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# The Over-Indebtedness Regulatory System in the Light of the Changing Economic Landscape<sup>\*1</sup>

The number of individuals' insolvency proceedings, including cross-border insolvency proceedings, has increased globally. The last quarter century has witnessed a rapid expansion of consumer credit, manifested most notably through the proliferation of credit-card lending. This expansion has led to what social scientists term the democratisation of consumer credit, a process in which credit is extended to social groups to whom it was not traditionally available.<sup>\*2</sup> For instance, 20 years ago an academic book about consumer bankruptcy systems around the world would not have been possible, because most countries did not have a consumer bankruptcy system.<sup>\*3</sup> In 2001, the Council of the European Union noticed that only 10 European Union member states had specific legislation concerning the collective settlement of debts governing the social, legal, and economic treatment of over-indebted consumers, whereas ordinary debt collection procedures continued to apply in the other Member States.<sup>\*4</sup> The democratisation of credit has led to a re-examination of the importance of having consumer insolvency laws, and the grant of a discharge for over-indebted individuals. On the basis of social and economic considerations, countries have decided that it is necessary to develop solutions to address the increase in the number of consumer over-indebtedness cases, by somehow regulating this type of insolvency. The question remains—how? The current financial crisis has influenced states to find and take under consideration more rapid measures to deal with consumer over-indebtedness problems. The question arises then of how to find solutions to the problem of over-indebtedness and regulate individuals' insolvency, also in cross border insolvency cases. The author of this paper is of the opinion that insolvency law should always be simple, transparent, and efficient and should prevent or support mechanisms and developments that appear in the economy. Unfortunately, governmental actions on national and EU level reveal no transparent systematic approach to the problem of individuals' over-indebtedness. Furthermore, different policies are applied also in cross-border insolvency proceedings, which influence the simple and proper functioning of the procedures, especially in the context of secondary insolvency proceedings based on Council Regulation (EC) 1346/2000, of 29 May 2000, on insolvency proceedings (hereinafter 'European Insolvency Regulation',

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<sup>2</sup> D. McKenzie Skene, A. Walters. *Consuming Passions: Benchmarking Consumer Bankruptcy Law Systems*. – P. J. Omar (ed.). *International Insolvency Law. Themes and Perspectives*. Ashgate 2008, p. 136.

<sup>3</sup> J. Niemi-Kiesiläinen, I. Ramsay, W. C. Whiteford. Introduction. – J. Niemi-Kiesiläinen, I. Ramsay, W. C. Whiteford. *Consumer Bankruptcy in Global Perspective*. Oxford, Portland, Oregon: Hart Publishing 2003, p. 1.

<sup>4</sup> Council Resolution of 26 November 2001 on consumer credit and indebtedness. – OJ 2001/C 364/01.

or EIR).<sup>5</sup> Therefore, the purpose of this paper is to consider possible regulatory measures in finding a balance between the needs to provide an appropriate mechanism for enabling over-indebted individuals to start over with their lives and social concerns that debts should always be paid (*pacta sunt servanda*).

## 1. Different national approaches to individuals' insolvency

Credit is as old as mankind. Representing a pattern of social behaviour, credit also is subject to human weaknesses and environmental conditions. There is no causal necessity ensuring that a loan will be repaid. On the contrary, default is an ever-present possibility, although the relative risks of default can be identified and managed to an extent. Where there is credit, non-payment can equally occur. Although debts are generally repaid, the possibility of default can be seen as an inevitable feature of the credit phenomenon. Laws from the earliest times (the Code of Hammurabi, the Twelve Tables of early Rome, laws of ancient Greece, etc.) reflect this and provided various remedies for a creditor against the insolvent, from enslavement to death. Under early Roman law, when a debtor had too many creditors, the law gave them the option of cutting the debtor in pieces to be divided among themselves.<sup>6</sup>

Nowadays, there are two primary paradigms for individuals' insolvency: the American liberal paradigm and the European welfare state paradigm.<sup>7</sup> Consumer bankruptcy law in the United States (US) is described as a market function in which bankruptcy serves as an exit from and a complement to the open-access credit market system.<sup>8</sup> Conversely, a goal of the welfare state is to protect citizens against risks caused by natural disaster, accident, illness, and economic misfortune. In such systems, the state actively promotes equality of citizens and legal regulation as one means by which politically set goals are achieved.<sup>9</sup>

In everyday usage, the term 'bankruptcy' carries the meaning of personal disaster and a fate to be avoided at all costs. Yet, in the majority of modern societies, the process of bankruptcy aims to relieve the debtor from the cumulative burden of debts that, as a result of his current economic circumstances, he cannot realistically repay in full. Historical and cultural differences underlying civil and common law jurisdictions also lead to different approaches to bankruptcy. Notably, in the US, the term 'bankruptcy' refers generically both to liquidation and to reorganisation, with or without a trustee. A trustee is always appointed in liquidation (Chapter 7 in the US Bankruptcy Code) and in repayment plans for wage-earners (Chapter 13), and one may be appointed in exceptional circumstances in reorganisation (Chapter 11). Natural persons, corporations, and most other entities are eligible to seek protection under Chapter 7 or Chapter 11 of the US Bankruptcy Code, which can be applied to both natural persons and corporations.<sup>10</sup> Chapter 13 is available only to physical persons with a regular income.

Even terms such as 'consumer bankruptcy', 'indebtedness', 'over-indebtedness', 'debt counselling', 'debt restructuring', and 'fraudulent debts' may have a different meaning and usage from one country to another. For example, in Portugal, indebtedness means the amount owed by a family unit, whether resulting from a single credit obligation or from multiple obligations, from multiple sources. Frequently, where there is more than one debt, the concept of multi-indebtedness is applied.<sup>11</sup> As used in the INSOL International Consumer Debt Report (hereinafter 'INSOL Report')<sup>12</sup>, the term 'consumer debtor' refers to a debtor whose liabilities are incurred primarily for private, family, or household purposes, as distinct from business debts incurred either on the debtor's own account or in partnership with others, or arising from guarantees given on behalf of limited-liability entities. The INSOL Report describes the following types of consumer debts: survival

<sup>5</sup> Council Regulation (EC) No. 1346/2000 29 May 2000 on insolvency proceedings. – OJ S 160, 30.06.2000, pp. 1–18.

<sup>6</sup> J. Kilppi. *The Ethics of Bankruptcy*. London, New York: Routledge 1997, p. 9.

<sup>7</sup> Habermas distinguishes between two contemporary legal paradigms, the liberal paradigm and the welfare state paradigm. See J. Niemi-Kiesiläinen. *Collective or Individual? Constructions of Debtors and Creditors in Consumer Bankruptcy*. – J. Niemi-Kiesiläinen, I. Ramsay, W. C. Whiteford. *Consumer Bankruptcy in Global Perspective*. Oxford, Portland, Oregon: Hart Publishing 2003, pp. 46 and 48.

<sup>8</sup> *Ibid.*, pp. 46–47.

<sup>9</sup> *Ibid.*, p. 48.

<sup>10</sup> Chapter 11 is only available for natural persons of a higher net worth, whereas most natural persons will be eligible for a wage earner plan of reorganisation under Chapter 13.

<sup>11</sup> M. M. L. Marques, C. Frade. *Searching For an Over-indebtedness Regulatory System for Portugal and the European Union*. – J. Niemi-Kiesiläinen, I. Ramsay, W. C. Whiteford. *Consumer Bankruptcy in Global Perspective*. Oxford, Portland, Oregon: Hart Publishing 2003, p. 121.

<sup>12</sup> INSOL International, *Consumer Debt Report—Report of Findings and Recommendations*, May 2001. Available at [www.insol.org/pdf/consdebt.pdf](http://www.insol.org/pdf/consdebt.pdf) (15.03.2010).

debts<sup>\*13</sup>, over-consumption debts<sup>\*14</sup>, compensation debts<sup>\*15</sup>, relational debts<sup>\*16</sup>, accommodation debts<sup>\*17</sup>, and fraudulent debts.<sup>\*18</sup> In short, as defined in the INSOL Report, a consumer debtor's liabilities are related primarily to bank overdrafts, loans from banks and other financial institutions, personal credit cards, mortgages, and hire-purchase or credit-sales agreements associated with purchases of capital items such as automobiles.<sup>\*19</sup> No generally recognised definition of a consumer debtor exists. These words may have different meanings in different jurisdictions. Whether liquidation or rehabilitation procedures by nature, these are usually collectively referred to as insolvency procedures.<sup>\*20</sup>

The credit card is a symbol of consumer-led societies. As consumer-led economies having high levels of personal financial credit and allowing a discharge, the US and Canadian systems depend on important monitoring and control mechanisms to manage the risks of default. Instead of punishing the debtor, the US Bankruptcy Code facilitates a 'fresh start' for a debtor at the conclusion of a bankruptcy proceeding by allowing a discharge of all dischargeable debts. Under US bankruptcy law, most general unsecured consumer debts are dischargeable, including credit-card debt and medical debt. Some debts are considered non-dischargeable, among them student loans<sup>\*21</sup>, domestic support obligations, and many tax obligations, or debts that were incurred through fraud or wrongdoing. When a debt is discharged, it may no longer be collected from the debtor, but it is not cancelled.<sup>\*22</sup> The bankruptcy system permits a debtor to keep certain of his assets that are considered to be 'exempt' from the bankruptcy estate and therefore not subject to the claims of creditors. A debtor has an option to elect the exemptions granted either by federal law (i.e., the Bankruptcy Code) or by state law. Some states in the US have much more generous exemptions than others. For example, New York state law permits a debtor to retain \$50,000 in a homestead exemption, \$2,400 in a motor vehicle exemption, food and fuel to last 60 days, clothing, and household furniture. Under Texas state law, a debtor may keep up to 200 acres of rural homestead property, along with other exemptions. Even if creditors are not repaid in full, the debtor is allowed to keep exempt assets in order to provide a 'fresh start' in his economic life following the discharge.<sup>\*23</sup>

Canadian bankrupts are now required to pay their creditors a portion of the surplus income they earn during the period between their filing for bankruptcy and the discharge of their debts. An administrative edict defines surplus income as a function of Canadian poverty lines. After discharge, however, no payments are required from the former bankrupt's income.<sup>\*24</sup>

Under most European bankruptcy laws, the discharge of a debtor from (all) debts is almost unheard of without the creditors' approval. This could be the result of widespread historical perceptions about causes of insolvency being attributable to economic distress, unemployment, serious disease, or financial mismanagement. As a result, consumer insolvency in Europe is generally treated as a social problem caused by a *force majeure*, rather than as a market exit or adjustment mechanism.

<sup>13</sup> Survival debts occur as a matter of survival strategy, when recurrent debts for life necessities accumulate, such as household debts (food, rent, electricity, education, clothing).

<sup>14</sup> Over-consumption debts result from overconsumption by a debtor who initially may have a budget surplus, but finances an extravagant life-style with borrowed money. Typically, such a debtor enters into more than one loan, causing an increased extension of debt.

<sup>15</sup> Compensation debts result from over-consumption by a debtor who typically suffers deprivation or social exclusion. It is triggered by advertising, and establishing social class, power, status or as compensation for other loss. This behavior may result in illness-related debts, gambling debts, alcoholism and mental illness.

<sup>16</sup> Relational debts are acquired through connection with others because of marriage, other relationship or death. In some states, they arise by operation of law as a result of liabilities incurred by a spouse.

<sup>17</sup> Accommodation debts are caused by the inability to adapt to misfortune, a sudden drop in income or unforeseen expenses.

<sup>18</sup> Fraudulent debts occur when a debtor over-commits himself financially. Typically, such a debtor fails to act in good faith or deliberately attempts to defraud his creditors, either while incurring the debt or in his representations of his ability to repay. These debtors are frequently excluded from a discharge altogether.

<sup>19</sup> INSOL Report, p. 1.

<sup>20</sup> INSOL Report, pp. 2–3.

<sup>21</sup> The dischargeability of student loans has been a contentious issue in both the US and in Canada, because the negative consequences of making discharge 'freely available' or 'unfair' since students are thought to be likely to have high future incomes. See S. Schwartz. *Personal Bankruptcy Law: A Behavioural Perspective*. – J. Niemi-Kiesiläinen, I. Ramsay, W. C. Whiteford. *Consumer Bankruptcy in Global Perspective*. Oxford, Portland, Oregon: Hart Publishing 2003, p. 80.

<sup>22</sup> That is, if someone else is also responsible to pay the debt, such as a guarantor or co-obligor, then the debt may still be collected from that person or entity. Note that in most Chapter 7 cases (liquidation) of natural persons, there are no assets available to distribute to the creditors, but the debtor may still receive a discharge. See E. Stong. *Fresh Start and Convergences in the Treatment of Insolvent Companies in the European Union: the United States Contribution*. *Forthcoming*.

<sup>23</sup> In the Chapter 7 case, the debtor, whether a natural person or an entity, turns over to the trustee his non-exempt assets as of the date of the filing of the bankruptcy petition, and those assets are applied to satisfy his debts as of the petition date. In a Chapter 13 case, the debtor, who may only be a natural person, commits his post-petition disposable income for up to five years to repay his creditors, in whole or in part. He must repay the creditors at least as much as they would receive in liquidation. In both Chapter 7 and Chapter 13, if the case is successful, the debtor's pre-petition dischargeable debts will be discharged. Source: E. Stong (Note 22).

<sup>24</sup> S. Schwartz (Note 21), p. 74.

A development in the opposite direction has taken place in continental Europe. Denmark was the first continental European country to adopt a specific legal regime aimed at treating the ills associated with consumer over-indebtedness, beginning in January 1972 and culminating with the adoption of the Danish consumer debt adjustment act, *Gældssaneringslov*, on 9 May 1984.<sup>\*25</sup> The aims of the consumer debt adjustment laws in Scandinavia are quite similar to those aims presented in the doctrine of social *force majeure*.<sup>\*26</sup> The laws on judicial debt adjustment for consumers entered into force in 1993 in Finland and in Norway, then in 1994 in Sweden. The French law on prevention and regulation of individual and household over-indebtedness was already enacted by 1989, but its very restrictive discharge provision was substantially expanded in 1998. The Netherlands passed a law on consumer debt adjustment in 1997 and Belgium in 1998. In Austria, debt adjustment legislation was accepted in 1993, and in Germany similar legislation entered into force in 1999.<sup>\*27</sup>

With the exception of the Czech and Slovak republics, Estonia, and Russia, prior to 2002, the majority of Eastern European transition countries had not tackled the problem of consumer insolvency.<sup>\*28</sup> Influenced mainly by the German insolvency regulation system, Estonia adopted a separate procedure for discharge of debts within insolvency proceedings in January 2003. Since 1 January 2004, Chapter XI of the Bankruptcy Act<sup>\*29</sup> has regulated discharge of obligations. There is no automatic discharge of debts available in Estonia. Pursuant to the Bankruptcy Act's § 175 (1), a court shall decide on discharge by a ruling made five years after commencement of the proceedings stipulated in Chapter XI of the Bankruptcy Act.<sup>\*30</sup> The additional period of time before entering Chapter XI proceedings cannot be predicted, as a consequence of the complexity of insolvency cases. The debtor is not prevented from obtaining more than one discharge but should wait 10 years before becoming eligible for another discharge.<sup>\*31</sup>

All mature market economies have well-developed provisions for the bankruptcy of individuals (which are not just households or consumers but also may be owners of very small, micro enterprises).<sup>\*32</sup> For example, in England and Wales, the main alternative to bankruptcy is an individual voluntary arrangement (hereinafter 'IVA') under Part VIII of the Insolvency Act 1986. An IVA is a composition or scheme of arrangement that arises from a proposal made by an individual debtor (whether a business or consumer debtor) to his creditors. It is essentially an extra-judicial procedure, as the court has only a limited supervisory role. The proposal, which may encompass the debtor's assets, income, or both, is formulated by the debtor in conjunction with an insolvency process practitioner (the nominee). The creditors vote on the proposal, and, if it is approved, the nominee becomes the supervisor of the IVA and oversees its implementation. If the proposal is approved by the requisite majority, all creditors who were entitled to vote are bound, regardless of whether or how they voted.<sup>\*33</sup>

From a creditor's perspective, the infringement of claims pursuant to statutory debt restructuring schemes may seem unjustified. For example, a Finnish creditor complained that the Finnish Debt Restructuring Act violated his rights of ownership under Article 1 of Protocol 1 of the European Convention on Human Rights. From the ECHR's decision dated 20 July 2004<sup>\*34</sup>, the following general conclusions can be drawn:

- a) The debt-adjustment legislation clearly serves legitimate social and economic policies and is not therefore, *ipso facto*, an infringement of Article 1 of Protocol 1.
- b) That in the case of bankruptcy the creditor's claims would have remained legally valid and enforceable at a later stage does not change the fact that, by entering into an agreement with a debtor, a creditor takes upon himself a risk of financial loss.
- c) The European Court of Human Rights would not exclude the possibility that a court-ordered irrevocable extinction of a debt, as opposed to the scheduling of payments of a debt over a longer period of time, or the bankruptcy of a private individual, could in some circumstances result in the placing of an excessive burden on a creditor.
- d) Whether such a burden was placed on the applicant also depends on whether the procedure applied provided him with a fair possibility of defending his interests as one of some 70 creditors.<sup>\*35</sup>

<sup>25</sup> J. J. Kilborn. Twenty-Five Years of Consumer Bankruptcy in Continental Europe: Internalizing Negative Externalities and Humanizing Justice in Denmark. – *International Insolvency Review* 2009 (18), p. 155.

<sup>26</sup> J. Niemi-Kiesiläinen (Note 7), p. 48.

<sup>27</sup> *Ibid.*

<sup>28</sup> J. Lowitzsch (ed.). The Insolvency Law of Central and Eastern Europe. Twelve Country Screenings of the New Member and Candidate Countries of the European Union: A Comparative Analysis. – *INSOL Europe* 2007/2, p. 40.

<sup>29</sup> Pankrotiseadus. Adopted on 22 January 2003. – RT I 2003, 17, 95; 2009, 68, 463 (in Estonian).

<sup>30</sup> Note: not after submission of bankruptcy petition and commencement of the bankruptcy proceedings.

<sup>31</sup> Bankruptcy Act § 171 (2) 3).

<sup>32</sup> See Table 1. J. Lowitzsch (Note 28), pp. 41–42.

<sup>33</sup> D. McKenzie Skene, A. Walters (Note 2), p. 141.

<sup>34</sup> ECHR, *Bäck v. Finland*, Application No. 37598/97. Available at <http://www.echr.coe.int/echr> (15.03.2010).

<sup>35</sup> See summary of A. Noordam Doctoral Thesis "Schuldsanering en goede trouw" (Debt Restructuring and Good Faith). Amsterdam: Vrije University 2007, pp. 678–679. Available at <http://bobwessels.nl/wordpress/wp-content/uploads/2007/11/summary.pdf> (15.03.2010).

A fascinating spectrum of policy approaches can be found in states across Europe, including those having recently emerged from operation as command economies and that are now struggling with the different challenges of free-market capitalism. Recently, a number of European countries have initiated consumer insolvency reforms, mainly following the examples of discharge provided in Chapters 7 and 13 of the US Bankruptcy Code. The British discharge may be even more generous than the US. In the UK, the discharge now takes effect after one year has passed from the commencement of bankruptcy, a reduction from the previous period of three years.<sup>\*36</sup> Furthermore, debtors may obtain more than one discharge and do not have to wait for a specified minimum period of time before becoming eligible for another discharge.<sup>\*37</sup> In mediaeval England, a debtor could be placed in a debtor's prison until he repaid his debt, which was impossible while one was imprisoned and unable to generate an income. Against such practices, the concept of a discharge of indebtedness must be seen as a great privilege, without which many debtors would never find relief from their debts.

As of January 2007, Swedish consumers need not necessarily seek counselling before applying for formal debt relief. Sweden is the first continental European country to do away with the requirement of out-of-court credit counselling and negotiation as a prerequisite to formal relief. Swedish debtors can still seek budget- and debt-related counselling from local state-supported counselling services, but in most cases, neither counselling nor negotiation with creditors is required. As in France and Luxembourg, debtors in Sweden file petitions for relief not with a court but with an official administrative body. Unlike in France and Luxembourg, the Swedish agency in charge of the consumer insolvency system is the state Enforcement Agency (*Kronofogdemyndigheten*, KFM). Formerly an arm of the Tax Service (*Skatteverket*) but a free-standing agency as of June 2006, the KFM's primary function is to act as the official collector of both public and private debts. The courts play almost no role in the Swedish consumer debt adjustment process. They continue to hear appeals from debtors and creditors unhappy with the KFM's findings regarding debtors' qualification for relief and the terms of payment plans, though in the overwhelming majority of cases in the past, courts have affirmed the KFM's decisions.<sup>\*38</sup>

In the Netherlands, as of 2008, it is the debtor's responsibility to demonstrate that he acted in good faith for the five years prior to the *wet schuldsanering natuurlijke personen* application.<sup>\*39</sup> Belgium and Luxembourg exclude debtors who knowingly brought about their own circumstances of insolvency. The bankruptcy rules in England and Wales, Germany<sup>\*40</sup>, and the US give no subjective grounds to reject a debtor's application for a debt restructuring scheme. Since October 2005, however, a disposable income test has been applied in the US to determine whether the debtor may file directly for liquidation under Chapter 7 or, instead, must file a plan of reorganisation of its debts under Chapter 13.

In Eastern Europe, Latvia represents a country that recently adopted a more modern consumer insolvency law process. On 1 January 2008, the Latvian Insolvency Act established a new procedure that is similar to the British IVA for individuals. The purpose of insolvency proceedings for a natural person is to provide an opportunity for this person to renew paying capacity or to be released from the debt commitment specified in the plan for the sale of his property and satisfaction of creditors' claims, by observing creditors' interests without necessarily being declared bankrupt.<sup>\*41</sup> A natural person may apply for insolvency proceedings if this person does not have possibilities for settling the debt commitment, for which the due data has come to pass and the total commitment exceeds 50 times the minimum wage for one month, or, because of the conditions to be proved, it will not be possible for this person to settle the debt commitment, the due data of which will have elapsed within a year, where the debt commitment in total exceeds 100 times the minimum monthly wage.<sup>\*42</sup>

The Czech Insolvency Act (Act 182/2006 Coll.) took effect on 1 January 2008, replacing the previous Bankruptcy and Composition Act (Act 328/1991 Coll.). One of the novelties introduced by the act is the set of proceedings called *oddlužení* in Czech, best translated as discharge of unpaid debt or, in shorthand, discharge. In short, in the discharge proceedings, the creditors either receive the proceeds of the sale of the debtor's assets, whereupon the debtor's future income is protected, or they receive instalments from the debtor's income for five years, in which case the debtor's assets are protected—in each case provided that the method chosen leads

<sup>36</sup> D. McKenzie Skene, A. Walters (Note 2), p. 147.

<sup>37</sup> This contrasts with the position in the US where a debtor who receives a discharge in Chapter 7 must wait eight years before qualifying for another discharge through a Chapter 7 filing. D. McKenzie Skene, A. Walters (Note 2), p. 147.

<sup>38</sup> J. J. Kilborn. *Comparative Consumer Bankruptcy*. Durham: Carolina Academic Press 2007, pp. 48 and 89–90.

<sup>39</sup> Note: The Dutch Financial Services Act (*Wetfinanciële dienstverlening*) and the Dutch Finance Supervisory Act (*Wet financieel toezicht*) have not been effective in terms of preventing consumers from falling into debt situations from which they are unable to independently extricate themselves. Debt counselling is not always effective and creditors frequently refuse out-of-court debt settlements. The Dutch Act on Debt Restructuring for Natural Persons (*Wet schuldsanering natuurlijke personen*), included in the Dutch Bankruptcy Act in 1998 and generally referred to as the *Wsnp*, operates as a final resort for individuals experiencing serious debt problems. In 1999, one in every 2000 people in the Netherlands were either declared bankrupt or applied to undergo *Wsnp* debt restructuring. This number had doubled by 2005. See A. Noordam (Note 35), pp. 667 and 678.

<sup>40</sup> See E. Braun (ed.). *Commentary on the German Insolvency Code*. Düsseldorf: IDW-Verlag, p. 497 ff.

<sup>41</sup> Latvian Insolvency Act Part D Chapter XXIV, § 149 (1).

<sup>42</sup> Latvian Insolvency Act Part D Chapter XXIV, § 151.

to the payment of at least 30% of the debtor's unsecured debt.<sup>\*43</sup> After the sale or the elapsing of the five-year instalment period, the court will, in a new order issued upon the debtor's application, discharge the debtor from the remaining part of his debts (under § 414 of the Act). The order will be issued only if the debtor paid at least 30% of his unsecured debts<sup>\*44</sup>, unless individual unsecured creditors agreed to receive less or unless the debtor can show that he was prevented from paying the minimum amount by circumstances beyond his control and that the unsecured creditors have in any case not received less than they would have in liquidation proceedings (under § 415 of the Act). In the three years following the discharge order, the court may reverse the order if it turns out that the debtor acted fraudulently in the proceedings or committed a crime in relation thereto (described in § 417 of the Act).<sup>\*45</sup>

In the Czech Republic, in 2008, the first year of the new act being in force, some 1,700 applications for discharge proceedings were filed, amounting to approximately 1/3 of all insolvency petitions (a total of approx. 5,300) filed under the new act in that first year.<sup>\*46</sup> The overwhelming majority of the confirmed applications involved instalments as the chosen method of satisfaction of the debts. The first quarter of 2009 saw a significant increase in new insolvency petitions (up 17.2% from the figure for the fourth quarter of 2008) and even greater growth in the number of applications for discharge proceedings (up almost 50% from the fourth quarter of 2008). These developments are correlated with the deepening economic recession that arrived later to the Czech economy than to some other European markets.<sup>\*47</sup>

Since 31 March 2009, there have been personal insolvency proceedings available in Poland.<sup>\*48</sup> The scope of the new regulation covers those debtors who are not involved in business (consumers). Before, insolvency proceedings were also available to so-called business individuals (individual entrepreneurs). The new law provides that only the debtor and not its creditors may file for bankruptcy. The consumer insolvency is exclusively a winding-up insolvency, which means that all of the assets will be liquidated and the creditors will be (partially) paid off by means of the proceeds. The liquidation of assets is usually managed by the appointed liquidator; however, it may be allowed for the debtor to carry it on personally under the supervision of a liquidator.<sup>\*49</sup> In Poland, by the end of June 2009, in the first three months of the new law being in force, there were about 450 court applications, of which only two (!) succeeded. In both cases, debtors secured their spouses' businesses, which went bankrupt later. The statistics indicate clearly that regulation proves to be too strict with respect to both the material and the financial prerequisites for filing of an effective consumer insolvency petition.<sup>\*50</sup>

No individual insolvency law is available in Romania and Hungary. In Hungary, there has been some discussion about introducing the concept of individual insolvency, but no laws have been adopted yet. A proposal was presented in February 2009 concerning procedures available to individuals trying to settle their claims with creditors. This draft proposes to introduce two types of individual bankruptcy:

- a) a regulated procedure that aims to establish a compromise between the debtor and his creditors—in such a procedure, the supervision of the debtor's financial decisions is secured; and
- b) a procedure (also aimed at securing a compromise between the debtor and creditor) initiated by the request of the debtor or creditor but that does not assume an agreement with the other party.<sup>\*51</sup>

Also, a separate new draft law on natural persons' debt adjustment has been pending in the Estonian Parliament since 21 April 2010.<sup>\*52</sup> In this draft, a separate court procedure has been proposed in which an individual may apply for several debt adjustment measures. The court in debt adjustment proceedings has the leading and supervisory role in finding balanced interests between creditors and debtor. The proceedings are substantially alternative procedures to bankruptcy proceedings and aimed at preventing individuals from being involved in bankruptcy proceedings. The procedure is similar to and based on restructuring proceedings applied for

<sup>43</sup> T. Richter. Consumer Insolvency Proceedings under the New Czech Insolvency Law. Paper presented in INSOL Europe conference in Stockholm 2009.

<sup>44</sup> Notably, the Act does not require that this be measured in the present value of the payments, i.e., the debtors will in effect pay less than 30 per cent of their debt.

<sup>45</sup> T. Richter (Note 43).

<sup>46</sup> For details see T. Richter. *Insolvenční zákon v roce dva: první statistické údaje a jejich prozatímní interpretace* (The Insolvency Act in Year Two: First Statistics and a Tentative Attempt at Interpretation). XVII. Karlovarské právnícké dny. Praha: Linde 2009 (in Czech).

<sup>47</sup> T. Richter (Note 43).

<sup>48</sup> Articles 491<sup>1</sup>–491<sup>12</sup> of the Polish Bankruptcy and Reorganisation Act dated 28 February 2003 amended by the Law of 5 December 2008. – *Journal of Laws* 2008 (234), section 1572.

<sup>49</sup> P. Filipiak. Consumer Insolvency Proceedings under the Amended Polish Bankruptcy Law. Paper presented in INSOL Europe conference in Stockholm 2009.

<sup>50</sup> *Ibid.*

<sup>51</sup> C. M. S. Cameron McKenna. Individual Insolvency in Russia and Certain Central and Eastern European Countries. September 2009.

<sup>52</sup> *Võlgade ümberkujundamise ja võlakaitse seaduse eelnõu seletuskiri* (Explanatory Memorandum to the Draft Act on Restructuring of Debts and Debt Protection), draft act No. 743 SE. Available at [http://www.riigikogu.ee/?page=en\\_vaade&op=ems&eid=1004095&u=20100519125501](http://www.riigikogu.ee/?page=en_vaade&op=ems&eid=1004095&u=20100519125501) (22.04.2010) (in Estonian).

reorganisation of corporate debtors as stipulated in the Reorganisation Act<sup>\*53</sup>, but it takes into account the different nature of the types of debtor.

## 2. Various aspects to address in a European cross-border insolvency system

In cases of cross-border insolvency in Europe, the European Insolvency Regulation resolves conflicts among the national law regimes and conflicts of jurisdiction among the courts of the various Member States. The regulation has three basic goals:

- a) to provide for legal certainty in matters of cross-border insolvency;
- b) to promote the efficiency of insolvency proceedings, by favouring those solutions that facilitate their administration and improve the *ex ante* planning of transactions; and
- c) to eliminate inequalities among Union-based creditors with regard to access to and participation in such proceedings.<sup>\*54</sup>

All of these aims are closely related to creditors' rights, whether in main and/or in territorial insolvency proceedings.<sup>\*55</sup> In order to achieve the above-mentioned goals, the regulation does not seek to establish a uniform code of insolvency law in the European Union.

However, uniform rules of conflict of laws—Articles 4 and 28—which replace national rules of private international law<sup>\*56</sup>, stipulate that the law of the state in which the proceedings are opened (*lex fori concursus*) is applicable for the insolvency proceedings and their effects. Because of the current rapidly changing socio-economic landscape, it can nowadays be debatable whether, as a result of widely differing national substantive laws, it was (at the time when the EIR was written) not practical to introduce insolvency proceedings with a universal scope throughout the Union<sup>\*57</sup>, as the drafters believed that the application of the law of the state opening an insolvency proceeding would, against this background, frequently lead to difficulties unless there were exceptions, which were drafted and stipulated in Articles 5 to 15. The rules related to the lodging, verification, and admission of claims are governed by *lex fori concursus* according to Article 4 (2) (h) and uniform substantive rules contained in Articles 32 and 39–42 of the EIR itself; the latter provisions also replace national rules of private international law in the Member States.

Equally important for the application of the regulation are the three annexes. These contain, respectively, a list of insolvency proceedings (Annex A), of winding-up proceedings (Annex B), and of liquidators (Annex C). These lists supplement the legal definitions contained in Article 2 of the EIR. By dictating which national legal institutions fall within the definitions, they ease the interpretation of these. According to Article 45 of the EIR, the Council of Europe, acting by qualified majority on the initiative of one of its members or on a proposal from the European Commission, may amend the annexes.<sup>\*58</sup> This 'closed-list system'<sup>\*59</sup> provides legal certainty, as it enables the parties applying it to ascertain exactly which proceedings fall within the scope of the regulation's application.<sup>\*60</sup>

The regulation permits insolvency proceedings to be opened against the same debtor (applicable to both natural and legal persons) in two or more (!) Member States. The regulation does not establish any limit to the number of the territorial proceedings that may be opened, as long as the debtor has an establishment within the meaning of Article 2 (h) of the EIR in the Member State of the opening. As indicated above, Articles 4 and 28—which replace national rules of private international law—stipulate that the law of the state in which the proceedings are opened (*lex fori concursus*) is applicable to the different insolvency proceedings and their effects. Finding of the proper, correctly applicable law may be incomprehensive, costly, and burdensome for individual debtors and also for creditors. Doubling of insolvency proceedings also requires double liquidators

<sup>53</sup> Saneerimisseadus. 4 December 2008. – RT I 2008, 53, 296; 2010, 2, 3 (in Estonian).

<sup>54</sup> M. Virgós, F. Garcimartin. *The European Insolvency Regulation: Law and Practice*. Kluwer Law International 2004, margin No. 5, pp. 7–8.

<sup>55</sup> Territorial insolvency proceedings can be characterised as either secondary insolvency proceedings pursuant to Article 3 (3) of the EIR, or independent territorial insolvency proceedings pursuant to Article 3 (4) of the EIR, depending on whether the main proceedings have been opened or not.

<sup>56</sup> See M. Virgós, E. Schmit. *Report on the Convention on Insolvency Proceedings*, 8 July 1996, margin No. 87 ff.

<sup>57</sup> M. Virgós, F. Garcimartin (Note 54), margin No. 5, pp. 7–8.

<sup>58</sup> K. Pannen (ed.) *European Insolvency Regulation*. De Gruyter Commentaries on European Law. Berlin: De Gruyter Recht 2007, Introduction, margin No. 45, p. 17.

<sup>59</sup> M. Virgós, F. Garcimartin. *The European Insolvency Regulation: Law and Practice*, 2004, p. 30. – K. Pannen (Note 58), Article 2, margin No. 3, p. 52.

<sup>60</sup> K. Pannen (Note 58), Article 2, margin No. 3, p. 52.

in various Member States to be appointed by the courts to handle these proceedings, which is definitely costly for the system where individuals' insolvency proceedings are concerned.

Another aspect is that all proceedings opened after the main insolvency proceedings must necessarily be winding-up proceedings within the meaning of Article 2 (c) of the EIR.<sup>\*61</sup> According to the EIR, this principle applies for both individual and corporate debtors' insolvency proceedings. Member States having seen a constantly increasing number of individuals' insolvencies (which was not an issue in the early 1990s), the requirement stipulated in the EIR that secondary insolvency proceedings may only be winding-up proceedings, by nature, is not, in the author's opinion, well grounded or justified anymore. An appropriate transparent regulatory measure for enabling over-indebted individuals to start over with their lives and for participants in insolvency proceedings to recognise the proceedings in other Member State is needed within the European Insolvency Regulation framework.<sup>\*62</sup> Whether it is to involve an abolishment of secondary proceedings from the European Insolvency Regulation framework or some further amendments to the EIR has yet to be considered. The nature of individuals' insolvency proceedings is common to all national legal systems—in the bankruptcy of an individual, the debtor will not cease to exist, unlike corporate debtors. That secondary insolvency proceedings must be winding-up proceedings might not create difficulties in Member States that have separate forms of insolvency proceedings, such as France or Italy.<sup>\*63</sup> For Estonia, the proceeding listed in Annex B of the EIR is the *pankrotimenetus*. *Pankrotimenetus* (directly translated into English as 'bankruptcy proceeding') pursuant to the Estonian Bankruptcy Act's § 2 may be either a winding-up or a reorganisation proceeding. In contrast to other legal systems, Estonian insolvency law (as is the case in Spanish law, with *concurso* in annexes A and B of the EIR, or German law, *Insolvenzverfahren*, in annexes A and B of the EIR) does not distinguish from the outset between winding-up and reorganisation proceedings. There might arise problems in other Member States in terms of the recognition and transparency of the proceeding in question. Debatable is, for instance, whether an insolvency plan proceeding under German law should be regarded as a winding-up proceeding within the meaning of the regulation.<sup>\*64</sup>

In the author's opinion, revision of provisions in national laws and the European Insolvency Regulation is needed in relation to questions of secondary insolvency proceedings and individual debtors (consumers). Because of the complexity of the over-indebtedness problem, some countries have already excluded certain types of debtors from insolvency proceedings altogether, while in other countries a natural person cannot be declared bankrupt unless he acted in the capacity of a merchant.<sup>\*65</sup> These constantly changing policies and governmental attitudes do not make European and domestic insolvency systems more predictable, simple, transparent, and efficient for the creditors and debtors to apply. Consumer over-indebtedness may raise wider socio-economic concerns. Firstly, there are concerns of the 'ticking time bomb' variety. Highly leveraged consumers are vulnerable to sudden drops in income caused by changes in their personal circumstances, such as job loss, illness, or family breakdown, or changes in their general economic outlook.<sup>\*66</sup> For example, most Western European countries have been dependent on sustained consumer spending. Credit has been a driving force for economic growth and the welfare of consumers. Yet it also poses a risk for credit-providers and threatens additional costs and insolvency for a growing number of consumers. Secondly, there are concerns about the social impact of over-indebtedness on families and communities. Over-indebtedness affects a significant and growing number of European consumers in all Member States. In most cases, over-indebtedness is due to increasing uncertainty in predictability of income. In other cases, changes in societal attitudes to debt and enjoying the present at the expense of the future lead to over-indebtedness.

Naturally, nothing in the regulation prevents only one set of main proceedings from being opened in the Community against the same debtor even though he has establishments operating in multiple Member States; the plurality of proceedings is simply a possibility that the regulation offers to those involved.<sup>\*67</sup> However, as a creditor, one should always be aware that

<sup>61</sup> M. Virgós, F. Garcimartin (Note 54), margin No. 443, p. 235.

<sup>62</sup> During the negotiations on the 1995 Draft Convention on Insolvency Proceedings, many of the Member States wished to restrict the scope of the convention to winding-up proceedings. By way of compromise, it was finally agreed that main insolvency proceedings could also be geared to the reorganisation of the debtor, but that secondary insolvency proceedings could not; these must result in a winding-up. Historical reason for this is that secondary insolvency proceedings geared to the reorganisation of the debtor could pose problems of compatibility and coordination with the main insolvency proceedings. These arguments are not well-grounded within the changed economic landscape in EU.

<sup>63</sup> K. Pannen (Note 58), Article 2, margin No. 13, p. 54.

<sup>64</sup> On this, see, e.g.: S. Smid. *Deutsches und Europäisches Internationales Insolvenzrecht*. Kohlhammer 2004, Article 2, margin No. 11; C. G. Paulus. *Europäische Insolvenzverordnung. Kommentar*. Frankfurt a. M.: Recht und Wirtschaft 2006, Article 2, margin No.11; K. Pannen (Note 58), Article 2, margin No. 14, p. 54.

<sup>65</sup> This is the case in France, Greece, Italy, Luxembourg, Portugal and Spain. See K. Pannen (Note 58), Article 4, margin No. 40, p. 223.

<sup>66</sup> D. McKenzie Skene, A. Walters (Note 2), p. 137.

<sup>67</sup> M. Virgós, F. Garcimartin. *The European Insolvency Regulation: Law and Practice*. Kluwer Law International 2004, margin No. 418, p. 225.

- a) the main insolvency proceedings have automatic universal world-wide effects<sup>\*68</sup> upon opening of the insolvency proceedings in respect of all the debtor's assets, wherever such assets are located<sup>\*69</sup> within the Union<sup>\*70</sup>, and for all creditors (including residents of other Member States) as being automatically involved in these proceedings<sup>\*71</sup>;
- b) the decision to request the commencement of secondary proceedings<sup>\*72</sup> will only make sense when the expected value of the claim in the secondary proceedings is greater than that in the main proceedings<sup>\*73</sup> or in situations in which it is not possible to initiate main proceedings<sup>\*74</sup>;
- c) the general rule stated in Article 4 (1) of the EIR, that the *lex fori concursus* applies to the insolvency proceedings opened—either main or secondary proceedings—is subject to a considerable number of exceptions set out in Articles 5–15, 32, and 39–42 of the EIR; and
- d) the effects of main insolvency proceedings will not be recognised in relation to local assets since the opening of the secondary proceedings. Once secondary proceedings are commenced, the local assets form part of those proceedings and are governed by local law. This enables local expectations with regard to such matters as local law priorities in respect of dividends and the validity of locally perfected security to be met.<sup>\*75</sup>

In addition, most probably the creditor and the debtor need to communicate with, co-operate with, and protect their interests in front of the foreign-language-speaking liquidator, who most probably is not familiar with foreign domestic law in cross-border insolvency cases. The task is not an easy one for all of the participants in cross-border insolvency proceedings if the insolvency system is far too complex and unpredictable.

Legislators should take into account that there are already some unpleasant examples of court cases involving individuals in cross-border insolvency proceedings—in particular, the *Stojevic* case.<sup>\*76</sup> In this case, Mr Stojevic, a Croatian national of Russian extraction, was declared bankrupt in two courts in succession, on 27 March 2003 in England and on 28 January 2004 in Austria, both proceedings being the main insolvency proceedings. The annulment of the Austrian Bankruptcy Order removed the conflict of jurisdiction between the two European countries—England and Austria—but in this case, the centre of the debtor's main interests within the meaning of the European Insolvency Regulation, when the bankruptcy petition was filed, was actually in Austria and not in England. It took four years to resolve this matter legally, and the situation resulted in the annulment of the English Bankruptcy Order dated 27 March 2003 under Section 282 (1) (a) of the 1986 Act. The downside of this action meant that Mr. Stojevic, who had huge debts both in Austria and in England, and no assets in either country, escaped bankruptcy altogether.<sup>\*77</sup>

### 3. Conclusions

Attitudes toward individuals' bankruptcy differ significantly between individual societies and cultures. These diversities are reflected in the insolvency laws and in the policies of the respective countries, which shape both the terms of the laws and the mode of their application.

However, the nature of the proceedings is common for all legal systems—in the bankruptcy of an individual, the debtor does not cease to exist. Therefore, we often find ourselves pondering how to find a balance between the need to provide an appropriate mechanism for enabling over-indebted individuals to start over with their lives, on one hand, and social concerns that debts should be paid (moral duty).

Moral philosophy tells us that we should keep to our promises. This is the starting point of contract law as well. The key to the moral obligation to pay a debt lies in the act of promising. If we have a moral duty to keep our promises, it applies to our contractual debts too. The answer to the question 'What makes a promise

<sup>68</sup> Recognition based on Article 16 of the EIR.

<sup>69</sup> Uniform rules determining the location of assets in Member States are determined in Article 2 (g).

<sup>70</sup> Article 4 of the EIR.

<sup>71</sup> Article 32 (1) of the EIR.

<sup>72</sup> Article 29 (b) empowers to request the opening of secondary proceedings by any person under the law of the Member State within the territory of which the opening of secondary proceedings is requested.

<sup>73</sup> It seems logical because the effects of secondary proceedings are restricted to assets only located in the Member State of the opening of secondary proceedings from which claims may be satisfied.

<sup>74</sup> M. Virgós, F. Garcimartin (Note 54), margin No. 418, p. 225.

<sup>75</sup> I. F. Fletcher. *The Law of Insolvency*. 3rd edition. London: Sweet & Maxwell 2002, paragraphs 31–029. – G. Moss, I. F. Fletcher, S. Isaacs (eds). *The EC Regulation on Insolvency Proceedings. A Commentary and Annotated Guide*. 2nd ed. Oxford University Press, 2009, margin No. 8.269, p. 307.

<sup>76</sup> Case No. 9849 of 2002, High Court of Justice in Bankruptcy, London, 20 December 2006.

<sup>77</sup> *Ibid.*

morally binding?’ will set the ethical boundaries for the public enforcement of contracts. It is logical to conclude that a society should, as a general rule, sanction only those contracts that, in some rational sense, are morally binding. There are several ways whereby promises can be seen to introduce moral force to contractual obligations.<sup>\*78</sup> However, Christianity has played an important role in Western culture and societies. One of its central doctrines is forgiveness, with the Bible advising us to forgive debts every seventh year. Even if the duty to keep promises is given the strictest possible interpretation, to the effect that promises must always be kept, there are circumstances (for example, involving the duty to perform impossible acts) wherein obligation simply becomes void. An insolvent debtor is under no obligation, moral or legal, to pay his debts in a society where there is a law allowing discharge. The most common argument for laws protecting debtors is that their consequences are favourable. They are seen as producing the best outcome, at least from the debtor’s and society’s point of view, but often from the creditor’s perspective as well.<sup>\*79</sup>

Among the innovative responses to the rising volume of consumer bankruptcies in many societies, specially targeted procedures are being introduced with the aim of bringing relief to those debtors with limited means, or without any regular income, who are overwhelmed by the level of their debts. When countries evaluate and reform their insolvency laws, the key question will often be how to find the appropriate balance between a variety of social, political, and economic interests that will induce all players in the economy to participate in the system.

Although the bankruptcy laws of individual countries differ in many important respects, we should keep in mind firstly that the overall aim of the bankruptcy laws should be the allocation of risks among participants in a market economy in a transparent, equitable, and predictable manner and, secondly, that the aim of the bankruptcy law is to protect and maximise value for the benefit of all interested parties and the economy in general. When determining how to strike a balance between the various objectives, it is necessary to avoid easy stereotypes—debtors are not always fraudulent or incompetent in their actions, and creditors are not always selfish and grasping. However, discharge for individual debtors should not be made available to those who have engaged in fraudulent behaviour or who have failed to disclose material information during the proceedings.

To achieve a fair and equitable allocation of consumer credit risks, the INSOL Report recommends that legislators enact regulatory means to assure a fair and equitable, efficient and cost-effective, accessible and transparent settlement and discharge of consumer and small business debts.<sup>\*80</sup> Whether an appropriate legal measure is an abolishment of secondary insolvency proceedings from the European Insolvency Regulation framework or some further amendments and modifications to the European Insolvency Regulation is yet to be decided.

<sup>78</sup> J. Kilppi (Note 6), p. 17.

<sup>79</sup> *Ibid.*, pp. 68–70.

<sup>80</sup> INSOL Report, p. 14.