

# Legislative Model and System Construction of Personal Bankruptcy Exemption in China

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**Abstract**— With the social and economic development of the country, the imbalance of the legal relationship between the debtor and the creditor has become more and more obvious. Personal bankruptcy system was born to solve the problem of "difficult to execute", and personal bankruptcy exemption system is the core of it. Social utility theory and debt forgiveness theory as a good theoretical basis for personal bankruptcy exemption system, China's personal bankruptcy exemption system legislation should be taken to permit the exemption of the legislative model. In the construction of the specific system, detailed provisions should be made on the scope of debts to be exempted.

**Keywords**— Personal insolvency; insolvency exemptions; exemption models.

## I. INTRODUCTION

The traditional idea of "repayment of debts" has been deeply rooted in our country, and with the rapid development of economy and society, the fact that individuals do not belong to the subjects regulated by the bankruptcy law has led to an imbalance among market subjects, which makes it impossible for insolvent debtors to withdraw from the market, and creditors to be paid. The construction of personal bankruptcy exemption system can solve this problem to a greater extent, some provinces and cities have promulgated personal bankruptcy regulations and set up bankruptcy administrators' associations, laying a solid foundation for the construction of personal bankruptcy exemption system in China.

The core of the personal bankruptcy system is the personal bankruptcy exemption system, and most individuals apply for the granting of property with the purpose of being able to forgive part of their debts. As a matter of fact, China began to explore whether China should construct a personal bankruptcy exemption system as early as 2007 during the formulation and revision of the Bankruptcy Law of the People's Republic of China, which was implemented in 2007 and appeared in the legislative proposal, but was not reflected in the legislation. In 2018, Zhou Qiang, the President of the Supreme Court, proposed in the Report of the Supreme People's Court on the Work Situation of the People's Courts on the Resolution of the "Difficulty of Execution" report on the work situation of the Supreme People's Court, proposed that the construction of a personal property exemption system would be promoted, which attracted extensive attention in the academic and practical fields.<sup>1</sup> On 31 August 2020 Shenzhen promulgated the Shenzhen Special Economic Zone Personal Bankruptcy Regulations, which is a bold practice of constructing a personal bankruptcy exemption system in China.

## II. JURISPRUDENTIAL BASIS OF THE PERSONAL INSOLVENCY EXEMPTION REGIME

For a long time China's personal debt settlement disputes mainly rely on civil and commercial law to solve, coupled with the "debt repayment, natural and natural" traditional thought of confinement, the demand for personal debt relief will inevitably

be suppressed, but with China's economic and social development, personal debt can affect their own social credit, and even can bring about great Unfavourable impact, the demand for personal bankruptcy exemption system is also getting louder and louder.

### A. Debt forgiveness theory

As early as the 18th century, the United Kingdom was the first country to establish a bankruptcy exemption system, which provided that, with the consent of a majority of creditors, 5 per cent of the debt could be discharged if the debtor was able to pay part of the debt and there were no other exceptions. The personal bankruptcy exemption system can, to a certain extent, encourage the debtor to file for bankruptcy and endeavour to settle the debt under the premise of exemption. However, under this model, personal bankruptcy exemptions must be granted with the consent of creditors, which is difficult to achieve in practice, as it is not up to the debtor to decide whether or not to grant exemptions, thus affecting the debtor's willingness to file for bankruptcy.

The main causes of personal indebtedness are consumer and investment indebtedness, and in recent years there has been an increase in the number of suicides due to debt overload. There is no lack of the influence of bad consumption concepts such as overspending, but personal bankruptcy exemption has also become a hot topic of concern. Due to the depth of traditional concepts, the demand for debt forgiveness has been greatly suppressed, and yes, debtors are unable to alleviate their debts and restore social credit, and there is an urgent need for a personal bankruptcy exemption system to solve this problem.

Excessive restrictions on the debtor's freedom did not in fact benefit creditors, and the theory of debt forgiveness held that creditors should be lenient with insolvent debtors, and that the personal bankruptcy exemption system should preserve the debtor's dignity and enable the debtor to survive in society.

### B. Social utility theory

The bankruptcy of a debtor may involve third-party interests of the public, in addition to disputes over the interests of the debtor and creditors. The construction of a personal bankruptcy exemption system can enable an overburdened debtor to forgive part of his debts and restore his social credit, so that he can

continue to devote himself to his work. From the perspective of social benefits, the social value created by the debtor's reintegration into society can be greater than the value of the part of the debt forgiven.

The social utility theory suggests that the personal bankruptcy exemption system should balance the interests of creditors and debtors, with a particular focus on leveraging the social utility between them, and that the important role of the personal bankruptcy exemption system lies in incentivising entrepreneurs to be boldly creative and to produce the social value that they should. From the perspective of risk-taking, the personal bankruptcy exemption system, as a limitation on personal debt liability, can be equated to a limited liability company, with the same purpose and desire of the company law. That is, creditors have more experience of dealing with debtors and should have a greater obligation to monitor debt than other individuals, and the risk of the debtor failing to repay the debt should be borne in part by the creditor.

At the same time, social utility theory is concerned with the overall development of the debtor. Since a debtor's inability to pay its debts brings not only losses to creditors, but also wasted judicial resources due to lengthy litigation, the absence of an exemption can have a knock-on negative effect. For example, the debtor will be mired in economic crisis and negative social judgement, making it difficult for him or her to re-engage with society and realise his or her value. In addition, the debtor may lose the motivation or opportunity to create social wealth again because of the negative evaluation by society, which will not bring more satisfaction to creditors, and also increase the destabilising factors, such as endangering the society, for the desperate debtor.

### III. DIFFICULTIES IN ESTABLISHING A PERSONAL BANKRUPTCY EXEMPTION REGIME

#### A. *Difficulties with other laws*

After the enactment of the Civil Code, other laws must be interpreted and amended on the basis of the Civil Code, and the legislation on the personal bankruptcy exemption system is no exception. However, the Civil Code does not provide for the right of natural persons to be exempted from liability in bankruptcy, thus making it impossible for the absence of civil rights in bankruptcy of natural persons to have the effect provided for by law, and resulting in the legal effect of the exemption of natural persons from liability in bankruptcy not being reflected in the Civil Code.

The Reform Programme on Accelerating and Improving the Exit System of Market Entities, jointly issued by the National Development and Reform Commission and other departments in June 2019, refers to the construction of a personal bankruptcy system, focusing on solving the problem of natural persons' joint and several secured debts arising from the bankruptcy of enterprises.<sup>3</sup> However, this conception of a personal bankruptcy system is not perfect, confuses the concepts of indebtedness and bankruptcy, and is not conducive to the construction of a personal bankruptcy exemption system.<sup>2</sup> At the same time, the scope of personal bankruptcy in this proposal is too small, limited only to natural persons who provide guarantees for bankrupt enterprises, ignoring such issues as individual

businessmen. The vague conception of the personal bankruptcy exemption system, coupled with the gap between the rights and obligations of individuals and enterprises, makes it impossible for the personal bankruptcy exemption system to be rampant in the Enterprise Bankruptcy Law.

At present, China mainly relies on the Civil Procedure Law of the People's Republic of China to resolve disputes over claims between natural persons. Since China's long-standing legal philosophy is that "natural persons cannot go bankrupt", the linkage of the natural person bankruptcy exemption system to the Civil Procedure Law will exacerbate the conflict between enforcement and bankruptcy exemption. The Supreme People's Court proposed the establishment of a personal bankruptcy exemption system in order to solve the problem of "enforcement difficulties", but the purpose of this enforcement procedure is to confirm the priority of individual claims, and the problem of the inability of natural persons to pay their debts has not been solved. The personal bankruptcy exemption system is a good medicine for solving the problem of debtors' inability to repay their debts, but there is still a gap between the results of the implementation of the two, and the difference between the two should be correctly distinguished.

#### B. *Lack of credit following insolvency exemptions*

Although the social utility and humanitarian theories forgave part of the debtor's debt in terms of socio-economic and human dignity, the aim was to enable the debtor to re-engage with society and create wealth. However, in reality, the most important thing is the social credit problem. Even if the debtor obtains the bankruptcy exemption through various procedures, it is impossible to avoid the fact that his credit cannot be restored in the society. Social credit is mainly divided into two aspects: financial credit and social evaluation. In terms of financial credit, due to the memorability of information data in the network, the record of debtor's default will cause an uneradicable impact, and even after being exempted from liability by personal bankruptcy, there is still a gap in his financial credit.<sup>2021</sup> Article 20 of the "Methods for the Administration of Credit Collection Businesses" issued by the People's Bank of China stipulates that the period of personal bad information kept by credit collection agencies shall be the period of the termination of the bad behaviour. The period of personal bad information is five years from the date of termination of the bad behaviour. It can be seen that the bad credit information in the debtor's credit record can be eliminated only after the debt is repaid.<sup>4</sup> In addition, the debtor's bad credit record can only be modified by the financial institution of the original record, and the People's Bank of China cannot modify or delete it. At the same time, there are some gaps in the credit repair policies of different regions, which aggravates the difficulty for debtors to recover their credit records.

From the point of view of social evaluation, a natural person who has been exempted from debts through the bankruptcy exemption system will inevitably have difficulties in restoring social credit, and a natural person who has not completed the discharge of his or her debts will not be able to avoid negative evaluations in his or her social relations. Debtors who are exempted from liability in bankruptcy will also have

corresponding employment problems, for example, state-owned enterprises, institutions, financial organisations and social organisations may restrict the employment of "defaulters".

#### IV. LEGISLATIVE OPTIONS FOR CHINA'S PERSONAL BANKRUPTCY EXEMPTION SYSTEM

The personal insolvency regime is constructed to distribute equitably to creditors the property available to the debtor for satisfaction, which is related to but not essential to the personal insolvency exemption regime, and the personal insolvency process does not require the emergence of personal insolvency exemptions.

##### A. *Preconditions for the application of personal insolvency exemptions*

Neither the social utility theory nor the humanitarian theory can ignore the reasonable rights of creditors and exempt debtors from bankruptcy liability without any bottom line. An important prerequisite for the construction of a personal bankruptcy exemption system is to clarify the prerequisites for the application of the system; exempting the debtor from liability without any bottom line will make the worker's property exemption system a tool for the debtor to evade debts.

1. Debtor may not intentionally obstruct the discharge of the debt

In the common-law system, the debtor cannot act in a way that prevents creditors from recovering compensation either before or during the bankruptcy filing process, otherwise the exemption of each individual from bankruptcy cannot be found. The specific behaviour of the debtor that prevents the creditor from recovering includes the following aspects: firstly, the debtor intentionally transfers or destroys property in an attempt to exclude personal property from the scope of enforcement of personal bankruptcy proceedings; secondly, the debtor's behaviour of transferring property reduces the property available for distribution to the creditors and infringes on the creditors' actual interests; and thirdly, the creditor's retrospective claim should be within the retrospective statute of limitations.

2. Debtor justifies loss of property

There are many types of reasons for personal bankruptcy, broadly classified as: financial borrowing; investment failure; sudden illness or incapacity to work; gambling, drug abuse and other offences. The personal bankruptcy exemption system should be limited and not exempted in all areas.

The scope of personal bankruptcy exemption should be legal financial investment behaviour, and illegal acts such as casino operation and smuggling should be excluded. Moderate and lawful investment is the requirement of active market economy, financial investment is inevitably risky, and property loss after investment failure is reasonable; the property lost by the debtor because of consumption should not be exempted from the scope of personal bankruptcy, if it is put into the scope of exemption, it will encourage the debtor to consume luxuriously and slacken in repayment of debts. In the long run, it may cause the interest rate of the lending market to increase, which is not conducive to the long-term development of the market economy; if the

debtor is unable to repay the debt because of sudden illness or loss of labour capacity, the debtor should be determined whether he meets the conditions of personal bankruptcy exemption, taking into account the reasonableness of the occurrence of the accident; lastly, the loss of one's own property due to the unlawful acts of endangering the society, should not be attributed to the personal bankruptcy exemption. exemptions from personal bankruptcy.

##### 3. Debtor's fulfilment of obligations under insolvency proceedings

The prerequisite for the debtor to obtain debt exemption shall be the debtor's fulfilment of the obligations stipulated in the insolvency proceedings, which mainly include the following aspects: firstly, truthful provision of the materials required in the personal insolvency proceedings, which specifically refers to the accurate, complete and truthful provision of the materials that have not been falsified. The materials required for personal bankruptcy submitted by the debtor is an important element for the fairness of the bankruptcy proceedings, and is also the proper meaning of obtaining exemption from bankruptcy; secondly, the debtor should actively cooperate with the court, the bankruptcy administrator, the creditors' meeting partners and the bankruptcy administration agency as well as the enquiries, and cooperate with the personal bankruptcy proceedings; thirdly, the debtor should abide by the behavioural restrictions required after the commencement of the bankruptcy proceedings, which is mainly the restriction of consumption behaviour. Thirdly, the debtor shall comply with the restrictions on behaviour required after the commencement of the bankruptcy proceedings, which are mainly restrictions on consumer behaviour. For example, the debtor shall not purchase luxury goods, travel in business class, purchase flats or high-value financial products, etc.; fourthly, the debtor shall strictly implement the bankruptcy reorganisation plan and the settlement agreement formulated by the insolvency administration agency.

##### B. *Rules applicable to personal insolvency exemptions*

###### 1. Scope of exemptions from personal insolvency

The definition of the scope of personal bankruptcy exemptions is mainly concerned with two aspects: firstly, the scope of personal bankruptcy exemptions is determined according to the type of debt, and the scope of debt that violates the provisions of the law is of course excluded from the scope of exemptions; secondly, it is determined according to the order of establishment of the debt to determine whether or not it can be exempted, for example, the debt prior to the establishment of the application for personal bankruptcy is exempted from the scope of exemptions, and the debt is not exempted if it arose after the occurrence of the bankruptcy. Exemption. If the law classifies debts incurred after the filing of the personal bankruptcy petition as exempt from the scope of the bankruptcy exemption, it may reduce the efficiency of the debtor's credit restoration, and may even deteriorate the debtor's re-established social trust, which may lead to the debtor's loss of the ability to fulfil the previous agreement. Therefore, the scope of personal bankruptcy exemptions is mainly defined in terms of the type

of debt and the time when the debt was incurred to determine whether it can be exempted.

## 2. Modalities of exemption from liability in personal bankruptcy

Looking at the countries that have established personal insolvency exemption systems, the ways of personal insolvency exemption are broadly divided into two: one is automatic exemption, i.e., after the end of the personal insolvency application process, the debtor does not need to make a separate application again in order to enjoy exemption of debts. The first is automatic exemption, i.e. after the personal bankruptcy application process is completed, the debtor does not need to make another separate application to enjoy the debt exemption. This approach is prevalent in Japan and Germany.

There are advantages and disadvantages to both types of debtor exemptions. The main reason for the United States to adopt automatic exemptions is that the United States has a well-developed debtor examination mechanism outside the courtroom, which can avoid the abuse of the personal bankruptcy exemption system. The out-of-court examination in the United States mainly examines the creditworthiness of the debtor applying for bankruptcy, and the material formed by the out-of-court credit examination is an important source of material for the debtor's bankruptcy proceedings. Therefore, after the completion of personal bankruptcy proceedings in the United States, the debtor does not need to file another application for debt exemption in order to obtain debt exemption. Germany and Japan, unlike the United States, take a permissive exemption approach whereby the debtor is required to file a second application for exemption at the same time as filing for personal bankruptcy, promising that a portion of the income received will be used to satisfy the debt for a period of six years from the date of the commencement of the bankruptcy proceeding.

Since China's personal bankruptcy system started relatively late, the establishment of an additional out-of-court debt settlement review mechanism will consume a great deal of judicial resources. At the same time, if the cancellation of the court internal audit personal qualification due to bankruptcy exemption procedure, will increase the debtor does not participate in the bankruptcy process and a series of unethical behaviour.<sup>6</sup>Therefore, it is not a matter of direct exemption in China, and licence exemption is more in line with the actual situation of personal bankruptcy in China.

### C. Supervision of personal insolvency exemptions

Regardless of whether our country adopts permissive exemption or direct exemption, a monitoring mechanism for personal bankruptcy exemption should be established to prevent debtors from avoiding debts and to effectively protect the legitimate rights and interests of creditors. The rights and remedies for creditors' losses due to the personal bankruptcy exemption system mainly include two aspects: one is the exemption objection, within the legal period after the court makes the personal bankruptcy exemption, the creditors can apply for reconsideration of their objections; the second is the exemption cancellation, that is, after the personal bankruptcy exemption occurs, the creditors or other interested persons who find that the debtor adopts fraudulent means to obtain the

exemption of the debts have the right to apply for the cancellation to the people's court.

## V. ESTABLISHMENT OF SPECIAL NORMS FOR PERSONAL INSOLVENCY EXEMPTIONS

The final result of the personal bankruptcy exemption system is for the benefit of the debtor, and setting up the rule that personal bankruptcy is not exempted from liability is of great significance in safeguarding the interests of creditors and balancing the interests of creditors and debtors at the same time.

### A. Definition of non-exemptions

Looking at the exceptions to the personal bankruptcy exemption in various countries, the scope of debts not to be exempted from liability can be broadly divided into the following parts: first, debts arising from tortious acts, for which Germany has detailed provisions, and debts arising from intentional tortious acts, if placed in the scope of personal bankruptcy exemption, will give rise to the corresponding moral hazards; the second is due to the legal obligations arising from the debt, such as alimony, alimony and maintenance and other debt arising from this part of the legal debt generally can directly affect the personal rights of the alimony or the person who is dependent on the exemption of this part of the debt may be on the legal creditors of the normal life of the impact; the third is due to the labour contract debt, if placed in the scope of personal bankruptcy exemption, will lead to moral hazard. Thirdly, debts such as wages and social insurance arising from labour contracts or employment contracts should not be exempted. Wages are the source of a worker's livelihood, and exempting them from this debt increases the risk that the worker's costs will not be repaid, which is contrary to the principle of fairness; fourthly, fines for tax evasion or other types of penalties should not be exempted, so as to protect the normal order of society.

### B. Non-exculpation of liability

Regardless of whether our country adopts permissive or automatic exemptions for personal bankruptcy, it is necessary to consider the causes of non-exemptions, which are set up to prevent debtors from taking advantage of the bankruptcy exemption system to evade their debts, and which can be broadly classified into three types of fraudulent behaviour: first, the debtor intentionally or negligently increases the original debt or reduces the amount of property available for repayment. For example, the act of transferring property without compensation or at a low price, or intentionally using consumer credit to increase personal debt; secondly, disrupting the sequence of bankruptcy compensation, and setting burdens on specific property; thirdly, after the debtor enters into bankruptcy proceedings, in order to conceal the property II submits false materials, and reduces the burden of debt by fraudulent means, and obstructs the bankruptcy administrator from carrying out his duties; fourthly, the debtor applies for multiple times in the short term In response to this phenomenon, the general personal insolvency exemption system will adopt legislative means to provide for a continuous period of exemption, and where multiple applications for personal

insolvency debt exemption are made within that period, it shall be ruled that no exemption shall be granted.

## VI. CONCLUSION

The Regulations on Personal Bankruptcy of the Shenzhen Economic Special Zone, which has been implemented since March 2021, is an important attempt to implement a personal bankruptcy system in China, but the limitations of the local legislative hierarchy, coupled with the imperfections of the top-level design, have prevented it from being integrated with the Civil Code, the Law on Enterprise Bankruptcy, and the Civil Procedure Law. Whether a personal bankruptcy exemption system should be introduced is the focus of discussion in the process of implementing the personal bankruptcy system. A reasonable exemption system will not only not harm the interests of creditors, but may even motivate debtors to actively repay their debts and realise the benefits of social justice.<sup>7</sup>The personal bankruptcy exemption system is, in terms of its content, an exemption to alleviate the debtor's burden, and its

fundamental purpose is to help the debtor to return to society to give full play to its benefits.

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