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Bankruptcy Filing Obligation of Directors in Distressed Enterprises

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Abstract

In practice, when a company falls into financial distress and reaches a state of de facto bankruptcy, some directors may continue business operations, leading to a continuous deterioration of the company's financial condition and an unreasonable reduction in creditors' repayment ratios. China's current legal system lacks an effective regulatory mechanism to address this issue. In contrast, Germany's mandatory bankruptcy filing system and the UK's wrongful trading regime have proven effective in safeguarding creditors' repayment rights, offering valuable insights for China to critically reference. When establishing a mandatory bankruptcy filing obligation system for directors of distressed enterprises in the future, China should clearly define directors' duty to file for bankruptcy during a company's de facto insolvency, establish a legal liability framework for violations of this obligation, grant bankruptcy administrators the right to claim damages, and permit directors to defend their actions by demonstrating compliance with the business judgment rule.

Keywords

Bankruptcy filing obligation, de facto bankruptcy, mandatory bankruptcy, business judgment rule.

1. Introduction

When a debtor company loses its ability to repay debts, it should undergo bankruptcy proceedings as stipulated in the Enterprise Bankruptcy Law to settle its liabilities. Article 7 of China's Enterprise Bankruptcy Law grants creditors, debtors, and those legally responsible for liquidation the right to initiate bankruptcy liquidation proceedings. Directors are not listed as applicants for bankruptcy, nor are they held accountable for failing to timely file for bankruptcy, which may lead to losses for creditors. This has resulted in a significant number of "zombie enterprises" in judicial practice[1]. Due to the collective repayment nature of bankruptcy proceedings, stakeholders with the right to file for bankruptcy have direct conflicts of interest in repayment. Unless absolutely necessary, creditors often make "adverse choices" and refrain from actively initiating bankruptcy proceedings, instead seeking civil preservation or enforcement measures against the company to maximize their repayment interests[2]. Furthermore, bankruptcy proceedings have a comprehensive preservation effect, freezing the company's assets and liabilities as a whole upon commencement—this includes the administrator taking over the company's assets, suspending operations, halting individual debt repayments, and ceasing asset preservation or enforcement actions. Such measures are highly unfavorable to directors, who thus lack endogenous motivation to file for bankruptcy. Therefore, when a company loses its ability to repay, if creditors or the company are reluctant to file for bankruptcy, the goal of fairly settling debts through bankruptcy proceedings will be difficult to achieve.

When a company loses its ability to repay, preventing the company from delaying bankruptcy filings—which could worsen its financial condition—and effectively maintaining its solvency

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without harming creditors' fair repayment interests naturally becomes an issue for legislators across jurisdictions. Most scholars argue that China should learn from foreign systems by establishing a director bankruptcy filing obligation, grounding this obligation in fiduciary duties, specifically the duty of diligence[3]. When a company faces financial distress, directors should owe fiduciary duties to creditors under company law, including obligations such as prudent business decision-making, avoiding preferential repayments, prohibiting asset depletion, ensuring asset adequacy, and initiating bankruptcy proceedings[4]. However, some scholars oppose introducing foreign director bankruptcy filing obligations, arguing that it could negatively incentivize entrepreneurial willingness and lead to premature bankruptcy filings[5]. This paper supports the establishment of a mandatory bankruptcy filing obligation for directors of distressed enterprises. It explores the theoretical justification for such an obligation in China, compares and draws lessons from foreign regulations, and proposes targeted recommendations for constructing a mandatory bankruptcy filing obligation system for directors of distressed enterprises in China.

2. Theoretical Justification for the Mandatory Bankruptcy Filing Obligation of Directors in Distressed Enterprises

According to traditional corporate law theory, creditors are external stakeholders, and directors represent the company in dealings with creditors, with no governance-level legal relationship between directors and external creditors, let alone any obligation to creditors. However, when a company faces financial distress, directors' obligations shift, extending from general duties to the company and shareholders to special duties to creditors, such as the bankruptcy filing obligation. This change in the structure of rights and obligations has solid theoretical justification.

First, insufficient solvency leads to a transfer of operational risk. At the level of corporate control, the stakeholders whose risk-return alignment matches the company's are the ultimate monitors, minimizing externalities arising from rational maximization behavior. These stakeholders, typically holding residual claims on the company's assets and cash flows, are referred to as residual claimants, as their wealth fluctuates with the company's value[6]. When a company operates normally, shareholders, as residual claimants, possess residual control rights over the company's assets and bear operational risks. However, once the company faces financial distress, shareholders' distribution rights over the company's assets weaken, and their residual claims effectively diminish to zero. At this point, creditors replace shareholders as the residual claimants of the company's asset value, thereby assuming the residual operational risks.

Second, the transfer of operational risk intensifies conflicts of interest. When a company nears bankruptcy, conflicts between creditors and shareholders become pronounced. Driven by self-interest, shareholders often opt for high-risk strategies to boost stock prices and profits for debt repayment and residual gains. Protected by limited liability, shareholders are not personally liable for debts beyond their investment if their decisions fail, incentivizing them to externalize risks to creditors through opportunistic behaviors such as asset dilution, claim dilution, and asset substitution.

Finally, intensified conflicts of interest prompt creditors to seek self-help remedies. To safeguard their claims, creditors prefer conservative strategies to avoid excessive corporate debt. As fixed claimants, creditors cannot share in the company's excess profits, and additional debt reduces their repayment ratios, weakening their cash flow claims and exacerbating financial distress. For directors, their careers are closely tied to the company's survival, as ongoing operations ensure their positions and income. Thus, even if the company becomes insolvent, directors lack motivation to initiate bankruptcy proceedings and are unlikely to fully

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protect creditors' interests. Ultimately, intensified conflicts of interest lead creditors to resort to self-help remedies. After a company faces financial distress, conflicts between creditors and shareholders worsen, and further losses may trigger bankruptcy. To protect their interests, creditors often rely on contracts as self-help tools, but due to information asymmetry, power imbalances, and contractual flaws, they struggle to curb shareholder opportunism. Such behaviors are often covert and evade oversight, driving up monitoring costs. Therefore, relying solely on creditor contracts is insufficient to protect creditors' rights. Instead, clarifying directors' bankruptcy filing obligations can prevent opportunistic behavior by shareholders and directors, avoid internal governance failures, and establish a more effective creditor protection mechanism.

3. Regulatory Models for the Mandatory Bankruptcy Filing Obligation of Directors in Distressed Enterprises in Foreign Jurisdictions

3.1. Direct Regulatory Model

Germany is a typical example of the direct regulatory model. Since November 1, 2008, the bankruptcy filing obligations for all limited liability entities in Germany have been consolidated in Section 15a of the new Insolvency Code (InsO), which regulates directors' bankruptcy filing obligations in four main aspects.

First, triggering conditions. Directors' bankruptcy filing obligations are triggered primarily under two conditions: illiquidity and over-indebtedness. Illiquidity refers to a company's inability to pay due debts, though minor delays in payment do not qualify. German case law generally holds that delayed payments amounting to less than 10% of total debts do not constitute illiquidity unless the shortfall is expected to exceed this threshold. If a company suspends payments, it is typically deemed illiquid, but temporary liquidity bottlenecks resolvable within three weeks do not qualify. Over-indebtedness is defined under Section 19 of the German Insolvency Code as when a company's liquidation value falls below its total liabilities, unless there is sufficient evidence that the company can continue operating for the next 12 months. This assessment requires a comprehensive evaluation of whether the company has a positive business outlook, including not only the intent to continue operations but also a feasible business and financial plan ensuring solvency for the current and next fiscal year. In exceptional cases, the assessment period may be extended[7].

Second, filing deadlines and reorganization plans. In Germany, directors of limited liability companies must strictly adhere to filing deadlines after illiquidity or over-indebtedness occurs. For illiquidity, bankruptcy must be filed within three weeks. For over-indebtedness, the filing must be made within six weeks. During these periods, directors may study the company's financial condition and prepare a reorganization plan. Under Section 270 of the German Insolvency Code, debtors may apply for self-administration of assets to facilitate reorganization upon the formal initiation of bankruptcy proceedings. This requires directors to draft a debtor-in-possession plan (i.e., a reorganization plan) within the three-week filing period, laying the groundwork for subsequent reorganization[7].

Third, obligated parties. Under German insolvency law, any managing director of a company is obligated to file for bankruptcy. If a company has multiple managing directors, each bears independent responsibility for filing. Even with internal divisions of labor, directors cannot avoid mutual oversight obligations, especially during financial distress, when each director must proactively monitor the company's financial condition[8]. Additionally, shareholders and supervisory board members also bear filing obligations if no directors are in office, provided they are aware of the company's illiquidity or over-indebtedness.

Fourth, legal liabilities. If a company is illiquid or over-indebted and its directors fail to file for bankruptcy, or fail to do so timely or correctly, they commit a criminal offense. Violations of

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bankruptcy filing obligations may result in fines or imprisonment of up to three years. Directors may also be liable for damages to the company and its creditors for breaching these obligations. Individuals convicted of such offenses within the past five years are barred from serving as managing directors of limited liability companies or stock corporations[9]. Clearly, mandatory bankruptcy filing obligations combined with liability for delayed proceedings form the cornerstone of Germany's exit responsibility framework, clarifying the extent of management's accountability during crises.

3.2. Indirect Regulatory Model

The indirect regulatory model is exemplified by the UK, where the legal theory centers on wrongful trading. Wrongful trading liability applies in specific circumstances: when a company in liquidation (with assets insufficient to repay debts) has directors who may be sued by the liquidator to contribute to the company's assets. Liability requires two conditions. The company has entered insolvency proceedings and the directors knew or should have known, before liquidation, that the company had no reasonable prospect of avoiding insolvency. However, directors may avoid liability if they can prove they took all possible steps to minimize creditors' losses after realizing insolvency was inevitable[10]. Additionally, a company's insolvency is determined by a balance sheet test, assessing whether directors should have known the company could not avoid bankruptcy. Liability is judged objectively, disregarding individual directors' knowledge or capabilities, and using only the behavior expected of a rational director as the benchmark[11].

3.3. Implications for China

Foreign regulatory models for mandatory bankruptcy filing obligations for directors of distressed enterprises offer three key insights for China. First of all, Clarify directors' bankruptcy filing obligations and liabilities. When a company faces insolvency, directors' self-interest may lead to delayed debt resolution, threatening creditors' interests. While the UK and Germany impose director liability, their approaches differ: the UK grants directors operational autonomy but prohibits wrongful trading, whereas Germany mandates bankruptcy filings within deadlines, barring continued operations. Both hold directors liable for damages to creditors if obligations are breached. China can learn from these experiences to refine directors' obligations during bankruptcy.Secondly, expand the subjective elements of director liability. As company managers, directors must act as prudent administrators during bankruptcy. If directors knowingly or negligently continue operations despite insolvency, they exacerbate asset depletion and third-party risks. Thus, China should extend liability beyond intentional misconduct to include negligent failures to recognize insolvency, strengthening accountability. Thirdly, balance obligations with defenses. German law imposes strict bankruptcy filing obligations with no defenses for delays, while UK law offers flexibility, allowing directors to justify decisions based on efforts to minimize creditor losses[12]. China's system should carefully link obligation content with defense mechanisms, balancing accountability and reasonable decision-making autonomy.

4. Constructing China's Mandatory Bankruptcy Filing Obligation System for Directors of Distressed Enterprises

4.1. Define Directors' Bankruptcy Filing Obligations During De Facto Insolvency

Establishing directors' obligations and creditor recourse mechanisms during de facto insolvency is key to recovering losses caused by directors' misconduct. In practice, many Chinese companies delay bankruptcy filings and continue operating, often due to corporate structures. Small and medium-sized enterprises (SMEs) dominate, and many directors are also shareholders. Their deep emotional and financial ties to the company may lead them to persist in operations even when recovery is impossible, ultimately shrinking assets and reducing creditor repayments. Thus, clarifying directors' bankruptcy filing obligations aligns with China's realities. Unlike the UK's wrongful trading rules, which grant directors broad discretion to continue operations if they believe recovery is possible, China's immature professional manager market and lack of societal trust in director decisions necessitate a more binding liability mechanism[13].

Setting a filing deadline is crucial. German law mandates filing within three weeks of insolvency, with no extensions permitted even for recovery efforts. Directors may delay filing if they can prove insolvency will resolve within three weeks; otherwise, they must file immediately. During this period, directors may explore restructuring or debt negotiations. For China, a 30-day deadline is more suitable. On the one hand, it allows diligent directors sufficient time to explore recovery options while preventing excessive delays. On the other hand, fixed deadlines align with China's legislative tradition, as seen in the Company Law and Enterprise Bankruptcy Law, facilitating comprehension and application.

4.2. Establish Legal Liability for Directors Who Violate Bankruptcy Filing Obligations

Many distressed companies meet bankruptcy criteria but avoid filing due to government reluctance, court inefficiencies, and low public acceptance of bankruptcy. "Zombie enterprises" far outnumber those undergoing market clearance. For listed companies, bankruptcy reorganization often becomes a tool for capital manipulation or backdoor listings, deviating from the system's original purpose of "rescuing debtors". Few listed companies undergo liquidation for legitimate business reasons, instead occupying capital market resources as "shell companies". Mandatory bankruptcy filing obligations could be a "strong remedy" for delayed filings[14]. Thus, it is necessary to regulate bankruptcy filings by imposing liability on directors for delays during de facto insolvency, enabling creditors to claim damages.

German law holds directors liable to creditors for damages. While Section 15a of the German Insolvency Code does not explicitly provide for damages, Section 42(2) of the Civil Code offers guidance. China's Civil Code lacks corresponding provisions, so merely imposing bankruptcy filing obligations without liability clauses would render the law ineffective. Therefore, China should not only define directors' obligations during de facto insolvency but also specify liability for delays, holding directors jointly liable for creditors' expanded losses to establish a complete legal basis for claims.

Another key issue is whether director obligations and liabilities should be governed by company law or bankruptcy law. Different countries adopt varying approaches. This paper argues that, given the timing of director misconduct (during de facto insolvency) and the goal of creditor protection, these rules are better placed in the Enterprise Bankruptcy Law. Article 7(1) of China's Enterprise Bankruptcy Law grants debtors the right to file for bankruptcy. If subsequent provisions assign this right to directors and impose mandatory filing obligations and liabilities, a coherent system would emerge, simplifying legal application[15].

4.3. Grant Bankruptcy Administrators the Right to Claim Damages

Countries differ in designating claimants for director liability during de facto insolvency. Germany distinguishes between old and new creditors, granting direct claims to the latter. However, this approach has drawbacks: competing lawsuits may allow early winners to monopolize compensation, leaving later claimants uncompensated. It also burdens directors, who may prioritize repaying dominant creditors to avoid liability, harming weaker parties. While Germany's distinction is informative, separating claimants lacks substantive necessity since all creditor losses stem from the same delayed filing.

China could follow the UK by assigning claims to bankruptcy administrators, who would uniformly seek compensation for unsecured creditors. However, UK administrators must advance litigation costs, which may deter claims if company assets are insufficient. China could optimize this by classifying such costs as bankruptcy expenses, payable from the company's assets as a priority, ensuring administrators' motivation and protecting creditors' collective interests.

4.4. Establish Directors' Defense—Business Judgment Rule

During de facto insolvency, directors must assess recovery prospects to decide operational strategies, leading to four scenarios. Firstly, the company may recover, and directors continue operations but file for bankruptcy if insolvency persists beyond 30 days. Secondly, the company may recover, but directors file immediately due to liability concerns. Thirdly, the company cannot recover, and directors file promptly. Lastly, the company cannot recover, but directors persist in operations. Scenarios 1 and 3 are ideal, while 2 and 4 are more common. Directors in Scenario 4 are clearly liable to creditors, but Scenario 2 is also blameworthy. Under fiduciary duty expansion theory, directors must prioritize creditor interests during insolvency, avoiding both harm to creditors and unnecessary liquidation. Fear-driven filings breach these duties, warranting liability. The business judgment rule provides a benchmark for evaluating director decisions. Its core presumption is that directors act in good faith, with adequate information, and in the company's best interests. If directors meet these criteria, they are protected even if decisions ultimately harm the company[16].

While Chinese company law does not explicitly adopt this rule, judicial practice has begun applying its principles[17]. When constructing director liability for delayed filings, China could require administrators to prove directors knew or should have known the company was irrecoverably insolvent, while allowing directors to defend their decisions under the business judgment rule. This would encourage reasonable decision-making without excessive judicial interference, balancing director and creditor interests.

5. Conclusion

Creditors are among the most important stakeholders in a company, and protecting them is a shared goal of corporate and bankruptcy law. As companies transition from solvency to distress, creditors replace shareholders as the primary risk-bearers, necessitating a shift in governance focus[18]. Establishing mandatory bankruptcy filing obligations for directors of distressed enterprises in China is both reasonable and necessary. By learning from foreign models, China can construct a localized system that clarifies directors' obligations to file within deadlines while preserving their operational autonomy. This would deter opportunistic behavior, enhance creditor protection, and promote fair debt resolution.

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