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Bankruptcy Law and the Redistribution of Distortion: A Comparative Law and Economics Analysis of Australia and China

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Abstract. Bankruptcy law often redistributes rather than fully eliminates economic inefficiency by changing the allocation of insolvency risk, and therefore reflects broader political economy choices about who should bear the costs of corporate failure. This article compares Australia's safe harbour reforms with the administrative management of zombie companies in China and contends that insolvency regimes do not resolve the tension between creditor protection and corporate rescue, but rather redistribute the costs of financial distress according to different institutional priorities. Australia's safe harbour regime shifts insolvency risk toward creditors by making it easier for directors to reduce their personal exposure and by allowing for delayed filings and speculative restructuring. China's interventionist approach, through state support and administrative forbearance, sustains zombie firms and weakens competitive discipline through capital misallocation. Bankruptcy law therefore cannot eliminate the tensions inherent in insolvency; it can only redistribute them within the constraints of political economy and institutional design.

Keywords: bankruptcy law, safe harbour, zombie firms, creditor risk allocation, law and economics.

1. Introduction

Bankruptcy law operates not as a neutral mechanism for distributing losses, but as a framework that reallocates risk and shapes managerial incentives before insolvency occurs. The COVID-19 pandemic exposed this dynamic when many jurisdictions temporarily suspended traditional insolvency duties to prevent widespread insolvencies [1, 2]. These interventions revealed a broader insight: insolvency law does not eliminate the tensions inherent in financial distress, but rather reallocates risk, discipline, and adjustment costs among different stakeholders.

As the title of this article suggests, the "redistribution of distortion" refers to various forms of economic inefficiency and governance failure that arise when firms operate near or beyond insolvency. These distortions include moral hazard, delayed insolvency filings, creditor risk externalisation, resource misallocation, and weakened market discipline, where the threat of insolvency no longer effectively constrains managerial behaviour [2-5]. The "redistribution" element refers to how bankruptcy law reallocates the costs of these distortions among directors, shareholders,

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creditors, the state, and the broader economy according to differing institutional priorities and political economy constraints.

Traditional bankruptcy scholarship has focused primarily on procedural efficiency and distributional fairness, often giving insufficient attention to how insolvency rules shape managerial incentives before formal insolvency occurs. As firms approach insolvency, shareholders and managers may face incentives to pursue excessive risk-taking because gains remain with equity holders while losses fall disproportionately on creditors [2]. Insolvency regimes respond to these incentive asymmetries in different ways.

This article compares the Australian safe harbour regime with the administrative management of zombie firms in China. The safe harbour reforms in Australia in 2017 are an example of creditor externalisation. The safe harbour protects directors from personal liability during restructuring attempts, reduces the risks associated with continued trading during financial distress, and may shift losses onto unsecured creditors [3]. The other extreme is China's interventionist way of handling insolvency, the socialisation of insolvency costs through state support and administrative intervention. Rather than relying primarily on market-based insolvency mechanisms to discipline failing firms, the Chinese government has frequently kept zombie firms alive by providing them with subsidies, allocating credit and granting administrative forbearance [5, 6].

It is important to clarify the methodological scope of this comparison. The Australian safe harbour is a specific statutory mechanism codified in s 588GA of the Corporations Act 2001 (Cth) [7], which modifies directors' personal liability for insolvent trading during restructuring attempts. Zombie firm governance in China, in contrast, is not just a single statutory rule, but a broader macro-institutional phenomenon of administrative interventions, state credit allocation and regulatory forbearance operating alongside, and often in tension with, the formal provisions of the Enterprise Bankruptcy Law 2006 [8]. Accordingly, this article compares two different institutional logics for handling corporate financial distress and allocating insolvency risk: one through private law mechanisms such as director liability and creditor rights, and another through state intervention and administrative coordination. Though different in structure, both practices are institutional responses and reflect deliberate institutional choices about who should bear the costs of corporate failure.

The two systems prioritise different governance objectives and therefore tolerate different forms of inefficiency. Australia provides for greater creditor exposure and increased restructuring risk in return for director autonomy and flexibility in corporate rescue. China allows for resource misallocation and weakened market discipline in return for employment preservation and social stability. Neither system eliminates insolvency risk; both merely redistribute it according to different institutional preferences and political economy considerations.

2. Insolvency risk and governance trade-offs

This section develops the theoretical framework for the comparative analysis, which is structured along three analytical dimensions: the question of who bears the risk of insolvency, how different risk allocations affect the behaviour of the key actors and the efficiency-stability trade-off in institutions.

2.1. Who bears the risk

Traditional insolvency law allocates risk primarily among three groups: directors through personal liability for insolvent trading, creditors through potential losses on their claims, and the state or

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broader economy through the social costs of firm failure. This allocation is never neutral; it reflects institutional choices about which stakeholders should internalize the costs of financial distress.

Insolvent trading duties seek to address moral hazard by imposing personal liability on directors who continue trading while the company is in financial distress, in order to partially reallocate insolvency risk from creditors to directors and thereby encourage earlier restructuring or insolvency filings [3]. But this distribution of risk comes with its governance trade-offs. Directors who could be personally exposed may initiate insolvency proceedings prematurely to avoid exposure, even though the company might be viable in the short term when going through a period of temporary financial difficulty [2].

When companies are heading towards insolvency, shareholders retain the potential upside gains while creditors bear much of the downside risk. The asymmetry could lead to excessive risk-taking because directors and shareholders could engage in high-risk strategies that benefit equity holders but at the expense of creditors [2]. By contrast, when the state absorbs insolvency risk through subsidies or directed lending, the costs are diffused across the financial system and the broader economy, thereby weakening managerial and creditor incentives to discipline underperformance [4].

2.2. How risk allocation changes behaviour

Different risk allocations generate systematically different incentives for key actors. Directors face stronger incentives to file promptly when they have higher personal liabilities, but they also may file too early for this reason, potentially liquidating viable firms [2]. When creditors bear greater risk, the directors have less incentive to file in a timely manner and may keep trying to restructure in an attempt to shift downside risks onto creditors while retaining potential upside gains [3]. State support also reduces the incentives of banks to monitor borrowers or enforce debt discipline [4]. If governments take on the burden of insolvency to preserve employment, the managers of the supported firm will have less reason to improve efficiency or shut down unprofitable operations [5].

Insolvency law therefore confronts an unavoidable governance dilemma. Allocating greater risk to creditors may weaken managerial discipline and encourage speculative restructuring behaviour. Greater director exposure may create stronger incentives for early filing, potentially resulting in the unnecessary liquidation of viable companies. While state absorption of insolvency risk can help stabilise the short-term situation, it can also dampen market discipline and help sustain the existence of zombie firms and capital misallocation more generally [4].

2.3. Efficiency versus stability trade-offs

The central challenge for insolvency regimes is to balance economic efficiency and social stability. Market-oriented systems with strong insolvency discipline help in the efficient reallocation of resources, but also have sharp adjustment costs in terms of job losses and transitional economic dislocation [1]. Interventionist systems that provide state support or regulatory forbearance lower immediate social costs, but sustain inefficient firms and weaken long-run productivity growth [5]. No insolvency regime can eliminate this trade-off; institutional design instead reflects varying tolerances for different forms of economic cost.

These tensions cannot be completely removed under any bankruptcy rules. Insolvency regimes instead distribute the costs of financial distress according to competing institutional priorities and varying tolerances for economic adjustment costs. Bounded rationality and varying degrees of insolvency literacy by the directors further complicate these dynamics as they may shape directors' perceptions and responses to financial distress [9].

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3. Australia: Safe harbour and creditor externalisation

The safe harbour provisions in Australia are designed to encourage companies to attempt corporate rescue by minimising the personal exposure of directors to continued trading whilst the company is in financial distress. The 2017 reforms changed the incentive structure for directors by reducing personal liability for insolvent trading if directors take action towards restructuring in line with the requirements of s 588GA of the Corporations Act 2001 (Cth) [7]. While the regime was designed to allow restructuring of businesses and to keep viable businesses alive, it also has the effect of redistributing insolvency risk between the directors, shareholders and creditors, with one of the most important effects being to dampen the personal consequences of failed restructuring efforts [3].

3.1. Moral hazard and delayed filing

It is appropriate to recognise the safe harbour's legitimate institutional purpose before looking at the costs of the safe harbour regime. The safe harbour has been designed to overcome an existing issue with Australian insolvency law: that directors facing strict personal liability for insolvent trading may file prematurely out of fear of personal exposure, even when the company may have realistic prospects of recovery [2]. By providing a statutory defence for directors who take reasonable steps toward restructuring, the safe harbour can preserve restructuring space for financially viable firms and help prevent unnecessary liquidations [3]. This reflects a deliberate policy choice to promote corporate rescue and reduce the social costs of premature firm closures. However, this arrangement necessarily involves a trade-off: by reducing directors' personal liability, the safe harbour may shift part of the downside risk of unsuccessful restructuring efforts onto unsecured creditors, whose recoveries may be diminished if restructuring ultimately fails [3].

The safe harbour may weaken insolvency discipline by reducing directors' incentives to initiate formal insolvency proceedings promptly, and by encouraging continued trading in the expectation of a recovery. The regime could lead to a situation where directors and shareholders have greater potential upside gains in the event of the restructuring being successful, but creditors bear much of the downside risk in the event of the restructuring failing, which could create incentives for excessive optimism and delayed recognition of failure [2]. Directors may therefore continue restructuring efforts even where prospects of recovery are uncertain because it will either save the company if effective or provide a defence against personal liability if unsuccessful. Again, the losses are disproportionately shifted toward unsecured creditors [3].

Systematic evaluation of the outcomes of safe harbours remains difficult because many restructuring efforts occur privately and outside formal insolvency processes, limiting assessment of creditor recoveries and restructuring success rates.

3.2. Risk-shifting and creditor externalisation

The safe harbour may also facilitate speculative restructuring behaviour as it lowers the personal costs incurred by directors for failed rescue attempts. When firms are close to insolvency, shareholders retain the potential gains from a successful restructuring while creditors absorb much of the potential loss, which incentivises the firm's directors to take high-risk restructuring actions that can maximise the value for equity holders, even if it comes at the cost of creditors [2]. The regime may result in more daring restructuring even in the face of uncertainty of recovery because the personal liability of the participants in the restructuring is reduced, and most of the costs of failure will be borne by unsecured creditors.

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Another way in which creditor externalisation takes place is through debt dilution. If the companies continue to trade within the safe harbour, then they could incur further unsecured obligations ranking equally with existing unsecured claims. If restructuring efforts ultimately fail and liquidation follows, these additional debts dilute the recovery available to unsecured creditors. For trade creditors and small suppliers, the impact can be large since they tend to lack the bargaining power to renegotiate terms of trade with their customers or adequately price heightened insolvency risk. It has also been commented that the interaction of the safe harbour protections with the director penalty notice regime in Australia may distort payment incentives. Directors might be personally liable for some of the tax debts, and the directors of a company may rationally choose to pay the Australian Tax Office rather than other unsecured creditors when a company is considering a restructuring [3].

An example of how this imbalance might play out can be seen in Virgin Australia's 2020 voluntary administration. Throughout the administration, the Federal Court granted orders relieving administrators from personal liability for a variety of company obligations incurred during the administration process, such as customer travel credit [10]. The Court recognised that, in the event of restructure or liquidation of the companies, the affected customers were not likely to get 100 per cent of their recovery. The administrators themselves said they wouldn't be able to keep providing conditional travel credits unless they were protected from personal liability. Although the case arose in the context of voluntary administration rather than the safe harbour regime itself, it illustrates a similar structural logic within corporate restructuring frameworks: responsibility protections designed to facilitate restructuring may operate alongside the externalisation of downside risk onto unsecured creditors. The case, therefore, exemplifies the structural logic of creditor externalisation within restructuring regimes: the persons in charge of restructuring operations may be insulated from significant personal exposure, while unsecured creditors may bear much of the downside risk associated with failed rescue attempts.

4. China: Zombie firms and risk socialisation

With the enactment of the Enterprise Bankruptcy Law of the People's Republic of China in 2006 [8], a formally market-oriented insolvency framework was established to ensure the orderly exit of insolvent firms and the reallocation of resources to more productive uses. The law includes both liquidation and reorganisation processes, allows for creditor participation in insolvency proceedings and formally assigns courts the authority to adjudicate insolvency cases.

In reality, however, the market exit effects of the Bankruptcy Law are systematically undermined by three institutional mechanisms: administrative intervention by local governments concerned with employment and social stability; continued lending by state-owned banks, which extend or evergreen credit to insolvent firms rather than enforcing debt discipline; and direct subsidies and regulatory forbearance, which sever the link between poor performance and market exit. Zombie firms are economically non-viable enterprises kept alive through subsidies, directed credit allocation and administrative forbearance. Their persistence demonstrates that the formal bankruptcy law framework is often displaced in practice by competing institutional priorities [5, 6]. Australia's safe harbour regime pushes insolvency risk towards creditors, while China's interventionist regime redistributes insolvency costs through state support and administrative intervention.

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4.1. State support and weakened market discipline

The market exit function of the Enterprise Bankruptcy Law (2006) [8] is compromised in three interconnected ways. Local governments, motivated by employment preservation and social stability concerns, appear to be more likely to deter or prevent bankruptcy proceedings for politically sensitive companies, effectively substituting administrative forbearance for the law's liquidation mechanisms [5]. State-owned banks extend additional credit or evergreen existing loans to insolvent firms rather than initiating insolvency proceedings, which delays the realisation of losses and perpetuates the survival of non-viable enterprises [4, 6]. Direct subsidies and regulatory relief allow insolvent firms to continue operating without the efficiency pressures that ordinary market exit would impose [5]. These mechanisms shift the costs of insolvency from the private creditors and shareholders to the public institutions and broader economy, and systematically weaken the discipline mechanism built into the Bankruptcy Law.

State assistance reduces market discipline by severing the link between poor performance and market exit. Instead of using an insolvency mechanism to exercise control over bankrupt companies, the Chinese government has provided subsidies and favourable financing to zombie companies, and even continued to extend loans to these companies by state-owned banks [6]. This is a socialisation of the risk of insolvency because the economic costs of becoming insolvent are transferred from individual creditors and shareholders to public institutions and the broader economy through public financial support and resource misallocation.

The incentive structure created by state support is the mirror image of Australia's safe harbour regime. The safe harbour reduces directors' personal liability in order to encourage restructuring, whilst the Chinese intervention decreases the threat of liquidation for state-supported firms. As a result, the incentives for the managers of zombie firms to improve efficiency, restructure or exit unprofitable activities are diminished, as losses can be covered by subsidies and loan forbearance, while existing managerial structures remain intact [4]. Indeed, such rescuing of zombie firms is shaped by broader political economy priorities, as local governments may resist liquidation where firm closures threaten employment and social stability [5].

4.2. Administrative monopoly and zombie firm persistence

Some recent empirical evidence indicates that zombie firm persistence is not merely cyclical, but institutional. Bi and Wang, analysing Chinese A-listed non-financial firms from 2014 to 2019, find that about 15% of all firms were classified as zombie firms, defined as firms whose profits remained negative for three consecutive years after excluding government and credit subsidies while continuing to receive external support [11]. The authors use the implementation of China's Fair Competition Review System (FCRS) as a quasi-natural experiment to identify administrative monopoly as an important institutional driver of zombification. Firms that received preferential subsidies, had distorted credit allocation, and local protectionism were significantly more likely to become zombie firms.

The mechanism operates through both macro- and micro-level channels. At the macro level, administrative monopoly leads to distorted subsidy allocation and credit distribution in favour of politically protected firms rather than more productive firms. On the micro side, firms insulated from competitive discipline are less inclined to innovate or improve operational efficiency [11]. The study also shows that the FCRS reduced zombie firm formation by approximately 8.5% among treated firms, mainly due to improved subsidy neutrality and credit allocation efficiency.

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More recent evidence suggests that the problem has intensified. Davis and Kelly, analysing Chinese non-financial firms between 2018 and 2024, found that the share of total assets held by zombie firms increased from 5% to 16% during this period. The deterioration appears particularly acute in the real estate and manufacturing industries [12]. The mechanism enabling this escalation is structural: China's captive domestic savings and capital controls remove the funding pressure on the state-owned banks, facilitating the "evergreening" of bad loans to insolvent firms in order to avoid recognising losses on bank balance sheets. Insolvency risk is therefore absorbed through directed credit allocation and administrative forbearance, eroding both managerial and creditor incentives to discipline underperformance while diffusing the resulting costs across the broader economy in the form of capital misallocation and reduced productivity growth.

4.3. Resource misallocation and competitive distortion

The existence of zombie firms also imposes wider economic costs by preventing the reallocation of capital and labour toward more productive uses. Continued state support sustains inefficient firms that would otherwise exit through ordinary insolvency processes, contributing to persistent resource misallocation and weaker long-run productivity growth [5]. Another issue is that zombie firms distort credit allocation by absorbing bank lending that could otherwise flow to healthier firms and more productive sectors of the economy, thereby creating a crowding-out effect in credit markets [4].

Competitive distortion is particularly significant, as zombie firms operate with state subsidies and favourable financing, enabling them to compete on artificially favourable terms. Consequently, efficient firms may face intensified competition from subsidised firms, which would not be able to survive under ordinary market conditions, reducing profitability and weakening incentives for innovation and productive investment [6]. The long-run consequence is slower productivity growth and reduced economic dynamism, reflecting a broader governance trade-off between short-term stability and long-term economic efficiency [5].

5. Comparative analysis

The Australian safe harbour regime and the Chinese zombie firm governance system both show that insolvency regimes reallocate, rather than eliminate, the economic costs of corporate failure. This section is a synthesis of the comparison on three explicit questions: who bears the risk, whose behavioural incentives are changed, and what each system ultimately sacrifices.

5.1. Risk allocation comparison

The two systems distribute insolvency risk to structurally different bearers. In Australia, the main downside risk of failed restructuring attempts lies with unsecured creditors, namely trade creditors and small suppliers. Directors and shareholders are able to benefit from the restructuring if it is successful, while creditors absorb losses if the restructuring fails. The risk is still concentrated within the private law relationship between the firm and its creditors. In China, the state and broader economy bear much of the insolvency risk. Insolvency costs are shifted from private stakeholders to public institutions and the wider economy as a result of public financial support, directed lending by state-owned banks and the opportunity costs of chronic capital misallocation. The risk is diffused rather than concentrated, but its aggregate scale is correspondingly larger.

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Such divergent mechanisms are representative of differing political economy priorities. Australia accepts increased creditor exposure as the cost of encouraging corporate rescue and director autonomy. China accepts resource misallocation and weakened competitive discipline as the cost of preserving employment and social stability. Each system reflects a different institutional tolerance for economic adjustment costs.

5.2. Whose incentives are changed

The two systems alter the behaviour of different actors in systematically different ways. The safe harbour in Australia primarily reshapes directors' incentives. Limited personal liability diminishes the incentive to make timely filings and creates stronger incentives for speculative restructuring, since directors retain upside gains while creditors absorb downside losses. Unsecured creditors bear increased exposure but have limited ability to monitor or constrain directors' restructuring decisions.

The incentive distortions in China are more widespread and systemic. Managers of zombie firms face diminished pressure to improve efficiency or exit unprofitable operations, as losses are absorbed through subsidies and forbearance. The state-owned banks lack effective incentives to monitor borrowers or to enforce debt discipline, since the banks make loans based on administrative instead of commercial risk assessments. Local governments prioritise stability over efficiency and therefore continue to support non-viable firms irrespective of economic merit.

The key structural difference lies in the locus of governance failure. The distortion in Australia is mainly at the firm level, as individual directors are encouraged to pursue speculative rescue measures at the expense of creditors. China's distortion operates at the systemic level, as multiple institutional actors simultaneously face incentives that perpetuate zombie firm survival rather than encouraging restructuring or market exit. While the distributional consequences differ, both systems weaken the disciplinary function that insolvency law is designed to serve.

5.3. What each system sacrifices

The comparison reveals that each system makes explicit trade-offs in pursuit of its institutional priorities. The safe harbour sacrifices creditor protection and timely insolvency discipline in exchange for director autonomy and restructuring flexibility. The regime also allows for higher creditor exposure, an increased risk of delayed insolvency filings and the potential for speculative restructuring behaviour, as the price of encouraging corporate rescue.

China's interventionist approach sacrifices market competition, capital allocation efficiency and long-term productivity growth in exchange for employment preservation and social stability. Persistent resource misallocation, weakened competitive discipline and reduced economic dynamism are tolerated as the cost of avoiding large-scale firm closures.

This tension has been exacerbated by the COVID-19 pandemic. Many jurisdictions opted to temporarily suspend their insolvency obligations, deliberately accepting greater creditor exposure and incentive asymmetry in exchange for employment preservation and macroeconomic stability. The crisis showed that, even in fairly market-oriented insolvency regimes, there is a trade-off between stability and efficiency when the social costs of rapid economic adjustment become sufficiently severe [2, 3].

The right balance will thus not only be related to economic efficiency, but also to broader political economy constraints and institutional capacity to absorb the costs of economic adjustment.

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5.4. Reallocation rather than elimination

The main takeaway from this comparison is that insolvency law reallocates rather than eliminates the economic tensions associated with financial distress. Australia's safe harbour regime does not eliminate risk-shifting incentives; instead, it transfers part of the downside risk of failed restructuring efforts onto creditors. China's interventionist framework does not eliminate insolvency risk, but redistributes much of that risk to public institutions and the broader economy via state support and directed credit allocation.

This perspective has important implications for insolvency reform. Often, reforms intended to address one type of inefficiency will actually intensify another inefficiency. Strengthening director liability may reduce excessive risk-taking, but it could also lead to premature insolvency filings and the liquidation of otherwise viable firms. Weakening director liability may encourage restructuring and corporate rescue, but it can also result in greater creditor exposure and speculative restructuring incentives. Expanding state support may preserve employment and social stability, but at the expense of greater capital misallocation and weaker competitive discipline. Insolvency reform therefore involves choosing which forms of economic cost and governance failure a system is willing to tolerate under particular institutional and political economy conditions.

6. Conclusion

There are two different approaches to allocating insolvency risk, as reflected in Australia's safe harbour legislation and China's zombie firm management. The unique characteristics of the Australian insolvency system mean that a higher proportion of the costs of corporate failure is externalised to unsecured creditors by reducing directors' exposure to personal liability during restructuring attempts. While the Chinese system socialises the cost of a company's failures by state-directed credit allocation and administrative support, diffusing the costs of financial distress across public institutions and the broader economy.

The comparison shows that incentive asymmetries are inevitable in insolvency systems. The central issue is therefore not whether insolvency law can eliminate governance failures altogether, but rather how insolvency risks and economic costs are distributed among stakeholders. Reducing directors' liability may encourage restructuring and corporate rescue, but can also facilitate excessive risk-taking and delayed filings. A high level of state support can help to maintain jobs and social stability, but it comes at a price: persistent poor capital allocation and weaker competitive discipline.

Analysis also shows a more general trade-off between economic efficiency and social stability. Market-oriented systems promote more efficient resource allocation but impose sharper adjustment costs, whereas interventionist systems reduce immediate social disruption while weakening long-run productivity and economic dynamism. This tension was further highlighted by the COVID-19 pandemic, which illustrated that even market-oriented insolvency systems may prioritise stability over strict insolvency discipline during periods of systemic crisis.

The contribution of this article is not to determine which system is normatively superior, but to demonstrate that bankruptcy law is an institutional mechanism for redistributing the costs of economic distortion. The basic conflicts between creditor protection and corporate rescue, or between economic efficiency and social stability, are not resolved by insolvency regimes. Instead, they allocate these tensions across stakeholders differently, depending on varying institutional priorities and political economy constraints. Understanding bankruptcy law as a mechanism of redistribution rather than resolution provides a more realistic framework for evaluating insolvency reform and for recognising the inevitable trade-offs inherent in any insolvency regime.

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