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Practical dilemmas and improvement proposals for the personal bankruptcy discharge system

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Abstract. In recent years, China has launched pilot programs for the personal bankruptcy system in cities such as Shenzhen, Wenzhou, and Xiamen. This institutional innovation not only offers a fresh start to "honest but unfortunate" debtors, but also plays a significant role in addressing difficulties in enforcement and maintaining social and economic stability. Taking Shenzhen as an example, current pilot practice still faces several problems, including ambiguous standards for determining "honesty," insufficient flexibility in the discharge observation period, disputes over the legal effect of discharge, and inadequate protection of creditors' rights. To address these issues, it is necessary to formulate a list of non-dischargeable circumstances and introduce a fault-based allocation mechanism to refine the criteria for determining honesty; establish a flexible observation period to increase the adaptability of discharge conditions; clarify the legal effect of discharge; and strengthen creditors' procedural rights protection, thereby promoting the sound development of the personal bankruptcy discharge system.

Keywords: personal bankruptcy, discharge system, honest but unfortunate debtor, observation period, credit rehabilitation

1. Introduction

The personal bankruptcy system constitutes an important component of the legal framework of a modern market economy. Its core function is to provide natural persons in financial distress with an orderly mechanism for debt resolution and economic rehabilitation. For a long time, China lacked a unified nationwide personal bankruptcy regime, leaving a large number of "honest but unfortunate" debtors outside the scope of bankruptcy relief. This not only hindered individual survival and development, but also exacerbated social problems such as difficulties in judicial enforcement. The implementation of the Shenzhen Special Economic Zone Personal Bankruptcy Regulations in 2021 marked a breakthrough in China's local pilot experimentation with personal bankruptcy. Among its various mechanisms, the discharge system—which grants debtors a "fresh start"—has attracted considerable attention from both scholars and practitioners. However, after five years of pilot operation, the practical application of the system has revealed numerous ambiguities and rigidities in areas such as discharge requirements, observation period rules, the legal effect of discharge, and creditor protection, thereby constraining the full realization of the system's intended functions. Although existing scholarship has provided substantial justification for the legitimacy of the discharge system, systematic responses to operational issues—including the standard for determining honesty, flexible observation mechanisms, and the balance of competing interests—remain insufficient.

Using the Shenzhen pilot program as an observational sample and drawing on representative cases as well as comparative legal experience, this article conducts an in-depth analysis of the practical dilemmas facing the discharge system. It further proposes improvement measures in four dimensions: refining the criteria for determining eligibility, introducing flexibility into the observation period, clarifying the legal effect of discharge, and strengthening the protection of creditors' rights and interests. The aim is to provide reference for the localized construction of China's personal bankruptcy discharge regime and for future national legislation.

2. Statement of the problem

In a market economy, business failure, unexpected personal hardships, and excessive borrowing can easily lead individuals into insolvency. Under the traditional civil enforcement regime, which adheres to the principle of unlimited liability for debt repayment, debtors often remain burdened with debt for life, losing both the incentive and the capacity to work and rebuild their lives. At the same time, creditors frequently remain unable to realize their claims, while judicial resources are repeatedly consumed through prolonged enforcement proceedings. Against this backdrop, the personal bankruptcy system has emerged as an institutional solution, with the discharge mechanism serving as its core component by enabling honest debtors to obtain relief from overwhelming debt.

The *Shenzhen Special Economic Zone Personal Bankruptcy Regulations* (hereinafter the "*Shenzhen Regulations*"), which came into force in March 2021, marked the beginning of China's local pilot program for personal bankruptcy. The primary objective of the system is to provide a fresh start for "honest but unfortunate" debtors. Nevertheless, concerns have persisted that the system could be abused as a means of evading legitimate debts. Existing cases indicate that debtors granted discharge generally fall into three categories: entrepreneurs whose businesses have failed, salaried workers trapped in cycles of debt refinancing, and ordinary individuals overwhelmed by family-related financial obligations.

Current judicial practice faces several practical challenges. First, the *Shenzhen Regulations* do not clearly define the core requirement of "honesty." Instead, they establish the boundary of eligibility through a negative list of circumstances in which discharge is unavailable. This approach leaves considerable ambiguity in judicial decision-making, creating the risk that eligible debtors may be denied relief while dishonest debtors may exploit the system. Second, the uniformly prescribed three-year discharge observation period lacks flexibility. Debtors with strong repayment capacity remain subject to prolonged restrictions despite demonstrating good compliance, whereas debtors who engage in subsequent dishonest conduct during the observation period are subject to insufficient additional constraints. Third, the legal effect of a discharge order remains unclear, and creditors are not provided with adequate mechanisms for objection or judicial relief. As a result, many creditors remain skeptical of the system, hindering the efficient resolution of bankruptcy cases.

A thorough examination of these issues and the corresponding institutional deficiencies is essential for improving China's personal bankruptcy regime. A more effective discharge system can provide "honest but unfortunate" individuals with a genuine opportunity for a fresh start while safeguarding their fundamental rights to subsistence and development.

3. Theoretical analysis of the personal bankruptcy discharge system

The personal bankruptcy discharge system is not a legal construct created in isolation. Rather, it is supported by well-established jurisprudential, social, and normative foundations. Clarifying the legitimacy and functional orientation of the discharge system is a prerequisite for identifying its shortcomings and proposing meaningful reforms.

3.1. Theoretical foundations of the discharge system

The modern personal bankruptcy discharge system has evolved over several centuries. Three major theories have emerged to justify its legitimacy: the debtor cooperation theory, the social utility theory, and the humanitarian theory. Together, these theories constitute the jurisprudential foundation of the discharge system [1].

First, the debtor cooperation theory forms the cornerstone of the discharge system. Personal bankruptcy proceedings require debtors to make comprehensive disclosures of their assets, income, and liabilities, to cooperate fully with the bankruptcy administrator in asset investigation and liquidation, and to voluntarily comply with behavioral restrictions during the observation period. In exchange for such cooperation and the temporary limitation of their rights, debtors are granted a discharge of qualifying debts. Conversely, debtors who conceal assets, make false disclosures, or otherwise fail to cooperate are disqualified from obtaining a discharge.

Second, the social utility theory emphasizes the broader economic benefits of debt discharge. Large numbers of individuals trapped in unsustainable debt discourage labor participation, entrepreneurship, and consumption, thereby weakening overall market vitality. The discharge system relieves honest debtors of excessive financial burdens, enabling them to re-enter economic life and create social value. Moreover, centralized bankruptcy proceedings facilitate the comprehensive resolution of all claims and liabilities in a single process, reducing repetitive litigation and enforcement proceedings, conserving judicial resources, and improving the overall efficiency of the legal system.

Third, the humanitarian theory reflects the modern legal commitment to protecting fundamental human rights. Unlike the outdated practice of personal liability in ancient legal systems, contemporary law recognizes the rights to subsistence and development as fundamental civil rights. Where individuals fall into financial distress due to objective circumstances, the unlimited pursuit of debt repayment may condemn both debtors and their families to long-term hardship. The discharge system therefore preserves a debtor's essential living necessities and income, demonstrating the law's humanitarian values while safeguarding basic human dignity.

3.2. Functional orientation of the discharge system

Building upon these theoretical foundations, the personal bankruptcy discharge system serves multiple, well-defined functions. By design, it excludes dishonest debtors and those who are reasonably expected to regain sufficient repayment capacity in the future [2]. The system plays an important role in promoting good faith in debt repayment and functions simultaneously as a mechanism of relief, deterrence, guidance, and legal regulation.

First, the discharge system provides a pathway to economic rehabilitation for honest debtors while excluding those who seek to evade their obligations in bad faith. This reflects both its relief function and its screening and deterrence functions. The system is specifically intended to assist "honest but unfortunate" debtors by relieving them of unsustainable debt, safeguarding their basic right to subsistence, and enabling them to rebuild their lives. However, discharge is by no means unconditional. Debtors who act in bad faith are inherently excluded from its protection. The *Shenzhen Regulations* enumerate circumstances in which discharge is unavailable, including the concealment of assets, fraudulent transactions, malicious dissipation of property, asset transfers designed to prejudice creditors, and debts arising from gambling or drug abuse. Such conduct directly disqualifies debtors from obtaining a discharge. In addition, the bankruptcy system is complemented by mechanisms such as avoidance powers and asset recovery rules, which permit the rescission of preferential repayments, gratuitous transfers, and transfers of assets at undervalue made prior to bankruptcy. These mechanisms recover improperly transferred assets, rectify dishonest conduct, and impose meaningful sanctions on debtors who attempt to evade their obligations.

Given the finality of bankruptcy proceedings, personal bankruptcy law provides more rigorous mechanisms for asset investigation, preservation, and recovery than those available under ordinary civil enforcement procedures. These mechanisms enable the timely correction of preferential repayments, fraudulent asset transfers, and other forms of dishonest conduct. Combined with the bankruptcy avoidance system, they achieve what has been described as "retrospective equal treatment" among creditors [3]. This also reflects the system's interest-balancing function. Accordingly, the discharge system serves an important normative and guiding function. On the one hand, it signals to market participants that debts must be repaid in accordance with the law and that malicious debt evasion will result in consequences such as the loss of bankruptcy privileges, credit sanctions, and permanent ineligibility for discharge. On the other hand, it encourages individuals to borrow and invest prudently, to recognize the inherent risks of market activities, and to avoid excessive indebtedness.

4. Practical challenges facing the personal bankruptcy discharge system

Since the implementation of the *Shenzhen Special Economic Zone Personal Bankruptcy Regulations*, personal bankruptcy cases have been processed in an orderly manner, demonstrating the feasibility of the pilot program. Nevertheless, a disconnect remains between the detailed institutional rules and the practical demands of judicial practice, and a number of systemic challenges have gradually emerged.

4.1. Ambiguous standards for establishing "honesty" as a condition for discharge

Jurisdictions that have established personal bankruptcy systems generally adopt a similar approach to defining an "honest" debtor: rather than providing a positive definition, they specify circumstances under which a debtor is ineligible for discharge. The *Shenzhen Regulations* follow the same legislative approach. Article 98 enumerates situations indicating that a debtor intends to evade repayment obligations, in which case discharge should be denied. However, Article 98 does not provide a clear or comprehensive explanation of what constitutes "honesty." Moreover, although it lists several disqualifying circumstances, the provision remains relatively general in light of the complexity of real-world situations, and the temporal scope of the relevant conduct is not defined with sufficient precision [4].

The first personal bankruptcy liquidation case in Shenzhen (the Hu case)[1] illustrates this problem. The court ultimately concluded that the debtor had committed no fraudulent conduct and had fully disclosed all assets, thereby allowing the debtor to proceed with the discharge process. However, the case also exposed a broader institutional weakness. Judicial decisions are generally limited to making a binary determination as to whether fraud exists, without providing a more nuanced assessment of the debtor's specific conduct or

[1] Shenzhen Intermediate People's Court. (2021). Civil ruling in Case No. (2021) Yue 03 Po 417.

the degree of fault involved. Consequently, many similar cases become stalled at the stage of determining honesty. Ambiguous standards may allow dishonest debtors to obtain discharge improperly, while excessively stringent interpretations may deprive genuinely honest debtors of the relief to which they are entitled.

4.2. The rigid design of the discharge observation period

The discharge observation period ensures that individual debtors cannot obtain a discharge immediately upon the commencement of bankruptcy proceedings without making any effort to satisfy their obligations. To a considerable extent, this mechanism reduces the moral hazard associated with personal bankruptcy [5]. However, practical experience demonstrates that the uniform three-year observation period is overly rigid and fails to accommodate the diverse circumstances of different debtors, giving rise to several practical difficulties.

The amount of debt, income level, and repayment capacity vary significantly from one debtor to another. Some debtors owe relatively modest amounts and maintain stable employment. Under approved reorganization or settlement plans, they may fully satisfy their repayment obligations within one year—or even sooner. These debtors demonstrate both good faith and a strong capacity to perform their obligations. Nevertheless, under the current rules, even after fulfilling all repayment requirements ahead of schedule, they must still remain subject to the full three-year observation period before becoming eligible for discharge. Prolonged behavioral restrictions may discourage employment, income growth, and entrepreneurial activity. By contrast, other debtors carry substantial liabilities while earning only limited income. Even after the expiration of the three-year observation period, they may remain financially vulnerable. Some may even engage in new dishonest conduct during the observation period, such as defaulting on obligations, concealing income, or otherwise breaching their duties. Yet the current legal framework does not authorize courts to extend the observation period in response to such conduct, creating significant gaps in judicial supervision and enforcement.

Furthermore, the existing regime treats the completion of a three-year observation period, combined with the absence of any dishonest conduct throughout that period, as the sole prerequisite for obtaining a full discharge of debts. This single-track approach lacks a graduated discharge mechanism. Even where debtors substantially exceed their repayment obligations or consistently demonstrate exemplary credit behavior, they remain ineligible for an earlier or partial discharge. As a result, the system provides insufficient positive incentives and does little to encourage proactive debt repayment.

4.3. Uncertainty regarding the legal effect of discharge and inadequate protection of creditors

The legal effect of discharge orders, the scope of discharged debts, and the availability of remedies for creditors remain among the most controversial issues in current practice. These concerns also constitute one of the principal reasons why many creditors remain resistant to the implementation of the personal bankruptcy system.

On the one hand, there is no consistent understanding of the binding force of discharge orders. Some creditors refuse to recognize the discharge of debts and continue pursuing collection efforts or initiating litigation even after the discharge order has taken legal effect. Conversely, some debtors mistakenly assume that all debts are automatically extinguished and refuse to perform any continuing legal obligations. These conflicting interpretations have generated frequent disputes and have undermined the authority of judicial decisions. Moreover, the *Shenzhen Regulations* do not provide a sufficiently detailed enumeration of non-dischargeable debts. The legal boundaries governing obligations such as maintenance and support payments, compensation for personal injury, and tax liabilities remain unclear, creating the risk that debtors may attempt to use bankruptcy proceedings to evade statutory obligations.

On the other hand, creditors enjoy only limited procedural protections. Throughout the bankruptcy process—including the filing of the petition, the examination of discharge eligibility, and the issuance of the discharge order—creditors are largely confined to a passive role, receiving information without meaningful opportunities for participation. When creditors discover that a debtor has made false disclosures or intentionally incurred debts in bad faith, they often face considerable evidentiary difficulties and lack effective mechanisms for raising objections or seeking appellate review. As a result, their legitimate rights and interests are inadequately protected. Many creditors therefore become reluctant to cooperate with bankruptcy proceedings, ultimately reducing the efficiency of case administration.

5. Proposals for improving the personal bankruptcy discharge system

In light of the practical challenges revealed by the Shenzhen pilot program, and based on the theoretical foundations and functional orientation of the discharge system, this article proposes a systematic optimization of the personal bankruptcy discharge regime. Guided by the principles of distinguishing good faith from bad faith, graduated regulation, flexible application, and balancing competing interests, reforms should focus on four key dimensions: the criteria for determining eligibility, the observation period, creditor protection, and credit-related institutional coordination. The objective is to establish a discharge framework that is compatible with China's national conditions, practically enforceable, and capable of nationwide replication.

5.1. Refining the criteria for determining "honest but unfortunate" debtors

Addressing the subjective and ambiguous nature of the current "honesty" standard requires transforming an abstract moral concept into a concrete, measurable, and tiered legal standard, thereby promoting greater consistency in judicial decision-making.

The author proposes establishing a statutory negative list specifying circumstances in which discharge should be categorically denied. Such circumstances should include: (1) debts arising from illegal or criminal activities such as gambling, drug abuse, or prostitution; (2) the intentional concealment, transfer, or destruction of assets, as well as false declarations of income, assets, or liabilities; (3) the fabrication of debts, sham transactions, or gratuitous or undervalued transfers of property; (4) reckless spending, excessive consumption, or the deliberate expansion of debt shortly before bankruptcy; and (5) the malicious division or transfer of assets through sham divorce, family property division, gifts, or similar arrangements designed to evade creditors. By specifying concrete categories of misconduct, such a list would reduce judicial discretion and improve the operability of the system.

At the same time, a graded fault-based assessment mechanism should be introduced to distinguish different degrees of culpability. According to the debtor's subjective fault, both indebtedness and disclosure conduct may be classified into three categories, each corresponding to a different discharge outcome. First, minor negligence refers to situations in which a debtor, due to inadequate legal knowledge or simple oversight, fails to disclose minor assets or temporary income without any intention to evade debts. Such debtors fully satisfy the "honest but unfortunate" standard and should be granted a full discharge. Second, gross negligence applies where the debtor incompletely discloses assets or fails to cooperate fully with bankruptcy proceedings but has no fraudulent intent or deliberate purpose of evading debts. In such cases, partial discharge should be granted, with the scope of debt relief reduced in proportion to the degree of fault, while the debtor remains liable for a corresponding portion of the outstanding obligations. Third, intentional fraud encompasses conduct falling within the statutory negative list, including deliberate attempts to evade repayment obligations. Debtors engaging in such conduct should be permanently disqualified from obtaining a discharge, remain fully liable for all debts throughout their lifetime, and bear any additional legal liability prescribed by law.

5.2. Optimizing the observation period and conditions for discharge

The design of the observation period should take into account the debtor's level of indebtedness, income, and performance in fulfilling repayment obligations by introducing differentiated observation periods and phased discharge mechanisms. Such reforms would enhance both institutional flexibility and positive incentives for compliance.

The author proposes adopting a tiered and flexible observation period based on the amount of debt and the debtor's repayment capacity. For debtors with relatively small debts, stable income, and a demonstrated willingness to perform their obligations, the observation period may be shortened to one year or one and a half years. Debtors with moderate debt and ordinary repayment capacity should remain subject to the standard three-year observation period. By contrast, debtors with substantial liabilities, weak repayment capacity, or significant negligence may be required to complete an extended observation period of four to five years.

Courts should also be granted authority to dynamically adjust the observation period according to the debtor's conduct. If the debtor engages in new dishonest behavior during the observation period, the court should have the power to extend the period accordingly. Conversely, where the debtor completes all repayment obligations ahead of schedule and consistently maintains good credit standing, the court should permit an application for early termination of the observation period.

In addition, the discharge system should incorporate partial discharge and phased discharge mechanisms. Rather than relying exclusively on a single discharge granted upon completion of the observation period, a graduated framework should be established. Once debtors achieve specified repayment milestones under approved reorganization or settlement plans, they should be permitted to apply for discharge of a corresponding proportion of their outstanding debts. Likewise, debtors who truthfully report their income and comply with all legal obligations over a sustained period should progressively regain rights that had been restricted during bankruptcy, including certain consumption and employment restrictions. Such positive incentives would encourage debtors to actively fulfill their repayment obligations.

5.3. Clarifying the legal effect of discharge and strengthening the protection of creditors' interests

To achieve its objective of providing debtors with a genuine fresh start, personal bankruptcy law inevitably requires creditors to bear a certain degree of economic sacrifice. In order to mitigate the resulting tension with the traditional legal framework governing debt repayment, personal bankruptcy legislation must provide reasonable safeguards for creditors' legitimate interests [4].

On the one hand, the legal status of debts that have been discharged should be clearly defined. The author proposes classifying discharged obligations as natural obligations. Under this approach, creditors would retain the opportunity to receive voluntary repayment from debtors after discharge, while debtors who later regain financial capacity could choose, for moral or other personal reasons, to satisfy discharged obligations voluntarily. Such voluntary repayment should be recognized and encouraged as an expression of personal integrity and moral responsibility. This approach would also contribute to the development of China's social credit system by facilitating the restoration of the debtor's credibility through voluntary performance after bankruptcy. Accordingly, the law should expressly define both the legal effect of discharge orders and the scope of non-dischargeable debts [6].

On the other hand, a more comprehensive objection and appellate mechanism should be established to protect creditors' procedural rights. At critical stages of the discharge review process, a dedicated objection period should be provided. Where creditors possess evidence that the debtor has engaged in fraudulent conduct, malicious debt evasion, false disclosures, or similar misconduct, they should be entitled to submit written objections, together with supporting evidence, to the court or the bankruptcy administrator within the prescribed statutory period. The court should promptly organize hearings, examine the evidence, and issue a written decision. Furthermore, creditors dissatisfied with a discharge order should be granted the statutory right to appeal, thereby ensuring effective judicial remedies.

In addition, creditors' right to information throughout the bankruptcy process should be strengthened. Bankruptcy administrators should be required to disclose, on a regular basis, key information to all creditors, including the debtor's assets, income, performance of repayment obligations, and compliance during the observation period. Continuous access to such information would enable creditors to monitor the progress of bankruptcy proceedings, reduce disputes arising from information asymmetry, and enhance confidence in the integrity of the personal bankruptcy system.

6. Conclusion

The personal bankruptcy discharge system represents an important milestone in the maturation of China's market economy and the continued advancement of the rule of law. The Shenzhen pilot program has not only provided valuable experience for future national personal bankruptcy legislation but has also exposed a number of shortcomings in the existing framework, particularly with respect to eligibility criteria, the duration of the observation period, the balance between competing interests, and the coordination between bankruptcy and the social credit system. At its core, the discharge system seeks to strike an appropriate balance between providing relief to honest debtors and preventing strategic debt evasion. It should neither undermine market credit and creditors' legitimate interests through excessive protection of debtors nor deprive innocent debtors of their rights to subsistence and development by placing undue emphasis on debt enforcement.

To address the practical challenges arising from the ambiguous definition of "honesty," the rigidity of the observation period, and the inadequate protection afforded to creditors, comprehensive institutional reform is essential. Refining tiered eligibility criteria, establishing a flexible observation mechanism, and strengthening creditors' procedural remedies are all necessary steps toward improving the discharge system and overcoming the shortcomings revealed in current practice. Looking ahead, as further experience is accumulated through local pilot programs and the legal framework continues to evolve, China's personal bankruptcy discharge system is expected to become increasingly mature. A well-designed discharge regime will not only facilitate the efficient resolution of large numbers of personal debt disputes and reduce the risk of systemic indebtedness, but also safeguard the integrity of the market economy by maintaining an appropriate balance between debt relief and creditor protection. Most importantly, it will provide every "honest but unfortunate" debtor with a genuine opportunity to lay down the burden of overwhelming debt, rebuild financial stability, and resume a normal and productive life.

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