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# Realigning the American Consumer Bankruptcy System with the Goals of the Fresh-Start Doctrine: A Global Comparative Analysis

ASSAF LICHTASH\*

## I. INTRODUCTION

Two decades ago, consumer bankruptcy had not yet assumed an impactful role in most countries' economies.<sup>1</sup> In its nascent stages, consumer bankruptcy was primarily practiced and developed in the United States, the world leader in the use of consumer credit.<sup>2</sup> In the past two decades, consumer credit grew around the world and it served as a nucleus for the growth of consumer bankruptcy.<sup>3</sup> The proliferation of credit card companies has extended the democratization of credit to include consumers from around the globe, and has become a ubiquitous practice.<sup>4</sup> As a result of this unfettered global access to credit, the relationship between consumers and money has fundamentally changed.<sup>5</sup>

The increase of access to credit has led the consumer lifestyle to become both strongly reliant on debt and more costly as people borrow funds to purchase that which they cannot afford.<sup>6</sup> For many individuals today, life's necessities, such as housing and education can only be

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\* J.D., Loyola Law School, 2012; B.A., Hebrew University of Jerusalem, 2008. I would like to thank my wife, Charlene, for her love, support, and insight throughout the process of writing this article.

1. CONSUMER BANKRUPTCY IN GLOBAL PERSPECTIVE 1 (Johanna Niemi-Kiesilainen, Ian Ramsey, & William Whitford eds., 2003).

2. *Id.* at 12.

3. *Id.* at 2–5.

4. *Id.* at 2–3.

5. See Charles J. Tabb, *Lessons From the Globalization of Consumer Bankruptcy*, 30 LAW & SOC. INQUIRY 763, 773 (2005).

6. Niemi-Kiesilainen, *supra* note 1, at 2–3; see JACOB S. ZIEGEL, *COMPARATIVE CONSUMER INSOLVENCY REGIMES: A CANADIAN PERSPECTIVE* 30–35 (2003).

obtained through loans, which put a growing number of consumers at risk of becoming over-indebted.<sup>7</sup> As a result, many individuals find themselves in precarious financial conditions where any unforeseen turmoil could lead to insolvency.<sup>8</sup>

Liberal access to credit is often cited as the cause of the global growth in consumer bankruptcy filings around the world.<sup>9</sup> In the United States alone, annual bankruptcy filings have soared to over 1.5 million petitions in recent years.<sup>10</sup> Legislatures have adopted different approaches in response to the global explosion in bankruptcy filings.<sup>11</sup> Although the approaches of the various states differ in their implementation, they all strive to offer debtors a “fresh-start.”<sup>12</sup> The main tenet of the fresh-start doctrine is the desire to provide relief to honest individuals, who by some misfortune have become insolvent.<sup>13</sup> According to this doctrine, such individuals should be afforded the opportunity to restart their financial lives, unencumbered by previous debt.<sup>14</sup> The most efficient and common way to offer a fresh-start is by discharging most, or all, of the consumer’s pre-bankruptcy debt.<sup>15</sup>

A disagreement among policy-makers revolves around the scope of discharge. Some scholars say that granting permissive access to discharge encourages reckless financial behavior among consumers and contributes to the climbing number of bankruptcies.<sup>16</sup> Others claim that barring access to discharge stifles entrepreneurship and hurts the middle

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7. Niemi-Kielsilainen, *supra* note 1, at 3.

8. *Id.* at 4.

9. Kent Anderson, *The Explosive Global Growth of Personal Insolvency and the Concomitant Birth of the Study of Comparative Consumer Bankruptcy Consumer Bankruptcy in Global Perspective*, 42 OSGOODE HALL L.J. 661, 667 (2004); Ronald J. Mann, *Optimizing Consumer Credit Markets and Bankruptcy Policy*, 7 THEORETICAL INQUIRIES L. 395, 402–04 (2006); see JASON J. KILBORN, *COMPARATIVE CONSUMER BANKRUPTCY* 99–100 (2007) [hereinafter KILBORN, *COMPARATIVE*].

10. WILLIAM D. WARREN & DANIEL J. BUSSEL, *BANKRUPTCY* 507 (7th ed. 2006).

11. *Id.* at 51; Rafael Efrat, *The Fresh-Start Policy in Bankruptcy in Modern Day Israel*, 7 AM. BANKR. INST. L. REV. 555, 556 (1999) [hereinafter Efrat, *Israel*].

12. Efrat, *Israel*, *supra* note 11, at 571.

13. IAN F. FLETCHER, *THE LAW OF INSOLVENCY* 34 (1st ed. 1990).

14. Efrat, *Israel*, *supra* note 11, at 555; Mechele Dickerson, *Consumer Over-Indebtedness: A U.S. Perspective*, 43 TEX. INT’L L.J. 135, 144 (2008).

15. See WARREN, *supra* note 10, at 508; see also Efrat, *Israel*, *supra* note 11, at 558–59 (making a fresh-start option available promotes the efficient allocation of the risk of loss between debtors and creditors).

16. See Todd J. Zywicki, *Why So Many Bankruptcies and What To Do About It: An Economic Analysis of Bankruptcy Reform*, 57 (George Mason Law & Econ. Ctr., Working Paper No. 03-46, 2003) [hereinafter Zywicki, *Bankruptcy Reform*], available at [http://www.law.gmu.edu/assets/files/publications/working\\_papers/03-46.pdf](http://www.law.gmu.edu/assets/files/publications/working_papers/03-46.pdf).

class, who most rely on consumer credit.<sup>17</sup> This dispute, between those who wish to limit debtor access to discharge of debt and those who wish to expand it, is the focus of the discussion here. The purpose of this article is to revisit the balance built into the American bankruptcy system *vis-à-vis* the availability of discharge, and to ultimately consider a shift toward a new balance in consumer bankruptcy.

Part II of this article will briefly describe the goals of the fresh-start doctrine. These goals will be the standard against which the rest of the discussion about fresh-start legislation will be measured and will guide the subsequent evaluation of various forms of this legislation.

Part III of this article will provide an overview of the formation of current American bankruptcy laws, and the positions taken by those who either oppose or support them. This part will introduce the tensions and hurdles faced on the road to forming a more workable standard for consumer bankruptcy in the United States.

Part IV of this article will discuss fresh-start legislation in England and Wales, France, Germany, and Israel, and identify the various policy tools used by lawmakers to both *treat* and *prevent* bankruptcies.

Part V of this article will apply the policy tools identified in Part IV to the American bankruptcy system and will discuss the difference in approaches to implementing the fresh-start doctrine. Finally, this part will offer a new balance for discharge in the United States that will better adhere to the goals of the fresh-start doctrine.

## II. THE GOALS OF THE FRESH-START DOCTRINE

While policy-makers differ on the scope of the doctrine,<sup>18</sup> all fresh-start laws share the same core goals: *treatment* of existing over-indebtedness, and *prevention* of future over-indebtedness.<sup>19</sup> The first goal of the fresh start doctrine is the principled need to provide humanitarian relief, and *treat* over-indebted consumers.<sup>20</sup> This goal is divided into three requirements. The first requirement is the enactment of a fair and efficient debt-forgiveness mechanism at the heart of the consumer bankruptcy system.<sup>21</sup> The second is that a country's consumer bankruptcy system allows debtors to keep certain items that are deemed

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17. See generally Margaret Howard, *The Fragile Middle Class: Americans in Debt*, 17 BANKR. DEV. J. 425, 427 (2001).

18. See, e.g., Efrat, *Israel*, *supra* note 11, at 556.

19. Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L. J. 81, 82 (2002) [hereinafter Efrat, *Global Trends*].

20. See Efrat, *Israel*, *supra* note 11, at 568–71.

21. *Id.* at 556.

essential for their self-sufficiency and human dignity.<sup>22</sup> Together, these two requirements are guided by a humanitarian aspiration to aid over-indebted individuals in repairing their financial lives.<sup>23</sup> Finally, the third requirement is that legislatures treat the underlying causes of the debtor's financial failure.<sup>24</sup>

The second goal of the fresh-start doctrine addresses the inevitable cost of bankruptcy to society and attempts to discourage irresponsible financial conduct.<sup>25</sup> In an effort to *prevent* over-indebtedness the doctrine identifies two parties to which the risk of loss can be allocated, namely the debtor and the creditor.<sup>26</sup> One theory is that the party who can best prevent the risk of loss and efficiently insure against it should bear the risk.<sup>27</sup> Policy-makers differ, however, as to which of the two parties have such capacity.<sup>28</sup> Some contend that the debtors, in having the power to make conscious decisions to incur debt, should bear the risk of loss.<sup>29</sup> Others maintain that creditors are better suited to bear this risk, because they possess the ability to deny loans to unreliable applicants, and they can ultimately afford the cost of faulty investments.<sup>30</sup>

The two goals of the fresh-start doctrine are inversely related. A pro-creditor approach posits that permissive access to discharge would encourage debtors to incur dangerous and risky loans.<sup>31</sup> Under this approach, a prudent policy would limit debtors' access to discharge.<sup>32</sup> The pro-debtor approach, however, maintains that liberal access to discharge would give *creditors* an incentive to avoid giving dangerous loans.<sup>33</sup> These two opposing views on the implementation of the fresh-start doctrine define the gamut of varying global approaches to the structure of bankruptcy systems.<sup>34</sup> The next chapter will discuss where the American Bankruptcy System is situated on this spectrum.

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22. *Id.*

23. *See id.* at 558.

24. *Id.* at 556.

25. *See id.* at 558–60.

26. *Id.* at 558–59.

27. *See id.* at 558.

28. *Id.* at 558–59.

29. *Id.*

30. *See id.* at 559.

31. *Id.* at 562.

32. *Id.* at 559.

33. *Id.* at 562–63.

34. *Id.* at 559–63.

## III. CONSUMER BANKRUPTCY IN THE UNITED STATES

The United States, much like its counterparts in Europe and elsewhere, has suffered from a sharp increase in consumer bankruptcy filings in recent decades, reaching 1.41 million filings in 2009.<sup>35</sup> Striking the appropriate balance between the availability of and limitations on relief has long vexed American policy-makers.<sup>36</sup>

Between the passage of the 1978 Bankruptcy Code and reforms introduced in 2005, American bankruptcy law provided nearly unfettered consumer access to debt discharge, also known as Chapter 7 bankruptcy.<sup>37</sup> The Chapter 7 discharge mechanism, still available today, requires debtors to submit all of their non-exempt property for liquidation and distribution to creditors. In return, their entire unsecured debt is expunged.<sup>38</sup> As bankruptcy filings continued to rise throughout the 1980s and 1990s, creditors, scholars, and politicians called for reform.<sup>39</sup>

What followed was a deeply contentious discussion between pro-creditor and pro-debtor advocates.<sup>40</sup> Pro-creditor advocates argued that the cause of the uncontrolled rise in bankruptcies was abuse of discharge by debtors.<sup>41</sup> According to these advocates, many debtors chose to discharge their entire debt, even when they were able to repay some or all of it.<sup>42</sup> On these grounds, pro-creditor advocates maintained that consumer access to discharge should be strictly limited.<sup>43</sup> Opposing this theory, pro-debtor advocates claimed that the reason for the rise in bankruptcies was not abuse, but rather strong consumer reliance on credit.<sup>44</sup> According to this theory, Chapter 7 bankruptcy served as a

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35. Sara Murray, *Personal Bankruptcy Filings Rising Fast*, WALL ST. J., Jan. 7, 2010, <http://online.wsj.com/article/SB126263231055415303.html>. See Donna McKenzie Skene, *Consumer Bankruptcy Law Reform in Great Britain*, 80 AM. BANKR. L.J. 477, 477 (2006) (discussing a similar situation in the U.K.).

36. WARREN, *supra* note 10, at 507.

37. National Bankruptcy Review Commission, Report of the National Bankruptcy Review Commission (1997); Title 11, Bankruptcy, 11 U.S.C. §§ 101-1532 (1978); Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23.

38. WARREN, *supra* note 10, at 509.

39. Corinne Ball & Jacqueline B. Stuart, *The Battle Over Bankruptcy Law for the New Millennium*, 55 BUS. L. J. 1487, 1487, 1489 (2000).

40. *Id.*

41. Zywicki, *Bankruptcy Reform*, *supra* note 16; Todd J. Zywicki, *An Economic Analysis of the Bankruptcy Crisis*, 99 NW. U. L. REV. 1463, 1540 (2005) [hereinafter Zywicki, *Bankruptcy Crisis*].

42. Zywicki, *Bankruptcy Crisis*, *supra* note 41, at 1540.

43. See Zywicki, *Bankruptcy Reform*, *supra* note 16, at 57-60, 96.

44. Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L. J. 1079, 1080 (1998).

necessary safety net—especially to middle class consumers—and limiting it would render consumers defenseless against the threat of insolvency.<sup>45</sup>

The American battle over the future direction of consumer bankruptcy was temporarily settled in 2005 with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).<sup>46</sup> Creditors aggressively spearheaded and lobbied for the BAPCPA on Capitol Hill.<sup>47</sup> This legislation drastically restricted consumer access to Chapter 7 bankruptcy by implementing a system called the “means test,”<sup>48</sup> by which the debtor was classified according to his or her income. According to this test, any bankruptcy petitioner whose household income is over the median in his or her state of residence is subject to a rebuttable presumption of abuse.<sup>49</sup> To rebut this presumption, the petitioner must show that his or her disposable household income<sup>50</sup> does not exceed one hundred dollars each month.<sup>51</sup> This rigid requirement prevents a large number of consumers from getting a fresh-start from their over-indebtedness.<sup>52</sup>

Petitioners who are ineligible for Chapter 7 bankruptcy under the 2005 legislation can enter a repayment program called Chapter 13 bankruptcy.<sup>53</sup> Under Chapter 13 the court creates a three- to five-year repayment plan, during which the debtor must repay some, or all, of his or her debt.<sup>54</sup> If the debtor fails to make timely payments, the court can dismiss the petition and the debtor may be left without recourse.<sup>55</sup> Pro-debtor advocates do not view the Chapter 13 repayment plans as an adequate alternative to Chapter 7 discharge, because they claim it falls short of the basic goals of the fresh-start doctrine.<sup>56</sup> According to BAPCPA, debtors can keep their post-bankruptcy earnings only under Chapter 7; under Chapter 13 such earnings are at least partially

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45. WARREN, *supra* note 10, at 515–16.

46. Bankruptcy Abuse Prevention and Consumer Protection Act §§ 201–34.

47. WARREN, *supra* note 10, at 507.

48. Bankruptcy Abuse Prevention and Consumer Protection Act § 102(h); *see* Charles J. Tabb, *The Death of Consumer Bankruptcy in the United States*, 18 BANKR. DEV. J. 1, 12–18 (2001).

49. WARREN, *supra* note 10, at 474; 11 U.S.C. § 707(b) (2011).

50. “Disposable Income” is current monthly income less amounts reasonably necessary for the maintenance or support of the debtor or dependents and less charitable contributions up to fifteen percent of the debtor’s gross income. 11 U.S.C. § 1325(b)(2) (2011).

51. *See* 11 U.S.C. § 707(b).

52. WARREN, *supra* note 10, at 517–18.

53. *See* 11 U.S.C. § 707(b).

54. WARREN, *supra* note 10, at 539.

55. *See id.* at 539; 11 U.S.C. § 1307(c)(4) (2011).

56. WARREN, *supra* note 10, at 510.

designated for repayment.<sup>57</sup> In addition, time has shown that Chapter 13 repayment plans often fail and are difficult for courts to administer.<sup>58</sup> Thus, the goals of the fresh-start doctrine are best advanced by Chapter 7 bankruptcy, which, under BAPCPA, is no longer available to a many consumers.<sup>59</sup>

The aftermath of the BAPCPA led to intensified opposition by pro-debtor advocates.<sup>60</sup> According to a 2005 study, about half of all bankruptcies in the United States were caused by large medical bills that drove households into insolvency.<sup>61</sup> This important finding discredited BAPCPA supporters' main premise that the rise of bankruptcy filings was due to debtor abuse.<sup>62</sup> With the advent of the 2008 financial crisis, consumer demand for bankruptcy has continued to rise, and the voices calling for reform have only intensified.<sup>63</sup> Some scholars are calling for the BAPCPA to be repealed and insist that such action by Congress should be on the horizon.<sup>64</sup>

#### IV. CONSUMER BANKRUPTCY OUTSIDE THE UNITED STATES

While vigorous public debate was taking place in the United States over consumer bankruptcy, legislatures across Europe and elsewhere were dealing with a similar spike in bankruptcy filings.<sup>65</sup> The democratization of credit has now become a global phenomenon, making consumers around the world ever more reliant on debt.<sup>66</sup> Much like the U.S. Congress, the legislatures of the United Kingdom, France, Germany, and Israel have all enacted fresh-start laws.<sup>67</sup> The different

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57. WARREN, *supra* note 10, at 36; 11 U.S.C. § 541(a)(6) (2011).

58. See Ian Domowitz & Elie Tamer, Two Hundred Years of Bankruptcy: A Tale of Legislation and Economic Fluctuations 36–37 (May 1997) (unpublished manuscript) (submitted to the National Bankruptcy Review Commission).

59. WARREN, *supra* note 10, at 517–18.

60. See Thomas Evans et al., *An Empirical Economic Analysis of the 2005 Bankruptcy Reforms*, 24 EMORY BANKR. DEV. J. 327, 327–28 (2008).

61. See David U. Himmelstein, et al., *Marketwatch: Illness and Injury as Contributors to Bankruptcy*, HEALTH AFF. (Feb. 2, 2005), <http://content.healthaffairs.org/content/suppl/2005/01/28/hlthaff.w5.63.DC1>.

62. See U.S. Gov. Accountability Office, *Bankruptcy Reform: Value of Credit Counseling Requirement Is Not Clear*, GAO-07-203 (2007).

63. Renuka Rayasam, *Tidal Wave of Foreclosures Will Force Bankruptcy Reform*, KIPLINGER (Oct. 10, 2008), [http://www.kiplinger.com/businessresource/forecast/archive/Tidal\\_Wave\\_of\\_Foreclosures\\_Bring\\_s\\_Actions\\_081010.html](http://www.kiplinger.com/businessresource/forecast/archive/Tidal_Wave_of_Foreclosures_Bring_s_Actions_081010.html).

64. Melissa B. Jacoby, *Bankruptcy Reform and the Financial Crisis*, 13 N.C. BANKING INST. 115, 120–21 (2009).

65. See Niemi-Kiesilainen, *supra* note 1, at 1, 3.

66. *Id.* at 3.

67. See *infra* Part IV.A–D.



legislatures, however, have applied varying approaches to implementing the fresh-start doctrine.<sup>68</sup> This chapter will examine how these countries *treat* over-indebtedness by providing debt relief to a growing number of consumers, and how they *prevent* the rise of bankruptcy filings by allocating the risk of loss to debtors and creditors.

### A. England and Wales<sup>69</sup>

#### 1. Treatment: Imposed Out-of-Court Settlements and Post-Bankruptcy Contributions

Bankruptcy in England and Wales is governed by the Insolvency Act of 1986, which was substantially amended by the Enterprise Act of 2002.<sup>70</sup> The British bankruptcy system offers two tracks for relief: a negotiated-repayment-plan track and a coercive-bankruptcy track.<sup>71</sup>

The goal of the negotiated repayment plan track is to have an Individual Voluntary Agreement (IVA) reached between the debtor and the creditor.<sup>72</sup> Throughout this process, the debtor retains the services of an Insolvency Practitioner.<sup>73</sup> Together they devise a three- to five-year repayment plan, which must be authorized by creditors holding at least 75 percent of the debtor's unsecured claims.<sup>74</sup> Although they were used in approximately 40 percent of insolvency cases in 2006, IVA plans often fail.<sup>75</sup> As a result, debtors, who may incur expenses of up to \$24,000 in managing their IVAs,<sup>76</sup> risk being left in worse financial distress than before and without substantial relief in case of default.<sup>77</sup>

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68. *Id.*

69. Although the Insolvency Act of 1986, and the subsequent Enterprise Act of 2002 apply to all of Britain, the discussion here is limited to the parts of the code that govern England and Wales, but not Northern Ireland and Scotland.

70. Insolvency Act of 1986, 1986, c. 45; Enterprise Act of 2002, 2002, c. 40; Donna McKenzie Skene & Adrian Walters, Consumer Bankruptcy Law Reform in Scotland, England and Wales 4, 7 (July 2006) (unpublished manuscript) (available at <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/persdocs.htm>).

71. Insolvency Act of 1986, 1986, c. 45, pt. VIII; KILBORN, COMPARATIVE, *supra* note 9, at 88.

72. Ian Ramsey, *Bankruptcy in Transition: The Case of England and Wales – The Neo-Liberal Cuckoo in the European Bankruptcy Nest?*, in CONSUMER BANKRUPTCY IN GLOBAL PERSPECTIVE 205, 211 (Johanna Niemi-Kiesilainen, Ian Ramsey, William Whitford eds., 2003).

73. *Id.* at 217.

74. KILBORN, COMPARATIVE, *supra* note 9, at 88.

75. *Id.*

76. *Id.* at 88–89.

77. *Id.* at 89.

The second form of relief offered by the Enterprise Act is discharge.<sup>78</sup> The majority of British debtors receive full discharge from their unsecured debt as early as one year after the commencement of bankruptcy.<sup>79</sup> In order to qualify for full discharge, the debtor must show an inability to repay the debt and pay costs of approximately nineteen hundred dollars.<sup>80</sup> An interesting feature of the English version of discharge is its requirement that *some* debtors make contributions to their discharged debt out of any surplus income for up to three years.<sup>81</sup> The choice of who is required to pay is left to the discretion of the Official Receiver, a government official who manages the bankruptcy process in England and Wales.<sup>82</sup> Surprisingly, as a result of this provision, the percentage of English bankruptcy cases in which debtors repaid at least a portion of their debt has doubled to nearly 20 percent of all cases.<sup>83</sup>

## 2. Prevention: The “Third Way” Approach

The Enterprise Act of 2002 marks a significant reform in the British insolvency system. This Act was inspired, to a large extent, by the American spirit of entrepreneurialism and its place in the structure of the American bankruptcy system.<sup>84</sup> English legislators were drawn to the “tailwind” the American bankruptcy system provided to entrepreneurs through its lax approach to discharge in Chapter 7 bankruptcies.<sup>85</sup> As a result, British legislators intended to legislate a new approach to discharge that would bolster entrepreneurialism, and offer a safety net to consumers who wish to engage in risk taking.<sup>86</sup>

This strategy emerged out of a political philosophy that predominated the ruling British Labour Party at the time, the so-called “Third Way.”<sup>87</sup> The Third Way is a centrist methodology of policy making, which addresses all facets of a problem by developing an approach that reconciles right-wing economics with left-wing political

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78. Enterprise Act of 2002, 2002, c. 40, pt. 10.

79. Enterprise Act, 2002, c. 40 § 256 (Eng).

80. KILBORN, COMPARATIVE, *supra* note 9, at 89.

81. Ramsey, *supra* note 72, at 218–22.

82. *Id.*

83. KILBORN, COMPARATIVE, *supra* note 9, at 89.

84. Iain D.C. Ramsay, *Functionalism and Political Economy in the Comparative Study of Consumer Insolvency: An Unfinished Story from England to Wales*, 7 THEORETICAL INQUIRIES L. 625, 646 (2006).

85. *See id.*

86. *Id.*

87. *Id.* at 655.

thought.<sup>88</sup> Third Way policy makers in England believed that a careful and thoughtful implementation of regulatory instruments could help form a healthy consumer credit market, where both debtors and creditors conduct themselves with financial responsibility.<sup>89</sup>

Such regulatory instruments range from better credit scoring and new consumer credit rights, to self-regulation.<sup>90</sup> This goal is detailed in the U.K.'s Department of Trade and Industry's (DTI) Plan to Tackling Over-Indebtedness. It states:

Working with our partners in the credit industry, the voluntary sector and consumer groups, the Government seeks to minimise the number of people who become over-indebted and to improve the support and processes for those who have fallen into unsustainable debt . . . Our aim is to get to a position where consumers have the capability and information they need to make informed decisions about borrowing and where lenders make responsible decisions about whether and how much credit to grant.<sup>91</sup>

Currently, DTI produces annual reports that describe the steps taken each year to ensure these goals are met.<sup>92</sup> The reports focus on various policies that, in concert, are believed to “put out the fire” of over-indebtedness, without denying individuals the opportunity to enter free enterprise and engage in *responsible* risk taking.<sup>93</sup> These policies include:

[D]evelopment of a national strategy for financial capability; increases in affordable credit through development of credit unions and alternative models of affordable credit; introduction of a “stakeholder suite” of financial products to promote asset savings; investigation of the role of interest rate ceilings; strengthening of credit licensing and attacks on unfair lending practices; attack on illegal money lending; improved data sharing to underpin responsible lending decisions; increases in the funding of free and available debt advice; alternative dispute resolution for debt disputes; the improvement of insolvency with the introduction of a “no income

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88. *Id.*

89. *Id.*

90. *Id.*

91. Dep't for Work & Pensions, *Tackling Over-Indebtedness Action Plan 2004* 1 (2004) [hereinafter *Tackling Over-Indebtedness*], available at <http://webarchive.nationalarchives.gov.uk/+http://www.berr.gov.uk/files/file18559.pdf>.

92. *Id.* at 7.

93. *Id.* at 8–9.

no asset” procedure; and finally, improvement in housing benefits and the administration of council tax benefits.<sup>94</sup>

Despite the steps taken by the legislature, the outcome of the “Third Way” approach has yet to be seen. Between 2003 and the third quarter of 2006, there was a steady climb in personal bankruptcies, where the number of actual bankruptcies predominated compared with IVAs.<sup>95</sup> Since 2006, the number of bankruptcies has steadily declined, with the portion of IVAs getting smaller each year and the portion of actual bankruptcies remaining the same.<sup>96</sup> Although more time is required to determine its success, the English approach to prevention of over-indebtedness introduces a unique model of government actions extraneous to the bankruptcy system.

### B. France

#### 1. Treatment: A System of Gradation

Like the British system, the French insolvency system coerces parties to engage in out-of-court negotiations prior to filing for bankruptcy.<sup>97</sup> In fact, the majority of insolvency cases in France are resolved in out-of-court settlements and only 35 percent of cases are reverted to the bankruptcy system.<sup>98</sup> In contrast to the English government, however, the French legislature has attempted to avoid the use of discharge.<sup>99</sup> The French insolvency system is designed to gradually intervene between debtors and creditors.<sup>100</sup> The level of intervention is primarily guided by the status of the debtor; the more she is indebted, the greater role the insolvency system plays.<sup>101</sup> The level of intervention is divided into three alternatives for relief, each of which gives rise to certain powers of the insolvency system over the parties: (i) “ordinary” forced renegotiation; (ii) “extraordinary” moratoria and partial forced discharge; and (iii) personal recovery.<sup>102</sup>

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94. Ramsay, *supra* note 84, at 654–55.

95. Skene, *supra* note 70, at 60–61 figs.1 & 1a.

96. Dep’t for Bus. Enterprise & Reg. Reform, *Tackling Over-Indebtedness: Annual Report 2007 19* (2007), available at <http://www.bis.gov.uk/files/file42700.pdf>.

97. Maria Gerhardt, *Consumer Bankruptcy Regimes and Credit Default in the US and Europe A Comparative Study*, CEPS Working Document No. 318, CENTER FOR EUR. POL’Y STUD. 10 (July 2009), available at <http://www.ceps.eu/files/book/1887.pdf>.

98. KILBORN, *COMPARATIVE*, *supra* note 9, at 63.

99. *See id.* at 62–63.

100. *Id.* at 63.

101. *Id.*

102. *Id.*

## i. "Ordinary" forced-renegotiations

The "ordinary" forced-renegotiations alternative compels a creditor who is unwilling to yield to a reasonable settlement offer to enter renegotiations of the debt under the auspices of the insolvency system.<sup>103</sup> A commission whose role is to make a preliminary settlement recommendation and facilitate communication between the parties controls renegotiation.<sup>104</sup> The process may last for a period of up to ten years.<sup>105</sup>

The commission's authority to impose measures is limited to merely "ordinary" measures of relief, such as granting time extensions for payments and reducing the interest owed.<sup>106</sup> The commission may order discharge of debt only where the mortgage on the debtor's home is higher than the value of the property itself.<sup>107</sup> Out of the 35 percent of insolvency cases whose out-of-court negotiations fail, one-third is resolved by means of "ordinary" forced renegotiations.<sup>108</sup> Accordingly, 80 percent of all insolvency cases in France are solved through either independent out-of-court settlements or a mild, albeit coerced, court-directed compromise.<sup>109</sup>

## ii. "Extraordinary" moratoria and partial forced discharge

Despite the relative success of "ordinary" forced renegotiations, this measure did not always prove sufficient.<sup>110</sup> Some debtors who consented to the court-imposed payment plan were not able to satisfy their commitment to repay.<sup>111</sup> It soon became clear to legislators that "ordinary" forced renegotiations offered insufficient solutions.<sup>112</sup> Some debtors whose debt was too overwhelming were unable to follow through on any settlement plan and required a more extensive form of relief.<sup>113</sup> In 1999, the French legislature took another step in the

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103. Law No. 89-1010 of Dec. 31, 1989, J.O., Jan. 2, 1990 (Fr.); *id.* at 63–64.

104. Gerhardt, *supra* note 97, at 9–10.

105. *Id.* at 10.

106. KILBORN, *COMPARATIVE*, *supra* note 9, at 64.

107. *Id.*

108. *Id.*

109. *Id.*

110. Jason Kilborn, *La Responsabilisation De L'Economie: What the United States Can Learn from the New French Law on Consumer Overindebtedness*, 26 MICH. J. INT'L L. 619, 649 (2005) [hereinafter Kilborn, *La Responsabilisation*].

111. *Id.*

112. KILBORN, *COMPARATIVE*, *supra* note 9, at 64.

113. Kilborn, *La Responsabilisation*, *supra* note 110, at 649–50.

direction of liberalizing relief and expanded the commissions' authority to undertake so-called "extraordinary" measures.<sup>114</sup>

In cases of heavy over-indebtedness, the commission's authority becomes twofold. First, it may negotiate a settlement plan for a period of up to ten years, but the debtors and creditors must approve the settlement plan before it goes into effect.<sup>115</sup> Second, at the end of the commission-imposed settlement negotiation, the commission may propose a moratorium to reexamine the debtor's propensity to repay her debt, and the possibility of reverting back to "ordinary" measures.<sup>116</sup> If the commission concludes that the debtor has not regained her ability to repay her debts, the commission has the authority to discharge some or all debt.<sup>117</sup>

Following the passage of this law, commissions began to recommend some form of discharge to 18 percent of "extraordinary" cases in 2001, and approximately 30 percent in 2003.<sup>118</sup> This rate has remained more or less the same since 2003.<sup>119</sup> The French legislature continued to expand its liberal approach to discharge, and passed another law whose extent of discharge is similar to that of the United States' Chapter 7.<sup>120</sup>

### iii. Personal recovery

In 2004, the French legislature passed a law that offers full and immediate discharge to debtors whose insolvency is deemed "irremediable."<sup>121</sup> This law requires debtors to undergo a simplified "procedure of personal recovery."<sup>122</sup> Since its establishment in 2004, the number of debtors seeking "personal recovery" has doubled from 16,321 to 33,378 in 2008.<sup>123</sup> Procedurally, this law is similar to Chapter 7 bankruptcy because it requires debtors' assets to be turned over to a trustee or liquidator, liquidated, and distributed prior to discharge.<sup>124</sup> The difference between the French law and Chapter 7, however, is that

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114. Law No. 98-657 of July 29, 1998 art. 99; *id.* at 650.

115. Gerhardt, *supra* note 97, at 9–10.

116. *Id.* at 10.

117. *Id.*

118. KILBORN, COMPARATIVE, *supra* note 9, at 66–67.

119. *Id.* at 67.

120. *Id.*

121. ASSEMBLEE NATIONALE, AVIS, DOC. NO. 1003, TOM, at 13–14; KILBORN, COMPARATIVE, *supra* note 9, at 66–67.

122. *Id.*

123. Gerhardt, *supra* note 97, at 10.

124. KILBORN, COMPARATIVE, *supra* note 9, at 68.

the French system reserves this extreme form of relief for only the most heavily indebted petitioners.<sup>125</sup>

Since the adoption of the personal recovery law, the number of petitioners seeking personal recovery has soared.<sup>126</sup> In 2006, approximately 25 percent of all cases were diverted to the personal recovery procedure.<sup>127</sup> While the number of personal bankruptcies seeking personal recovery has significantly grown, this growth seems to have moderated in recent years.<sup>128</sup>

## 2. Prevention: Responsibility as a Two Way Street

Traditionally, the French insolvency system has placed the cost of bankruptcy on debtors, demanding that they settle and repay their loans.<sup>129</sup> This requirement, along with the legislature's original shunning of discharge, has led consumers to take conservative risks.<sup>130</sup> While the number of cases that settled amicably was almost an astounding 70 percent between 1998 and 2003, French legislators began to recognize a need to offer greater access to discharge.<sup>131</sup> By passing the liberalizing laws described above, the French legislature expanded access to discharge.<sup>132</sup> Concomitant to liberalizing its discharge laws, however, the French legislature demanded accountability on the side of creditors as well.<sup>133</sup> The French approach to prevention of over-indebtedness is founded on the concept of "responsibility as a two way street," meaning both debtors and creditors must bear the risk of loss created by reckless financial behavior.<sup>134</sup>

By enacting a credit rating system similar to that of the US, the French insolvency system views less favorably creditors who recklessly extend loans to debtors with poor credit, and makes creditors bear their share of the responsibility for consumer over-indebtedness.<sup>135</sup> According to this law, the commission will determine what relief should become available, while "[taking] into account the knowledge of the debtor's debt situation that each creditor might have had at the time of execution

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125. *Id.* at 67, 68.

126. *See id.* at 69.

127. *Id.*

128. *See id.* at 70.

129. Gerhardt, *supra* note 97, at 9.

130. Kilborn, *La Responsabilisation*, *supra* note 110, at 669.

131. Gerhardt, *supra* note 97, at 10.

132. *See id.* at 9–10.

133. Kilborn, *La Responsabilisation*, *supra* note 110, at 669.

134. *Id.*

135. *Id.*

of the different contracts.”<sup>136</sup> The commission “may also verify that the contract was entered into with the seriousness imposed by standards of professional practice.”<sup>137</sup> This approach puts a heavy burden on creditors, particularly those who extend credit to overextended debtors.<sup>138</sup>

An additional method of holding creditors responsible is the so-called “Stick Behind the Door” method, which refers to a requirement for creditors to engage in voluntary, and then possibly involuntary settlement negotiations.<sup>139</sup> If creditors refuse to compromise with a debtor who is ready to negotiate, the court can penalize the creditors by granting the debtor a discharge.<sup>140</sup> This practice gives debtors some leverage in negotiations, and makes creditors more willing to settle.<sup>141</sup>

Although the last decade has seen a significant increase in the number of annual bankruptcy filings in France, it seems that France’s liberal legislation did have a moderating effect. After the first liberalizing laws were passed in the early 1990s, France witnessed a decrease in the number of bankruptcy filings.<sup>142</sup> By 1996, however, the number of filings increased again, to approximately 95,000 in 1997.<sup>143</sup> By 2000, bankruptcy filings rose to 150,000 filings per year.<sup>144</sup> This upward trend continued through 2003, when France witnessed a surge in personal bankruptcies.<sup>145</sup> The subsequent liberalizing laws, passed the same year, were followed by relative stagnation in France’s annual rate of filings.<sup>146</sup> One possible explanation for this slowdown is that the liberalization of the insolvency system, while risky, offered over-indebted consumers a fresh-start without opening the floodgates to uncontrollable filings and possible consumer abuse.<sup>147</sup>

France has taken a cautious approach, and has chosen to enact liberalizing laws over an extended period of time. Each law was carefully crafted to put the burdens created by bankruptcy on both debtors and creditors, and at the same time, moderated government

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136. *Id.*

137. *Id.*

138. *Id.*

139. See KILBORN, *COMPARATIVE*, *supra* note 9, at 103.

140. *Id.*

141. *Id.*

142. Kilborn, *La Responsabilisation*, *supra* note 110, at 661–62.

143. *Id.*

144. See *id.* at 662.

145. Gerhardt, *supra* note 97, at 16.

146. See Kilborn, *La Responsabilisation*, *supra* note 110, at 662; Gerhardt, *supra* note 97, at 16.

147. Gerhardt, *supra* note 97, at 10.



intervention where the parties could settle out-of-court.<sup>148</sup> As a result, the rise of bankruptcy filings in France, while initially sharp, is now controlled, although a rise in unemployment is expected to increase the number of insolvencies as well.<sup>149</sup>

### C. Germany

#### 1. Treatment: A “Period of Good Behavior”

Compared to its European counterparts, the German insolvency system employs a unique approach to the treatment of over-indebted consumers.<sup>150</sup> The purpose of its approach is to bridge the gap between the need of debtors to obtain discharge and the need of creditors to moderate consumer access to it, and have debtors repay their debts.<sup>151</sup> Similar to the English and French systems, the German system requires the parties to attempt out-of-court settlements.<sup>152</sup> As with the French insolvency system, if out-of-court negotiations fail, the court tries to impose in-court negotiations.<sup>153</sup> The uniqueness of the German system, however, surfaces when the parties fail to reach an agreement under coerced negotiations. Following such failure, the court requires debtors to formally turnover all nonexempt, work-related income to a trustee.<sup>154</sup> The trustee is required to annually distribute portions of the funds to creditors.<sup>155</sup> At the end of a six-year period, the court discharges most remaining debt, so long as the debtor has shown “good behavior” and adhered to the conditions and requirements of the plan.<sup>156</sup>

The German legislature realized that imposing a six-year period of strict prerequisites on debtors is a daunting task that might lead them to default.<sup>157</sup> In order to help the debtors maintain the required “good behavior,” the legislature enacted a series of periodical incentives that help debtors endure the six-year plan.<sup>158</sup> At the end of the fourth year the trustee refunds debtors a sum equal to 10 percent of any non-exempt

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148. *Id.* at 9–10.

149. Gerhardt, *supra* note 97, at 11.

150. Gerhardt, *supra* note 97, at 8–9.

151. *Id.* at 8.

152. *Id.*

153. *Id.*

154. Jason Kilborn, *The Innovative German Approach to Consumer Debt Relief: Revolutionary Changes in German Law, and Surprising Lessons for the United States*, 24 NW. J. INT'L L. & BUS. 257, 279 (2004) [hereinafter Kilborn, *German Approach*].

155. *Id.*

156. *Id.* at 279–80.

157. *Id.* at 283–85.

158. *Id.* at 279.

income collected during the year.<sup>159</sup> The refund increases to 15 percent in the fifth year, and the discharge at the end of the sixth year is considered the ultimate incentive.<sup>160</sup> Another innovation of the German legislature is its requirement that debtors maintain “reasonable employment.”<sup>161</sup> Failure to do so gives creditors the right to seek a denial of discharge.<sup>162</sup>

Based on the rigidity of these provisions, the German legislature did not intend to give discharge-seeking debtors an easy time.<sup>163</sup> The policy behind this rather grueling six-year plan is a German perception that a discharge of debt is an extraordinary “privilege” that must be earned.<sup>164</sup> The legislation also functions as a protective measure against frivolous and abusive petitions by debtors, which leads to the discussion on the Germany’s approach to prevention of future bankruptcies.<sup>165</sup>

## 2. Prevention: Keeping Bankruptcy Unpleasant to Debtors

The idea of discharge took time to settle in Germany.<sup>166</sup> Even when discharge was finally made into law, the German legislature largely avoided the permissive Chapter 7 model of discharge.<sup>167</sup> Likewise, even the most socially-minded members of parliament disapproved of the concept of granting a “get-out-of-jail-free” card to German consumers.<sup>168</sup>

By mandating a series of negotiations and imposing a six-year period of “good behavior,” the German legislature intentionally departed from the American model, and placed many hurdles in the debtor’s way to full discharge.<sup>169</sup> The German word for the six-year period is *Wohlverhaltensperiode*, which literally translates to “good behavior period.”<sup>170</sup> This reveals the hidden legislative intent beneath the surface of this law; namely, the desire to re-socialize the debtor and allow her to reenter the market as a contributing member.<sup>171</sup> By imposing a six-year hiatus, the German system forces debtors to reflect

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159. *Id.* at 279–80.

160. *Id.* at 280.

161. *Id.* at 280.

162. *Id.*

163. *Id.* at 281.

164. *Id.* at 281–82.

165. *Id.* at 282.

166. *Id.* at 269–71.

167. *Id.* at 289.

168. *Id.*

169. *Id.* at 279–80.

170. *Id.* at 279.

171. *Id.* at 296.

and take control over their financial lives, negotiate with creditors, and maintain working status in order to reach a fair outcome for all parties.<sup>172</sup>

While the stigma attached to bankruptcy has not eroded, Germany experienced a period of increase in annual filings for personal bankruptcy.<sup>173</sup> From 1999 to 2007, the number of personal bankruptcies in Germany exploded from 1,634 to 103,085.<sup>174</sup> Despite the rise in filings, however, the German insolvency law has turned Germany's insolvency system into a necessary evil rather than a convenient outlet for over-indebted consumers.

Whether this law has succeeded in curbing the growth of over-indebted consumers in Germany remains to be seen. In 2008, bankruptcy filings there receded to 95,730, and this statistic has not significantly changed since.<sup>175</sup> The earlier rise in bankruptcy filings between 1999 and 2007 may be explained by the introduction of debt discharge in 1999.<sup>176</sup> This policy opened the door to a great number of over-stretched consumers yearning for relief.<sup>177</sup> The German legislation, however, by designing a harsh yet efficient treatment process, was able to control the rising number of filings, which possibly reached its equilibrium point by 2008.<sup>178</sup> As of now, this explanation remains speculation, and the question of whether this legislation effectively prevents any further rise of filings in Germany still remains unanswered. The rate of bankruptcy filings in Germany over time will determine the success of this truly unique legislation.

#### D. Israel

##### 1. Treatment: Rigid Approach Toward Over-Indebted Consumers

The Israeli bankruptcy system inherited the rigidity of the traditional English insolvency system.<sup>179</sup> Due to some cultural and legal

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172. *Id.*

173. Gerhardt, *supra* note 97, at 9.

174. *Id.*

175. *Number of Insolvencies in Germany from 1950 to 2011*, STATISTA (2012), <http://de.statista.com/statistik/daten/studie/4898/umfrage/anzahl-von-insolvenzen-in-deutschland/>.

176. Gerhardt, *supra* note 97, at 9.

177. *See id.* at 8–9.

178. *Id.* at 9.

179. On English bankruptcy law, see Nathalie Martin, *Common-Law Bankruptcy Systems: Similarities and Differences*, 11 AM. BANKR. INST. L. REV. 367, 370–75 (2003).

variations, however, it evolved quite differently.<sup>180</sup> As other developed nations liberalize their approach toward over-indebted individuals, Israel's liberalization is occurring at a much slower pace.<sup>181</sup> In the context of this article, Israel represents the most conservative application of the fresh-start doctrine.

From its inception, the Israeli insolvency system has been defined by an unforgiving and, at times, hostile attitude towards over-indebted consumers.<sup>182</sup> Legislators, judges and lawyers adopted this approach out of fear that permissive discharge would lead to the financial instability of Israel, which was a young, poor, and beleaguered country in the 1950s and 1960s.<sup>183</sup> Until the mid-1990s, debtors could face imprisonment—a decidedly heavy-handed approach—if they failed to repay their loans.<sup>184</sup> In the 1990s, Israel experienced an increase in imprisonment orders issued against non-paying debtors, a statistic which led to reform in 1996.<sup>185</sup> The reform adopted a pro-debtor approach, and favored the goals of the fresh-start doctrine.<sup>186</sup> The legal culture in Israel, however, has hindered the reception of the reform, and its implementation.<sup>187</sup> Currently, only one of the four districts in Israel, the Jerusalem district, fully yields to the liberalizing provisions put forth by the reform.<sup>188</sup> This division has created an interesting reality in which two opposing paradigms of consumer bankruptcy exist side by side, creating a unique opportunity for comparison.

The Official Receiver's Office is the most influential body in the Israeli consumer bankruptcy system.<sup>189</sup> It is a government agency that conducts all insolvency cases in its district.<sup>190</sup> The focus of the Official Receiver's Office is to find the reasons for the debtor's financial failure.<sup>191</sup> This focus is guided by the perception that debtors whose over-indebtedness is the result of reckless financial conduct are not

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180. See Rafel Efrat, *The Political Economy of Personal Bankruptcy in Israel*, in CONSUMER BANKRUPTCY IN GLOBAL PERSPECTIVE 163–73 (Johanna Niemi-Kiesilainen Ian Ramsey, William Whitford eds., 2003) [hereinafter Efrat, *Political Economy*].

181. *Id.* at 181–82.

182. *Id.* at 170.

183. *Id.* at 170–71.

184. Richard I. Aaron, *Festschrift for Ruth Ann and James Wilson: A Review of Consumer Bankruptcy in Global Perspective*, 12 AM. BANKR. INST. L. REV. 521, 526 (2004).

185. Efrat, *Political Economy*, *supra* note 180, at 167.

186. *Id.*

187. *Id.* at 176.

188. *Id.*

189. *Id.* at 179.

190. *Id.* at 170 n.25.

191. See Efrat, *Israel supra* note 11, at 578–79.

worthy of discharge.<sup>192</sup> Therefore, the Official Receiver's Office spends a good amount of time and effort in investigating the causes of debtors' financial downfall.<sup>193</sup> This harsh measure is particular to the Israeli bankruptcy system,<sup>194</sup> and often intrudes on debtors' privacy, a result running counter to the humanitarian purpose of the fresh-start doctrine.<sup>195</sup>

Once the investigation is complete, and the debtor is deemed honest, she is obligated to make monthly payments to creditors.<sup>196</sup> The amount to be paid is normally determined by the court,<sup>197</sup> and the various benefits and protections awarded by the bankruptcy system, such as stay and discharge, are contingent upon the debtor's payments.<sup>198</sup> Since courts are given great discretion in determining the amount of monthly payments, the court's considerations differ between the pro-debtor district, where the amount is normally low, and the pro-creditor districts, where the amount is normally high.<sup>199</sup> The pro-debtor and liberalized district bases the amount of monthly payments on the debtor's ability to pay.<sup>200</sup> In contrast, the pro-creditor districts base the amount on the size of the debtor's debts.<sup>201</sup> In addition to requiring high monthly payments, the pro-creditor districts mount bureaucratic hurdles, such as a prolonged waiting period for the issuance of a commencement order,<sup>202</sup> which is required under court approval to begin the bankruptcy proceeding.<sup>203</sup> Prior to such issuance, the debtor cannot be declared bankrupt and cannot enjoy the protections of the bankruptcy system.<sup>204</sup> While the commencement order is issued within three weeks in the pro-debtor district, the pro-creditor districts take as long as eighteen weeks to produce this order.<sup>205</sup> Debtors are also required to attend hearings in the pro-creditor districts, whereas the pro-debtor district does not require their presence.<sup>206</sup> Ultimately, the inclination to give discharge is

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192. See Efrat, *Political Economy* *supra* note 180, at 174–78, 183.

193. See *id.* at 183.

194. Efrat, *Israel*, *supra* note 11, at 556–57.

195. *Id.* at 563 n.66; Efrat, *Political Economy*, *supra* note 180, at 183.

196. Efrat, *Political Economy*, *supra* note 180, at 177 n.47.

197. *Id.* at 177.

198. *Id.*

199. *Id.* at 177.

200. *Id.* at 176–77.

201. *Id.*

202. *Id.*

203. *Id.* at 176 n.46.

204. *Id.*

205. *Id.* at 177.

206. *Id.* at 178.

greater in the pro-debtor district, and lower in the pro-creditor districts.<sup>207</sup>

Therefore, the treatment of consumer bankruptcy in Israel is far from uniform as a result of the discrepancy between pro-debtor and pro-creditor districts. Recent findings indicate that Israel's annual rate of personal bankruptcy filings has surged by 2660 percent between 1995 and 2010, particularly in pro-creditor districts.<sup>208</sup> The reason cited for this surge in filings is the 2008 global economic crisis.<sup>209</sup> Nevertheless, the controlled low growth of bankruptcy filings in the pro-debtor district might be an indication of future liberalizing reforms in Israel.<sup>210</sup>

## 2. Prevention: Slow and Cautious Liberalization as the Key to Effective Prevention

In 1997, Israel had approximately 0.16 bankruptcies per 1,000 people.<sup>211</sup> This statistic, in comparison with the United States (5 bankruptcies per one thousand people)<sup>212</sup> and the United Kingdom (0.47 bankruptcies per one thousand people),<sup>213</sup> would have been remarkable if Israel's bankruptcy laws were more open to discharge.<sup>214</sup> While the rate of growth of Israel's consumer bankruptcy filings is still low, those of the United States and the United Kingdom continue to climb sharply.<sup>215</sup> Israel's strikingly low rate of bankruptcy filings can be linked to its harsh, and often unforgiving, treatment of debtors.<sup>216</sup>

Israel's policy tools for preventing the rise of bankruptcy filings, however, are not limited to its grudgingly given discharge, or the costly and unpleasant procedure imposed on relief-seeking debtors. Part of Israel's economic policy is also to employ stringent restrictions on financial institutions, limiting the propensity of creditors to extend risky

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207. *Id.*

208. Mark Sean, *The Crisis by Numbers: A Sharp Rise in Bankruptcies in 2009*, CALCALIST (Feb. 2, 2010), <http://www.calcalist.co.il/local/articles/0,7340,L-3390707,00.html>; Mark Sean, *A Surge of Personal Bankruptcy Filings, Almost 30 Times Then 1995–2010*, CALCALIST (Aug. 18, 2011), <http://www.calcalist.co.il/local/articles/0,7340,L-3528521,00.html>.

209. *Id.*

210. Rafael Efrat, *The Transformation of the Israeli Bankruptcy System as a Reflection of Societal Changes*, 10 J. TRANSNAT'L L. & POL'Y 39, 41–46 (2000) [hereinafter Efrat, *Transformation*].

211. Efrat, *Political Economy*, *supra* note 180, at 173 n.32.

212. Efrat, *Global Trends*, *supra* note 19, at 100–01.

213. *Id.* at 101.

214. *Id.* at 101–05.

215. Efrat, *Political Economy*, *supra* note 180, at 163–73.

216. *Id.* at 181–82.

loans.<sup>217</sup> Stigma also plays an important role in curbing the number of people willing to resort to bankruptcy, which leads them to act with financial responsibility.<sup>218</sup>

Based on these findings, it may be unjust to label Israel's bankruptcy system as resoundingly pro-creditor. Israel's policies can be described as cautious towards *both* debtors and creditor.<sup>219</sup> Throughout its short and precarious history, the Israeli legislature knowingly put a heavy burden on both parties (with an admitted emphasis on debtors) in an effort to prevent bankruptcy filings and over-indebtedness and the inevitable financial instability.<sup>220</sup> The Israeli approach is perhaps most helpful in demonstrating that incentives do work.<sup>221</sup> While the implementation of the fresh-start doctrine in Israel is admittedly lacking,<sup>222</sup> it is possible that Israel's careful and slow liberalization might be the source of its success in steadily preventing bankruptcy filings.

#### V. REALIGNING THE AMERICAN CONSUMER BANKRUPTCY SYSTEM: DEVISING A NEW APPROACH

Discharge of debt is the most radical form of treatment for over-indebtedness.<sup>223</sup> Even the National Bankruptcy Review Commission in the United States, which holds a fairly pro-debtor approach to consumer bankruptcy,<sup>224</sup> concluded in its 1997 report that the 1978 Bankruptcy Code's permissive approach to discharge was flawed as originally enacted.<sup>225</sup> While the United States has long maintained a liberal approach to discharge, the BAPCPA has led the American bankruptcy system to the other extreme, and adopted a strongly pro-creditor approach.<sup>226</sup> With the passage of the BAPCPA, it is clear that Congress rejects the permissive Chapter 7 approach to discharge.<sup>227</sup> The

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217. Efrat, *Transformation*, *supra* note 210, at 104 n.112.

218. *Id.* at 106.

219. See Efrat, *Israel*, *supra* note 11, at 587–90.

220. See Efrat, *Israel*, *supra* note 11, at 587.

221. Efrat, *Transformation*, *supra* note 210, at 51.

222. Efrat, *Israel*, *supra* note 11, at 557.

223. Niemi-Kiesilainen, *supra* note 1, at 6.

224. Tabb, *supra* note 5, at 775.

225. WARREN, *supra* note 10, at 507.

226. *Id.* at 517.

227. WARREN, *supra* note 10, at 515.

alternative offered by the BAPCPA, however, fails to uphold the goals of the fresh-start doctrine.<sup>228</sup>

The discussion above offers a rudimentary, albeit comprehensive, review of the various tools with which consumer bankruptcy policies were created in Europe and Israel. The following discussion will apply these tools to the BAPCPA, and consider new possible approaches to discharge of consumer debt in the United States.

### *A. Imposition of Out-of-Court Negotiations*

In reforming the American bankruptcy system, one must consider installing forceful policies that would encourage debtors and creditors to settle out of court. Such policies, which are pervasive in the three European countries examined, have proven a useful and amicable replacement to the coercive bankruptcy process, and do not burden a country's judicial system since bankruptcy cases are kept out of court.<sup>229</sup>

The English IVA model may not be the best one to follow. Due to its high cost, the IVA model exposes debtors to even greater indebtedness and leaves them without recourse if they fail to comply with the IVA repayment plan.<sup>230</sup> Alternatively, the French insolvency system offers more tailored relief to debtors. The French legislature's aversion to discharge and its decision to apply discharge only in correlation to the size of indebtedness has given debtors and creditors an opportunity to resolve their issues independently.<sup>231</sup> As the parties fail to reach a solution, a commission is gradually given more power to force one upon them.<sup>232</sup> The American Chapter 7 discharge model, which offers a single quick discharge to all forms of debtors, maximizes the loss creditors must suffer, and encourages debtors to act recklessly with relative impunity.<sup>233</sup> Further, the Chapter 7 approach to discharge places a great burden on the judicial system, funneling all cases to courts, when some could reach out-of-court agreements. By making distinctions between debtors based on the size of their indebtedness, the

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228. *Sen. Kerry on Bankruptcy Reform*, AM. BANKR. INST. (Aug. 1, 2004), <http://www.abiworld.org/AM/PrinterTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=52637>.

229. KILBORN, *COMPARATIVE*, *supra* note 9, at 64, 88.

230. *Id.* at 88–89.

231. *Id.* at 69.

232. *Id.* at 63.

233. Zywicki, *Bankruptcy Reform*, *supra* note 16, at 57–60.



French insolvency system allows at least 80 percent of its bankruptcy cases to be resolved through settlements.<sup>234</sup>

The French approach to out-of-court negotiations is largely defined by the “Stick Behind the Door” system.<sup>235</sup> As discussed above, this system penalizes creditors who are unwilling to negotiate with a willing debtor by granting the debtor some type of discharge.<sup>236</sup> American bankruptcy law does not have a similar provision. In fact, it actively denounces distinctions between creditors under Chapter 13 bankruptcy.<sup>237</sup>

The one provision that seems to require some out-of-court negotiation in U.S. Bankruptcy Code states that the court may reduce the creditor’s claim if a creditor “refuses to negotiate a reasonable alternative repayment schedule proposed on behalf of the debtor by an approved nonprofit budget and credit counseling agency.”<sup>238</sup> This provision, however, loses its efficiency due to its own limitations. One limitation is that the “reasonable alternative repayment schedule” must have been made at least 60 days before the debtor’s bankruptcy filing; once the creditor makes it clear that it will not settle out of court, the debtor will immediately file for bankruptcy and not wait sixty days.<sup>239</sup> A second limitation is that the debtor must offer to pay at least 60 percent of the payment to any one creditor within a “reasonable extension” of the original contractual repayment period.<sup>240</sup> Needless to say, many debtors cannot afford to make such an offer.<sup>241</sup> A third limitation is that the maximum punishment to creditors is a 20 percent reduction of their claim.<sup>242</sup> This sanction is too low to deter creditors from refusing alternative dispute resolution.<sup>243</sup> Therefore, despite the apparent inclusion of a “Stick Behind the Door” provision in the American Bankruptcy Code, this aspect of the code remains toothless and ineffective.<sup>244</sup>

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234. KILBORN, COMPARATIVE, *supra* note 9, at 64; Kilborn, *La Responsabilisation*, *supra* note 110, at 663.

235. KILBORN, COMPARATIVE, *supra* note 9, at 103.

236. *Id.*

237. 11 U.S.C. § 1322(b)(1) (2004).

238. 11 U.S.C. § 502(k)(1)(A) (2004).

239. KILBORN, COMPARATIVE, *supra* note 9, at 104.

240. *Id.*

241. *Id.*

242. *Id.*

243. *Id.*

244. *Id.*

*B. Adoption of a “Good Behavior Period” Approach to Discharge*

The American bankruptcy system ought to heed the unique “good behavior period” law of the German insolvency system. The “good behavior period” maintains both goals of the fresh-start doctrine by providing adequate relief to over-indebtedness, and attaches the risk of loss to both debtors and creditors.<sup>245</sup> The six-year period mandated by German law can deter abusive conduct by making the process too protracted for abuse to be worthwhile.<sup>246</sup> In addition, the German law wields a large “stick” over debtors in the form of the “good behavior” requirement, which demands the debtor maintain a working status.<sup>247</sup> With the promise of discharge at the end of the sixth year, debtors are strongly incentivized to endure the six-year period or lose the protections of the bankruptcy system by failing to comply with the “good behavior” requirement.<sup>248</sup>

Enacting such a law in the United States would appease those who advocated for the BAPCPA by imposing an arduous path on the way to discharge, while at the same time upholding the goals of the fresh-start doctrine, which the BAPCPA approach currently does not maintain.<sup>249</sup>

In addition, the focus of the German law is on debtors’ financial accountability.<sup>250</sup> This is what ultimately sets the German insolvency system apart from that of the United States.<sup>251</sup> While the BAPCPA did much to eliminate free access to discharge, it did little to evoke a sense of financial responsibility with consumers and encourage them to reflect on the long-term goals of their financial lives.<sup>252</sup> One of the useful by-products of the German law is the creation of a six-year buffer between the time of insolvency and the time of debtor’s re-socialization.<sup>253</sup> It offers debtors an opportunity to reflect on what went wrong and how they can avoid insolvency in the future.<sup>254</sup>

However, the application of the “good behavior period” approach in the United States is not without problems. Due to the United States’ modest social welfare system and its low wage exemptions, bankrupts

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245. See Kilborn, *German Approach*, *supra* note 154, at 280.

246. *Id.* at 281, 285.

247. *Id.* at 280.

248. *Id.* at 280–81.

249. See Warren *supra* note 10 at 517–18; Kilborn, *German Approach*, *supra* note 154, at 296.

250. Kilborn, *German Approach*, *supra* note 154, at 279–82.

251. *Id.* at 281–82.

252. *Id.* at 296–97.

253. *Id.* at 296.

254. *Id.* at 297.

have little support to help them through a “good behavior period.”<sup>255</sup> With extensive welfare benefits and high wage exemptions, German bankrupts enjoy firm support and are, therefore, more likely to endure the protracted period than their American counterparts.<sup>256</sup> The consistent failures of many Chapter 13 repayment plans bolster this argument.<sup>257</sup>

### C. Adoption of a “Third Way” Approach to Prevent Over-Indebtedness

The construction of an effective over-indebtedness prevention policy cannot be confined to the bankruptcy system alone. The “Third Way” envisions a consumer credit market in which both debtors and creditors are sufficiently informed and motivated to take reasonable risks and engage in responsible conduct.<sup>258</sup> To promote this vision, the English DTI created the so-called “Over-indebtedness Action Plan,”<sup>259</sup> an effort to which future reformers ought to pay attention.

Preventative measures should not be limited to provisions and incentives within the bankruptcy system, but should extend to the various extraneous players who shape the consumer credit industry.<sup>260</sup> The “Third Way” approach maintains that the task of preventing over-indebtedness could go beyond mere incentives and actually set a standard of conduct within the industry.<sup>261</sup>

A notable initiative by the British DTI is the introduction of a mechanism to investigate interest rate ceilings, which is intended to limit predatory loans extended to weak lenders.<sup>262</sup> The 2008 subprime crisis was defined by the practice of extending high interest loans to risky debtors. Unscrupulous creditors generate large profit through this practice while ignoring the fact that debtors will ultimately become over-indebted.<sup>263</sup>

Such efforts to extraneously curb over-indebtedness should coincide with the creation of limiting provisions within the bankruptcy system.<sup>264</sup> Such provisions could include, for instance, laws that refuse to accommodate the interests of predatory creditors.<sup>265</sup> In France, the

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255. *Id.* at 292–94.

256. *Id.* at 293.

257. *See id.* at 294–96.

258. Ramsay, *supra* note 84, at 655.

259. Kilborn, *German Approach*, *supra* note 154, at 296–97.

260. Ramsay, *supra* note 84, at 655–56.

261. *Id.* at 655.

262. *Id.* at 253.

263. *See id.*

264. Ramsay, *supra* note 84, at 654–55.

265. Kilborn, *La Responsabilisation*, *supra* note 110, at 669.

insolvency laws require courts to view the interests of predatory lenders in an unfavorable light.<sup>266</sup> Currently, American bankruptcy laws do not offer such a distinction between abusive and non-abusive creditors and, in some cases, even proscribe it.<sup>267</sup> Creating provisions that would galvanize the parties to be responsible, concomitant with efforts to influence extraneous players within the consumer credit industry, could effectively curb the yearly rise in bankruptcy filings.<sup>268</sup>

One of the obstacles to undertaking such efforts in the United States is the existence of a federalist system, in which the authority over credit and debt regulation is divided between the state and federal governments.<sup>269</sup> A concentrated government effort to tackle over-indebtedness by adopting the “Third Way” approach requires greater control over the different players in the consumer credit market.<sup>270</sup> Therefore, if such efforts are to be seriously implemented in the United States, it must be done in concert between the states and the federal government.

## VI. CONCLUSION

In order to comply with the goals of the fresh-start doctrine, the American bankruptcy system should move away from the presumption that most debtors intend to abuse the system. At the same time, while debtors are not inherently abusive, the American bankruptcy system should not return to the lax approach to discharge applied in the 1978 Bankruptcy Code. The realignment of the American bankruptcy system with the goals of the fresh-start doctrine means that while debtors are offered an opportunity to rejoin the consumer market, unencumbered by debt, proper safeguards are put in place to accommodate the interests of creditors as well.<sup>271</sup>

Such safeguards should exist in both the treatment of existing, and the prevention of future, over-indebtedness. As in France, most solutions of existing over-indebtedness should be made outside of court, and as part of a consensual and amicable settlement. It would benefit both parties and the judicial system if debtors and creditors were encouraged to resolve their issues without intervention.

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266. *Id.*

267. 11 U.S.C. § 1322(b)(1) (2004).

268. Kilborn, *La Responsabilisation*, *supra* note 110, at 671.

269. Ramsay, *supra* note 84, at 656.

270. *Id.* at 655.

271. Dickerson, *supra* note 14, at 155.

Where intervention in the bankruptcy system cannot be avoided, such intervention should be need-based, and performed with care. If parties do not need strong intervention, the bankruptcy system should exercise only mild coercion that would help the parties obtain compromise. Where compromise seems impossible, it would be prudent to give full discharge.

Discharge is a privilege, so in order to avoid a perverse consumer incentive to prefer extreme indebtedness in order to avoid repayment and compromise, a “good behavior period” system should be enacted in cases where full discharge is contemplated. By taking such measures, discharge would become a necessary evil to debtors, who would not rush to take risky loans. In addition, it would make creditors more selective in extending loans to consumers.<sup>272</sup>

Furthermore, Congress should make sincere efforts to work with the consumer credit industry to promote a standard of responsible conduct. The combination of incentivizing provisions within the bankruptcy system and cooperation between Congress and the consumer credit industry will effectively prevent over-indebtedness.<sup>273</sup> Such efforts should concentrate on curbing abuse, such as predatory loans, that cannot be remedied through the bankruptcy system alone.

Finally, the process of reforming the American bankruptcy system must not occur overnight. The Israeli insolvency system is a useful example in understanding the transition from a conservative to liberal bankruptcy system. While Israel’s transition is not complete and is not defined by efficiency, it provides financial stability to a country that suffers from regional geo-political instability.<sup>274</sup> This gradual liberalization is also evident in the French insolvency system, which liberalized based on the need to offer debtors greater relief.<sup>275</sup> In such precarious times, the American economy requires stability, and the lesson to be taken from the French and Israeli experiences is that any reform to the American bankruptcy system should not occur immediately, but over time.

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272. See David A. Moss, *The Rise of Consumer Bankruptcy: Evolution, Revolution or Both?*, 73 AM. BANKR. L.J. 311, 328–31 (1999).

273. Kilborn, *La Responsabilisation*, *supra* note 110, at 671; David A. Lander, “It ‘Is’ the Best of Times, It ‘Is’ the Worst of Times”: *A Short Essay on Consumer Bankruptcy After the Revolution*, 78 AM. BANKR. L.J. 201, 219 (2004).

274. Efrat, *Political Economy*, *supra* note 180, at 170–71, 181–83.

275. Kilborn, *La Responsabilisation*, *supra* note 110, at 621.