



Insolvency and Creditor/Debtor Regimes Task Force

**Working Group on the Treatment of the
Insolvency of Natural Persons**

INFORMAL DRAFT FOR DISCUSSION PURPOSES

The World Bank – Insolvency and Creditor/Debtor Regimes Initiative Task Force

**Working Group on the Treatment of the
Insolvency of Natural Persons**

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Draft Report on the Treatment of the Insolvency of Natural Persons

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I. Introduction

I.1. General background

1. Under the Standards and Codes Initiative of the International Financial Architecture, the World Bank was mandated by the Financial Stability Forum – now the Financial Stability Board – to develop a unified standard for the comparative examination of business insolvency and creditor/debtor regimes (the “ICR Standard”).

2. The ICR Standard is composed of the recommendations from the UNCITRAL Legislative Guide on Insolvency Law (the “Guide”) (2004) and the World Bank Principles for Effective Insolvency and Creditor Rights Systems (the “Principles”), which were originally formulated in 2001, and subsequently revised in 2005 and in 2011, in consultation with UNCITRAL, the IMF and the World Bank’s international partners. As presented together in the ICR Standard, the Principles and the Guide’s Recommendations represent a single point of reference for the evaluation of enterprise distress resolution regimes. The World Bank is responsible for supporting the efforts of developing countries to strengthen the legal, regulatory and institutional frameworks that govern ICR regimes through the preparation of in-depth diagnostic reports (Reports on the Observation of Standards and Codes, “ROSCs”), the provision of technical assistance and the development and dissemination of knowledge and expertise on insolvency-related issues.

3. The World Bank’s Insolvency and Creditor/Debtor Regimes Task Force (the “Task Force”) is fundamental to the implementation of the World Bank’s mandate. Bringing together experienced judges, expert practitioners, academics and policymakers from across the world, the Task Force provides an important forum for a collaborative and inclusive dialogue on the ICR Standard to further increase understanding and expertise on law and policy in the insolvency area.

4. The World Bank convened the Task Force on 10th – 11th January 2011 to discuss revisions to the ICR Standard as well as a number of insolvency-related issues arising in the wake of the global financial crisis. As part of this discussion, the Task Force was asked to consider, for the first time, the topic of the insolvency of natural persons, an issue brought into sharp focus in the wake of national mortgage crises and the resulting global financial crisis and characterized by divergent regulatory treatment afforded under national laws, with implications for international financial stability and for economic development and access to finance.

5. The World Bank conducted a preliminary survey on the laws of insolvency of natural persons in existence around the world.¹ The survey covered 59 countries, of which 25 are high-income economies and 34 are low- and middle-income economies. The countries surveyed covered 67.5% of the world population. The main objective of the survey was to find out about the existence of legislation addressing consumer insolvency, and it was found that in more than half of the low- and middle-income countries surveyed there is no legislative system at all.

6. The January 2011 meeting of the Task Force recognized the significance of this issue and discussed the feasibility of utilizing the expertise of the Task Force for the study of the key regulatory aspects underlying the insolvency of natural persons, the variation in legal treatment under national legal regimes and the implications of these divergences for international collaboration and coordination.²

7. In the closing statement to the January 2011 Task Force meeting, it was stated that:

[O]ne of the lessons from the recent financial crisis was the recognition of the problem of consumer insolvency as a systemic risk and the consequent need for the modernization of domestic laws and institutions to enable jurisdictions to deal effectively and efficiently with the risks of individual over indebtedness. The importance of these issues to the international financial architecture that has been recognized in various ways by the G-20 and by the Financial Stability Board has today been reconfirmed and emphasized by this Task Force. It is important to recognize the diversity of policy perspectives, values, cultural preferences and legal traditions that shape the way jurisdictions may choose to deal with the problems of individual over indebtedness. Yet recent events suggest that the expansion of access to finance, the extension of

¹ The survey was directed by Adolfo Rouillon, from the World Bank. The results of the survey can be accessed at <http://siteresources.worldbank.org/EXTGILD/Resources/Jan11-CI-Rouillon.pdf>.

² See *Best Practices in the Insolvency of Natural Persons*, report by Professor Susan Block-Lieb, at http://siteresources.worldbank.org/EXTGILD/Resources/WB_TF_2011_Consumer_Insolvency.pdf. The Task Force meeting devoted two sessions to the treatment of the insolvency of natural persons. The first session gave a panoramic view of comparative approaches to the insolvency of natural persons. The session was chaired by Adolfo Rouillon (World Bank) and the panellists were Jason Kilborn (USA), Alexander Byriukov (Ukraine), P. R. Chinien (Mauritius), Kazuhiro Yanahira (Japan) and Luiz Fernando Valente de Paiva (Brazil) The second session examined the issue of the lack of guidance for personal insolvency regimes from the point of view of international organizations and international NGOs. Adolfo Rouillon (World Bank) chaired the session, and the panel included representatives from UNCITRAL, the World Bank, the IMF, EBRD, IBA, and INSOL.

*modern modes of financial intermediation, and the mobility and globalization of financial flows may have changed the character and scale of the risk of consumer insolvency in similar ways in many different economies. In response to these concerns, the World Bank, through the Legal Vice-Presidency, will organize an appropriate Working Group of the Insolvency Law Task Force to begin work on identifying the policies and general principles that underlie the diverse legal systems that have evolved for effectively managing the risks of consumer insolvency and individual over indebtedness in the modern context. The World Bank will work with its international partners and use its convening power to bring together a representative group of internationally recognized experts in order to address these important issues.*³

8. Following up on the Task Force Meeting discussion, the World Bank and the Task Force created a special working group of expert academics, judges, practitioners and policy-makers (the “Working Group”) to study the issue of natural person insolvency and produce a reflective document on this matter, suggesting guidance for the treatment of the different issues involved, and taking into account different policy options and the diverse sensitivities around the world.

9. The Working Group met in Washington DC from November 16-17, 2011. Over the course of the sessions, the participants debated numerous issues relevant to the insolvency of natural persons and commented on the draft that was submitted to the Working Group. Written comments were also received during the sessions and afterwards. The comments enriched the document and were taken into account in the preparation of the second version of the draft.

I.2. Objectives and nature of this report

10. The main objective of this document is to provide guidance on the characteristics of an insolvency regime for natural persons and on the opportunities and challenges encountered in the development of an effective regime for the treatment of the insolvency of natural persons. In this regard, the document intends to raise awareness about the importance of a regime for the treatment of the insolvency of natural persons, and explores the advantages and disadvantages of the solutions to the numerous practical issues that have to be confronted in the design of an insolvency regime for natural persons.

³ Concluding remarks of the Task Force meeting, by Vijay S. Tata (Chief Counsel, LEGPS, World Bank). See http://siteresources.worldbank.org/EXTGILD/Resources/WB_TF_2011_Consumer_Insolvency.pdf.

11. This document, therefore, is a *report* that provides guidance on policy issues that need to be addressed in developing modern legal regimes for the treatment of the insolvency of natural persons, but it does not purport to identify any set of “best practices” for the regulation of the insolvency of natural persons. The report addresses issues that fall outside the scope of the benchmark (or assessment “standard”) used in the ICR assessments under the Reports on the Observance of Standards and Codes program of the World Bank and the IMF. In this regard, it is important to recall that the ICR ROSC assessment standard, consisting of the World Bank Principles and the UNCITRAL Legislative Guide (the ICR Standard), seeks to address the treatment of business insolvency, both for corporate entities and for business activities of natural persons. This report acknowledges the value of the ICR Standard in its treatment of business insolvency, and recognizes its fundamental role in providing guidance for business insolvency regimes.

12. There is general consensus that it would be premature to identify any single approach (or “best practice”) for the legal treatment of the insolvency of natural persons not engaged in business activities. The insolvency of natural persons is intertwined with social, political and cultural issues that present too many differences to be treated uniformly. It would be difficult for a uniform approach to emerge. Policymakers should be aware of the social, legal and economic peculiarities that may affect the functioning of a regime for the insolvency of natural persons.

13. The fact that the development of a common set of “best practices” is unlikely at the present state of affairs does not imply that the insolvency of natural persons should be left out of the scope of research and of the reform efforts of policymakers worldwide. Indeed, this document presents a case for the analysis that policy makers should carry out in their own legal systems, to better understand the effects and benefits of the various policy choices in designing an effective system for the treatment of the insolvency of natural persons. By setting out the advantages and disadvantages of the different and sometimes competing approaches to the regulation of the insolvency of natural persons, this report is designed to help policymakers develop a better sense of the social and economic advantages of some of the modern approaches to the insolvency of natural persons.

I.3. Methodology

14. This document offers a reflective, non-prescriptive approach: by describing specific problems, and specific solutions with their positive and negative consequences, it aims to provide a *map* of the questions faced in the complex

task of creating a regime for the treatment of the insolvency of natural persons, as well as ideas and alternatives for the benefit of those involved in insolvency reform and of those affected, in any capacity, in the application of insolvency laws.

15. The report presents ideas and solutions for problems experienced in the regulation and implementation of systems for the insolvency of natural persons. The countries on which these observations are based are not identified, for the sake of the universality to which this document aspires, and in the understanding that the lessons learned in certain systems may provide very valid precedents for other countries. At any rate, the observations included in the report are based on tested models and practical experiences.

16. The report also references a number of empirical studies. Legal scholarship on the insolvency of natural persons has benefited from the work of specialists who have produced research based on the empirical analysis of the implementation and application of systems of insolvency of natural persons. Those invaluable empirical studies have been taken into account for the elaboration of this report, and many of them have been referenced in footnotes to provide ready examples, though these references should not be regarded as an exhaustive list of all available studies that have influenced the observations in this report.

I.4. Terminology

17. By “insolvency,” this document refers not to a particular legal structure or approach, but rather to the distressed condition of the debtor and the constellation of potential approaches to treating that condition. This document uses the term “insolvency” rather than the variety of terms in use throughout the world today to describe various systems offering some combination of collective creditor redress and alleviation of the burdens of debt on an insolvent debtor. Whether it be called “bankruptcy” or “sequestration” or “debt relief” or “debt adjustment,” the common, unifying factor is the focus of this document; that is, any system for alleviating the burdens of excessive debt and allocating benefits and losses, both among creditors and as between creditors and natural person debtors, falls within the intended ambit of “treatment of insolvency of natural persons.” If such a system exists or is contemplated in any given country, to whatever extent, its characteristics and effects are intended to be encompassed within the discussion to follow, whatever label might have been assigned to that system.

18. This document refers, generically, to the “insolvency of natural persons”. As discussed below, the coverage of all situations of insolvency of natural persons presents some

problems of delimitation (see below, section I.8.C). The focus of this report is on all the questions that affect the debtor *as a person*, and the report does not adopt the approach of defining painstakingly the debtors who are natural persons and who are the objects of the analysis here developed. Having recognized the value and relevance of the ICR Standard, and stating clearly that the ICR Standard governs the insolvency of natural persons who are engaged in business activities (traders or merchants), this report centers its attention on the *personal* aspects of insolvency: these aspects are prevalent in the insolvency of persons who cannot be said to be engaged in significant business activity, but they also exist in the cases of individuals who can be classified as “traders”, “merchants”, or “entrepreneurs”. The report avoids the use of the expression “consumer insolvency” because it would raise similar questions as to the distinction between consumers and non-consumers in numerous legal systems. Therefore, the report uses the expressions “insolvency of natural persons” and “personal insolvency” indistinctly. The document is addressed to the questions posed by the insolvency of individuals, rather than to those questions raised by the interaction of business activities and commercial credit, and it is for policy makers to determine the relevance of the analysis contained in this report to the specific circumstances that affect insolvent individuals in any particular system.

I.5. Precedents

19. This document is built on numerous sources for, and experiences in, the regulation of the insolvency of natural persons around the world.

20. The national experiences in the design of a functional insolvency regime for natural persons are too numerous to be listed, but they have served as the basis for the analysis developed in this document.

21. The study of the regimes of the insolvency of natural persons has benefited from reports from different international organizations, including the following:

(a) The *Consumer Debt Report* of INSOL International (I, 2001 and II, 2011);

(b) The report on *Legal Solutions to Debt Problems in Credit Societies* of the Council of Europe (2005);

(c) The reports of the European Commission, *Consumer Overindebtedness and Consumer Law in the European Union*, for the Commission of the European Communities (2003); and *Towards a Common Operational European Definition of Over-Indebtedness* (2008);

(d) The Model Law on Family Insolvency for Latin America and the Caribbean, of Consumers International (2011).

I.6. Intended users of this document

22. The potential readership of this report comprises all those who are interested in the development of regimes for the insolvency of natural persons.

- (a) Policy makers wishing to design a balanced system for the treatment of the insolvency of natural persons;
- (b) International organizations, both governmental and non-governmental;
- (c) Members of the judiciary;
- (d) Lawyers and insolvency practitioners;
- (e) Financial and credit institutions that provide credit to natural persons; and
- (f) All persons and institutions involved in insolvency reform and reform assistance.

23. Not all of these potential readers will have legal training. Accordingly, the document is intended to be formulated in an accessible “plain language” style.

24. The document has been formulated in a fashion that enables it to be used by countries with diverse legal traditions. It uses neutral generic terminology, except where the analysis requires the use of specific legal terms belonging to certain systems.

I.7. Context and coordination of insolvency treatment for natural persons

25. Any consideration of a regime for addressing the insolvency of natural persons should take into account the surrounding context of laws, policies, and practices with which such a regime must necessarily coordinate. Perhaps most directly, a regime for addressing the insolvency of natural persons is essentially an extension, a final stage of the judicial system, in particular the procedural regime for enforcing obligations and property rights. Less directly, but no less importantly, insolvency regimes for natural persons implicate salient issues of data protection and personal privacy, as well as a whole host of social and economic regulatory issues, such as individual counseling, education, social welfare provision, and family and housing policy. Both practically and as a matter of legal policy, financial distress and insolvency are inextricably linked with credit extension, banking, taxation, and business entrepreneurship, as well as with the more fundamental laws of contractual and delictual

obligations and property—and the interaction of the obligations and property regimes. How any society regards debt will impact on any consideration of treating the excessive burdens of that debt. For example, a given legal or cultural system might regard debts as a collective obligation of a family, tribe, or some larger group beyond the individual debtor most directly responsible for the onset of the obligation. In such a situation, the need for and proper structure of a system for treating insolvency would be profoundly affected by such a perspective, which differs from the basic notion of individual liability upon which the discussion in this document—and most present insolvency systems—is premised.

26. The degree to which each of these coordinate systems functions satisfactorily -or not- in any given country will necessarily impact on a proper assessment of a potential insolvency regime for natural persons, both in general and with respect to specific provisions and implementation strategies. Many countries, for example, continue to struggle with “rule of law” issues, including low popular acceptance of and adherence to law generally, an insufficiently supported or qualified judiciary, and even corruption in one or more levels of government. The degree to which an insolvency mechanism might function against—or in spite of—a backdrop of such systemic weaknesses is an important consideration to be taken into account.

27. The need for and desired extent and operation of an insolvency system for natural persons will not only be influenced by such coordinate areas of law and society, an insolvency regime will also influence the structure and operation of these surrounding systems. To take a simple example, a country without a robust system of lending and borrowing may well have far less need for a system of natural person insolvency—though other sources of obligations and their enforcement may produce the pernicious effects discussed below, and an insolvency system may well have at least a limited role to play in achieving some of the benefits described below. Conversely, the existence or absence of a system of natural person insolvency might well impact on the willingness or ability of creditors to make financing available to consumers or entrepreneurs, though the specific direction and extent of these theoretical effects is subject to substantial uncertainty, despite a wealth of research and academic debate on the issue.

28. Likewise, a country may choose to deal with the challenges of personal financial distress not through a specific system concentrated on the treatment of insolvency, but through broad limitations on the enforcement of judgments and other claims. A middle ground might be an aggressive regime of what might be called “consumer protection,” even if such a system protects small business

people and others who are not “pure” consumers. Conversely, the existence of an insolvency regime for natural persons may well alleviate or exacerbate pressure in other areas of a country’s legal and social infrastructure. For example, issues of inefficient claims enforcement, poor counseling and financial education infrastructure, weak (or liberal) credit regulation, and incentives for entrepreneurship might be dealt with to a greater or lesser degree in an insolvency system rather than through more direct regulation.

29. Different policymakers may well come to different conclusions as to the proper methods and places to guide and influence behavior through social or economic regulation (or the lack thereof). Part of an assessment of an insolvency regime for natural persons, however, must be to take into account how such a system might fit within broader societal factors and the policy choices made in other areas of law that constrain or allow the kinds of practices and behaviors implicating or implicated by the insolvency of natural persons. Some of these practices and behaviors are discussed in section I.9, below, and section I.8.E again emphasizes that diversity of approach is all but inevitable in a world marked by different policy choices in what might be called “non-insolvency law.”

I.8. Scope, General Goals and Distinguishing Characteristics of an Insolvency Regime for Natural Persons

30. The notion of an insolvency regime for natural persons is by no means a monolithic concept. Natural persons engage in a wide variety of activities with implications for debt and indebtedness. Financial distress can manifest itself in very different forms, insolvency can arise from a diverse range of causes, and policymakers might select from among a range of very different approaches to combating one or another form or degree of financial distress. Therefore, any discussion of a regime of insolvency for natural persons must begin by considering the scope of the topic to be encompassed—or left aside for treatment elsewhere. This section identifies the carefully limited scope of this document, focusing on the characteristics of the debtors and the type of financial distress treatment addressed here. It also clarifies the primary distinctions among the general goals and key elements of different kinds of regimes for responding to financial distress involving natural persons, especially those engaged to a greater or lesser degree in business activity.

A) Treatment, not prevention, of insolvency

31. As discussed in section I.7 above, the relatively narrow subject of this document is situated in the midst of an extremely broad constellation of topics with a direct or indirect relationship with the financial distress of natural persons. One topic especially closely related to treatment of insolvency is *prevention* of insolvency. Policy discussions and legal reforms in many current systems have incorporated a desire to attempt to address insolvency by avoiding it altogether through such techniques as more expansive credit reporting and financial literacy training. Financial literacy education in particular might be implemented within a system for treating existing insolvency, though the primary purpose of such education is not to treat existing insolvency, but rather to prevent repeat insolvency.

32. An entire separate document could well be devoted to an exploration of the need for, proper structure, and effectiveness of such preventive measures. These issues are quite complex and subject to substantial debate and disagreement among experts. Accordingly, to avoid getting mired in a parallel series of disputes and to maintain focus, this document will not address *preventive* measures. Rather, this document will address only the *treatment* of already existing insolvency in the context of natural persons.

B) Treatment of insolvency, not poverty

33. Regimes for providing insolvency relief to natural persons are commonly compared to regimes for providing social assistance (welfare), especially to the impoverished. While insolvency and social support regimes can work in tandem, and there might be a small area of overlap in coverage, these distinct systems are designed with distinct goals in mind. As discussed in section I.9, below, most of the goals of insolvency regimes are economic in focus, avoiding waste and enhancing productivity. While the structures and goals of social assistance regimes vary greatly, they are generally driven primarily if not exclusively by humanitarian concerns for social solidarity and social planning, often whether or not this has any positive economic impact on any segment of society. While some of the goals of insolvency also involve compassion and a general desire to relieve suffering, goals relating to economic performance and efficiency are at least equally as prominent, if not predominant.

34. The primary goal of most social support regimes is simply to redistribute income or other types of resources to individuals who lack those resources and are somehow inhibited from accumulating appropriate resources for

themselves. This redistribution often occurs over extended periods of time, and it might be offered regardless of “need.” Social assistance systems generally are designed to ensure that every member of society has access to a baseline level of resources to meet their basic needs for necessities such as food, shelter, and healthcare. Of course, this goal is marked by conflicting visions of an appropriate baseline. Some social assistance is extended to support other social goals, such as reproduction and parenthood (e.g., child allowances). One need not have any debt burden to qualify for social assistance.

35. Insolvency regimes are less like social *assistance*, and more like social *insurance*, protecting individuals from financial tragedy. For some debtors, an insolvency regime might function somewhat like a social assistance program designed specifically to support individuals with unmanageable debt and prevent unnecessary suffering and social exclusion. But insolvency systems do not offer cash support payments, and far from every overburdened debtor faces social exclusion and utter destitution. Lack of resources to meet basic needs may well lead to problems managing debt, but these two problems do not always appear together. Indeed, some have questioned the appropriateness of extending insolvency relief to impoverished debtors totally and permanently reliant on social assistance. Many of the benefits for creditors and society discussed below in section 1.9 are not available in such cases. Others have pointed out that several of the advantages are present even in such cases; e.g., those relating to reducing wasteful collections costs and reducing stress and health problems, not to mention the humanitarian and religious concerns for offering relief to debtors themselves. These advantages are present even—and perhaps especially—in cases involving so-called “judgment-proof” debtors, with no assets or income that can be seized by creditors under ordinary restrictions on enforcement.

36. Most debtors served by an insolvency regime will rely on social assistance only temporarily (e.g., unemployment or medical assistance), if at all. An insolvency regime serves mainly individuals who do not suffer from a long-term disability or general surfeit of resources and who thus do not need affirmative social support. Insolvency regimes are designed primarily and work best for individuals who are capable of producing sufficient income to support themselves and their families, but an overwhelming debt burden saps their initiative and depresses their productive capacity. These debtors do not seek *more* government intervention in their lives; they seek *less* government intervention from officially sanctioned wasteful and destructive debt enforcement action. The goal is to stop counterproductive debt collection, not to receive financial or other resources.

37. Fundamentally, the core distinction between regimes to combat poverty and insolvency is that the problem of poverty cannot be “solved” in one procedure for any given individual, whereas the practical problems of insolvency can be solved in one procedure. The real problems of insolvency flow not from the fact of inability to pay, but from creditors’ and the state’s failing to recognize inability to pay and to appropriately curtail the pointless and destructive *pursuit* of uncollectible debts. Stopping these pursuits, or at least striking a rational compromise for satisfying them, is an almost instantaneous solution to the core practical problems that distressed debt poses for creditors, debtors, and society.

38. One might argue that an insolvency regime indeed does impose a redistribution of resources away from creditors, but as discussed below, preventing creditors’ pursuit of an illusion of collectable debt does not deprive creditors of a real “resource”; it simply prompts them to accept reality and stop the wasteful and destructive continuing pursuit of chimerical returns. The losses confirmed in this process may well be financed indirectly by society (much like a social assistance regime) as creditors increase the cost of credit, but this is in many cases the result of the fact of the debtor’s insolvency, not the result of the insolvency relief process itself.

39. Also, a properly functioning insolvency regime should provide relief only to those debtors in need, and relief should be delivered in a brief procedure. Most debtors are able to manage their reasonable debt burdens, even if they experience some measure of distress along the way, so only a limited percentage of all debtors should expect to obtain relief through an insolvency procedure. Such a regime is designed only to provide relief needed by debtors whose means are expected to be overwhelmed by their debt servicing obligations for some extended period of time. Most likely, this mismatch between disposable income and debt service will have been triggered by one of the many accidents of life, such as unemployment, illness, divorce, or other income interruption or unexpected expense. Any well-designed insolvency regime will impose some entry requirements, as discussed below. By removing or alleviating the unserviceable debt burden and reinvigorating the debtor’s capacity for self-support, an insolvency procedure should provide relief not gradually over an extended time, but quite quickly. Within a relatively short period of time following an insolvency procedure, most debtors who can benefit from an insolvency system should be back on solid financial footing, and most of these debtors will not be expected to seek more relief later.

C) Insolvency of natural persons: “Pure” consumers versus those engaged in business

40. One particular area of law with which a regime for natural person insolvency must coordinate is business insolvency. Many of the same issues of law, policy, and practice that arise in business insolvency might also arise in the context of addressing the insolvency of natural persons. This is especially true when the insolvent natural person is or has been also engaged in business, whether or not the insolvency arises as a direct consequence of business activity. See the following section I.8.D for a discussion of the principal policy distinctions between business insolvency and the insolvency of natural persons.

41. In some insolvency systems, traders, artisans and self-employed professionals can become debtors in general insolvency procedures, whereas other natural persons may be excluded from these procedures. In many other countries, the debtor in an insolvency procedure can be, in principle at least, any legal subject, including natural persons who have become indebted in their private, non-business capacity. However, if the insolvency law of such a country does not include a discharge of debt—or makes it quite difficult to obtain a discharge—natural persons not engaged in business rarely file for the insolvency procedure, even if it is theoretically possible. In recent decades, many systems have developed specifically to provide debt relief to natural persons, and some of these systems exclude debtors with significant on-going business activity, though there is a notable trend to find specific solutions for debtors with relatively limited ongoing business activity.

42. As explained in section I.1, above, the ICR Standard governs the proper treatment of *business* insolvency. For natural persons with substantial business activity representing most or all of the indebtedness giving rise to the situation of insolvency to be treated, the ICR Standard represents the source of guidance on the proper structure of and approach to a regime of business insolvency. This report does not diminish the relevance of the ICR Standard.

43. Two essential differences distinguish this document from the ICR Standard: First, unlike the ICR Standard, this document is a “reflective document (. . .) suggesting guidance,” as explained above in section I.1. It is explicitly non-prescriptive, leaving readers to arrive at their own conclusions “taking into account different policy options and the diverse sensitivities around the world.” This document does not create a “standard,” and it contains no recommendations or “best practices”; rather, it simply identifies particularly salient issues and offers empirical

observations from experts regarding evolving practices and the results of those practices around the world.

44. Second, while the ICR Standard concentrates on the resolution of *business* insolvency, whether the debtor is a natural or artificial entity, this report focuses on those issues most relevant to *natural persons* as debtors, whether or not engaged in business. To be sure, the ICR Standard contains discussion of several topics that are equally relevant for the treatment of insolvency of natural persons not engaged in business; for example, the functions and qualifications of insolvency representatives and other system administrators, and the importance and design of a moratorium or stay of actions against the debtor and the debtor's property to provide "breathing space" for the development of a payment plan or other resolution. Nonetheless, the ICR Standard was not designed to address the specific and often unique concerns of natural person debtors whose insolvency has limited or no connection to business activity. Consequently, such concerns are the primary focus of this document. Legal issues that are relevant primarily to the insolvency of businesses or traders are only referred to here when some salient distinction is to be drawn between the operation of such issues in business cases and in those involving natural persons engaged in little or no significant business activity.

45. This document is not restricted, however, to debtors with little or no business activity. The animating premise of this document is that insolvent natural persons face a shared core of key issues, whether or not business activity is a part of the context of the insolvency, and these concerns differ in important respects from those discussed in the context of the ICR Standard. All insolvency regimes have the potential to share key elements and issues; nonetheless, this document proceeds from the standpoint that any debtor's status as a natural person raises unique considerations that are at least equally central, if not more so, to the proper structure and assessment of a system for addressing natural person insolvency. A multi-national corporate conglomerate certainly has relevant similarities with the individual proprietor of a local food stand in terms of regulating the insolvencies of these businesses. The shared characteristics are at least as central, if not significantly more so, however, as between the local food stand owner and a "pure" consumer with no business activity.

46. This document concentrates on the issues that differentiate any natural person's insolvency from that of an artificial entity, and it addresses common insolvency issues, if at all, only from the distinct perspective of individual natural persons and their specific needs, motivations, and other characteristics. In other words, as discussed in section I.8.D, below, this document concentrates on issues most implicated

by the “human factor” inherent in any insolvency case involving a natural person as debtor.

47. Similar “scope” observations might be made with respect to natural persons engaged in other specific business or professional activities. For example, this document highlights concerns that will inevitably arise in the context of natural persons engaged in farming operations, so it does conceivably apply to the insolvency of farmers. Once again, however, the focus here is on natural persons and the issues that unite a farming debtor and a non-farming debtor in that context. Little or no specific reference is made to the specific concerns of natural persons engaged in agricultural production or any other specific industry, though this document should not be read to downplay the existence or importance of specific challenges related to, for example, the insolvency of debtors engaged in farming (e.g., land tenure, government subsidies, and farm financing).

48. As the ICR Standard expressly acknowledges, it is often quite difficult to draw a meaningful distinction between “business” and “non-business” or “pure consumer” debtors. Natural persons quite commonly carry heavy debt loads after a termination of business activity. This kind of debt load may derive from a business that debtors have carried out in their own name or in a partnership, in which the partners have personal liability for the debts of the partnership. Quite often debtors have become personally liable for debts because they have given personal guarantees for the loans of a company with limited liability. Such debtors may have different connections with that company, for example, as shareholders or directors of the company or as next of kin of such persons. Also, persons who engage in small-scale business activity in their own name are often essentially in a similar situation as wage-earning debtors who have become insolvent. For example, if the main source of debt is a housing loan or a guarantee for another person’s loan, there is little salient difference between a wage earner and a debtor who earns her living by providing services to a small number of different clients. While this kind of business activity has traditionally been common among artisans, craftsmen, traders, farmers, and many providers of professional services, the transformation of the labor market during the past few decades has transformed many providers of low-skill services from employees into self-employed service providers.

49. Where and whether to draw a boundary line in the law at the point where business (or farming) considerations end and personal considerations begin, or where business (or farming) insolvency considerations predominate over natural person insolvency considerations is, once again, a matter for individual readers to assess. This document highlights the considerations most salient for natural person debtors of all

kinds, to allow policymakers to evaluate for themselves whether and to what degree the specific and unifying concerns of natural person insolvency warrant special treatment in the distinct context of any given country.

D) Distinction between business insolvency and the insolvency of natural persons

50. The contrast between business and natural person insolvency regimes is essentially the opposite of the contrast between insolvency and social assistance relief, discussed above in section I.8.B. Whereas social assistance programs usually rest almost exclusively on humanitarian sentiments, insolvency relief for natural persons *also* involves a powerful element of economic concern. Business insolvency regimes lie at the other end of this spectrum; that is, while insolvency relief for natural persons *does* include some element of humanitarian empathy, business insolvency policy is driven almost exclusively by economic concerns. At the very least, arguments supporting business insolvency that are *not* entirely economic in nature usually appeal to a desire to support communities and jobs as a positive side-effect of saving failing businesses. The desire to relieve individual suffering is more direct and more central in the context of natural person insolvency. In the insolvency of companies and other legal entities, the debtor can be and often is completely dismembered and allowed to die. One of the primary goals of a regime of insolvency for natural persons, in contrast, is avoiding this fate for the debtor, not just in light of the negative consequences for other people in the debtor's household and community.

51. As explored in section I.9, below, many of the goals of the two types of insolvency regimes overlap, such as increasing and more fairly distributing payment to creditors, reducing waste and redundant burdens on official organs, and enhancing economic performance for the ultimate benefit of society. The human element often adds a slight but important twist to several of these economic goals. Take, for example, the goal of reinvigorating natural person debtors and offering them an incentive to engage in income-producing activity. Artificial entities need not be "incentivized" to remain productive; their human owners can simply shut down and restart their business activity somewhere else, though at significant expense. Nonetheless, the process of restructuring a company's debt burdens results in continued productivity, avoiding a long interruption while the entrepreneurs re-launch their business elsewhere. Often in the context of business insolvency, it is fundamentally the human element behind the business that needs to be protected. If the entrepreneur is ruined with no access to personal insolvency relief, the opportunity for

accessing future productive, entrepreneurial energies is lost. Only a regime of insolvency relief for natural persons can get to the heart of this problem.

52. Not only the goals and techniques, but also the assumptions underlying the two different types of insolvency systems differ for important reasons. For example, business insolvency rules are often crafted on the (usually unstated) assumption that the actors involved, including the debtor, are fully rational economic actors who took on (or should have taken on) debts with full and adequate information. A wealth of behavioral studies now makes clear that this foundational assumption is wholly inappropriate in the context of most natural persons.⁴ Especially if the debtor has not had the benefit of expert advice—as will usually be the case for debtors with mainly consumption-type loans—natural persons seldom behave in a way consistent with the classical economic ideals on which business insolvency systems are founded. Likewise, the incentives, both positive and negative, benefits and sanctions, built into business insolvency systems are less likely to influence natural persons (especially those not engaged in business) in the same way as sophisticated commercial entities with well-supported advisory resources.

E) The divergence in the treatment of natural person insolvency under national legal regimes

53. In the design and implementation of an insolvency regime for natural persons, it is most likely the case that one size does not fit all. As acknowledged above in section I.7, various regions, nations, groups, and even individuals have starkly contrasting views on the religious, moral, cultural, and economic implications of debt, risk, and forgiveness. Other important topics are similarly subject to widely divergent viewpoints, including notions of collective versus individual responsibility, obligations running from society to individuals and *vice versa*, and formal versus informal dispute resolution. More concrete factors also create very different foundations for supporting an insolvency system, including institutional capacities of a variety of kinds, the stability of the banking or other lending sector, and the scope and nature of economic activity, especially the

⁴ See, e.g., Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004); Saul Schwartz, *Personal Bankruptcy Law: A Behavioral Perspective*, in CONSUMER BANKRUPTCY IN GLOBAL PERSPECTIVE 61 (Johanna Niemi-Kiesiläinen, Iain Ramsay & William Whitford eds., 2003); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051 (2000); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630 (1999); Christine Jolls, Cass R. Sunstein, and Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STANFORD L. REV. 1471 (1998).

prevalence of personal versus impersonal exchange and activity involving credit and borrowing. Not all creditors are large institutions, and the ripple effects of declaring some claims to be uncollectible can wreak havoc on a small economy, especially one based on close personal relationships—though, as discussed below, it is likely the fact of insolvency, not the system for confirming and relieving it, that is responsible for this problem. The many factors that might impact on and be impacted by an insolvency system were mentioned above in section I.7.

54. In light of these widespread and fundamental divergences in circumstance, philosophy, and capacity, international coordinating institutions must take care in avoiding a “mainstreaming” approach, compelling countries to adopt regimes or aspects of regimes that are incompatible with local conditions. The many benefits of such regimes may be more or less attractive, and more or less applicable, in various countries. Likewise, discrete aspects of these regimes might be more appropriate for some social, cultural, economic, political, and judicial structures than for others. The current state of insolvency regimes for natural persons demonstrates this. Despite the close connections and similarities among the some two dozen nations that have adopted full-fledged insolvency regimes for natural persons today, the structure and operation of these systems differ, often dramatically, from country to country, even in the closely clustered nations of Northern, Central, and Western Europe. Many of these differences will be explored in this document, though the reasons for these differences remain difficult if not impossible to explain adequately.

55. In light of these considerations, this document offers not prescriptions and direct recommendations, but simply reflections. It represents the observations of expert observers not on *the* state of the art, but on the variety of approaches taken to various aspects of insolvency relief systems, and the benefits and obstacles that have revealed themselves over the past several decades of especially vibrant growth in these systems. It identifies issues to be considered in any insolvency regime for natural persons, alternative means of addressing those issues, and the consequences of making one or another choice, based on empirical observations from existing systems. This document thus endeavors not to convince policymakers throughout the world to follow the example of the various regimes existing today, but rather to enrich their own independent development process by considering the successes and struggles of a growing number of countries that have reaped the benefits of an insolvency regime for natural persons.

I.9. Foundations of insolvency for natural persons

56. In order to evaluate any regime of insolvency for natural persons, one has to consider the particular salutary effects of such a system. In particular, as discussed above, one has to distinguish these effects from those pursued by other similar systems, such as social safety nets (welfare) and business insolvency. In considering whether to adopt an insolvency regime for natural persons, and which approach might be taken with respect to various aspects of the structure of that system, lawmakers should bear in mind the broad range of purposes to be served and the degree to which each of these purposes is relevant for any given country's cultural, political, and economic circumstances.

57. In the past several decades, lawmakers from a variety of regions have explicitly identified and evaluated a wide range of desired benefits to be achieved by an insolvency regime for natural persons. The desired benefits fall into at least three distinct categories: First, benefits for creditors have historically constituted the main objective of insolvency regimes, which until the late 1900s had been often primarily if not exclusively designed for business debtors. Second, more recent discussions of insolvency regimes, especially those specifically designed for non-business debtors, have focused on benefits for debtors and their families. While the creditor-debtor relationship often has been viewed in simple binary terms, a third category of much more substantial benefits has also received substantial attention recently: benefits redounding broadly to significant segments of wider society and to society as a whole. As the discussion below will reveal, this third category encompasses a much longer and more significant list of benefits and purposes for an insolvency regime for natural persons. It is this category on which lawmakers seem to have concentrated most attention in evaluating the need for and the desired effects of such systems.

A) Benefits for creditors

58. A legal regime of insolvency never exists in a vacuum. From the perspective of creditors, such a system is necessary in large part in response to a weakness or failure in a coordinate system. An insolvency regime benefits creditors primarily by addressing two major weaknesses of the system of ordinary enforcement (collections) of obligations; namely, (1) ineffective mechanisms for finding value and the resulting waste resulting from individual creditors' blindly pursuing enforcement actions to the detriment of themselves and other creditors, and (2) inequitable distribution of available value to one or a few aggressive or sophisticated creditors, to the detriment of the collective of all creditors. These

weaknesses theoretically could be overcome without a separate insolvency system if the enforcement system were restructured. Proposals for such an approach have arisen in some countries, though to date, lawmakers seem to have concluded that adopting an insolvency system represents a more efficient and effective means of increasing payment to creditors and enhancing the fair distribution of such payments among all creditors. These benefits and the arguments that support them are largely identical in the context of insolvency of both debtors engaged in business and “pure” consumers, and they have existed largely unchanged since the very advent of the idea of a formal response to financial distress.

(i) *Increasing payment to individual creditors*

59. Most fundamentally, an insolvency regime might address weakness in the ordinary system of enforcement of obligations by supplanting it entirely as the collection mechanism of choice. When the ordinary enforcement system is hindered by formalities and restrictions and inefficiencies of a variety of kinds, independent insolvency regimes might offer creditors a more effective means—perhaps the only effective means—to coerce payment from debtors. Even if the ordinary enforcement regime works relatively well, however, an insolvency regime might enhance its operation in several important ways.

60. The simplest enhancement of a collective insolvency system is eliminating the waste inherent in multiple individual enforcement actions and fire sales of the debtor’s assets. Without a collective insolvency regime, each creditor has to engage and finance its own investigation of the debtor’s assets. If the debtor claims financial distress, each creditor has to decide whether the debtor’s claims of inability to pay are credible and further investment in futile collections efforts should be avoided. In close cases, each individual creditor has little incentive to maximize the value of a limited pool of assets or to avoid wasting value in depressed “fire sales.” Laboring under the dual burdens of information asymmetry and uncertainty, each creditor has an incentive to spend money on enforcement action, acting hastily to extract as much value as possible to protect its own interests. Individual, uncoordinated enforcement actions might represent a dead-weight loss if the assets produce no return beyond the enforcement costs. Even if significant asset value is available, such actions inevitably destroy value and increase losses for many if not most creditors that could be avoided by coordinated, collective action. An insolvency regime can offer creditors more convincing evidence of the folly of further collections, allowing creditors to avoid the expense of a multiplication of unsuccessful enforcement actions. For whatever assets are available, a collective

insolvency regime concentrates the administrative expenses of enforcement into one proceeding in which an administrator has an interest in maximizing the value of assets for all creditors.

61. A related enhancement concerns identification and location of the debtor's assets. Maximizing the value of assets requires creditors first to find assets. Even if some source of value is found, individual creditors face significant costs in pursuing those sources of value, often in competition with a debtor intent on evading or at least hindering these pursuits. Ordinary enforcement proceedings generally contain some mechanism for coercing the debtor to reveal the location of assets, but positive incentives generally work more effectively than negative threats. Debtors can be made to reveal their assets much more fully and readily with a warm positive incentive, rather than a cold blustery threat. At the very least, debtors might be more forthcoming with respect to the location of assets if they can rest assured that they will have to undergo such an interrogation only once in a collective proceeding, avoiding a multiplicity of inconvenient interruptions of their lives. More likely, an insolvency proceeding can provide an incentive in the form of a global delay or even discharge of renewed collections actions in exchange for debtors' being forthcoming about the location of their present assets.

62. As attractive as these "asset-based" benefits are in the business context, they are generally far less valuable in the context of natural persons, especially those with no ongoing business activity. Though natural persons engaged in business might have business assets to distribute among creditors, most individual debtors have little or no available asset value by the time enforcement actions have begun to multiply. As discussed below in section II.5.B, creditors are likely to recover payment from a natural person only if they can gain access to some source of *future* value. Luckily for creditors, natural persons cannot fade out of existence like corporations, dissolving upon the conclusion of insolvency proceedings. Individuals will continue to produce income from business or work or receive external support of some kind. More important than *locating* assets, the benefit of an insolvency system lies in *creating* asset value by encouraging debtors to be productive, facilitating compromise payment of some of that future value to creditors, and monitoring compliance with that compromise over a period of years. Experience suggests that such benefits can be severely limited in the context of natural persons not engaged in business, as discussed below in section II.5, but even the promise of a limited benefit is better than a certain loss. Another effect of the existence of an insolvency system for natural persons is that it encourages proper valuation of claims, and in this way creditors admit their losses and, in

most systems, claim tax deductions for them (see below, section I.9C (i)).

63. Most ordinary enforcement systems contain no mechanism for forcing debtors to work to produce future value for creditors. Indeed, the abolition of slavery and debt peonage in most areas by the mid-19th century rendered unlawful most forms of legally coerced labor to pay off debt. Even debtor's prison is not a sure method of coercing debtors to pay, and the tragic irony of imprisoning a debtor in order to goad him into working to pay creditors ought to be obvious. Imprisonment for debt was abandoned in most areas at the same time and for many of the same reasons as slavery and debt peonage, though also because it was spectacularly ineffective in producing payment for creditors.

64. Though the debtor's person today is largely insulated from debt enforcement, the debtor's property is not, and the most important type of property—wages and other earnings—has become the dominant target of collections actions. Garnishment of wages and other debts owed to debtors was limited in the middle of the 20th century in many systems, but even these limitations expose a significant portion of debtors' income to expropriation by creditors. If most or all of their future earnings are destined for creditors, debtors have little incentive to produce income and, indeed, a natural incentive to "go on strike" and simply refuse to work for the benefit of their creditors. Debtors might simply rely on public assistance to support themselves and their families, or they might withdraw into the underground or "black market" economy, producing value that cannot be accessed by creditors. Indeed, even in the regular economy of some especially large nations, natural person debtors can easily move from job to job and hide business income entirely, temporarily or permanently hindering creditors' efforts to find value.

65. Here again, positive incentives are far more effective than punishment, and an insolvency regime can offer a respite or discharge as a very effective incentive for debtors to produce value to share with creditors. Without the incentives an insolvency system can offer, the alternative for creditors of natural persons is generally not payment; it is a lifetime of fruitless pursuit by creditors of debtors completely withdrawn from regular economic life. Experience in many countries over the past several decades attests to the effectiveness of insolvency regimes in incentivizing debtors to produce value for creditors that simply would not have been realized otherwise.

66. An essential aspect of getting debtors to produce value is striking a compromise that binds all creditors in exchange for a distribution of that value. In the ordinary enforcement system, each creditor has to decide whether the debtor's

compromise offer of less than full payment should be accepted as reasonable. As discussed in section II.1, below, informal workout negotiations are just as common among natural person debtors as they are in the corporate context, but for a variety of reasons, creditors often find natural persons less trustworthy than corporate managers. Also, creditors' perspectives and expectations in the context of natural persons often differ markedly from the corporate context with respect to reasonable sacrifices and the moral compulsion to fulfill obligations. A settlement proposal that creditors might accept as a reasonable business measure for a corporation tends to be viewed in much more moralistic and judgmental terms when advanced by an individual, especially those not engaged in "morally neutral" business activity. Questions of appropriate personal sacrifices and standards of living make the process of deciding whether to pursue an individual debtor all the more complicated.

67. Coordinating the decision by numerous individual creditors to accept whatever the debtor has to offer presents a classic collective action problem that is unlikely to be overcome without some external control. In an insolvency regime, a neutral administrator might more efficiently and effectively coordinate the investigation, evaluation, and negotiated division of the debtor's productive capacity. Creditors are more likely to accept the conclusions of a neutral administrator, and empowering one administrator to strike the most reasonable compromise deal for creditors benefits the collective by overcoming the problem of irrational holdouts and conflicting strategic behaviors by isolated creditors.

68. A final potential benefit of an insolvency system for creditors concerns continuous monitoring. Once a compromise deal is in place with the debtor, someone has to ensure that the debtor abides by the new arrangement. In an informal workout, each creditor would bear its own costs of monitoring the debtor's ongoing financial situation and performance under the workout agreement. An insolvency system might again eliminate wasteful duplication of monitoring costs, concentrating that task on one administrator who might well have greater authority to scrutinize the debtor's activities than any individual creditor would. The insolvency representative might be empowered to take remedial action in case of default by the debtor, further alleviating the burden on creditors in pursuing maximum payment from the debtor.

**(ii) Enhancing fair distribution of payment
among the collective of creditors**

69. In addition to increasing payment to any one creditor, an insolvency regime might enhance the ordinary enforcement system simply by its collective nature. Taking into account the interests of all creditors at once, an insolvency regime is better able to ensure a fair distribution of available value among all creditors. This redounds to the particular benefit of unsophisticated creditors, who are unable or unwilling to pursue individual collections actions, or who have weak bargaining positions with respect to the debtor. Indeed, this effect is enhanced in an insolvency system where debtors have an incentive to seek relief themselves, rather than waiting for creditors to engage the insolvency system. If individual sophisticated creditors are better off engaging the ordinary enforcement system, seizing all available value and leaving nothing for other creditors, a system that encourages the debtor to engage the collective redress system offers the potential of all of the benefits discussed above to unsophisticated creditors without any action or expense on their part.

B) Benefits for debtors and their families

70. Perhaps even more obvious than increasing payment to creditors, providing relief to “honest but unfortunate” debtors has long been a primary purpose of insolvency regimes for natural persons. Though business insolvency systems have developed in the past several centuries with an all-but-exclusive aim of enhancing *collections* for creditors, insolvency systems have been used also to provide *relief* for debtors for an even longer period. Policymakers for millennia have engaged insolvency systems based on a variety of motivations related to relieving the suffering of debtors, including religious conviction, ideals of social solidarity, and basic sentiments of empathy and humanitarian concern for reducing long-term suffering.

71. Unmanageable debt burdens cause a host of serious psychic, and ultimately physical, problems for debtors. Empirical studies have documented widespread and profound debtor suffering from the fear and anxiety produced by constant worry about inability to repay debts, as well as nagging feelings of failure.⁵ Constant anxiety

⁵ See, e.g., Laura Choi, Federal Reserve Bank of San Francisco, *Financial Stress and Its Physical Effects On Individuals and Communities*, 5 COMMUNITY DEVELOPMENT INVESTMENT REVIEW 120 (2009); AP-AOL/ABT SRBI, Credit Card / Debt Stress Study (2008), http://surveys.ap.org/data/SRBI/AP-AOL%20Health%20Poll%20Topline%20040808_FINAL_debt%20stress.pdf; Fr. Bang Olsen, *Social-retspleje*, ADVOKATBLADET, nr. 1 (1972).

arising from inability to pay or from harassment by creditors can cause serious emotional and other problems for debtors, including depression and social withdrawal. Ironically, overwhelming debt burdens might cause debtors to be unable to concentrate on work and other responsibilities, thus preventing debtors from responsibly managing their own financial distress and plunging debtors into a descending spiral of failure. This situation of hopelessness can sap not only the debtor's motivation to engage in productive work, but also the debtor's essential joy or even desire for living.

72. Left unaddressed, these psychic maladies can manifest themselves in serious physical problems. High stress levels and constant anxiety have been known to produce a wide range of physical ailments in debtors, ranging from sleep deprivation to inability to concentrate at work to more serious maladies, such as indigestion, heart and nerve problems, weakness and depression, and even thoughts of suicide. In one country, the system of insolvency for natural persons arose largely in response to a call by a doctor who observed a high incidence of physical ailments directly linked to the counterproductive operation of the debt collection system. In another country, media reports have drawn attention to the desperate plight of numerous debtors who have taken their own lives as a result of their hopeless insolvency.

73. Systems for treating insolvency generally provide quite direct and often immediate relief from the stress, anxiety, and other negative emotional and physical reactions associated with inability to manage debts. Studies of debtors in insolvency systems have reported on the tremendous sense of relief that a simple respite—even a temporary one—can offer to debtors plagued by anxiety, guilt, shame, and helplessness.⁶ Many policymakers around the world have concluded that relieving the long-term pain and suffering of these debtors is a worthy goal in and of itself.

74. As discussed below, however, most of the benefits for debtors have spillover effects on broader society, and modern discussions of insolvency regimes for natural persons most often rely on these wider benefits rather than concentrating on compassion for individual debtors.

75. One important set of wider benefits moves only slightly beyond the debtor to the debtor's family, especially children. The spouses and especially children of distressed debtors

⁶ See, e.g., Götz Lechner & Wolfram Backert, *Menschen in der Verbraucherinsolvenz: Rechtliche und soziale Wirksamkeit des Verbraucherinsolvenzverfahrens einschließlich Darstellung der Haushaltsstrukturdaten des untersuchten Personenkreises*, in BMFSFJ, MATERIALIEN ZUR FAMILIENPOLITIK: LEBENSLAGEN VON FAMILIEN UND KINDERN: ÜBERSCHULDUNG PRIVATER HAUSHALTE 33-54 (2008).

suffer through no fault of their own and so are especially deserving of compassion and relief. Children of hopelessly distressed debtors suffer serious deleterious effects growing up in a household constantly hounded by creditor calls and financial strain, especially if the parent debtor withdraws from productive economic activity as a result of this constant pressure. These childhood effects can manifest themselves later in life in the form of poor socialization due to social exclusion, as well as unconstructive attitudes toward financial responsibility, paying taxes, and productive engagement. Already moving toward the next, broader set of goals, ensuring that children grow up in environments of constructive engagement with obligations, work, and society redounds to the benefit not only of the debtor and his children, but also to society.

C) Benefits for society, national and international

76. If financial distress were an isolated phenomenon, affecting only small pockets of individuals, an official regime for treating insolvency would most likely not be regarded as a moral or political imperative. The benefits to the few creditors and debtors involved would be the same as discussed above, but these benefits would not warrant the efforts and other significant costs of setting up and administering a relief system. Even where levels of financial distress have risen high enough to justify consideration of formal relief, the numbers of creditors and debtors directly impacted have been quite limited, representing only small fractions of the total population. The primary goals of an insolvency regime for natural persons are thus not so much based on isolated benefits to specific creditors and debtors, but rather on the more widespread benefits to the broader society on which those creditors and debtors have a variety of important indirect influences.

77. The most powerful driving concerns behind an insolvency regime are about ameliorating the negative *systemic* effects of unregulated distressed debt. Thus, as mentioned above in section I.7, in societies that lack a broad base of instances of distressed debt, or if those problems are addressed effectively by cultural responses such as collective responsibility within families, tribes, or villages, an insolvency regime for natural persons might well not serve a sufficiently substantial purpose to warrant the costs of implementation. But where traditional methods of collective redress have begun to break down, a societal response may well be warranted in light not so much of the desired benefits to individuals, but of the desired follow-on benefits flowing through the web of relationships in complex societies.

78. These benefits to society can be grouped loosely into two categories. One category encompasses a variety of

benefits associated with disciplining creditors to acknowledge the reality of their low-value claims against distressed debtors, internalize the costs of their own lax credit evaluation, and more effectively and fairly redistribute those costs among the society that benefits from the availability of credit. The other category focuses on the *intra-national* and *inter-national* benefits of maximizing engagement and productivity by debtors, especially in light of the increasingly competitive global marketplace.

(i) Establishing proper account valuation

79. For institutional creditors, the value of their own accounts receivable plays an important role in a variety of interactions with broader society. Properly valuing those accounts is vitally important to providing a proper basis on which investors and regulators can manage their relationships with such creditors. Investors' decisions with respect to properly managing and investing in such companies depend, often to a very significant degree, on an accurate vision of the expected cash flow and value to be derived from these accounts. More broadly, government regulators often rely on statements of account value, especially for lending institutions, in assessing the strength of these institutions, in judging the need for regulatory intervention, and in allowing these institutions to take deposits and otherwise manage the money of individual accountholders.

80. An essential aspect of valuing an account receivable is assessing the likelihood that the account balance will, in fact, ultimately be collected from the account debtor. While the overwhelming bulk of accounts are collected in the ordinary course, a rising tide of financial distress among account debtors can quickly erode the real value of accounts. Even if creditor institutions honestly perceive this erosion of value, the full scope and extent of the problem may be difficult to assess. To maintain good standing with external interests, creditors have powerful incentives to underestimate the degree of distress, perhaps grossly underestimating a delay in collecting on a series of accounts or failing to charge off uncollectible accounts as worthless. A human propensity for over-optimism, combined with a desire by creditor institutions to report pleasing figures to investors and regulators, can all too often lead to overly optimistic estimates of the collectability and therefore the value of accounts owed by distressed debtors.

81. If the value of a key asset like accounts is improperly inflated, a chain reaction of negative effects can flow quite quickly once the reality of the situation is discovered. If this occurs as a result of a series of unexpected defaults by account debtors, the negative effects can be immediate and

quite severe. The housing crisis that spread from the United States to infect the global economy in the late 2000s offers a vivid illustration of this problem. Banks and investors with interests in loans secured by home mortgages generally failed to admit until it was far too late that borrower financial distress had severely undermined the value of these accounts, a problem that was exacerbated by inflated valuations of many homes securing such loans. For distressed accounts that could be saved, creditors failed to take proper remedial action to put debtors back into a position from which they might reasonably service their debts. Similar stories have played out with respect to many different kinds of receivables.

82. Accounting standards reflect the need for proper discounting of distressed account assets, and banking regulations often require non-performing loans to be written off after a relatively short period of time. Regulations and regulators in some countries are quite strict about this, but in many countries, the substantial flexibility inherent in accounting and banking regulatory standards often allows institutional creditors to convey a misleading picture of the value of their accounts. If this situation is allowed to drag on for years, the ill effects of this over-valuation of accounts can grow extensively, and by the time when the reality of the value-destroying insolvency is acknowledged, it is too late to avoid serious disruptions reverberating far beyond the creditor's own balance sheet.

83. An insolvency system cannot avoid this problem entirely, but it can force creditors to acknowledge in a more timely fashion the reality that financial distress has destroyed or undermined the value of their accounts—and compel creditors to accept proper remedial action. An official declaration and confirmation of the account debtors' inability to pay prompts a more effective reevaluation of creditors' non-performing loan portfolios and more sound decisions with respect to investment in and regulation of such creditors. In addition, the confirmation of the debtor's inability to pay may have a tax effect in most systems, allowing creditors to claim tax deductions for their losses. Ultimately all of these effects produce a healthier climate for investing and managing the increasingly important role that such creditors play in financial society.

84. The fear that an insolvency relief system will undermine the balance sheets of institutional lenders—or of an entire lending industry—may well ignore a difficult but important reality: It is not an insolvency *relief* system that might destroy value, but the *fact* of account debtor insolvency itself that has already destroyed that value. Propping up a creditor institution and even an entire industry of such creditors may well simply delay the inevitable. Acknowledging the fact of account debtor insolvency and swallowing the bitter

medicine of an insolvency relief system can put creditors and their troubled industry back on the right path toward healthy financial dealings. Delaying this adjustment by treating non-performing loans as potentially performing will likely increase the severity and duration of a lending industry crisis when the reality of account debtor insolvency can no longer be ignored.

(ii) *Reducing wasteful collections costs and destroyed value in depressed asset sales*

85. Policymakers in several countries have expressed concern that the enforcement system commonly sustains an illusion that certain debts are enforceable. This phenomenon becomes a problem when creditors engage the official collections apparatus against debtors who have either no assets at all or too few assets to cover anything beyond the costs of collection. In cases where the debtor's assets are seized and sold to no effect other than paying the costs of seizure and sale, the use of the collections process produces little more than a dead-weight loss. The question is whether it is preferable to leave the debtor's meager assets alone rather than redistributing their value in a socially counterproductive way to enforcement officials and distressed auction buyers.

86. When creditors are allowed to pursue enforcement actions against hopelessly insolvent debtors, at least three negative effects follow. First, the courts are clogged with ordinary enforcement actions that strain their often already overtaxed resources. In most countries, the ordinary courts of first instance are charged with debt collection cases in addition to most other sorts of general disputes. Liability in debt collections cases is often not disputed, yet because creditors sustain a sliver of hope of collecting on judgments against insolvent debtors, they engage the scarce resources of the general court system to obtain a default judgment that often proves to be practically uncollectible. Though creditors bear part of the costs of such proceedings, their filing fees do not fully cover the direct and indirect costs of burdening the judicial system with a formalistic and fruitless process. Second, if an official authority is charged with enforcing these fruitless judgments, its time and resources are expended in vain as well. These costs may also not be recovered fully by charging the pursuing creditor. Finally, if available assets are located, their value is often consumed in covering enforcement costs, leaving the creditor's position largely or entirely unchanged, as much of the real objective value of these assets is wasted in an inefficient piecemeal sale process. Indeed, many policymakers have identified a fourth negative effect in having deprived the debtor of assets that likely had far greater personal value to him than to any

third party, an effect further exacerbated by imposing a significant replacement cost on the debtor.

87. An insolvency regime can reduce or eliminate this waste. Rather than imposing on the courts to manage multiple collections actions, a single collective proceeding can efficiently and effectively establish the essential fact of the debtor's insolvency and save time and other resources for the court system. If an objective evaluation compels creditors to accept that their claims are not covered by the paltry value of the debtor's assets, creditors themselves avoid wasting their own resources, as discussed above, but they also avoid wasting the official resources of the judicial and enforcement authorities. Moreover, the dead-weight loss of value in seizing and selling the personal effects of insolvent debtors can be avoided, and property can remain in a context where it has its greatest value, if a dispassionate neutral administrator is able to properly evaluate the lack of real available value in such property. This advances more than simple humanitarian concern for the debtor's comfort and convenience; it achieves a more appropriate distribution of resources, which benefits any society.

***(iii) Encouraging responsible lending and
reducing negative externalities***

88. The variety of harms that an insolvency regime seeks to avoid all represent costs caused at least in part by creditors' inaccurate risk assessment. Particularly in the context of modern individual lending, with aggressive advertising and computerized credit scoring, sophisticated institutional creditors are in a far better position than most borrowers to manage the inevitable risks of default and debt distress. An insolvency regime can encourage creditors to engage in more responsible credit underwriting and loan extension by concentrating the risks of overly aggressive credit decisions on lenders themselves.

89. When creditors make loans that ultimately default, they incur costs themselves, but they also externalize costs onto others. For creditors, these costs may be expected, almost welcome casualties of an aggressive business model of high-risk, high-profit lending. Even substantial losses can be managed if an aggressive lending model produces countervailing substantial returns from the "can-pay" debtors. Creditors can reduce the impact of their own lax credit underwriting decisions by factoring a loss ratio into their costs of doing business. They can plan for and adjust accordingly to expected losses, reducing the effect if not the incidence of default.

90. Debtors and society, in contrast, are either unable or ill-equipped to do this. While one might think that debtors are in the best position to simply avoid taking loans if the risk of default is too great, this is easier said than done. A voluminous literature on behavioral economics has revealed that human cognition is not well suited to decision-making under circumstances of uncertainty. Borrowers suffer a bias toward overconfidence, inflating their perceived likelihood of success and underestimating the risk of default. They also discount the ultimate cost of credit more powerfully than they discount the expected future value of a present good. These tendencies are known to and often exploited by sophisticated lenders. While the lenders can factor statistically likely losses into their investment and lending decisions, debtors are all but incapable of striking the proper balance of future risks.

91. Indeed, for some creditors, the cost of anticipated defaults might well be less than the cost of a more diligent credit assessment and underwriting process. The “payday” and other “subprime” lending industries offer an extreme illustration of this business model. These creditors can predict with virtual certainty that a substantial number of their low- to moderate-income borrowers will fail to repay their loans timely. Consequently, their business model accounts for such losses and recoups it on the front end with substantial fees charged to every borrower, in addition to steep default fees and penalties charged to those who fail to pay on time. This industry has enjoyed spectacular profitability despite an expected high rate of debt default; indeed, arguably *because of* an expected high rate of default.

92. These and many other creditors simply externalize the losses resulting from their lax credit underwriting onto third parties. Other borrowers pay substantially higher fees than they would if their own credit were properly evaluated, the communities where these borrowers live suffer from the stultifying effects of constant chain indebtedness, the court system devotes time and other resources to entering uncollectible default judgments, and society suffers from the existence of a constant underclass of debtors trapped in a never-ending debt spiral. In extreme cases, this process has even resulted in the loss of some debtors to suicide. Not only are these costs not visited on the creditors whose business model caused them, but they represent the leverage that produces the elevated returns on investment that are the core of the subprime lending model.

93. Once again, an insolvency regime cannot eliminate these problems, but it has the distinct potential to reduce them. In addition to directly alleviating other negative externalities as discussed in this section, an insolvency system can sharpen

creditors' attention to a more responsible lending model.⁷ Creditors who know that their borrowers have ready access to an escape hatch have an incentive to engage in more careful underwriting. They have an incentive to bring to bear their own risk calculations on their lending decisions, rather than relying on their debtors' innumeracy and overconfidence and creditors' ability to externalize or counterbalance expected default losses. Ultimately, direct regulation of certain extreme lending practices is necessary to avoid a continuing expansion of risk and externalized leverage from subprime lending. And given the costs involved in challenging unlawfully predatory lending, a collective insolvency proceeding may be the only forum in which such practices might meaningfully be challenged by debtors. For both prime and subprime lending, an insolvency regime puts a greater premium on responsible lending and avoiding losses that are more foreseeable to and can be more quickly and directly redirected back onto lenders. This produces a safer and healthier lending industry for all. Naturally, the issues of the regulation of the credit industry and lending practices are much broader than the impact of insolvency law on that industry, but natural personal insolvency law can have a prominent role in the promotion of responsible lending practices.

(iv) Concentrating losses on more efficient and effective loss distributors

94. The other side of the responsible lending and loss avoidance coin is the closely related benefit of concentrating inevitable losses on actors best suited to distribute the pain efficiently, effectively, and fairly. If failure to fulfill obligations were solely a function of debtors' irresponsibility or immorality, redistributing the consequences of undesirable behavior onto the rest of society would itself be undesirable. But default is rather seldom solely the consequence of factors within the debtor's control. Debtors in agricultural societies are at the mercy of weather and other environmental factors. Debtors in industrial societies are at the mercy of business cycles and commercial developments. Debtors in modern financial societies are at the mercy of swings in currency valuations and actions taken by finance houses seemingly far removed from the debtors' lives. Similarly, economic cycles may take their toll on debtors' home purchase and investment decisions. Indeed, the globalization of many world economies has placed debtors at

⁷ See Financial Stability Board, *Consumer Finance Protection with Particular Focus on Credit* (24 October 2011), section 4.1, at http://www.financialstabilityboard.org/publications/r_111026a.pdf. See World Bank, Report on good practices for financial consumer protection, <http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/Good-Practices-for-Financial-Consumer-Protection-Draft.pdf>.

the mercy of forces in far-flung areas of the globe whose influence is neither anticipated nor controllable. Debtors in all societies are at the mercy of potential health problems, divorce, childbirth, and all manner of life events that strain an otherwise manageable budget to the breaking point. Many individuals live paycheck to paycheck, and it may well be the loss of a job, a medical emergency, or a divorce that pushes the debtor over the edge and leads the debtor to seek insolvency relief. Indeed, the mere fact of living for an extended period “on the razor’s edge” in a situation of poverty or near poverty may expose low-income debtors to a constant risk of inability to service even modest debts, even if such debtors incur debts during a period of relative prosperity or, perhaps more commonly, in an instance of extreme desperation.

95. One tragedy concentrated on a few debtors is likely to destroy these individuals. But dividing and dispersing the burden of tragedy among all members of society produces an equitable and solidary solution. Everyone contributes a little in exchange for the promise of salvation from devastating demands. Rather than using such a direct collect-and-distribute approach, many modern societies instead use insurance to fairly and effectively redistribute the inevitable casualties of expected but unpredictable phenomena like fire, weather, and auto accidents. An insolvency regime fills a similar function in redistributing the inevitable casualties of expected but unpredictable financial distress. No one can accurately predict where financial distress will strike, but the lenders in charge of a substantial portion of the debts behind any given instance of financial distress are able to factor *aggregate* losses into their business model and incorporate the costs of such casualties into the rates they charge all borrowers. Lenders who increase the likelihood that individual borrowers will experience financial distress should bear the resulting losses, as discussed above, and some measure of official regulation might be an appropriate response if such behavior becomes extreme. But for “honest but unfortunate” borrowers who fulfill the entry requirements for an insolvency regime, a natural role for lenders is to concentrate and redistribute the increased costs of inevitable financial distress among all borrowers. All borrowers benefit from the availability of credit despite the risk of default, all borrowers benefit from the variety of positive effects that flow from the availability of a safety-valve insolvency regime, and so all borrowers can fairly be expected to share in the widely distributed costs of default and rehabilitation.

96. Some have argued that this approach imposes an unfair penalty on “responsible” borrowers who would never default. This perspective, though, is akin to equating auto insurance premiums with a penalty on safe drivers who would never experience an accident. No matter how carefully one drives,

one never knows when, through forces beyond one's control, an auto casualty will occur. Likewise, no matter how carefully and responsibly one manages one's finances; one can never be sure when financial distress will strike unexpectedly as a result of distant and perhaps unexpected forces. Some element of "moral hazard" will always be present, as there is with auto insurance. Some people will choose to drive in a riskier way, and some people will consume credit in a riskier way. But the answer to these hazards is not to eliminate either auto insurance or insolvency relief. Proper enforcement of driving rules will isolate and punish those who drive in an excessively risky way, and careful entry and exit requirements for an insolvency regime will isolate and exclude debtors who engage in excessively risky credit behavior.

97. Auto accidents and distressed debt could both be entirely avoided, of course, by never driving or borrowing against future earnings. This raises distinct issues and a different debate, however. The societies to which this discussion is directed do not wish to discourage driving or borrowing. A society that wishes to discourage borrowing likely has no need for an insolvency system. This discussion is directed at societies that have accepted the benefits of lending; e.g., smoothing consumption and reducing the volatility of financial supply and demand over time. A society that has embraced the good of lending is in a similar position to one that has embraced the benefits of driving. Each carries inevitable risks and casualties, and some form of loss spreading is a healthy way of maximizing and smoothing the benefits for all. An insolvency regime thus represents a sort of trade-off for deregulation of consumer lending. If natural persons are to be exposed to inevitable risks that they do not—and likely cannot—understand or avoid, insolvency restores fair equilibrium by offering insurance against those risks, with the "premiums" financed through small and appropriately distributed increases in the cost of credit.

98. Natural persons have a variety of creditors, not all of which are well suited to aggregating default losses and distributing the costs of financial distress throughout society. More direct and effective methods of redistributing these costs might well be identified, such as taxation or even a specific regime of mandatory credit insurance. These alternatives, though, require careful regulation, they are subject to inaccuracy and undesirable manipulation, and they are sufficiently unwieldy and costly that no significant movement for regulating default risk for natural persons has arisen anywhere in the world today. Insolvency regimes are increasingly serving a second-best alternative means of concentrating risk on creditors, who are the most efficient redistributors of default risk available. Once again, at the very least, these creditors are in a much better position to redistribute the costs of financial distress than are the

natural person debtors stricken by unexpected financial tragedy.

(v) *Reducing the costs of illness, crime, unemployment, and other welfare-related costs*

99. Turning from creditor-oriented benefits to debtor-oriented benefits, a second series of goals of insolvency regimes for natural persons involves advantages to society of lifting the debilitating thumb of collections pressure from debtors and reinvigorating their productive potential in the mainstream economy. This series of benefits can be viewed from two perspectives: removing negatives and enhancing positives.

100. As for removing negatives, an insolvency regime can reduce or eliminate a variety of direct and indirect social costs of leaving debtors to languish in a state of perpetual debt distress. Individuals trapped in an endless debt cycle consume precious social benefits, especially but not exclusively in states that provide some measure of social support (welfare). Most obviously, debtors discouraged from working might collect unemployment benefits. In states that offer other sorts of transfer payments (e.g., child allowances), this money directly or indirectly might find its way into the pockets of creditors rather than being applied for its intended purpose. Even more troubling, as discussed above in section I.9.B, constant harassment by creditors has been identified as the cause of chronic health and medical problems in debtors. States that provide medical support thus face an increased burden from greater numbers of patients suffering from debt-related maladies. Even in states that do not offer direct medical support, emergency rooms and other forms of last-resort health care can be clogged with people suffering from man-made distress. Moreover, simple medical problems often become much more serious and resource-intensive as a result of debtors' having foregone preventive care due to inability to devote resources to avoiding future health problems. At the extreme, financial desperation has driven many debtors to take out grey- or black-market loans at usurious interest rates, to engage in crime, or even to commit suicide, thus imposing significant costs on society.

101. No one system could ever eliminate all of these costs, but an insolvency system can reduce or eliminate the artificial causes of such problems. If a neutral arbiter can confirm that the debtor is not able to pay, or that a more rational, long-term repayment plan is appropriate, the acute stress of constant creditor pursuit of immediate payment can be alleviated. The unwarranted costs of unproductive

enforcement pressure can thus be substantially reduced if not eliminated in very short order. Even if a full discharge of liability is not available, any process for coordinating and humanizing the collections process can put debtors on a healthier path to supporting themselves, addressing their obligations in a more measured and regular way, and participating in society rather than viewing themselves as victims of it.

(vi) Increasing production of regular taxable income

102. Along with reducing social costs, an insolvency system can affect the other side of the ledger by increasing social contributions, again both directly and indirectly. The direct benefits of offering debtors an incentive to re-enter society and again have the opportunity to produce regular income were discussed above in terms of benefits to creditors. The direct benefits to society are much more significant and long-term.

103. Active and engaged debtors contribute to society in a variety of ways, some of which are explored in the following section. One obvious and often cited contribution involves tax revenue. Debtors pushed into the grey or underground economy might produce revenue, but taxing authorities are unable to benefit from that production. Insolvency regimes can provide incentives for debtors to apply their productive energies to the regular economy, maximizing their long-term future productive potential and making income tax and social security contributions from their income. The renewal of tax and benefit contributions from hopelessly indebted potential workers has been a prime consideration in the adoption of many current insolvency regimes. To be sure, unemployment and a lack of available jobs are among the primary causes of insolvency of natural persons, so the problem of a lack of suitable job opportunities may well need to be addressed as a prerequisite to achieving the benefits of returning debtors to active, formal employment.

104. Where regular jobs are available, some lawmakers have perceived a pernicious competition between creditors and society when creditors continue to pursue insolvent debtors for years on the slim and likely illusory hope of a small payment. For example, policymakers in one country acknowledged the undesirable but understandable tendency for debtors to go “on strike” and refuse to work to produce regular income if most or all of the fruits of their efforts will be siphoned off by creditors. This lost income harms not only the pursuing creditors, but society as a whole, and the losses to society far outstrip the losses to creditors, especially in light of the fact that continuing pressure from creditors often

produces not payment from debtors, but their continued self-exclusion from the regular workforce. By keeping potentially productive debtors under threat of expropriation of any excess income, these creditors for the sake of a relatively small sum rob society of the potentially much larger long-term productive energies of these repressed debtors.

105. The pursuing creditor can often be the state taxing authority. Even if the state itself is the pursuing creditor, inhibiting future productivity by pursuing fruitless collections on past obligations is no less undesirable. The moral hazard of relieving debtors of duties to the state (and society) might be theoretically more troubling in this context (see below, section I.10.A), but many countries' legislators have accepted the stark reality that it makes little practical sense to sacrifice a large potential future benefit in pursuit of a smaller past-due debt in such situations.

(vii) Maximizing economic activity, encouraging entrepreneurship

106. The benefits of an engaged citizenry extend far beyond mere tax receipts. Legislators in some countries have been especially concerned about the problem of social exclusion in general, and particularly as it affected the hopelessly indebted. Effectively removing citizens from active participation in public life carries many costs, not only in terms of economic productivity, but in terms of fostering a vibrant society. One desired effect of an effective insolvency regime, as envisioned particularly by lawmakers in the countries just mentioned, is reinvigoration and reinsertion of the hopelessly indebted into engaged society.

107. Activating as many members of society as possible has at least two prominent positive impacts. First, removing the weight of creditor pressure not only encourages regular income production, it can also enhance debtors' willingness and desire to be creative, even entrepreneurial. When debtors know that they will enjoy most of the value of their creative enterprise, they are more likely to push beyond mere subsistence and maximize returns for themselves and, indirectly, society. Moreover, if potential entrepreneurs know beforehand that the risks of failure are mitigated by an insolvency regime, they are more likely to confront the risks involved in entrepreneurship. Small- and medium-sized business is a major driver of many world economies, and a well-functioning insolvency regime can provide a powerful impetus to undertake the risks that necessarily accompany the rewards of starting a business. Facilitating entrepreneurialism was the primary goal behind the

fundamental revision of at least one insolvency law for natural persons in the early 2000s.

108. Second, enhancing entrepreneurialism and general social engagement maximizes national economic activity and international competitiveness. Every disengaged citizen is a link in a long chain of now lost economic and social potential. In closely integrated modern economies, one person's activity leverages the activity of many others. This is especially true in countries whose economies are heavily reliant on individual service and consumer spending. A few distressed debtors here and there are likely to have little impact on national GDP, but the substantial numbers of debtors seeking relief each year in many nations today represent a significant, even if not particularly substantial, portion of these nations' economic potential. As countries compete in foreign markets and vie for foreign direct investment, a maximally engaged citizenry is essential to achieving maximum competitiveness with other nations.

109. Ultimately, part of achieving maximum economic activity is reasonable individual consumption itself. Though spending from available means is generally regarded as the optimal approach to sustainable consumption, many policymakers from around the world today recognize an important value in individual borrowing from future income to smooth and optimize consumption patterns over time. Simply engaging in modern economic life is a sort of entrepreneurial risk, and international competitiveness calls for nations to encourage individuals to take reasonable risks in smoothing consumption through credit transactions. Excessive borrowing is surely a problem to be avoided, but as discussed above, avoiding all risk is not a cost-free proposition. Excessive saving and avoiding financial risk altogether can lead—and has led in some countries—to stagnation and accompanying economic potential lost. If individuals are overly cautious, saving more than necessary to appropriately hedge against potential income interruptions, unnecessarily voluminous savings represent lost potential to the present economy.

110. The optimal rate of insolvency is not zero if reasonable maximization of economic activity is desired. Risk is an inevitable aspect of pushing an economic system to acceptable limits. An insolvency regime accounts for inevitable miscalculations, spreading the costs across society (as discussed above) in exchange for the societal benefits of this approach. It offers individuals a backstop, a safety net, encouraging them to be as economically active as society believes is reasonably appropriate. As discussed below in section I.10.A, identifying the line between reasonably appropriate risk and moral hazard is a challenging task, but one goal of an insolvency system is to signal where the line is and to police access to the recovery system for those who

honestly miscalculated its location or who suffered the misfortune of having been pushed beyond it.

(viii) Enhancing stability, predictability in broader financial system, economy

111. Many of the benefits discussed in this section are derived, at least in part, from a more fundamental and nuanced benefit of an insolvency system: the stability and predictability that such a system lends to the broader financial and economic environment. Insolvency systems function essentially as a safety valve, to release pressure that builds up in a financial system as a result of excessive leverage and pent up productivity. Indeed, many lawmakers have described their new insolvency systems for natural persons in precisely these terms: to offer a safety valve in order to regulate financial and economic activity more smoothly. Supervisory regulation can maintain stable and predictable economic activity by preventing excessive incentive for activity, a build-up often called a “bubble,” in one or more segments of the economy. Conversely, an insolvency system can help to maintain stability and predictability in the opposite situation, where activity is excessively burdened by widespread debt. Rather than relying on natural, long-term economic forces to correct the negative imbalance, an insolvency system can assure a more timely and less disruptive treatment of the casualties of economic activity, ensuring a smoother, more stable and predictable continuation of economic activity throughout the system.

I.10. Countervailing factors: Combating moral hazard, fraud, and stigma

112. Despite the many advantages offered by a system for treating the insolvency of natural persons, three particularly salient concerns might hinder the adoption or proper implementation of such a system. As the following short discussion will suggest, these concerns have been overcome in many existing insolvency systems, and these concerns need not stand in the way of legislators hoping to reap the benefits described above.

A) Moral hazard

113. Applying a classical theoretical economic concept, many policymakers have expressed concern about the “moral hazard” created by offering improper incentives for debtors to act irresponsibly with respect to their finances and obligations. If the extraordinary option of escaping one’s

obligations is made widely available, the theory goes, debtors will have a greater incentive to act in an immoral or irresponsible way, both by recklessly taking on more debt than they can reasonably service, and by abdicating their responsibility to deal with their obligations once insolvency has set in.

114. As discussed above, however (see especially section I.9.C (iv)), the specter of moral hazard is an inevitable part of accepting the broader benefits of a system of insolvency treatment. Some debtors may well consume credit in a riskier way in response to the presence of a “safety net” in case of failure, and some debtors will attempt to evade their obligations by seeking insolvency relief when they could address their obligations through reasonable sacrifices and modifications to their budgets and lifestyle choices. Nevertheless, as mentioned above, the most sensible response to moral hazard in this context, and the one adopted by many existing insolvency systems, is to design and implement proper access requirements—both for entry into the insolvency system and for receipt of a discharge or other relief—to isolate and exclude debtors who engage in excessively risky or other undesirable credit behavior.

115. To be sure, the goal of offering relief to debtors and their families is tempered by a countervailing goal of preventing the dishonest evasion of responsibility by debtors capable of paying their debts with reasonable sacrifices. The importance of abiding by one’s obligations if reasonably possible is a bedrock notion that need not be undermined by the introduction of an insolvency regime, no matter how generous the relief offered might be. An overarching goal of any insolvency system is striking a careful balance between two competing considerations: first, demanding much of those who incur obligations, but second, not demanding more than can be reasonably borne by the victims of economic volatility and other common dangers of life. Just as an insolvency relief system carries a risk of undermining payment morality, there is an equally significant risk in losing the many benefits of an insolvency system by failing to provide effective relief. Some danger of moral hazard (and fraud, see below) will be present in any system, but these slippages should not overshadow the substantial benefits of providing relief in the overwhelming majority of cases involving debtors who have tried and failed due to factors largely or entirely beyond their control. Care should be taken to avoid sacrificing the great good of such a system simply because perfection cannot be assured.

116. Finally, as mentioned in sections I.9.C (iii), above, policymakers in recent years have increasingly considered the countervailing positive effect that an insolvency system has on reducing *creditors’* moral hazard. In making lending decisions, creditors face their own moral hazard in balancing

the desire for maximum profitability with the need to engage in careful underwriting and evaluation of borrowers' ability to pay. The possibility that an insolvent debtor will now have access to a relief system sharpens creditors' incentives to engage in responsible credit extension behavior. Thus, the moral hazard issue has both potentially negative and potentially positive aspects, which should be considered together, further reducing the concerns that moral hazard poses for a well-designed and implemented insolvency system.

B) Debtor fraud

117. Closely related to the issue of moral hazard is a commonly expressed concern related to debtor fraud. Policymakers have for centuries expressed deep concerns about debtors improperly gaining the extraordinary advantages of an insolvency system and evading their legitimate obligations by means of fraud. Debtors might perpetrate this fraud in a variety of ways, including lying about their financial situation or concealing assets or income. Preventing an insolvency relief system from being perverted to advantage fraudulent debtors is, on the one hand, a serious concern, and no easy or perfect solution to this problem presents itself. Careful monitoring by administrators and creditors is the only effective way to minimize debtor fraud.

118. On the other hand, one should not overemphasize the danger that such fraud represents. Empirical observation of many existing insolvency systems has confirmed repeatedly that the instance of real fraud is vanishingly low (on the order of 1-3% of all cases).⁸ Proper monitoring by system administrators and creditors seems to have rooted out most instances of debtors' attempting to take improper advantage. This is an issue to which system designers and policymakers remain sensitive, and appropriate safeguards can and should be incorporated into the system to detect and deter fraudulent conduct by debtors and others. This might be a particularly relevant concern in areas where cultural or other differences lead to greater tolerance for fraud. But in the

⁸ Unfortunately, most of this empirical observation has been informal and not recorded in published studies. The sparse available evidence from formal insolvency system oversight, however, confirms the widespread anecdotal accounts; *see, e.g.*, The Insolvency Service, Annual Report and Accounts 2010-11, at 33-35, www.bis.gov.uk/insolvency/Publications; US Department of Justice, US Trustee Program, *Annual Report of Significant Accomplishments 2010*, at 17-19, www.justice.gov/ust/eo/public_affairs/annualreport/index.htm. Voluminous academic empirical study has more clearly belied the notion of "fraud" in the broader sense of solvent debtors' attempts to evade their obligations. *See, e.g.*, Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STANFORD L. REV. 213 (2006) (and earlier studies cited therein).

final analysis, isolated anecdotes never provide a solid basis for policymaking. For every shocking instance of material fraud in existing systems, all available evidence suggests that many hundreds or even thousands of honest debtors seek and receive relief legitimately.

119. As with moral hazard, isolated instances of debtor fraud are present in virtually every system that has ever existed, and perfect exclusion of fraud is not an achievable goal. All existing systems accept the risk—indeed the certainty—that some limited amount of fraud will creep into the system and some undeserving debtors will take improper advantage. This has not dissuaded policymakers from pursuing the greater good of relief for the vast majority of honest but unfortunate debtors who can derive legitimate benefit—and pass on significant benefits to creditors and society, as discussed above in section I.9—and it need not dissuade policymakers in the future.

C) Stigma

120. A much more intractable challenge relates not to the problem of keeping undeserving debtors *out* of an insolvency system, but to enticing honest but unfortunate debtors *into* the system. Even in well-developed insolvency regimes, significant numbers of debtors continue to avoid seeking relief, or they seek relief far later than would be optimal—for themselves and the other beneficiaries of an insolvency system.

121. The notion of announcing one's failure, either in writing or in person before a public or private administrator, is a deeply embarrassing and stigmatizing event. Formal and informal surveys of debtors in many well-established insolvency systems reveal pervasive and profound feelings of guilt, shame, and stigma. These feelings act as powerful disincentives to debtors considering seeking insolvency relief. Indeed, if inability to pay is dealt with through private cultural traditions, or if a powerful stigma is associated with debt and admission of failure, an "official" mechanism for administering such problems may turn out to be superfluous, as debtors and creditors alike refrain from using it.

122. Declaring oneself unable to manage one's obligations has for centuries signaled a sort of social and economic death in many parts of the world, and such connotations are difficult to overcome. Policymakers should be particularly sensitive to the cultural context of shame and stigma in the context of admission of financial failure, as these notions can prevent the effective uptake of debtors even in the best designed system.

123. Some aspects of the problem are easier to address than others. For example, if debtors are unaware of the benefits of the system, or if they overestimate the downsides and dangers of seeking relief, a public campaign of education and awareness can correct misimpressions as to new options for relief. At least one country launched an aggressive campaign of public information regarding its new insolvency relief system to overcome the potential problem of low debtor acceptance. Some countries have redesigned their insolvency systems for natural persons to minimize or eliminate stigmatizing elements that had undesirable effects. In several countries in which insolvency law had subjected debtors to a long list of civil disabilities and restrictions following an insolvency case, lawmakers have reduced or eliminated these disabilities and restrictions, thereby reducing in part the stigma associated with seeking relief.

124. There is certainly nothing inherently wrong with a healthy bit of stigma to deter debtors from seeking an easy way out of their legitimate obligations. Debtors should be prompted to do their utmost reasonably to address their own debt problems on their own. But policymakers in many countries in recent years have discovered to their dismay that excessive stigmatization of debtors seeking relief can powerfully undermine an otherwise well-designed system and curtail the many benefits outlined in section I.9 above.

125. Attitudes about debt and cultural stigma change slowly, and relatively little can be done to affect such an expansive and disperse notion directly, but policymakers can make and have made choices to minimize stigma by avoiding or repealing judgmental language and punitive measures in existing laws, such as by referring to the “debtor” as opposed to the “bankrupt,” or by reducing post-relief restrictions on activity by debtors. The process of reducing stigma thus goes hand in hand with appropriately containing concerns about moral hazard and fraud, as discussed above.

II. Core legal attributes of an insolvency regime for natural persons

II.1. General regime design: procedural options and the relation with informal workouts

126. An essential aspect of the design of a regime of formal insolvency treatment for natural persons is its interaction with informal systems for resolving financial distress amicably. One important function of a formal insolvency system is to encourage informal negotiation and resolution, as creditors and debtors “bargain in the shadow of

insolvency.” A clear trend has emerged in natural person insolvency policy to favor informal, negotiated alternatives and to avoid formal intervention between debtor and creditors. The methods by which this preference is expressed, especially the degree to which debt-and-credit counseling might support negotiated alternatives, and the results of these methods, are vital considerations that should precede a discussion of formal regime design. As for the design of the formal regime itself, legislators face another important preliminary choice of where to locate the system, either within an existing insolvency regime—probably designed for business debtors—or in a separate, perhaps even free-standing law. This section addresses these two key preliminary considerations.

A) Informal alternatives to insolvency procedures for natural persons

127. Legislators in many regions have emphasized the priority of preventing formal insolvency proceedings, in part by favouring negotiated solutions to debt problems. This preference is apparent in the common requirement that voluntary agreements between the debtor and the creditors should have priority over court proceedings. In several countries, negotiations between debtors and their creditors are a precondition for filing formal insolvency proceedings, and the law provides for an institutionalized debt negotiation and settlement framework. In some countries, before a formal insolvency procedure for natural persons came into force, an institutionalized network of consumer and debt counselors had developed, and the counselors in this system had acquired significant expertise in advising debtors and negotiating on their behalf with creditors. Therefore, it was natural to continue and buttress the role of these debt counselors in the new context of formal insolvency and debt relief. But also countries with relatively little experience in debt counseling have introduced negotiation with creditors as a precondition for access to formal insolvency procedures for natural persons, at least for those debtors whose debts arise predominantly from non-business sources.

128. The preference for voluntary settlement has in many countries led to a two-stage procedure in the natural person insolvency laws. In such systems, debtors are required to make an effort to reach a voluntary settlement with their creditors before they are allowed to file for formal insolvency relief. A debt counselor is usually available and obliged to assist the debtor in the negotiations for a voluntary settlement. In some countries, the attempt to reach a voluntary settlement is regulated in a more formal framework, such as a commission for over-indebtedness or the debt enforcement authorities. In others, debtors are left

to find counseling and negotiation support from semi-private or private-sector actors.

129. The following arguments can be advanced in favor of voluntary debt settlements:

- a) The debtor may avoid the stigma of insolvency and registration in the credit information data banks that follows from an officially recorded insolvency procedure.
- b) The costs of a court procedure are higher than those of informal settlement negotiations.
- c) The debtor may have an incentive to make a higher offer to creditors to avoid the inconvenience of the court procedure, which would benefit the creditors.
- d) The filing that comes to the courts after an unsuccessful attempt to settle is already well prepared and, thus, easier to process. This preparatory work is done by debt counsellors, whose work is less costly than that of insolvency lawyers.
- e) Voluntary settlements allow for more flexibility that can serve the needs of the debtor and the creditors. For example, the guarantors of loans can be included in the settlements in a flexible way, which is often not possible in judicial debt adjustments. If the debtor is a homeowner, the home can sometimes be better protected in a voluntary settlement than in judicial debt adjustment.
- f) Financial institutions regularly renegotiate repayment terms with their debtors. It may be a desirable political goal to emphasize the importance of such renegotiations as a matter of policy.

130. Experience in many existing systems, however, has revealed that the merits of voluntary settlements are often illusory. In practice, it is not easy for debtors to reach voluntary settlements with all their creditors. Debtors often face long delays in obtaining counseling sessions, and counselors often face even longer delays in collecting the necessary information, formulating compromise proposals, and receiving creditor feedback on these proposals. Delays of weeks or even months have plagued many systems that require counseling as a prerequisite to filing a formal insolvency case. There is also a risk that creditors will use their bargaining power to pressure debtors into accepting onerous payment plans that are not viable.

131. At least one system has abandoned its former position of requiring informal negotiation with creditors as a prerequisite to seeking formal insolvency relief. Policy investigators discovered that many creditors were simply

refusing to participate in good faith in this process, refusing in principle to agree to any modification of their claims. Under such common circumstances, the negotiation stage was rendered little more than a pure formality, and legislators ultimately agreed to scrap the requirement and allow debtors to proceed directly into the formal insolvency system if they fulfilled the standard entry requirements.

132. Even in countries where debt counselors had more positive experience in negotiating settlements before a formal insolvency law was enacted, only a small portion of cases were settled voluntarily. Budget and debt counseling more often than not simply reveals the hopeless situation faced by the debtor, and the counselor has little option but to recommend pursuit of a formal insolvency case. In many countries studies have shown and counselors report that few debtors have any hope of achieving a consensual arrangement and avoiding a formal insolvency procedure.⁹

133. There are several reasons for the low rates of voluntary settlements:

- a) Creditors demanding enforcement of their claims may make negotiations impossible.
- b) Just one of several creditors may make the settlement impossible by a veto.
- c) Some creditors trust formal, monitored procedures more than informal settlement proposals. In particular, public creditors, such as the tax authorities, have often been reluctant to accept voluntary settlements, either because they lacked legislative authority to accept such settlements, or because they simply had greater confidence in a more transparent, formal procedure.
- d) Sometimes tax and banking regulations for accounting for bad-debt losses give preference to a formal decision as creditors write down (deduct) the losses.
- e) Some creditors are quite difficult to locate and some others remain passive when a proposal for voluntary settlement is presented to them. Unless the law stipulates that passive creditors are bound by a settlement, they will not be bound and often feel free to disregard attempts at negotiation.

⁹ See, e.g., Bund-Länder-Arbeitsgruppe "Insolvenzrecht," *Probleme der praktischen Anwendungen und Schwachstellen des Verbraucherinsolvenzverfahrens* (2000); *Ett steg mot ett enklare och snabbare skuldsaneringsförfarande*, SOU 2004:81; Nat'l Found. for Credit Counseling, *Consumer Counseling and Education Under BAPCPA* (2006); Institute for Financial Literacy, *First Demographic Analysis of Post-BAPCPA Debtors* (2006).

f) The law concerning third party guarantees is often a disincentive for creditors to agree to a settlement. According to general private law, the guarantor may be freed from liability when the debtor and creditor agree on relief, whereas the guarantor has to pay in a formal debt relief procedure.

134. In many countries, political decision makers favour the idea of informal settlements. The wish for voluntary settlements will not, however, be fulfilled automatically or by the order of the law; some institutional support and incentives are needed.

135. In the few systems where voluntary settlements have been most successful, achieved in as many as one-third of all cases, one of two factors generally explains this higher success rate: Either the negotiation is overseen or even facilitated by a particularly persuasive government regulator—such as a central bank—or a central, well-established counseling agency has developed deep and productive relationships with key creditors, and the agency has leveraged this position of trust to negotiate broad-based concessions, such as from taxing or fine-collecting authorities. Only under circumstances of well-organized and carefully structured negotiation have informal alternatives to insolvency relief proven reliable, and even then, only a relatively small fraction of cases can be resolved through negotiation.

136. Experience in many systems suggests that the successful procedures for negotiating informal alternatives to formal insolvency should include some elements that promote a plan confirmation:

a) First, professional, low-cost or cost-free assistance has to be available and the advisor should have experience in negotiations with creditors. The counsellors or mediators have to have credibility in both debtors' and creditors' eyes. Experience in several systems demonstrates that, if creditors do not regard counsellors as dispassionate, they might refuse to acknowledge and cooperate with the negotiation process entirely.

b) Second, the negotiations proceed better if they can be carried out without a threat of debt enforcement. Some reliable, formal mechanism should be available for stopping enforcement while the negotiations are pending.

c) Third, creditor passivity should not prevent the acceptance of the settlement, which should be binding on all creditors who have been notified. Passive creditors are bound by a settlement according to the laws of some countries. This kind of regulation seems to be a condition for a meaningful debt settlement program, but it requires

that the institutional setting in which the proposals are prepared be well regulated and supervised.

d) Fourth, the rights of a dissenting creditor should be regulated. There is usually no vote on the payment plan. Usually, any dissenting creditor can bring the case to the court. Dissent by a minority of the creditors should not lead to an automatic dismissal of the plan.

B) Formal insolvency law and its placement within the broad legislative scheme

137. The fundamental legal issues in insolvency law concern the rights and obligations of the creditors and the debtor, both in relation to the debtor and his or her creditors and among the creditors generally. These are rights and obligations that in all systems are ultimately adjudicated and enforced by the courts. The recourse to courts is further enforced by the human rights instruments that confirm the right of access to courts in the determination of the civil rights and obligations of a person. Furthermore, most human rights instruments acknowledge the right to property as a human right, even though the exercise of this right needs to take into account the respect for the rights of others and the community. Traditionally, it has been held that the regulation of insolvency situations is not hampered by the demands of constitutional rights, and this doctrine is today confirmed by some human rights bodies—considering of course that the insolvency law does not encroach on the (property) rights of the creditors more than is appropriate. It has to be kept in mind that the insolvency law seldom deprives creditors of any substantial claims that they would have been able to enforce, given that a right to enforce a claim against a hopelessly insolvent debtor has little or no practical value. The right to property may, however, have a special impact on the regulation of the rights of secured creditors in personal insolvency law.

138. In addition to property rights, the right to work and fair remuneration and the basic social rights are also at issue in personal insolvency law. Even if the social rights are not acknowledged as subjective rights in all parts of the world, they should have some credence in the design of the legal institutions.

139. Furthermore, all human rights instruments acknowledge the right to a fair trial. The content of this right is regulated in detail in national laws. One important aspect of this right is the right to be heard in matters that concern one's rights. Even if the right to be heard can be regulated in an insolvency procedure in forms that differ from ordinary civil procedure, it is important to emphasize that the human

rights instruments do not allow limitations of the right to a fair trial. However, it is an established interpretation of human rights instruments that the access to court can be subject to a prior processing of the case by specific boards or bodies, considering that the process as a whole fulfills the requirements of a fair trial.

140. Thus, there is an evident need for some degree of court involvement in the insolvency procedure, both in light of the traditional law of obligations and in light of constitutional and human rights doctrines. There are, however, somewhat differing opinions on how much court involvement is needed. See below, section II.2.B. Besides the civil and human rights considerations noted above, a number of insolvency-specific matters are of relevance when the issue of court involvement is addressed.

141. A substantial number of countries have introduced insolvency proceedings for natural persons only since 1990, lacking a tradition of dealing with the challenges of this particular type of proceeding. The lack of tradition has led to innovative procedural solutions that vary from country to country. In some countries the social and administrative aspects are emphasized, while in some others, the rights of the parties are emphasized, leading to different procedural designs. One key question is whether the systemic context of personal insolvency laws should be contained either in a specific law or in the general insolvency law.

142. As described above in section I.8, insolvency laws for natural persons have a lot in common with general insolvency laws designed primarily for business debtors, but laws focused on natural person debtors differ in their more pronounced interest in the rehabilitation of the debtor and in the social good. Depending on legal culture and traditions of respective countries, either the systematic similarity or the differences between business insolvency and personal insolvency are emphasized. These different approaches are to some extent reflected in the choice of placing natural person insolvency laws either within a general (business) insolvency law (Bankruptcy or Insolvency Code) or in a separate law.

143. Historically, natural person insolvency has developed as part of general insolvency law, primarily in several Anglo-American systems. As debtors have been granted relief in these systems, certain regulations specifically designed for natural persons have developed within the broader insolvency law. Still today, many countries have incorporated procedures for natural person insolvency into their general insolvency codes. Even if insolvency for natural persons is incorporated in an insolvency code, it is usually a summary and quite simple court proceeding, distinct from the more complex procedures applied in business cases.

144. In contrast, several countries that have enacted personal insolvency law during the last two decades have opted for a separate law. These laws are often not called “insolvency” laws, much less “bankruptcy” laws. Rather, the titles of these laws refer to rearrangement or adjustment of debts. Many countries use a derivation of the word *sanering* (“rehabilitation”), drawing a parallel between individual insolvency and business reorganization.

145. Some of these laws are specifically designed to serve natural persons not engaged in significant business activity. Quite often the term “consumer debtor” is used, either in law or, even more often, in doctrine, to point out that the purpose of these laws is to provide an insolvency procedure for persons who seek relief in their private capacity as opposed to business debtors. The term consumer does not necessarily mean that the debtor would have become indebted through the consumption of goods and services. It only means that the debtor is not pursuing a business at the time of filing (or at least that the debtor’s business activity is limited).

146. In many countries, these laws come close to traditional insolvency regulations, with an emphasis on rehabilitation. For example, the specific debt adjustment laws in one region offer the debtor a full insolvency procedure. These specific procedures tend to focus more on the evaluation of the debtor’s pre-insolvency behavior than the procedures in the insolvency context. These systems also tend to offer debtors counseling on budgeting and managing debts.

147. Placing debt relief within the general insolvency context and enacting a separate law each seem to have their merits. A separate law offers a better opportunity to take into account the special needs of insolvent individuals as opposed to businesses. This is helpful where there is a need for a broader range of counseling services, including financial counseling and reference to social agencies. These services are easier to attach to a specific procedure than to the general insolvency regime. Also, specific regulations for access to the procedure and for the content and proposals for payment plans are easier to formulate in a separate law. In some countries, personal insolvency procedure is delegated to some other authority than the court, such as specific commissions or debt enforcement authorities. In others, specialized counselors have specific responsibilities to aid the debtor and prepare the case before going to court. These special needs are easier to take into account in the design of the system if personal insolvency is regulated in a specific law.

148. The placement of personal insolvency into the general insolvency context has its merits as well. The separate laws are often enacted for relatively simple cases, especially for

debtors with low income and few assets, but some insolvency cases for natural persons include complicated legal issues. Examples include cases of natural persons who have a considerable debt-load from former businesses or who at the time of filing are self-employed and/or debtors with notable assets to distribute among the creditors. If natural person insolvency is regulated in the context of general insolvency law, it is possible to resort to the specific institutions of insolvency law, such as the automatic (or court imposed) stay of execution and other creditor actions, exceptions from the stay, other effects of the opening of the procedure, voidable transfers and other avoidance actions, and protection of the family home, as well as to general principles of insolvency law, such as equality of creditors. As many natural persons' insolvency cases have a background in business failure, in some cases a smooth transfer from business bankruptcy to natural person insolvency treatment is needed. The placement of natural person insolvency in the general insolvency law makes these kinds of overlaps between business insolvency and personal insolvency easier to manage.

149. The political discourse about natural person insolvency takes quite different tones in different countries. In some countries, the idea of "consumer bankruptcy" referring to straight discharge has been difficult to accept. In other countries, the idea of a separate law on debt relief for consumers has been related to excessive consumer spending and use of consumer credit, whereas the general insolvency regime has been understood as a more neutral area of regulation.

II.2. The institutional framework

150. An institutional framework for the insolvency of natural persons should minimize overall social costs. These include error costs in determining the validity of debts and levels of repayment, and costs to creditors, debtors and third parties. It should provide timely outcomes and achieve confidence in its operation by stakeholders and the general public.

151. An institutional framework for the insolvency of natural persons is part of the ground rules for consumer and commercial credit. Establishing a framework for the insolvency of natural persons should be integral to the development of consumer credit granting and debt collection institutions within a country. These institutions include banking regulations, procedures for the enforcement of judgment debts, credit reporting and data privacy regulations, financial education programs, debt counseling services, and housing and social welfare policy. Insolvency institutions are often linked closely to court systems and

confidence in the court system by both creditors and debtors is a pre-condition of the effective operation of a court system.

152. Individual insolvency cases are not a high stakes game, even if in aggregate they now represent large numbers of debtors in high income countries. The overwhelming majority of individual debtors have few assets to liquidate and limited income to repay debts or pay for advice. A significant percentage has no capacity to repay (see section I.8.C). However, individual insolvency may raise legal, budgeting, and social issues that are not always simple. Moreover, there is not one individual “insolvency type”. There are different reasons for insolvency, and debtor repayment capabilities. Several insolvency systems have developed options for both partial repayment or restructuring and an immediate discharge. “Gatekeepers” – who may be lawyers, debt counselors, insolvency practitioners, state officials, and judges – play an important role in screening and channeling individuals to the appropriate solution.

153. The growth of significant numbers of over-indebted debtors in high-income countries has created a challenge in fashioning an efficient and fair system of personal insolvency administration. More individuals may be over-indebted but cost pressures on financing justice systems and public programs also exist. The treatment of over-indebtedness, which addresses both consumption and production risks, raises problems in public administration and governance, such as the relative balance of public and private actors and the appropriate role of legal, economic and social expertise. Insolvency as a modest method of redistribution raises issues similar to social welfare programs in terms of assuring access to qualified applicants, similar treatment for individuals similarly situated, the prevention of fraud and abuse (see section I.8.B), and the reduction of unnecessary bureaucratic requirements.

154. Experience suggests that as the numbers of individual debtors needing insolvency relief increases – there is no definite “tipping point” – individual insolvency becomes a routinized process where the policy issues become those of cost-effective targeting of relief based on relatively clear rules that can be applied in a straightforward manner by decision makers. Section II.5.B documents this movement from individualized discretion to standardization in repayment plans in those countries with substantial numbers of individual insolvents.

155. Institutional frameworks are related to many factors, including the history and politics of insolvency reform that shape different countries’ conceptualization of the insolvency of natural persons. Insolvency relief may be conceptualized as part of welfare or consumer protection,

integrated with educational and preventive measures to address debt, or treated as simply an issue of economic adjustment between private actors permitting an individual reentry to the credit market. This conceptualization affects issues such as financing of the system and access, as well as the type and role of intermediaries (lawyers, debt counselors, and accountants) involved in the system. Irrespective of the nature of the intermediaries, existing experience suggests that many countries are unwilling to invest substantially in support systems to address debtors' problems in a comprehensive manner, so that intermediaries tend to be primarily concerned with shepherding individuals through the system. This is a modest but valuable role. Insolvency can also be a mechanism for referring individuals with social problems to other social institutions.

156. Institutional frameworks are linked to the complexity of the law. Open textured provisions and complex provisions may increase disputes and the need for specialist expertise. Relatively bright line rules, while creating potential individual injustice, can be computerized, and processed quickly by individuals without high levels of professional expertise. A routinized approach may work best in the context of a majority of cases where creditors are to receive a minimal distribution for their claims, if anything at all.

157. Responsibility for the overall management of the system may be assigned to a Ministry or specialized agency that can oversee individual insolvencies and the institutional actors involved as part of economic and social policy. Specialist agencies can exercise policing, rulemaking and enforcement powers, as well as intervening in matters of public interest. The existence of a robust, yet neutral, policeman is often a key part of ensuring public confidence in the integrity of the insolvency system. Reliable data on the operation of the system should be collected because individual over-indebtedness and insolvency are politically charged issues and the media often reports "atrocious stories" about the conduct of debtors and creditors.

A) Existing frameworks for the insolvency of natural persons

158. Institutional frameworks exist on a continuum ranging from: (1) systems in which an administrative agency dominates; to (2) hybrid public/private systems where public processing of insolvents co-exists with private restructuring alternatives; and to (3) court-based systems primarily serviced by publicly funded or private intermediaries. These are of course ideal types. Thus, courts play some role in all systems. Personal insolvency may be included within existing insolvency law, or be part of a distinct code. The comparative

advantages of these options were discussed earlier in section II.1.

159. Systems can be classified according to the balance of public and private sector alternatives and actors. Some countries ban private debt management companies and a public agency dominates the system. In contrast, others provide alternatives that include both state processing of bankrupts and the involvement of a significant private sector in administering restructuring alternatives. The main arguments against the existence of a large private sector are the potential dangers of exploitation of a vulnerable population of debtors and the belief that debt problems are a social issue that can only be effectively addressed by courts and/or public agencies. The existence of private over-indebtedness industries has certainly given rise to abuses and necessitated public regulation, itself a cost that must be factored into any assessment of the role of the private and public sectors. However, there are benefits in terms of expertise and costs in harnessing the private sector to address over-indebtedness: any system that relies solely on the public sector is likely to incur delays in the treatment of debtors; a careful balance needs to be achieved between the role of the private and public sectors.

B) Court-based systems and the role of courts

160. The majority of countries have court-based systems for personal insolvency and restructuring. However, the actual role in practice of courts may vary significantly and include the following: acting as gatekeepers to entry; establishing repayment plans; determining issues relating to assets and liabilities of a debtor; monitoring insolvency representatives; and determining the dischargeability of debts. There is an increased tendency in high-income countries to reduce the role of courts, for example to dispense with the necessity for a court hearing for filing for insolvency, and to recognize that the court hearing is often a formality in the insolvency of natural persons. In some countries, individuals make an application for insolvency through an administrative agency. In other countries, judges or their deputies may ensure that formalities have been complied with where much work will already have been completed by debt counselors, lawyers or accountants. These observations do not mean that courts play an unimportant role in determining individual rights in insolvency, but rather that their intervention is the exception rather than the norm.

161. Courts have a number of institutional advantages. Judges can act as impartial and trusted decision-makers. Indeed, courts may be required to play some role in personal insolvency in the light of constitutional and Human Rights norms (see section II.1.B). They can oversee those

intermediaries involved in administering repayment plans addressing in summary procedure exceptional cases of disputes that may arise between the parties.

162. However, courts have disadvantages. Courts and judges are costly, may be regarded as inaccessible and intimidating by individual debtors, and focus on legal rights. Adversarial legal disputes between creditors and debtors are rare in individual insolvency cases so that personal insolvency adjudication is primarily an administrative process even in those systems where lawyers and courts are central actors. If courts are to be involved, there is a need for education of judges on issues related to credit and debt, budgeting and social issues. The ability of courts to oversee and regulate the individual insolvency process is limited. They can act only when individuals bring issues before them and are heavily dependent on individual initiative. Given the stakes in individual insolvency neither creditor nor debtor may have adequate incentives to bring issues before a judge.

163. Court-based systems may have significant delays. The pressure on public funding of the judicial system, the limited ability of lower courts to address economic and social issues of debt, and variable decision making by judges create pressure for increased specialization and administrative processing particularly for the large percentage of “NINA (no income, no assets) debtors”, and more effective sorting of cases where private negotiation will be meaningful.

164. Several countries responded to the upsurge of over-indebtedness after the late 1980s recession through modification of court procedures to permit judicially sanctioned debt repayment plans with the possibility of discharge of debts after a period of repayment. They attempted to conserve judicial resources by requiring an attempt at a supervised negotiated settlement before a court application. However, this was often not successful in diverting cases and resulted in queuing by debtors for both advice and court hearings.

C) The role of trusted intermediaries

165. Intermediaries in the insolvency of natural persons may be lawyers, accountants, or debt counselors. These intermediaries may have different backgrounds, qualifications and roles. They may be public officials or private professionals; they may be acting as officers of the court or be subject to professional norms. In the majority of states, the activities of intermediaries are not subsidized by the state. In some countries, the local or central state budgets subsidize their activities where individual debtors are unable to finance insolvency. Thus, state-accredited institutions employing lawyers and social workers may

undertake judicial mediation and act as court appointed administrators of debt repayment plans. In other countries, a combination of state-financed debt counselors and lawyers may assist debtors.

166. A court-based system inevitably relies more heavily than an administrative system on trusted intermediaries to assist debtors, and negotiate, administer and supervise repayment plans. Their role is crucial in establishing the viability and integrity of the system. Trusted intermediaries can significantly reduce transaction and error costs. They can ensure realistic repayment schedules, check the validity of debts, identify and investigate different types of debtors, administer repayment plans and provide impartial advice. A loss of trust in intermediaries can undermine the effectiveness of a system of debt relief. One reason for creditors' preference in one country for the use of the statutory court process rather than informal settlement was a perception of the courts as more impartial than debt counseling agencies. In another, a combination of complex legislation and a limited number of trained debt counselors resulted in a large backlog of cases and in a breakdown in trust between debtors' intermediaries and creditors.

167. Intermediaries often play a number of potentially conflicting roles – acting as counselor to the debtor but also administering plans, reporting to courts and ensuring compliance by debtors with insolvency requirements and repayment plans. Debtors may often lack knowledge of an insolvency system and the potential implications of choices, particularly in a multi-track system. This confers significant power on intermediaries, whether they are lawyers, accountants or debt counselors. Studies in some countries indicate that intermediaries may further their own financial or ideological interests by inappropriate steering of debtors to particular solutions without a debtor being aware of this fact.¹⁰ It is probably impossible to excise the exercise of discretion by a professional, but a simplified system can reduce the need for extensive professional intervention and reduce debtor costs.

168. Whatever their professional background intermediaries are generally constrained by costs—either through budget limitations or the limited ability of individuals to pay for advice. Processes become routinized to reduce costs.

¹⁰ See, e.g., Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling* (2005); Consumer Federation of America & National Consumer Law Center, *Credit Counseling in Crisis: The Impact on Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants* (2003); Iain Ramsay, *Market Imperatives, Professional Discretion and the Role of Intermediaries in Consumer Bankruptcy: A Comparative Study of the Canadian Trustee in Bankruptcy*, 74 AM. BANKR. L.J. 399 (2000).

Computerization can reduce professional discretion and possibly ensure greater individualization of treatment. Careful attention to the design of computer programs for channeling consumer debtors to distinct solutions may attain long term economic and social benefits.

169. Given the above comments it is important to promote strong ethical codes and/or regulation for intermediaries dealing with debtors. The UNCITRAL Legislative Guide on Insolvency Law provides in section III.B 1-7 a guide to qualifications and personal qualities for insolvency representatives. The insolvency of natural persons raises budgeting, family and social issues as well as the legal rights of the parties. There are advantages to intermediaries acting in the insolvency of natural persons being qualified in these areas at least to a level of knowledge appropriate to refer an individual to a family or social agency. There is always a danger with professional licensing that it may unduly restrict entry to the profession. Thus, in determining who may act as intermediary a balance needs to be struck between ensuring intermediaries are qualified to address the problems of individual insolvents, on the one hand, and on the other hand, not unduly limiting the range of individuals who may provide advice and assistance.

D) Administrative models of insolvency processing

170. Public agencies play a significant role in several countries in sorting, processing and administering the insolvency of natural persons.

171. Administrative processing can introduce a stable bureaucracy with the ability to develop experience in identifying and sorting cases that deserve examination and investigation and providing impartial advice and information to debtors and creditors. It can act proactively to deter abuse of the system and address moral hazard issues. The disadvantages of administrative processing include the dangers of capture by creditors, debtors or professional groups, and potential conflicts of interest within the administration. Since public agencies often do not have clear measures of success (in terms of profit and loss) ensuring an appropriate monitoring and reporting framework for an agency is also necessary.

172. Experience of administrative processing does not indicate the existence of capture, although using existing institutions such as Tax enforcement regimes to administer insolvency of natural persons may require retraining of employees. Conflicts of interest may be addressed through separation of administration and investigation functions. There are significant differences between existing public processors of individual insolvents. The following material

outlines the main contours of distinct approaches that reflect partly historical path dependency and political factors.

173. Several countries have a modified Official Receiver model where a state agency investigates an insolvent debtor's affairs and acts as the administrator of small insolvency estates (which have always constituted the vast majority of estates) where the assets of the estate do not justify the appointment of a private insolvency representative and outsources the larger, more complicated cases. (In some systems adopting this model, there has been a movement to try to outsource all cases.) The original rationale for this state regulation was the failure of creditor control. State supervision might protect small creditors and ensure the maintenance of commercial morality. The transformation of individual insolvency during the past few decades, from a creditor-initiated process primarily used against small businesses, to one where individuals initiate the great majority of insolvency cases means that these agencies administer primarily individual cases. Some countries using this model have developed low-cost summary procedures, requiring no court involvement, available on-line for those individuals with no significant income or assets. These agencies can also provide information and advice to over-indebted individuals. The existence of such an agency reduces the need for (and costs of) professional advice and representation and may reduce formalities and costs through the use of modern technologies.

174. Some countries have developed a state-financed "one-stop shop" for over-indebted individuals. This institution determines whether a debtor meets the entry criteria, suggests a conciliated plan (including moratoria or rescheduling of debts), and, where necessary, asserts the power to impose an agreement or recommend a discharge of debts after a short period of time for individuals who have no possibility of putting in place a repayment plan. Courts now play a residual role within such a system and the key to the operation of the system is the secretariat staffed by state employees. Other countries have adapted existing institutions such as tax collection agencies or debt enforcement agencies to administer individual insolvency proceedings.

175. Hybrid public-private models also exist where the primary actors are private insolvency practitioners who assess, administer and investigate debtors, but there is close supervision through a public regulator which licenses practitioners and may also intervene in the process.

176. The existence of state processing of insolvent debtors who rarely have significant assets or income to pay for the

process raises the issue of how to fund a public system of processing (see II.2.F).

E) Comparative institutional issues in the choice of the institutional framework

177. Sections II.2 C and D outlined advantages and disadvantages of courts and administrative agencies. A comparative institutional analysis of the role of courts and administrative agencies must take into account the context of existing institutions in particular countries. If there is little general confidence in the court system of a country or limited numbers of qualified professionals to assist debtors then court reform and the development of qualified professionals might precede or coincide with the introduction of insolvency procedures. It may be useful to develop ADR mechanisms or experiments with new procedures in some courts as a prelude to national implementation.

178. Developing economies with increasing levels of indebted individuals may face significant costs in establishing a novel, nationwide infrastructure of officials and intermediaries for an effective personal insolvency system. Research on other areas of the law concludes that it may not be desirable to transplant overly complex procedures from richer to poorer countries since the courts in these countries may not have the administrative capacity to address these issues. There may be advantages therefore in building on existing institutional infrastructures and keeping procedures simple, at least initially.

179. Several high-income countries developed an institutional framework for the insolvency of natural persons by modifying judicial procedures. Others modified existing administrative structures. A few introduced novel structures for addressing consumer over-indebtedness. The process in many countries has generally been one of incremental responses to the changing nature of the demand for insolvency, for example the recognition of the need for NINA procedures. This experience also counsels in favor of informed incrementalism rather than comprehensive rationality in institutional design. Such an approach may be more politically acceptable in the politically contentious area of personal insolvency.

180. The use of computer technology might provide an opportunity for reducing both processing and error costs. Online access to insolvency through approved intermediaries using standardized insolvency programs with the possibility

of random audits and using data from credit bureaus, where available, could provide relief while assuring the prevention of abuse. Several countries have adopted this approach sometimes restricting it to individuals with debts under a certain level. Random audits are especially important; if debtors believe that proper investigation will not take place in cases in which there are no assets, some debtors might be tempted to “dispose” of all of their assets pre-petition.

F) Financing issues

181. Many individuals have difficulties in financing access to insolvency. Four approaches to financing exist: (1) state funding of the process (including both creditor and debtor costs); (2) cross-subsidization of low value insolvencies by higher value estates; (3) state subsidies to professionals involved in the process and writing off court costs where there is an inability to repay; (4) levies on creditors, such as taxation of distressed debt to fund those cases where individuals have no ability to pay; and (5) no state support beyond any general public good funding of the court system. The majority of countries have adopted the final alternative. In some countries, the challenge of funding individual debtors and providing access to insolvency has been met through innovative methods of private processing by private professionals. In other countries, the absence of state support is likely to undermine the possibility of relief. Providing high quality professional support for personal insolvency systems where debtors have few resources is a policy challenge. All of the above systems of funding have some disadvantages. Full public funding of the process subsidizes both debtors and creditors whose costs of recovery are reduced. Since these are paid from general revenues there is likely to be continuing pressure to reduce the level of expenditure. Cross-subsidization depends on a significant level of non-subsidized insolvencies that may vary in amount over time. Taxation of distressed debt may be subject to manipulation. User pay systems may result in exclusion from access for those unable to pay the fees or poor preparation of the necessary documentation by debtors, increasing administrative costs.

182. Section I.9 argued that there are economic and social benefits to debtors, creditors, and third parties from the existence of personal insolvency. If the existence of these benefits is accepted, there are arguments that all parties should contribute their fair share to the financing of the framework. “Fair share” may mean that creditors contribute through a levy. Creditors may pass along some of this cost to the public, but may also have incentives to reduce the number of debtors in default. For some debtors with limited resources fair share could mean no contribution.

183. Financing issues can be softened quite effectively by addressing the expense side of the system. Several countries have reduced the costs of personal insolvency by introducing summary procedures, so that the traditional formalities of insolvency such as creditors' meetings, or the examination of a debtor occur only in exceptional cases. These changes often reflect the reality of existing practice. As mentioned earlier there is the increased use of the Internet (section II.2.E) in the initial processing of cases. The use of online systems can reduce costs throughout an insolvency system, for example, through standardized programs for assessing and calculating debtors' disposable incomes and monitoring repayment plans. Intelligent use of online programs could achieve a desired balance between uniformity and discretion in the treatment of debtors.

II.3. Access to the formal insolvency regime

184. The standards for access to individual insolvency and restructuring procedures should be transparent and certain while ensuring against improper use by either creditor or debtor. Both creditor and debtor can initiate individual insolvency proceedings in several countries. However, almost all countries that have introduced distinct systems of insolvency of natural persons in recent decades only accept filings by debtors for admission into these proceedings. As indicated in section II.1, creditors' insolvency petitions against individual debtors are uncommon even in most of the countries where such petitions are possible. There are some systems, however, where personal bankruptcy is used as a threat in the collection efforts of creditors, and the threat is more intense where the stigma attached to bankruptcy is greater. This use of personal bankruptcy may undermine many of the potential benefits of a regime of insolvency of natural persons outlined in section 1.9.

185. If creditor petitions are permitted then controls may be desirable on the extent to which insolvency can be used as an individual creditor's remedy and to prevent its abuse as a collection tool. This may be either through a requirement that more than one creditor initiate a petition, or establishing a high financial floor for an individual debt as a prerequisite for a petition. The disadvantage of the latter approach is that the financial limits must be kept under review to ensure that they do not become outdated.

186. Insolvency systems traditionally appeal to two standards as a gateway to insolvency proceedings: a cessation of payments test and a balance sheet test (see generally UNCITRAL Legislative Guide at 45-67; and Principle C4.2 of the World Bank Principles for Effective Insolvency and Creditor Rights Systems). The former is the primary test in insolvency of natural persons and is simpler to apply than a

balance sheet test. Some countries include further “acts of bankruptcy” as a trigger for an insolvency application. These are historical criteria that fit uneasily into contemporary personal insolvency law where the central issue is inability to repay rather than wrongful actions by debtors.

A) Debtor access

187. Personal insolvency and debt adjustment systems differ on the extent to which there is open access for debtors. Open access may be defined as the idea that an individual who meets an insolvency test such as the inability to pay debts as they fall due may, without more, gain access to an insolvency procedure permitting an ultimate discharge of debts. There is a system that does not require a debtor to be insolvent as a condition of access. The advantage of this approach is that it reduces the initial screening costs of an insolvency test, transferring them to discharge. It also may encourage over-indebted individuals to petition for insolvency relief. There are however disadvantages. In practice individuals who are not insolvent do not file, but the absence of an insolvency requirement is politically contentious, raising unnecessary debate about moral hazard. Indeed although this system does not require an insolvency test it does now impose mandatory counseling on debtors as a condition for filing that may add over inclusive screening costs.

188. Some systems provide relatively open access but require a debtor to undergo a period of good behavior over several years before being permitted to discharge debts. During this period, individuals must set aside a certain portion of their income to the repayment of debts, although in practice the majority make no repayments because they have no surplus income.

189. Access to insolvency procedures for a debtor may be subject to several legal and practical conditions including the following: a minimum level of debt; a future oriented test of “permanent insolvency”; “good faith”; or a requirement that debts are caused by events beyond a debtor’s control such as illness or unemployment. A debtor may have to demonstrate that he has consulted an approved intermediary, obtained counseling, or attempted a negotiated settlement before being permitted to make an application for insolvency. Access may be dependent on ability to pay.

190. A distinction may be drawn between those systems that define insolvency as a current inability to meet present debts and those that include the possibility at a future date of a debtor being able to improve his/her financial situation and repay debts. Some countries adopt this forward looking perspective of “permanent insolvency”. This is a more

speculative and consequently uncertain standard to apply that raises decision making and error costs and may result in the adoption of over inclusive proxies. Thus in certain systems it may be more difficult for younger debtors to access insolvency.

191. This latter approach often shades into a second objective of access criteria, the maintenance of commercial morality and *pacta sunt servanda* (“agreements must be kept”), or, in economic terms, protection against moral hazard – in other words, for application where individuals may be tempted to incur excessive debts knowing that they can be discharged in insolvency. Some countries limit access to individuals who have experienced social *force majeure* such as involuntary unemployment or make judgments on the conduct of the debtor through good faith requirements. It is difficult to measure the effects of this approach on maintaining a payment morality but there is little substantial evidence of moral hazard in existing systems (see section I.9.A) where there is relatively open access. In addition, the effects need to be balanced against the increased screening costs and the social costs of more restricted access, which may include loss of productivity and effects on families and health. Section I.9.C outlined the potential extent of these costs.

192. One method of addressing potential moral hazard is to limit the frequency of access to insolvency. This might be accomplished by applying a bright line rule restricting access within a defined period of time. Various countries prevent repeat access within two, four, six, or ten years following a first insolvency case. Alternatively, some countries subject a repeat insolvent automatically to more intensive investigation, with only “exceptional” cases admitted for a second relief proceeding.

193. The concept of “good faith” is an explicit criterion for access in several countries. This open-textured standard has resulted in substantial litigation in several systems with lower courts basing decisions on a variety of distinct perceptions of the debtor’s situation and conduct. It is often difficult to judge the conduct of an individual *ex post facto* determining whether his conduct was unfortunate, imprudent or negligent, and whether negligence should be equated with bad faith. As a consequence of these difficulties, most systems have adopted a lower standard of intentional fraud or the concept of honesty. It may be impossible to excise moral judgments from insolvency administration. However, the good faith requirement is likely to lead to variable decision making and increase disputes. This is particularly problematic in countries with a relatively decentralized judiciary.

194. Access criteria may be a combination of rules and standards. Insolvency systems may both specify through

rules conduct which might prevent access, such as failure to disclose assets or the provision of false information while also leaving a residual discretion to judges or administrators to police for abuse through a standard. It is difficult to determine the optimal balance of rules and standards in policy making. The over- and under-inclusiveness of rules (including individuals who do not fit the underlying policy and excluding those who do) must be balanced against the costs of application of a general standard. In the context of access to individual insolvency there are advantages to favoring rules with a limited discretion. This requires legislatures to articulate clearly the rules for insolvency relief and to avoid the easy political choice for hard decisions, namely to pass responsibility to the judiciary through the enactment of a standard. Rules are also less costly to administer, reducing the need for unnecessarily high levels of expertise.

195. High access barriers to the formal system of relief may result in individuals being in a state of “informal insolvency”. Individuals unable to access debt relief lose incentives to participate in society, may require continuing state support or might go “underground” for several years to avoid creditors until their problems go away or passions cool off. Creditors may be unlikely to recover significant amounts in the free-for-all of individual collection but they nevertheless inflict a significant social and emotional toll. Inability to access debt relief may also result in a political backlash such as debt strikes. Sections 1.9.A, B, and C have already described these issues in outlining the benefits of an insolvency system.

196. In some countries, access may be dependent on a legal requirement of consulting an intermediary and obtaining advice on alternatives to insolvency. These intermediaries may include lawyers, debt counselors, accountants, or social workers. This requirement may be premised on an assumption that individuals may not think through the consequences of insolvency or may be unaware of potential alternatives. It may also be intended to protect against potential abuse of the system. This requirement can be useful if there is adequate, high-quality advice and if there is evidence that the benefits of this intervention is likely to exceed its costs. Existing evidence suggests that mandatory pre-insolvency counseling is radically over-inclusive in protecting against abuse or in assisting debtors in avoiding insolvency. A general requirement of such counseling may divert limited counseling resources from those cases where counseling may be most productive.

197. A distinction may be drawn between those systems that create high initial barriers to access based on a debtor’s conduct and those where individuals may be permitted to enter the system but may be sanctioned for their conduct.

Thus, in some systems there is relatively open access but if a debtor has engaged in culpable conduct, such as incurring before insolvency a debt that the debtor has no reasonable expectation of being able to repay, then such an individual may be subject to a sanction or have limits imposed on the discharge of debts. Open access does not mean, therefore, that an individual's conduct will not be reviewed or sanctioned in insolvency. Insolvency can provide both a protective and disciplinary function. Creditors or state agencies can play a role here through opportunities to challenge an individual's discharge.

198. An opportunity for a creditor or agency to challenge a discharge or otherwise sanction a debtor provides a protection against moral hazard and adds legitimacy to a system of individual insolvency by increasing participation by creditors. However, creditors have other opportunities to participate (see section II.4) and unless the criteria for such a challenge are relatively sharp, the increase in decision making and error costs may outweigh the benefits. Some systems that confer substantial discretion on judges to determine discharge issues exhibit wide variation in decision making. Courts face difficulties in making accurate judgments in hindsight on whether an individual's behavior is, for example, 'extravagant'. There is a danger that errors here can undermine the opportunity of a fresh start for an individual debtor. Section II.6 discusses those specific debts that many systems exclude from a discharge that reflect political decisions by legislatures.

B) Controlling access in a multi-track insolvency system

199. Insolvency systems offer a variety of options ranging from temporary moratoria, through restructuring to a full discharge. Section II.5.B discusses the role of repayment plans. The law may structure access to these options through income or asset criteria, or the requirement that all debtors must go through a similar procedure, for example a repayment program, before being able to access a discharge. Ideally, options should match the broad contours of the different types of over-indebted individuals as discussed in section II.2 (Institutional Framework). The existence of insolvency options raises the question of the extent to which access should be (a) dependent on consumer choice or (b) a decision of a public agency or official.

200. The more complex an insolvency system in terms of distinct and overlapping procedures, the greater will be the difficulties facing an over-indebted individual, who may be in a vulnerable position, in making an effective choice.

201. Impartial intermediaries can assist individuals. In a multi-track system based on consumer choice, intermediaries may however have significant power and may be tempted to steer individuals to a particular solution based on their financial or ideological interests rather than the best interests of the debtor, and this provides support for the regulation of such intermediaries. Simplification also reduces the power of intermediaries and debtors' information costs and information processing costs. Appropriate information for debtors and creditors provided by an agency or ministry might reduce information costs.

202. Some systems use initial screening based on income criteria to determine the debtor's choice. This is based on the simple –but often difficult to apply in practice– distinction that debtors who “can pay”, “should pay” a portion of their income. This approach may be desirable at the point of entry in a system where post-insolvency income is not treated as part of the estate. This approach also assists in getting creditors to support the process. Other systems that do not screen as aggressively at the initial stage may automatically apply a surplus income requirement, based on regulations, which will capture any surplus income over a period of time (see discussion at section II.5.B). In a few systems, a central agency effectively decides the particular option for a consumer.

203. Some systems restrict access to debt relief to individuals with consumer rather than business debts. Restrictions on access to those with only consumer debts may result in litigation over the nature of debts, particularly given the increased overlap in small businesses between consumption and production debts. Experience indicates that in many countries a significant percentage of individuals using the insolvency system have debts related to failed businesses. The advantage of a separate consumer insolvency system is that it will tend to ensure that the system considers more straightforward consumer cases. The disadvantage is that it increases screening costs and may deny access to individuals with business debts who differ in only modest ways from consumer debtors (see section I.8 and section II.1).

II.4. Participation of creditors

A) Creditor participation in general

204. In business insolvency, significant value is often available for creditors, and the restructuring of a company and the regulation of debt are subject to vote by the creditors and often the involvement of creditors' committees (especially in large cases). The voting rules may be complex and the

outcome dependent on the number of creditors and on the amount of outstanding debt.

205. In insolvency procedures for natural persons, in contrast, very little value is usually available, and the creditors normally play little or no role in the procedure. Even where creditors are invited to participate, creditors' participation in natural personal insolvency cases cannot be taken for granted. Creditors will participate where they view it as being in their best interest to do so, and they will be reluctant to participate where they believe that it will be unlikely to increase their dividend. Thus, in the great bulk of natural person insolvency cases, where little or no dividend to creditors is expected, creditor passivity might well be the rational choice. In insolvency cases involving natural persons, creditors have most often regarded the likely dividends from such proceedings to be insufficient to warrant their participation. Even if an objection might be sustained, the result is most likely to be an uncollectible claim against a debtor who is practically insolvent even if not legally entitled to relief. Consequently, in the overwhelming majority of insolvency cases involving natural persons in the world today, active creditor participation is a rare exception.

206. Some systems deal with this issue by lowering the quorum for creditors' meetings (in one system to as low as one creditor), though the more common reaction has been to find ways to limit or even eliminate opportunities for creditor participation in natural person insolvency cases altogether, except in cases where significant value from assets or future income is expected. Legislators in many areas in recent years have concluded that the paltry gains to be had from inviting creditors to participate in most natural person insolvency cases are far outweighed by the significant administrative costs and delays occasioned by such participation. As a result, a notable trend has developed to scrap creditors' meetings, submission and verification of claims, and other forms of creditor participation in all but the small fraction of cases in which a significant sum is expected to be distributed to creditors.

B) Creditor participation in plan confirmation

207. An especially important contrast with business insolvency is that creditors generally have little if any meaningful influence over the establishment (confirmation) of a payment plan or other requirement for discharge or other relief. Even in those relatively few systems in which creditors may vote on the plan, their vote generally influences how much the debtor has to pay but not the issue of discharge as such. Some systems vest more authority over plan approval in creditors holding certain identified percentages of claims (usually at least a majority, if not

more), though in such systems, a fully non-consensual route to discharge is available to most debtors if creditors refuse the proposed plan. In one system in particular, the availability of a standard discharge procedure is explicitly regarded as a “stick behind the door” to threaten creditors with undesirable consequences if they refuse to accept a consensual plan.

208. In the business context, renegotiation of distressed debt is regarded as almost entirely a matter of private contracting, rather than social planning. The limited liability of business entities offers powerful inherent leverage to debtors in such situations, and the state might well have little specific interest in preventing creditors from simply demanding that the debtor-company liquidate and go out of existence. To be sure, this position has been evolving rapidly over the past several decades, as a culture of rescue and rehabilitation has swept the world of business insolvency, as well. But the desire for rescue and preservation of business, particularly artificial entities, is generally regarded as far less pressing than the moral and economic imperatives to protect and preserve natural persons and their families.

209. Most societies today are not willing to allow creditors to push their natural person debtors out of existence, or even to confine them in a distressed state indefinitely. Moreover, natural person debtors most often occupy a substantially weaker bargaining position than their business debtor counterparts, and at the very least, they are generally less capable of making sophisticated financial analyses or of engaging professional assistance to help them in doing so. Once the situation has deteriorated to the point where a natural person debtor would seek formal insolvency relief, natural market forces and free contract negotiation are no longer sufficient safeguards of the public health and welfare.

210. For societies that have chosen to adopt an insolvency regime, the decision as to how debts will be adjusted through legal intervention is generally regarded as more than a simple matter of contract. Creditors’ interests are protected not through their negotiating leverage, but through their representation by state authorities. The proper levels of sacrifice by distressed debtors, and the appropriate levels of protection of and compromise by their creditors, are matters of sensitive social policy. Policymakers from a wide variety of regions seem to have all but unanimously concluded that these questions in the final analysis are best resolved by political representatives whose task is to balance the competing interests of different constituencies, such as debtors and creditors. Rather than leaving these questions to private negotiations among creditors and debtors, state authorities have consistently been assigned to make the key decisions with respect to the duration and level of sacrifice in insolvency payment plans. If debtors are willing and able to

fulfill the carefully structured demands placed on them by the insolvency system, they receive the relief offered by that system, despite what would be in virtually every case vociferous creditor objection if creditors were asked their opinion on the terms of relief.

211. Even if a fully coercive endgame stands as the final option, some element of contractual freedom and creditor participation continues to play a central role in many insolvency systems. The discussion above in section II.1 about informal, out-of-court arrangements offers a primary example. Even in the formal relief system, the resolution of any individual case might be influenced at least in part by creditor agreement. In several systems, for example, creditors have an option to avoid the court-imposed payment-plan-and-discharge process by accepting a compromise plan. If a majority of creditors accepts the debtor's offer of five years of projected non-exempt income, such a plan can be confirmed over the objection of a dissenting minority of creditors. This combination of creditor assent and court coercion has met with success in a substantial number of natural person insolvency cases in a few systems in recent years. Such intermediate approaches have enjoyed markedly less success elsewhere, however, especially where more than simple majority support from creditors is required. Concerns about eroding contractual freedom have been addressed by giving creditors a chance to accept the reality of the debtor's distress. If they refuse, however, the underlying premise of most existing insolvency systems is that the goals of such a system can be achieved only if a higher authority is willing to step in and impose a compromise arrangement for the benefit of creditors, debtors, and society in general.

212. The reasons why the decision on plan confirmation and discharge is generally assigned to the court or relevant administrative body rather than creditors include the following:

- Creditors adopt very different policies regarding debt adjustment. Sometimes important creditors, such as the tax authorities, major banks, or debt collection agencies who have bought a large number of claims, make policy decisions to oppose all or most categories of insolvency filings by natural persons. In some systems, some types of creditors are on record as opposing relief in such cases "on principle." In many systems, tax authorities and other governmental actors are prohibited by law from voting to offer relief from public debts. Such policies and laws can be very detrimental to the debtors, especially because those broad policies ignore the worthiness of the debtor or the quality of the payment plan, and such policies ultimately undermine the achievement of the many benefits of the system for other creditors and society, as discussed in section I.9, above.

- There is a problem of creditor passivity. This can have serious consequences in a vote: a “majority” decision may reflect a random majority if most of the creditors remain passive. A few systems have devised a solution to this problem short of excluding creditors entirely from participation in the plan confirmation process: Creditors are invited to vote on a plan, but creditor passivity is interpreted as a lack of opposition against the plan or a discharge. Thus, if a vote is taken, passive creditors are counted as implicitly accepting the plan rather than not being included in the quorum.
- Creditors may not be well informed about the debtor’s circumstances and situation. Thus their opinion can be based on partial information. According to the general principles of procedural law the creditors as parties have a right to access and examine all relevant information. But very often creditors lack interest and they do not attend the hearings nor request full documentation. The court or other administrator gathers the needed information and has a duty to study it, and to hear the debtor when appropriate. Thus the court or administrator is in a better position to make the decision on the total circumstances of the debtor.
- Creditors may also find themselves in a situation where other motives affect their ability to make a rational judgment about the consequences of insolvency proceedings for the debtor. In these circumstances, creditors might be heard and be given a chance to present their case but conflicting interests may prevent them from being in the best position to judge the consequences of the case.

213. In insolvency systems for natural persons, creditors’ rights are guaranteed in other ways. Generally, creditors are given an opportunity to be heard in the court or administrative procedure, and they have the right to object to the relief. They also have the chance to offer evidence of circumstances that make the relief unwarranted. They may request that an examination of the debtor or of third parties be commenced. They are sometimes also allowed to make comments on the content of the plan and, for example, demand higher payments than the debtor proposes. There may be a hearing in the court or in front of an administrator if the discharge and the plan are opposed by the creditors. In those systems in which an administrative body or an insolvency representative has the main responsibility for the proceedings, a dissenting creditor has the right to bring the case to the court. After the court has confirmed a plan, a creditor may appeal to a higher court. As mentioned above, however, such instances of creditor participation have been vanishingly rare, as the economic stakes are usually simply too small to justify the investment.

214. One particular way in which creditors' rights are sometimes protected despite their lack of participation is for the law to include a procedure for cases in which assets or unexpected income are discovered post-discharge or post-confirmation. Several systems include a mechanism for allowing creditors or system administrators to request re-opening of such cases and collecting and retroactively distributing the new value to creditors. In several existing systems, however, such windfalls are reserved to debtors. Finality is an important consideration that in some systems is regarded as even more important than ensuring creditors maximal payment from debtors' later discovered resources.

C) Claims submission and verification

215. As mentioned above, an increasing number of systems have done away with submission and verification of creditor claims entirely in cases involving natural person debtors, except in cases where a system administrator establishes that value is expected to be available for distribution to creditors. Where claims filing has not been abolished, the procedures for creditors filing proofs of claim vary from system to system. Much of the claims process is premised on the voluntary and honest compliance by the parties, and many countries therefore have sanctions applicable to debtors or creditors who file incorrect or fraudulent claims. This topic is covered in the ICR Standard, and claims submission and verification raises few unique issues in the context of natural person debtors.

216. At least one insolvency law developed specifically for natural persons, however, contains a unique provision on claims disallowance. This law singles out creditors who extended credit to natural person debtors without taking sufficient account of the debtor's other existing debts, income capacity, or general creditworthiness. Though this provision has been applied rarely in practice, it represents an important reflection of legislators' common desire to inculcate responsibility not only among debtors accessing credit, but also among creditors offering it. This desired effect was discussed above in section I.9.C (iii), and this provision is one unique manifestation of how the desire for emphasizing creditor responsibility might be effectuated in the claims verification process.

217. One final issue of particular importance to natural person insolvency cases is the strict enforcement of claim filing deadlines, especially in cases involving payment plans. Some systems simply deny any distribution to creditors filing claims beyond a deadline, while others retroactively adjust the payment plan or other value distribution mechanism to take into account late-filed claims. This has caused significant problems in cases where debtors' obligations are

retroactively modified in a way that makes them unable to fulfill the new demands. As a result, at least one system specifically designed for natural persons has been revised recently to prohibit such post-confirmation modifications of payment plans and to deny recovery to the affected creditors unless the debtor is regarded as somehow culpable in having neglected to mention such debts in the original application for relief.

II.5. Solutions to the insolvency process and payment of claims

A) Payment through liquidation of the estate

218. Historically, insolvency systems looked to the debtor's assets as the sole source of value to be distributed among creditors in payment of their claims. There is one system that uniquely relies on debtors themselves to sell their own assets and distribute the value to creditors before seeking relief, as a sign of the debtor's seriousness about dealing with her debt problems and responsibly applying available value. In virtually every other system, however, a public administrator or trustee of some kind is appointed to inventory, collect, and sell the debtor's assets to produce value for creditors. A notable trend has developed in many insolvency and creditor/debtor regimes to abandon exclusive reliance on public auctions for such sales and instead to give the insolvency representative flexibility to choose to dispose of the debtor's assets in private sales if that solution is likely to produce greater value for creditors.

219. Most modern systems continue to take the approach of focusing on the debtor's assets, at least initially (for a discussion of payment plans, see below in section II.5.B), but usually this is little more than a formality. Practically, the overwhelming majority of debtors in every existing system of insolvency for natural persons have proven to have few if any assets of any value that are available for liquidation and distribution to creditors. Consequently, several systems have all but abandoned the step of attempting to liquidate the debtor's available assets unless the debtor appears to have substantial assets to warrant the significant administrative expenses of the inventory and liquidation process.

220. One reason for the paucity of debtor assets is that most societies have decided that debtors cannot be left with no assets whatsoever with which to support themselves and their families. Any discussion of liquidation of debtors' assets must therefore focus on which assets are *not* available as a matter of law, as very few other assets of any value are likely to be available as a matter of practical reality.

(i) Property exemptions

221. The notion of exempting some of the debtor's property from liquidation and distribution to creditors is closely tied to the discharge principle. It is also related to the exemption policy in many countries' non-bankruptcy law safeguarding certain assets from post-judgment (and in some countries, pre-judgment) execution and garnishment. The idea is that when debtors receive a discharge, exit from insolvency, and obtain a fresh start, they should first be provided with sufficient property to meet post-insolvency minimum domestic needs for themselves and their families and, where necessary, minimum business needs. The discussion below distinguishes between exemptions relating to property existing at the time the insolvency case is commenced and property that comes into existence post-commencement.

222. In some systems, property exemptions function as an imperfect alternative to an insolvency relief regime. In these systems, exemptions have played the role, historically, of alleviating the condition of the insolvent debtor, especially in the absence of a discharge. However, the effects of exemptions are insufficient to provide debtors with a real opportunity for starting anew. While insolvency relief conclusively limits creditors' rights and offers debtors a fresh start and new incentives for future productivity, exemptions generally do not limit creditors' rights over time. That is, while debtors derive some protection from exemptions, their incentives for productivity remain depressed because any future excess property or earnings beyond the exemption limits remain available to creditors, often indefinitely. An exemptions regime is thus insufficient to achieve most of the benefits of an insolvency system, discussed above in section 1.9.

223. Many systems have mechanisms for dealing with debtor abuse of exemption policies. For example, in some systems, if the debtor tries to hide an asset, he will not be able to exempt it. Avoidance actions are covered in detail in the ICR Standard.

224. Historically, most systems set exempt property levels at very low levels. In some areas, the fact that exemption provisions set a low monetary limit to the total value of goods that the debtor may retain, inclusive of tools of the trade and necessary wearing apparel and bedding of himself and his dependents, reflects a harsh approach, operating in a cultural environment in which creditors were skeptical about the bona fides of bankrupt debtors, and granting debtors just the bare minimum. A problem that arises with outdated provision for exemptions is that they become unworkable and ignored in practice.

225. There is a growing trend to liberalize property exemptions. When countries modernize their property exemptions they generally increase the levels and scope of exempt property. This also saves on expenses because valuation in many countries has become increasingly burdensome.

226. There are primarily three different approaches for deciding which property may be exempted. The first approach is to set aside a range of assets with a value up to a specified limit that the debtor may seek to get exempted from the property of the estate. This historically was a popular approach. A second approach currently adopted by many systems modernized the first approach and set out categories of particular assets (and values) for these assets that the debtor may seek to get exempted. The burden is on the debtor to seek to get those assets exempted from the estate. A third approach that has also been adopted in many systems is to adopt a more general standards-based approach that exempts most property from the estate and puts the burden on the system administrator to object to the exemption of valuable domestic or household assets so that such assets may be brought back into the estate.

227. It can be seen from the operation of these three different approaches that the adoption of one approach over the other has significant ramifications for the insolvency procedures and processes.

228. It is important to keep in mind that, as a general principle, exemptions do not interfere with security interests granted over assets that otherwise would be exempt. Thus, if debtors are experiencing problems with mortgages over their homes, a home exemption will not prove of assistance.

a) Exemption of narrow range of assets by a debtor up to a total value

229. Under this approach, all of debtors' assets existing at the time of the petition (or order) for insolvency relief automatically become property of the estate, and debtors are then given the opportunity to exempt a narrow range of assets for themselves and their families. Historically, assets available for exemption under this approach were often quite limited and only included the tools of the debtor's trade, necessary wearing apparel and bedding for debtors and their families up to very low levels. This approach to exemption dated from an era in which insolvency law was more penal in nature. Under such a level of exemptions, debtors and their families would live at close to poverty levels.

230. The limitations as to both the amount and the scope of the exempt assets in these old laws are far from reasonable

by modern standards, and they left many debtors in a depressed state, sacrificing their future contributions to society. Over the years, in many countries adopting this approach, if the levels and the scope of the exemptions were not increased, the limits were often ignored in practice.

b) Exemption of particular assets by the debtor

231. This approach is a modern adaptation of the first approach. Under this approach, all of the debtor's assets existing at the time of the petition (or order) for insolvency relief are technically available for distribution to creditors, and the debtor is then given the opportunity to exempt particular assets in particular categories and up to a certain amount.

232. This approach grows out of the approach in many systems for providing protection for debtors from the execution (usually post-judgment) against a debtor's assets. In such systems, the exemptions that are provided to a debtor depend on a variety of factors, such as where a debtor lives, what the debtor's profession is, and whether the debtor has a family. Thus, the exemptions, and values of exempt property, might be different in farming and urban areas; or might be different for individual debtors and debtors with families. In the systems that follow this approach, the law sets out a broad range of categories of assets that the debtor may seek to exempt including family homes, automobiles, household goods and furnishings, and tools of the trade.

233. The procedure will set out exemption limits for broad categories of assets, including the debtor's home, motor vehicle (or mode of transport), general household goods held primarily for the personal, family, or household use of the debtor or the debtor's family, professional books or tools of the trade of the debtor, unmaturing life insurance policies, and health aids.

234. In some systems, if the debtor is unable to use up the exemption limits in some categories of assets (e.g., the family home) the debtor may instead apply the unused amount (perhaps up to a limit) to other assets. Some systems even allow the debtor to sell off some assets to buy exempt assets. To take this to the limit, in those places where the exemption law places the family home entirely outside the reach of creditors, there are incentives for debtors to buy as expensive a house as they can afford. This behavior would not be considered fraudulent in such systems because the debtor is merely taking advantage of an available exemption in the law. To prevent these types of machinations some systems have established a limit on the value of a home that may be exempted for those debtors who have purchased the

home within a certain period (perhaps as long as 3 or 4 years) leading up to the insolvency case.

235. In situations where the value of an asset is only partially exempt, leaving some equity value available for creditors, if the insolvency representative sells off such an asset in which the debtor has an exemption, the insolvency representative must pay the debtor up to the amount of the exemption (within the limit) that the debtor has in the asset. To avoid a variety of direct and indirect losses associated with forced sales, some systems instead permit the debtor to pay the insolvency representative the amount above the exemption if the debtor wishes to keep the asset.

236. The use of an exemption mechanism that allows the debtor to claim exempt property from certain categories and up to certain values has the advantage of general fairness. This approach may be of interest in countries in which many insolvent individuals are middle-class with many assets. However, this fairness comes at the expense of efficiency because there can be disagreement between the debtor and the insolvency representative (or the debtor's creditors) when the debtor tries to maximize benefits under the broader categories. Another weakness of this approach is that the limits on the value of exempt assets that may be excluded from the estate are often too low, or become too low over time if their values in the legislation are not increased to keep in line with inflation. When that happens, the practice in some systems is to stop strictly enforcing the exemptions and to allow debtors to retain more than their statutory entitlement. In some countries that have experienced hyperinflation, the system includes artificial or notional measures of value—i.e., a unit of value whose value is regularly updated by the Government—in order to avoid the problem.

c) Standards-based approach in which the insolvency representative seeks to reclaim items of excessive value

237. The standards-based approach approaches the issue from the opposite perspective of the first two approaches. Under this approach, all of the debtor's assets existing at the time of the insolvency petition (or order) are exempt, and the burden switches to the insolvency representative /government regulator to petition to reclaim particular items of excess value that could be of value to the creditors and the estate.

238. An underlying assumption of this approach is that most of debtors' personal items are of greater value to them and their families than they are of economic value to their

creditors. In systems in which most insolvent debtors have a limited amount of personal assets, this approach can be much more efficient. The insolvency representative/government regulator only needs to intervene in those cases in which the debtor has particular items of excess value.

(ii) Specific exemptions by asset type

a) Family home exemptions

239. Debtors' homes are usually their most valuable asset and, in many cases, the asset in which debtors have lost the most equity. It is arguably also the most important asset psychologically, for the home provides shelter for the family and serves as the family meeting point. Thus, losing one's home in foreclosure or insolvency can take a significant toll on a debtor. The family home is thus arguably one of the most important assets to be protected.

240. Although there is agreement as to the importance of the exemption for the family home, there is a great variety of limits that are permitted. In countries that have a more complicated state/federal system, there can be great variety even within a single country. For example, some states may have no limit at all on the amount of a family home exemption and even permit debtors to sell off other assets with a view to buying an expensive home.

241. Another approach to the family home exemption that some systems have adopted is to provide that debtors and their dependents are entitled to continue residing in the family home for a specified period of time (e.g., six months) with the ability to apply for a further extension. Under this approach, the debtor is unable to exempt the family home from liquidation and distribution to creditors, but is able to ensure that that commencement of an insolvency case does not lead to the immediate eviction from the family home.

242. The family home often involves complicated matters involving joint ownership and the related issues of whether (and how) creditors can seek a partition of the joint assets or a split of the assets between the insolvent and the non-insolvent party (See section II.5.A(v) below.)

243. In some systems, upon the granting of a discharge, the debtor's assets that vested in the insolvency estate will not return to the discharged debtor. This rule caused complications in some systems in which the insolvency representative delayed selling the debtor's home – in some cases until after the debtor was discharged – in the hope of getting a better price. There is one system in which this practice ended when an amendment was made to the law

that provided that the debtor's interest in the family home would revert to him three years after the commencement of the insolvency case if the insolvency representative had not realized the asset for the benefit of creditors or commenced proceedings to do so during that period.

b) Automobiles/mode of transportation

244. The exemption of a debtor's automobile or mode of transportation is another of the debtor's most valuable exemptions. Depending on where debtors live, if they are not able to exempt their mode of transportation, they might be unable to get to work and could lose their job.

c) Household furnishings

245. In most cases, the debtor's household furnishings have a *de minimis* value. Most countries adopting the individual category approach will set out both an overall amount of exemption for all household furnishings and a limit on the amount of exemption for any individual item.

246. In those systems that adopt the standards-based approach, the debtor will generally be permitted to retain all of his household furnishings. The insolvency representative will be permitted to reclaim items of significant value for creditors. Similarly, some countries that adopt the exemption of particular assets by debtor approach specify that object above a certain value cannot be included as "household assets."

d) Exemption of part of salary/wages and pension/retirement plans

247. Most systems allow the debtor to retain earnings from services performed by an individual debtor after the commencement of the insolvency case. Some systems then provide for the entering of an income payment order against the debtor or encourage the debtor to voluntarily agree to pay over to the estate a portion of his post-commencement earnings. (See the discussion of payment plans in section II.5 B)). At a minimum, debtors are able to retain sufficient post-petition income that is adequate to meet the debtor's and their family's reasonable domestic needs. Permitting the debtors to retain sufficient income is based on humanitarian concerns, but it also favors the creditors because it increases repayment capacity.

248. At present, for many middle class debtors, the largest asset is their pension/retirement assets. The effect of insolvency law on pension rights is one of the more confusing and difficult areas of insolvency law, as the law

tries to balance debtors' obligations to pay off their creditors against the debtors' fresh start and right to pension assets to assist with their retirement.

249. Some systems make a distinction between (1) a debtor's personal pension policies, which are contractual agreements entered into with pension providers and (2) occupational schemes, which are pension trusts set up by employers. In systems that adopt this distinction, as a general rule the personal pension contracts vest in the insolvency representative. As for occupational schemes, the treatment is more confusing. In some systems, a forfeiture clause, that is, a clause pursuant to which a member's interest would be forfeited upon insolvency and paid to the member (i.e., the debtor or spouse or dependent) would not be effective against an insolvency representative— subject to the language of the individual forfeiture clause. In some systems, in regard to pre-insolvency contributions, a distinction is made between the validity of forfeiture clauses as to the employer's contributions (permitted) and the employee's (insolvent debtor's) contributions (not permitted). As for post-insolvency contributions, there is a line of authority that post-insolvency contributions form part of the estate and thus, when they become payable to the debtor, should be paid to the insolvency representative. However, there is some uncertainty as to whether the insolvency representative must serve a notice related to after-acquired property. Another approach is for the insolvency representative to agree not to lay claim to the mandatory contributions of both the insolvent debtor and the employer as long as the funds remain in the general fund.

250. Other systems take a simpler approach and allow for certain defined retirement schemes to be exempt either in full, or up to high limitations even exceeding very substantial sums.

251. Overall, the situation in many systems is confusing and would require some type of legislative intervention to clarify whether the debtors' pension or retirement assets should be made available for distribution to creditors –and if so, up to what amount-, or should be immune to creditor attack and preserved for the debtors' eventual retirement.

e) Exemption of professional books, implements, equipment, or tools of the trade

252. Most systems exempt at least a defined amount of professional books, equipment or tools of the trade. Limitations might be in place in systems adopting the exemption of particular assets by debtor approach. Systems adopting the standards-based approach in which the insolvency representative seeks to reclaim items of excessive

value would normally be more generous. With the increasing focus on the rehabilitation of debtors, it is logical that higher, rather than lower limitations for these assets are included in the system.

253. In some systems, the exemption of an automobile is tied to arguments based on tool-of-trade exemptions. Exempting debtors' cars will often make it easier for debtors to commute to work and thus be able to repay their creditors. See II. 5. A. ii b above.

(iii) The consequences of the exemption regime

254. As can be seen from the discussion immediately above, there are significant consequences flowing from the choice of an exemption regime. Historically, the level of exempt assets for debtors left them but slightly above the poverty line. The modern trend is to enable debtors to have a true fresh start and the debate revolves around defining the level of sufficiency. The issue of retirement assets is one of the most important, given the large amounts that many debtors have in their retirement accounts.

255. There are also significant differences in the efficiency and costs of administration. The approach based on the exemption of particular assets by the debtor can be more costly to administer than the standards-based approach in which the insolvency representative seeks to reclaim items of excessive value. However, the differences might be narrower in systems in which many debtors are in the middle-class and have numerous assets of excessive value.

256. A factor to be taken into account in the design of an exemption regime is that the administrative costs incurred in liquidating low-value assets rarely represent an efficient use of resources.

(iv) After-acquired property

257. Most systems generally make a distinction between assets that a debtor has as of the commencement of an insolvency case (which are available for distribution to creditors) and assets that the debtor obtains post-petition or post-insolvency order, as the case may be (these assets usually remain with the debtor). However, insolvency regimes want to prevent debtors from strategically timing the filing of insolvency petitions to allow a debtor to escape from paying creditors 100 percent of their claims, yet benefit from post-petition or post-insolvency order windfalls such as inheritances. Thus, many countries provide that certain interests that the debtor acquires post-petition or post-

insolvency-order within a certain time period (for example 180 days) becomes property available for distribution to creditors. These interests might include interests by bequest, devise or inheritance; as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; as a beneficiary of a life insurance policy or of a death benefit plan, or from lottery winnings. In the absence of rules providing for these occurrences, debtors could strategically file and keep the post-petition windfalls for themselves.

(v) Family property and division of assets

258. As noted above, joint ownership provides complicated legal issues for individual debtors, and such problems frequently arise in regard to assessing the interests of debtors and their spouses. The resolution of such issues will often depend on the relevant non-insolvency law and the ability to split such interests.

259. In some systems, there is a presumption that in the absence of evidence to the contrary, upon the making of an order for insolvency relief, the one half of the property owned by the debtor as a joint tenant shall be held by the insolvent debtor and vest in the insolvency estate (as long as the property is not exempt). Of course, it is a separate issue whether the insolvency representative will be able to sell the debtor's interest in such property (especially where the property is being used by the debtor and his/her spouse). In other systems, the courts are less sympathetic to a creditor's claim to sell a family home when the co-owner (spouse) objects, the creditor is unlikely to get a large financial benefit, and there will be significant dislocation and psychological and emotional injuries to the spouse and the dependents.

260. Complicated issues can also arise in regard to the family home in regard to contributions by the non-insolvent spouse that were used to purchase the home or to pay the mortgage. Sales of joint tenancy or other co-owned property are easiest when the property is not the family home, where the co-owners are not husband and wife, or where there is a large financial benefit to the creditors.

B) Payment through a payment plan

261. Because most natural person debtors have little value in available assets, existing insolvency regimes most commonly require some contribution from debtors' future income in exchange for whatever benefit the system offers (usually a discharge of unpaid debt). Whatever the form and extent of relief offered, most systems envision an "earned start" for natural persons, rather than a simple "fresh start" with no

contribution or exertion expected of debtors. Some of the most difficult questions in natural person insolvency policy arise in the context of formulating a payment plan, especially the twin issues of how long debtors should be required to toil for the benefit of their creditors, and how much debtors should be required to pay during that period; that is, how much can they retain, with all “excess” applied to paying off debt. Once the plan is established, an effective insolvency regime must consider assigning responsibility for monitoring the debtor’s compliance and the possibility of modifications to the plan for changed circumstances. These issues are discussed in the following subsections.

(i) Plan duration

262. Constructing a payment plan regime begins with a seemingly simple but devilishly divisive and challenging question: How long should debtors be expected to devote their surplus income to paying down their debts? Policymakers have long struggled to formulate a reasoned basis for choosing any particular time period, and no single choice has attracted a consistent following among existing systems. In part, the answer to this question depends on the desired goals of imposing a payment plan on debtors in exchange for a promise of insolvency relief.

263. If the goal is simply to maximize payment to creditors, one might think that a longer term would be appropriate, but this immediately raises the most salient countervailing consideration here. Recall that several of the primary goals of insolvency regimes for natural persons generally relate to removing disincentives to being productive. A lifetime of liability can be a debilitating disincentive to productivity, but even a limited repayment term can squelch the debtor’s motivation and delay the debtor’s rehabilitation and the attainment of the many other goals of the insolvency regime discussed earlier. The point of rapidly diminishing returns can be reached quite quickly when deciding on the proper repayment term. Moreover, experience in every major insolvency regime in existence has revealed that few debtors will have the wherewithal to produce anything substantial for creditors beyond covering the debtor’s basic needs and the administrative costs of the insolvency system, no matter how long or short the repayment period might be. Increasing the repayment period thus is likely to actually depress creditor returns and to reduce the numbers of debtors who can be helped by the system, sharply limiting the positive effects of the system.

264. A more generally attainable goal is simply to inculcate payment responsibility and avoid moral hazard among debtors. Accepting that most debtors are unlikely to be able to produce a significant return to creditors, many existing

systems seem to pursue primarily this sort of educational goal. Habituating debtors to regular budgeting, paying bills, and submitting tax returns has been regarded by some policymakers as a benefit in its own right. This approach is far more complicated than trying to maximize returns to creditors. Returns to creditors can be easily quantified and measured, whereas making debtors more financially responsible represents a hidden battle with minds and attitudes. Whether or not an insolvency system can have a meaningful impact on debtor attitudes and behaviors is a question that eludes satisfying analysis. Nonetheless, available evidence suggests that it is all but certain that a longer repayment term will have a quite powerful suppressing influence on the number of debtors who seek and receive the relief and thus achieve the goals of such a system. Experience in many existing systems has shown that, once debtors discover the demands and rigors of an extended, multi-year payment plan, some will abandon the process for fear they will be unable to withstand the sacrifices, and many will be forced out by their actual failure to do so.

265. Whatever plan duration term is ultimately chosen, there are at least two techniques for making that choice, and one is rather clearly less effective than the other: First, the decision might be left to the case-by-case discretion of a decision-maker, such as a judge, or second, it might be pre-defined in the law and applied to all cases in like manner. In either event, as discussed in section II.4 B, above, creditors are seldom invited to participate in this decision-making process.

266. The former, flexible approach has most often led to one of two undesirable and self-defeating results. First, early systems that took the flexible approach soon discovered that the decision-makers too often imposed overly extended repayment terms (e.g., more than ten years), all but assuring that debtors would fail to complete their plans. Few of the goals of an insolvency system can be achieved if the requirements for relief are practically unattainable. At the very least, if a flexible approach is to be taken successfully, the decision-makers must be properly educated on the variety of practical and behavioral impediments to debtors' complying with payment plans that extend beyond a few years.

267. The second and quite common result of the flexible approach has been a spontaneous and systemic standardization of the repayment term. This has been true especially in systems that have offered time period ranges as a "guideline" for the ultimate determination. More often than not, the actors in these systems have perceived too few benefits from adopting various approaches to various cases, and they have simply applied one single, more or less

uniform approach to the repayment term in the overwhelming majority of cases. Two opposite examples illustrate this point. In one country, though the law allows for plans of between three and five years, practice quickly standardized such that the overwhelming majority of plans are set at the five-year term. In contrast, the law in another country as originally promulgated also assigned discretion to the judge to design plans extending over three to five years, but there, the lower end of the scale became the norm, as very few plans in that country have exceeded the standard three-year term. This rejection of flexibility and gravitation toward a standard can be observed even more prominently in determining the amount of payment demanded, as discussed below, but the same phenomenon has affected the plan repayment term, as well.

268.If a single standard term is to be chosen for all plans, what might be the optimal length of time? Unfortunately, very little uniformity can be observed in existing systems. The most common repayment terms tend to fall between three and five years, with a notable congregation of laws with a standard five-year term. The rationales for these decisions, however, are seldom clear or particularly convincing. The choice of five years in one country, for example, was based on a scattered sampling of comparable practices, including existing norms for forgiveness of social assistance repayment debts in and general offer-in-compromise practice by tax authorities, as well as the evolving norms in other countries' laws. The most empirically meaningful basis for selecting one term over another appears in the legislative history of another insolvency law, in which policymakers concluded that accumulated experience with voluntary workout arrangements indicated that expecting debtors to live longer than three years at a subsistence level would be "from a social point of view not responsible."

269.This is obviously a value judgment in one sense, but practically, lawmakers have also borne in mind the need to strike a balance between setting high goals and setting attainable goals. Practice in many countries has indicated that plans longer than three years produce more failure than success. In one large system, for example, a consistent two-thirds of all payment plans fail before they reach the end of their five-year term. Unfortunately, very little empirical evidence exists on plan performance in most countries, so strong conclusions on the results of longer plan periods are not well supported by data. Existing evidence and widespread anecdotal reporting, however, consistently indicate an inverse relationship between plan length and plan success. Particularly in developing countries with economies marked by high levels of volatility and uncertainty (especially rampant inflation), rapidly changing economic

conditions can make successful planning for even a short period all but impossible.

270. The negative effects of longer plan terms might be mitigated, as illustrated by unique experience in two recently reformed systems. In these systems, the law contains an ingenious tactic for encouraging debtors to struggle through by offering debtors standard, graduated “motivation rebates” of 10% or 15% of their annual assigned income as a reward and incentive for making it through the later years of the extended payment plan period. In addition, to avoid the unintended problem of extending the payment period beyond the already longer than average standard term, its starting point was explicitly tied to the beginning of the sometimes protracted insolvency administration process, not its conclusion.

271. More recently, policymakers in two systems have made or proposed a more thorough-going reform by reducing the payment term to three years. The latest proposal from one of these systems, however, imposes a *quid-pro-quo* requirement that excludes all but a small portion of debtors. It offers the shorter term only to debtors whose surplus income covers at least one-quarter of their debts. Given the often observed fact that the overwhelming majority of debtors in this system have insufficient income to make *any* distribution to creditors, the proposed reduction of the term for debtors who can pay a substantial portion of their debts in three years is most likely an all but illusory reform.

272. Nonetheless, there is something to be said for the idea of adopting a sliding-scale approach, imposing a longer repayment term for debtors unable to make significant contributions, but releasing debtors early as a reward for making more substantial payments, thus creating a set of incentives for debtors. On the other hand, imposing longer repayment terms on chronically destitute debtors seems rather counterproductive. This approach offers few benefits to creditors, it only enhances the pain and sacrifice suffered by debtors, and it delays the real societal benefits of an insolvency relief system without an obvious countervailing benefit. This point will be taken up again below.

***(ii) Payments to creditors: Reasonable expenses
and “surplus” income***

273. The common goal of imposing a payment plan on debtors is to encourage and extract debtors’ best efforts at servicing their debts during a defined—and limited—repayment term. How much payment to expect or demand of debtors is a core issue that, like the determination of the repayment term, has divided policymakers along several

different axes. Most agree, however, that proper resolution of this issue is less a matter of defining a predetermined benefit for creditors than defining a predetermined level of sacrifice for debtors. Whether from a moral or simply pragmatic standpoint, the determination of potential payment to creditors should begin with a determination of an amount to be reserved for the reasonable support of the debtor and those dependent on the debtor. Only income in excess of this, and probably *all* income in excess of this, represents “surplus” that might be assigned to creditors. There is mild disagreement even on this basic starting point, and beyond this, existing systems are divided on the details of evaluating both income and reasonable support expenses.

a) Income: Actual or projected, exclusions and enhancements

274. Because payment plans regulate future activity, an immediate complication arises with respect to determining the most basic term: How much income does the debtor have, from which reasonable expenses can be deducted to produce an offer of payment? Two broad approaches might be taken to this foundational question.

275. One approach makes no projection and instead bases future payments on the debtor’s actual income in any given period. In the most prominent example of this simple and elegant approach, debtors formally (contractually) assign whatever portion of their future income exceeds the standard exemption, and these assignments are collected by an insolvency representative for distribution once per year among creditors. When the plan is confirmed, no one can predict exactly how much creditors will receive, but they are assured maximum payment based on the debtor’s income and the simple statutory exemption (discussed below).

276. The other approach defines a specific payment for each creditor by projecting an income for the debtor over the repayment term. Though this is the most common approach, it has obvious weaknesses. Any projection of something as volatile as individual income over a period stretching three or five or more years into the future is bound to be wrong. The inaccuracy might be small, but it might be quite large. The projection might under- or over-estimate the debtor’s income, and either case presents problems. An underestimation leaves value with the debtor that might more appropriately have been distributed to creditors, while an overestimation may well leave the debtor unable to make the necessary payments from a smaller than expected income.

277. Despite the complications of using an income projection, there are compelling reasons to accept these limitations and

take this approach. The reason has little to do with offering creditors greater certainty. Even if creditors are involved in the process of accepting or rejecting a plan (which is rare, as discussed above), they should prefer a solution that offers them the maximum possible return in light of the debtor's actual abilities and income, not a projected return that might or might not square with the debtor's actual means. The primary complication with an "actual receipts" approach is a potentially significant monitoring burden. Someone has to calculate the fluctuating amount to be ceded to creditors each month (or other payment period). In systems where debtors are allocated a uniform allowance, this calculation is simple and might be done by employers, much like in the ordinary wage garnishment system. If employers cannot be relied on to perform this function—especially if the debtor is self-employed—or if concerns such as privacy or avoiding stigma prevent them from doing so, or if debtors' expense allowances are not based on a simple and straightforward calculation, the periodic turnover of actual surplus income involves a significant monitoring and administrative burden. Thus, the optimal method for determining the debtor's income is closely tied to the chosen method for determining reasonable expenses. In many cases, the compromise from both creditors and the system in general consequently is to accept greater uncertainty in exchange for avoiding a substantial administrative cost. Given the movement toward greater standardization of expense allowances, discussed below, it is not entirely clear that this compromise is justified.

278. Even if projecting income is unavoidable, experience suggests that one particular approach to such projections should be avoided. A particularly problematic approach to anticipating future income emerged in one system that has drawn widespread criticism and produced a litany of unintended negative results. One aspect of this recently reformed system imposes payment plans on debtors if their current monthly income is sufficient to cover their allotted expenses and offer a minimum return to creditors. Projecting the debtor's future income based on current income is problematic by itself, but "current monthly income" is not "current." Instead, that term is defined to mean the average of the debtor's monthly income over the preceding six months. Naturally, most debtors seeking insolvency relief have experienced an income disruption (e.g., unemployment, divorce, medical problem) that has depressed their income during the preceding six months. In addition, experience with this approach has revealed a substantial number of debtors who happen to have received an extraordinary income boost during that six-month period (a bonus, tax refund, sale of a large asset, gift, etc.). In either event, a future projection based on this exceptional six months of past income is very likely to produce substantial inaccuracy. A variety of actors have called for efforts to anticipate what the debtor's *actual* future income will likely be, and in some

cases, this approach was ultimately mandated by the courts. Though past experience can be useful in making projections of future income, the rigid approach described here has been roundly criticized.

279. In systems that make transfer payments to debtors through social assistance or social support systems, consideration should be given to whether these payments should be excluded from the debtor's available income. On the one hand, if the expense allowances in insolvency are coordinated with or even keyed to the social assistance standards, this might not be an issue at all. Any income debtors receive from state transfer payments might be excluded by virtue of the fact that these debtors' incomes are by definition below the level at which any "surplus" might be available to creditors. In many such systems, however, transfer payments are made to debtors without regard to incomes that exceed the "poverty" or "social minimum" level. For example, many countries in Northern Europe provide child allowances to families with children largely without regard to family income, and the same is true of social insurance pension payments in much of Europe and the United States. In such cases, these transfer payments might subsidize payments to creditors rather than flowing to their intended beneficiaries. If non-transfer income is displaced into creditor pockets because this "surplus" income is no longer necessary to cover basic expenses in light of the extra transfer payment, this might be less objectionable. But if low-income debtors wholly reliant on transfer payments receive child allowance or pension benefits that are diverted to creditors, the inevitable diversion of state funds to creditors might be regarded as problematic. The most recent revision of one individual insolvency law placed child allowance transfer payments outside the scope of "income," while a neighboring country with a very similar system continues to consider these and other transfer payments as available income. In another system, transfer payments related to the "social security" system are excluded from consideration as "income."

280. Finally, since one of the main goals of an insolvency system is to encourage natural person debtors to be productive and avoid going "on strike," consideration should be given to how the system might enhance the former effect and sanction the latter. The most prominent, fundamental, and effective way of encouraging debtors to be as productive as possible is simply to offer the relief of a discharge of unpaid debts. Most systems simply hope that this incentive will encourage maximum productivity by debtors. Rarely have existing systems done anything specific to address the possible moral hazard of debtors continuing to be unproductive until they have obtained relief.

281. A few countries have prominently incorporated both incentives and penalties into their approach. As discussed above, two systems offer debtors an incentive to be maximally productive by refunding 10% or 15% of their incomes assigned during the later years of a payment plan. As small as this reward is, it at least represents an effort to enhance the incentive already inherent in the insolvency system in general. On the other side, several systems require debtors to earn their discharge by at least seeking if not engaging in productive work. Debtors who fail to apply at least reasonable efforts can be denied the relief otherwise offered by the system. While rejections of discharge for failure to apply best efforts have been vanishingly rare, the mere statutory requirements add to the urgency of debtors' engaging their best efforts in exchange for the extraordinary relief the insolvency system offers. Another system with a presumption of a four-year period leading up to discharge for debtors who are declared insolvent for the first time, offers an early discharge for debtors who cooperate and a delay in discharge for up to four additional years for those who do not.

b) Expenses: Flexibility and standardization

282. As mentioned above, the heart of any payment plan regime is the particularly sensitive issue of what resources to reserve for the support of debtors and their dependents. Given the depressed income-earning capacity and elevated cost of living faced by most insolvent debtors, the ultimate return to creditors will be determined predominantly as a function of how much of debtors' income is placed beyond creditors' reach. This crucial issue has challenged policymakers for centuries, and the evolving modern insolvency systems for natural persons have struggled mightily with the proper balance between providing adequate support for debtors and producing a desired benefit for creditors. Moreover, these systems have increasingly perceived a problem with unequal treatment of similarly situated debtors facing decision-makers in different areas. This poses serious problems for modern societies who prize equal access to justice and predictably equal treatment of citizens.

283. Perhaps the most significant challenge in defining a proper reserve budget for debtors is deciding how best to achieve fair and equal treatment. Should equality be pursued through a flexible approach that seeks to meet each debtor's specific, unique basic needs, or should this determination be made in like fashion for all according to some objective, neutral guideline as to basic needs, with only minor variations for specific circumstances? Many existing systems have begun from the former position, assigning responsibility to judges or other decision-makers to use their discretion to

establish debtor budgets in a manner that ensures “human dignity” or some similar vague principle. Some of these systems have attempted to steer that discretion toward austerity, suggesting that decision-makers should use their discretion to establish “modest” budgets, though most have hewed closer to a middle line, using subjective guidelines like “ordinary and necessary expenses” or “reasonable needs.”

284. One lesson that seems to have emerged most clearly from the last three decades of experience is that a flexible, discretionary approach, while theoretically attractive, is practically quite problematic. When legislatures have delegated to judges the authority (broad or narrow) to define appropriate debtor budgetary guidelines, at least four serious problems have emerged. Legislators in many of the existing insolvency systems for natural persons have reformed their laws in the past several years in large part to address one of these four problems.

285. First, a rather isolated problem has arisen in one system where, for a variety of historical reasons, the insolvency courts have to a substantial degree tended to regard their primary duty to rehabilitate debtors and thus to favor debtor interests. Consequently, when faced with the task of defining the “amounts reasonably necessary” to support the debtor and dependents, the insolvency courts often tended to take what many regarded as an extremely debtor-friendly position, interpreting “reasonable necessity” liberally to encompass a wider variety of expenses than many legislators (and policy commentators) regarded as appropriate. The legislature ultimately responded to this perceived imbalance in a particularly unconstructive way, as discussed further below, but an exercise of discretion overly favorable to debtors is one consequence, one might say potential danger, of a discretionary approach to debtor budgeting.

286. Second, the opposite problem is even more undermining to the success of an insolvency system, as lawmakers in another country discovered. In the early years of this country’s new system for treating “individual overindebtedness,” the commissions in charge of this system exercised their assigned discretion to establish debtor budgets in a strikingly over-conservative manner. Proposed payment plans there often allocated less income to debtors than would be available to destitute recipients of social assistance. The commissions’ methods for determining debtor budgets ignored the modern realities of basic human needs for such things as utility service, insurance, and other basic non-food expenses. Analysts predicted that as many as three-quarters of these plans were destined for failure in light of these “scandalously low” budgets. To prevent this disastrously counterproductive exercise of discretion from undermining the entire system, both the administration and

ultimately the legislature had to intervene to establish clearer budgetary guidelines, as discussed below.

287. A third problem with relegating debtor budgets to the discretion of system administrators is the inevitable variation in how decision-makers in various regions will exercise this discretion. While some variance is to be expected in light of natural differences among debtors and even judges, insolvency regimes have too often produced extreme regional differences, raising serious concerns of fairness and equality of treatment. A prominent study of payment plans in one system in the early 1990s revealed that different courts in the same jurisdictional division were imposing strikingly different demands for payment. Courts in one district might demand that debtors abide by budgets that would produce nearly full payment to creditors, while other courts had more realistic expectations of often quite modest payment. Another new insolvency system for natural persons underwent its first reform primarily to address a problem with extreme variation in payment plan budgeting practices. The original law in this system had vested the courts with discretion to establish budgets to support “modest” lifestyles for debtors. Even in this relatively small and homogenous country, different courts in different regions arrived at strikingly different conclusions as to the makeup of a “modest” budget. These extreme variations prompted some debt counselors to suggest that their clients move house from districts with especially miserly judges to nearby areas where insolvency relief was available on more livable terms. This problem has plagued many systems whose laws initially perceived flexibility and discretion as strengths, and the legislatures of many countries have since stepped in to constrain that discretion.

288. Finally, in some instances, discretion has been set aside not by external regulators, but by the system actors themselves. In at least two particularly notable instances, judges and administrators who have had to deal with these cases on the ground have concluded that flexibility and discretion are not virtues given the relatively standardized nature of the financial problems to be addressed. Debtors’ reasonable needs do not deviate so far from a set of standards as to warrant a largely unbridled flexible approach. Moreover, the time spent carefully tailoring an appropriate budget for each unique case will most likely turn out to be a poor investment, as this expenditure of resources will consistently far outweigh the depressed maximum returns that might be extracted from debtors for creditors in these cases. In two particularly noteworthy examples, the law initially provided a base budgetary guideline (discussed below) designed simply to “guide” the decision-maker in the formulation of appropriate payment plans. In both systems, however, administrators rejected the discretion inherent in the suggested “guideline” and chose instead to develop a

largely uniform approach across all cases. The legislatures in these two countries eventually confirmed this practice by revising the laws to abandon the wholly discretionary approach.

289. The appropriate measure of sacrifice to be demanded of debtors in exchange for whatever relief an insolvency system offers is a crucial and inherently political decision. Such a central issue of public policy is likely better made by a legislature or other representative entity, rather than by insolvency system administrators. While the relevant judicial and executive actors indeed do have close contact with debtors and creditors and thus have insight into the specific needs of the people most closely impacted by the system, they are simply not in the best position to make the sensitive social policy decisions that drive an insolvency regime. As discussed below, discretion need not be totally eliminated, but experience suggests that it is probably better that politically responsible entities at least make a solidary and unifying choice as to an agreed baseline from which mild discretion might then depart.

290. Selecting an optimal approach to payment plan budgeting is not a simple binary choice between wide open discretion and rigid, bright-line rules. Even if a standard budgeting rule or rubric is adopted, some discretionary element is likely desirable if not unavoidable. An example from one system illustrates a moderate compromise in this regard in two ways. First, as in many other systems, the base budgetary exemption is designed to cover all of a debtor's expenses other than housing costs, which are separately allowed so long as they are "reasonable" according to guidelines developed by the Tax Service. In addition, however, the "standard" can be supplemented by non-standard allowances for debtors' actual expenses for transportation to and from work, childcare expenses, as well as support and even sometimes extra medical expenses. A similar "lodestar" approach of allowing discretionary, case-by-case additions to a basic subsistence budget is taken in several other systems, as well. In addition, however, administrators in the example system highlighted here developed a practice of further supplementing debtors' basic budgets with a small monthly "buffer" for possible unanticipated expenses. This second, mild incursion of discretion into an otherwise standard approach has been adopted elsewhere, as well. While administrators in another system were eventually required by law to allocate at least a standard minimum budget to all debtors, this minimum is described as "one part" of the necessary resources for supporting the debtor's household. This bifurcated approach to budgeting represents a common and probably sensible compromise between the many undesirable effects of discretion and the undesirably constricting imposition of one inflexible norm.

291. The easiest and most widespread approach to selecting the basic budgetary standard has been simply to regard the insolvency system as an extension of (indeed, a limitation on) the existing ordinary system of debt collection. The same limitations on “garnishment” or seizure of wages and other income that would have applied in ordinary collections cases will also apply in defining available income for an insolvency payment plan. This is the straightforward approach taken in many current laws, though as mentioned above, at least one system defines this minimum budgetary reserve as only “one part” of a proper budget. Indeed, as discussed above, while some laws suggested that insolvency administrators simply consider the ordinary “exemption” law as “guiding,” that standard already allowed sufficient discretion to accommodate the mild variations among insolvency cases, so it was simply adopted as the norm.

292. Co-opting an existing “minimum income” norm poses a substantial danger, however, as illustrated by experience in one system in particular. When this country’s insolvency law was implemented, the general wage exemption law had been revised only once each decade, and the exemption level had not been increased for inflation in many years. Expecting debtors to live on an income that might have been appropriate seven, eight, or even nine years earlier was obviously inappropriate in a country where consumer buying power was constantly eroded by rising costs, not to mention the effect of currency fluctuations on the many imported goods consumed by natural person debtors. Lawmakers responded quickly and responsibly by increasing the statutory wage exemptions substantially for most debtors and providing for indexation every other year to keep constant pace with inflation.

293. A choice of one objective and uniform standard does not necessarily entail a choice of one single figure to be applied to all debtors in all situations. Instead, existing systems commonly establish bands of uniformity, with debtors categorized into groups with various vital characteristics, and different exemption amounts are calculated for each of these groups, often with a possibility for increasing these standard amounts for specific, variable expenses. In many countries, the “exempt” income level is not one simple figure. Indeed, it is not even a series of simple figures to be applied to debtors with and without spouse or children. Instead, various figures are often established for debtors with spouses and various numbers of children of various ages, and these figures are often supplemented by allowances for “reasonable” expenses for housing and child care, as discussed above.

294. Because they apply in ordinary debt collection cases, these wage exemptions are perhaps the most common and appropriate standards for establishing repayment budgets in insolvency cases. If creditors are subject to the same

restrictions on available income in both the ordinary collections system and the insolvency system, this approach clarifies exactly what the insolvency overlay is designed to do: Rather than taking the more radical (though often proposed) approach of limiting all creditors to a much shorter prescriptive period (statute of limitations) for enforcing their claims, the insolvency system identifies a small subgroup of debtors for whom general collection activity will be limited to the term of the repayment plan. All creditors will share in the administrative costs of expropriating available income from debtors, and all will be included in the distribution of whatever would have been available to any creditor collecting on its claim in any event, but all creditors will be limited to whatever the standard collections process would have extracted from the debtor during a limited period (as discussed above, usually five years or less).

295. In some countries, the “minimum income” that is insulated from seizure in ordinary collections actions is (or has later become) coextensive with the “subsistence minimum” income reserved for supporting debtors’ essential expenses. In one system, for example, the standard budget allowance for insolvency payment plans is defined by statute as 90% of the minimum income assured by the social assistance system. This ultra-depressed allowance would likely lead to mass failure of payment plans, even in light of the short three-year repayment term in this country’s practice. The unique application of this statute by local judges, however, is particularly ingenious. A national working group of insolvency judges boldly took the initiative to develop harmonized budgetary guidelines that would eventually be applied to both ordinary collections actions and insolvency payment plans. They started, as directed by law, with the baseline of 90% of the national social assistance minimum income, but in part to further encourage debtors to find productive work, this minimum reserve is augmented in virtually all cases by substantial supplements for debtors with full-time work, as well as for debtors with children and a variety of itemized expenses for such items as housing, transportation, and child care. Once again, choosing a standard baseline need not exclude salutary exercises of discretion to supplement the minimum budget allocation. Indeed, such supplementation may be necessary if the floor is set too low, as in the preceding example.

296. Finally, if general enforcement restrictions or social assistance minimum incomes are unavailable or incompatible with social policy for insolvency cases, a basic budget standard might be built from scratch using the sorts of techniques that have produced these other guidelines. National statistical, labor, consumer, or taxing authorities in many countries have identified baskets of standard household items consumed by various family sizes during, for example, a month, and constructed a budget based on

surveys of the costs of these items. Often these costs fluctuate, and subsequent surveys then track the fluctuations and alter the budgetary guidelines, sometimes several times each year. The range of items that might be included in these baskets varies considerably from country to country based on local views of “necessity” and dignified existence. In one country, for example, a standard expense was recently added to the basket to cover charges for the use of cellular phones, and internet access has increasingly been regarded as a necessity in many parts of the world. To be sure, living standards vary significantly around the world, and simple access to basic food staples and water may well be a more pressing concern than internet access in many areas. The point is simply to observe that appropriate standard budgets can be developed on the basis of widely varying expectations in different regions and countries. Many examples of constructing a basic consumer budget in this way are available to policymakers interested in developing a sensitive and livable approach to payment plans.

c) What to do with debtors with no income, no assets (NINAs)

297. For some debtors, and likely many, the result of deducting the standard expense allowance from actual or anticipated income may well reveal little or no surplus. Indeed, a common and quite sensible approach to the administrative expenses of administering payment plans is to charge these expenses against any surplus before distributing the remainder to creditors. Whether or not debtor income is further reduced by administrative costs, substantial numbers of debtors will have no surplus income available for distribution to creditors. These debtors may well have sufficient resources to cover their basic needs, but they have no extra to pass on to creditors. Significant numbers of debtors in all insolvency systems for natural persons today fall into this category.

298. Because these debtors produce no value for creditors, thus failing to achieve one of the most salient goals of an insolvency system, a minority of insolvency systems has all but excluded them from relief. One system in particular has long held firm to its “economic benefit” perspective of allowing relief only to debtors with sufficient surplus income to cover not only administrative costs, but also a minimum 10% dividend to creditors. Another relatively new law is similarly restrictive, demanding at least a 30% projected dividend in order to confirm a payment plan. The former law allows for hardship relief for debtors stricken by specific, compelling, exceptional circumstances, but many no-income, no-asset debtors have been denied relief.

299. The preferred position among both commentators and established insolvency systems, however, is to avoid this kind of discrimination and provide the same relief to all debtors, regardless of their financial means. So-called “zero plans” have consistently represented a significant portion of all “payment plans” in insolvency cases for natural persons. It is not uncommon for payment plans in one-third, two-thirds, or even a greater proportion of all confirmed cases to be purely symbolic, paying only the fees of the insolvency representative, if even that. In one well-established system in particular, early resistance by courts to confirming “zero plans” was quickly overcome, and such plans came to represent an estimated 80% of all individual insolvency cases. In another system where resistance to “zero plans” did not subside on its own, judicial intervention at the highest levels resolved the matter in favor of debtors with insufficient income or assets to offer creditors any dividend. This country’s constitutional court ruled that extending relief only to debtors who could pay some portion of their debt violated the equality principle in this state’s Constitution. It is probably both more honest and more meaningful to refer to these arrangements as “debt adjustment” plans, rather than “payment” plans, or better yet something like “rehabilitation” plans, to focus on their real purpose.

300. Indeed, efforts have been made to help these particularly distressed debtors to overcome an ironic challenge. Given their depressed financial condition, these debtors might well be unable to afford the administrative costs of seeking relief, at least in systems that charge fees to debtors for access to insolvency relief. In one relatively new system, for example, barely 150 insolvency cases were opened for natural persons seeking discharge during the first three-and-a-half years of the new law, most likely because cases there are dismissed if the debtor’s income is insufficient to cover the anticipated insolvency representative’s fees. More established systems have struggled to find solutions to problems like this. Volunteer lawyers in one country often agree to waive their fees—the most substantial cost in this country’s insolvency system—for low-income debtors, and another system allows low-income debtors to delay paying the administrative costs of the insolvency case until after they have completed the six-year “good behavior period.” Authorities in another country have recently developed a formal solution for this particular problem. The multi-option menu of debt-relief processes now includes a low-cost alternative for destitute debtors. For individual debtors with limited debts, little income, and few assets, a low-cost administrative proceeding is available from the state authority charged with overseeing the insolvency system. By reducing the formalities and expenses of the court-based “insolvency” procedure, the new administrative process was specifically designed to make relief available to

low- and no-income debtors for whom court costs would otherwise have been a barrier to relief.

(iii) Plan implementation, monitoring and supervision

301. The challenges do not end with confirmation of a plan. Debtors who struggled to budget and distribute proper payments to creditors before an insolvency procedure are likely to struggle afterward, as well. To facilitate the proper implementation of, and debtor compliance with, a plan, a neutral insolvency representative is most commonly appointed to monitor and even collect and distribute payments for creditors. Generally, the insolvency representative collects periodic payments made by debtors on their own, though some systems require or allow for plan payments to be formally assigned to the representative and automatically deducted from debtors' periodic income to ensure timely payment. The insolvency representative also divides these collected amounts for distribution to individual creditors and is responsible for actually making the payments (often electronically). After early experiments with more frequent payments to creditors, many systems have settled on annual distributions, both to reduce cost and because more frequent distribution often results in very small payments to creditors. The processing fees for these payments can exceed the amounts transferred to the individual creditors unless larger payments are allowed to accumulate over a longer period.

302. The qualifications and role of such an insolvency representative are mentioned above in section II.2.C, and in greater depth in the ICR Standard and other sources. In systems where insolvency representatives administer payment plans, this represents the most time- and resource-intensive task that the insolvency representative generally fulfills. As mentioned above, the remuneration of the insolvency representative is most often drawn from whatever surplus income the system extracts from debtors, and only income in excess of the fee of the insolvency representative is then distributed to creditors. Often the deposited surplus is insufficient to cover even the fees of the insolvency representative, and in only a small minority of cases do creditors receive any significant distribution. A dual logic supports charging the fees of the insolvency representative against amounts otherwise destined for creditors. First, this operates as an incentive for creditors to agree to informal arrangements (workouts) with debtors to avoid an administrative transaction cost. Second, appointing an insolvency representative to manage these payments frees individual creditors from the time and expense of monitoring debtor performance, both in terms of payments and in terms

of any other obligations the debtor might have under the plan, such as actively seeking work. Insolvency representatives are often charged with objecting to discharge or other relief at the conclusion of a plan term if the debtor has failed to adequately comply with the requirements of the plan.

303. Not all existing insolvency regimes for natural persons invoke the aid of an insolvency representative, however. In some countries, payment plans developed in the natural person insolvency system are regarded simply as contracts like any other. Debtors receive no guidance or supervision in making the required payments, and creditors bear the burden of monitoring these payments and enforcing the debtor's duty to perform via ordinary enforcement mechanisms. This approach might be explained in part by the fact that such payment plans arise only in cases involving mildly distressed debtors who remain fully solvent. Cases involving more distressed debtors generally result in global moratoria on collections and possibly a full discharge, with no ongoing payments under a rehabilitation plan. In one country in particular, however, even significantly distressed debtors are left on their own in collecting and distributing payments to creditors.

304. One system has developed an admirable middle-ground approach of helping debtors to organize and process their payments, but leaving it to debtors themselves to make the appropriate deposits—leaving monitoring burdens on creditors. That system engages trustees to develop payment plans, but once the plan is confirmed, the insolvency representative's job is complete. To help debtors to manage the payments by themselves, the insolvency representative at the beginning of the insolvency procedure opens a dedicated bank account to which debtor-applicants immediately begin depositing their disposable income, thus immediately starting the five-year payment plan clock and reducing the total period during which debtors are forced to live on depressed resources. For plans that are ultimately approved, the insolvency representative generally forwards to the bank a list of creditors, their account numbers, and the percentages of the debtor's accumulated monthly deposits to be transferred to each creditor's account once each year electronically. Debtors are encouraged to make the required deposits and payments through automatic bank transfers, but debtors generally retain free disposition of their income and are responsible for making the monthly deposits themselves. Despite the debtor's freedom and creditor's lack of ability to monitor monthly deposits, this arrangement had functioned quite well in practice. The cooperation of banks in supporting this system and charging more reasonable processing fees was required, however, not to mention an advanced technological infrastructure.

***(iv) Modification of payment plans for changes
in debtor's circumstances***

305. Finally, even if debt adjustment plans are reasonable at first, much can change over the long rehabilitation periods called for by many existing laws. If the debtor's financial position unexpectedly deteriorates, the debtor will likely be unable to make the payments called for in the plan without undue sacrifice. Conversely, if the debtor's financial position improves markedly, creditors might have a legitimate interest in sharing in that improvement, given that their future rights against the debtor will likely be curtailed.

306. For payment plans that call for fluctuating payments based on the debtor's *actual* income and expenses, this poses little problem. Such plans are inherently self-modifying. The debtor's payment requirements change automatically as the debtor's income rises and falls. This approach has been taken in a handful of countries. As mentioned above, the benefits of such self-modifying plans come at a potentially higher monitoring price. Creditors or the insolvency representative are responsible for tracking changes in plan payments and assuring themselves that these changes represent appropriate responses to changed circumstances, rather than simple debtor failure to fulfill the terms of the plan.

307. The more common approach is to base future plan payments on *projected* income and expenses, so changes in circumstances lead to problems that call for affirmative solutions to avoid plan failure and possible repeat requests for relief. In such systems, the law usually anticipates the possibility of the debtor's (or creditors') application to modify plans prospectively to take into account the effect of deterioration or improvement in the debtor's actual situation as compared to the projections embodied in the plan. One system takes a unique approach, allowing modification only in the debtor's "most exceptional interest." That is, modifications to reduce the debtor's payment obligations are allowed, but creditors are not allowed to request an increase in payments if the debtor's situation improves. Indeed, as recently reformed, this system allows for plan modification to reduce the required payout to as little as zero.

308. For systems that rely on debtors to pay for lawyers or court costs to request a modification, this may produce the ironic problem of debtors' being unable to request a modification to allow them to pay less money because they do not have enough money even to ask for such relief. Some policymakers have considered empowering (or requiring) the insolvency representative to request modifications on debtors' behalf. Otherwise, common deteriorations in

debtors' positions may result in needlessly burdensome repeat filings seeking relief anew, which benefit no one and produce cost and resource burdens for debtors and the system. Policymakers in several regions have concluded that these burdens can and should be avoided by developing a more rational approach to modifying plans in case of unexpected complications.

C) Advantages and disadvantages of the different approaches to payment

309. To advance the primary historical goal of insolvency systems—enhancing efforts to achieve some return for creditors—most insolvency regimes for natural persons today combine the two approaches to payment discussed here. That is, they require *both* a turnover and liquidation of debtors' non-exempt assets owned at the time of the procedure, *in addition to* a multi-year payment plan to access the usually much more significant value in debtors' future earning capacity. While there are obvious advantages to combining the two approaches, proceeding through both stages in every case has arguably significant disadvantages, and not all systems force all debtors to proceed through both methods of value extraction.

310. The basic disadvantage of each approach to value extraction is wasted cost in terms of time, money, and other resources of usually already thinly spread administrative resources. Consistently, the overwhelming majority of debtors in existing systems have been shown to have few if any non-exempt assets of any significant value. The realization costs for these assets often exceed their depressed value, to say nothing of the simple cost of investigation if an administrator is required to verify the debtors' own descriptions of their assets. Consequently, though most existing systems purport to make the value of debtors' assets available to creditors, this provision is more theoretical than practical. Rather than extracting value from available assets, the primary benefit of the collective approach to insolvency in the context of natural persons is avoiding wasteful and unproductive pursuit of value. As discussed above in section 1.9, one single official investigation can reveal the folly of pursuing the debtor's low-value assets, and creditors can be convinced or at least prevented from wasting their own and society's precious resources in a fruitless pursuit of illusory asset value—and they can be more effectively prevented from destroying the purely personal value of the debtor's household items. Asset investigation in the insolvency of natural persons most often results not in the discovery of value for creditors, but in the confirmation for the collective that further pursuit of chimerical value is fruitless and should stop.

311. Much to the frustration of creditors and policymakers alike, the same has very often held true of mandatory payment plans. As discussed above, though the majority of debtors have *some* future income, most have insufficient future income to cover their own reasonable living expenses, the costs of administering a payment plan, and a distribution to creditors. In the majority of existing systems, in which fewer than one-fifth of cases initiated each year will produce *any* return to creditors at all, it is highly questionable whether the administrative costs of the “good behavior system” are justified. Many commentators and even legislators have questioned the value of imposing plans on individuals who have little or no ability to pay simply as a result of feelings of retribution.

312. For the great majority of cases in most areas, the payment plan process achieves no financial goal beyond funding its own operation. Indeed, many of these systems fail to achieve even self-sufficiency, relying on subsidization from other government funds to meet basic operating costs. Even in areas where more debtors manage to produce some distribution for creditors, very seldom do these distributions amount to more than about 10%-15% of creditors’ claims, even when accruing interest is halted and several years of surplus income are accumulated.

313. Careful empirical study of the situation in one country in particular reveals that the result of the payment plan process may be even more troubling when debtors realize the magnitude of their sacrifices. Debtors in this one unique system self-select into the payment plan track, and only debtors with “regular income” are even allowed to petition for relief in this track. Only about one-third of all debtors choose the payment plan track, and one would thus expect these to be among the most viable candidates for successful completion of a payment plan. Unfortunately, a consistent two-thirds of these payment plans have failed. Most debtors have simply not been able to withstand the rigors of a multi-year plan on a strictly limited budget. Granted, these dour figures may be explained in part by the fact that the payment plan track in this country is often used by debtors simply as a short-term delay tactic to prevent foreclosure on a home mortgage or car loan, and most debtors have the free option to change their minds and seek relief in the less demanding one-time-asset-liquidation track. Nonetheless, decades of unsatisfying experience cast significant doubt on the effectiveness of payment plans to achieve the goals of natural person insolvency.

314. That being said, required payment plans have remained extremely popular with legislators in many areas, especially those that have extended insolvency relief to natural persons only in the last few decades. As mentioned above, these legislators seem to have concluded rather consistently that

even if these plans serve a financial purpose only poorly at best, they at least serve an important moral or educational purpose. Multi-year plans remind debtors and those around them that everyone must do their best to fulfill their obligations, whatever that “best” is, and relief from one’s duly undertaken obligations does not come lightly and without sacrifice. More than exacting a monetary return for creditors, these plans inculcate good payment morality among debtors. One country’s government and parliament made this point explicitly, noting that zero-payment plans have a “symbolic character,” with debtors demonstrating worthiness for discharge by subjecting themselves to the plan’s constraints and furnishing an *effort* to pay their debts over several years. While legislators in more and more countries have concluded that lifelong indebtedness and social exclusion for debtors are not reasonable expectations, legislators in all but a handful of countries continue to adhere to the position that creditors might legitimately expect debtors to apply their full disposable payment capacity over a reasonable period of time to service their debts—however modest that payment capacity might be.

315. Thus, few existing systems allow significant percentages of debtors to receive relief without passing through both an asset liquidation and a payment plan. In particular, the idea of affording relief without at least offering creditors a possibility of payment from debtors’ future income is widely regarded as unjustified. But several systems notably do provide relief to many debtors without one or another of the two value-extraction approaches.

316. For example, in two long-standing systems, an administrator evaluates the future earning capacity of each debtor, and only about one-fifth of debtors are required to make substantial payments from future income in exchange for insolvency relief. Debtors with depressed incomes are not required to make future contributions; they are routed immediately to a liquidation of any non-exempt assets (usually none) and an eventual discharge. A somewhat similar approach is taken in another system. Since the late 1990s, a rising proportion of especially distressed debtors—exceeding one-quarter in recent years—have been routed by the system administrator into a full or partial discharge of their debts without a payment plan. Indeed, while the assets of most of these debtors are inventoried and any non-exempt assets are sold, some debtors avoid even this step. After the most recent revision of this system, the administrator can conclude, based simply on the paperwork filed by the debtor that no significant value is reasonably likely to be realized from an asset sale, and a discharge should be offered with neither a payment plan nor a liquidation of assets. In each of these systems, an administrator can and often does make the decision that administering a payment plan—or even a liquidation—is an

inappropriate expenditure of time, effort, and other resources given the likelihood of no return to creditors.

317. One long-standing and particularly robust insolvency system represents one of the last holdouts in continuing the practice of allowing debtors to self-select into either a liquidation track or a payment-plan track. This is likely the product of path dependence resulting from decades of gradual system development, rather than a carefully measured policy decision. In any event, leaving this choice to debtors has created significant problems, and attempts to develop a standard for imposing payment plans on “can pay” debtors have proven counter-productive. After creditors demanded that some mechanism be put in place to force payment plans on debtors whose future income might provide creditors a respectable return, the legislature revised this system to impose a complex new test for identifying debtors with sufficient “means”—that is, future disposable income—to make some reasonable payment to creditors. The costly and complex test for establishing “ability to pay” revealed only a small fraction of debtors with substantial “means,” and implementing this screening mechanism saddled the system with a substantial administrative sorting burden and sustained litigation about which debtors should gain access to relief on what terms. Moreover, this approach achieved little if any long-term effect on increasing the percentages of debtors in payment plans. This system’s experience underscores the importance of basing any screening mechanism on the reality of debtors’ ability to pay, rather than on presumptions of ability, and it illustrates the difficulty—or as many have argued, futility—of trying to steer debtor choice rather than assigning the sorting function to other, disinterested actors.

D) Special consideration of the payment of mortgages and other secured loans

324. In general, secured credit does not play a very important role in systems for addressing the insolvency of natural persons. Most debtors have few valuable assets that have been used or could be used as collateral for debts, and secured creditors have usually already seized whatever collateral had formerly secured certain debts by the time when a debtor files for insolvency relief. If a debtor has assets that serve as collateral for a claim, these assets usually have to be sold before relief can be offered or a payment plan can be confirmed, as the plan does not leave room for payment of claims secured by these items. In many countries the starting point of the insolvency legislation is that debtors do not and should not have secured debt or non-essential assets that can be used as collateral.

325. In some other countries, especially where insolvency is more of a middle-class phenomenon, the attitude towards certain assets and secured debt is not so restrictive. In some countries assets that are important for the debtor's post-insolvency existence, such as a home, a car and necessary household items, may under certain conditions be encompassed within the insolvency procedure even when they are collateral for a debt (on exemptions, see section II.5.A above).

326. Even so, secured creditors are in principle protected in insolvency procedures. The strong position of secured creditors is deemed justified to protect the credit markets. Also the constitutional right to property can be invoked as a principle that limits the possibility to restrict the rights of secured creditors in insolvency cases.

327. Policymakers generally fear that any undermining of the rights of secured creditors will have a broad and deeply detrimental effect on the availability of credit to finance important social activities, especially home acquisition. In societies where home acquisition lending is widespread, such high-value lending activity is often a central component of national financial markets and a foundation for a healthy economic system. A broad array of benefits flow both from the activity of lending and the stability that broad-based home ownership provides as a societal support for economic activity. As lenders collect large portfolios of claims secured by home mortgages, the value of these rights to collect—and the value of the home assets backing up the right to collect—becomes a vital component of the balance sheets and financial health of these banks. In many countries, it has been argued that any significant weakening of the value of creditors' rights to collect claims secured by home mortgages could have devastating impacts on the health of broad segments of the lending sector and the financial stability of entire national economies.

328. Despite these fears, and within legal limitations, some countries have found solutions that respect the interests of debtors and the rights of secured creditors in the insolvency procedure. Several distinct systems have developed to balance, for example, the competing fears of destabilizing the mortgage credit markets and displacing significant numbers of debtors from their homes, especially in light of the negative effects of mass mortgage foreclosure activity in depressing home values.

329. The key to understanding the motivation behind these systems is that policymakers have acknowledged that the financial damage and the losses they fear have already materialized. A properly structured system for relieving insolvency or mortgage distress does not cause losses to the banking sector and does not destabilize the financial sector;

rather, these losses *already exist*, created by the unavoidable fact of debtors' inability to service their debts properly, sometimes exacerbated by chronically depressed collateral values, especially homes. Policymakers who have taken one or more of the approaches described below have most often been motivated by a desire to force creditors to acknowledge the reality of their debtors' long-term distress and the long-term loss of value of the collateral, including homes, securing their claims. Real healing at a macroeconomic, societal level is delayed by allowing creditors to maintain the illusion of debtor's capacity to pay, or worse yet, the illusion that collateral values either have not fallen or will eminently return to previous inflated levels. Worse yet, healing is actively undermined by unchecked foreclosure actions that, in large volumes, cause substantial downward pressure on collateral values, especially for homes, resulting in a downward spiral of ever falling home values and rising defaults.

330. These systems are to a greater or lesser degree designed to compel creditors to accept the bitter reality of the distressed state of debtors and/or collateral values, accept whatever payment capacity debtors realistically have to offer to finance whatever value is realistically present in collateral, and avoid taking rash action to enforce rights in collateral and create further avoidable losses. By introducing systems to debunk illusions of value, establish real values based on current market conditions, and crystallize and limit losses, policymakers in a number of areas have sought to use legal levers to break unhealthy impasses and force creditors and debtors to move on toward healthy and sustainable economic relationships, for the sake of the many benefits discussed above in section I.9.

(i) Home mortgages

331. Home mortgages differ from other secured debts of natural persons in importance to the debtor, as well as in the value and nature of the collateral. The most important secured debts for households are those that have collateral in the house or apartment of the debtor. Since debtors who file for debt adjustment are very seriously over-indebted, the point of departure in most insolvency systems for natural persons is that debtors do not own their homes or, even if they do, they will not be able to keep the home in the personal insolvency procedure. Therefore, in most countries, the debtor's home is sold either before or during the personal insolvency procedure. Usually the creditor can sell the home or file for forced sale if the debtor is in default on secured debt irrespective of a personal insolvency procedure. After the sale the outstanding debt for a now-unsecured deficiency is treated like any other debt in personal insolvency.

332. In some other countries, protection of homeownership is considered a noteworthy value even in insolvency cases. Protection of homes and access to housing are fundamental elements of human well-being. To some degree they have even been recognized in human rights instruments, such as the UN Covenant on Economic, Social and Cultural Rights of 1966 (article 11). Many countries rely in their housing policy on private ownership to such an extent that alternative housing is not easily available. It is also acknowledged that notable economic value may be lost if large amounts of foreclosures take place at the same time during an economic crisis. These considerations have led countries to adopt either temporary protection measures in times of crisis or to include some degree of protection of homeownership even in the insolvency law.

a) Crisis measures

333. The post-2007 worldwide economic crisis was at its core a mortgage crisis in which millions of homeowners were no longer able to continue servicing their mortgage debts. Property prices collapsed in many countries and foreclosure rates hit levels not seen since the Great Depression. The high levels of foreclosure, in turn, led to the collapse of many financial institutions in several countries. The crisis showed very clearly the connection between the indebtedness of individuals and the stability of financial systems.

334. In many systems, policies have been implemented to support the housing market and assist homeowners in retaining possession of their homes. Most of these responses were aimed at debtors in the worst financial predicament; i.e., those debtors with negative equity (where the value of the homes exceeded the amount of the mortgage debt) and debtors in serious arrearage in the payment of their mortgage debts. There has been a broad range of responses to facilitate the restructuring of home mortgage indebtedness. Many have been out-of-court; others have been administrative or court-based. Many involve alternative dispute resolution (ADR), some on a mandatory basis and others on a voluntary basis. Some initiatives have been undertaken by government entities or with government financing; others have been undertaken on a voluntary basis by financial institutions either individually or on an industry-wide basis.

335. Of course, these measures put a heavy burden on financial institutions if substantial numbers of homeowners seek to modify the terms of their mortgages. For this reason, many systems have limited the scope and/or duration of such measures. Similarly, other systems have not moved forward with such measures in the absence of financial industry support.

336. Among the policy measures that have been implemented, the following ones are relevant for the treatment of the insolvency of natural persons:

- i) Broad variety of moratoria
- ii) ADR mechanisms
- iii) Reduction of interest rates and/or extension of repayment periods
- iv) Principal reduction

i) Broad variety of moratoria

337. Moratoria responses have been aimed at delaying, or stopping, foreclosures by staying the enforcement of mortgages. In the midst of a financial crisis, it is often difficult for lenders to find purchasers for foreclosed property, as there is a severe liquidity crunch, and as more and more foreclosed property comes on the market, prices continue to fall, and the crisis worsens. Moratoria are intended to slow down this spiral and provide a breathing spell for both debtors and lenders, perhaps enabling them to work out a solution to their differences. The moratoria are more likely to prove successful where they are in place for as long as the relevant debtors are affected by the crisis. These kinds of temporary crisis measures are usually implemented and regulated through the laws on property or enforcement of obligations, instead of in insolvency law, but temporary measures may be considered in the context of insolvency law as well.

ii) ADR mechanisms

338. Like the moratoria, the ADR mechanisms are a procedural device to slow down the foreclosure. There are many variants of this approach, but what they have in common is that they attempt to get debtors and lenders to sit down and talk to each other with a view to finding a constructive compromise arrangement for moving forward and avoiding the many negative effects of a foreclosure action.

339. ADR mechanisms might be enacted independently or jointly with moratoria measures.

340. Each of these first two mechanisms – the moratoria and the ADR mechanisms – are likely to be more effective against a backdrop of severe systemic distress in which lenders are either unable to sell foreclosed property or can only sell at depressed prices. They often fail to gain the support of lenders when the property markets are operating more

efficiently and it is easier to for them to find buyers for the distressed property.

iii) Reduction of interest rates and/or extension of repayment periods

341. These measures have been implemented either on a large-scale out-of-court basis or through inclusion in insolvency laws. These measures are aimed at debtors who are unable to meet their current repayment obligations but who will likely be able to meet modified, smaller monthly financial obligations. These measures are more likely to prove effective when they provide substantive overall relief (e.g., lowering the total amount of debt through the lowering of the interest rate). Where the debt extension merely enables the debtor to pay out the debt over a longer period of time, the ultimate resolution of the debtor's financial problems is often merely delayed – and months or years later the debtor finds that it is necessary to again try to re-negotiate with the financial institution. One system in particular has faced this “revolving door” phenomenon, and policymakers revised this system to include more aggressive relief to make debtors' first pass through the door more effective.

iv) Principal reduction

342. For many homeowners, merely being able to lock in a lower interest rate and pay back the loan over a longer period of time will not solve the longer-term problems and might well burden the debtors with a lifetime obligation that they are never able to repay. Moreover, in situations where home values have fallen broadly, homeowners face powerful negative incentives to making maximum efforts to maintain their home loan obligations. They may perceive it as unjustified to continue to “throw good money after bad” by paying an inflated price for an asset, the value of which has declined precipitously and has little prospect of returning. As a matter of fact, one reason why some financial institutions are reluctant to sit down and re-negotiate mortgage terms with their borrowers during a financial crisis is that the bankers fear that once homeowners realize that they will be in debt forever - or that it is unlikely that the value of their homes will ever exceed the amount that the homeowners borrowed to buy their homes - the homeowners might decide to simply default and walk away from their mortgages, which might well be the rational decision to be made. Against this backdrop, the first three remedial measures are likely to prove insufficient in the absence of a reduction in

the principal amount owing by a debtor on the mortgage loan.

343. Of course, reducing the principal amount of the debt forces financial institutions to write off parts of their loans and to mark down the value of their mortgage collateral. This, in turn, puts greater pressure on the financial institutions' balance sheets and might well force the financial institutions to seek additional capital at the very time that sources of additional capital are hard to find. In addition, financial institutions fear that if such relief is too easily granted to debtors it will create the perverse incentive for some "can-pay" homeowners to "strategically" default with the hope of having the principal amount of their debts reduced.

344. As discussed above, however, writing down claims and marking down the value of mortgage collateral may in many cases represent a simple acknowledgement of unavoidable reality, not the creation of losses or balance sheet pressure. If the true value of the home collateral or the debtor's ability to repay is compromised, the "value" of full recovery on such a loan is not value at all, but simply an illusory hope of value. Practically, a loss already exists, and the bank's action in finally recognizing this and taking appropriate remedial action by modifying the principal balance of the loan is a starting point for healing, not the cause of further distress. The process of acknowledging such pre-existing losses may be painful, but maintaining an illusion of non-existent value simply delays—and perhaps complicates—the healing process.

345. To make proposals for reducing the principal of secured loans acceptable to the financial sector – and to take into account that such a change would adversely affect financial institutions' rights as secured creditors – proposals have been made to allow financial institutions to share in a certain percentage of any future increase in the home's value over a certain period of time. For example, a lender who had written down the principal of a home loan might regain the right to collect some of the written-off claim if the home's value increased during the next five years (whether or not the debtor sold the home during this period). In this way, the creditor would be granted a potential future benefit in exchange for the reductions in interest and principal.

346. The four groups of measures that have been described are among the most frequently discussed responses to the crisis. Another possible solution is to transfer ownership of mortgaged property to the lender, with the possibility of the debtor retaining possession of the property under a lease. This solution, of course, comes at a great financial and psychic loss to the debtor, as well as leading many a financial institution into new business lines (e.g., property management), for which the institution may be ill-equipped.

347. Another proposed solution to the mortgage crisis that is relevant to personal insolvency involves a rebalancing of pension and insolvency policies. Normally, a debtor with retirement assets would not be allowed to draw upon those assets to avert mortgage foreclosure, under the reasoning that such funds are intended for the debtor's retirement. However, as noted above (see section II.5.A (ii)(d)), in many systems, debtors' retirement assets are increasingly of substantial value. One proposal is that during times of systemic crisis, debtors should be able to either receive a distribution or borrow from pension/retirement assets (perhaps up to a certain limit) to enable them to avert mortgage foreclosure. An advantage of this proposal is that it enables debtors to draw upon their own funds without the need to enter into perhaps lengthy or contentious negotiations with third parties. A major disadvantage is that raiding retirement savings might well leave the debtor with insufficient support during retirement, possibly externalizing the burden of supporting the debtor in retirement onto a public support system. Some have argued that it is unjustified for creditors to recover full payment in the present at the expense of a future burden on society, especially if a reasonable compromise arrangement could avert both a foreclosure and future complications with the debtor's retirement.

348. Lastly, when considering the effectiveness of possible remedial measures in a given system, it is important to take into account whether mortgage lending is recourse or non-recourse; that is, whether the debtor remains personally liable for the home mortgage loan if the home is sold in foreclosure for less than the amount of the secured loan. In a system where mortgage lending is recourse and it is difficult for a debtor to get a discharge, the result can be unlimited liability for a debtor from which there is little likelihood of escaping. In such systems, the pressure for some sort of relief from this burden is particularly acute. In contrast, in a system where mortgage lending is non-recourse, at some stage debtors can walk away from their mortgage obligations (and leave the financial institution with the property) and try to start over even in the absence of specific insolvency relief.

b) Home mortgages in personal insolvency

349. Informal measures have proven largely unsuccessful in achieving solutions to the systemic problem of large numbers of distressed home mortgages. Though proposals have been put forth repeatedly over the years in many different countries, only a few systems have developed special regulations on home mortgages in insolvency law. These systems have arisen in countries that rely strongly on homeownership in their housing policy. When protection of homeownership in insolvency law is adopted on a permanent

basis, the starting point has been that the rights of the secured creditors are protected, but subjected to some modification. What kind of modification is allowed is subject to a number of difficult considerations.

350. The requirements for retaining homeownership through the insolvency procedure vary. In some systems, the only allowed modifications involve reductions of interest rates or extensions of the payment period. In others, an insolvency case prevents the continuation of initiation of a foreclosure action, but regular payments on the mortgage loan must continue, along with some payment plan for any arrearage. Another variation is to allow the debtor to pay only interest during the first years of the plan, while resuming normal payments thereafter. In some cases the payments are debited first to the outstanding capital and last to the interest (usually this measure is equivalent to the lowering of the interest).

351. The most aggressive form of relief is to modify the principal owing on a home mortgage loan. Where modification of the principal is allowed in an insolvency case, the first issue to address is whether the home mortgage is treated as a unified whole or whether it is divided into a secured part that is covered by the value of the collateral (home) and an unsecured part. If the home mortgage debt is considered as a unified whole, the debtor is usually required to pay the whole debt according to the original contract. In some systems this is based on specific insolvency regulations, in some others, the law is silent on homes and home mortgages but the courts may allow debtors to keep their homes if that alternative is not economically less favorable to the creditors than selling the home. Such a situation may occur when the home has little economic value and the living costs in it are low.

352. In those systems in which the home mortgage debt is divided into a secured part and an unsecured part, the unsecured part may be treated in personal insolvency like any other unsecured claim. The unsecured part of the debt may also be subject to a liquidation test; that is, the debtor has to pay at least as much of the unsecured part of the debt as he or she could have paid in an insolvency in which the home would have been sold. Such a test may be quite complicated in design, however. As a basic rule, the secured part of the debt has to be paid in full or with some modification.

353. To avoid unfairly depriving the mortgage creditors of a future increase in home value, two systems allow for reduction of the principal amount of a home mortgage down to the value of the home, but the value of the home is enhanced by a buffer of ten percent over its market value (110% of current market value). In other systems, proposals

have been made to provide for a recapture or “claw-back” of any future rise in value, automatically increasing the secured creditor’s claim by all or a declining percentage of this increase in value over time. No such recapture proposal has been enacted as law yet. Policymakers continue to search for appropriate compromises, however, as a counterbalance to any proposal to reduce the principal owed on a home mortgage in light of a reduction in the value of the home.

354. To guarantee that the secured debt is paid in full (or with some modification) the payments often have to be extended up to twenty years or more. Thus, the payment plan concerning the secured debt may be much longer than the plan for the unsecured debt, which usually has an upper limit of five years (see above, section II.5 B)(i)). Obviously, there is the risk that the debtor will face other hardships during such a long time, possibly leading to the loss of the home after considerable sacrifice. This danger is generally accepted, as no current system is designed to keep debtors in homes despite their long-term inability to service proper repayment of the real value of the home.

(ii) Debt secured by other household assets

355. Other assets besides homes might serve as collateral for a secured loan, particularly the debtor’s automobile, and some systems allow debtors to retain these assets in the event of personal insolvency. Such items might include those that are necessary for the debtor’s household or for earning his or her living. The debtor may often keep them as protected assets (*beneficium*; see the discussion on exemptions at section II.5.A).

356. These assets often have very little real economic value to creditors. Almost invariably they have a far higher utility value to debtors and their families as compared to their economic value to the creditors. Moveable items like cars often experience steep value depreciation that makes them of very little value to a foreclosing creditor, especially taking into account the costs of foreclosure.

357. Especially for assets that are necessary in a normal household, the payments that the debtor has to make on the secured loan may be included in the household budget as a necessary living cost (as opposed to a debt payment). Thus, some systems allow debtors to maintain such items by paying the secured loan as a reasonable allowed living cost.

358. At least one system allows the court discretion to modify the secured payment obligation of the debtor on loans secured by movables, such as automobiles. Such loans are divided into a secured portion (backed by real collateral value), which must be paid in full, and an unsecured portion

(not backed by real value), which is paid pro rata along with other unsecured claims. Even in this system, however, the rules for bifurcating such claims into secured and unsecured portions are subject to exceptions for newer items, allowing bifurcation only for cars and other items purchased in the more distant past.

II.6. Discharge

A) Purpose and characteristics of the discharge

359. One of the principal purposes of an insolvency system for natural persons is to re-establish the debtor's economic capability, in other words, *economic rehabilitation*. Rehabilitation can be said to include three elements. First, the debtor has to be freed from excessive debt. The benefits of the discharge have been extensively discussed from the point of view of the debtors, creditors and the society in section I.9, above. Second, the debtor should be treated on an equal basis with non-debtors after receiving relief (the principle of non-discrimination). Third, the debtor should be able to avoid becoming excessively indebted again in the future, which may require some attempt to change debtors' attitudes concerning proper credit use.

360. The most effective form of relief from debt is a *fresh start*, which in historical usage refers to a straight discharge; that is, to the possibility to be freed from debt without a payment plan. Several recently implemented systems have moved away from requiring payment plans of all debtors, offering an immediate "straight" discharge to at least the most impecunious debtors. In contrast, in one system in particular, the concept of fresh start can be identified with the ideology of a nation of immigrants, many of whom started a new life after having left everything, including debts, in their old home countries. After a recent reform of that system, however, the discharge for some debtors is no longer so "straight," as debtors are subject to closer scrutiny of their attempt to receive a discharge without offering creditors payment from future income, and some debtors with payment capacity are now required to pay part of their debts according to a payment plan before they receive a discharge.

361. Most systems continue to reject the notion of a straight discharge. Most set as a condition for discharge a partial payment of debts, or at least a period of time during which the debtor's economic life is regulated by a debt adjustment plan or payment plan that lasts usually from three to five years. Thus, the debt is only reduced to such an amount that is considered reasonable for the debtor to pay. Instead of a fresh start we could speak of a delayed or *earned new start*. (On different plan models, see section II.5.B).

362. A small number of systems require or at least expect some kind of minimum payment from debtors as a prerequisite to obtaining a discharge. Such minimum payment would usually be in proportion to the debt, perhaps ten percent, or maybe even a symbolic payment of some modest amount. As many debtors have very few assets and little income, this kind of rule invariably produces undesirable results. Significant numbers of “honest but unfortunate” debtors who otherwise qualify for relief have been denied a discharge because of their inability to make minimum payments to creditors in the few countries that impose such a requirement. The courts have in some countries found such requirements to be discriminatory against debtors with little or no means. Another variation is that the length of the payment plan is related to the amount of payment. If the debtor pays a certain percentage of the debt, the payment period may be shorter than the normal one. This variation has impacted very few insolvency procedures for natural persons, however, given that only a small fraction of debtors in such systems have been able to produce the larger payments to creditors necessary to benefit from the reduced payment period.

363. The payment plan is often assessed from the point of view of its (quite modest) yield to creditors. In many countries the payment plan seems to have a different nature; it is considered “the price” of an earned new start (discharge). There are different views on how high this “price” should be. When a country is considering introducing a new law on natural person insolvency, an onerous payment plan is easily considered as congruent with the general principle of private law, such as *pacta sunt servanda*. A realistic view of debtors’ situations, however, often leads to prioritizing more lenient and shorter payment plans, as discussed above in section II.5. B)(i)-(ii).

364. The benefits of a discharge may remain illusory, however, unless the discharge is respected after the insolvency procedure has concluded. Thus, two other elements are sometimes included as ancillary support for the concepts of discharge and rehabilitation.

365. First, the principle of *non-discrimination* is an important consideration in achieving the full benefit of a discharge. Since payment plans last for several years, discrimination both during the plan and after its completion may be a problem that warrants careful attention. Actually, discrimination issues have rarely been discussed in this context and there seems to be no explicit prohibition against discrimination in most laws addressing the insolvency of natural persons. Data protection regulations in some countries prohibit the registration and use of information on completed payment plans, which is in effect a prohibition against discrimination. In many other countries, however,

any insolvency filing is reflected among other “negative” credit entries, at least for a limited number of years following conclusion of an insolvency case, which often gives rise to discrimination against former natural person debtors who have undergone insolvency procedures. It would be advisable that both researchers and legislators pay attention to the principle of non-discrimination in the future.

366. Second, inculcating more healthy and responsible use of credit as a goal and a result of a debt relief procedure is much more difficult to achieve or measure. One indication of the idea that one should not run into debt again after obtaining relief is the virtually universal bar (prohibition) of a repeat filing for debt relief. Different attitudes are reflected in the length of such a bar. In most countries, a new filing is possible only after a period of years, while in some others, consumer debt adjustment is generally regarded as a “once in a lifetime” event, sometimes with exceptions for extremely compelling cases.

367. In the past decade there has been growing interest in financial education, the importance of which is acknowledged both in school systems and in adult educational facilities. The fact that a debtor has filed for debt relief is sometimes taken as a sign of financial mismanagement. While the reasons for debtors’ economic failure may vary, there is evidence that a considerable portion of debtors have insufficient financial skills.

368. In the context of an insolvency system for natural persons, instilling better credit use habits in debtors is often sought either through individual debt counselling or imposed financial education. As explained in section II.1, many countries require the debtor to engage with budget and debt counsellors and/or enter into prior negotiations with creditors before filing for a formal debt relief procedure. While the debtor in such negotiations is almost always assisted by a debt counsellor, this is an opportunity to assist the debtor in financial planning. However, the focus of the work of debt counsellors is often the insolvency procedure, and resources for individual budget advice are often limited. Some countries have resorted to classroom financial education for consumer debtors in insolvency proceedings. The efficacy of these required classes, the likelihood of behavior modification and the obligatory nature of such courses are contested issues, but this is a field for ongoing development work and research.

369. The fulfilment of the payment plan is, in a way, proof of debtors’ capacity to control their financial affairs. In some countries, debtors also have a special obligation of “good behavior” during the plan. That is, the debtor is obliged to work during the plan or look for a job if he or she is unemployed. This obligation is a legal one, and the creditors

may claim that the debtor has not fulfilled it and ask for denial of the discharge at the end of the payment plan if the debtor has not fulfilled the obligation. Where such a system of pre-discharge scrutiny has been imposed, creditors have proven reluctant to expend time and money objecting to relief, and the more likely source of such objections has been the appointed insolvency representative.

370. Along the same lines, the principle of *good faith* is present in almost all insolvency laws. A central idea of insolvency law is to help unfortunate but honest debtors. In principle, all laws require that debtors who abuse the system be denied discharge. If the debtor has incurred debt in a fraudulent manner, it is very difficult to obtain a discharge in any country. Even more severe is the attitude towards fraud during the insolvency procedure. Such fraud leads to denial of discharge and perhaps to criminal prosecution. The standards on disclosure are also quite stringent. Debtors are required to disclose their economic affairs in the insolvency procedure on the penalty of being denied a discharge.

371. Moral hazard from the debtors' side, that is, risky borrowing that is not fraudulent *per se*, is more difficult to assess. Though simple "irresponsibility" in borrowing too much generally does not lead to denial of relief, some countries deny discharge when the debtor has incurred debt in an unscrupulous manner or in a way that the court regards as obviously and objectively reckless or speculative. This leads to denial of discharge on the basis of debtor behavior and may lead to denying discharge to debtors who genuinely need it. On the other side, granting discharge to high-flyers and risk takers can seriously undermine the legitimacy of the system. For a discussion of moral hazard and fraud, see section I.10, above.

B) The scope of the discharge

372. For rehabilitation it is important that as many as possible of the debtor's debts be included in the discharge. The more debts that are excluded from the effect of the discharge, the less effective the insolvency regime can be in achieving the debtor's rehabilitation and the many related goals outlined above in section I.9. The old insolvency law principle of equality of treatment of creditors is another important principle in natural person insolvency. Most insolvency laws for natural persons continue in a general way to adhere to the principle of equality of creditors so that very few claims are excepted from the discharge. There are some exceptions to this general trend, even in countries that are known as "debtor-friendly." Some debts that are not created in the market context are in many systems excluded from the discharge. In particular, maintenance debts to the debtor's children, and sometimes to a former spouse, are often

excluded from discharge. Similarly, taxes, fines, and other public obligations are often excluded, though the recent tendency has been to eliminate special treatment for debts owed to public bodies. These exceptions are discussed next.

(i) Maintenance: child/spousal support

373. The most important and common exceptions apply to maintenance obligations to children and perhaps former spouses. These debts are generally excluded from the discharge for several closely related reasons of fundamental public policy. Insolvency policy generally concerns proper allocation of responsibility and burden, and most systems are simply unwilling to allow the debtor's most fundamental responsibility, to family, to be avoided, nor to allow debtors to externalize this burden onto other, equally vulnerable parties. The creditors in family support claims are regarded as among the most sensitive to disruptions in their rights, and depriving them of their claims to necessary support would endanger their basic welfare and undermine a public policy of family support just as fundamental as the policy of freeing the debtor from undue financial burdens. The notion of family responsibility creates a "non-market" obligation that is regarded as outside the appropriate realm of insolvency relief. While many non-business and even non-financial debts are included within the discharge for natural persons, the focus of insolvency relief remains largely concentrated on debts created in the commercial marketplace, rather than within the intimate confines of the home and family relations.

374. Various systems take a variety of approaches to excluding maintenance obligations from discharge. Either all maintenance is excluded, including alimony to a former spouse, or only child support. In some welfare states, if a debtor has missed maintenance payments, especially to a child, the state steps in and pays the support to the child's guardian] and is then subrogated to the rights of the child to collect the overdue support from the debtor. In such systems, the state's right to step into the shoes of the maintenance claimant by subrogation is excluded from discharge just as the claimant's direct claim would have been excluded.

(ii) Fines and other sanctions

375. Another quite common exclusion concerns fines and other liabilities that are a consequence of a crime. A few systems extend this reasoning to exclude private claims for restitution arising from personal injury or even property damage caused to another person. Here again, the underlying policy concerns proper allocation of responsibility. Insolvency relief is designed to offer relief to "honest but

unfortunate” debtors, casualties of volatile economic and social conditions beyond debtors’ control. Debts related to fines are all but universally regarded as not falling within this paradigm. Debtors can avoid incurring fines simply by abiding by societal rules, and very few systems are willing to allow debtors to evade punishment for violations of public rules. Fines are thus even less “market-based” than family maintenance obligations, and these debts are thus generally regarded as not appropriate subjects for the extraordinary relief of an insolvency discharge.

376. Only a few systems extend this reasoning to personal and property damage claims. Of those that do, often the excluded claims are based on some level of culpable conduct, such as intoxication or reckless disregard for the welfare of others. Claims for simple negligence that unfortunately resulted in harm to another person or property are very seldom excluded from discharge.

(iii) Taxes and other government debts

377. While taxes and other non-punitive liabilities towards the state have been commonly excluded from discharge in the past, a notable trend has emerged to abolish the exception for such debts. Taxes and other government claims are still excluded from discharge in many countries, apparently for the same reasons as the exclusion for family maintenance debts: taxes and government debts are part of the fundamental obligation of citizens to support their society. These are not simple debts arising in bi-lateral relations in the marketplace, but rather higher-order debts owed to society as a whole to support the operation of government. Allowing individual debtors to evade this fundamental responsibility not just to one creditor, but to society, is widely regarded as unjustified.

378. A number of countries in recent years, however, have repealed special priorities and exceptions to discharge for taxes and other government debts for at least two reasons. First, taxes in particular are often among the largest debts contributing to a debtor’s insolvency, especially for current and former small business people. If government debts are not subject to discharge, that undermines the entire insolvency relief system, depriving debtors, creditors, and society of the many benefits of relief discussed in section I.9, above. More and more legislatures have accepted that, if they are willing to force “ordinary” creditors to forego their legitimate claims against debtors, then the state, too, should be willing to play by the same rules and support the relief system, at least for non-punitive debts like taxes and fees. Second, if taxes are not excluded from discharge, they are probably also entitled to a privilege that entitles them to payment before any other creditor. This has been criticized

as quite unfair against other creditors, and as legislatures have been convinced to repeal the privilege for taxes, so also their exclusion from discharge has been repealed, at least in some cases. Indeed, some countries that retain the privilege and exclusion from discharge for taxes in business insolvency have abolished it in relief procedures designed for natural persons engaged in little or no business activity.

(iv) Educational loans

379. Only a few countries exclude educational loans from the discharge, even though this is a hotly debated topic. The policy underlying such an exclusion seems to be that educational debts represent a current investment that is designed to be paid off from the future benefits flowing directly from this investment in education. Allowing debtors to accept all of the future benefit of income growth attributable precisely to that educational support, while leaving the entire burden on lenders, is regarded in some countries as unfair and unjustified. Also, since these debts can be quite large, and often one central state authority is responsible for extending such loans, allowing such loans to be discharged would potentially impose a very heavy burden on the state lending authority. Few countries have identified any evidence of newly examined professionals, such as medical doctors and lawyers, filing for debt adjustment to discharge their study loans, however. The general good faith tests have been sufficient in most countries to stop such behavior. On the other hand, some debtors with no prospect of significant incomes have serious problems repaying student loans. Depriving these debtors, their other creditors, and society of the many benefits of insolvency relief is, therefore, not regarded as the best solution in most systems.

(v) Reaffirmation agreements

380. There are basically two opposing views on agreements between the debtor and individual creditors during the insolvency procedure to exempt individual debts from the operation of the discharge. In some countries, such individual contracts are strictly forbidden as unjustified violations of the principle of equality of creditors. The favoring of certain creditors in the event of insolvency is held null and void. In some cases such favoring of one creditor even constitutes a criminal act. In some other countries, so called reaffirmation agreements between the debtor and a creditor are allowed subject to the court's discretion. Such an agreement should serve the interests of the debtor, and the debtor should voluntarily affirm such an obligation.

(vi) Post-commencement debts

381. The discharge generally affected only debts arising before the commencement of a formal insolvency case (pre-petition debts). If the debtor incurs new debts during the court proceedings or the repayment period of the plan, these debts have to be paid in full. Because of the stringent conditions of the payment plan, most debtors must be very careful not to incur new debts before the plan is completed. It has to be remembered, however, that a rescheduling loan, which is used to pay off an agreed part of the debts, is a very useful tool in debt restructuring. Its legal status, however, depends on the national law.

C) Discharge and guarantees, co-debtors and third party collateral

382. Insolvency is always a problem for the debtor's entire family. Sometimes family members and others close to the debtor are drawn into the debtor's economic crisis because they have personally guaranteed the loan of the debtor or given their property as collateral for a loan. Since payment can be quite easily demanded from the guarantor or from the value of the collateral if the principal debtor does not pay or is insolvent, guarantors often face payment claims on the eve or after the opening of an insolvency procedure. The legal position of the guarantor has been found to be quite hard in many countries.

383. There seems to be very little quantitative or qualitative information or legal research on such guarantees. A questionnaire distributed to the member states of the Council of Europe in 2004 collected information on the legal position of the guarantor in the context of consumer debt adjustment (insolvency proceedings involving natural persons). The legal situation seems to be fairly similar in the states surveyed and can be summarised as follows.

384. Personal guarantees extended by—as well as collateral security owned by—family members are commonly accepted to secure loans in many countries, with few legal restrictions. Few laws on insolvency of natural persons contain any specific provision on the effect of an insolvency case filed by the main debtor on the guarantor's legal position. Because payments are at that point usually late, the creditor may collect the debt from the guarantor or from the value of the collateral that a third person has given for the loan. After the guarantor has paid the loan he or she has the same right against the debtor as the creditor had before the payment. In practice, the guarantor will be one of the creditors that receives a partial payment according to the plan. A co-signer of a loan is treated in the same way as the guarantor. When a third person has given property as collateral, the same applies up to the value of the collateral. To summarise, the

insolvency procedure and discharge have no alleviating effect on the liability of the guarantor.

385. The specific concern of co-obligors was raised in the legislative discussion of one country's law, but protections for guarantors and other co-obligors were intentionally excluded from the effects of the principal obligor's insolvency proceeding, since guarantors and other co-obligors could simply apply for relief under the personal insolvency law themselves in case of need. In very few systems has the plight of guarantors been specifically addressed in the natural person insolvency legislation. In one system, only natural persons and gratuitous sureties are covered, but such people are allowed to petition for a discharge of a suretyship obligation implicated in the principal obligor's pending natural person insolvency case if the surety's resulting obligation is "disproportionate to his revenue and patrimony." In another system, guarantors may file a specific alleviation procedure in which the guarantee obligation may be given an extended payment period. Such a procedure does not cover the guarantor's other debt obligations.

386. In a voluntary debt settlement, the rules may be the opposite. According to the private law of many countries, a voluntary agreement on the payment of the debt, including partial forgiveness of the debt, is valid against the guarantor as well.

387. Many guarantors and co-debtors have been bitter over their legal position in insolvency. They have felt that it is unfair that they have been obliged to pay the loan in full when the debtor is discharged and the guarantor only gets a meager portion of the payment back according to the principal debtor's payment plan.

388. The rationale of personal guarantees or third-party collateral is to ensure that the creditor gets paid in case the principal debtor turns out to be insolvent. When the debtor files for insolvency he or she is obviously insolvent and, thus, the guarantor's liability comes into the picture. If the guarantor's liability would be adjusted in such a situation, the creditors would be less protected and less willing to give credit.

389. The difficult situation of family members as guarantors has given reason to consider the economic argumentation anew. The problems have often emerged in the courts when the creditors have claimed payment from the guarantors who have argued that they have given the promise under duress or without adequate information or that the guarantee is simply unreasonable. The courts have in some cases had sympathy with the guarantors, and consequently the duties of the creditors at the time of signing the contract have been

strengthened. Especially, the creditors have a responsibility to give adequate and detailed information to the guarantor in many countries. In one country, the Constitutional Court has even imposed some restrictions on what kinds of guarantees a spouse, a child or other dependent person can validly give. It is argued that the persons who are dependent or have strong emotional ties with the debtor need some protection against exploitative contracts.

390. There are persuasive arguments in favor of the information rights of guarantors and restrictions on the use of guarantees by family members. As long as guarantees are used, however, the guarantor's position in the debtor's natural person insolvency case remains a problem. This may be a problem for which there is no good solution. There are, however, some possibilities to mitigate the situation:

- a) First, the insolvency procedure might include some regulations that give time to the parties to adjust and negotiate. The guarantors, co-debtors, and those who have given collateral on behalf of the debtor could be protected by the stay of debt enforcement measures that the opening of an insolvency procedure for a natural person imposes on the creditors, though this would be an extraordinary departure from the approach of the ICR Standard in business insolvency cases. If the guarantor hides property, the court could give the creditor the right to enforcement.
- b) Second, the guarantor's and the debtor's liability could be divided in the debt adjustment. For example, the guarantor could be made liable only for that part of the debt that exceeds what the debtor pays according to the plan to the creditor. This could give the debtor an incentive to pay more.
- c) Third, the guarantor's payment could also be adjusted in the main debtor's debt adjustment procedure, for example, into instalment payments.
- d) Fourth, the courts could be given discretion to favour the reimbursement claims of individual guarantors in the payment plan if the guarantor has made great sacrifices to pay the debt. This may sound unfair to other creditors but is not necessarily so. If the guarantor has lost his or her home to pay the debt and the other creditors are institutions, it is not unjustified to favour the guarantor in the payment plan.

391. These proposals mean that the guarantor's liability would not be equal to that of the debtor. Interestingly, the European Union in an early draft of the 2008 Consumer Credit Directive made proposals that go in the same direction, though these early proposals were ultimately not adopted. According to that proposal, the creditor could take action against the guarantor only after the debtor has been

in default for three months. In addition, the proposal aimed at furthering rescheduling agreements on the payment of debt. These proposals are in line with a greater flexibility for the guarantor's position in the debt adjustment.