

# Individual Bankruptcy in the US

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Lessons for Hungary

by

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## **A b s t r a c t**

Indebtedness of individuals is a recognized issue by the US and every major jurisdiction in Europe. A possible legislative response for this problem is the individual bankruptcy. This procedure rearranges debtor's financial situation, closes the prior bankruptcy life of the debtor and discharges him from the constraints of pre-bankruptcy debts. Discharge is the counter point of two opposite interests: the debtors are naturally in favor of sharing of the risk of their default with creditors while the creditors are lobbying for the unavailability or for the tightening of discharge.

The Hungarian legislation has not yet enacted any law concerning individual bankruptcy despite the serious over-indebtedness of Hungarian households. There are only a few legal scholar articles about this topic and those only argue for establishing the system but do not make any suggestions how the legislator should regulate this field. That is why the ultimate goal of this thesis is elaborating the theoretical basis of a Hungarian individual bankruptcy procedure.

In order to reach this outcome I summarize the possible justifications and also the drawbacks related to the fresh start of individual debtors. After that, I show what the pillars of a working individual bankruptcy system are by describing the main points of the US Bankruptcy Code. Then after a brief insight into the financial conditions of Hungarian families I propose a liberal and at the same time strict regulation which gives a generous discharge in exchange for serious sacrifice.



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## Introduction

Availability of consumer credit increased dramatically worldwide from the 1990's.<sup>1</sup> If credit is easily available consumers will use it and start consuming from their future earnings. But "where debt goes inability to pay will follow".<sup>2</sup> The question remains how (if at all) states handle the drastically increased indebtedness of consumers. One possible solution is individual bankruptcy, a judicially supervised legal procedure for the rearrangement of a debtor's financial situation. In fact, the US legislator had recognized individual's need for help of the legal system in the case of financial trouble and provided the possibility of financial relief for individuals as early as the middle of the 19<sup>th</sup> century. In the last decades of the 20<sup>th</sup> century Western-European and later Central-East European countries enacted individual bankruptcy laws as an acknowledgement of the fact that the overall social benefits provided by this procedure outweighs such general principles as freedom of contracts and the obligation of full-performance of contracts and creditors' interest in the full repayment of every outstanding debt.

Despite the serious over-indebtedness of Hungarian households caused by the boom of consumer credit from 2000 and the global economic crisis, the Hungarian legal system has not given helping hand for individuals by giving them the shelter of bankruptcy. In the lack of the legal procedure of individual bankruptcy "creditors may kick the debtor who is already in the

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<sup>1</sup> Tabb, Charles J.: *Lessons from the Globalization of Consumer Bankruptcy*; University of Illinois College of Law, Law and Economics Working Papers, 2005 Paper 29 (hereinafter: *Lessons from the Globalization of Consumer Bankruptcy*) ; p 6

<sup>2</sup> *id.* p 5



ground” until they think they can get more payment from the debtor and push him even to homelessness. Few legal scholars emphasized the need for such a procedure but they did not suggest how it should be implemented. Among the boundaries of the length of a short thesis and my own theoretical and practical knowledge the ultimate goal of this thesis is to establish the basic notions of a possible Hungarian regulation to fill this legislative and scholarly gap.

In order to reach this outcome, in the first chapter I summarize the justifications of the discharge given by individual bankruptcy. As US has one of the longest history and most sophisticated individual bankruptcy system, in the second chapter I outline the basic legal institutions of US Bankruptcy Code which may serve as pattern for the Hungarian legislation. In the third chapter I briefly show the current financial situation of Hungarian households and then elaborate my proposal for the theoretical framework of a future Hungarian legislation.



# Chapter 1 General Overview of Individual Bankruptcy

## 1.1. Definition and general structure

For laymen bankruptcy means financial failure<sup>3</sup>, the expression “going bankrupt” has a negative tone. In a legal sense bankruptcy means much more than financial trouble, for example, insolvency is not a requirement to be voluntary individual debtor under U.S Bankruptcy Code.<sup>4</sup> According to the definition in Black’s Law Dictionary<sup>5</sup> bankruptcy is not a status, but a judicially supervised legal procedure. This procedure’s fundamental characteristics are the financial relief provided for the debtor and the repayment of debts for creditors via a repayment plan or liquidation of the debtor’s asset. I would add one more very important feature which is not explicitly expressed in the definition above: bankruptcy is a collective debt collection device.

The two main types of bankruptcy procedures are distinguished by the time a debtor gets financial relief. In the case of liquidation of assets the debtor receives an immediate discharge in exchange for the sale of debtor’s assets for the benefit of creditors. Here the debtor’s future earnings are free from creditors’ claim for the price of giving up every non-exempt asset. Only a handful of countries provide the opportunity of immediate discharge for an individual<sup>6</sup>. Legislators mostly<sup>7</sup> require debtors to make a repayment plan which works the

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<sup>3</sup> “Bankruptcy is a legal status of a person or organization that cannot repay the debts it owes to creditors.” - Wikipedia

<sup>4</sup> Baird, Douglas G.: THE ELEMENTS OF BANKRUPTCY, Fifth Edition, New York, New York, The Foundation Press, Inc. 2010; (hereinafter: The Elements of Bankruptcy) p 8

<sup>5</sup> “A statutory procedure by which a (usu. insolvent) debtor obtains financial relief and undergoes a judicially supervised reorganization or liquidation of the debtor’s assets for the benefit of creditors; a case under the Bankruptcy Code (Title 11 of the United States Code).” Black’s Law Dictionary 9<sup>th</sup> Edition 2009

<sup>6</sup> In the US Chapter 7 of Bankruptcy Code provides immediate discharge for debtors, see details *infra* 2.2 France has similar procedure to Chapter 7, the so called *procédure de redressement personnel sans liquidation*



opposite way to liquidation. The debtor can keep every asset but has to satisfy at least partly creditors' claims during a given time<sup>8</sup> scheduled by a repayment plan. If the plan is successfully fulfilled the debtor is free from debts not satisfied by the plan.

Collective debt collection nature of bankruptcy is a key feature. From the beginning of the procedure creditors are barred from any individual debt collection effort against the debtor. Filing of petition in bankruptcy stops the race of creditors for debtor's assets and every claim is enforced against the debtor in a single procedure in pro rata basis as a general rule. The trustee or administrator registers the claims, collects and distributes debtor's assets among creditors in liquidation or supervises the completion of repayment plan. Every party saves time and costs. The debtor does not have to be involved in several parallel procedures and creditors are assured that the debtor does not have more available assets.

## 1.2. History of US discharge

Granting relief for a financially distressed debtor was not always the aim of bankruptcy procedures. In ancient and medieval ages non-performing debtors were subjects of criminal procedures, they often had to pay for their outstanding debts with their and their families' life, freedom or human dignity.<sup>9</sup> US bankruptcy law as the whole US legal system originates from English law. The first bankruptcy act providing discharge of debts was enacted in England, the Statute of 4 Anne, titled "An act to prevent frauds frequently

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*judiciaire.*; see Lőrinczi Gyula: *A csődjogi mentesítés elméleti alapjai* [Theoretical Foundations of Bankruptcy Discharge] Jogelméleti Szemle, 2011/2 available at <http://jesz.ajk.elte.hu/lorinczi46.html> (hereinafter: *Theoretical Foundations of Bankruptcy Discharge*)

<sup>7</sup> For a detailed comparison of the US and major Western-European consumer bankruptcy systems see Kilborn, Jason J. - *COMPARATIVE CONSUMER BANKRUPTCY*; Durham, North Carolina; Carolina Academic Press, 2007; 114 p (hereinafter: *COMPARATIVE CONSUMER BANKRUPTCY*)

<sup>8</sup> In US the length of repayment plan is between three and five years. - *THE ELEMENTS OF BANKRUPTCY supra note 4*; p50

In Austria it is seven years, in Germany six years, and three years in the Netherlands. *COMPARATIVE CONSUMER BANKRUPTCY supra note 7*; pp 78-85

<sup>9</sup> for a summary of evolution of ancient and medieval bankruptcy laws see Levinthal, Louis Edward: *The Early History of Bankruptcy Law*; University of Pennsylvania Law Review and American Law Register, Vol. 66, No. 5/6(Apr., 1918), pp. 223-250



committed by bankrupts”. The title clearly shows the primary goal of the act was not to provide help for debtors in trouble but to prevent debtor’s fraudulent conducts. The statute applied a carrot and stick approach. The statute offered discharge and five percent of the gathered assets for debtors who cooperated. But those debtors, who tried to hide assets or hampered any other way the satisfaction of creditors, were sentenced to capital punishment.<sup>10</sup>

The founding Founders thought that furtherance of interstate commerce could be better achieved by a federal level regulation of bankruptcy.<sup>11 12</sup> The first three federal bankruptcy acts were issued in times of financial crises<sup>13</sup> and were in force for a very short time.<sup>14</sup> But the second bankruptcy act brought a significant change in the underlying policy. The Bankruptcy Act of 1841 made discharge available for individuals too, and during the debate it was articulated clearly that legislator intended bankruptcy not to be only a debt collection device but a procedure by which the state gives help to “honest but unfortunate” debtors.<sup>15</sup> Permanent bankruptcy legislation began in 1898<sup>16</sup>. The Bankruptcy Act of 1898 was truly debtor-friendly in its original version; it provided immediate discharge with few exceptions for individual debtors too, without creditors’ consent. The subsequent history of legislation

<sup>10</sup> Baird, Douglas G.: *A World Without Bankruptcy* ; Law and Contemporary Problems, 1987 Vol. 50 No. 2 pp. 173-193 (hereinafter: *A World Without Bankruptcy*) p 174

<sup>11</sup> Czarnetzky, John M. : *The Individual and Failure: A Theory of the Bankruptcy Discharge*; Arizona State Law Journal Summer, 2000; 32 Ariz. St. L.J. 393 (hereinafter: *The Individual and Failure*) p 427

<sup>12</sup> U.S. CONST. art. I, § 8, cl. 4. “The Congress shall have Power To... establish... uniform Laws on the subject of Bankruptcies throughout the United States”

<sup>13</sup> *The Individual and Failure supra note 11*; p 427

<sup>14</sup> The first federal bankruptcy law was issued in 1800 and remained in force for three year. The second was enacted in 1841 and were in existence for two years. The third one was passed in 1867 and existed until 1878. Sousa, Michael D.: *The Principle of Consumer Utility – A Contemporary Theory of the Bankruptcy Discharge*, Kansas Law Review 2010. Vol. 58. pp 553-614 (hereinafter: *The Principle of Consumer Utility*) pp 563-564

<sup>15</sup>“ [t]he right of the State (I use the term in its broadest sense[, ie., the nation]) to the use of the unimpaired faculties of its citizens as producers, as consumers, and as defenders of the commonwealth, is paramount to any rights or relations which can be created between citizen and citizen. But an honest and unfortunate debtor, borne down by a hopeless mass of debt from beneath which he can never rise, is prostrated and paralyzed, and rendered utterly incapable of performing his duties to his family or his country. To say nothing of the dictates of humanity ... I maintain that the public right of the State, in all the faculties of its members, moral and physical, is paramount to any supposed rights which appertain to a private creditor. This is the great principle which lies at the bottom of all bankrupt laws, and it is this which gives to the States the right to demand the passage, and imposes upon congress the duty of enacting a bankrupt system.” *The Individual and Failure supra note 11*; p 428 quoting 26th Cong., 1st Sess., Cong. Globe 816 (June 4, 1840 App.)

<sup>16</sup> Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898) (repealed 1978).



was determined by creditors' fight for a pro-creditor regulation, for a narrower and conditional discharge. Most important achievement of creditors' was the enactment of Chapter 13<sup>17</sup> which provided a voluntary conditional and not immediate discharge provision. Creditors' efforts for making Chapter 13 mandatory were not successful.<sup>18</sup>

What we call the today the Bankruptcy Code was passed as the Bankruptcy Reform Act of 1978. The Code was standing on the ground of broad discharge until 2005. In 2005 the Bankruptcy Abuse Prevention and Consumer Protection Act<sup>19</sup> (hereinafter: BAPCPA) was enacted after decades of active lobbying activity of the credit industry.<sup>20</sup> BAPCPA amended the Bankruptcy Code in favor of creditors. The most important provisions are the implementation of means tests, extended mandatory minimum time period between two discharges, requirement of credit counseling before filing and the narrowing the scope of discharge. All of these changes were meant to prevent alleged abuses committed by high-income debtors to escape from their debts and directing them to conditional discharge of Chapter 13. According to statistics, BAPCPA did not reach this goal; the number of debtors eligible for immediate relief did not change significantly since "the individuals filing for bankruptcy are not high-income earners shirking their contractual obligations, but rather individuals and families struggling with insurmountable debt loads."<sup>21</sup>

This short summary clearly shows that the history of bankruptcy is determined by the conflicting interests of debtors and creditors. Modern acts distinguished bankruptcy from criminal procedure and a pro-debtor attitude was reflected by federal bankruptcy acts from the middle of nineteenth century in the US. This perception was changed by BAPCPA which created a more creditor friendly legal environment in the field of individual bankruptcy.

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<sup>17</sup> see details *infra* 2.3

<sup>18</sup> *The Individual and Failure supra* note 11; pp 430-431

<sup>19</sup> Public Law No. 109-8, 119 Stat. 23, April 20, 2005

<sup>20</sup> *The Principle of Consumer Utility supra* note 14, p 574

<sup>21</sup> *id.* p 578



## 1.3. Justifications of discharge

### 1.3.1. Legal theoretical foundations

Gyula Lőrinczi<sup>22</sup> found the legal basis of discharge in the immanent nature of private law. Private law governs legal relations between independent, equal parties. Since private parties are theoretically equal, private law treats parties equally and tries to maintain the balance in the parties' relationship. But there are certain relations where the economic reality is different and one party is considerably weaker than the other. In these situations law steps in to equalize the parties' strength. Consumers are obviously weaker in an economic and professional sense compared to businesses. The legal system recognizes the inequality because of the inside nature of private law and by legal measures set the balance between the parties. The same pattern works if one party gets into financial trouble. The party in financial distress is not equal anymore and becomes completely dependent on his creditors. This is the reason why major jurisdictions provide an escape option for heavily indebted debtors from their contractual obligation. When the over-indebted party is a consumer, the inequality is even bigger and that is why even more drastic legal responses can be justified.<sup>23</sup> Lőrinczi considers discharge as an exception from the obligation of full-performance for maintaining equality between the parties in legal relation.

Thomas Jackson<sup>24</sup> establishes legal foundation before he explains his impulse control and incomplete heuristics theories.<sup>25</sup> Freedom of contract is a basic notion of American legal system and society. Principle of freedom of contracts is based on two assumptions: individuals can act rationally in favor of their best interests and third parties do not bear any

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<sup>22</sup> *Theoretical Foundations of Bankruptcy Discharge supra note 6*

<sup>23</sup> *id.* p 9-10

<sup>24</sup> Jackson, Thomas H. – *Fresh-Start Policy in Bankruptcy Law*, Harvard Law Review, Vol. 98, No. 7 (May, 1985), pp. 1393-1448 [hereinafter: *Fresh-Start Policy in Bankruptcy Law*]

<sup>25</sup> see details *infra* 1.2.3.4.



costs. If any of these two assumptions do not stand in a particular case then application of the principle which is built on them can be restricted. He mentions fraud, undue influence as examples of legal responses to inability of acting in one's best own interest and tort law as instance of legal intervention supporting those who are adversely affected by others' conduct. According to his impulse control and incomplete heuristics theories consumers cannot enter into contractual relationships rationally because they are impulse buyers and underestimate the risk of consuming from their future income. Furthermore, he shows that third parties be adversely affected by their irrational decisions. Since he challenges both presumptions he finds his theories justify nonwaivable discharge as an intervention into an individual's autonomy.<sup>26</sup>

Jackson, compared to Lőrinczi, additionally includes the costs imposed on third parties as a possible reason for providing escape for debtors from the obligation of full performance.

John M. Czarnecky<sup>27</sup> draws an analogy between impossibility excuse doctrine and bankruptcy discharge as theoretical starting point of his entrepreneurial hypothesis.<sup>28</sup> Courts use foreseeability, superior risk-bearer and fairness tests to examine the applicability of impossibility excuse. In Czarnecky's opinion, the same logic can be applied for bankruptcy discharge as for impossibility. Bankruptcy discharge is justified if a debtor cannot perform; neither party could foresee debtor's financial failure; the creditor is a superior risk bearer because he is in a better position to prevent failure or to insure himself for the case of other party's inability to perform; and discharge has fair results.<sup>29</sup>

Financial relief offered by the US Bankruptcy Code or other bankruptcy laws is not a general rule, but an exception. From a civil law perspective it is a *lex specialis* to reset the

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<sup>26</sup> *Fresh-Start Policy in Bankruptcy Law supra note 24*; p 1405

<sup>27</sup> *The Individual and Failure supra note 11*

<sup>28</sup> see details *infra* 1.3.2.2.

<sup>29</sup> *The Individual and Failure supra note 11* pp 415-423



disturbed balance between private parties. For common lawyers nonwaivable discharge can be viewed as an exception from the freedom of contracts applicable when one party cannot act in his best interest or costs are imposed on non-contracting third parties. From another common law aspect discharge is an excuse of non-performance analogous to impossibility doctrine. The common point of these theories is the legal nature of discharge as an exception. Moreover, it is an exception of such strong basic legal notions like freedom of contract and *pacta sunt servanda*. The following subchapters summarize economic, psychological and humanitarian justifications of the application of such a drastic intervention into private legal relations.

### 1.3.2. Economic reasoning

#### *1.3.2.1. Risk allocation*

Risk allocation is a central issue because who bears risk will pay costs too. Basic economic notion of risk allocation is the internalization of risk. Risk of a particular relationship should be borne by parties whose conduct gives rise to the risk. For bankruptcy it means the costs emerging from debtors' default should be paid by debtors and creditors and not by the taxpayers in general. Inside the credit relationship the risk of financial distress should be imposed on the party who is the better risk bearer.<sup>30</sup> This is the party who is more able to prevent the risk from materialization and who is the "superior insurer".<sup>31</sup> The ability to prevent default and insure for the occurring of it depends on availability of information and on who sets the rules of the market.<sup>32</sup>

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<sup>30</sup> *Theoretical Foundations of Bankruptcy Discharge supra note 6; p 12-13*

Howard, Margaret: *A Theory of Discharge in Consumer Bankruptcy*; Ohio State Law Journal 1987; 48 Ohio St. L.J. 1047 (hereinafter: *A Theory of Discharge in Consumer Bankruptcy*) p 1063

<sup>31</sup> *A Theory of Discharge in Consumer Bankruptcy supra note 30; p 1063*

<sup>32</sup> *Theoretical Foundations of Bankruptcy Discharge supra note 6; p 13*



In consumer debtor-commercial lender relations commercial lenders have more information than consumers. In an individual case, the borrower may know more about his own financial situation but on the market level lenders have actuary knowledge and by statistical measures they can predict the likelihood of financial failure. If the lender examines the financial affair of the borrower he can easily assess the risks by mathematical calculations. Once he obtains the necessary information about the borrower's financial affairs and calculated the risks they can decide whether they lend money to the specific borrower or not.<sup>33</sup> Moreover we cannot expect consumers to understand the often complicated and detailed financial structure of a loan contract. Furthermore, lenders determine the basic rules of the market by using their stronger bargain position to impose their general terms and conditions on borrowers. Lenders can easily prevent the occurring of default by not taking excessive risk. Even if they take risk, commercial lenders can buy bad-debt insurance.<sup>34</sup>

Insurance does not necessarily mean literally an insurance contract. Commercial lenders can calculate the risk of default into the price of the credit, into the interest rates. In the end it is not them who pay the costs of default but on the market level the community of debtors. This is the so-called insurance policy reasoning of discharge. Every debtor pays insurance premium for the availability of discharge which cumulated in the price of the credit and in return creditor bears the part of the loss of the particular debtor's failure.<sup>35</sup> That is why theoretically discharge has an interdebtor effect; costs of bad-debts' failure are borne by every debtor.

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<sup>33</sup> *Fresh-Start Policy in Bankruptcy Law* *supra* note 24; p 1426

<sup>34</sup> *A Theory of Discharge in Consumer Bankruptcy* *supra* note 30; p 1064

<sup>35</sup> Adler, Barry E., Baird, Douglas G., Jackson, Thomas H. – BANKRUPTCY: CASES, PROBLEMS AND MATERIALS; New York, New York Foundation Press; Fourth Edition, 2007; 797 p (hereinafter: BANKRUPTCY: CASES, PROBLEMS AND MATERIALS) p. 560



To summarize, discharge is justified by risk-allocation theory because lenders are in the best position with their information and economic power to bear the risk and costs caused by non-performing debtors.

#### *1.3.2.2. Entrepreneurial hypothesis<sup>36</sup>*

Czarnetzky considers discharge as part of the legal framework fostering entrepreneurship. Entrepreneurial spirit has a central role in the economy and in the overall well-being of the society because entrepreneurs find new opportunities and gaps in the market and their creativity contributes to economic development. Every new business has its risk because the future is not predictable. Businessmen can estimate the likelihood of success and possible obstacles but it is impossible to avoid every external effect of the market. If they had to bear these risks entirely they would be discouraged from realizing any new business ideas. Discharge provides the possibility for honest entrepreneurs to learn from their own mistakes. On the other hand dishonest businessmen know they will not have the chance to get discharge and have to bear the costs of their own faults. Bankruptcy discharge fosters entrepreneurship and supports economic development by providing fresh start for “honest but unfortunate” entrepreneurs. He summarizes “gains from entrepreneurship in the form of social improvement and prosperity are larger than the losses to the debtor's creditors from the discharge of his debts.”<sup>37</sup>

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<sup>36</sup> *The Individual and Failure supra note 11*

<sup>37</sup> *id.* pp 399-414



### 1.3.2.3. Justification based on participation in open credit economy

In Howard's theory discharge "should have only one goal - to restore the debtor to economic productivity and viable participation in the open credit economy."<sup>38</sup> The American economy and welfare are based on credit and more particularly consumer credit. Open credit economy provides predictable and reliable market for debtors and creditors. Bankruptcy supports these values by rules that make debtors' assets available for creditors and rehabilitate debtor "for continued and more value-productive participation."<sup>39</sup> The aim of bankruptcy is not to change the consumer behavior and not only to free debtors from current debts but to make them able to borrow in the future and repay those loans.<sup>40</sup> An overburdened debtor cannot consume and may become less interested in gathering more income since it is used for the creditors' satisfaction in the lack of available discharge.<sup>41</sup> If an honest but unfortunate debtor gets a discharge he becomes again motivated in producing value and consumption.

### 1.3.2.4. Debtor cooperation theory

The primary goal of the first modern bankruptcy acts was to help creditors collect their claims. For the first time in history in the Statute of 4 Anne besides punishment of fraudulent debtors discharge appeared as reward for cooperating debtors.<sup>42</sup> This policy is reflected in the US Bankruptcy Code §727, a judge denies discharge of debtors whose conduct hinders the success of the procedure. The debtor is encouraged and awarded to hand over all of his non-exempt assets by discharge and punished for fraudulent conducts in most serious cases by

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<sup>38</sup> *A Theory of Discharge in Consumer Bankruptcy* *supra* note 30; p 1069

<sup>39</sup> *id.* p 1062

<sup>40</sup> Porter, Katherine and Dr. Thorne, Deborah: *The Failure of Bankruptcy's Fresh Start*, Cornell Law Review Vol. 92:67 2006 (hereinafter: *The Failure of Bankruptcy's Fresh Start*) p. 75 citing KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (1999) p 99

<sup>41</sup> *Fresh-Start Policy in Bankruptcy Law* *supra* note 24; p 1421

<sup>42</sup> Tabb, Charles Jordan: *The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*; George Washington Law Review November, 1990 59 Geo. Wash. L. Rev. 56, p 90



criminal sanctions. Debtor cooperation explains the collective debt collection nature of bankruptcy too. All of the debtor's available assets are gathered in one procedure for distribution between his creditors. Since the debtor's cooperation is guaranteed by the bankruptcy procedure, creditors can be sure the debtor does not have any available assets and they do not have to spend money on individual debt collection remedies.

### 1.3.3. "Impulse control" and "incomplete heuristics" theories

Jackson offers two theories rooted in consumer behavior for the justification of discharge. In his volitional "impulse control" theory part of consumers' personality "approaches life like an addict, unable to consider or plan for the future". Consumers are "like animals" because it is their nature to prefer immediate consumption instead of long-term savings. On the other hand, they have a "rational" personality which would agree to restrain the impulse. Discharge serves this goal and works like a built-in checking mechanism.<sup>43</sup> As I discussed above, discharge imposes the costs of consumer's failure on the creditor because they are the best risk bearers. Because of this way of risk allocation, commercial lenders are encouraged to monitor debtor's financial affair to estimate his credit-worthiness. If risk-assessment of a creditor does not let the debtor to borrow, an impulsive, irrational buyer will be precluded from obtaining credit with high risk of default.

Incomplete heuristics is a cognitive justification. Consumers tend to underestimate risks and overestimate the likelihood of success during their decision-making process. More particularly they underestimate "the risks that their current consumption imposes on their future well-being". Discharge is the legislative tool to prevent consumers from the adverse effects of incomplete heuristics.

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<sup>43</sup> *Fresh-Start Policy in Bankruptcy Law* *supra* note 24 pp 1408-1410



Jackson's theories imply the picture of an irrational consumer who spends money on unnecessary goods. But the reality is that credit has become a necessity of everyday life for middle-class Americans to make ends meet.<sup>44</sup> The majority of debtors who seek financial relief by filing petition for bankruptcy are middle-class working people who are in financial trouble mainly because of medical expenses or job losses.<sup>45</sup> That's why discharge does not work as checking system against impulse borrowing but rather protects against long-term suffering.

#### 1.3.4. Humanitarian theory

The main finding of Karen Gross' humanitarian theory is that the underlying policy of discharge is forgiveness. Forgiveness is justified if the following preconditions are met: a wrong is committed which hurt someone, who resent it and the wrongdoer take steps to mitigate the caused losses. Each of these is presented in bankruptcy context: the debtor does wrong when he does not fulfill his obligation toward creditors; creditors' loss is the non-paid debt and they certainly resent it; the debtor by filing for relief acknowledges publicly his failure. Both sides are better off by bankruptcy. Creditors may feel justice has been done because they reached every non-exempt asset or available income of debtor. Debtor gets back his self-esteem because he is discharged from the burden of debts.

Richard E. Flint considers natural law theory as the basic of individual bankruptcy. He put human dignity as the desired goal and not economic efficiency. Empathy for less-fortunate members of the society is the driving force of bankruptcy relief and the aim is to put the debtor back on the way of self-determination.<sup>46</sup>

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<sup>44</sup> *The Principle of Consumer Utility* *supra* note 14; p 554

<sup>45</sup> *The Failure of Bankruptcy's Fresh Start* *supra* note 40; p 93

<sup>46</sup> Richard E. Flint, *Bankruptcy Policy: Toward a Moral Justification for Financial Rehabilitation of the Consumer Debtor*, 48 Wash. & Lee L. Rev. 515 (1991), <http://scholarlycommons.law.wlu.edu/wlulr/vol48/iss2/10>; p 520



### 1.3.5 Theory of consumer utility

According to Michael D. Sousa's theory, consumer utility should be the guiding line for legislation of bankruptcy as an overwhelming justification of discharge. He approaches individual discharge from a utilitarian point of view and finds that the overall well-being of the community of debtors should be the aim of financial relief provided by bankruptcy. In his opinion consumer utility cumulates economic and humanitarian theories mentioned above. Moreover, consumer utility takes into account more factors because it serves not only the financial but psychological, physical health of consumers. Beside material and moral considerations he takes into account "psychological, familial, and physical trauma and strain experienced by many debtors buried with insurmountable debt."<sup>47</sup>

## **1.4. Critics of discharge**

### 1.4.1. Moral hazard and adverse selection problems

As I noted above, nonwaivable bankruptcy discharge works like insurance for debtors in case of default. Whether a risk is insurable or not depends on the controllability of moral hazard and adverse selection problem. Take "gamble insurance" as a hypothetical example. Moral hazard means if such insurance would exist, the insured gambler would take bigger risks since it is not him who bears the costs of default. Adverse selection occurs because those would pay the premium for such insurance policy who have large losses. Discharge has both problems. The debtor might be tempted to borrow too much and those will pay higher interest rates who most likely take advantage of a fresh start.<sup>48</sup>

Bankruptcy fresh start does not work like gamble insurance but as fire insurance. People may become careless when having fire insurance but not significantly. Legislator and insurance

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<sup>47</sup> *The Principle of Consumer Utility* *supra* note 14; pp 596-602

<sup>48</sup> BANKRUPTCY: CASES, PROBLEMS AND MATERIALS *supra* note 35; pp 560-561



companies should set rules which punish arsonists.<sup>49</sup> It is Bankruptcy Code's and commercial lenders' duty to create such market conditions and legal environment which filter abusive conducts.

#### 1.4.2. Inefficiency

In an empirical study Katherine Porter and Dr. Deborah Thorne<sup>50</sup> examined debtors' post-bankruptcy financial conditions. They had phone interviews with bankruptcy filers one year after their fresh start. Subjects were asked if their financial situation became better, stayed the same or worsened compared to the time before they filed for bankruptcy. Two-third responded they are better-off but one third of subjects' financial situation did not change or became worse than before they received fresh start. The research showed the main causes of bankruptcy filing are medical expenses and job losses. The key factor of success after bankruptcy is at least a steady income.<sup>51</sup> There are situations where even a steady income is not enough. A debtor whose monthly expenses constantly exceed his income will not be better off by bankruptcy in the long run even with a steady income unless he can earn more money. I intentionally wrote raise of income as a solution because the study showed the average debtor does not become over-burdened because of excessive spending but because he cannot cover basic expenses like utilities and housing. In the case of job loss or health problems if the debtor cannot get a new job, fresh start is only a temporary solution because without a steady income his debts will accumulate again. This statement is supported by the study - worse-off subjects responded the main reason of their situation is their unemployment.<sup>52</sup>

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<sup>49</sup> *id.*

<sup>50</sup> *The Failure of Bankruptcy's Fresh Start supra note 40*

<sup>51</sup> *id.* pp 70-71

<sup>52</sup> *id.* p 100



The lesson of these findings is that discharge of debts is not a “magic bullet”<sup>53</sup>. It undoubtedly gives a chance to start again but by itself it is not guarantee for success. Discharge really means fresh start for debtors who are able to maintain their level of income above the amount of their expenses. Otherwise discharge provides only freedom from constraints of past debts but does not provide solution for the real problem of most of the debtors - lack of adequate income.

#### 1.4.3. Reduced satisfaction of debts and availability of credit

An opposition against discharge is that debtors may escape from their contractual obligations; despite they would be able to repay their debts. It is clear that where credit is available consumers will use it and where debt goes inability to pay will follow. The correlation between the rate of bankruptcy filings and the amount of outstanding consumer credit is high.<sup>54</sup> But it does not mean that debtors who file for bankruptcy abuse the available discharge. Significant part of liquidation of assets cases is non-asset case; debtors do not have any non-exempt assets to distribute between creditors.<sup>55</sup> Creditors are not worse-off by discharge of debtor because endless individual debt collection attempts would end with the same result – dissatisfaction of claims.

Decreased availability of credit argument’s starting point is the insurance feature of bankruptcy. Liberal discharge raises the price of credit; commercial lenders are less willing to lend money because of the escape option provided by bankruptcy. Not only generous discharge leads to fall of credit market but too strict rules as well. If bankruptcy discharge is too hardly or not at all available individuals will be reluctant to borrow, to bear the whole risk of default alone.

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<sup>53</sup> *id.* p 124

<sup>54</sup> *Lessons from the Globalization of Consumer Bankruptcy supra note 1; pp 5-6*

<sup>55</sup> White, J. James: *BANKRUPTCY AND CREDITOR’S RIGHTS*; West Publishing Co. St Paul Minn.; 1985, 812p (hereinafter: *BANKRUPTCY AND CREDITOR’S RIGHTS*) p 391



Bankruptcy legislation must find the balance. Discharge must have its costs to keep interest rates in an affordable level for borrowers.<sup>56</sup> On the other hand, it must provide discharge and not too restrictive one to encourage individuals to borrow and provide them safety net in case of financial distress.

### **1.5. Costs of discharge that are borne by individual debtor**

Bankruptcy discharge is not freely available; it has its costs and it must have as I noted above. In case of liquidation of assets debtor must give up every non-exempt assets while repayment plan obliges debtor to pay part of his debts from his future-earnings. As generally, legislation must find the correct balance here as well. Too generous exemption law or too low ratio of debt paid by the plan make discharge cheap and raises moral hazard and credit availability problems. On the other hand, it must guarantee a basic level of living to provide real fresh start for debtors.

Debtors who received financial relief cannot use this opportunity again for a certain length of time. In U.S. under current Bankruptcy Code this period is eight years between two immediate relieves. But for example in Sweden discharge is a once in a life-time privilege.<sup>57</sup> Debtors must consider the proper time of filing and once they filed, they must bear the risk of unavailability of another discharge for a given time.

Furthermore the fact of discharge appears in the credit records of debtor which may have theoretically two contrary effects. The fact he defaulted raises the price of borrowing after bankruptcy because creditor knows that at least once the debtor were not able to perform his contractual obligations. But the fact that debtor cannot file for another discharge for a

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<sup>56</sup> *The Fresh-Start Policy in Bankruptcy Law* *supra* note 24; p. 1427-28

<sup>57</sup> *COMPARATIVE CONSUMER BANKRUPTCY* *supra* note 7; p 90.



given period of time may decrease interest rates because creditor does not have to bear the risk of filing for bankruptcy.<sup>58</sup>

Debtors may feel they admit their weaknesses, their failure by filing for bankruptcy. While the legislative approach toward defaulted debtors changed radically and defaulted debtors are not considered as fraudsters nowadays social stigma is still attached to those who seek relief by filing for bankruptcy.<sup>59</sup> Rafael Efrat examined New York Times articles from the nineteenth century until nowadays to study the change of public perception toward individual bankrupts. He found a dramatic change in the 1960's. Before 1960, articles reflected a picture of a negligent, spendthrift individual who abusively escaped from repayment of debts and defrauded his creditors. In contrast, after the 1960's writers suggested a vision of an unfortunate debtor who struggles with problems of everyday life because of reasons outside his control. Interestingly he did not find any correlation between change of public perception and the number of bankruptcy filings.<sup>60</sup> Despite the change of public perception reflected by newspapers according to empirical studies debtors feel ashamed because of filing. Many subjects of such studies considered bankruptcy as a possible reason for committing suicide, debtors try to conceal the fact they filed for bankruptcy and they feel "just terrible" about the procedure.<sup>61</sup>

## 1.6. Summary

The goal of this chapter is providing the outline of individual bankruptcy's theoretical basis. The legal nature of bankruptcy is an exception from strong legal notions. An exception must have justifications to stand against general rules. History and legal scholars elaborated

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<sup>58</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4; p 37

<sup>59</sup> Efrat, Rafael: *The Evolution of Bankruptcy Stigma*; Theoretical Inquiries in Law. Volume 7, Issue 2, Pp 365-393 pp 377-378

<sup>60</sup> *id.* pp 390-393

<sup>61</sup> *id.* pp 377-379



several justifications of discharge provided by bankruptcy. From an economic point of view discharge is the proper way of risk allocation between the community of debtors and creditors. Furthermore, discharge enhances entrepreneurialism, helps creditor to take part again in open credit economy. Discharge serves as a reward for debtor in exchange of his cooperation from the very beginning of its history. Relief from debt provides safety net against the impulsive consumption of an average individual and his inability to predict every possible outcome of his actions. Discharge can be justified as moral obligation to help unlucky individual as well. Moreover, it can serve the overall financial, psychological, physical and familial well-being of debtor. Critics of discharge highlight what are other aspects that legislator must bear in mind when regulating this field. In order to handle moral hazard problem, risk aversion problem, less availability of credit and decreased satisfaction of debts legislator must find the balance between the benefits provided by discharge and the costs of it. Unfortunately social stigma is still attached to bankruptcy filers, a cost which is not intended by the legislator. Despite all the justifications discharge is not a “magic bullet” and we cannot expect from it to solve every financial problem of debtor on behalf of him. Discharge is a chance to change, to close the past and to start over. In the next chapter I describe briefly how US Bankruptcy Code puts all the above mentioned goals into reality.



## Chapter 2 Procedural Pillars of Individual Bankruptcy in the US

Title 11 of the United States Code is the Bankruptcy Code. Chapter 1, 3 and 5 contains common provisions for all kinds of bankruptcy procedures. Chapter 7 is Liquidation and Chapter 13 regulates Adjustment of Debts of an Individual with Regular Income. Chapter 7 is often referred as “straight bankruptcy” since the debtor gets an immediate relief from pre-petition debts in exchange for giving up every non-exempt property. Chapter 13 bankruptcy works the opposite way. A debtor can keep every asset but must pay back from his future income in three to five years at least as much as creditors would get under Chapter 7. The debtor gets relief if he successfully executes the repayment plan. In this chapter I describe the cornerstones of the Bankruptcy Code concerning individual bankruptcy. These provisions materialize the goals described in the previous chapter and make theory work in practice.

### 2.1. Rules regulating both Chapter 7 and Chapter 13

#### 2.1.1. “Butner principle”

First of all, I would like make clear the connection of bankruptcy and non-bankruptcy law. The two basic principles that govern this interplay are the “Butner principle”<sup>62</sup>. The discharge provided by bankruptcy is an exception from basic legal notions such as freedom of contracts and *pacta sunt servanda*. The bankruptcy procedure should not be considered merely as an exception from non-bankruptcy law. One should bear in mind that bankruptcy law is based on

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<sup>62</sup> The Supreme Court held in *Butner v. United States*: „Congress has generally left the determination of property rights in the assets of bankrupt’s estate to state law. Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceedings.” quoted in THE ELEMENTS OF BANKRUPTCY *supra* note 4; p 5



non-bankruptcy law and the former changes the latter only to the extent necessary for the purpose of the procedure. In a practical sense it means that in a bankruptcy procedure non-bankruptcy law governs unless the Bankruptcy Code provides differently. The Bankruptcy Code can be considered as an exception from non-bankruptcy law, but the bankruptcy procedure itself does not change the applicable law.

### 2.1.2. Property of the estate

The first and most important question of this procedures is what constitutes the debtor's available property for creditors. The first part of the answer is the property of the estate concept. Filing petition for bankruptcy creates an estate by operation of law. Property of the estate is comprised of all a debtor's interest in any property wherever located and by whomever held.<sup>63</sup> There are certain exceptions but the most important is any earnings from service of debtor after the commencement of the case.<sup>64</sup> The concept of estate has crucial role in both procedures. In straight bankruptcy creditors can seek satisfaction from the non-exempt property of the estate. Under Chapter 13, a debtor can retain the property of the estate and be obliged to pay back part of his debts, at least as much as creditors would get in a Chapter 7 case.

The Code does not have an exhaustive definition of property. The question may arise whether legal interests, which are not enforceable at the time of commencement of the case but may be enforced in the future, are part of the estate or not. The Code makes clear that employee compensation plans, health insurance plans and even education funds are not property of the estate.<sup>65</sup> Further problems are licenses or assets that a debtor cannot reach at the time of filing as spendthrift trusts. The answer to all of these problems is the principle of

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<sup>63</sup> 11 U.S.C. §541(a)

<sup>64</sup> 11 U.S.C. §541(a)(6)

<sup>65</sup> 11 U.S.C. §541(b)



*Chicago Board of Trade*<sup>66</sup> incorporated in 541§(a)(1). Creditors can reach everything in bankruptcy that a debtor has outside bankruptcy but nothing more. This principle ensures that bankruptcy procedure does not reach further than the property debtor has outside bankruptcy. Without explicit Code provisions courts held - based on the principle of *Chicago Board of Trade* - that cases are decided on the basis of whether a debtor has any enforceable right in the given property at the time of filing.<sup>67</sup> Another consideration can be the ratio of post-filing personal service of a debtor in the value of the property. Transferable licenses can be part of the estate, creditors may seek payment from the sale of them.<sup>68</sup> Assets that a debtor owns but cannot reach at the time of filing can also be part of estate<sup>69</sup>, with the very important spendthrift trust<sup>70</sup> exception of the Code.<sup>71</sup> Spendthrift trusts or retirement funds are earned by the debtor before filing so according to the general rule these should be part of the estate. The justification and also the limit of this exception are to preserve “income reasonably necessary for the support of a debtor and his dependents.”<sup>72</sup> Legislator enhances a debtor’s real fresh start and savings by precluding creditors from reaching these assets of the debtor.

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<sup>66</sup> 264 U.S. 1 (1924) This case concerned a restriction on the sale of a seat and its validity inside bankruptcy. Members of the Chicago Board of Trade were obliged to pay off any outstanding debt to other members before they sell their seats. A member, who owed money to other board members, went bankrupt and the trustee wanted the whole price of the sale to be part of the estate and treat board members as general creditors. The Supreme Court held general creditors have the rights in bankruptcy what debtor has. If debtor has right to get the proceeds after the board members are paid then general creditors can get proceeds after board members are paid. “The general creditors could not do any better outside of bankruptcy, so they should not be able to do any better inside of bankruptcy.” THE ELEMENTS OF BANKRUPTCY *supra* note 4; p 98.

<sup>67</sup> Sharp v. Dery 253 B.R. 204 (E.D. Mich. 2000)

<sup>68</sup> Warren, Elizabeth, Westbrook Jay Lawrence: THE LAW OF DEBTORS AND CREDITORS; New York. New York; Aspen Publishers, Sixth Edition 2009; 931 p; (hereinafter: THE LAW OF DEBTORS AND CREDITORS) p121

<sup>69</sup> 11 U.S.C. §541 (c)(1)

<sup>70</sup> Spendthrift trust: “A trust that prohibits the beneficiary's interest from being assigned and also prevents a creditor from attaching that interest; a trust by the terms of which a valid restraint is imposed on the voluntary or involuntary transfer of the beneficiary's interest.” Black’s Law Dictionary 9<sup>th</sup> Edition 2009

<sup>71</sup> 11 U.S.C. §541.(c)(2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

<sup>72</sup> S. REP. NO. 95-989, 95th Cong. 2d Sess. 2. 2 (1978) (hereinafter: Senate Report 95-989) 11 U.S.C. §541



### 2.1.3. The Trustee in Bankruptcy

The trustee in bankruptcy is the professional who administers the estate and guarantees debtor's and creditors' interests. The trustee's duties are to gather every asset of the debtor, to register claims, to sell every non-exempt asset and to distribute proceeds between creditors according to statutory provisions. In particular, it is the trustee's responsibility to scrutinize debtor's financial affairs and preclude or disclose any fraudulent conduct by the debtor, and to maintain equality between creditors or to ensure priority to certain creditors when statutory provisions require doing so. The trustee in bankruptcy is supervised by the US Trustee. The US Trustee is a governmental official who basically monitors the whole bankruptcy system.<sup>73</sup>

The trustee has a wide range of rights to gather as much assets to the part of property of the estate as possible. The trustee can step into the shoes of the debtor, any creditor and even a hypothetical creditor. The trustee can challenge every transfer that a debtor can under non-bankruptcy laws. Moreover, the trustee has the rights of a hypothetical lien creditor in case of personal property and rights of a bona fide purchaser for value of real property who obtains these rights at the time of commencement of the case.<sup>74</sup> This power enables the trustee to set aside any unperfected security interest on debtor's property and include the property in question in the estate. Furthermore, the trustee can use the rights of an actual creditor to challenge a transfer of a debtor's property. If the trustee finds a creditor who can challenge a transfer of an asset outside bankruptcy, the trustee can recover that asset from the third party and include it in the property of the estate.<sup>75</sup>

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<sup>73</sup> THE LAW OF DEBTORS AND CREDITORS *supra* note 68; p 129

<sup>74</sup> 11 U.S.C 544§ (a)

<sup>75</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4 pp 102-107



#### 2.1.4. Automatic stay

Filing a petition for bankruptcy does not only create the property of the estate but stops all debt collection attempts of creditors. While the goal of the above mentioned powers of trustee is to gather assets to the estate, the aim of the automatic stay is to prevent assets from leaving the estate. Put in a very simply way, §362 of Bankruptcy Code means: “upon the filing of the petition the creditor may continue to eat, sleep and breathe; perhaps he can smile at the debtor, but he may not do anything else.”<sup>76</sup> Automatic stay preserves the status quo of debtor’s assets and allows the trustee to deal with creditors in a single forum.<sup>77</sup> The three main characteristics of automatic stay are the followings: it is an injunction since it prohibits any debt collection effort against the estate; it is automatic because it goes into effect by filing without any order of the court and it is self-executing because any action violating automatic stay is invalid.<sup>78</sup>

Although automatic stay is intended to have a broad scope but one should not forget that automatic stay stops only the enforcement of prepetition claims and only against the debtor. Actions arising from post-petition claim or against guarantor, surety are not stayed.<sup>79</sup> Moreover, there are certain exceptions from its reach.<sup>80</sup> These are e.g. criminal proceedings, collections of domestic support obligations, proceedings related to divorce, child custody, and domestic violence.

Bankruptcy Code establishes rules against abusive behavior related to automatic stay. The Bankruptcy court may grant actual damages and even punitive damages to any individual

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<sup>76</sup> BANKRUPTCY AND CREDITOR’S RIGHTS) *supra* note 55; p 97.

<sup>77</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4; p 194

<sup>78</sup> Tabb, Charles Jordon.: BANKRUPTCY LAW: PRINCIPLES, POLICIES, AND PRACTICE; Cincinnati, Ohio : Anderson Publishing Co., 2003.; 686 p (hereinafter: BANKRUPTCY LAW)

<sup>79</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4; p 194.

<sup>80</sup> 11 U.S.C. 362§ (b)



injured by willful violation of the stay.<sup>81</sup> The Code presumes bad faith and automatic stay does not go into effect if two or more petitions of a debtor were dismissed during the prior year of filing, unless this presumption is rebutted by clear and convincing evidence.<sup>82</sup>

Automatic stay lasts until the end of the bankruptcy case as a general rule. However, automatic stay is only a presumption and it can be lifted by the court. A secured creditor or other party with interest in a property may ask relief from the bankruptcy court e.g. when adequate protection is not guaranteed by the trustee or because of lack of any connection with the bankruptcy case.<sup>83</sup>

#### 2.1.5. Debtor's duties<sup>84</sup>

The Bankruptcy Code imposes three main duties on a debtor filing for bankruptcy. The first is duty of disclosure. The debtor has to file a list of creditors, a schedule of assets and liabilities and a statement of his financial affairs. Moreover, the Code makes the attorney of the debtor liable for the accuracy and trustworthiness of provided information. Secondly, the debtor has to cooperate with the trustee and thirdly, he has to handover every asset of the estate and any recorded information about the estate.<sup>85</sup> Any breach of these duties may lead to denial of discharge.<sup>86</sup>

Before filing for bankruptcy a debtor is obliged to participate in credit counseling from an “approved nonprofit budget and credit counseling agency” in 180 days before filing.<sup>87</sup> The counseling can be conducted via telephone or internet and intended to provide alternatives for debtors instead of filing for bankruptcy. The problem with this requirement is that debtors

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<sup>81</sup> 11 U.S.C. §362 (k)

<sup>82</sup> 11 U.S.C. §362 (c)(4)(D)

<sup>83</sup> Senate Report no. 95-989 11. U.S.C. §362

<sup>84</sup> 11 U.S.C. §521

<sup>85</sup> Senate Report no. 95-989 11. U.S.C. §521

<sup>86</sup> 11.U.S.C. §727(a)

<sup>87</sup> 11.U.S.C. §109(h)(1)



often file for bankruptcy at the very last moment before foreclosure and in the lack of fulfillment of this obligation the court will dismiss their case and they cannot use the protection of automatic stay. Furthermore, in practice this consultation can be completed in thirty minutes a time unlikely to be enough to deeply examine debtor's financial situation and to provide prudent advice for him.<sup>88</sup>

## 2.2. Chapter 7

### 2.2.1. Eligibility for immediate relief - The Means Test

BAPCPA's main goal was to filter high-income debtors who try to escape from their financial obligations while they would be able to repay their debts from their future income. Before BAPCPA was enacted, courts had wide discretion to decide if a debtor's filing constitutes "substantial abuse" of Chapter 7. BAPCPA narrowed courts' discretion and established a formula which determines debtor's eligibility for immediate relief – inability to repay at least something to his creditors.<sup>89</sup> If a debtor does not pass the means test the court denies discharge and directs the debtor to Chapter 13 proceeding, unless special circumstances are demonstrated such as medical expenses.<sup>90</sup> The court has discretion only if a debtor passes the test. In such a case the court has to consider if the petition was filed in bad faith or "the totality of circumstances of debtor's financial situation demonstrates abuse."<sup>91</sup> Considering totality of circumstances allows courts to refine the detailed and strict rules of the means test but it does not entitle them to contravene with those rules. Courts may take into

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<sup>88</sup> *The Principle of Consumer Utility supra note 14; p 604*

<sup>89</sup> 11 U.S.C. §707 (b)(2)(A)

<sup>90</sup> 11 U.S.C. §707(b)(2)(B)

<sup>91</sup> 11 U.S.C. §707(b)(3)



“unusual circumstances that the Means Test does not – and could not reasonably be expected to – account for.”<sup>92</sup>

Application of means test has two prongs. If a debtor’s current monthly income is not higher than the median income of families similar to a debtor’s family in the state where he filed then no further calculation is required and abuse is not presumed. If a debtor earns more than the median, the court applies the second step of means test to judge if a debtor is able to pay back something to his creditors. Based on the tables of Internal Revenue Service, a court deducts allowable living expenses from a debtor’s income such as housing, food and transportation. Judges may make adjustments and add more reasonable monthly expenses such as payments to secured creditors to keep motor vehicle or primary residence of debtor; medical expenses, support of disabled household members. The court subtracts debtor’s monthly expenses from his monthly income and if the result is less than \$100 debtor is eligible for Chapter 7. If the result is above 167\$, abuse is presumed and the debtor is ineligible for immediate fresh start. When the amount of disposable income is between, the debtor is eligible for discharge if cannot pay at least 25 cents on a dollar for general creditors.<sup>93</sup>

Means test has received much criticism. In Sousa’s opinion, families who have \$167 in their pocket by the end of each months are forced to Chapter 13 repayment plan and that is why they are blocked from gathering savings. Above the income necessary for their everyday life they are left unprepared for any unexpected event.<sup>94</sup> According to Czarnetzky, denial of discharge only because a debtor has potential income “discourages entrepreneurship”.<sup>95</sup> A means test has its extra costs. Debtors have to provide more information which makes lawyer

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<sup>92</sup> In re Kirk Lee Jensen and Linda Jean Jensen; 407 B.R. 378

<sup>93</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4 pp 32-34

<sup>94</sup> *The Principle of Consumer Utility supra* note 14; p 606

<sup>95</sup> *The Individual and Failure supra* note 11; p 463



fees higher and makes filing more time-consuming. These have adverse effect especially on those debtors who are in the worst situation and do not have money or need relief as soon as possible.<sup>96</sup>

### 2.2.2. Exempted property

In a Chapter 7 case debts are paid from the non-exempt property of debtor. Exempt property is one main part of a debtor's fresh start besides dischargeable debts. Defining exempt property is a crucial element of straight bankruptcy procedures because the main cost of debtor is the surrender of non-exempt property. If exemption rules are too generous bankruptcy becomes easily available and raises the possibility of moral hazard problem. On the other hand, too strict rules may deter otherwise eligible individuals from filing for bankruptcy.

Bankruptcy contains detailed rules of property that debtors can keep as part of their fresh start. States may issue different exemption rules but in the absence of them federal bankruptcy law governs the case.<sup>97</sup> Exemptions are set in dollar amounts which are adjusted every three years.<sup>98</sup> The most important is the federal homestead exemption. Debtor's interest in real property is exempt up to \$15000. Prior BAPCPA some states' homestead exemptions were unlimited (e.g. Texas, Florida).<sup>99</sup> From 2005 Bankruptcy Code sets a \$125000 cap to state homestead exemptions.<sup>100</sup> Moreover, a debtor may keep one motor vehicle; household furnishings; household goods<sup>101</sup>; wearing apparel; jewelry held for personal use; professional

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<sup>96</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4 p 35

<sup>97</sup> *id.* p 42

<sup>98</sup> Kenneth W. Clarkson, Roger LeRoy Miller, Gaylord A. Jentz, frank B. Cross BUSINESS LAW, TEXT AND CASES, LEGAL, ETHICAL, GLOBAL AND E-COMMERCE ENVIRONMENTS; Eleventh Edition, South Western, Cengage Learning, 2009; 1082 p (hereinafter: BUSINESS LAW) p 617

<sup>99</sup> *id.* p 618

<sup>100</sup> 11. U.S.C. §522 (p)

<sup>101</sup> defined by 11. U.S.C. §522(f)(4)(A)and(B)



books, tools of debtor's trade; certain social benefits and retirement funds.<sup>102</sup> The Bankruptcy Code also allows a debtor to avoid the fixing of certain liens if the lien impairs debtor from exercising his exemption rights.<sup>103</sup> Federal exemption rules raise the issue of debtor worthiness by prohibiting the application of homestead exemption if filing is abusive or debts arises from violation of securities laws, fraud, criminal act, intentional tort, willful misconduct.<sup>104</sup>

Exemption rules have a central role in Chapter 7 bankruptcy because the majority of cases are non-asset cases. Typical debtors filing for bankruptcy are low and middle class working people who do not have anything else but a house, a car, household goods and clothes. Since usually houses and cars are subject to security interest and even without it would be exempted, there is not any asset available for general creditors. That's why general creditors are unlikely to play an active role in straight bankruptcy cases.

### 2.2.3. Discharge

Discharge is the other main part of fresh start besides exempt property. Exempt property allows debtors to keep certain necessary assets for his life after bankruptcy and discharge relieves a debtor's future earnings from the burden of pre-petition debts. Theoretically a debtor gets discharge after distribution of his non-exempt assets but as I wrote above, typical Chapter 7 cases are non-asset cases and that is why straight bankruptcy is considered as a "discharge process rather than a liquidation and distribution process."<sup>105</sup>

Discharge operates in two ways. It voids any judgment against the debtor and as an injunction prevents creditors from any debt collection effort against the debtor or property of

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<sup>102</sup> 11 U.S.C. §522 (d)

<sup>103</sup> 11 U.S.C. 522§(f)

<sup>104</sup> 11 U.S.C. §522 (q)

<sup>105</sup> BANKRUPTCY AND CREDITORS' RIGHTS *supra* note 55; p 391



the debtor concerning any discharged debts.<sup>106</sup> However, discharge reaches only the personal liability of debtor and does not affect co-debtors as sureties, guarantors<sup>107</sup> and security interest in debtor's property. The principle of lien-pass through bankruptcy makes clear discharge does not preclude perfected secured creditor from the foreclosure of the collateral.<sup>108</sup> Discharge is designed to be broad but there are an ever growing number of exceptions; non-dischargeable debts listed under §523(a). Debts which are non-dischargeable by their nature include taxes, duties, domestic support obligations. Payment of these debts is too important to let them be discharged. Another type of debts is non-dischargeable due to debtor's conduct for example money obtained by fraud or false representation, debts not included in schedules, concealment of assets from trustee, and obligations arising from intoxicated driving. The bankruptcy process cannot support such conducts. An intoxicated driver or a debtor who tries to hide assets from creditors definitely does not fall in the category of honest, but unfortunate debtor.

Student loans are non-dischargeable as well unless the debtor proves that the repayment would impose undue hardship on him. Undue hardship has three elements: a debtor's current income and expenses does not allow him to repay the debt; his situation is unlikely to change during the period of a repayment plan and "debtor made good faith efforts to repay the loans."<sup>109</sup> Fresh graduates who have taken out loans usually do not have any assets, only their human capital. They could easily escape payment by a likely non-asset bankruptcy after graduation and then start their career without the burden of their student loans. The Bankruptcy Code made student loan non-dischargeable to avoid such abuse but created an undue hardship exception to make individualization available for certain cases.

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<sup>106</sup> 11 U.S.C. §524(a)

<sup>107</sup> BUSINESS LAW *supra* note 98; p 621

<sup>108</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4; p 14

<sup>109</sup> In re Mosley 494 F.3d 1320; cited in BUSINESS LAW *supra* note 98; p 622.



§523(2)(A) and (C) makes consumer debts for luxury goods above \$500 and cash advances as extension of open credit plan above \$750 obtained 90 or 70 days before filing presumably non-dischargeable. In practice these are credit card debts. The Bankruptcy Code presumes that the debtor misrepresented his financial situation toward creditor by purchasing goods on the eve of bankruptcy which are not necessary for the maintenance of debtor or his independents or by extension his consumer debt. Courts use totality of circumstances test to examine debtor's intent. Courts consider such factors as whether the debtor was employed or his prospects to be employed, amount of charges, usual purchase habits of the debtor.<sup>110</sup> These provisions became part of the Code by the enactment of BAPCPA and clearly support the interests of credit industry. Consumers for several reasons, for example in order to avoid social stigma attached to bankruptcy or they simply cannot recognize the seriousness of their problems, wait until the very last moment before they file for bankruptcy. Usually they try every other possible means to avoid filing, such as taking another loan hoping they get a job soon. These new provisions adversely affect these debtors who are in the most serious need for financial relief.

While the fact that discharge is available is not subject to debate,<sup>111</sup> unlike its scope is. Sousa argues in favor of broader discharge to serve consumer utility, to provide meaningful fresh start for debtors.<sup>112</sup> In his opinion, credit card debts should be non-dischargeable only if actual fraud is proven, because for typical debtors in bankruptcy the use of credit card is essential for every-day life. Student loans should be dischargeable after a certain period of time if a debtor attempted in good faith to repay the debt because in the current economic conditions it is very difficult for fresh graduates to earn enough money to repay their student t

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<sup>110</sup> *The Principle of Consumer Utility supra note 14*; pp 580-581

<sup>111</sup> But we have to keep in my mind that discharge "is a legislatively created benefit, not a constitutional one" - *United States v. Kras*, 409 U.S. 434, 447 (1973). cited by *A World Without Bankruptcy supra note 10*; p 175

<sup>112</sup> He suggests making every debt dischargeable except money obtained by fraud or misrepresentation, domestic support obligations and student loans with the proposed modifications.



loans.<sup>113</sup> In Howard's theory non-dischargeability of taxes is inconsistent with the goal of discharge to restore economic activity.<sup>114</sup>

## 2.3. Chapter 13

### 2.3.1. Repayment Plan

Chapter 13 of the Bankruptcy Code is Adjustment of Debts of an Individual with Regular Income. Only individuals may file for Chapter 13 bankruptcy who owe less than around \$300000 unsecured debts and less than approximately a million dollars secured debts.<sup>115</sup> This provision limits the availability of conditional discharge for those who really are in need of it – consumers and small business entrepreneurs with limited finances.<sup>116</sup> Chapter 13 bankruptcy can be filed voluntarily or be commenced by conversion from Chapter 7 if debtor does not pass a means test in a straight bankruptcy case. A debtor must file both the petition and the plan in good faith. Courts apply totality of circumstances test to examine debtor's intent.<sup>117</sup> Chapter 13 provides a conditional discharge; debtor gets relief from outstanding debts after the fulfillment of a repayment plan.<sup>118</sup> A debtor can keep every asset he has<sup>119</sup>, but he is obliged to repay at least part of his debts as provided by the court approved repayment plan.

A debtor must file a repayment plan which meets the following requirements. The debtor has to hand over necessary portion of his future earnings to the trustee for the execution of the plan. If the plan creates classes of claims, the debtor must treat claims equally within the same class. The plan must provide full repayment of debts which has priority such as administrative

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<sup>113</sup> *The Principle of Consumer Utility* *supra* note 14; pp 606-607

<sup>114</sup> *A Theory of Discharge in Consumer Bankruptcy* *supra* note 30; p 1071

<sup>115</sup> 11. U.S.C. §109(e)

<sup>116</sup> *THE ELEMENTS OF BANKRUPTCY* *supra* note 4; p 50

<sup>117</sup> *BUSINESS LAW* *supra* note 98; p 626

<sup>118</sup> 11 U.S.C. §1328(a)

<sup>119</sup> 11 U.S.C. §1306(b)



expenses or taxes.<sup>120</sup> Unsecured creditors must receive as much as they would get under Chapter 7.<sup>121</sup> Length of the repayment plan, “the applicable commitment period” is 5 years if debtor’s family income measured by means test is more than the state median and 3 years if his income is less than the state median,<sup>122</sup> and can only be shorter if the debtor pays back fully every unsecured debt in shorter time.<sup>123</sup>

If the plan meets the statutory requirements, the bankruptcy court shall confirm it. Secured creditor’s consent is required unless the plan provides that the secured creditor can retain his lien on the collateral until full-payment or discharge of debts; or debtor surrenders the collateral to the secured creditor.<sup>124</sup> Unsecured creditors’ and trustee’s acceptance is not necessary for the confirmation but they may object. In case of objection, the court shall approve the plan if the debtor pays back the whole amounts of unsecured debts or all of debtor’s disposable income is used for the satisfaction of unsecured creditors. Disposable income is calculated differently depending on debtor’s income. For below-median earners it is the current monthly income of debtor less necessary expenses for the maintenance and support of debtor and his dependents.<sup>125</sup> For above-median earners the test is parallel to means test but the Code uses the expression “projected disposable income.” It may require courts to calculate based not only on past but the future financial conditions of debtor.<sup>126</sup>

Confirmation of the plan starts the more important part of the procedure – the execution of the plan. During the commitment period debtor has to hand over portion of his wages, income to the trustee who distributes these amounts against creditors as provided by the plan. The court may modify the plan for the request of the debtor, creditor or trustee or even revoke the

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<sup>120</sup> 11 U.S.C. §1322(a)

<sup>121</sup> 11 U.S.C. §1325(a)(4)

<sup>122</sup> 11 U.S.C. §1322(d)(1)(2)

<sup>123</sup> 11 U.S.C. §1325(b)(4)(B)

<sup>124</sup> 11 U.S.C. 1325(a)(5)

<sup>125</sup> 11 U.S.C. 1325(b)(1)(2)

<sup>126</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4; p 52



confirmation order if fraud was committed. If the debtor cannot fulfill the plan the court may dismiss or convert the case into Chapter 7 for the request of any interested party.<sup>127</sup> According to empirical studies a relatively low ratio of Chapter 13 repayment plans are performed successfully.<sup>128</sup>

A debtor who performs a repayment plan successfully gets discharge from the remaining outstanding debts and keeps his assets free of any interests of creditors. A debtor can even get financial relief without full performance of the plan if the cause of default is beyond his control and unsecured creditors already received more than what they would have got under Chapter 7. Before BAPCPA the Code provided “superdischarge”, because even fraudulently occurred debts and debts arose from willful torts were dischargeable. BAPCPA narrowed the scope of Chapter 13 discharge, but it is still broader than what Chapter 7 allows.

### 2.3.2. Home mortgages

Defaulted debtors of home mortgage loans are likely to file for Chapter 13. Outside bankruptcy they do not have many chances to prevent foreclosure. Chapter 7 can be a reasonable solution if debtor can make an arrangement with the mortgage lender and by discharge make more income available for the repayment. Otherwise he must give up every equity in real property above the exempt amount. “Chapter 13 offers the debtor breathing room and a last chance to sort things out.”<sup>129</sup> Although, the debtor cannot modify the original terms of the loan agreement, automatic stay blocks attempts to foreclose and the debtor can keep his house even if he has defaulted. However, if the remaining time of the loan is shorter than the repayment period the anti-modification clause does not apply and debtor may have

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<sup>127</sup> 11 U.S.C. §1307(c)

<sup>128</sup> *The Failure of Bankruptcy's Fresh Start* *supra* note 40; p 76

Sarah W. Carroll and Wenli Li: *The Homeownership Experience of Households in Bankruptcy*; Cityscape, Vol. 13, No. 1, Discovering Homelessness (2011), pp. 113-134 (hereinafter: *The Homeownership Experience of Households in Bankruptcy*) p 119

<sup>129</sup> THE ELEMENTS OF BANKRUPTCY *supra* note 4; p 54



some space to “maneuver”. Furthermore, debtor gets relief from part of his unsecured debts which may leave him enough income to pay timely the monthly installments of the mortgage loan. Chapter 13 bankruptcy does not make the debtor 100% foreclosure-proof. In the empirical study of Sarah W. Carroll and Wenli Li 28% of subjects lost their home to foreclosure on average after 28 months after their filing for bankruptcy.<sup>130</sup>

## 2.4. Summary

The aim of this Chapter was not to give a deep insight into the individual bankruptcy procedures of US Bankruptcy Code but to highlight what are the main pillars of the system which keep it functioning. The legislator recognized two basic types of debtors. The first is who does not have considerable property and whose income is barely enough to live a basic standard life but accumulated overwhelming amount of debts. For these debtors the Code provides immediate relief in exchange for the surrender of every non-exempt asset they have. Another type of debtors who own property what they would like to keep and they are able to repay at least part of their debts from their future income. The Code provides them conditional discharge, they can keep every asset of theirs but they are obliged to make installments from their future earnings.

Automatic stay gives the trustee time to examine the financial situation of debtor. The concept of property of the estate ensures that everything what debtor can reach outside bankruptcy will be object of the procedure. The trustee has strong and broad entitlements, central role in the procedure to guarantee the rights of both sides and involvement in administering the case to mitigate the workload of courts. The Code tries to find the balance to make financial relief available for honest but unfortunate debtors and, on the other hand, to deter abusive conducts. Means testing was enacted to make sure every debtor is under the Chapter what he should be

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<sup>130</sup> *The Homeownership Experience of Households in Bankruptcy supra note 128*pp 123



according to legislator's intent. The Code enhances debtor's cooperation by the punishment of fraudulent, dishonest behavior. Certain costs are imposed on debtors to avoid the moral hazard problem. Main costs are the surrender of non-exempt existing assets under Chapter 7, and repayment from future-earnings under Chapter 13. The reach of creditors is limited in order to guarantee minimal standard of living for the debtor.

The US system of individual bankruptcy is a functioning example of a legislative mechanism which offers a plausible solution for indebted households and respects the interests of creditors at the same time. That is why it may serve as a pattern for Hungarian legislation. In the next chapter I propose the basic notion of a future Hungarian individual bankruptcy law based on the US Bankruptcy Code.



## Chapter 3 Lessons for Hungary

### 3.1 Over-indebtedness of Hungarian households

In this subchapter I give a short overview of the current financial situation of Hungarian households. While my focus is legal I still think it is necessary to use statistic data to demonstrate the seriousness of the problem and to show that further legislative intervention is needed to help Hungarian families out of financial distress.

In this chapter I will briefly summarize the reasons which mainly led to the deep indebtedness of Hungarian families. These are the transition from socialist to market economy and its effect on Hungarian citizens' financial culture, the easily available consumer credit from the millennium on, the significant number of foreign currency mortgage loans and interconnected to all these factors the 2008 financial crisis. Then I will shortly describe the financial conditions of Hungarian households and the legislative measures so far introduced by the government: exchange rate cap, conversion of non-performing foreign currency mortgage loans and the National Asset Management Agency. In the second subchapter I share my proposal for the guiding lines of the implementation of individual bankruptcy into Hungarian legal system.

#### 3.1.1. Reasons of the current situation

Hungary was part of the socialist block until 1989. Bankruptcy law in general did not exist during the socialist regime because companies were owned by the state and in case of financial difficulties the state provided further credit for the indebted companies to keep them alive and to provide jobs for its citizens. Since employment was mandatory and consumer



credits were not available individual's financial distress was not an issue in those times. The political transition changed this situation. A significant number of people lost their jobs and they had to face the fact that the socialist state which took care of them did not exist anymore and they had to stand on their own feet.<sup>131</sup> The above mentioned characteristics of the former regime led to - among other consequences - the low level of financial culture of Hungarian society.

Two recent study of the Hungarian Central Bank clearly showed the ignorant attitude of Hungarian population toward finances and that a significant part of the Hungarian society is lack of the necessary knowledge to make responsible financial decisions.<sup>132</sup>

Another change that market economy brought into the everyday life of people is the wide range of credit available for individuals. Before the political transition "western-European lifestyle" was unavailable for Hungarians because of political and financial reasons.

<sup>131</sup> Wagner Ildikó: *A magáncsőd hiányából eredő problémák* [Problems arising from the lack of individual bankruptcy] THEMIS – Electronic periodical of the Doctoral School of Eötvös Loránd University Faculty of Law and Political Sciences; December 2009 (hereinafter: *Problems arising from the lack of individual bankruptcy*) ; p 58.

<sup>132</sup> According to a survey of the Hungarian Central Bank made in 2006 – [Magyar Nemzeti Bank – A lakosság pénzügyi kultúrájának felmérése /Kvalitatív kutatás a 15-17, illetve a 18-30 évesek körében/ September 2006. Budapest [Hungarian Central Bank – Survey on public's financial culture /Qualitative study among 15-17 and 18-30 years old subjects] available at:[http://www.mnb.hu/Root/Dokumentumtar/MNB/penzugyi-kultura/mnb\\_penzugyi\\_kultura\\_kvalitativ.pdf](http://www.mnb.hu/Root/Dokumentumtar/MNB/penzugyi-kultura/mnb_penzugyi_kultura_kvalitativ.pdf)] one third of the subjects still had a "rejective and suspicious attitude" toward loans offered by financial service providers - p 28. This survey showed youngsters in the age between fifteen and seventeen are lack of the basic financial knowledge. For example, very few of them knew about the existence of the Hungarian Financial Supervisory Authority. They hardly knew the difference between commercial and central banks. The awareness of basic financial definitions among people in the age between eighteen and thirty is very limited. For instance, not every subject knew the difference between annual interest rate and annual percentage rate of charge-p 32. Subjects consider their pensioner age as something very far and most of them do not have any long term savings- p 37. Another survey in 2011 [available at: [http://www.mnb.hu/Penzugyi\\_kultura/kutatasok/penzugyi-kultura-alapkutatas](http://www.mnb.hu/Penzugyi_kultura/kutatasok/penzugyi-kultura-alapkutatas)] showed that almost 40 % of the subjects were not able to make basic financial calculation like how much will be in their account after one year if they deposit 100.000 HUF for one year with 5 % annual interest rate and they did not deposit more and withdraw from that account. According to the press release of the Hungarian Central Bank 7th April 2011. [available at: [http://www.mnb.hu/Root/MNB/Sajtoszoba/mnbhu\\_pressreleases/mnbhu\\_pressreleases\\_2011/mnbhu\\_kozlemenye\\_20110407](http://www.mnb.hu/Root/MNB/Sajtoszoba/mnbhu_pressreleases/mnbhu_pressreleases_2011/mnbhu_kozlemenye_20110407)] more than 50 % of them did not have any savings.



After the transition the borders opened and supply of consumer goods increased. Around 2000 consumer credit appeared in the Hungarian market and gave consumers the opportunity to spend their income before they actually had earned it.<sup>133</sup> Banks and businessmen introduced more and more new types of consumer credits to increase the consumption and the demand for new consumer goods. The overall sum of outstanding loans of Hungarian households rose twelve times 2000 to 2008. By the end of 2008 – the first time since socialist regime- the sum of outstanding loans was higher than the overall sum of deposit and cash owned by households.<sup>134</sup> Consumer credits in a strict sense (every type of loan other than loans for house construction) reached a five times rise from 2004 to 2009.<sup>135</sup> The main point of these numbers is that financial service providers offered consumers the chance to obtain goods that they could not afford. People did not refuse the temptation of easily available credit and started to consume from their future income. The general tendency of gathering savings turned into a consumption oriented attitude.

Foreign currency mortgage loan was especially popular. This type had a quick and successful “carrier” until the financial crisis. By 2008 59 % of housing loans were denominated in foreign currency, mainly in Swiss francs (hereinafter: CHF). The low interest rate and the almost American style practice of Hungarian banks made this type of loans the flagship of Hungarian loan market.<sup>136</sup> Borrowers before the crisis often neglected the risk of a possible change of the exchange rate to their detriment. Before the crisis 1 CHF was worth around 160 Hungarian forints (hereinafter: HUF). After the outburst of the crisis the exchange rate suddenly increased above 200 HUF. Nowadays it is around 230-240 HUF.<sup>137</sup>

<sup>133</sup> Bánfi Zoltán – *(M)értéktelenül – A lakossági hitelek növekedése a válság előtt [Increase of household loans before the crisis]*; Hitelintézési Szemle 2010. 9th vol. , No. 4. pp. 349-350

<sup>134</sup> *id.*, p. 351

<sup>135</sup> *id.*, p. 359

<sup>136</sup> *id.* p. 354-355

<sup>137</sup> Official central exchange rate statistics of the Hungarian Central Bank; available at: <http://www.mnb.hu/Statisztika/statisztikai-adatok-informaciok/adatok-idosorok>



### 3.1.2. The current situation and measures enacted by the legislation so far

What is the outcome of the above mentioned factors in 2013? More than 16 % of the total outstanding loans of Hungarian households has more than ninety days past due.<sup>138</sup> This ratio is even worse in the case of foreign currency mortgage loans.<sup>139</sup> There are nearly one million foreign currency mortgage loan contracts in Hungary. Almost half of the borrowers have more than one loan contract. The most surprising fact is that there are almost a thousand borrowers, who have more than ten foreign currency mortgage loan contracts and - not surprisingly - almost half of them cannot pay their monthly installments.<sup>140</sup> In my opinion, these figures clearly show that indebtedness; especially in foreign currency is a crucial and wide-spread problem of Hungary.

The government tried to solve the problem of household loans with the following measures: exchange rate cap, conversion of non-performing foreign currency mortgage loans and establishment of the National Asset Management Agency.

The essence of the exchange rate cap is that debtors pay their monthly installments at a fixed change rate for sixty months and after that they follow the repayment at the market prices. The difference between this fixed amount and the market one during this period is partly paid by the borrower, the lender and the state. The principal part is collected on a separate account that the borrower will start to pay back after the sixty months period. The lender and the state bear the interest part.<sup>141</sup> The advantage of this cap is the moratorium that the borrower gets because he does not bear directly the risk of fluctuations of exchange rate and receives extra time to pay his loan back. The main weakness of this program is one of the eligibility

<sup>138</sup> Hungarian Central Bank's Report on Financial Stability November 2012; available at: [http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben\\_stabil/mnben\\_stab\\_jel\\_201211/jelentes\\_penzugyi\\_stabilitas\\_201211\\_en.pdf](http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben_stabil/mnben_stab_jel_201211/jelentes_penzugyi_stabilitas_201211_en.pdf) p. 40, chart 37

<sup>139</sup> It is above twenty percent; see *id.*, p. 42, chart 38

<sup>140</sup> *id.*, p 43, chart 39

<sup>141</sup> *Id.*, p41.

Summary of exchange rate cap by the Hungarian Financial Supervisory Authority, available at: [http://www.pszaf.hu/fogyasztoknak/hitelek/fizetesi\\_nehezsegek/arfolyamgat\\_120509.html](http://www.pszaf.hu/fogyasztoknak/hitelek/fizetesi_nehezsegek/arfolyamgat_120509.html)



requirements: only those borrowers may apply whose outstanding loan is not due for more than ninety days. So it did not provide solutions for a significant number of borrowers who are in the worst conditions.

The conversion of non-performing foreign currency mortgage loans was intended to help those borrowers whose loan past due was more than ninety days. They could convert their loan into HUF mortgage loan at an average market exchange rate of a given period. The banks had to cancel 25% of the converted debt and in exchange they got a discount from bank levy. This program solved the problems of only a small portion of borrowers because the requirements were too strict<sup>142</sup> and since the interest rate of the forint loan is higher the overall burden of the borrower only slightly lightened.<sup>143</sup>

The National Asset Management Agency was established in the summer of 2012 to purchase and let back at an equitable price the real estate of borrowers who have at least one child and receive some kind of social benefits. With the mutual consent of the borrower and lender the purchase price is used to satisfy the creditor's claim and the pledgee gives up any remaining claim. Because the eligibility criteria are reasonable and the fixed sum of rent is low (1,5 % of the purchase price per annum) this program is the most promising from the mentioned measures. The practical realization of it is still in progress but the aim is to acquire 25000 real estates until 2014.<sup>144</sup>

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<sup>142</sup> for example the value of the real estate collateral cannot exceed 20 million HUF - Hungarian Central Bank's Report on Financial Stability November 2012 *supra note* 138; p 41

<sup>143</sup> Hungarian Central Bank's Report on Financial Stability November 2012, *supra note* 138; p 41.

<sup>144</sup> *id.*, p 42.



## 3.2. Proposal for the Hungarian legislation of individual bankruptcy

### 3.2.1. Lack of Individual Bankruptcy in Hungary

As I described above, the average Hungarian household faces serious financial problems. The burden of dramatically increased monthly installments of foreign currency mortgage loans paralyzes hundreds of thousands of families, default of the payment for utilities and on consumer loans are common phenomena in the everyday life of an average Hungarian household. The helping hand of individual bankruptcy is not available for indebted Hungarians; the Hungarian legal system does not know this institution.

As I noted above bankruptcy law did not exist during the former regime. The rules of corporate bankruptcy were enacted during the transition, but individual bankruptcy was not; and has not been enacted yet. According to one theory the legislator simply neglected individual bankruptcy because the focus was on the bankruptcy of former socialist conglomerates. Another theory assumes an intention not to regulate in order to examine the experience of other countries.<sup>145</sup> Well, more than twenty years have passed since the change of regime, and individual bankruptcy is provided by every Western-European legal system.<sup>146</sup> In addition, Slovak Republic, Czech Republic and Poland<sup>147</sup> have also enacted their laws governing individual bankruptcy but Hungary has not done it yet.

Without this opportunity indebted individuals must find other ways to get out of financial trouble. One possibility is taking another loan to cover prior debts by which a debtor can avoid foreclosure. It is clearly not the proper long-term solution. In the less developed part of

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<sup>145</sup> *Problems arising from the lack of individual bankruptcy supra note 131; p 58*

<sup>146</sup> for a detailed discussion of West-European individual bankruptcy procedures *see* COMPARATIVE CONSUMER BANKRUPTCY *supra note 7*

<sup>147</sup> for a discussion of individual bankruptcy in these countries *see*: Sprinz, Petr – *Fresh-Start Policy of Bankruptcy Law in Visegrad Countries: Economic and Legal Analysis*; LL.M. Short Thesis, Central European University Budapest, 2011 pp 29-44



the country usury is an everyday practice. Debtors may try to renegotiate their loans with creditors but creditors are not bound by any law to be open for such negotiations. In addition, debtors may try to hide their assets and income from the reach of creditors if the law does not provide shelter for them.

Despite the need for individual bankruptcy procedure is communicated via media as common opinion of parties in parliament, in recent years there were two bills drafted in the topic and both of them were rejected in the very early stage of legislative process. At the time of writing this thesis – end of March 2013 – not even a draft has been submitted yet.

### 3.2.2. Proposal for the Hungarian legislation based on US Bankruptcy Code

My proposed system in general is a strict one which requires serious sacrifice from the debtor to get financial relief in order to avoid moral hazard problem and make the new procedure acceptable for the credit industry as well. On the other hand, I suggest a broad and in certain cases immediate discharge to provide the real possibility of fresh start to the debtors. In my opinion, this can be a working balance between debtors' and creditors' interests.

#### *3.2.2.1. The debtor*

Actual default should not be a requirement of filing for bankruptcy. Any individual could file who feels the need for a judicially supervised bankruptcy to provide financial help for him. Under any individual I mean not only consumers but individuals who do business under their own name so discharge could enhance entrepreneurialism. Filing should be only voluntary. If a debtor thinks he does not need the protection of bankruptcy he should not be forced to be subject of it because non-bankruptcy law provides enough debt collection tools



for creditors. But once a debtor has decided to file for bankruptcy he is obliged to cooperate, to disclose any relevant information concerning his financial situation and to act in good faith. Serious breach of these obligations may lead to denial of discharge and in certain cases to liability for damages and to criminal sanctions as well.

#### *3.2.2.2. The Credit Counseling and the Automatic stay*

Mandatory credit counseling in the US is criticized because it takes time of a debtor that he does not have and it is can be done in a very short time without real help for the debtor. In order to cure the weaknesses of the US pattern I would make it part of the bankruptcy procedure in Hungary. Participation in credit counseling should be mandatory before the debtor proceed to actual bankruptcy. If we make credit counseling an immanent part of the procedure, automatic stay would apply from the moment of applying for consultation. This would solve the time problem related to credit counseling. The debtor would enjoy the shelter of automatic stay and the counselor would have time to provide feasible advice to the debtor. Credit counseling should not be as automatic as in the US. In my proposed system this early bankruptcy stage would be the only one where the debtor has any space to maneuver. After counseling a statutorily detailed, an almost mechanical procedure would follow in order to make it quick and cost-effective. The debtor should have duty of disclosure from the moment he turns to the counselor. The credit counselor would examine the financial situation of debtor based on information provided by the debtor and if there is any other way out of financial trouble the counselor should find it and suggest the debtor to follow it. The counselor should warn the debtor for the costs of bankruptcy. If there is no other solution than bankruptcy the counselor would summarize the financial conditions of the debtor and certify that the debtor fulfilled the obligation to participate in credit counseling. Practicing credit counseling should be subject of a state issued license due to their important



role. The amount of their remuneration should be higher if they can suggest any other viable solution than bankruptcy. If the counseling is followed by bankruptcy counselor's remuneration is an administrative cost, otherwise the debtor pays a certain percentage of debts.

### *3.2.2.3. Need for discharge*

The legislator must decide if he wants to provide any kind of discharge for debtors or only a debt rearrangement procedure. Because of the justifications described in Chapter 1, I advise to provide financial relief for debtors and not only a legally governed renegotiation process. A negotiation legally imposed on creditors for the request of the debtor with the requirement of good faith and cooperation on both sides may help certain debtors. As another alternative, a court approved repayment plan created by the debtor and imposed on creditors without discharge only as restructuring of loans may provide some aid but I think without any kind of discharge the new procedure would not be able to provide a real, meaningful solution. Discharge is the “carrot” for debtors. Without discharge what would encourage the debtor to perform the repayment plan? If he does not cooperate he cannot be in a worse situation than he was before and even if he sticks to the plan he has to repay all their debts. There is no real reward for the debtor, however, cooperation of the debtor is a crucial element of debt collection procedures and it was recognized centuries ago.<sup>148</sup> Without any discharge debtors would not be really interested in even choosing this new opportunity and probably they would rather opt for the other solutions mentioned above.

The second step after the legislator decided to provide discharge is the choice of what kind of financial relief should the new procedure provide. A Chapter 7 style immediate relief or rather a Chapter 13 conditional discharge, or both of them is a possibility. I would provide

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<sup>148</sup> see above history at 1.2.



both of them. The Bankruptcy Code by offering two possible ways for individuals to get relief makes an important step toward the individualization of cases and reaches more debtors than without any of the two procedures. Every case is different; every debtor has his own unique life situation but two basic types that the US Bankruptcy Code recognizes can be distinguished in Hungary as well. As I noted above, liquidation bankruptcy is suitable for debtors who are in default with utilities' bills and installments of their consumer loans in amounts which are higher than their yearly income and do not have any significant assets besides their homes. It is not reasonable to kick them when they are already on the floor. Fresh start can give them a new chance. A conditional discharge would be suitable for low and middle class working people whose foreign currency mortgage loan installments increased suddenly and are on the edge of foreclosure, but who have regular income and a considerable amount of assets. Usually these families face the decision every month to pay their mortgage loan installments or fulfill other financial obligations. Bankruptcy would give them time to rearrange their financial conditions. They would get relief from part of their non-secured debts and more income would be available for the repayment of their mortgage loans.

#### 3.2.2.4. *"The Hungarian Means Test"*

In order to mitigate the moral hazard problem both ways of discharge must have mechanisms to make sure only honest but unfortunate debtors can get the benefit of discharge. Eligibility for immediate discharge must have strict requirements because it is a very drastic exception from the obligation of full performance of contracts. I would not give broad discretion to judges to decide about eligibility, in my opinion, a simple and easily applicable formula makes the procedure quicker. My proposed formula would be the following. At first, the court should determine the average monthly income of debtor. It would include any kind of income the debtor's household receives in regular basis during one year prior to filing,



social benefits as well. Based on the minimum of subsistence data of Hungarian Central Statistical Office the court would deduct the necessary expenses for a minimum of subsistence and the result would be the debtor's available income for repayment of debts. The only allowable extra expenses would be medical expenses and the monthly installment of secured loans. Minimum of subsistence data can be used in this context because it represents income which meets demands beyond basic needs.<sup>149</sup> If the disposable income of a debtor is enough to pay back the considerable ratio of unsecured debts in a reasonable time then debtor would not be eligible for immediate relief. This threshold is low enough to filter those who are not in real trouble. On the other hand, it is unreasonable to pursue someone who can barely cover basic expenses of his household. Considerable ratio should be around 10-20 % of unsecured debts.<sup>150</sup> I think below this interval it is simply not worth to pursue any procedure against debtor. I would determine the threshold in ratio of over-all debt instead of a given amount of money because I think the proportion of repayment compared to the whole amount of debts expresses better the debtor's ability to repay and it does not require regular modifications.

### 3.2.2.5. *Exempt property*

Another important aspect of protection against moral hazard problem is the costs of fresh start. In case of straight bankruptcy the main cost is the surrendered property. I would stick to the strict approach reflected above in the "Hungarian means test". In the context of straight bankruptcy I would use the rules of judicial execution for movables and immovables except debtor's residence which set narrow range of exempt property<sup>151</sup>, but leave necessary

<sup>149</sup> Hungarian Central Statistical Office: Minimum of Subsistence 2011; June 2012; available at: <http://www.ksh.hu/docs/eng/xftp/idoszaki/letmin/eletmin11.pdf> ; p 2

<sup>150</sup> for example, in Austria the threshold is 10% - COMPARATIVE CONSUMER BANKRUPTCY *supra* note 7; p 83.

<sup>151</sup> Act LIII of 1994 of Hungary on judicial execution §90;



property for the debtor. Every movable asset of debtor which is not in the list of exempt property should be available for creditors unless the debtor proves special circumstances. This exception gives a small room for court's discretion. According to the rules of judicial execution not even the residence of a debtor is an exempt immovable asset. In the context of bankruptcy I would change it and I suggest a setting the ratio of value of residence and amount of unsecured debts. Below a certain ratio debtor's residence would be exempt property.

In case of mortgage loans or any other security interest on the residence of debtor the US system could be used. If a debtor's residence is subject to security interest he may choose between giving up the property and paying the monthly installments after the relief from unsecured debts. If the debtor cannot repay in installments his mortgage loans even after relief from unsecured debts he should give up his residence and find another house he can afford to himself. I think this solution could be acceptable by the credit industry as well, because straight bankruptcy would not change the secured loan contracts but would leave more available income for debtor for the repayment of these loans.

#### *3.2.2.6. Repayment plan*

Three main aspects of repayment plan must be determined: the mandatory length; the minimum amount of debts to be repaid and the amount of disposable income. "Hungarian means test" can be used to set the minimum amount to be repaid and the amount of disposable income. If debtor cannot repay at least 20-30 % of his debts from his income above minimum of subsistence he is not eligible for a conditional discharge. The length of repayment plan is a crucial point. If it is short, creditors may not get enough money back on the other hand,



success of repayment plan is more likely if it does not constraint the debtor's financial life for a long time. The three to five year period applied by the US Bankruptcy Code could be followed; European jurisdictions apply similar intervals too.<sup>152</sup> Three to five years is a feasible compromise.

#### *3.2.2.7. Scope of discharge*

Another basic element of fresh start besides exempt property and exempt income is the scope of discharge. The list of non-dischargeable debts should be exhaustive. The scope of immediate discharge should be narrower than the conditional one's because immediate discharge is a more generous benefit. Debts arisen from any fraudulent conduct; support of debtor's dependent, liability for tort should not be dischargeable. US Bankruptcy Code provisions could be used as a pattern here as well, but contrary to them, I suggest making taxes and duties dischargeable. I propose a strict individual bankruptcy system but in my opinion, the state should contribute to the goals mentioned in chapter 1 by letting taxes be dischargeable debts because on the macroeconomic level those justifications outweigh the individual obligation to share past public burden.

#### *3.2.2.8. Role of Courts and Bailiffs*

Law in books can only be effective if it is implemented by potent institutions. Hungarian courts are generally over-burdened and that is why court's role in these procedures should be only supervisory in nature. Bailiffs should have a central role in the administration of the case. They have the necessary knowledge and infrastructure to execute the liquidation of debtors' assets and to distribute debtor earnings between creditors; basically that is what

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<sup>152</sup> COMPARATIVE CONSUMER BANKRUPTCY *supra* note 7; pp 78-85



they already do under the current law of judicial execution. Their role would not change at all, only the applicable law in bankruptcy would be slightly different from the general rules of judicial execution. Bailiffs get their remuneration in percentage of the liquidated property, distributed money; fulfillment of these new obligations would mean further income for them and not only burden. The bankruptcy system could maintain itself from this income. Administrative costs already have priority. This solution shares the risk between debtor and creditor because administrative costs are covered by the debtor but it also makes creditors portion smaller. The new law should grant US Bankruptcy Code style strong entitlements in order to guarantee both sides' interests and to administer efficiently the procedure. Courts would only supervise the lawfulness of the procedure and order the discharge of debtor if the procedure met the statutory requirements.

### 3.3 Summary

In the first part of this chapter I summarized very briefly and in a very simplified way the current financial situation of Hungarian households and the possible main reasons which led to it. The “saver attitude” of the society turned to the opposite because lenders flooded the market with easily available consumer and housing loans. Borrowers neglected the risk and gave into the temptation of lower interest rate of foreign currency loans partly because of their low financial culture. HUF dramatically weakened compared to CHF from the beginning of the financial crisis. Borrowers whose loans were nominated in foreign currency still had to pay their extremely increased monthly installment (which was rising as HUF was falling) from their salary which they got in HUF. Since for most of the borrowers the initial amount of installment already reached the limit of their household budget, the increased sum pushed hundred thousands of them every year<sup>153</sup> to the edge of insolvency.<sup>154</sup> Legislative measures

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<sup>153</sup> Forced liquidation data of the Hungarian Financial Supervisory Authority  
[http://www.pszaf.hu/en/left\\_menu/pszafen\\_publication/forced\\_liquidation.html](http://www.pszaf.hu/en/left_menu/pszafen_publication/forced_liquidation.html)



enacted by the government were not sufficient enough to provide considerable solution for this problem.

As a possible solution for the over-indebtedness of Hungarian households I suggest the introduction of individual bankruptcy into the Hungarian legal system. My proposed procedure is liberal and strict at the same time. It is liberal because immediate and relatively broad discharge would be available for individuals in financial hopelessness and give conditional discharge for those who can repay at least part of their debts. On the other hand, serious sacrifice would be required from the debtor in exchange of the benefit of fresh start. The list of exempt personal property is narrow under the current rules of judicial execution and I would not change it, debtors would have to give up every asset they have to get immediate relief except those which are necessary for a very minimal way of life. The residence of a debtor would be exempt only if the amount of unsecured debts does not reach a certain ratio of the value of the real estate. The principle of lien pass-through bankruptcy would be respected. During the fulfillment of a repayment plan debtor would have to hand over all earned income above the amount of minimum of subsistence. The procedure would be supervised by the courts but administered by bailiffs with a wide range of rights in order to fulfill their tasks. The system should be statutorily detailed and would leave little room for court discretion in order to make the system time- and cost-effective. In contrast to the US system, credit counseling would be part of the bankruptcy procedure and should not be mechanical, but counselors should really examine the situation of debtor and try to work out a solution other than bankruptcy. This way of credit counseling would be the first filter of ineligible debtors and would make sure that debtors use bankruptcy only as a last resort.

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<sup>154</sup> According to the calculation of Hungarian Central Bank the rise in installment is the main aim for default of foreign currency mortgage loans. It had bigger effect than the increase of unemployment. – Report on Financial Stability April 2012.; p. 47, box 6., available at : [http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben\\_stabil/mnben\\_stab\\_jel\\_201204/jelentes\\_penzugyi\\_stabilitas\\_201204\\_en.pdf](http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben_stabil/mnben_stab_jel_201204/jelentes_penzugyi_stabilitas_201204_en.pdf)



## Conclusion

Despite the Europe-wide trend toward the regulation of individual bankruptcy and the general over-indebtedness of Hungarian families, the Hungarian legal system does not provide this opportunity for individual debtors in financial distress. Previous Hungarian legal scholars have already identified this issue but they have not come up with any exact suggestions. The aim of this thesis has been establishing a theoretical basis of a possible regulation.

Before elaborating my thoughts about the guidelines of Hungarian legislation at first I summarized the justifications and critics of fresh-start offered by individual bankruptcy. I showed what are the goals that this procedure can serve and what are the drawbacks that the legislator must handle in order to set a system which provides a feasible balance between debtors' and creditor's opposing interests. By describing the main institutions of US Bankruptcy Code concerning individual bankruptcy I highlighted how that balance can be achieved.

My proposed system is liberal and strict at the same time. It is liberal because it provides immediate discharge as well and the scope of discharge can be considered as broad. On the other hand, it is strict because only debtor's in hopeless conditions are eligible for immediate relief and debtors who opt for conditional discharge have to live in a very minimal standard of life and pay back as much as possible of their debts in the three to five years long commitment period. The liberal side gives meaningful fresh start for debtors while the strict part of the system makes it acceptable for the credit industry as well. For cost-efficiency reason bailiffs would have central role in the procedure. Courts would have only supervisory function to assure the lawfulness of the procedure. I would make credit counseling a



mandatory and substantial part of the procedure. Automatic stay would operate even during credit counseling and the duty of cooperation and full disclosure would bind debtor already in this early stage of the procedure. These provisions would make the counselor able to advise other possible solutions of debtor's financial problem. Counselors could filter those who are not in real need and they could make sure that debtors use bankruptcy only as last resort and not as a way of escape from financial obligations.

Individual bankruptcy is not a magical cure and would not solve all the financial problems of every Hungarian family. It would be a possible and efficient way for them to deal with their debts. A properly drafted act would make social gains to the extent which significantly overrides the particular creditor's interest in full-repayment of every single debt. This thesis contributes to this work by setting a theoretical framework based on the US individual bankruptcy system.



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