



The World Bank
Insolvency and Creditor/Debtor Regimes
Task Force Meetings

BEST PRACTICES IN THE INSOLVENCY OF
NATURAL PERSONS

January 11, 2011
Held at the World Bank
Washington, DC

Rapporteur's Synopsis

By Susan Block-Lieb, Fordham Law School

The statements, findings, interpretations and conclusions expressed in this report are those of the authors and do not necessarily reflect the view of, nor are they endorsed by, the Board of Executive Directors of the World Bank, or the governments they represent.

© 2011 The International Bank for Reconstruction and Development / The World Bank

INSOLVENCY AND CREDITOR/DEBTOR REGIMES
TASK FORCE MEETING
JANUARY 10-11, 2011, WASHINGTON DC

CONFERENCE REPORT: DAY 2 – AFTERNOON SESSION

BEST PRACTICES IN THE INSOLVENCY OF NATURAL PERSONS

13.30 – 16.30, JANUARY 11, 2011

PRESENTATION OF THE SESSION: THE NEED FOR THE DEVELOPMENT OF INSOLVENCY REGIMES FOR NATURAL PERSONS AND THE LINK TO CREDIT EXPANSION AND FINANCIAL STABILITY

ADOLFO ROUILLON, WORLD BANK

[1] Originally, the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems did not address issues relating to the insolvency of individuals, especially consumers who are not engaged in business or commercial activities. Since then, however, many countries' consumer credit have expanded and created macro-economic pressures. It seems appropriate at this juncture to examine the effectiveness of domestic insolvency regimes in addressing issues of consumer over indebtedness.

To this end, the World Bank has conducted a preliminary survey on consumer insolvency laws in existence around the world. The survey covered 59 countries, of which 25 are high-income economies and 34 are low-income and middle-income economies. The countries surveyed covered 67.5% of the world population. We asked about the existence of a collective liquidation proceeding for consumers. We asked also about the existence of a debt restructuring mechanism or proceeding for consumers and the existence of discharge for consumers. The results reveal that there is a significant difference between high income countries and low and middle income countries.

- For example, in terms of a collective liquidation proceeding, only 16 percent of the surveyed high income economies still do not have legislation establishing a collective liquidation proceeding for consumer insolvency (including in this 16 percent countries that are planning to adopt a system very soon, like Hungary, Croatia and Italy). Whereas more than 50 percent of the surveyed low and middle income economies still do not have a system for collectively dealing with consumer insolvency.

- The figures are similar with respect to debt restructuring proceedings: again, more than 50 percent of the surveyed countries do not have a way to provide consumers with debt restructuring mechanisms. The lack of consumer debt restructuring legislation was more prominent among the low-to-middle income economies that were surveyed.
- With respect to the possibility of discharging the obligations of consumers, the figures are also similar: almost 50 percent of middle and low income countries surveyed do not provide the population with a possibility of a discharge.

As regards those countries that do have a debt restructuring mechanism for consumer insolvency, in the vast majority of them, the proceeding is judicial, although in some countries that have a judicial proceeding there are also complementary proceedings, like administrative proceedings, or out of court proceedings.

In countries where there are collective proceedings for dealing with consumer insolvency, there are no significant differences between high income and middle and low income countries regarding the legal requirement of analyzing a consumer behavior with respect to his or her indebtedness. Only in a few countries is there no analysis of consumer behavior before permitting access to the system, granting access to the proceeding for dealing with consumer insolvency, or for granting a discharge.

In those countries reporting a consumer insolvency system, the survey asked whether the system involves insolvency professionals in these proceedings. We learned that, in the vast majority of both developed and developing economies, insolvency professionals play a role in consumer insolvency proceedings. Also in the majority of countries (30 countries out of 37) there is no state funding available for consumer insolvency proceedings. Of those countries that made public funding available, 6 were higher income economies and 1 low to middle income economy.

These findings are merely preliminary. The survey did not ask about the effectiveness of the existent consumer insolvency systems. It did not ask either about how easy it is to get a discharge or not (preliminary findings would be indicating that in some countries where discharge is contemplated in the law, it is very difficult to obtain in practice). The main objective of the survey was to find out about the existence of legislation addressing consumer insolvency, and found that in more than half of the middle and low income countries surveyed there is no system at all.

PART 1: ROUNDTABLE ON THE REGULATION OF THE INSOLVENCY OF NATURAL PERSONS: A PANORAMIC VIEW OF THE DIVERSITY IN THE TREATMENT OF INSOLVENT NATURAL PERSONS.

CHAIRPERSON: ADOLFO ROUILLON, WORLD BANK

SPEAKERS: JASON KILBORN, USA / EUROPE

KAZUHIRO YANAGIRA, JAPAN

ALEXANDER BIRYUKOV, UKRAINE

D.P. CHINIEN, MAURITIUS

LUIZ FERNANDO VALENTE DE PAIVA, BRAZIL

PRESENTATIONS

[2] In his presentation on the development of insolvency regimes for natural persons, Jason Kilborn made a comparative study of consumer insolvency legal regimes within the European Union. He found enormous progress over the past decade. In 1990, Prof. Kilborn reports, there were only 2 European insolvency regimes providing individual debtors with the possibility of a bankruptcy discharge; currently 19 European member states have adopted laws permitting the discharge of non-business obligations in the context of an insolvency proceeding, while 5 other countries are investigating such legal reform (Romania, Hungary, etc.). Although legal provisions and methodologies vary from country to country, most member states require individual debtors to “earn” their discharge by making payments on a plan for a period of years, although several permit individual debtors to confirm “zero payment plans” where the debtor earns insufficient income to confirm a payment plan but is determined under the terms of the statute to be entitled to a discharge nonetheless. Prof. Kilborn provided some detail regarding consumer insolvency regimes in place in Denmark, Sweden, Germany, France, the Netherlands, Poland and Slovakia, and noted the influence of EU Commission on Human Rights as relates to discharge of consumer indebtedness. He concluded both by comparing the European experience to current consumer bankruptcy reforms in the US, and by noting that the success of any consumer insolvency regime covering individual debtors depends on the goals of the regime and so how success is to be defined.

[3] In his presentation on Personal Insolvency Law in Japan, Kazuhiro Yanagira gave an overview of personal insolvency law in Japan. There are three types of judicial insolvency procedures available to individual debtors in Japan, i.e. bankruptcy proceedings, special civil rehabilitation, and special conciliation procedures. Bankruptcy proceedings, which are liquidation proceedings, are more highly used by individual debtors than special civil rehabilitation procedures or special conciliations. Prof. Yanagira detailed the processes involved in each type of proceeding,

In bankruptcy proceedings, for example, Prof. Yanagira explained that a trustee generally is

appointed upon commencement; the trustee administers and disposes of the debtor's non-exempt assets. If the court determines that the debtor is unable to pay the administrative costs of the proceeding and that there is no need to investigate the debtor's pre-bankruptcy transfers, it may simultaneously open and terminate the bankruptcy proceedings, but only if the debtor is represented by counsel. Bankruptcy proceedings are relatively inexpensive in Japan, costing roughly 200,000 yen (\$2,400) for cases involving a trustee, and 10,000 yen (\$120) for cases that are simultaneously terminated upon commencement. If not simultaneously terminated, bankruptcy proceedings last approximately 2 to 3 months. Individual debtors are entitled to exempt household furnishing and cash up to 990,000 yen (\$12,000), as well as wages or salary up to 330,000 yen (\$4,000). While courts may increase the value of permissible exemptions, for example, in the case of elderly or sick individual debtors, there is no homestead exemption available to individuals under Japanese law. Courts also generally enter discharge orders in bankruptcy proceedings, even those simultaneously terminated, unless the debtor refuses to cooperate with the trustee or makes false statements in the proceeding; the statute also specifies certain debts that are excepted from discharge, for example debts relating to the debtor's willful torts, domestic support obligations, debts from an earlier bankruptcy proceeding (if it was filed less than 7 years ago), etc.

Special civil rehabilitations are as costly as bankruptcy proceedings (200,000 yen or roughly \$2,400), perhaps because in one a trustee is appointed and in the other a rehabilitation commissioner is appointed. Special rehabilitation plans, which generally require a debtor to repay 80% of his creditors' claims over a 3 year period, are approved unless a majority in the number of creditors and the value of creditors' claims object to its terms; thus, special rehabilitation plans are easier to confirm than general rehabilitation plans. This is because special rehabilitation is available only to individuals with a regular income, while general rehabilitation proceedings are also open to corporate debtors. If the debtor defaults on a special civil rehabilitation plan, the debtor generally is required to file a bankruptcy proceeding, although in some cases the court can grant the debtor an immediate discharge without conversion to bankruptcy.

Special conciliation proceedings are not collective proceedings; they permit resolution of some but not all of a debtor's indebtedness. These proceedings are relatively inexpensive (10,000 yen or roughly \$120) and quick (two months). Nonetheless, conciliations are difficult to reach where the debtor has numerous creditors; where the attempt is unsuccessful, the court may issue an order in lieu of conciliation, but such an order does not operate as a discharge.

It is worth noting, Prof. Yanagira emphasized, that consumer bankruptcy laws raise cultural concerns in Japan. The stigma caused by cultural stereotypes prevents some individuals from commencing personal insolvency proceedings. Nonetheless, data show that individuals are far more likely to commence bankruptcy proceedings (in 2009, roughly 126,000 individuals commenced this sort of case) than special rehabilitation proceedings (21,000 individuals cases in 2009) or conciliation proceedings (68,000 in 2009) in Japan.

[4] Alexander Biryukov shared with the audience Ukraine's efforts to enact legislation on the insolvency of natural persons. He praised the technical assistance that the World Bank has provided over the years in this regard. Ukrainian bankruptcy law was originally adopted in 2000.

More than 35,000 petitions have been filed under this law. Since enactment, more than 35 amendments to the law have been adopted, clarifying conflicts and complications regarding interpretation and implementation. Recently, the World Bank reviewed the law and its amendments and suggested revisions, but the Ukrainian government reformed only the corporate provisions and ignored the problem of over indebted consumers. Prof. Biryukov explained that one of Ukraine's biggest economic problems involves the extent of over indebtedness due to individuals' inability to meet basic living expenses for water, electricity, gas and so on. The World Bank had suggested to the Ukrainian government that the institution of a consumer bankruptcy regime could assist in resolving this situation, at least in the short term. Although so far there has been no major breakthrough in the legislative process, reports Prof. Biryukov, he optimistically predicts adoption of a consumer bankruptcy law in the Ukraine in the near future. First, Ukraine's intention to take part in European integration, including a position on the Council of Europe, provides important incentives for Ukraine to demonstrate a willingness and ability to modernize its insolvency regime. Moreover, the Russian Federation is considering enactment of a consumer bankruptcy law; while this has not yet been adopted, Russia's willingness to consider such an initiative may suggest to the Ukrainian legislature that a consumer bankruptcy regime is appropriate for both developed and developing nations. Ukrainian lawyers appear already to agree with the proposal, Prof. Biryukov reports; it is only a matter of time before government officials also recognize that consumer bankruptcy legislation will provide an important boost to the middle class, which is the foundation of democracy and market stability in the Ukraine.

[5] In her presentation on the Reform of the Insolvency Process in Mauritius, D.P. Chinien gave a brief introduction to the new Insolvency Act, which came into force in Mauritius in 2009. The new law introduces a comprehensive insolvency regime covering individuals, corporations and other business entities. Before this omnibus legislation went into effect, there were three different laws governing insolvency – one governing companies and two others applicable to individuals. The new law also established both a commercial court and an Office of the Director of Insolvency Service, which carries out multiple insolvency-related services, including the provision of debt advice to over indebted consumers. It also reformed insolvency proceedings involving individuals; it removed the distinction between traders and non-traders, streamline access to bankruptcy by no longer requiring proof of an act of bankruptcy, applied an automatic discharge after 3 years, reformed bankruptcy notices, introduced flexible provisions regarding summary administration, etc. The new provisions enable individuals to initiate judicial or alternative administrative proceedings. Although the law is new, it is unified and clear. Because of this clarity, Mauritians – individuals and corporations, small businesses and even banks – have commenced a growing number of bankruptcy cases under the new law.

[6] In his presentation on Brazilian Insolvency Legal System, Luiz Fernando Valente de Paiva briefly introduced the major effects of the Brazilian Bankruptcy and Reorganization Law enacted in 2005. This law, however, has not unified the previous insolvency regime, which contemplated different regimes for the bankruptcy of corporations and individuals engaged in business –now governed by the new Bankruptcy and Reorganization Law; and the civil legislation rules contained in the Civil Code and the Code of Civil Procedure, which applied (and continue applying) to individuals or other legal entities that are not engaged in business, such as consumers and law firms. The debtor or one of its creditors may request the opening of a civil

insolvency proceeding if the liabilities of the debtor exceed the value of its assets. In practice, creditors typically have little incentive to initiate liquidation proceedings involving an individual except in the unlikely case in which the debtor has substantial assets. If the court decides to open an insolvency proceeding against the debtor, it will appoint an administrator of the estate (chosen among its major creditors), which will have the duty to collect and sell the assets of the debtor. The proceeds of such sale will be distributed among creditors pursuant to the priority rule established by law. There is no other proceeding, either judicial or administrative aimed at dealing with the over-indebtedness of consumers. Mr. Valente de Paiva expressed his frustration with current Brazilian consumer bankruptcy law and the difficulty Brazilians face in seeking a discharge from their indebtedness. Liquidation proceedings often take too long to open, even where the debtor has filed an application; courts are overloaded and insolvency proceedings do not present a priority for the courts. Discharge is very difficult for individual debtors to obtain; debtors can only apply for a discharge five years after a liquidation proceeding has been terminated. In addition to being time consuming, consumer bankruptcy proceedings are also expensive in Brazil as a debtor cannot commence a case without the assistance of a lawyer. These problems suggested to Mr. Valente de Paiva that Brazilian consumer bankruptcy law required further reform.

PART 2: ROUNDTABLE ON THE FEASIBILITY OF DRAFTING GENERAL PRINCIPLES FOR THE INSOLVENCY OF NATURAL PERSON.

CHAIRPERSON: ADOLFO ROUILLON, WORLD BANK

SPEAKERS: NICK BRAINSBY, EBRD

YAN LIU, IMF

SUMANT BATRA, INSOL PRESIDENT

CLAUDIA GROSS, UNCITRAL

SUE RUTLEDGE, WORLD BANK

SOPHIE SIRTAINE, WORLD BANK

LEONARD GILBERT, IBA

CLOSING REMARKS: VIJAY S. TATA, WORLD BANK

PRESENTATIONS

[7] In response to a question as to how non-performing loans to individuals could affect systemic stability, Sophie Sirtaine differentiated the Asian financial crisis in the late 1990s with the current financial crisis. In the current crisis, individual consumers have been seriously affected, not only in Europe and Central Asia, but also in the United States and several other countries. Economic difficulties have affected consumers' ability to repay indebtedness; non-performing consumer loans and residential mortgages have increased substantially. The problem of non-performing consumer loans has been exacerbated by outdated consumer bankruptcy laws, and by the difficulty of loan enforcement when engaged on a systemic scale. Where banks have had difficulty foreclosing mortgages, they have had to learn to renegotiate mortgage debt. This has led to not only systemic economic effects, but also social stability risk.

[8] Yan Liu shared with the audience the main challenges that her team has faced when providing technical assistance relating to financial and insolvency systems in European countries affected by the financial crisis. The first challenge is that the process of reforming consumer bankruptcy laws is highly politically charged. Law-making with regard to natural persons is more challenging than corporate insolvency law, because it affects ordinary people, in other words, voters. The second challenge is that it is not enough to enact a well designed household insolvency law; a supporting legal and institutional system is indispensable for the implementation of insolvency law in a transparent and consistent manner. Strong collections laws should also exist in the background. The third challenge lies in the design of the insolvency law itself. There is no international best practice so far; as a result, the design of the law needs to take into account the specific circumstances of each country in which reform is attempted. Certain features are especially challenging. For example: What debt should be covered by the law? Under what conditions can a debtor access bankruptcy or creditors force a debtor into

bankruptcy? Should the law condition any discharge on a debtor's repayment in bankruptcy, and for what period of time? How should tax claims be treated under the bankruptcy law; should they be subject to discharge? Many of these questions relate to whether the law can and should create incentives for debtors to file for bankruptcy, and when filing amounts to bad faith. Finally, people fail to recognize the limits of insolvency law. It cannot resolve all situations involving consumers' financial distress. Insolvency law is not a panacea, so other tools may be needed to resolve macro-economic imbalances. A country may also need to implement a short-term systemic moratorium; it may need to provide transfer payments to some part of society. Notwithstanding this need for breadth, legislators should not attempt to include aspects other than insolvency in the insolvency law.

[9] Nick Brainsby provided the EBRD vision of the future potential demand for legal reform in the area of personal insolvency. Many EBRD countries do not have a legal consumer bankruptcy law regime for cultural and historical reasons. However, there are two positive drives for a further demand for legal reforms in the course of transition to market economy: one is that increases in consumer credit can lead to increasing consumer over-indebtedness; the other is that the economic growth comes from SMEs in these countries, thus a well established personal insolvency regime is an incentive for entrepreneurs to take economic risks without fear of burdening future generations with debt. In order to structure a successful legal reform project, Mr. Brainsby noted that it is crucial to get deep political engagement, to get credible and influential local leadership, and to be able to operate effectively. While there is much agreement about the substantive content of corporate insolvency laws, there remain very different ideas about consumer insolvency law. Dialogue about these political and social differences should be encouraged.

[10] As member of the Project on Consumer Protection and Financial Literacy of the World Bank, Sue Rutledge expressed the need to develop international guidance on consumer insolvency. The relationship between consumer insolvency and financial sector development and stability is crucial. To ensure a stable financial environment, legal systems can be neither too lender-friendly nor too consumer-friendly. Therefore the real challenge for legislators is to find a right balance. The Project on Consumer Protection and Financial Literacy has developed best practices in various aspects of consumer protection. It would be helpful if principles or guidance on consumer insolvency be developed and incorporated into the general framework of best practices on consumer protection.

[11] Leonard Gilbert of the International Bar Association brought up potential abuses relating to consumer insolvency that legislators should be aware of. There is a rising interest in so-called bankruptcy tourism, *i.e.* forum shopping of legal systems by individuals in order to enjoy a preferential personal insolvency treatment.

[12] From the point of view of INSOL, Sumant Batra supported efforts to develop principles for consumer insolvency applicable to all jurisdictions, regardless of cultural differences. He raised three precautions for international organizations when developing principles on consumer insolvency. First, it is important to secure effective ownership of any such work. International organizations represent a wide range of countries and stakeholder interests. Second, any such work should be inclusive of views from different jurisdictions. Views from developing economies, which often differ dramatically from others, should be respected. Third, the process

of any such exercise should be conducted in a manner that engages the participation of private sector organizations.

[13] Claudia Gross clarified UNCITRAL's strategy regarding consumer insolvency. Consumers were not specifically addressed by UNCITRAL, because its mandate is to promote international trade law. Reference can be made to article 8 of the UNCITRAL Legislative Guide on Insolvency Law. As for UNCITRAL's Model Law on Cross Border Insolvency, there is no definition of debtor. Consumers are not explicitly excluded from the Model Law. Reference can be made to article 1 of the Model Law.

DISCUSSIONS

[14] The participants generally acknowledged the necessity and importance for international organizations to develop guidance with regard to consumer insolvency law and policy. It was hoped that any such efforts should take into consideration the differences in cultural traditions and economic development among jurisdictions. In many jurisdictions, cultural taboos regarding debt and insolvency may undermine reform; thus, efforts should be made to educate professionals and others regarding the economic benefits of access to bankruptcy proceedings. Questions regarding the availability of a bankruptcy discharge and exemptions are especially important in this regard.

[15] There has been concern about the complexity of consumer bankruptcy laws. Bureaucracy should be kept to a minimum in this area of the law. Deep political engagement is indispensable for law-making in this regard. Consumer insolvency regimes are also highly related to the financial sector stability. Therefore, any legislative process should follow a balanced approach.

[16] The current financial crisis has seriously impacted middle and lower income individuals because the relative ease of access to consumer credit enabled low to middle income individuals to borrow, sometimes for the first time, and then default. Countries may wish to provide early-stage consumer counseling to individuals, as well as a consumer insolvency law that provides for a discharge. Adoption of a consumer insolvency law may not be enough; the need for qualified insolvency professionals should be taken into account during the law-making process. The relationship between consumer insolvency law and consumer financial protections should also be considered.

CLOSING REMARKS

[17] In his closing remarks, Vijay S. Tata (Chief Counsel, World Bank LEGPS) reviewed the evolution of the World Bank's initiatives on insolvency. He pointed out that one 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 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 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.