptcy and Reorganisation* (2015), p.125.

[50] Tomasic and Zhang, "From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation" (2012) 12 *Journal of Corporate Law Studies* 295, 316–317.

[51] ST companies refer to Chinese listed companies that receive special treatment by the stock exchanges because of abnormal financial conditions.

[52] S. Li and Z. Wang, "Empirical Study on Chinese Bankruptcy Law in Its Third Year of Application" available at: *http://www.civillaw.com.cn/article/default.asp?id=53480* [Accessed 27 March 2014].

[53] "The Largest Bankruptcy Case That Spanned Five Years and Involved 11 Billion Debts" (23 January 2014) available at: *http://www.boznews.com/2014/0123/30469.shtml* [Accessed 5 October 2017].

threat, local SOEs actually have a "soft budget" that enables them to continue to receive financing and make investments regardless of failures.[54] This is in contrast with a "hard budget" under which a company has to pay for its failures with its own income. The lack of a hard budget creates perverse incentives for managers, who are prone to overlook the need for cash as they assume they can always maintain liquidity through governmental subsidies or bank loans.[55]

Secondly, the "soft budget" problem exists not only in SOEs but also in private enterprises that are supported by the Government. This has led to overcapacity of policy-supported industries and engenders moral hazard on the part of both companies and their creditors. On one hand, companies may take excessive risks and pursue highly leveraged strategies. They will reap the benefits if they succeed and transfer costs to the Government (in fact, taxpayers) in the event of failure. On the other hand, creditors will be less cautious and lend to companies that are implicitly guaranteed by the Government. Excessive investments have led to overcapacity in many industries in China and created "zombie companies" that live on subsidies. This occurs not only in heavy industries, such as steel, coal and cement, but has also become an acute problem in high-tech industries including the solar power industry.[56] The fall of Suntech and LDK, two giant solar power companies, is evidence to such a problem. Both of them have been "bailed out" through reorganisation with the support of the local government.[57]

Thirdly, the Government can sacrifice creditors' interests to save local companies in order to preserve local tax bases and prevent social instability caused by unemployment. In the late 1990s, the restructuring and closing down of local SOEs was relatively successful because of the funds provided by the Central Government to compensate redundant workers. However, debt evasion through bankruptcy was endemic during the period and was usually supported by local governments. With the introduction of the reorganisation procedure by the EBL, new ways of "debt evasion" have emerged. The next section will focus on the problem of debt evasion.

Debt evasion in bankruptcies

Debt evasion during the SOE restructuring

A surprising fact about Chinese bankruptcy law is that the number of bankruptcy cases has significantly declined from the peak in 2001.[58] The predecessor of the EBL, the Interim Bankruptcy Law enacted in 1986, was promulgated in order to facilitate the restructuring (*gaizhi*) of SOEs and thus applied only to SOEs. Why was the enactment of the EBL in 2006, which applies to all enterprises, followed by a decrease not an increase in bankruptcy cases?

To answer this question, we need first to examine the underlying reason for the peak in bankruptcy cases around 2001. It is often neglected that SOEs bankruptcies in China, which have always accounted for the major portion of all bankruptcies in the country, are closely associated with the SOE *gaizhi* reform in the late 1990s, during which bankruptcy was used as a means to close down unprofitable SOEs, resulting in a sharp rise in bankruptcies. It can also be argued that the supply-side reform initiated in 2015 is a continuation of the SOE restructuring reform and likewise will stir up a wave of bankruptcies.

In 1994, to solve the problem that many SOEs were heavily indebted to banks, the State Council launched the Capital Structure Optimisation Program (CSOP) which assigned to state-owned banks (SOBs) debt write-off quotas for SOE bankruptcies and mergers.[59] SOBs were instructed to use funds provided by the state to write off debts up to specific quotas owed by SOEs. Workers and retirees were paid primarily using land use rights and employee housing and other social assets were excluded from the bankrupts' estates.[60] Further, under the programme, merger, not bankruptcy was initially the main restructuring tool to be applied to distressed SOEs.

However, the balance sheets of SOEs did not improve. In 1995, a survey found that 37% of non-financial SOEs were insolvent based on their book values of assets and liabilities. In 1998, industrial SOEs incurred estimated aggregate losses of CNY 80 billion and profits of CNY 120 billion.[61] In order to meet targets to reduce the number of loss-making SOEs within three years (1999–2001),[62] bankruptcy took priority over mergers and the number of bankruptcy cases surged. In 1999, 133 major bankruptcy cases were approved and acquired an average write-off quota of CNY 135 million or a total of CNY 18

[54] J. Kornai, "The Soft Budget Constraint" (1986) 39 *Kyklos* 3.
[55] J.Y. Lin and Z. Li, "Policy Burden, Privatization and Soft Budget Constraint" (2008) 36 *Journal of Comparative Economics* 90.
[56] L. Zhang, "Rebalancing in China: Progress and Prospects" (6 September 2016) available at: *http://www.imf.org/en/Publications/WP/Issues/2016/12/31/Rebalancing-in-China-Progress-and-Prospects-44225* [Accessed 5 October 2017].
[57] These cases will be further discussed later.
[58] 21 Century News, "SPC Report Claims That SOEs Account for 80% of the 40,000 Bankruptcy Cases" (2014).
[59] State Council, "Notice of the State Council on the Relevant Issues Concerning the Pilot Implementation of Bankruptcy of a State-Owned Enterprise in Some Cities" (1994) 59 *Guofa* available at: *http://news.china.com/finance/11155042/20140904/18760967_1.html* [Accessed 5 October 2017].
[60] State Council, "Supplementary Notice of the State Council on the Relevant Issues About the Pilot Implementation of the Merger and Bankruptcy of State-Owned Enterprises in Some Cities and the Reemployment of Workers" (1997) 10 *Guofa* available at: *http://www.mofcom.gov.cn/aarticle/b/bf/200207/20020700031314.html* [Accessed 5 October 2017].
[61] World Bank, "Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System" (20 September 2000) available at: *http://documents.worldbank.org/curated/en/2000/09/14451105/bankruptcy-state-enterprises-china-case-agenda-reforming-insolvency-system* [Accessed 5 October 2017].
[62] "The Central Economic Working Conference in 1998" (1998) available at: *http://www.people.com.cn/GB/channel5/21/19981210/333568.html* [Accessed 5 October 2017].

billion.[63] With such concerted efforts made to close down unprofitable SOEs, the peak of bankruptcy cases in 2001 is hardly surprising.

The concepts and policies of the CSOP were carried on and continued to be applied to SOEs until the EBL was enacted in 2006. SOE bankruptcies directed by the Government were described as "policy bankruptcies" as they were supported by governmental policies, funded by the state, and put employees' claims before bank loans. The EBL has addressed the conflict between ordinary bankruptcies and policy bankruptcies by stating that "special issues" relating to the SOE bankruptcies that are carried out within the period and scope as prescribed by the State Council shall be handled according to the relevant regulations of the State Council.[64] As the restructuring of SOEs was completed, policy bankruptcies were brought to an end in 2008.[65]

Without a knowledge of the historical background, one might assume that a large number of bankruptcy cases during the SOE restructuring reform indicated progress in the bankruptcy law. However, in fact, many SOEs applied for bankruptcy in order to obtain state funding for reorganisation, avoiding transferal of assets to creditors. Typically, bankrupt SOEs continued to operate on the same site with the same management,[66] while their bank debts were written off with the funds provided by the Central Government.

Debt evasion was supported by local governments[67] and bankruptcy became an administrative procedure with courts playing a rubber-stamp role.[68] Local governments were most at risk from social instability caused by massive lay-offs and they owned most non-key SOEs that closed during the restructuring reform. On the other hand, the Central Government retained controlling shareholdings in key SOEs that were reorganised in part by transferring shares to private investors.[69] These key SOEs were concentrated in banking, telecom, energy and natural resource sectors.[70] With SOBs still controlled by the Central Government, the debts owed by key SOEs to SOBs were effectively owed to the Central Government and could be written off. Top management of *gaizhi* enterprises were more concerned with employees' claims than with bank debts. A survey has found that 90% of CEOs of SOEs reckoned bankruptcy could be used to resolve debt problems.[71]

As a result, banks clearly incurred substantial losses during the restructuring of SOEs as they could only recover only 3–10% of their claims while laid-off employees of large SOEs were usually entitled to a substantial amount of compensation.[72] Debt evasion explains why debtors applied for bankruptcy voluntarily in most bankruptcy cases during the restructuring. Rarely did banks file bankruptcy applications and some actually tried to stop SOEs from going into bankruptcy.[73]

After the Central Government tightened the reins on bankruptcy, the number of bankruptcies slightly decreased in the late 1990s and then increased in 2000–01 when *gaizhi* was at its peak.[74] To address the problem of debt evasion by *gaizhi* enterprises, the Central Government adopted several measures. It required each *gaizhi* enterprise to commit to a schedule for paying its debts. Failure to meet the schedule would result in being registered as a debt-escaping firm subject to a bank credit downgrade ineligible to receive new loans.[75] In 2002, the SPC stated that applications for bankruptcy protection by companies seeking to escape bank debts would not be accepted.[76] Subsequently, the China Banking Association (CBA), the self-regulatory association of banks in China, issued *Guidance on the Register of Debt Evasion Institutions* in 2006 (amended in 2013).[77]

[63] World Bank, "Bankruptcy of State Enterprises in China" (2000).
[64] EBL 2006 art.133.
[65] R. Li, *Report on Supervision of State Assets and SOE Reform* (26 April 2005) available at: *http://www.npc.gov.cn/wxzl/gongbao/2005-05/30/content_5341707.htm* [Accessed 5 October 2017].
[66] There were various means of escaping bank debts through bankruptcy. For example, an enterprise could merge with others to form a new company, transfer its assets to the new company and then go into bankruptcy. It could also distribute the proceeds of the sale of assets regardless of the bank's claim as a secured creditor. At the same time, the enterprise would tamper with the asset/debt ratio, inflate the bankruptcy fees and reduce the value of the bankruptcy estate. See State Council, "Notice on Evading Bank Debts by PBC (Forwarded by State Council)" (2001) available at: *http://www.chinaacc.com/new/63/69/110/2001/4/ad98071930111214100221060.htm* [Accessed 5 October 2017].
[67] For example, the officials of Pingu, a county in Beijing, even proclaimed: "By getting rid of debts through bankruptcy, enterprises could continue to operate with the existing factory and equipment." As a result, some enterprises in the county, which had a relatively good performance, went into bankruptcy to escape bank debts. They changed their name and continued their operations on the old site. It had been found that 88.51% of the restructured enterprises in the county escaped bank debts, resulting in bad debts comprising 78.19% of the bank loans extended to the local restructured enterprises. See State Council, "Notice on Evading Bank Debts by PBC" (2001).
[68] State Council, "Notice on Evading Bank Debts by PBC" (2001).
[69] The report by the former director of the SASAC in 2005 (Li, *Report on Supervision of State Assets and SOE Reform* (2005)) pointed out that, nationally, 1,464 out of 2,903 large SOEs had been converted into corporations with outside investors and 48% of SOEs owned by the Central Government had completed the corporatisation reform.
[70] It has been estimated that the number of SOEs was 238,000 in 1998 and reduced to 119,000 in 2006. The number of SOEs owned by the Central Government was reduced to 151 in 2007, and 82.8% of their assets are concentrated on oil, electricity, national security, telecom and other curtail sectors. See S. Huang, "Analysis of the Evolution and Experience of SOEs' Reform" [2008] *Study on Economics and Management* 20.
[71] B.M. Fleisher, *Policy Reform and Chinese Markets: Progress and Challenges* (Cheltenham: Edward Elgar, 2008), p.54.
[72] World Bank, "Bankruptcy of State Enterprises in China" (20 September 2000).
[73] S. Cao, "Legislation and Implementation of Chinese Bankruptcy Law in a Decade" (1997) available at: *http://www.modernchinastudies.org/cn/issues/past-issues/57-mcs-1997-issue-2/400-2011-12-29-17-45-11.html* [Accessed 5 October 2017].
[74] As of the end of 2000, 51.29 % of all the restructured (*gaizhi*) enterprises had evaded bank debts, according to the survey on those that had bank accounts with the major SOEs. The bad debts they incurred amounted to 31.96% of the entire bank loans (plus interests) allotted to restructured enterprises. It was commercial banks owned by the state that had suffered most from the wave of debt defaults. See Cao, "Legislation and Implementation of Chinese Bankruptcy Law in a Decade" (1997).
[75] Cao, "Legislation and Implementation of Chinese Bankruptcy Law in a Decade" (1997).
[76] SPC, "SPC's Urgent Notice on Preventing Debt Evasion in Adjudicating Bankrupcy and Gaizhi Cases" (2001) available at: *http://www.chinacourt.org/law/detail/2001/08/id/40952.shtml* [Accessed 5 October 2017].
[77] CBA, *China Banking Association's Guidance on the Register of Debt Evasion Institutions* (2006, revised in 2013) available at: *http://www.china-cba.net/bencandy.php?fid=88&id=10978* [Accessed 5 October 2017].

Debt evasion through reorganisation

Implementation of the supply-side reform of 2015 to close down "zombie companies" and reduce overcapacity has led to the number of bankruptcy cases rising sharply. Many cases involve large industrial and manufacturing enterprises that had been stimulated by massive subsidies to overproduce. For example, two local SOEs, the Nonferrous Metals and the Special Steel Group, went into bankruptcy after defaulting in the interbank bond market.

Again, the rising number of bankruptcy cases comes with increasing cases of abuse. And this time, not only SOEs but also private companies are using bankruptcy to escape debts.[78] The discussion here will focus on the abuse of reorganisation, a procedure introduced by the EBL in 2006. The purpose of the reorganisation procedure is to enhance creditors' value and give the debtor a "second chance".[79] However, under governmental intervention, the reorganisation procedure in China has been misused to prolong the lives of unprofitable companies and to effect debt evasion.

Misuse can occur in three main ways. First, local government dominates the creditors' meeting, which is supposed to represent the interests of creditors, and forces banks to extend further credit to the debtor. This effectively changes the creditors' meeting into a bank syndicate to provide loans to the debtor. For example, when LDK Solar went into financial difficulties, the local government of Jiangxi province called for banks to establish a syndicate to provide LDK with loans worth CNY 2 billion. The bank syndicate offered a loan at a discount. The interest rate was reduced to 90% of that normally required and new loans were unsecured loans ranking pari passu with ordinary creditors.[80]

Secondly, the reorganisation plans usually involve debt-for-equity swaps, which carry great uncertainties for creditors and are often driven by political factors rather than economic ones. For example, Sinosteel, a SOE mired in financial difficulties, with a debt-to-asset ratio of around 90%, became the first Chinese steel company to default in the interbank bond market. In September 2016, Sinosteel reached an agreement with its creditors on a debt-for-equity swap and therefore avoided going into bankruptcy.[81] It was probably saved because its controlling shareholder was the national State Owned Assets Supervision and Administration Commission (SASAC) and it therefore had the support of the Central Government. The good fortune of Sinosteel stands in stark contrast to Special Steel Group, which was a local SOE and had no choice but apply for bankruptcy after failed negotiations for a debt-for-equity swap with its creditors.[82]

Thirdly, it is relatively common for reorganisation plans that do not significantly improve the repayment rate for creditors to be crammed down by the courts. For a reorganisation to be approved by the court, it must be passed by each of the creditors' groups by a double majority.[83] If the reorganisation plan is not approved by all of the creditors' groups, the court can use its power to cram down the reorganisation plan, i.e. force creditors to accept the plan.[84] The repayment rate in most reorganisation cases that have been carried out is estimated to be below 20%.[85] Under the reorganisation plan of LDK, the average repayment rate for its creditors was 6.62%.[86] Despite strong opposition from creditors, that reorganisation plan was crammed down by the court.

However, there are reasons to believe that in the future there will be more restraints on debtor companies than in the past. First, with the diversification of their ownership, Chinese banks are no longer merely instruments for channelling funds to SOEs. Rather, many of them are listed companies that need to improve shareholder value.[87] They are no longer willing to yield to local governments and have become more active in the bankruptcy procedures. For example, when the Special Steel Group proposed a debt-for-equity plan, creditors vehement opposed it and forced the company to go into liquidation. Secondly, the Central Government is taking measures to address debt evasion in bankruptcy and the underlying problem of governmental intervention and local protectionism. For example, although the State Council has urged using debt-for-equity swaps to deleverage SOEs, it forbids "zombie companies" in a bankruptcy from using the debt-for-equity swap to evade debts and requires that banks lead the debt-for-equity process.[88] Unlike in the past, the Government will no longer select those enterprises that are to be restructured and local governments are forbidden to interfere with the decisions of banks.

78 Tsinghua PBCSF, *Report on Improvement of Bankruptcy Law and Market Exit by Law* (2016).
79 R.M. Goode, *Goode on Principles of Corporate Insolvency Law*, 4th edn (London; Sweet & Maxwell, 2011), p.314.
80 Sina, "Jiangxi LDK's Reorganisation Plan Crammed Down by the Court" (9 October 2016) available at: *http://finance.sina.com.cn/money/bank/bank_hydt/2016-10-09/doc-ifxwrhpm2717413.shtml* [Accessed 5 October 2017].
81 Y. Jin, "Debt-for-Equity Swap of Sinosteel" (August 2016) available at: *http://epaper.21jingji.com/html/2016-08/17/content_45212.htm* [Accessed 5 October 2017].
82 "Will State Council Guidance on Debt-to-Equity Swap Lead to 'Forced Marriages'" (October 2016) available at: *http://news.ifeng.com/a/20161011/50083374_0.shtml* [Accessed 5 October 2017].
83 To be specific, a reorganisation plan is deemed to be passed by a creditors' group if it is approved by more than half (simple majority) of the creditors in each group, as well as those who represent more than two-thirds (absolute majority) of the total debts of the group. See EBL 2006 art.86.
84 EBL 2006 art.86.
85 Li and Wang, "Empirical Study on Chinese Bankruptcy Law in Its Third Year of Application".
86 Sina, "Jiangxi LDK's Reorganisation Plan Crammed Down by the Court" (2016).
87 D. Zhang et al, "Non-Performing Loans, Moral Hazard and Regulation of the Chinese Commercial Banking System" (2016) 63 *Journal of Banking & Finance* 48.
88 State Council, State Council's Opinions on Lowering the Leverage of Enterprises and *Guideline on Market-Based Debt-to-Equity Swap* (October 2016) available at: *http://www.gov.cn/zhengce/content/2016-10/10/content_5116835.htm* [Accessed 5 October 2017].

Cross-border insolvency

Owing to the high cost and stringent regulatory requirements of the domestic bond market,[89] the number of Chinese companies issuing bonds abroad has been on the increase. In 2015, the dollar-denominated bonds sold by Chinese companies totalled $60.3 billion, more than six times the 2010 figure.[90] This has given rise to concerns of how offshore creditors would fare in a bankruptcy, as cross-border insolvency issues are not clearly addressed by the current law.

The EBL has provided that Chinese courts shall recognise and enforce a foreign judgment based on international treaties of mutual recognition or the principle of reciprocity, provided that it does not contravene the basic legal principles of China, does not jeopardise the sovereignty, national security or public interests of the country, and does not undermine the legitimate rights and interests of the creditors within the country.[91]

However, China has only concluded mutual recognition treaties with a few countries[92] and there is no clear guidance on how courts should decide under the principle of reciprocity. Further, the conditions imposed on recognition of foreign judgments may be interpreted broadly by Chinese courts, so local protectionism is likely to come into play. For example, public interests may be interpreted to include social stability and, therefore, a foreign judgment may be denied by a Chinese court, on the grounds of threatening the social stability.

In addition to the uncertainties of law and local protectionism, foreign creditors have to face the fact that they are structurally subordinated to domestic creditors. To circumvent regulations on issuing debts to foreign creditors, Chinese companies usually issue debts through offshore entities, e.g. by incorporating a company in "tax havens" such as the British Virgin Islands (BVI), the Cayman Islands or Bermuda. The offshore company is typically listed in a jurisdiction such as Hong Kong and issues bonds to foreign creditors, injecting funds into domestic companies, which are typically subsidiaries or associates of the offshore company.[93] If it is a holding company, the offshore company would not have assets or real business operations and depends on the dividends received from the domestic companies to meet the claims of foreign bondholders. If the domestic companies slipped into financial difficulty, the offshore parent would be unable to repay foreign bondholders. Further, foreign bondholders would not be able to make direct claims against domestic companies, as the bondholders would have lent through the offshore parent. As creditors of the equity holding parent (offshore company), foreign bondholders' claims would be subordinated to the onshore creditors of the domestic companies, including domestic banks, suppliers, employees and tax authorities. Therefore, the foreign bondholders would probably get little or nothing, receiving only the leftovers after domestic creditors were paid.

The complexities faced by offshore bondholders of Chinese companies were highlighted by Suntech and LDK Solar, both of which were Chinese companies with holding companies registered in the Cayman Islands. In these cases, offshore bondholders found themselves excluded from the domestic insolvency proceedings and could recover little after domestic creditors were paid.

In Suntech, its domestic creditors, mainly Chinese banks, applied for reorganisation on 21 March 2013. At that time, the debts owed by Suntech consisted of USD 541 million of convertible bonds and RMB 7.1 billion (USD 1.1 billion) of loans issued by Chinese banks.[94] On 15 November 2013, the Intermediate People's Court of Wuxi approved the reorganisation plan of Suntech and declared the termination of the reorganisation procedure. In September 2013, Suntech reached a scheme with offshore bondholders in the Cayman Islands and was subsequently taken over by joint provisional liquidators (JPLs). On the application of the JPLs, the bankruptcy proceeding in Cayman was recognised by the US Bankruptcy Court as the main bankruptcy proceeding that has the effect of automatic stay on the debtor's property in the US. The sequence of events in Suntech shows that the restructuring of offshore bonds and domestic reorganisation proceedings were conducted separately from the domestic reorganisation.

Unlike Suntech, LDK Solar entered into the bankruptcy proceedings in China after the completion of the restructuring of offshore bonds. It implemented parallel schemes under the law of the Cayman Islands and Hong Kong in November 2014.[95] Subsequently, the US court recognised the Cayman Islands bankruptcy proceeding as the main bankruptcy proceeding and at the same time approved the prepackaged reorganisation plan for LDK's US subsidiary (offshore senior note guarantor) pursuant to Ch.11 of the USBC. After these steps to restructure LDK's offshore bonds, its domestic creditors applied for reorganisation in China. LDK's main domestic creditors were banks, with 12 banks holding a total of USD 27.1 billion of loans. After the creditors' meeting failed to reach the requisite majority to pass the reorganisation plan, the Intermediate People's Court in Xinyu crammed down a reorganisation plan and put an end to the

[89] M. Guonan and W. Yao, "Can the Chinese Bond Market Facilitate a Globalizing Renminbi?" (6 February 2016), p.1 available at: *http://www.bof.fi/bofit* [Accessed 5 October 2017].
[90] "Moody's: Lower Offshore Funding Costs Are Credit Positive for Chinese Property Developers" (June 2015) available at: *https://www.moodys.com/research/Moodys-Lower-offshore-funding-costs-are-credit-positive-for-Chinese--PR_339884* [Accessed 5 October 2017].
[91] EBL 2006 art.5.
[92] W. Zheng, "Strategic Choice for Cross-Border Issues in China" (2012) 1 *Modern Legal Studies* 18.
[93] K. David and W. James, "Extracting Value for Offshore Creditors Either Side of the Chinese Wall: Restructuring PRC Financing Structures" (May 2016) available at: *http://blogs.lexisnexis.co.uk/loanranger/wp-content/uploads/sites/9/2016/06/extracting-value.pdf* [Accessed 5 October 2017].
[94] A. Wang and C. Yi, "Suntech Power: Challenges Under PRC Bankruptcy" (April 2013) available at: *https://business-finance-restructuring.weil.com/international/suntech-power-challenges-under-prc-bankruptcy/* [Accessed 5 October 2017].
[95] Harneys, "Parallel Schemes of Arrangement" (May 2015) available at: *http://www.insol.org/emailer/May_2015_downloads/Document%201.pdf* [Accessed 5 October 2017].

reorganisation procedure. The domestic reorganisation procedure failed to involve offshore bondholders and in fact rendered their previous agreements void as they were left with almost nothing after domestic creditors were paid. Hence, upon the joint application of offshore creditors, the Cayman Court ordered the liquidation of LDK on 11 February 2016.[96]

Proposals for future changes

In order to resolve the problems in legislation and practice, this section will make proposals on the future reform of Chinese bankruptcy law. First, the legislation should be revised or further interpreted to ensure the fairness and impartiality of the bankruptcy procedure. For example, the effect of automatic stay and avoidance actions should be strengthened so as to achieve fair distributions among creditors. Further, specific guidance should be given as to how Chinese courts should recognise foreign bankruptcy judgments and involve foreign creditors in domestic bankruptcy proceedings. This will help to improve the situation of foreign creditors who should be treated fairly vis-à-vis domestic creditors.

Secondly, local governments should refrain from intervening in the bankruptcy procedure, respecting the decisions of the creditors' meetings and courts. The objective of the 2015 supply-side reform is to ensure that "zombie companies" exit the market in a lawful and orderly manner. As shareholders for local SOEs, local governments should prevent the misappropriation of state assets and hold management accountable. Moreover, local governments should facilitate the bankruptcy process by providing public services and co-ordinating the compensation of laid-off workers.

Thirdly, an important factor that undermines the function of Chinese bankruptcy law is the lack of judicial independence of local courts. To solve this problem, it is advisable for the country to emulate the bankruptcy courts in the US, which are federal courts established by the USBC and have exclusive jurisdiction over cases arising from the USBC.[97] China has already begun to establish bankruptcy chambers within intermediate courts, which are reported to have improved the efficiency in the adjudication of bankruptcy cases.[98]Although they differ from the centralised bankruptcy courts under the USBC, they have acquired some independence from the local governments. It is possible and desirable to establish a fully fledged national bankruptcy court system in China that would provide opportunities for judges to become specialised in bankruptcy cases, which require extensive knowledge in different areas including contract, property rights and financial law. With an increasing number of complex cases, especially cross-border ones, well-trained bankruptcy judges are essential for the future development of Chinese bankruptcy law.

Finally, it is urgent for China to establish a bankruptcy regime for financial institutions, given the rising level of bad loans in the country.[99] Following the Deposit Insurance Regulation coming into effect in 2015, a formal regime for bank bankruptcy in China should be enacted. In 2017, the CBRC announced that it is contemplating regulations for bank bankruptcy and will accelerate the pace of their implementation.[100] However, the promulgation of rules for the bankruptcy of financial institutions can be particularly challenging in China considering the political and economic realities of the country. Most importantly, as the deposit insurance only pays maximum compensation of CNY 500,000 (USD 725.74) per depositor in the event of bank bankruptcy, it is imperative to adopt further measures, such as setting up compensation funds, in order to protect depositors. In addition, with the fast development of financial conglomerates, the existing regulatory regime, consisting of different authorities for insurance, banking and securities are being challenged.[101] Increased co-ordination of regulators is essential for resolving large financial institutions efficiently and without causing systemic damage. Moreover, the growing shadow banking sector, including the Internet financing platforms, should be taken into account when drafting the rules for the bankruptcy of financial institutions.[102]

Conclusion

This article has examined the main problems of Chinese bankruptcy law, of which the most crucial one is the inappropriate intervention of local governments. Further, detailed rules for cross-border insolvency and bankruptcy of financial institutions are still missing in the picture. However, with the governmental efforts to implement the supply-side reform, initiatives to reform the bankruptcy law are well underway. In a word, despite all the challenges, it is foreseeable that Chinese bankruptcy law will make strides in the near future and assume a greater role in the Chinese society.

[96] "Ldk Solar Investors Press Release" (April 2016) available at: *http://investor.ldksolar.com/phoenix.zhtml?c=196973&p=irol-newsArticle* [Accessed 5 October 2017].
[97] E.G. Behrens, "Stern v. Marshall: the Supreme Court's Continuing Erosion of Bankruptcy Court Jurisdiction and Article I Courts" (2011) 85 Am. Bankr. L.J. 387.
[98] Xinhua News, "China to Set Up More Bankruptcy Courts" (11 August 2016) available at: *http://news.xinhuanet.com/english/2016-08/11/c_135587198.htm* [Accessed 5 October 2017].
[99] IMF, "Resolving China's Corporate Debt Problem" (October 2016) available at: *https://www.imf.org/external/pubs/ft/wp/2016/wp16203.pdf* [Accessed 5 October 2017].
[100] "Central Government Permits Banks to Go Bankrupt" (13 April 2017) available at: *http://www.sohu.com/a/133931518_715549* [Accessed 5 October 2017].
[101] G. Li, "Financial Conglomerates in China: Legality, Model and Concerns" (2008) 1 Peking U.J. Legal Stud. 255.
[102] S. Wei, "Wealth Management Products in the Context of China's Shadow Banking: Systemic Risks, Consumer Protection and Regulatory Instruments" (2015) 23 *Asia Pacific Law Review* 91.

Emergency Liquidity Assistance under the EU Legal Framework

Dr Edoardo Muratori*

Central banks; Credit institutions; Emergency powers; EU law; European Central Bank; Liquidity

Introduction

This article examines the EU's framework for emergency liquidity assistance (ELA), adopting a holistic approach which ensures consistency of reasoning and aims at offering analytical insights.

This article outlines the main characteristics of ELA, with specific focus on its nature and duration. It sets out the conditions that need to be satisfied for having access to ELA, describing in particular the temporary liquidity difficulties condition and the solvency condition. An overview of the process for obtaining ELA is provided and the respective role in this process of the European Central Bank (ECB) and national central banks (NCBs) is clarified. The interplay between the ELA framework and other sectors of the EU's legislation, such as the State aid, market abuse and transparency frameworks, is thoroughly assessed. Reference is also made to the relationship between ELA and the single monetary policy. The concept of lender of last resort and the risk of moral hazard are analysed and critical views are provided.

This article is mostly based on the EU's legal framework (including European primary and secondary legislation), acts and publications issued by the ECB (such as opinions, bulletins, procedures and reports) as well as acts issued by the European Commission (such as Communications).

This article is not intended to analyse the framework of specific Member States within the EU or to assess the financial or economic aspects of ELA.

Definition and characteristics

ELA is a facility provided in exceptional circumstances by a central bank to a solvent credit institution which is experiencing temporary liquidity difficulties.[1] The provision of ELA aims at preventing or mitigating the potential negative systemic repercussions on financial institutions and financial market infrastructures, e.g. the disruption of payment and settlement systems.[2] The provision of ELA is based on the assumption that the resources borrowed by the institution can be recovered in full by the lending central bank. ELA can be granted at the NCB's discretion to credit institutions which are unable to gather liquidity in the market or by means of monetary policy operations.[3]

ELA consists of the provision by NCBs of central bank money and/or any other assistance that may lead to an increase in central bank money. Two conditions need to be satisfied by a credit institution for it to be eligible for ELA, namely:

(1) the credit institution is solvent at the time of the provision of ELA; and
(2) the credit institution is experiencing temporary liquidity difficulties.

Assessment of solvency

Central banks are usually not responsible for assessing the solvency of credit institutions and, therefore, for the verification of the solvency condition, they need to rely on the assessment carried out by the banking supervisors (which often are independent departments within the central banks). Banking supervisors are the authorities normally responsible for the assessment of the solvency/insolvency of credit institutions.

For the purposes of the ELA operations, a credit institution is deemed to be solvent if one of the following conditions is met:

(1) Common Equity Tier 1, Tier 1 and the total capital ratios of the credit institution determined pursuant to Regulation 575/2013[4] at solo or consolidated level (depending on the case) should comply with the harmonised minimum regulatory capital requirements, namely 4.5, 6 and 8% respectively; or
(2) if the harmonised minimum regulatory capital requirements are not complied with, there is a credible prospect of recapitalisation which would restore the harmonised minimum regulatory capital requirements within 24 weeks as from the end date of the quarter whose data revealed the failure to comply with the harmonised regulatory minimum capital requirements by the credit institution. The Governing Council of the ECB can decide to extend the 24-week period in exceptional and duly justified circumstances.

* The views and opinions contained in this article are the personal views and opinions of the author and they do not necessarily reflect the position of the organisation that the author works for.
1 Opinion at the request of the Banca d'Italia on behalf of the Italian Ministry for Economic Affairs and Finance on two Decree-Laws containing urgent measures to guarantee the stability of the banking system and the continuity of the provision of credit (CON/2008/58), p.5.
2 ECB, *Monthly Bulletin* (February 2007), p.80.
3 ECB, *Monthly Bulletin* (February 2007), p.80.
4 Regulation 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation 648/2012 [2013] OJ L176/1.

Temporary liquidity difficulties

Temporary liquidity difficulties are considered as difficulties for which a solution is foreseeable in the near future. If there is no prospect of resolving the liquidity difficulties in the near future, it is arguable that such difficulties relate more to the longer-run non-viability of the institution, which ultimately would lead to its insolvency. The institution should have a clear and viable plan to remedy and correct its liquidity position and to reimburse to the relevant NCB the provided ELA. In other words, the institution must be able to demonstrate a credible prospect of redeeming the ELA operations on or before the relevant maturity.

The temporary nature of the liquidity difficulties is reflected in the short-term duration of the ELA operations (on this topic see below). The duration of the ELA will be as long as the underlying liquidity needs.

Procedural requirements[5]

The procedure for ELA operations, adopted and published by the ECB in October 2013,[6] is based on a close co-operation between the NCBs and the ECB since the NCBs are required to notify the ECB the details of any ELA operations ex ante or ex post within two business days as of the date of the relevant operation.[7] In particular, the NCBs are required to notify to the ECB of the following:

(1) the name of the institution or group recipient of the ELA;
(2) the effective date and maturity date of the ELA operation;
(3) the amount of the ELA operation;
(4) the currency of the ELA operation;
(5) the details of the collateral and guarantees (including type, value haircuts, contractual safeguards) provided in connection with the ELA operation;
(6) the interest rate of the ELA operation;
(7) the specific reasons for the ELA operation;
(8) the assessment by the banking supervisor of the liquidity position and solvency of the institution or group recipient of the ELA; and
(9) the assessment of the cross-border effects and potentially systemic implications of the situation of the institution or group recipient of the ELA.[8]

NCBs are required to inform the ECB on a daily basis if any of the features of the ELA operation has been amended.

Should the ECB deem that the information concerning the ELA operation provided by the relevant NCB is not sufficient, its Governing Council is empowered to request the NCB to provide additional information.

In the case of ELA operations involving particularly high amounts (in particular above the threshold of €500 million or of €2 billion), special procedural requirements apply. Indeed, the ECB should be informed upfront of the terms and features of the envisaged ELA operation and should assess any possible interference with the tasks and objectives of the Eurosystem.

Such binding information requirements are provided, in particular, in order to allow the ECB to perform the functions and tasks referred to in art.14(4) of the ESCB Statute[9] with regard to the provision of ELA.

Interplay between the ECB and national central banks

Since the responsibility for safeguarding the financial stability at national level lies primarily with NCBs, NCBs are also responsible for providing ELA and, as a consequence, any related risks and costs are taken and incurred by them.[10] Indeed,

> "the main guiding principle is that the competent NCB takes the decision concerning the provision of ELA to an institution operating in its jurisdiction. This would take place under the responsibility and at the cost of the NCB in question".[11]

Therefore, the legal basis for ELA operations must be found in the relevant national legal framework.

The ECB, however, performs an oversight function with regard to the ELA provided by NCBs since, according to art.14(4) of the ESCB Statute, its Governing Council may decide to restrict the ELA operations if they are considered to interfere with the objectives and tasks of the Eurosystem. Therefore, the ECB can control the provision of ELA by NCBs and shall be consulted on any legislative proposal which may affect the ECB's competences.

In any case, the provision of ELA by NCBs should not interfere with the primary objective of the Eurosystem to maintain price stability,[12] and should be compatible with

[5] See ELA Procedures of the ECB (the procedures underlying the Governing Council's role pursuant to art.14(4) of Protocol 4 on the Statute of the European System of Central Banks and of the European Central Bank [2012] OJ C326/230 (ESCB Statute) with regard to the provision of ELA to individual credit institutions).
[6] In fact, the ECB procedure for ELA operations has been in place since 1999 and has been subject to periodical review. Nevertheless, this procedure initially was not publicly disclosed, for the reasons briefly summarised below.
[7] In particular, the details of ELA operations below €500 million can be provided ex post to the ECB. However, in practice, the Governing Council of the ECB is notified ex ante also of such ELA operations. In this respect, see ECB, "The financial risk management of the Eurosystem's monetary policy operations" (July 2015), p.33.
[8] In this respect, see also ECB, "The financial risk management of the Eurosystem's monetary policy operations" (2015), p.33.
[9] See art.14(4) of Protocol 4 on the Statute of the European System of Central Banks and of the European Central Bank [2012] OJ C326/230 (ESCB Statute) to the Treaty on the Functioning of the European Union [2016] OJ C202/47 (TFEU).
[10] In this respect, see, for instance, ECB, "The financial risk management of the Eurosystem's monetary policy operations" (2015), p.33.
[11] See ECB, *Annual Report* (1999), p.98.
[12] See art.127(1) TFEU.

the principle of independence of the central banking function,[13] the prohibition on monetary financing[14] and the principle of the open market economy with free competition.[15]

Duration of ELA

Credit institutions can receive ELA for a period normally not exceeding 12 months. However, the Governor of the relevant NCB may request the Governing Council of the ECB not to object to the provision of ELA for a period exceeding 12 months.

Following the submission of a reasoned letter from the Governor of the relevant NCB to the President of the ECB, the request is subject to the non-objection procedure of the Governing Council of the ECB which may decide to impose additional requirements and conditions.

Disclosure of ELA

Transparency is regarded as one of the main objectives of the EU's regulatory framework on financial services, which ultimately aims at enhancing both the protection of investors and market confidence. Nevertheless, in certain circumstances, the disclosure requirements provided by the legal framework may jeopardise the effectiveness of the ELA operations. Indeed, the disclosure of ELA operations may cause a wider loss of confidence in the financial markets and may induce third parties to terminate and/or not enter into any new business transaction with the institution which has been granted ELA. Besides, the disclosure of ELA operations may undermine also the so-called constructive ambiguity, which is analysed below.

The most relevant pieces of the EU's legislation which need to be considered for the purposes of this analysis and which provide broad disclosure requirements are the Market Abuse Directive[16] and Market Abuse Regulation,[17] the Prospectus Regulation[18] and the Transparency Directive.[19] Nevertheless, these pieces of legislation also envisage exceptions from such disclosure requirements which are potentially applicable to ELA operations as well. In particular, as regards the Market Abuse framework, art.17(4) and (5) of the Market Abuse Regulation allow issuers to delay, on their own responsibility, disclosure to the public of inside information, including information concerning temporary liquidity problems and, in particular, the need to receive temporary liquidity assistance from a central bank or lender of last resort, for reasons related to the protection of the legitimate interests of the issuers or the preservation of the financial stability. As for the rules regarding the publication of the prospectus, art.18(1) of the Prospectus Regulation allows the omission from the prospectus of certain information (which may also include information about ELA operations) if the disclosure of such information would be contrary to the public interest or would be seriously detrimental to the issuer. As for the Transparency Directive, it is worth noting that the provision of art.11(1) allows an exception from certain notification requirements established by the directive in the case of shares provided to NCBs as collateral under a pledge or repurchase agreement or similar agreement for liquidity granted for monetary policy purposes.

Relationship with monetary policy

ELA operations should not be regarded as being part of the single monetary policy. Institutions can benefit from central banks' facilities not only by means of monetary policy operations but, exceptionally and under the conditions set out above, also by means of ELA operations. Indeed, ELA operations do not fall within the scope of the standard instruments at the Eurosystem's disposal for the implementation of the monetary policy. Besides, it is to be noted that ELA should not conflict with the Eurosystem's monetary policy, which is implemented by means of credit operations.[20]

EU State aid framework

The Commission's Banking Communication published on 30 July 2013,[21] which replaces the previous Commission's Banking Communication published on 13 October 2008,[22] provides guidance as regards the application of the rules of the EU State aid framework and art.107(3)(b) TFEU with respect to credit institutions.

In addition, the 2013 Commission's Banking Communication addresses specifically the provision of ELA. In particular, on the basis of this Communication, the provision of ELA by NCBs may constitute State aid unless: (1) the credit institution is temporarily illiquid but solvent and the provision of ELA takes place in exceptional circumstances and is not part of a larger aid package; (2) the provision of ELA is backed by collateral to which appropriate haircuts are applied; (3) penalty

[13] See, in particular, art.130 TFEU.
[14] See art.123(1) TFEU.
[15] See art.127(1) third sentence TFEU.
[16] Directive 2014/57 on criminal sanctions for market abuse [2014] OJ L173/179.
[17] Regulation 596/2014 on market abuse (Market Abuse Regulation), repealing Directive 2003/6 and Commission Directives 2003/124, 2003/125 and 2004/72 [2014] OJ L173/1 .
[18] Regulation 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, repealing Directive 2003/71 [2017] OJ L168/12.
[19] Directive 2004/109 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34, as amended [2004] OJ L390/38.
[20] In this respect, see ECB, "The financial risk management of the Eurosystem's monetary policy operations" (2015), p.33.
[21] Commission, "The application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis" (2013/C 216/01) [2013] OJ C216/1.
[22] Commission, "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis" [2008] OJ C270/8.

interest rates are applied to the provision of ELA; and (4) ELA is provided by the central bank at its own initiative and is not counter-guaranteed by the state.

If these conditions are not cumulatively satisfied, the provision of ELA should be regarded as State aid subject to the notification and authorisation procedure for State aid. In such a case, the European Commission may decide to forbid the provision of ELA by the relevant NCB or to subject it to some conditions. In the case of a lack of prior notification to the Commission, the provision of ELA shall be regarded as unlawful aid and shall be suspended. If the Commission subsequently takes a negative decision with respect to such ELA provision, a recovery injunction vis-à-vis the beneficiary may be granted.

Lender of last resort and moral hazard

In the years following the financial crisis of 2008, the lending of last resort by NCBs has significantly increased and nowadays is essential for ensuring the safety of the financial sector. NCBs, in fact, act as lenders of last resort, providing ELA to illiquid credit institutions. NCBs perform this function with the objective to pursue the general public interest and not the interest of individual credit institutions. NCBs provide liquidity support in such a way as to mitigate as much as possible the risk of moral hazard and the emergency liquidity is provided, as mentioned above, on relatively unfavourable terms. Besides, NCBs do not act as lender of last resort indiscriminately in respect of any illiquid credit institution and in any case the lending of last resort does not replace or undermine sound and prudent banking practices.

Despite the remarkable upsides in terms of systemic financial stability, the provision of ELA may also raise concerns in terms of "moral hazard" and efficient functioning of the market. Along these lines the ECB has also highlighted that ELA should not be regarded as "a primary means of supporting financial stability".[23]

The reliance on the provision of ELA by NCBs may lead the management bodies of credit institutions to be more inclined to enter into more risky transactions and to adopt a less cautious liquidity strategy.[24]

For this reason, central banks have been rather reluctant to publicly disclose the exact criteria and conditions for having access to ELA. Traditionally, central banks have preferred not to inform the industry of the conditions upon which ELA can be made available: they have deliberately chosen not to make the procedure fully transparent and to keep some room for discretion. This approach has been defined as "constructive ambiguity" since it aims at securing the upsides of ELA in terms of financial stability but at the same time preventing the downsides of "moral hazard".

In recent years, however, most of the central banks of the most advanced countries have reconsidered this approach and have decided to publicly disclose their ELA policy. Nonetheless, bearing in mind the "moral hazard" concerns, central banks have intentionally kept these policies rather general and have just set out broad guidelines and principles. Similarly, as explained above, in 2013, the ECB also decided to make public its ELA policy.

Conclusions

In light of the foregoing analysis, the following conclusions can be drawn:

- the main objective of ELA is to prevent or mitigate the potential negative systemic repercussions of temporary liquidity difficulties experienced by solvent credit institutions on other institutions and financial market infrastructures;
- since the NCBs are responsible for safeguarding the financial stability at national level, they are empowered to provide ELA following a procedure which is based on a close co-operation with the ECB and which ensures the oversight function of the ECB;
- ELA should not be regarded as part of the single monetary policy—ELA may constitute State aid which would be subject to the European Commission's notification and authorisation process; and ELA may be subject to disclosure requirements under the market abuse, prospectus and transparency framework; and
- although the ELA framework may increase the risk of moral hazard, it allows NCBs to act as lender of last resort for the purpose of ensuring the safety of the financial sector.

[23] See ECB, *Annual Report* (1999), p.98.

[24] It is worth noting that the moral hazard is in fact mitigated by the penalty interest rates applied in case of ELA and by the stigma associated with the provision of ELA. However, if the provision of ELA is not disclosed to the public (on this topic see section "Disclosure of ELA" above), this second mitigating element is not relevant.

The Rule of Ultra Vires in Company Law: Understanding English Perspectives and Legal Issues

Dr Ali Khaled Qtaishat*

Company law; Exemptions; Legal history; Ultra vires

Introduction

English company law has guided and shaped the corporate laws of most of the countries following the common law. The earliest developments in this area in the English legal system have had tremendous implications for common law jurisdictions around the world. This still holds true and the English judgments on key principles such as the rule of ultra vires have kept on having a profound impact on their application in foreign jurisdictions.

The literal meaning of the Latin term "ultra vires" is something which is "beyond the powers of". In the realm of company law, this term has various connotations depending upon the context. An act can be ultra vires the company's memorandum of association,[1] ultra vires the company's articles of association[2] or merely outside the scope of the powers of the company's officers. These distinctions are important as different consequences ensue depending upon the nature of the ultra vires act. Thus, while in the case of the last two categories of act, the company ordinarily reserves the right to ratify the ultra vires transactions. However, this is not the case with a "dealing" that is beyond the objects stated in the memorandum. Such transactions as per the traditional ultra vires doctrine are simply null and void. Therefore, the transactions which are ultra vires the memorandum will be wholly void and cannot be ratified by the company, even though all the shareholders consent or purport to ratify such transactions. In this connection, Lord Cranworth's celebrated observation is worth mentioning:

> "It must therefore be now considered as well settled doctrine that a company incorporated by Act of Parliament for a special purpose cannot devote any part of its funds to objects unauthorized by the terms of its incorporation, however desirable such an application appear to be."[3]

It is with the latter kind of transactions which are beyond the objects stated in the memorandum that this article is primarily concerned, and any reference to the terms ultra vires doctrine or rule in this article is also to be construed accordingly.

Tracing the origin of the ultra vires rule in corporate law

It was in 1855, when the Limited Liability Act was introduced in England, that, for the first time, there was a widespread need for the application of a strict rule in the interests of creditors.[4] With the introduction of limited liability, it was deemed proper that the use of the shareholders' and the creditors' funds with the company should be only for certain specified objects. The elaboration of such a rule was facilitated by the Joint Stock Companies Act 1856, which specified that a company should include an objects clause within its memorandum that would define the contractual capacity of the company.[5]

However, insofar as the 1856 Act failed to stipulate any method by which the alteration of the objects clause could be achieved, the status of the clause and its effect on contractual capacity remained unclear.[6]

Fortunately, such a vexed question did not arise clearly until after the passing of the Companies Act 1862, which expressly provided for the alteration but with the exception[7] that "no alterations shall be made by any company in the conditions contained in the memorandum of association".[8] The position in this regard was not finally settled until 1875, when the House of Lords decided the celebrated case of *Ashbury Railway Carriage*.[9] The House of Lords held that a contract that was ultra vires the company's objects was altogether void. Lord Cairns LC, after stating that the subscribers "are to state the objects for which the proposed company is to be established and then the company comes into existence for those objects and for those objects alone", and after referring to the words at the end of s.12 (re-enacted in an amended form

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1 Referred to as memorandum or MoA.

2 Referred to as articles or AoA.

3 *Eastern Counties Railway v Hawkes* 10 E.R. 928; (1855) 5 H.L. Cas. 331 PC (UK).

4 B.C. Hunt, *The Development of the Business Corporation in England, 1800–1867* (Cambridge, MA: Harvard University Press, 1936), p.75.

5 L.C.B. Gower, *Principles of Modern Company Law*, 4th edn (London: Sweet & Maxwell, 1979), p.85.

6 For example, the omission of any alteration powers in relation to the objects clause could, on the one hand, have been indicative of the legislature's desire to prohibit any alteration to a company's object clause subsequent to the company's registration. Alternatively, by failing to expressly state that the alteration of an objects clause was prohibited, the 1856 Act could have been interpreted as allowing alterations to the clause (following the consent of the company's membership), in which case any attempted restriction on corporate capacity would have been seriously weakened.

7 Reorganisation of share capital and, with consent of the board of trade, alteration of name.

8 Companies Act 1862 s.12.

9 *Ashbury Railway Carriage & Iron Co Ltd v Riche* (1874–75) L.R. 7 H.L. 653 HL. In this case, the objects of a company were to carry on the business as manufacturers of railway carriages, wagons and railway plants, fittings etc to business as mechanical engineers and general contractors, and to work in mining minerals etc. The company had entered into a contract in relation to financing the construction of a railway line in Belgium and the question was raised in the action challenging the contract.

in s.4 of the Act of 1948) to the effect that no alteration shall be made by any company in the conditions contained in its memorandum of association, proceeded as follows:

> "If that is the purpose for which the corporation is established … it is a mode of incorporation that contains in it both that which is affirmative and that which is negative. It states affirmatively the ambit and extent of vitality and power which by law are given to the corporation, and it states, if it is necessary to state, negatively, that nothing shall be done beyond that ambit, and that no attempt shall be made to use the corporate life for any other purpose than, that which is so specified."[10]

Theoretical justification of the rule of ultra vires

There are various reasons that have been suggested in justification of the rule of ultra vires. According to Palmer, the reasons for the development of the rule are:

> "(i) As a matter of constitutional law Parliament as the sovereign power in .the country does not grant more power to delegated bodies than it has authorized.
>
> (ii) As a practical consideration it was thought that the rule would protect investors in the company and creditors of it against the unauthorized use of the funds."[11]

Subsequent erosion of the ultra vires doctrine

No sooner had the ultra vires doctrine been propounded in the *Ashbury Railway Carriage* case than the reaction against it started. Both the business community and the courts became aware of the disadvantages of the ultra vires doctrine and attempts were made at reducing the rigours of the absolute doctrine. Noticeably, on the part of the court, there has always been a conscious move towards validating transactions if possible by various legal interpretations. At the same time, on the part of the company management and those dealing with the companies, there were various types of attempts at the evasion of this rule.[12]

Attempts at avoidance of the company managers broadly took the following forms:

- wide powers were introduced in the objects clause of the memorandum of association and all sorts of powers "to do all sorts of businesses" were introduced. In such cases, the memorandum hardly gave any proper indication as to what was really the main business of the company;
- in the memorandum, sometimes an "all power purpose clause" was incorporated, giving the company the power to do any type of business that the management might want to do; and
- in some memoranda, a clause was introduced that all the objects stated in the memorandum in the objects clause were to be considered as main objects of the company.

The courts therefore strove to curb this abuse in two ways. First, they applied the *ejusdem generis*[13] rule to the construction of the objects clauses saying that when the main objects specified in the first few paragraphs were followed by general words, the latter should be construed as covering their exercise only for the purposes of the main objects. This, however, was avoided by the practice of inserting into the objects clause a clause to the effect that all the specified objects were deemed to be independent and in no way ancillary or subordinate to one another. Although this was challenged in *Cotman v Brougham*[14] and was severely criticised in the judgment, it was nonetheless considered to be valid and legal.[15]

The net result was that, if the management was careful to have a wide objects clause in the memorandum of association, there was no effective protection for the shareholders to prevent the application of assets of the company to objects other than those that were originally in the minds of the investors.[16]

Mitigation of hardships by judicial decisions

In *Simpson*,[17] where the question of ultra vires arose in connection with a hotel company which had powers under the objects to carry on a hotel business in the city of Westminster and the directors had let out a part of the premises, the House of Lords held that the letting was not ultra vires, on the grounds that the letting was temporary and preliminary and conducive to the ultimate object of being devoted to the proper purpose of the hotel. In *Attorney General*,[18] the House of Lords, while affirming the principles laid down in the *Ashbury Railway Company* case qualified the rule in the said case by laying down the principle that the ultra vires doctrine was one to be reasonably and not unreasonably understood and applied, and whatever may be regarded as incidental to or

[10] *Ashbury Railway Carriage* (1874–75) L.R. 7 H.L. 653 at 670.
[11] *Palmer's Company Law*, edited by C.M. Schmitthoff and J.H. Thompson, 21st edn (London: Sweet & Maxwell, 1969), p.73.
[12] S.C. Sen, *The New Frontiers of Company Law* (Calcutta: Eastern Law House, 1971), p.106.
[13] Latin for "of the same kind", used to interpret loosely written statutes. Where a law lists specific classes of persons or things and then refers to them in general, the general statements only apply to the same kinds of persons or things specifically listed. For example, if a law refers to automobiles, trucks, tractors, motorcycles and other motor-powered vehicles, "vehicles" would not include aeroplanes since the list was of land-based transportation.
[14] *Cotman v Brougham* [1918] A.C. 514 HL. See also H.R. Gray, "Cotman v. Brougham and the Ultra Vires Rule" (1960) 23(5) *Modern Law Review* 561.
[15] Companies Act 1862 s.12.
[16] Companies Act 1862 s.12.
[17] *Simpson v Westminster Palace Hotel Co* 11 E.R. 608; (1860) 8 H.L. Cas. 712 HL.
[18] *Attorney General v Great Eastern Railway Co* (1880) 5 App. Cas. 473 HL.

consequential upon those things which the legislature had authorised, and those things which have been specified in the memorandum as objects, ought not, unless expressly prohibited, to be held by the judicial construction to be ultra vires. These two cases established what has since been known as the implied power formula.[19] A large number of decisions extended the application of the doctrine by holding that companies have various types of implied powers.[20]

The harmful effects of the ultra vires rule and the need for reform

With such liberal judicial interpretations of the objects clause and clever draftsmanship, the objects clause has failed in keeping the company confined to a limited number of activities. The rather unfortunate result thus has been that while, on one hand, the ultra vires rule has not been able to effectively protect the shareholders' property, it has, on the other, created avoidable risks for third parties transacting with the company.

In the practical working of companies, the ultra vires rule creates difficulties both for the management as well as for persons dealing with the company. For the management, their powers of doing business become subject to restrictions. The doctrine also entails additional work to be undertaken by persons and their agents in the preparation of a company's constitution prior to its incorporation. For third persons, apart from the risk of their legitimate expectations being thwarted, there is additional delay and the incurrence of expenditure in ensuring that the transaction is within the objects stated in the company's memorandum.

The critics have even gone to the extent of stating that, in the *Ashbury Railway Carriage* case, the court became obsessed with the question of the protection of the property of shareholders. There were two things that the court should have taken into consideration. One was, of course, the protection of the shareholders' property but the other was the protection of the social obligation of the company or the social safeguards of third parties in respect of dealings and transactions with the company. Shareholders, when they invest in shares of a company, ask for one protection, namely, limited liability. This limitation of further liability is the basic part of the bargain, and that is the only protection which the statute has given to them. It does not seem correct that in addition to the rights and protection of limited liability, a further protection should have been given to the shareholders at the cost of the rest of society. It appears that, in choosing between the protection of property of the shareholders and the social commitments and obligations of a person, the House of Lords failed to take adequate note of the more important consideration and permitted its obsession with the protection of individual property to carry it away and lay down the foundation of a doctrine that has since then impeded business and commerce through companies and has in any event been an illusory safeguard to shareholders.[21]

However, while considering the question of the reform of the ultra vires rule, on the above counts one has to also consider some other equally important aspects, such as the fact that the liberal interpretation of the objects clause works both ways, to increase the scope for the company's operations as well as to bring a transaction with a third party within the vires of the company. Moreover, in actual practice, the courts have even allowed relief to the third parties in many cases keeping the ends of justice in mind.[22] Exceptions to the ultra vires rule have been carved out to protect third-party claims. To elaborate, the following illustrations may be cited:

- if some property is acquired by the company on account of the ultra vires transaction and used by the company to pay its own debts, the supplier of the property on account of the principle of subrogation[23] will step into the shoes of the creditors whose claims have been paid off by the company and acquire their rights against the company[24]; and
- if the property acquired by the company on account of an ultra vires transaction exists *in specie* or if it can be traced, the person handing it over can recover it from the company.[25]

In spite of these factors, which may appear to mitigate the harshness of the ultra vires rule, the fact remains that this doctrine has often enough perpetrated injustice upon innocent third parties.

If relief to third parties has been allowed at all, then it has been only in those cases where a part of the contract has been performed. On the other hand, in the case of executory contracts,[26] there is no remedy available to the third parties for the realisation of their legitimate expectations.

Moreover, even where the contract is executed (the promise by only one party having been performed), the law relating to the grant of relief to the third party is complex and lacking in principle. The courts have dealt with situations on an ad hoc basis according to the kind

[19] See also S. Griffin, "The Rise and Fall of the Ultra Vires Rule in Corporate Law" (1992) 15 *Mountbatten Journal of Legal Studies* 127.
[20] *Ashbury Railway Carriage* (1874–75) L.R. 7 H.L. 653.
[21] *Ashbury Railway Carriage* (1874–75) L.R. 7 H.L. 653.
[22] Griffin, "The Rise and Fall of the Ultra Vires Rule in Corporate Law" (1992) 15 *Mountbatten Journal of Legal Studies* 127.
[23] The substitution of one person in the place of another with reference to a lawful claim, demand or right, so that he or she who is substituted succeeds to the rights of the other in relation to the debt or claim, and its rights. The purpose of subrogation is to compel the ultimate payment of a debt by the party who, in equity and good conscience, should pay it. This subrogation is an equitable device used to avoid injustice. See *Free Legal Dictionary*, "Ejusdem generis" available at: *http://legal-dictionary.thefreedictionary.com/Ejusdem+generis* [Accessed 5 October 2107].
[24] *Blackburn and District Benefit Building Society v Cunliffe Brooks & Co (No.2)* (1885) 29 Ch. D. 902 CA.
[25] *Sinclair v Brougham* [1914] A.C. 398 HL.
[26] Executory contracts being contracts in which none of the parties has performed his part of the contract.

of contract involved and the mere fact that one party has fulfilled his promises under an ultra vires contract does not in itself entitle him to sue the other party for non-fulfilment of his obligations.[27]

The hardship that may be caused to completely innocent people is best illustrated by *Re Jon Beauforte*.[28] There, a company formed to make ladies' dresses decided to change to the manufacture of veneered panels, an activity which could not be brought within its objects clause, however liberally construed. Unhappily, no one seemed to have realised this and the necessary steps to alter its objects were never taken. The company entered into contracts for the construction of a factory, the purchase of veneers and the purchase of coke but failed to make success of its new enterprise and went into liquidation. It was held that none of the three contractors could prove in the liquidation as the transaction was ultra vires the company's objects. Also, no relief of any other kind was allowed to the contractors under common law as the case was not covered by any of the exceptional situations. Even the supplier of coke, who argued cogently that this might well have been needed for an intra vires activity, failed because the fuel had been ordered on notepaper describing the company as "veneered panel manufacturers". This judgment, which followed an extremely doctrinaire approach, shocked the conscience of the legal community and made the pundits of company law wake up to the need for the reform of this Victorian-era doctrine.

Not surprisingly, over time, the ultra vires rule has been almost abolished in many legal jurisdictions (the US, Canada, New Zealand, Australia, Ireland and the UK among others), which reflects the growing disenchantment with this doctrine. There has been a noticeable shift in favour of third-party protection, which is in line with the modem concept of a company's social responsibility.

Reform of the rule of ultra vires in the UK

In England, the first statutory reform of the ultra vires rule was made following the recommendations of the Cohen Committee.[29] The Cohen Committee had recommended that in favour of third parties a company should have all the powers of a natural person. If this recommendation had been implemented, the ultra vires rule would have been abolished in relation to third-party dealings. However, the reform that was actually made in the passing of s.5 of the Companies Act 1948 only allowed companies to alter their objects clause by special resolution. Though the validity of a company's capacity to enter into a transaction could be secured by an alteration of the objects clause, the reform did little to protect third parties in a situation where an alteration had not been made.

In 1962, the Jenkins Committee[30] recommended the abolition of the constructive knowledge rule[31] in relation to third-party dealings. Other than where a third party had actual knowledge of the contents of a company's constitutional documents, the consequences of this proposal would have enabled a third party to enforce any transaction against the company.

However, the recommendations of both the Cohen Committee and the Jenkins Committee reports failed to attain statutory recognition. It was only with the UK's entry into the European Community that the ultra vires rule was subjected to a major reform. Directives were issued by the council of ministers of the European Community[32] for the harmonisation of the company law in the Member States.

Article 9 of the First Directive[33] on Company Law provides:

> "(i) Acts done by the organs of the company shall be binding upon it even if those acts are not within the objects of the company unless such acts exceed the powers that the Law confers or allows to be conferred on those organs. However, Member States may provide that the company shall not be bound where such acts are outside the objects of the company if it proves that the third party knew that the act was outside those objects or could not in view of the circumstances have been unaware of it; disclosure of the statutes shall not of itself be sufficient proof thereof.
>
> (ii) The limits on the powers of the organs of the company arising under the statutes or from a decision of the competent organs may never be relied on as against third parties, even if they have been disclosed.
>
> (iii) If the national law provides that authority to represent a company may, in derogation from the legal rules governing the subject, be conferred by the statutes on a single person or on several persons acting jointing, that law may provide that such a person in

[27] R.R. Pennington, *Company Law*, 3rd edn (London: Butterworth's, 1973), p.93.
[28] *Re Jon Beauforte (London) Ltd* (1953) Ch. 131; [1953] 2 W.L.R. 465; (1953) 97 S.J. 152 Ch D; noted (1953) 69 L.Q.R. 166.
[29] For full detail, see E.M. Dodd, "Review: Report of the Committee on Company Law Amendment" (1945) 58(8) *Harvard Law Review* 1258. See also *Report of the Committee on Company Law Amendment (Cohen Report 1945)* (June 1945) available at: *http://www.takeovers.gov.au/content/Resources/other_resources/Cohen_Committee.aspx* [Accessed 5 October 2017].
[30] For full detail, see "Jenkins Committee on Company Law" (1963) 89(2) *Journal of the Institute of Actuaries* 105.
[31] It implies that persons dealing with the company were presumed to be aware of the contents of the company's public documents, including the memorandum. An application of the doctrine of constructive notice meant that a trader who entered into a contract with a company which was ultra vires the company's memorandum could not seek to uphold the contract by pleading that he was unaware of the company's incapacity. The injustice which the rule was capable of producing was vividly illustrated in *Re Jon Beauforte* (1953) Ch. 131.
[32] Directive 68/151 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community [1968] OJ L65/8.
[33] Directive 68/151 [1968] OJ L65/8.

> the statutes may be relied on as against third parties on condition that it relates to the general power of representation."

Section 35(1) of the Companies Act 1985, in attempting to comply with art.9(1) of the EU Directive referred to above, provided:

> "In favour of a person dealing with a company in good faith any transaction decided on by the directors is deemed to be one within the capacity of the company to enter into and the power of the directors to bind the company is deemed to be free of any limitation under the memorandum or articles."

In purporting to comply with art.9(2) of the EU Directive, s.35(2) provided:

> "A party to a transaction so decided on is not bound to inquire as to the capacity of the company to enter into it or as to any such limitation on the powers of the directors, and is presumed to have acted in good faith unless the contrary is proved."

There were, however, certain points of inconsistency between s.35 of the Companies Act 1985 and art.9 of the EU Directive, namely:

- in the use of the words "dealings" and "transaction" as opposed to art.9's use of the term "acts", s.35 failed to include gratuitous dispositions within its remit of contractual dispositions which would fall outside the ambit of the ultra vires rule; and
- although art.9 provides that a transaction may be set aside where a third party had actual knowledge of the fact that the transaction fell outside the objects of a company (or where the third party could not have been unaware that the act was outside the objects of the company), s.35 used the term "good faith" as the yardstick measure for those transactions which were to fall outside the protection of the section. Although a third party with actual knowledge of a transaction having exceeded a company's objects clause would necessarily be deemed to have acted otherwise than in good faith, a third party may also have been considered to have acted in bad faith notwithstanding the absence of any actual notice of a company's objects clause having prohibited the transaction. Notwithstanding the abolition of the constructive notice rule, where a third party in possession of a copy of a company's memorandum blatantly refused to digest its contents, then in such a situation when the third party does not have actual notice of the ultra vires nature of the transaction but still could not have been unaware that the act was outside the objects of the company. However, the term "good faith" retained an ability to invalidate contractual acts beyond those which would be deemed invalid under art.9. For example, it could still be argued that inasmuch as the third person did not bother to look into the company's documents, such a person may be deemed not to be acting in good faith. This would just undo the effect of abolishing the doctrine of constructive notice.

Thus, as a result of s.35 of the Companies Act 1985, the ultra vires rule had been put to rest but the ghost of the rule still remained. Its potential to haunt the business community continued to be an unwelcome nuisance.[34]

Following persistent anomalies in the ultra vires rule, the demands for further reforms kept on being raised. The Government then in 1985 appointed Professor Dan Prentice to examine the legal and commercial implications of abolishing the ultra vires rule. The *Prentice Report*[35] recommended the complete abrogation of the rule by conferring a company with the capacity of a natural person, a recommendation which would have brought the UK into line with other common law jurisdictions. In addition to conferring a company with the capacity of a natural person, the report recommended that the rules relating to directors' authority should be amended to avoid the imposition of excessive restrictions upon the authority of company directors. The latter recommendation was crucial insofar as the ability of a company to impose limitations on the given authority of its directors was an indirect means by which the contractual capacity of a company could still be called into question.

Consequent upon the *Prentice Report*, the Companies Act 1989 brought about a number of changes in the Companies Act 1985. The provisions that introduced amendments relating to the ultra vires rule in corporate law are as follows:

Section 35(1) of the Companies Act 1985, which, after amendment by the 1989 Act provides that

> "the validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum".

Section 35(2) of the Companies Act 1985, which provides that

> "a member of a company may bring proceedings to restrain the doing of an act which but for subsection (1) would be beyond the company's capacity; hut

[34] Griffin, "The Rise and Fall of the Ultra Vires Rule in Corporate Law" (1992) 15 *Mountbatten Journal of Legal Studies* 127, 135.

[35] *Prentice Report* (1986) led to the Companies Act 1989. This recommended abolishing constructive notice and that actions of a company could not be called into question for lack of capacity but still no ultra vires abolition.

> no such proceedings shall lie in respect of an act done in fulfillment of a legal obligation arising from a previous act of the company".

Section 35(3) of the Companies Act 1985, which states:

> "It remains the duty of the directors to observe any limitations on their powers flowing from the company's memorandum, and action by the directors which but for subsection (1) would be beyond the company's capacity may only be ratified by the company by special resolution. A resolution ratifying such action shall not affect any liability included by the directors or any other person; relief from any such liability must be agreed to separately by special resolution."

In accordance with s.35A(5), the Companies Act 1985 lays down:

> "The board or a person authorized by the board will (subject to the ratification of the act by the general meeting) remain personally liable to the company in respect of a transaction, which was entered into outside the scope of the company's constitution."

Having stated the relevant provisions, one may now consider the cumulative effect of the 1989 Act upon the ultra vires doctrine. Clearly, s.35(1) in its amended form drastically curtails the application of the ultra vires rule. By virtue of s.35(1) of the Companies Act 1985, now, even if an act of the company is outside of the objects stated in the memorandum of association, it would not become invalid merely on this ground. Section 35(1) of the Companies Act would allow a third party to enforce even an ultra vires claim against the company.

Having discussed the amended provisions, it would not be fully correct to infer that the ultra vires doctrine has been completely abolished. Some vestiges have been retained in the form of the still existing requirement to state the objects clause within a company's memorandum.[36] Although the Companies Act 1989 did not (contrary to the recommendations of the *Prentice Report*) remove the need for a company to include an objects clause within its memorandum, it nevertheless did seek to avoid the practice of prolonged clauses, commonly used after the decision in *Cotman v Brougham*.[37] This was achieved by introducing a standard type of objects clause which now permits companies to pursue any activity within a commercial context.

In the words of Stephen Griffin, the impact of the Companies Amendment Act 1989 in relation to the ultra vires rule may be summed up as follows:

> "Undoubtedly, shareholders and creditors who could have previously relied upon a company's constitutional documents to ensure that their investments were 'only employed in the pursuit of legitimate purposes', are the theoretical victims of the legislative reforms. However, whilst theoretical victims, in practice their loss should be of little significance. The limited liability company can no longer be viewed as a suspicious invention of the business community, its standing and regulation is now well established. The protection of shareholders and creditors is amply represented elsewhere within the companies legislation. The ultra vires rule, an outdated Victorian legacy, had the ability to place unnecessary burdens on the contractual capacity of corporations. Its abrogation was both essential and long overdue."[38]

Position of ultra vires rule under Companies Act of 2006

Substantive changes have been brought about in the ultra vires rule in English company law following the enactment of the Companies Act in 2006. Section 39 of the 2006 Act provides that any acts that are undertaken by the company (that is to say, its capacity to act) will not be questioned regardless of anything in its constitution.

Section 39 of the 2006 Act does not contain provisions corresponding to s.35(2)–(3) of the 1985 Act. It is considered that the combination of the fact that under the 2006 Act a company may have unrestricted objects (and where it has restricted objects, the directors' powers are correspondingly restricted), and the fact that a specific duty of directors to abide by the company's constitution is provided for in s.171 of the 2006 Act (duty to act within powers), makes these provisions unnecessary.

It should be noted that s.39 of the 2006 Act is independent of s.31 of the 2006 Act (statement of company's objects). Section 31 states that the company's objects are unrestricted unless the restrictions are set out in the AoA. The combined effect of ss.39 and 31 of the 2006 Act means that there are no limits to the company's capacity or the objects in which it can engage. A company has complete freedom in its commercial dealings with third parties. The effect is that the "act" in which the company is engaged cannot be questioned, thereby abolishing the remnants of any external effects of the ultra vires doctrine.

However, some companies may choose to restrict the scope of their objects under s.31 of the 2006 Act. Although, under s.39 of the 2006 Act, the company's act will not be called into question even though the objects specifically limited the scope of a company's capacity as set out in the AoA or the company's constitution (the latter having a wider meaning), the internal effects of the ultra vires doctrine still remain intact. Directors will be held accountable to their shareholders for engaging in prohibited acts or objects, as directors would have exceeded the company's capacity. If directors engaged in such prohibited acts, they would be held accountable

[36] See Companies Act 1985 s.35(2)–(3).
[37] *Cotman v Brougham* [1918] A.C. 514. See also H.R. Gray, "Cotman v. Brougham and the Ultra Vires Rule" (1960) 23(5) *The Modern Law Review* 561.
[38] Griffin, "The Rise and Fall of the Ultra Vires Rule in Corporate Law" (1992) 15 *Mountbatten Journal of Legal Studies* 127, 127–128.

before the shareholders for their actions and this would constitute a breach of statutory duty of the powers vested in directors.

Concluding remarks

The doctrine of ultra vires protects the investors in company by assuring them that their money will be utilised only in those activities which are mentioned in the object clause of the MoA of the company. According to Professor Gower,[39] this ensures that an investor in a gold mining company does not find himself holding shares in a fried-fish shop. Secondly, it ensures the creditors of a company that its assets will not be dissipated in unauthorised activities.

Looking at the developmental trajectories of the ultra vires rule in England, it can be said that this rule has seen several ups and downs, notably in the common law UK. The doctrine, which was put to rest in England by the English Companies (Amendment) Act 1989, was once again resuscitated in a very veiled manner in the UK Companies Act 2006. On the face of it, the Companies Act 2006 does claim to abolish the ultra vires rule from 1 October 2009.[40] Having said this, newly formed companies are still required to have a MoA for registration purposes but it will not form part of their constitution and will not contain an objects clause. The new Companies Act now says that a company may have unrestricted objects. This means that a company is free to do business in any area they chose and can diversify away from its original business. Overall, the ultra vires rule as emanating from the English common law still exerts a profound impact on other common law jurisdictions. The rule, which suffers from several anomalies as discussed with the help of exclusive English perspectives in this article, needs suitable changes, keeping in mind the necessities of the corporate world, but at any rate such changes should not come at the price of compromising the vital interests of the shareholders, creditors and Government. To this end, a holistic approach still needs to be found for the careful avoidance of the conflicting interests of the company and those of other stakeholders.

[39] Gower, *Principles of Modern Company Law* (1979).
[40] See generally, S.Sheikh, *A Guide to the Companies Act 2006* (Cavendish: Routledge, 2006).

BOOK REVIEWS

The Framework of Corporate Insolvency Law, by Hamish Anderson, (Oxford: Oxford University Press, 2017), xli + 304pp., hardback, £125.00, ISBN: 978-0-198-80531-1.

The law of corporate insolvency represents an increasingly important legal arena. Now recognised as meriting study in its own right, its recent evolution has been rapid and tumultuous at both national and international levels.

The Framework of Corporate Insolvency Law represents an attempt to provide order and guidance in this chaotic environment. It adopts a purely English perspective to study the statutory and regulatory changes introduced since the *Report of the Review Committee on Insolvency Law and Practice* (1982), Cmnd.8558 (Cork Report), whose publication marked a watershed moment in the evolution of this area of law.

The Cork Report favoured the adoption of an efficient and effective insolvency regime capable of promoting the enterprise, growth and employment, as well as the rescue, of distressed yet viable businesses. The last 30 years have seen great strides in the development of statutory and regulatory measures. However, a cursory look at the existing law gives the impression that statutes and rules have evolved in a piecemeal fashion and that little thought has been given to the rationale of the system since the publication of this breakthrough report.

Redressing this misguided perception represents a current and timely query, given that, no later than May 2016, the Insolvency Service launched a consultation on options for reform of the Corporate Insolvency Framework.

The question yet unanswered is therefore the following: is the current statutory framework in line with the goals set by the Cork Report and recently reinstated (among others) by the World Bank, the EU and the UN Commission on International Trade Law?

This question is addressed throughout the book, which represents a remarkable attempt to provide a critical examination of modern English corporate insolvency law. Its primary purpose is to identify a rational explanation for the form that the rules and institutions of the modern law take. In the very few cases where the author fails to find such a rational explanation, he takes refuge in the analysis of the history of the considered provisions to justify the present stance of the law.

The book is divided into eight parts, which cover all the most topical subjects of insolvency law. These subjects are investigated in the book are investigated from both conceptual and functional points of view. A preliminary section on the nature and purpose of insolvency law sets the scene for the critical examination that follows, in a progression from more general to increasingly detailed subjects.

As clearly outlined in the "Introduction", the author covers the existing insolvency procedures (hence, schemes of arrangement are mentioned only incidentally for their relevance for pre-pack and administration procedures). He then focuses on the role of office holders, the concept and composition of the insolvency estate, directors' wrongdoings, prepackaged procedures and the phoenix phenomenon, as well as the process of distribution. The book terminates with some considerations on cross-border insolvency issues.

Anderson does an excellent job in eviscerating the rationale that underpins the law while making constant reference to detailed statutory provisions. This is one of the rare cases in which the reader obtains both a holistic and an analytical understanding of the covered topics. By way of example, in Ch.11 of the work, Anderson meticulously analyses the variances between the roles and powers of administrators and liquidators on one side, and those of the other office holders on the other. His detailed investigation makes sense of decades of stratified layers of rules and rulings that could otherwise appear contradictory or conflicting. He provides detailed and logical explanations for the reasons why common sense principles such as discharge from liability have been progressively restricted after the termination of the insolvency proceedings and explains why these limitations are consistent with the rationale of the protection originally afforded to the office holders.

Similar considerations apply to a disproportionate majority of topics covered in the book. Owing to space and copyright restrictions, this review will not explore this area further. Only on a few occasions does it appear that some of the matters might have deserved a more detailed analysis. In particular, the author does not question policy choices, such as the opportunity for neater differentiation between insolvency procedures, the lack of the introduction of a proper debtor-in-possession restructuring mechanism and the stratification of rules dealing with cross-border issues. These are minor shortcomings in an otherwise well written and clearly laid-out scholarly work.

This brings us to the prospective audience. In addressing the topics described above, the author adopts neither an academic nor a practice-orientated approach. Although the book is outstandingly well referenced on both the theoretical and the practical side, the author succeeds in offering a work that "is neither a textbook nor a reference book but … complementary to both" (p.ix). Academics should and could expand on some of the theoretical arguments mentioned in the substantive chapters of the book, while practitioners would benefit from a deeper and more authentic understanding of the rationale of the law. As the recent rescue/bail-outs of financial institutions throughout Europe prove, the spirit of the law is frequently being given more weight than black letter law.

This book is therefore of interest to both academics and practitioners, as well as to any persons who have a true interest in investigating the structure of the existing insolvency system and in questioning its adequacy for the new challenges of the 21st century.

The book covers the literature and case law published before 1 December 2016, with three significant departures: the amendments to the Insolvency Act 1986 made by the Small Business, Enterprise and Employment Act 2015, the Insolvency (England and Wales) Rules 2016 (SI 2016/1024) (whose provisions entered into force on 6 April 2017) and the EU Recast Regulation on Insolvency Proceedings (adopted in 2015 but due to take effect for most parts from 26 June 2017).[1]

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Derivative Actions in Chinese Company Law, by Shaowei Lin, (Alphen aan den Rijn: Kluwer Law International, 2015), 263pp., hardback, £104.00, ISBN: 978-9-041-15988-5.

This book is a welcome and timely addition to the very few texts available in the English language which specialise in derivative actions in China. It is based on the author's PhD thesis, which provides comprehensive research and an in-depth analysis of derivative actions both in theory and in practice under the Chinese law. A comparative study of the rules in the UK and US also offers a very interesting insight into how the Chinese law can be further improved, taking into account China's unique political, social, economic and legal culture.

The derivative action is one of the main remedies for shareholders, which entitles an individual shareholder to sue controlling shareholders, directors and managers on behalf of the company. As such, it is an important corporate governance tool to deter mismanagement and protect the interests of shareholders, in particular, those of minority shareholders. It is therefore essential to strike a proper balance between the need to protect shareholders' interests and the need to promote corporate efficiency.

The book consists of six chapters, which are all clearly written, logically structured, well researched and coherently presented. Chapter 1, as the introductory chapter, discusses the nature and role of derivative actions. They act as one of the market mechanisms to align the interests of shareholders and managers. They also act as one of the legal mechanisms to reduce agency costs and impose legal liabilities on the wrongdoers. The choice of other jurisdictions such as the UK and US for the comparative study is well justified. The problems and obstacles of legal transplants into China, a country with unique characteristics, are also clearly identified and carefully considered.

Chapter 2 analyses the need to enhance derivative actions in China. It explores why derivative actions are necessary and significant to reduce agency costs and protect the interests of shareholders in China. It examines the double agency costs (the vertical and horizontal) which exist in China owing to state-owned enterprise reforms and insider control. This is unusual compared with many other countries which only experience one main type of agency costs. The vertical agency costs refer to the agency problems between shareholders and managers while the horizontal refer to those between majority and minority shareholders.

This chapter undertakes an overview of the legal protection for minority shareholders' interests under the Chinese Company Law, Securities Law, Judicial Interpretations issued by the Supreme People's Court and relevant administrative regulations. In particular, it focuses on shareholders' rights under the current Company Law 2005, such as the appraisal right to request the company to purchase their shares and the right to petition the court to wind up the company.

Chapter 3, which is the heart of the whole book, explores the relationship between shareholders' direct actions and derivative actions in China. It traces the historical background and the development of derivative actions before providing detailed guidance on the procedural and substantive rules. The current rules in art.152 of the Chinese Company Law 2005 are examined in relation to the standing requirements, the scope of defendants, the cause of action and the demand rules.

More impressively, a comprehensive empirical study has been conducted based on data collected from all the cases available since the implementation of the Chinese Company Law 2005. The judicial application of derivative actions is then analysed in the following aspects: the number of cases every year, the outcome of derivative actions, whether the demand rule was satisfied, the geographical location of the cases, the types of defendant and the costs of litigation. It is truly remarkable to conduct an empirical study of 103 derivative action cases which were decided from 1 January 2006 to 30 August 2013 in China. Indeed, the "interpretations and reflections upon them provide invaluable perspectives on the Chinese system's characteristics, successes and failures".[1]

As various cases have demonstrated, the fact that "the vagueness and defects of the law lead to the chaos and unsystematic judicial practice", it is concluded that

[1] Regulation 2015/848 on insolvency proceedings [2015] OJ L141/19.
[1] Shaowei Lin, *Derivative Actions in Chinese Company Law* (Alphen aan den Rijn: Kluwer Law International, 2015), Back Cover, para.4.

"China's mechanism for derivative actions … remains insufficient to support accountability for managers and controlling shareholders".[2] As such, Ch.4 provides a comparative analysis of the law on derivative actions in the UK and the US in order to evaluate whether there is any lesson that China can learn for future reforms.

Chapter 5 examines funding issues in relation to derivative actions, which are extremely significant in practice because high litigation costs may deter shareholders from bringing such actions. It reviews the current rules on court fees and lawyer's fees under the Measures on the Payment of Litigation Costs (2006). It then evaluates the indemnity costs orders in English law and the conditional fee arrangements in the US in order to assess which model is more suitable for adoption in China. Chapter 6 concludes the book and emphasises the important role of derivative actions in corporate governance, in particular in striking a fair balance between the protection of the company and minority shareholders, and the need for corporate efficiency.

I admire the way in which this book has made an original and distinctive contribution to the existing literature. Not only does it provide a theoretical examination of the current legal scholarship in China's derivative actions but it also proposes future reforms. More significantly, it conducts a comprehensive empirical study of the cases which were decided in China from 1993–2013. The interpretations of these cases have provided a new insight into the application of derivative actions in practice.

Apart from the main text, the appendices contain extremely useful information for readers. The names of cases on derivative actions in China between 1998 and 2005, which were decided prior to the implementation of the Chinese Company Law 2005, are listed in Annex I. The more recent cases (nearly 80), which were decided between 2006 and 2013, are included in Annex II. Both lists of cases are precious sources for any future research into the judicial application of derivative actions in China.

The comprehensive and comparative nature of this book makes it stand out from the existing literature on shareholders' remedies under the Chinese law. As a much-needed book on Chinese company law, it represents a significant and unique contribution to the understanding of derivative actions, as well as to corporate governance and Chinese law in general. This book will undoubtedly be invaluable to academics and students who are interested in Chinese company law, and to practitioners who advise their clients on issues in relation to shareholders' rights and remedies, in particular on derivative actions in China.

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[2] Lin, *Derivative Actions in Chinese Company Law* (2015), p.134.

News Section

Cyprus

COMPANY LAW

Transparency on environmental and social matters

Companies (Amending) No.3 Law of 2017, Law 51(I)/2017—disclosure of non-financial and diversity information by large companies and groups—items for report and manner of publication—incorporation of Provisions of Directive 2014/95 amending Accounting Directive 2013/34

Corporate social responsibility; Cyprus; EU law; Reporting requirements

The Companies (Amending) No.3 Law of 2017, Law 51(I)/2017, amends the Companies Law to incorporate the provisions of Directive 2014/95,[1] which amends the Accounting Directive 2013/34[2] and sets out rules for disclosure of non-financial and diversity information by large companies and groups.

The aim of the Law, like the directive it transposes, is to improve companies' transparency on environmental and social matters, in order to encourage them to better manage the related opportunities and non-financial risks. The Law will also enable investors to make more informed decisions by ensuring that companies are operating on an equal footing and presenting non-financial information in order to provide a comprehensive understanding of a company's performance and the impact of its activities.

The new Law applies only to public interest entities (listed companies, credit institutions and insurance undertakings) with an average number of employees exceeding 500 and which also have a total balance sheet of more than €20 million or a net turnover of more than €40 million, or both. It does not affect other companies.

For the financial year 2017 and subsequent years, companies falling within the scope of the law must compile annual non-financial reports (consolidated in the case of a group) explaining how they address environmental protection, social responsibility and the treatment of employees, human rights, anti-corruption and bribery and board diversity in terms of age, gender and educational and professional backgrounds. The reports must include a brief description of the company's business model, a description of its policy in relation to each issue, including monitoring procedures, and the outcome of the policies. The report on human rights, anti-corruption and bribery issues must set out the main risk areas in connection with the company's operations, business relationships, products or services which are likely to cause adverse impacts in those areas, and explain how the risks are managed. A company that does not have policies or procedures in any of the specified areas must provide an explanation for not doing so.

The new non-financial reports form part of the annual reporting requirements of the companies concerned. They are to be included in the company's management report and the company's external auditor is required to confirm that they are complete and consistent with the financial statements. They must also be published on the company's website within six months of the end of the financial year.

Elias Neocleous
Andreas Neocleous & Co LLC

[1] Directive 2014/95 amending Directive 2013/34 as regards disclosure of non-financial and diversity information by certain large undertakings and groups [2014] OJ L330/1.
[2] Directive 2013/34 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43 and repealing Directives 78/660 and 83/349 [2013] OJ L182/19.

NEWS

Czech Republic

INSOLVENCY

Legislative reforms

Act No.64/2017 Coll., amending the Insolvency Act No.182/2006 Coll.—new test of insolvency—insolvency submission procedures—disqualification of group creditors from voting in insolvency proceedings—debt relief procedures—role and jurisdiction of insolvency courts

☞ Allocation of jurisdiction; Corporate insolvency; Creditors' petitions; Cross-border insolvency; Czech Republic; Groups of companies; Voting rights

Act No.64/2017 Coll., amending the Insolvency Act No.182/2006 Coll., as amended, was published in the *Collection of Laws* on 3 March 2017 and took effect on 1 July 2017. It introduces a new test of insolvency, introduces more rigorous procedures for submitting insolvency petitions, disqualifies group creditors from voting in insolvency proceedings, amends the debt relief procedure and clarifies the jurisdiction of insolvency courts.

New insolvency test

The amending law introduces a new s.3(3) into the Insolvency Act providing that a business which maintains proper accounting records is deemed to be solvent as long as its due liabilities do not exceed 110% of its liquid funds. Consequently, if the "liquidity gap", i.e. the deficiency of liquid funds, is less than 10% of the due liabilities, any insolvency petition will be dismissed. In order to utilise this defence against an insolvency petition, the debtor must submit a liquidity report prepared by a registered auditor, insolvency consultant or equivalent to the insolvency court within 14 days from the commencement of the insolvency proceedings.

More stringent rules regarding unsubstantiated insolvency petitions

Before the amendments took effect, all insolvency petitions were published in the publicly accessible insolvency register as soon as they were presented, with an immediate, potentially catastrophic effect on the company's credit, even if the petition subsequently proved to be baseless. In order to discourage abuse of the process, several changes have been made to the procedures for filing petitions. First, the petition must be accompanied by payment in advance of court fees. For a petition against an individual the advance payment is CZK 10,000 (approximately USD 450); for a petition against a legal person it is CZK 50,000 (approximately USD 2,250). In addition, a petition against a legal person must now be substantiated by the debtor's acknowledgment of the debt signed by an authorised signatory, or confirmation of the claim by a registered auditor or tax or accounting expert.

Furthermore, where there are "good grounds to doubt the legitimacy" of an insolvency petition, the court is now required to undertake a preliminary review before allowing the petition to be published. If the court finds the petition to be unsubstantiated, it may impose a penalty of up to CZK 500,000 (approximately USD 22,500) and the petitioner will be prohibited from filing a new petition against the debtor for six months.

Disqualification of group creditors from voting in insolvency proceedings

The Insolvency Act originally prohibited creditors that were members of the same group of companies as the debtor from voting at meetings of creditors, but an amendment in 2014 removed this prohibition, allowing group creditors to vote, except in matters concerning them. The new amendment reverses the 2014 amendment and reintroduces a complete prohibition of voting rights for group creditors. The amendment does not affect group creditors' rights to dividends in the insolvency.

Clarification regarding the jurisdiction of insolvency courts

The amendments provide that the Czech insolvency court is to decide on which court has jurisdiction over a matter with an international element, in line with EU Regulation 2015/848,[1] which governs proper international jurisdiction in insolvency matters. For domestic insolvencies, in order to prevent "forum shopping" by moving the company's seat, the venue is now determined by the seat of the debtor according to the Commercial Register six months before the insolvency petition was filed.

Changes to the debt relief procedure

Section 389 of the Insolvency Act introduced a debt relief procedure for natural or legal persons whose debt does not arise from business activities. This has been widely used, accounting for almost two-thirds of insolvency proceedings in recent years. In order to improve standards and prevent unscrupulous commercial debt-relief companies from exploiting inadequately informed debtors, the amending law introduces a new s.390a to the Insolvency Act, restricting the eligibility to file a petition for a debt relief permit on behalf of a debtor to registered lawyers and other licensed individuals. The fee for such services is capped at CZK 4,000 (approximately USD 180) for an individual and CZK 6,000 (approximately USD 270) for joint petitions by spouses. The unlicensed provision of debt permit services is punishable by a fine of up to CZK 500,000 (approximately USD 22,500).

In addition, the role of the courts in debt relief proceedings is reduced, with a correspondingly increased role for insolvency practitioners, and the provisions regarding creditors' meetings have changed, with decisions now requiring the approval of a majority of creditors having an absolute majority of submitted claims.

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Ukraine

COMPANY LAW

Law on Amending Certain Legislative Acts on the Use of Seals by Legal Entities and Individual Entrepreneurs 1982-VIII

Public submission of documents and private commercial transactions—abolition measures and non-mandatory use of company seals

Attestation; Companies; Documents; Seals; Signatures; Ukraine

The Law of Ukraine on Amending Certain Legislative Acts of Ukraine on the Use of Seals by Legal Entities and Individual Entrepreneurs 1982-VIII was published in the Official Bulletin of Ukraine on 19 April 2017 and entered into force on 19 July 2017.

Following the entry into force of the new Law, the use of a company seal is no longer mandatory for Ukrainian entities and private entrepreneurs to validly submit documents to national and local government bodies. Signature by a person authorised to sign by a legal entity, or signature by an individual sole trader, are now adequate attestation. Public authorities and national or local government bodies have no right to require notarisation of a signature on copies of documents in order to accept them unless there is a specific legal requirement for the document concerned to be certified in that way. A fine of between UAH 850 and UAH 1,700 (approximately USD 33–66) may be imposed on national or local government officials who breach the law.

The new Law also amends the rules applicable to documents used in private business transactions by adding a provision to the Commercial Code of Ukraine that explicitly prohibits parties to an agreement from requiring the use of a seal. In addition, the requirement for a power of attorney for a representative office to be attested by a seal, if the legal entity or sole trader has one, no longer applies.

[1] Regulation 2015/848 on insolvency proceedings [2015] OJ L141/19.

The explanatory note published with the draft law before it was enacted explained that, although the process of transition from mandatory to voluntary use of corporate seals for business entities had begun some years ago, there was still considerable uncertainty and confusion. The requirement for the use of a seal had not been replaced in all laws and, in some cases, use of the corporate seal was compulsory if the company had one, and not discretionary. Following the entry into force of the new Law, a business entity may use a corporate seal if it wishes but it is not required to do so.

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Cumulative Tables

Contributions

Editorial

Editorial (Professor Mark Williams and Dr Angus Young) . . . 311

Articles

A Recommendation to Improve the Opt-out Mechanism in EU Regulation on Insolvency Proceedings Recast (Daoning Zhang) . . . 167
An Overview of Corporate Governance Practices in Iran: A Quantitative Survey of Listed Companies in the Tehran Stock Exchange (Ghorban B. Adabi, Seyed Rouhollah Hosseini Moghaddam, Ali Fouladi and Navajyoti Samanta) . . . 33
Comparative Corporate Governance: Germany, Japan and Pakistan in Context—The Beginning or the End of Corporate Law History? (Dr Khurram Parvez Raja) . . . 291
Competition Law Infringements and Directors' Personal Accountability: Making the Punishment Fit the Crime (Professor Mark Williams and Dr Angus Young) . . . 346
Corporate Enterprise Principles and UK Regulation of Modern Slavery in Supply Chains (Adaeze Okoye) . . . 196
Corporate Governance and Sustainability of Family Businesses in the UAE (Waleed Saeed Al Awadhi and Dr Harold Koster) . . . 424
Corporate Insolvency Reform in Emerging Africa: The Need, Challenges and Prospects (Damilola Odetola) . . . 362
Cross-border Conversion and Swedish Company Law (Carl Svernlöv) . . . 49
Derivative Actions in Nigeria: A Case for Reform (Oludara Awolalu) . . . 13
Double Liability of Banks: Case Study of Ukraine (Andrii Zharikov) . . . 400
Emergency Liquidity Assistance under the EU Legal Framework (Dr Edoardo Muratori) . . . 453
Employees' Rights in Business Rescue: Confrontation or Synergy? (Matthijs Van Schadewijk) . . . 65
Enter Brexit: What is the Impact on the Financial Services Industry? (Pierre E. Berger and Olivier Van den broeke) . . . 209
Establishing a New Competition Regime in Hong Kong (Rose Webb) . . . 313
"Fair and Equitable Treatment" in International Investment Law: Interpreting the Standard of Protection (Elke Hellinx) . . . 413
Future Developments of the ASEAN Competition Regime (Dr Wan Khatina Nawawi) . . . 329
Independence, Accountability and Transparency: Are the Conventional Accountability Mechanisms Suitable for the European Systemic Risk Board? (Anat Keller) . . . 176
Institutional Investors and the Stewardship Code: An Analysis of Why Institutional Investors do not Monitor or Engage (James Noguera) . . . 107
Leveraged Buy-outs in Portugal (João Guilherme Gil Figueira and Maria Antónia Cameira) . . . 149
Major Events and Policy Issues in EU Competition Law 2015–2016: Part 1 (John Ratliff) . . . 75
Major Events and Policy Issues in EU Competition Law 2015–2016: Part 2 (John Ratliff) . . . 119
Merger Control in China from a Comparative Law Perspective (Professor Fang Xiaomin) . . . 321
Mora' the Same: Reflecting on the Latest Attempts to Salvage Company Rescue (Chris Umfreville) . . . 385
OW Bunker: A Common Law Perspective on Multilateral Co-operation in Insolvency-related Cases (Eugenio Vaccari) . . . 245
Part-payment of Debt: A Variation on a Theme? (Daniel M. Collins) . . . 253
Pre-insolvency Proceedings: The Effect of the New EU Proposal on Germany's Insolvency Landscape (Dr Heike Luecke) . . . 377
Real Seat Theory v Incorporation Theory: The Belgian Case for Reform (Marc Van de Looverbosch) . . . 1
Reconciling the Obligations to Divulge Information to Financial Institutions and the Duty of Secrecy—Challenges and Dilemmas Facing Financial Institutions: Part 1 (Dr Charles Y.C. Chew) . . . 259
Reconciling the Obligations to Divulge Information to Financial Institutions and the Duty of Secrecy—Legislative Responses and Comparative Perspectives: Part 2 (Dr Charles Y.C. Chew) . . . 283
Re-examining the Basis of Derivative Action in Nigeria: The Need for Reform (Moses P. Richard) . . . 54
Reincarnating Malaysian Airline: Labour Rights from a Malaysian Perspective (Mohammad Rizal Salim) . . . 8
Rights to Consume Bunkers Before Payment: Neither as a Bailee nor as an Owner (Felix W.H. Chan) . . . 104
SME Growth Markets in 2018: Will MiFID II/MiFIR Drive Greater Choice of Capital Markets Based Financing Options for SMEs? (Michael Huertas and Katharina Ariane Beyersdorfer) . . . 407
The Common Law Powers Solving Cross-border Insolvency: New Developments in Hong Kong and Singapore (Bingdao Wang) . . . 395
The Dawn of the Digital Currency Era: A Global Analysis of Bitcoin and Its Implications in India (Samraat Basu and Sayan Basak) . . . 22
The EU Incremental Approach to Cross-border Insolvency Regulation: A Critical Analysis (Emilie Ghio) . . . 369
The Fallacy of Property Rights' Rhetoric in the Company Law Context: From Shareholder Exclusivity to the Erosion of Shareholders' Rights (Marios Koutsias) . . . 217
The Irresponsible Director (Nicholas Grier) . . . 355
The Pakistani Legal Regime on Stay of Court Proceedings in Favour of Arbitration (Ikram Ullah) . . . 234
The Prohibition of Single-Firm Market Abuses: US Monopolisation versus EU Abuse of Dominance (Professor Francisco Marcos) . . . 338
The Receipt Function of the Bill of Lading: New Challenges (Dr Melis Özdel) . . . 435
The Rule of Ultra Vires in Company Law: Understanding English Perspectives and Legal Issues (Dr Ali Khaled Qtaishat) . . . 457
The Termination of Property Rights in the Event of Bankruptcy Proceedings: A Belgian Law Perspective (Sander Baeyens) . . . 359
Towards a Better Future for Chinese Bankruptcy Law: Problems and Potential (Liu Mingkang and Chuyi Wei) . . . 443
Two New Specialist Market Segments Take Root in the Eurozone: Is This CMU Being Championed by the Private Sector? (Michael Huertas and Kai Schaffelhuber) . . . 155
Venture Capital and Corporate Governance: An Institutional Analysis in the Context of China (Dr Lin Zhang) . . . 271

Case Note

Re Yung Kee Holdings Ltd (Dr Raymond Siu Yeung Chan, Eliza Xue and Dr Angus Young) . . . 265

Book Reviews

Carver on Bills of Lading (4th edn) by Sir Guenter H. Treitel and Francis M.B. Reynolds QC (eds) *and* Carver on Charterparties by Professor Howard Bennett (ed.) (reviewed by Charles Debattista). 431
Commentary on the European Insolvency Regulation by Reinhard Bork and Kristin van Zwieten (eds) (reviewed by Paul J. Omar). 206
Construction All Risks Insurance (2nd edn) by Paul Reed QC (reviewed by Dr Kyriaki Noussia). 432
Corporate Social Responsibility, Private Law and Global Supply Chains by Andreas Ruhmkorf (reviewed by Carlo Corcione). 72
Derivative Actions in Chinese Company Law by Shaowei Lin (reviewed by Dr Fang Ma). 465
European Law on Unfair Commercial Practices and Contract Law by Mateja Durovic (reviewed by Eleni Kaprou). 164
Innovation and Venture Capital Law and Policy by Stephan Barkoczy, Tamara Wilkinson, Ann L. Monotti and Mark Davison (reviewed by Michael Blakeney). 309
International Commercial Arbitration: International Conventions, Country Reports and Comparative Analysis: A Handbook by Stephan Balthasar (ed.) (reviewed by Petya Ilieva). 353
IP Issues in Corporate Transactions: A Practical Guide to the Treatment of Intellectual Property in Acquisitions and Investments by Neil Coulson (ed.) (reviewed by John Hull). 30
Limited Liability: A Legal and Economic Analysis by Stephen M. Bainbridge and M. Todd Henderson (reviewed by Professor David Milman). 243
Principles of Takeover Regulation by David Kershaw (reviewed by Georgina Tsagas). 115
The Framework of Corporate Insolvency Law by Hamish Anderson (reviewed by Eugenio Vaccari). 464
The Law and Practice of Restructuring in the UK and US (2nd edn) by Christopher Mallon, Shai Y. Waisman and Ray C. Schrock (reviewed by Eugenio Vaccari). 393
The Law of Reinsurance in England and Bermuda (4th edn) by Terry O'Neill and Jan Woloniecki (eds) (reviewed by Professor Philip Rawlings). 270

Cumulative Index

This index has been prepared using Sweet & Maxwell's Legal Taxonomy.

Abuse of dominant position
EU law
developments, 75—103
Accountability
European Systemic Risk Board
democractic legitimacy, 176—195
independence, 176—195
Advertisements
State aid
Hungary, N-59—N-63
Africa
corporate insolvency
law reform, 362—368
receivership, 362—368
Air carriers
collective agreements
Malaysia, 8—12
restructuring, 8—12
fines
cartels, N-45—N-46
EU law, N-45—N-46
Aircraft
leasing
Brazil, N-19
Airports
Brazil
concession agreements, N-27—N-28
infrastructure investment, N-27—N-28
infrastructure projects, N-70
Allocation of jurisdiction
winding-up petitions
Hong Kong, 265—269
Anti-competitive practices
EU law
developments, 75—103
motor insurance
investigations, N-28—N-29
Ireland, N-28—N-29
private enforcement
Spain, N-64—N-65
Applicable law
Belgium
freedom of establishment, 1—7
incorporation theory, 1—7
place of effective management, 1—7
real seat theory, 1—7
relocation, 1—7
Arbitration
third party funding
Hong Kong, N-46
Assets
security
Belgium, N-67—N-69
moveable assets, N-67—N-69
Australia
business to business supplies
disclosure, 283—290, N-25—N-26
codes of practice
confidential information, 283—290
misleading advertising
unconscionability, N-73—N-75
Bailiffs
judgments and orders
enforcement, N-6—N-7
Ukraine, N-6—N-7
Bankers' duties
duty of disclosure
guarantors, 259—264
Banking customers
money laundering
Cyprus, N-12
identification, N-12
Bankruptcy proceedings
proprietary rights
Belgium, 359—361
third party rights
Belgium, 359—361
vesting
Belgium, 359—361
Banks
Brazil
corporate insolvency, N-1—N-2
transfer of assets, N-1—N-2
corporate insolvency
Brazil, N-1—N-2
transfer of assets, N-1—N-2
debt
Cyprus, N-56—N-57
liabilities
Ukraine, 400—406
Ukraine
liabilities, 400—406
Belgium
applicable law
freedom of establishment, 1—7
incorporation theory, 1—7
place of effective management, 1—7
real seat theory, 1—7
relocation, 1—7

company law
reform proposals, N-33—N-35
proprietary rights
bankruptcy proceedings, 359—361
security
moveable assets, N-67—N-69
Beneficial ownership
money laundering
Sweden, N-70—N-72
Sweden
money laundering, N-70—N-72
Bills of lading
carriers' liabilities
receipt function of bills of lading, 435—442
multimodal transport documents
receipt function of bills of lading, 435—442
Brazil
aircraft
leasing, N-19
tax administration, N-19
airports
concession agreements, N-27—N-28
infrastructure investment, N-27—N-28
banks
corporate insolvency, N-1—N-2
transfer of assets, N-1—N-2
double taxation
mutual procedure agreement, N-13
exchange of contracts
E-commerce, N-44
real property
investment funds, N-11—N-12
reporting requirements
limited companies, N-53
sustainable development
reporting requirements, N-53
tax havens
listed jurisdictions, N-9—N-10
Brexit
financial services
impact on industry, 208—216
Business restructuring
collective agreements
air carriers, 8—12
cross-border insolvency
EU law, 369—376
debt restructuring
Ukraine, N-22—N-23
employee consultation
transfer of undertakings, 65—71
insolvency proceedings
Germany, 377—384
Business to business supplies
unfair contract terms
Australia, N-25—N-26
Businesses
supervision
Ukraine, N-40—N-41
Capital adequacy
Investors Compensation Scheme
Cyprus, N-14
Cartels
EU law
developments, 75—103
Centre of main interests
cross-border insolvency
Hong Kong, 395—399
China
comparative law
corporate insolvency, 443—452
corporate governance
venture capital, 271—282
corporate insolvency
comparative law, 443—452
reform of bankruptcy law, 443—452
Codes of practice
confidential information
Australia, 283—290
Collective agreements
air carriers
Malaysia, 8—12
restructuring, 8—12
business restructuring
air carriers, 8—12
Collusive tendering
dawn raids
Ireland, N-57
Commercial arbitration
stay of proceedings
Pakistan, 234—242
Comparative law
China
corporate insolvency, 443—452
competition law
abuse of dominant position, 338—345
ASEAN, 329—337
China, 321—328
Germany, 321—328
overview, 311—312
corporate governance
Germany, 291—308
Japan, 291—308
Pakistan, 291—308
derivative claims
Nigeria, 13—21, 54—64
India
payment systems, 22—29
Nigeria
derivative claims, 13—21, 54—64
Competition law
comparative law
abuse of dominant position, 338—345
ASEAN, 329—337
China, 321—328
Germany, 321—328
directors' liabilities
Australia, 346—352

penalties, 346—352
EU law
major events and policy issues, 75—103, 119—154
Hong Kong
block exemptions, 313—320
Conflict of interest
investment funds
Brazil, N-11—N-12
Consideration
debt rescheduling
part payment of a debt, 253—258
Consumer credit
late payments
Czech Republic, N-21
Conversion
freedom of establishment
Sweden, 49—53
Corporate governance
China
venture capital, 271—282
comparative law
Germany, 291—308
Japan, 291—308
Pakistan, 291—308
derivative claims
shareholders' rights, 217—233
listed companies
Iran, N-33—N-48
Corporate insolvency
Africa
law reform, 362—368
receivership, 362—368
banks
Brazil, N-1—N-2
transfer of assets, N-1—N-2
China
comparative law, 443—452
reform of bankruptcy law, 443—452
debt restructuring
moratoriums, 385—392
directors' liabilities
Canada, 355—358
good faith, 355—358
Ireland, 355—358
good faith
directors' liabilities, 355—358
voting
Czech Republic, N-80—N-81
Corporate recovery
moratoriums
assessment of law, 385—392
historical background, 385—392
Corporate social responsibility
reporting requirements
Cyprus, N-79
Sweden
tax planning, N-29—N-32
Creditors' rights
Russia
statutory interest, N-22
winding-up
Hong Kong, N-63
Cross-border insolvency
business restructuring
EU law, 369—376
centre of main interests
Hong Kong, 395—399
international cooperation
comparative law, 245—252
maritime law, 245—252
Cross-border transactions
E-commerce
China, N-53—N-56
payments
Ukraine, N-17
Customary law
investment treaty arbitration
fair and equitable treatment, 424—430
United Arab Emirates, 424—430
Cyprus
corporate social responsibility
reporting requirements, N-79
investor protection
safeguarding client funds, N-19—N-21
market abuse
whistleblowing, N-35—N-36
securities law and regulation
settlement of trades, N-44—N-45
Czech Republic
corporate insolvency
voting, N-80—N-81
late payments
consumer credit, N-21
mortgages, N-21
Dawn raids
collusive tendering
Ireland, N-57
Debt
banks
Cyprus, N-56—N-57
Debt rescheduling
consideration
part payment of a debt, 253—258
Debt restructuring
business restructuring
Ukraine, N-22—N-23
corporate insolvency
moratoriums, 385—392
Ukraine
business restructuring, N-22—N-23
Derivative claims
comparative law
Nigeria, 13—21, 54—64
Directors' liabilities
competition law
Australia, 346—352

penalties, 346—352
corporate insolvency
Canada, 355—358
good faith, 355—358
Ireland, 355—358
good faith
corporate insolvency, 355—358
Dispute resolution
pre-trial procedure
Russia, N-14—N-15
Documents
Ukraine
seals, N-81—N-82
signatures, N-81—N-82
Drones
surveillance cameras
Sweden, N-50—N-51
Duty of disclosure
bankers' duties
guarantors, 259—264
E-commerce
cross-border transactions
China, N-53—N-56
exchange of contracts
Brazil, N-44
Emergency powers
liquidity
emergency liquidity assistance, 453—456
Employee consultation
business restructuring
transfer of undertakings, 65—71
transfer of undertakings
business restructuring, 65—71
Enforcement
judgments and orders
bailiffs, N-6—N-7
EU law
abuse of dominant position
developments, 75—103
anti-competitive practices
developments, 75—103
cartels
developments, 75—103
competition law
major events and policy issues, 75—103, 119—154
cross-border insolvency
business restructuring, 369—376
groups of companies
insolvency proceedings, 167—175
opt out elections, 167—175
liquidity
emergency liquidity assistance, 453—456
mobile telephony
mergers, N-2—N-3
State aid
developments, 75—103
European Systemic Risk Board
accountability
democractic legitimacy, 176—195
independence, 176—195
Exemptions
ultra vires
legal history, 457—463
Fair and equitable treatment
investment treaty arbitration
customary law, 413—422
Financial markets
small and medium-sized enterprises
Capital Markets Union, 155—163
EU law, 407—412
Financial services
Brexit
impact on industry, 208—216
Fines
air carriers
cartels, N-45—N-46
EU law, N-45—N-46
Freedom of establishment
conversion
Sweden, 49—53
Sweden
conversion, 49—53
Germany
insolvency proceedings
business restructuring, 377—384
pre-insolvency proceedings, 377—384
relocation
transfer of registered seat, N-4—N-5
Good faith
corporate insolvency
directors' liabilities, 355—358
directors' liabilities
corporate insolvency, 355—358
Groups of companies
EU law
insolvency proceedings, 167—175
opt out elections, 167—175
insolvency proceedings
EU law, 167—175
opt out elections, 167—175
Hong Kong
arbitration
third party funding, N-46
competition law
block exemptions, 313—320
listed companies
inside information, N-47—N-48
winding-up petitions
allocation of jurisdiction, 265—269
Hungary
State aid
advertisements, N-59—N-63
India
comparative law
payment systems, 22—29
payment systems
comparative law, 22—29
virtual currencies, 22—29

VAT
new framework, N-75—N-78
Insolvency proceedings
business restructuring
Germany, 377—384
Germany
pre-insolvency proceedings, 377—384
groups of companies
EU law, 167—175
opt out elections, 167—175
International cooperation
cross-border insolvency
comparative law, 245—252
maritime law, 245—252
Investment funds
conflict of interest
Brazil, N-11—N-12
real property, N-11—N-12
real property
Brazil, N-11—N-12
conflict of interest, N-11—N-12
Investment treaty arbitration
customary law
fair and equitable treatment, 424—430
United Arab Emirates, 424—430
fair and equitable treatment
customary law, 424—430
Investor protection
Cyprus
safeguarding client funds, N-19—N-21
Investors Compensation Scheme
capital adequacy
Cyprus, N-14
Iran
listed companies
corporate governance, N-33—N-48
Ireland
anti-competitive practices
investigations, N-28—N-29
motor insurance, N-28—N-29
collusive tendering
dawn raids, N-57
merger control
Competition and Consumer Protection Commission, N-48—N-50
motor insurance
anti-competitive practices, N-28—N-29
Judgments and orders
bailiffs
enforcement, N-6—N-7
Ukraine, N-6—N-7
enforcement
bailiffs, N-6—N-7
Late payments
consumer credit
Czech Republic, N-21
Czech Republic
consumer credit, N-21
mortgages, N-21
Leasing
aircraft
Brazil, N-19
Liabilities
banks
Ukraine, 400—406
Licensing
unmanned aerial vehicles
Sweden, N-15—N-17
Limited liability companies
ownership
Brazil, N-59
Liquidity
emergency powers
emergency liquidity assistance, 453—456
EU law
emergency liquidity assistance, 453—456
Listed companies
corporate governance
Iran, N-33—N-48
inside information
Hong Kong, N-47—N-48
Iran
corporate governance, N-33—N-48
Malaysia
air carriers
collective agreements, 8—12
Market abuse
whistleblowing
Cyprus, N-35—N-36
Merger control
Ireland
Competition and Consumer Protection Commission, N-48—N-50
Mergers
mobile telephony
EU law, N-2—N-3
Misleading advertising
unconscionability
Australia, N-73—N-75
Mobile telephony
EU law
mergers, N-2—N-3
mergers
EU law, N-2—N-3
Money laundering
banking customers
Cyprus, N-12
identification, N-12
beneficial ownership
Sweden, N-70—N-72
Russia
beneficial ownership, N-5, N-39
Sweden
beneficial ownership, N-70—N-72
Moratoriums
corporate recovery
assessment of law, 385—392
historical background, 385—392

Motor insurance
anti-competitive practices
investigations, N-28—N-29
Ireland, N-28—N-29
Multimodal transport documents
bills of lading
receipt function of bills of lading, 435—442
Multinational companies
human trafficking
accountability, 196—205
slavery, 196—205
slavery
accountability, 196—205
extraterritorial crime, 196—205
human trafficking, 196—205
Nigeria
comparative law
derivative claims, 13—21, 54—64
derivative claims
comparative law, 13—21, 54—64
Ownership
limited liability companies
Brazil, N-59
Pakistan
commercial arbitration
stay of proceedings, 234—242
Payment systems
India
virtual currencies, 22—29
virtual currencies
comparative law, 22—29
India, 22—29
Payments
cross-border transactions
Ukraine, N-17
Pre-trial procedure
dispute resolution
Russia, N-14—N-15
Private enforcement
anti-competitive practices
Spain, N-64—N-65
Private landlords
trade associations
anti-competitive practices, N-37—N-39
Ireland, N-37—N-39
Proprietary rights
bankruptcy proceedings
Belgium, 359—361
Belgium
bankruptcy proceedings, 359—361
Prospectuses
securities law and regulation
Brazil, N-43
Public offers
securities law and regulation
Brazil, N-43
Real property
Brazil
investment funds, N-11—N-12
investment funds
Brazil, N-11—N-12
conflict of interest, N-11—N-12
Relocation
Germany
transfer of registered seat, N-4—N-5
Reporting requirements
corporate social responsibility
Cyprus, N-79
sustainable development
Brazil, N-53
Russia
creditors' rights
statutory interest, N-22
money laundering
beneficial ownership, N-39, N-5
Sale of goods
tax
Czech Republic, N-36—N-37
Securities law and regulation
prospectuses
Brazil, N-43
public offers
Brazil, N-43
settlement of trades
Cyprus, N-44—N-45
Security
assets
Belgium, N-67—N-69
moveable assets, N-67—N-69
Belgium
moveable assets, N-67—N-69
Slavery
multinational companies
accountability, 196—205
extraterritorial crime, 196—205
human trafficking, 196—205
Small and medium-sized enterprises
financial markets
Capital Markets Union, 155—163
EU law, 407—412
State aid
advertisements
Hungary, N-59—N-63
EU law
developments, 75—103
Stay of proceedings
commercial arbitration
Pakistan, 234—242
Supervision
businesses
Ukraine, N-40—N-41
Surveillance cameras
drones
Sweden, N-50—N-51
Sustainable development
reporting requirements
Brazil, N-53

Sweden
beneficial ownership
money laundering, N-70—N-72
corporate social responsibility
tax planning, N-29—N-32
freedom of establishment
conversion, 49—53
money laundering
beneficial ownership, N-70—N-72
Tax
sale of goods
Czech Republic, N-36—N-37
Tax havens
Brazil
listed jurisdictions, N-9—N-10
Third party rights
bankruptcy proceedings
Belgium, 359—361
Trade associations
private landlords
anti-competitive practices, N-37—N-39
Ireland, N-37—N-39
Transfer of undertakings
employee consultation
business restructuring, 65—71
Ukraine
banks
liabilities, 400—406
businesses
deregulation of business activities, N-40—N-41
debt restructuring
voluntary arrangements, N-22—N-23
documents
seals, N-81—N-82
signatures, N-81—N-82
Ultra vires
exemptions
legal history, 457—463
Unconscionability
misleading advertising
Australia, N-73—N-75
Unfair contract terms
business to business supplies
Australia, N-25—N-26
Unmanned aerial vehicles
licensing
Sweden, N-15—N-17
VAT
India
new framework, N-75—N-78
Vesting
bankruptcy proceedings
Belgium, 359—361
Virtual currencies
payment systems
comparative law, 22—29
India, 22—29
Voting
corporate insolvency
Czech Republic, N-80—N-81
Whistleblowing
market abuse
Cyprus, N-35—N-36
Winding-up
creditors' rights
Hong Kong, N-63
Winding-up petitions
allocation of jurisdiction
Hong Kong, 265—269

Value added is time gained

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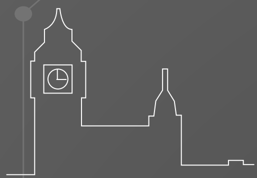

Legislation

We indicate where Bills propose to amend enacted legislation to help you prepare for change

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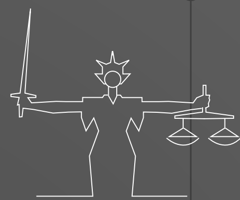
Amendments to existing legislation are made quickly so you can always see the law as it is in force right now



Cases

Our case analysis documents contain essential information about a judgment in one place

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