Individual Bankruptcy Law for Ethiopia: Lessons from United States and Germany

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Abstract

After deregulation of consumer credit and resultant availability, over-indebtedness became a problem for many countries. As a response to this many jurisdictions have departed from their "merchant oriented" bankruptcy law to include individuals giving them discharge and fresh start. Germany, United States, United Kingdom and France are some of the countries that adopted consumer bankruptcy laws after experiencing over-indebtedness problem.

There are also several other reasons for using individual bankruptcy discharge and fresh start as an important policy tool. Accordingly, individual bankruptcy law, with discharge and fresh start, is justified out of entrepreneurship policy, development policy, social insurance function, debtor rehabilitation and reintegration and human act of forgiveness. These factors also determine the scope of one's individual bankruptcy law. The German and United States individual bankruptcy laws confirm this fact.

In Ethiopia credit market is still highly regulated; nevertheless consumers have access to credit and are potentially exposed to risk of indebtedness and there is a move towards that. Adopting individual bankruptcy law can also be an *ex ante* solution. More importantly, introducing such law to Ethiopia is more convincing based on the entrepreneurship, social insurance, development policy and rehabilitative function of discharge and fresh start.

It is, therefore, my thesis that Ethiopia also should follow the global trend by adopting individual bankruptcy with adequate discharge and fresh start. This law should be based on German model, repayment plan and then discharge. The discharge should be subjected to payment of certain portion of debt and the debtors should cover cost of proceeding. This will reduce the burden of financing the system.

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Introduction

Recent trends in bankruptcy show that many countries of the world, industrialized or otherwise, have been introducing an individual bankruptcy law[1] to solve the problem of consumer over-indebtedness and concomitant social and economic problems.[2] The previously "merchant-oriented" bankruptcy system is considered to be vital tool for individuals as well. Indebtedness ceased to be problem of merchants and corporations only.[3] With the deregulation of credit market and individuals access to consumer credit, over-indebtedness is becoming a problem for consumers, the society and the economy.[4] To this effect adoption of individual bankruptcy law is being seen as a solution. Countries such as United Kingdom, United States, Germany and France adopted individual bankruptcy laws as a reaction to availability of consumer credit and accompanying indebtedness. There are, however, countries that still restricted their bankruptcy law to merchants only. A case in point is Ethiopia. Under Ethiopian law, only merchants are entitled to file for bankruptcy and individuals are excluded from the scope of the law. That was based on the French approach that restricted bankruptcy in the same way to businesses only.[5] French has departed from that philosophy and introduced bankruptcy for consumers in 1989.[6] The reasons for such departure are almost, universal and there is only a difference in the approaches to the solution. It is interesting to see if Ethiopia has to abandon its restriction and allow individuals to knock the door of courts for relief when they do not have a means to pay their debt.

[1] Rafael Efrat, *Global Trends in Personal Bankruptcy, 76 Am. Bankr. L.J, 81 (2002),* p. 81
[2] Adam Feibelman, *Consumer Bankruptcy as A Development Policy, 39 Seton Hall L. Rev. 63 (2009),* p. 96
[3] Johanna Niemi *et al*, CONSUMER CREDIT, DEBT AND BANKRUPTCY: COMPARATIVE AND INTERNATIONAL PERSPECTIVES, HART PUBLISHING, (2009) p. 225
[4] G. Stanley Joslin, *The Philosophy In Bankruptcy: A Re-Examination, 17 U. Fla. L. Rev. 189 (1964-1965)* pp.189-191
[5] Lencho, Tadesse, *Ethiopian Bankruptcy Law Commentary Part I, XXII*: *2 Journal of Ethiopian Law, 57 (2008),* p. 69
[6] Robert Anderson *et al, (Ed.) Consumer Bankruptcy in Europe: Different Paths for Debtors and Creditors, 09 EUI Working Papers (2011),* p. 19

Accordingly the thesis is organized as follows. The very opening of the body of the thesis deals with the historical development of individual bankruptcy discharge and fresh start and its theoretical underpinnings. It mainly discusses the Anglo-American jurisprudence, the pioneer of bankruptcy discharge and fresh start, as a bench mark for the theoretical and philosophical underpinnings of individual bankruptcy. History of discharge, justifications for it and associated costs to discharge and fresh start are discussed in this chapter. The second chapter is dedicated to deal with the comparative discussion of the United States and German individual bankruptcy laws. The two leading countries with contrasting fresh start policy are chosen to see the strengths and weaknesses of each system with a view of finding a suitable fit for Ethiopia. Chapter three is reserved to discuss the Ethiopian context and the need to adopt individual bankruptcy law to Ethiopia, if at all it means of some help to the country. The pros and cons of adopting individual bankruptcy law and fresh start is discussed from the experience of the jurisdictions discussed above. Finally, concluding remarks will be made.

Chapter One - General Overview Individual Bankruptcy Law

1.1 Historical Development of Individual Bankruptcy Law

In earlier times indebtedness was a matter only for business entities and individuals were excluded from the ambit of bankruptcy law.[7] Individual debtors were subjected to barbarous punishments when they fail to repay their debt.[8] These punishments include moral degradation of the debtor, physical punishment, relegation to the status of slavery, and even death penalty.[9] Part of the reason for such treatment was because failure to repay a debt was considered as contrary to the moral dictates of the society.[10] In many ancient jurisdictions creditors were entitled to a cruel and primitive self-help remedies against the defaulters' person and property.[11] Back in time, the today debtors' heaven United States was not even different in this regard.[12]

Bankruptcy law was dressed with criminal law type function and debtors were almost considered as criminals.[13] The protection it sought to provide was towards the creditor.[14] Creditors were allowed to individually, and not as a group, employ different self-help remedies to including "draconian punishments" against the person and property of the debtor.[15] However this was not helping the creditor since there were no effective ways of

[7] See G. Stanley Joslin, *supra note 4 p. 189*; see also Nathalie Martin, Common Law Bankruptcy Systems: Similarities and Differences, 11 Am. Bankr. Inst. L. Rev. 367 (2003), pp. 372-373; Charles J. Tabb & Ralph Brubaker, BANPRUPTCY LAW PRINCIPLES, POLICIES AND PRACTICE, Anderson Publishing Co. (2003), p. 479

[8] Rafael Efrat, *The Evolution of Bankruptcy Stigma, 7 Theoretical Inq. L. 365 (2006)*, pp. 367-368 & 372

[9] *Id*. p. 366;

[10] *Id. pp.* 367-368, see also John C. McCoid, II, The Origins of Voluntary Bankruptcy, 5 Bankr. Dev. J. 361 (1988), p. 387; Ramsay, Iain D. C., *Comparative Consumer Bankruptcy. University of Illinois Law Review, p. 241 (2007), p. 256, available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=958190 *last visited on 28 March 2014*

[11] See Rafael Efrat, *supra note 8, pp.* 370-374

[12] *Id*. pp. 374-385

[13] See Nathalie Martin, supra note 7, p. 370, ; see also G. Stanley Joslin, supra note 4, pp. 192-193

[14] See G. Stanley Joslin, supra note 4, p. 190

[15] *Id*., see also Rafael Efrat, supra note 8, pp. 366-368, 372, Nathalie Martin, supra note 7, p. 371; Charles J. Tabb, *The History of The Bankruptcy Laws in The United States, 3 Am. Bankr. Inst. L. Rev 5 (1995), p. 7*

discovering and seizing the assets of the bankrupt who may transfer or sell it and change his location to escape the consequences of his/her act.[16]

It was inevitable that the bankruptcy system had to be reformed and abandon sever treatments of the debtor on the one hand and should give creditors an effective debt collection and distribution tool on the other.[17] Factors that led to the reform of bankruptcy law into a debt collection tool were the expansion of credit, trade and commerce.[18] Around the end of 17th century, individual debt collection mechanisms became inadequate to cope with the development of commerce; distance traders have to travel and the increase and diversity of creditors. The "race of diligence" among creditors over the assets of the debtor prompted this change. Race among creditors with the rule "first come first served" was inequitable and as a solution to the problem of race among creditors[19] situated in the same footing, a common debt collection mechanism needed to be created.[20] This bankruptcy philosophy was not only protection of creditors against the debtors but also among creditors as well.[21] Accordingly, bankruptcy was recognized as a debt-collection tool while, incidentally, the debtor started to be treated humanely.[22]

In 1705, discharge as a legal doctrine was invented under English law[23] and "honest but unfortunate debtors" started to be released against surrendering all their non-exempt assets in satisfaction of the full amount they owed creditors.[24] For example, doctrine of

[16] *See* G. Stanley Joslin, *supra note 4,* p. 190
[17] *Id., p*. 191
[18] *See* Charles J. Tabb, *supra note 15*
[19] *See* Michelle J. White, Why don't More Households File for Bankruptcy, *Journal of Law, 14 Economics, & Organization*, 205 (1998) p. 211
[20] *See* Charles J. Tabb, *The Historical Evolution of Bankruptcy Discharge, 65 Am. Bankr. L. J, 325 (1991), p. 328*, see also Malhotra, Vibhooti, *Debtor's Discharge Under United States Bankruptcy Code: Mechanisms and Consequences (March 21, 2010).* p. 9, *Available at SSRN: http://ssrn.com/abstract=1646608 or http://dx.doi.org/10.2139/ssrn.1646608 last visited 26 March 2014*

[21] *See* Charles J. Tabb, *supra note 15*; see also Charles J. Tabb, *supra note 20*
[22] *See* Charles J. Tabb, supra *note 20, p. 333*; see also Malhotra, Vibhooti, *supra note 20*, p. 7

[23] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7*
[24] *See* G. Stanley Joslin, *supra note 4*, pp. 191-192

discharge was incorporated to the law of England at the beginning of the eighteenth century.[25] This change in bankruptcy philosophy was the result of industrial revolution that creates positive environment towards credit.[26] This marked the shift of bankruptcy philosophy from treating failure to pay harshly towards a rehabilitation tool of the debtors.[27]Punishing debtors or subjecting them to barbarous treatment proved to serve no one and this change was one of the most important developments in the history of bankruptcy. And the discovery of exemptions and discharge revolutionized bankruptcy philosophy in the world and particularly in United States into one that sympathizes the debtor than the earlier creditor-oriented approach.[28] This changed the philosophy and practice of United States bankruptcy law into rehabilitating and reorganizing tool than a punishment and liquidation instrument.

Despite the negative attitude society had towards individual bankruptcy, currently there is a trend towards adoption of individual bankruptcy into laws of many countries.[29] The scope and protection afforded by these laws vary through out history and across jurisdictions. It ranges from being totally creditor's collective remedy to a 'debtors' relief in the form of discharge and fresh start.[30] So it is conceivable to imagine rough variations from "no relief" to 'automatic debt relief' jurisdictions."[31] In some jurisdictions either there is no access for individuals to opt for bankruptcy or no relief is going to be granted even if there is access.[32] In jurisdictions where individuals have access it may simply be a debt collection tool for the

[25] *See* Charles J. Tabb, *supra note 15 p. 10;* see also Charles J. Tabb, *supra note 20, p. 333*; *See* Malhotra, Vibhooti, *supra note 20*, p. 7

[26] *See* Charles J. Tabb, *supra note 15*, p. 12

[27] *See* G. Stanley Joslin, *supra note 4, p.* 193,; see also Paolo Di Martino, *The Historical Evolution of Bankruptcy law in Italy, England and US*, Paper presented at workshop at the Södertörns Högskola (Stockholm, August 2005), p. 264; See also Margaret Howard, *A Theory of discharge in consumer Bankruptcy, 48 Ohio St. L.J. 1047 (1987), pp. 1051-1052*

[28] *See* G. Stanley Joslin, *supra note 4*, p. 194

[29] *See* Rafael Efrat, *supra note 1*

[30] See John C. McCoid II, *Discharge: The Most Important Development in Bankruptcy History, 70 Am. Bankr. L.J. 163 (1996),* pp.164-165

[31] *See* Rafael Efrat, *supra note 1*

[32] *Id*, p. 84

creditors and not intended to benefit the debtors in the form of discharge and fresh start. In other jurisdictions individuals are entitled to discharge and fresh start as part of the bankruptcy process. Notable example where debt forgiveness and discharge is available is United States.[33]

Hence, there is a trend towards convergence with regard to extending bankruptcy law to individuals but there are still significant differences in approaches.[34] These disparities in the treatment of individual debtors are attributed to several factors including but not limited to colonization,[35] deregulation of credit markets,[36] social welfare available,[37] and differing policy emphasis for entrepreneurship.[38] Worth to note at this point, however, is that countries that traditionally restrict their bankruptcy law to merchants are shifting towards allowing non-traders to be part of the bankruptcy process and benefit from discharge and fresh start.[39]

1.2 History of Discharge and Fresh Start in Bankruptcy

Discharge and fresh start is at the heart of individual bankruptcy.[40] It is a release of the debtor of his pre-petition debts against full surrender of all is his non-exempt property to the creditors.[41] This legal doctrine was invented in England and developed into a comprehensive legal doctrine in United States.[42] The invention of discharge was one of the

[33] *Id,* p. 87
[34] For example United States and Germany both have individual bankruptcy law. Debtors are entitled to file for bankruptcy. But the relief for bankrupt debtor is very different in the two countries. United States give relaxed and automatic discharge while Germany the debtor has to wait and act in a particular way to earn the fresh start. For more explanation see chapter 2.
[35] See Rafael Efrat, *supra note 1,* p. 91
[36] *Id.*, p. 92
[37] *Id.* p. 96
[38] *Id.* p. 98
[39] *Id.* pp. 81 &108, ; *see also* Lencho Tadesse, *supra note 5,* pp. 69-70
[40] Thomas H. Jackson, *The Fresh Start Policy in Bankruptcy Law, 98 Harv. L. Rev., 1393 (1985),* p. 1393
[41] *See* Charles J. Tabb, *supra note 20,* p. 351, see also Rendleman, Douglas R., *Bankruptcy Revision: Procedure and Process, 53 N.C.L. Rev. 1197 (1974-1975),* p. 1200*;* see also David G. Epstein et al, BANKRUPTCY, PRACTITIONER TRETISE SERIES, West Publishing Co., (1992), pp.12-13
[42] *See* John M. Czarnetzky, *The Individual and Failure: A Theory of Bankruptcy Discharge, 32 Ariz. St. L.J. 393 (2000),* p. 400

turning points in history of bankruptcy law that marked the shift from being only creditors remedy to that of debtors remedy.

The first time discharge invented in the Anglo-American jurisprudence was when it was first used under English law at the beginning of eighteenth century where "honest but unfortunate debtors" started to be released against giving their remaining property in satisfaction to their whole pre-petition debt.[43] At first, it was not intended to benefit debtors and rather the impact was incidental.[44] It was a kind of incentive for the debtor's cooperation and hence a collection device.[45] This first English discharge law was problematic in two ways.[46] Firstly, the scope was limited to that of merchant debtors and was therefore out of the reach of non-traders and secondly, voluntary bankruptcy was not put in place and it hampered the possibility of getting discharge.[47]

The use of credit by individuals was a condemned act and remedy of forgiveness was not available.[48] Rather the use of credit and accompanying risk was sympathized by the society and the remedy for failure was available for merchants only.[49] Even for the merchants the full utilization of the remedy was impacted by the fact that there exists only creditor triggered bankruptcy i.e. involuntary bankruptcy.[50] The consent of the creditor was also necessary for discharge.[51] This requirement was abolished later in 1883[52] and replaced by courts discretion either to grant or deny discharge.[53] The application of discharge was not automatic and should be raised as a defense by the debtor when approached by the creditor

[43] *See* Charles J. Tabb, *supra note 20*, p. 333
[44] *Id*., see also Malhotra, Vibhooti, *supra note 20, p. 7*; Margaret Howard, *Supra note 27, p.* 1049

[45] See Margaret Howard, supra note 27, p. 1049; See also Douglas G. Baird, ELEMENTS OF BANKRUPTCY, The Foundation Press, (2010) p.37
[46] *See* Charles J. Tabb, *supra note 20*, p. 334
[47] *Id*. pp. 334-336
[48] *Id*., p. 335
[49] *Id*., See G. Stanley Joslin, *supra note 4, p* 189
[50] *See* Charles J. Tabb, *supra note 20*, p. 336
[51] *Id*., pp. 337 & 339
[52] *Id.*, pp. 354 &357
[53] *Id.*, p. *363*

seeking repayment.[54] All these reveal that discharge incorporated in English law of the time was intended to help creditors' collection efforts and not to release the debtors as its objective. This however was an important development and in fact a shift from a barbarous treatment to a more humane view of the debtors. This move was followed by the recognition of individuals into the realm of bankruptcy in 1861 and voluntary bankruptcy for merchants was introduced altogether.[55]

The United States first bankruptcy Act, the 1800 Act, was not different from its English parent. Individuals were not recognized to the bankruptcy system, bankruptcy was involuntary, and discharge was not automatic as in English law.[56] Bankruptcy with debtor protection as its objective came only after the 1841 Act.[57] Though with creditors consent, voluntary bankruptcy was allowed for the first time and scope of bankruptcy was extended to non-traders.[58] This pro-debtor attitude later resulted in different reforms that favor the debtor to a certain extent. Invoking discharge, as an affirmative defense by the debtor was abolished and it became the duty of the creditor to file dissent.[59] Another change was, although creditors' consent for discharge remained in operation the majority required for blocking discharge was reduced.[60] The debtor was, also, granted right of appeal against denial of discharge for the first time.[61] This right of appeal was the result of the availability of discharge to all persons, individuals and businesses, and expanded grounds of denial of

[54] *Id.*, pp. 340-343
[55] *See* Charles J. Tabb, *supra note 20*, p.354
[56] *Id.*, pp. 345-346. As it was in English law, in order to benefit from discharge the debtor has to pay substantial percentage of the debt, get confirmation from the commissioners and finally the consent of the creditor.
[57] *Id.*, p. 349
[58] *See* Charles J. Tabb, *supra note 20*, pp. 349-350, *see also* Charles J. Tabb, *supra note 15, p.* 17
[59] *See* Charles J. Tabb, *supra note 20*, pp.351-352
[60] *Id.* p. 352
[61] *Id.*

discharge.[62] Subsequent amendment to the 1841 Act, i.e. the 1867 Act, made discharge very difficult to obtain because there existed several grounds of denial.[63]

Creditors' consent for discharge in United States was removed later in the 1898 bankruptcy Act.[64] Unlike its English counter part, the United States law did not give judges the discretion and denial and grant of discharge was statutorily fixed.[65] This was an important departure from the long existed bankruptcy jurisprudence, which had its prime focus of helping the creditor in his collection effort and incidentally benefiting the debtor by making discharge a relief for "honest but unfortunate debtors".[66] Here came 'fresh start' where "the debts of the debtor are wiped-out and he started life afresh as a productive member of the society".[67] The grounds of denial of discharge were reduced and only discharge was refused where the debtor committed acts of bankruptcy.[68] "This is the result of a moral distinction between fraudulent and "honest but unfortunate" debtors."[69] This pro-debtor policy was criticized as lax attitude and it became tight again and certain exceptions to it were provided.[70] Part of the criticism was that debtors were using the bankruptcy law as an escaping mechanism of their obligation[71] while they could have paid their obligation out of their future income.

As it is discussed earlier under Section 1.1, the first use of proper bankruptcy law was a means of debt collection and equitable distribution among creditors.[72] Even discharge

[62] *Id.*
[63] *Id*. pp. 356-358
[64] *Id.* p. 364
[65] *Id.*, p. 364
[66] *Id.*, pp. 364-365
[67] *Id.*, p. 365
[68] *Id.*, p. 366; Discharge could only be denied if the debtor committed bankruptcy crimes or committed fraud.
[69] *See* John M. Czarnetzky, *supra note 42,* pp. 425-426
[70] *See* Charles J. Tabb, *supra note 20,* p. 368
[71] *See generally* Irving A. Breitwoitz, *New developments in Consumer Bankruptcy: Chapter 7 Dismissal on the Basis of Substantial Abuse, 59 Am. Bankr. L.J. 327 (1985)*
[72] Rendleman, Douglas R., *The Bankruptcy Discharge: Towards A Fresher Start, 58 N.C. L. Rev. 723 (1979-1980),* p. 724 & 893; *See* also Rendleman, Douglas R, *supra note 41,* p. 1200

introduced at the earliest point of the invention of the concept was as a means of securing the cooperative hand of the debtor in the debt collection process[73] and discharge was just a kind of incentive for that. Later in the 20th century, however, the philosophy in bankruptcy discharge changed the other way-as a relief to "honest but unfortunate debtors".[74] This doctrine of discharge of debts of "honest but unfortunate debtor" was articulated in *Local Loan,* one of most famous United States Supreme Court cases in the history of the subject.[75] Accordingly, the debtor started to be released from pre-petition debts he incurred. Any asset acquired or income earned after bankruptcy petition could not be attached to the claims of the creditor.

The choice of protection between creditor and debtor has passed through different historical developments of the Anglo-American bankruptcy law. From 16th to mid 19th century, the concept of bankruptcy was purely and simply a creditors' vengeance-type remedy against debtors. Later the harsh treatment of the debtor by the legal system and creditors proved to be unnecessary in the debt collection process and bankruptcy was devised to serve as a debt collection tool. Incidentally the debtor started to be treated humanely.

At the end of 19th century and beginning of 20th century debtor protection and relief became the corner stone of the individual bankruptcy system. Accordingly, discharge became and is one of the means to give such protection. Further reforms to bankruptcy discharge and fresh start were motivated by the need to protect consumers who are overwhelmed by the availability and complexity of the credit market in particular and trade in general.[76] This was rationed on the idea of protecting the weaker party, which other social security systems failed

[73] Rendleman, Douglas R, *supra note* 72, pp. 724 & 893,
[74] *Id.*
[75] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7, pp. 479-80*
[76] *See* Malhotra, Vibhooti, *supra note 20*, p. 4; see also see also see also Rendleman, Douglas R, *supra note 41*, p. 1202

to address adequately.[77] It is consequential that discharge and fresh start is available to individuals and not businesses, in most cases.[78] Discharge is not any more a debt collection mechanism. It is justified out of several reasons that are not necessarily protecting the creditor.

1.3 Justifications for Discharge and Fresh Start

The conventional rule with regard to bankruptcy is that it is a tool to help the creditors seize the assets of the debtor and satisfy their claim. It was creditors' collection tool.[79] And debtors were not the concerns of legislators. This can be witnessed from the bankruptcy legislations worldwide that restricted bankruptcy proceedings only for businesses. Later it became clear that this creditor centered approach had to be reformed.

Individuals were admitted to the scope of bankruptcy long after it is first used for the sole purpose of protecting creditors.[80] Bankruptcy law started from the philosophy that stigmatized and severely treated debtors to the situation where they are released form of discharge and start life anew. So the invention of the concept of discharge was a turning point in history. It resulted in the release of "honest but unfortunate debtors" form their pre-petition debt.[81]

The philosophy of bankruptcy law that admitted individual debtors to its scope has to be backed by strong justifications. It is against state collection law that requires debtors to discharge their obligations. Discharge is an exception to the conventional norm of repaying one's debt. And as an exception it needs overwhelming justifications.[82] Different scholars

[77] *See* Rendleman, Douglas R, *supra note 41*, pp. 1202-1203
[78] *See* Malhotra, Vibhooti, *supra note 20*, p.7

[79] *See* Charles J. Tabb, *supra note 15*; pp.14-15; *see also* Jackson, Bankruptcy, *Non-bankruptcy entitlements, and The creditor's Bargain,* 91Yale L.J. 857, 857-68, *as cited in* Thomas H. Jackson, *supra note 40,* pp. 1395-1396
[80] *See* Charles J. Tabb, *supra note 15*, p. 14
[81] *See* Charles J. Tabb, *supra note 20*, p. 333
[82] *See* Margaret Howard, *supra note 27,* pp. 1047-1048

have tried to provide answer for this problem. To this effect they came up with justifications such as bankruptcy discharge as a debt-collection device,[83] incentive of debtor cooperation in the debt collection process,[84] incentive towards entrepreneurship and risk taking,[85] social insurance,[86] development policy[87], debtors' rehabilitation tool to keep him/her as a productive member of the society,[88] relief for honest but unfortunate debtors,[89] societal act of forgiveness,[90] corrective of human weakness,[91] reduce moral hazard in connection with lending[92] and consumer protection,[93] etc. But comprehensive legal research on the normative justifications on why discharge is becoming an important part of the individual bankruptcy law is lacking.[94] Most of the existing literatures studied in this paper also confirmed this fact. Despite the overwhelming effort scholars have dedicated comprehensive normative justification is far from being achieved.[95] Different scholars rather try to justify it from the perspectives they see it better justified.

The above justifications are not features individual bankruptcy laws of every jurisdiction. In any legal system one or a combination of some of them may be the justifications of the

[83] Douglas J Baird, *A world Without Bankruptcy, 50 Law and Contemporary Problems 173 (1987)* pp. 183-184
[84] *See* John M. Czarnetzky, *supra note 42, pp.* 395-96
[85] *see generally*, Seung-Hyun Lee & Mike W. Peng, *Bankruptcy Law and entrepreneurship Development: A Real Option Perspective, 32 Academy of Management Review, 257(2007), 257-272*; also *see generally* Wei Fan & Michelle J. White, *Personal Bankruptcy and The Level of Entrepreneurial Activity, 46 Journal of Law and Economics, 545 (2003),* pp. 545-567.

[86] *See generally*, Adam Feibelman, *Defining the Social Insurance Function of Bankruptcy, 13 Am. Bankr. Inst. L. Rev. 129 (2005),* pp. 129-186; See also Todd J Zywick, *An Economic Analysis of consumer Bankruptcy Crisis, 99 Northwestern University Law Review, 1463 (2005),* p.1473; *See* Douglas J Baird, *supra note 83, p.* 175, see also Barry Adler *et al, Regulating Consumer Bankruptcy: Theoretical Inquiry, 29 Jour. of Legal studies, 585 (2000),* p. 587;
[87] *See generally*, Adam Feibelman, *supra note 2*
[88] *See* Douglas J Baird, *supra note 83, p.* 176, see also John M. Czarnetzky, *supra note 42, p.* 396; See Rendleman, Douglas R., *supra note 72*
[89] *See* Todd J Zywick, *supra note 86,* p.1471
[90] *See* John M. Czarnetzky, *supra note 42,* p. 395-396
[91] *Id.*
[92] *See* Barry Adler *et al, supra note 86*, p. 608
[93] *See* Ramsay, Iain D. C, *supra note 10,* p. 262-263
[94] *See* Thomas H. Jackson, *supra note 40, p.* 1394; See also John M. Czarnetzky, *supra note 42,* p. 393
[95] *Id.* Thomas H. Jackson, p. 1394; John M. Czarnetzky, p.394

consumer bankruptcy system.[96] The decision to adopt individual bankruptcy differs across jurisdictions based on the socio-economic and political structures of a given country. The bottom line, however, is that many jurisdictions that restricted their bankruptcy to trader only are shifting their philosophy to include individual bankruptcy and fresh start.[97] This move has its backing from one or several of the above justifications discussed above.

The foregoing discussion is dedicated to the review of these theoretical, possible, justifications forwarded to back why we need discharge and fresh start in individual bankruptcy.

1.3.1 Entrepreneurial Analysis

Individual bankruptcy with discharge and fresh start has something to do with and entrepreneurship. One's bankruptcy system shapes (is shaped) the (by) entrepreneurship culture of a given jurisdiction. Some scholars argue that individual bankruptcy increases the level of entrepreneurial activity.[98]According to them, access to credit coupled with availability of filing for discharge gives individuals an incentive to go for business.[99] Individuals will be encouraged to take risks and that means some thing good to the business environment. The level of entrepreneurial activity will be good in jurisdictions where there is room for individuals in bankruptcy legislations and where the same provides for higher personal exemption levels.[100] This is because, according to those scholars, individual bankruptcy with discharge and fresh start gives entrepreneurs a kind of 'partial wealth insurance'.[101]

[96] *See* Margaret Howard, *supra note 27,* pp. 1087-88
[97] *See* Rafael Efrat, *supra note 1, pp.* 108-109
[98] *See generally* Wei Fan & Michelle J. White, *supra note 85*
[99] *Id., pp.* 547& 552
[100] *Id., p.* 563
[101] *Id. pp.* 547 & 552

It is a blunt fact that entrepreneurship and investing in new venture involves risk taking. Or stated otherwise, if investors are punished for failure to heavily they will be hesitant to take risk.[102] The risk may be exacerbated by the unlimited liability their unincorporated startup could bring if it is not successful.[103] The market place should be convenient for learning from mistakes and that environment will help us get the best entrepreneurs.[104] Individuals' incentive to take such risk and foster their entrepreneurial activity can be motivated by generous discharge and fresh start. Studies show that pro-entrepreneurship jurisdictions have generous debt forgiveness while jurisdictions where investment and entrepreneurial activities are limited have tight bankruptcy rules with no or less discharge and fresh start.[105] Fresh start has a direct positive impact on entrepreneurial activity.[106] The availability of discharge and the time it will take to obtain discharge are important very important in this regard.[107] When generous discharge is available and it is automatic or can be obtained in a short time it has good signal for entrepreneurs. Studies conducted on more than one jurisdiction found that well-crafted bankruptcy discharge and fresh start, in terms of availability, scope and time it takes to obtain, has its rational/impact in encouraging risk taking and entrepreneurship.[108] The release of "honest but unfortunate debtors" will hurt creditors for sure but the aggregate gains from entrepreneurship are higher than losses to the creditors.[109]

The assertion that individual bankruptcy with meaningful discharge is pro-entrepreneurship is neither a well-recognized theory nor there is clear evidence of a

[102] John Armour & Douglas Cumming, *Bankruptcy law and Entrepreneurship, Law Working Papers 105/2008, p. 4 ; See also* John M. Czarnetzky, *supra note 42, pp.* 398-399
[103] *See* Rafael Efrat, *supra note 1,* pp.98-99
[104] John M. Czarnetzky , *Time, Uncertainty and The Law of Corporate reorganizations, 67 Fordham L.Rev. 2939 (1999) as cited in* John M. Czarnetzky, *supra note 42*, p. 405
[105] Rafael Efrat, *supra note 1, pp.* 98-99
[106] John Armour and Douglas Cumming, *supra note 102*, p. 6
[107] *Id.*, p. 7
[108] *Id.* p. 18
[109] *See* John M. Czarnetzky, *supra note 42*, p. 414

bankruptcy system crafted based on the assertion.[110] But empirical studies on of individual bankruptcy shows that the 'entrepreneurial analysis' is consistent with the assertion.[111] Of course it is logical that when failure is not punished severely, there will be enthusiasms for entrepreneurship. There is a concern that generous discharge may increase interest rates. Studies, however, show that fresh start encourages entrepreneurship.[112] It is, therefore, quite possible for countries to consider their bankruptcy law while dealing with their entrepreneurship policy. The more generous and predictable bankruptcy discharge is the more entrepreneurship will be enhanced. Studies show that bankruptcy discharge and fresh start stimulates self-employment.[113]

1.3.2 Social Insurance Function

Individual bankruptcy is also justified out of the social insurance function it provides.[114] Proponents of this view see bankruptcy as a cure for capitalist state that has either abandoned or cut its welfare activities.[115] Indebtedness is not voluntary and different changed circumstances contributed for failure to pay one's debt .[116] Losses of job, illness of the individual or his/her family, divorce, business failures, are some of the circumstances that will force someone into financial distress.[117] The financial distress out of such changed circumstances is responsible for the rise in the filing of consumer bankruptcy in United

[110] *Id.* p. 448
[111] *Id.* p. 414
[112] Frank M. Fossen, *Personal Bankruptcy Law Wealth and Entrepreneurship-Theory and Evidence from the Introduction of "Fresh Start", German Socio-Economic Panel Study (SOEP) (2011),* p. 28

[113] *See* John Armour and Douglas Cumming, *supra note 102,* p. 18
[114] TERESA A. SULLIVAN, ELIZABETH WARREN & JAY WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 3-5 (2000) as cited in Admam Feibelman, *suora note 86, p.* 130; see Todd J Zywick *supra note 86, p.* 1473; see also BARRY E. ADLER et al, BANKRUPTCY CASES, PROBLEMS AND MATERIALS, Foundation Press (2007) p. 560
[115] *See* Ramsay, Iain D. C., *Individual Bankruptcy: Preliminary Findings on Socio-Legal Analysis, 37 OSGOODE HALL L. J. 15 (1999),* p. 17
[116] *Id. p.* 22; see also also Todd J Zywick *supra note 86,* p. 1473
[117] *Id.* Ramsay, Iain D. C p. 22; Todd J Zywick, 1473; See also Robert Anderson *et al, (Ed.) supra note 6,* p. 7

States.[118]Conventionally such problems are dealt under unemployment insurance, health insurance or other social assistance provided by the government based on need. But the above insurances are private ones and may be unavailable because of market failure. In a system where social insurance is unavailable or otherwise inadequate, bankruptcy discharge can be a substitute.[119] This, however, is not a complete substitute and only applicable to certain cases such as for unsecured debt.[120] A bankruptcy system that provides discharge and fresh start for unsecured debt can replace the social insurance function. This is the limitation of bankruptcy discharge unlike other social insurance tools.

Studies show that bankruptcy system with adequate pre-petition discharge of debts can be justified out of social insurance (welfare) functions against some financial difficulties that may arise from loss of job, divorce, sickness etc.[121]There appears to exist a direct relationship between the design of social insurances and bankruptcy system.[122] The more generous the bankruptcy discharge is the less social safety net programs are available and vice versa.[123] The United States bankruptcy law fits into this formulation.[124] The bankruptcy system is generous enough to allow troubled debtors see their debt wiped-out against surrender of non-exempt assets; the social safety net programs are, however, less extensive.[125]

[118] *See* Todd J Zywick, *supra note 86, pp.* 1473-1474: There are studies that show that medical costs are, partly, responsible for the rise in personal bankruptcy filings in United States. This is because United States has the weakest safety net programs for its citizens. In Europe where there are several safety net programs the bankruptcy filing rate is lower, significantly, to that of United States. For more information see generally, Sarah Emami, *Consumer Over-indebtedness and Health care Costs: How to Approach The Question From a Global Perspective, World Health Report 2010, A back Ground paper No-3, Available at* http://www.who.int/healthsystems/topics/financing/healthreport/3BackgroundPaperMedBankruptcy.pdf?ua=1, last visited on 12 March 2014

[119] *See* Admam Feibelman, *supra note 86,* p. 132

[120] *Id. p.* 141

[121] Id. pp.185-186; see also, Rendleman, Douglas R, *supra note 41, p.* 1203 as cited in Rendleman, Douglas R, *supra note* 72, p. 724

[122] *See* Admam Feibelman, *supra note 86, pp.* 185-186

[123] *See* Rafael Efrat, *supra note 1, pp.* 82-91 (2002) as cited in Admam Feibelman, *supra note 86*, p. 184

[124] Admam Feibelman, *supra note 86, p.* 142

[125] *See* Rafael Efrat, *supra note 1, pp.* 82-91 (2002) as cited in Admam Feibelman, *supra note 86*, p. 184

The conclusion that can be drawn from the discussion made so far is that where welfare activities of the government are limited individuals will opt to credit.[126] This will expose individuals for financial troubles.[127] This vulnerability is being seen dealt in some jurisdictions under their bankruptcy law that provides generous relief.[128] Welfare states have less bankruptcy filings compared to states that do not have significant welfare programs.[129] One can conclude that the more welfare state the government is the less debt forgiveness available in the bankruptcy law and vice versa.

1.3.3 Deregulation of Consumer Credit

The availability of consumer credit is another reason for adopting individual bankruptcy system [130] with generous discharge and fresh start. There are evidences that countries have liberalized their discharge rules after deregulation of consumer credit.[131] Access to consumer credit will make it possible for individuals to finance their own startups or pursue self-employment.[132] It will improve demand for products in the market; smooth consumption across income gaps, reduces income shocks[133] and increases consumption of some "discretionary goods" (food, health care, education, transportation etc.), which can be considered as indicators of development.[134] But it will be a source for competition in consumer lending industry, which will expose individuals to huge risks. There is a risk of over-indebtedness.[135] These risks are dealt by those jurisdictions by adopting debt forgiveness provisions in their individual bankruptcy rules.[136] In jurisdictions where there is

[126] *See* Rafael Efrat, *supra note 1, pp.* 102-104
[127] *Id.* pp. 96-97
[128] *Id.*
[129] *Id.,* pp. 103-104
[130] *See* G. Stanley Josling, *supra note 4,* p. 189
[131] *See* Rafael Efrat, *supra note 1,* pp. 92-93
[132] *See* Adam Feibelman, *supra note 2,* p. 66
[133] *Id.* pp. 66 & 75-76
[134] *Id.* p. 75
[135] *Id.* p. 66
[136] See Rafael Efrat, *supra note 1,* pp. 92-93

strict regulation of consumer credit there is less relief from bankruptcy discharge.[137] This is because individuals' access to credit is very restricted and consequently exposed to less risk than in countries where consumer credit is easily accessible.

1.3.4 Consumer Bankruptcy as a Development Policy

There are also arguments that adoption of consumer bankruptcy with automatic discharge has something to do with development policy. They argue that, consumer bankruptcy will potentially create efficient consumer finance market while solving the problem of over-indebtedness.[138] According to this line of argument well-crafted consumer bankruptcy system benefits both creditor and debtor. The debtor will have an opportunity to finance businesses or ideas that are worth put into market. Creditors are also compensated for the consequences of discharge in the form of high interest rates.[139] It will also solve the collective action problem, as it does in corporate bankruptcy, among creditors.[140] Coordinated collective action among creditors will increase probability of getting paid.[141] Race to the debtor's assets, under non-bankruptcy law, may hurt the debtor and incapacitate his ability to earn in the future.[142] So individual bankruptcy law with adequate discharge and fresh start may help promote consumer financial market.[143]

1.3.5 Rehabilitating the Debtor

Another most important justification for consumer bankruptcy, with meaningful discharge, is to keep the bankrupt individual as a productive member of the society.[144] It is a rehabilitation or reintegration of an individual to the society. If the individual bankrupt is

[137] *Id.* pp. 92-94
[138] *See* Adam Feibelman, *supra note 2*, pp. 89-90, 104
[139] *Id.* p. 92
[140] *Id.* p. 92-93
[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] *Id.* p. 92

discharged from part or whole of his/her debt he will have an incentive to earn income and own property in the future.[145] Their income is shielded, in whole or in part, from the reach of the creditors.[146] And that is a huge incentive to start life afresh as a productive member of the society.[147] Psychologically the debtor will get relief from the distress out of indebtedness.[148] Therefore, treating debtors harshly because they failed to pay their debt will make things more complicated. The bankrupt individual may engage in different undesirable activities such as crimes and that will be huge social problem.

1.3.6 Human Act of Forgiveness

Bankruptcy discharge is also seen as a human act of forgiveness and rehabilitation of the debtor.[149] This is what is called "humanistic view" of individual bankruptcy.[150] According to this view bankruptcy is a real problem affecting real people as opposed to people the neo-classical economists talking about. It rejects the hypothetical people and assumptions economists use in order to understand the market.[151] Real persons are not simply self-interested profit maximizers but they are also highly concerned about the wellbeing of others.[152] "Humanistic view" of 'fresh start' justification values people more than the money.[153] This view takes 'humanity' as essential element in bankruptcy discharge policy and not simply an incidental element to be considered when pursuing another end.[154] Accordingly, this view has its backing from biblical reasons than economic justifications.

[145] *See* Margaret Howard, *supra note 27, p.* 1062
[146] *See* Adam Feibelman, *supra note 2, p.* 92
[147] *See* John M. Czarnetzky, *supra note 42*, p. 415
[148] *see* Rendleman, Douglas R, *supra note* 72, p. 726
[149] S*ee generally* Susan Block-Lieb, Book Review: *A Humanistic Vision of Bankruptcy Law*, 6 Am. Bankr. Inst. L. Rev. 471 (1998), pp. 471-493, reviewing "KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (Yale University Press 1997)"

[150] *Id*.
[151] *Id.*, pp. 473 & 486-487
[152] *Id.* p. 473
[153] *Id.* p. 477
[154] *Id.* p. 477

Another economic justification for "non-waivable" right to fresh start is based on the theory of risk allocation.[155] The idea is that one in a better position to avoid the risk should be able to bear it.[156] Accordingly, the law has to choose one victim out of two innocents and it has to be the creditor. But this justification does not escape criticism because, according to some scholars, it is not possible to identify with certainty the superior risk bearer.[157]

The discussion made so far shows some of the justifications forwarded to back why individual bankruptcy is becoming an important policy tool. The reasons are all socio-economic and political. An individual bankruptcy regime in any jurisdiction will have its theoretical underpinning in one or more of the justifications discussed above either expressly or impliedly. And at the same time those justifications are benefits of individual bankruptcy with well-crafted discharge and fresh start rules.

However there are costs individual bankruptcy will bring to different stakeholders such as the creditor, the state and the community. The following section is dedicated to point out those pitfalls individual bankruptcy may bring.

1.4 Costs of Individual Bankruptcy

There is no doubt that the debtor will be better off when his debt is wiped-out by discharge and started his/her life afresh. It is true that credit will help the debtor finance his/her affairs (such as buying house, pay for school, etc.) or overcome temporary economic troubles that will make the individual life miserable. When he lost his job, incurred significant bill due to sickness of him/herself or a family member, divorced and has to rent new house, new tools etc., getting credit will help a lot. The problem will come later when the debtor is unable to pay back what he owed to creditors.

[155] *See* Thomas H. Jackson, *supra note 40,* pp. 1398-1401
[156] *Id.*
[157] *Id.*

Individual bankruptcy provides a solution. It provides a mechanism by which all the non-exempted assets of the debtor will be liquidated and paid to the creditors and the debtor will be set free, at least in principle, and starts life afresh. So it serves both the debtor and the creditor. The debtor will be freed of his pre-bankruptcy obligations and creditors will be treated equitably avoiding the problem of race among themselves.

But there are certain cost the creditor, the society and the state has to bear. And this is the "bittersweet paradox" of individual bankruptcy. The release of the debtor comes at a huge cost to those stakeholders. The first criticism of individual bankruptcy is that creditors' return is exposed to the risk of discharge.[158] Generous bankruptcy that releases debtors from their obligation will hurt creditors. In individual bankruptcy creditors, more likely, will see the debtor walk-off without paying a penny. This will also affect the institution of contract and principle of freedom of contract. Bankruptcy as a 'debt collection tool' is not true, at least in most cases, because individual debtors usually do not have assets left.[159] Studies show that most of the individual bankruptcies in the United States are based on chapter 7[160] and the same do not distribute any asset to unsecured creditors.[161] It is also true in Germany that most plans do not pay creditors and debtors are seen walk-off free.[162] Moreover, discharge policy is not intended to solve the creditors' collection problem.[163] It is intended for the debtor and debtor only. This will hurt creditors by reducing the return they should get.

The availability of generous discharge in individual bankruptcy also makes credit very expensive for debtors. The creditors will increase the premium charging high interest

[158] *See* Adam Feibelman, *supra note 2, p.* 68
[159] *See* Richard M. Hynes, *Why (Consumer) Bankruptcy? 56 Ala. L. Rev. 121 (2004/5),* p. 123
[160] *See* Michelle J. *White, Why It Pays to File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Law and a Proposal for Change, 65 U. Chi. L. Rev. 685 (1998),* p. 688
[161] *See* Richard M. Hynes, *supra note 159,* pp. 123 & 129
[162] Jason J. Kilborn, The Innovative German Approach to Consumer Debt Relief: Revolutionary Changes in German Law, and Surprising Lessons for the United States, 24 Nw. J. Int'l L. & Bus. 257 (2003/4), pp. 278-79; *see also* Johanna Niemi, *et al*, *supra note 3,* p. 336
[163] Thomas H. Jackson, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, BeardBooks (2001), p. 225

rates for the credit they provide.[164] There will be reaction from lenders in the form of increasing the rate of interest to offset the losses because of there is less chance of repayment.[165] This will affect the credit market making credit expensive or limiting its availability.[166] There will also be direct cost on the particular individual debtor whose access to credit will be limited or just come at high cost.[167] But it can be argued against it in that the debtor who has no creditors any more because of discharge can find it easy to get credit.[168] There are also other costs on the individual bankrupt debtor. In order to get discharge he has to give up his non-exempt assets to the creditor. The creditor and the debtor may value such assets differently and when it means so much for the debtor than the creditor then that is the cost the debtor has to bear.[169]

The other concern is that the failure of debtors to repay their debt will hurt financial markets. There are studies, however, that show on comparison the benefits of discharge outweigh the costs making entrepreneurial activity smooth.[170] Insurance effect benefits of individual bankruptcy are well above the costs of increased interest rates.[171] Two other problems associated with the insurance analogy of bankruptcy is moral hazard and adverse selection problems.[172] Knowing that s/he will file for bankruptcy discharge individual may be reckless in loan and spending decisions. And the customers of this insurance are those who are most likely will fail to repay; adverse selection problem.[173] But the reputation and stigma

[164] Michelle J. White, Economic Analysis of Corporate and Personal Bankruptcy, NBER Working Paper Series, p-64, available at http://www.nber.org/papers/w11536.pdf; last visited on 29 March 2014; *see* Adam Feibleman, *supra note 2, p.* 92; *see* Adam Feibelman, *supra note 86, p.* 171
[165] *See* Frank M. Fossen, *supra note 112*, p. 28
[166] *See* Michelle J. White, *supra note 164*; *see* Adam Feibelman, *supra note 86, p.* 171
[167] *See* Michelle J . White, *supra note* 19, p. 211; *see* Michelle J. White, *supra note 160, p.* 691; *see* Thomas H. Jackson, *supra note 40, pp.* 1426-1427; *see* Barry E. Adler *et al*, *supra note 114, p.* 560
[168] *See* Barry E. Adler *et al*, *supra note 114*
[169] *See* Thomas H. Jackson, *supra note 40, p.* 1427
[170] *See* Frank M. Fossen, *supra note 112*
[171] *Id.*
[172] *See* Barry E. Adler *et al*, *supra note 114*
[173] *Id.*

associated with being bankrupt will work against the moral hazard problem.[174] Even with discharge and fresh start, individuals will lose so much when they go bankrupt.[175]

There is also a criticism that individual bankruptcy hurts the state and community. To the government financing of the system is a huge burden. It wastes the taxpayers' money for the fault and financial mismanagement or misfortunes of individuals. The administration of bankruptcy proceedings will cost the state to a certain extent the individual is unable to cover the costs.

Stigma is another cost the bankrupt individual has to bear.[176] Even in United States, failure to pay one's debt is still seen as immoral and stigmatized though the degree of stigma is less now than it used to be.[177]

[174] *Id.* p. 561
[175] *Id.*
[176] *See* Michelle J. White, *supra note 160*, p. 691
[177] *See* Barry E. Adler *et al*, *supra note 114*

Chapter Two-Individual Bankruptcy Laws in United States and Germany

2.1 Individual Bankruptcy Law in United States

In United States individual debtors have two options while considering filing for individual bankruptcy: Chapter 7 or chapter 13.[178] The most important benefit associated with individual bankruptcy, under both chapters, is the benefit of discharge and thereby fresh start.[179] Unless the debtor committed any of acts of bankruptcy (fraud, concealment etc.), the debtor, as a rule, will be released of his obligation to repay.[180] Under chapter 7 the debtor has to surrender all assets in excess of the relevant exemption level; the trustee liquidates the assets, pay the creditors and debtor walk-off.[181] No creditor can ask for repayment from the debtor after bankruptcy. There will also be benefit of automatic stay soon after the debtor petitioned for bankruptcy. Individual bankruptcy under Chapter 7 is counterpart to that of business liquidation (also known as straight bankruptcy).

Chapter 13 is about adjustment of debts of an individual with regular income.[182] The debtor will put a plan to the creditors based on what s/he earns and the amount s/he need for living. The debtor will pay creditors according to the plan out of the disposable income for a certain period of time (3-5 years) then he will be discharged.[183] And this is counterpart to that of reorganization in business bankruptcy. Goal of chapter 13 is, hence, rehabilitation of the debtor. Chapter 7 has advantages over chapter 13 and vice versa. Under chapter 7 there is an

[178] *See* Robert H. Scott, III, *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: How the credit Card Industry's Preservance paid off*, 41 J. of Econ. Issues, 943 (2007) p. 944; *see* Elijah M. Alper, *Opportunistic Informal Bankruptcy: How BAPCPA May Fail to Make Wealthy Debtors Pay Up, 107 Columbia Law Review*, 1908 (2007), p. 1913

[179] *See* Thomas H. Jackson, *supra note 163*; *see* Carl Felsenfeld, Denial of discharge for Substantial abuse: refining-Not Changing Bankruptcy law, 67 Fordham L. Rev. 1369 (1999), pp. 1369-1370

[180] Thomas H. Jackson, The Logic and Limits of Bankruptcy

[181] *See* Robert H. Scott, III, *supra note 178*

[182] *See* Michelle J. White, *supra note 19,* p. 210; *see* David G. Epstein et al, *supra note 41, p.* 13; *see* Michelle J. White, *supra note* 691

[183] *See* Robert H. Scott, III, *supra note 178*

immediate discharge and the procedure is some how simple.[184] Chapter 13 requires the debtor to come up with a plan and the debtor has to perform his repayment obligation for a certain period of time.[185] Discharge will come after the plan is executed. Chapter 13 will allow the debtor to keep his/her assets while under chapter 7 such options is not available. Despite this, however, most of the individual bankruptcy cases are based on chapter 7.[186]

The philosophy of the United States individual bankruptcy law is very clear. No one should be put in jail for failure to pay his/her debt unless involved in bankruptcy crimes. Debtors who are not using the system to escape repayment duties will be given fresh start. Accordingly "honest but unfortunate debtors" will be released from part or whole of their debt. The two chapters are designed accordingly and will be discussed in detail in the following section.

2.1.1 Chapter 7

Chapter 7 governs the process of liquidation of the debtors' assets, individual or business, under the United States Bankruptcy Code.[187] The debtor will give up all his non-exempt assets in exchange for discharge.[188] This is "non-waiveable" right for every individual. When filing under chapter 7 there are two important concepts. The first is automatic stay, which stops any action of the creditor against the debtor, judicial or extra-judicial.[189] This is temporary order, pending the final decision of the court, which protects the debtor from harassment. The second important concept under chapter 7 filing is discharge.[190]

[184] *See* Elijah M. Alper, *supra note 178,* p. 1914
[185] *See* Richard H.W. Maloy, "She'll Be Able to Keep Her Home Won't She?"- The Plight of a Homeowner in Bankruptcy, Mich. St. DCL L. Rev. 315 (2003), pp. 339-40 as cited in Elijah M. Alper, *supra note 178, p.* 1914
[186] *See* Richard M. Hynes, Why (Consumer) Bankruptcy?, 56 Ala. L. Rev 121, 127 n.32 (2004) , as cited in Elijah M. Alper, *supra note178,* p. 1914
[187] 11 United States Code-Bankruptcy; available at http://www.law.cornell.edu/uscode/text/11/chapter-7/subchapter-II last visited on 16 March 2014 (*Here in after Bankruptcy Code)*
[188] *See generally* Michelle J. White, *supra note 19*, pp. 205-231; *See* Barry Adler *et al, supra note 86; See* Michelle J. White, *supra note 160*, p. 687
[189] *See* Richard M. Hynes, *supra note 159*, p. 129
[190] *Id.*

The exempt assets and future income of the debtor and human capital are shielded from the demand of the creditors.[191] But only debts incurred before the order of relief are subjected to discharge.[192] The individual is not required to give the exempt assets or pay debt out of his future income. Creditor is prohibited from pursuing collection efforts once discharge is granted to the debtor.[193] But that is restricted to the individual's pre-bankruptcy life and not future debts/obligations.

In order to be eligible for a chapter 7 discharge, there are certain conditions that should be fulfilled. The first condition is that only individual debtors are entitled for 'chapter 7 discharge'.[194] Chapter 7 filing is available for both businesses and individuals but 'discharge' is available for only individuals. Second, the debtor should not commit fraudulent acts such as mutilate, conceal or transfer assets within one year of filing or property of the estate after filing.[195] To benefit from discharge the debtor has to disclose the whereabouts of all his assets and turn them over to the creditors' consideration.[196] This will make sure that no property is hidden from the creditors[197] and this builds the integrity of the bankruptcy system. Third, unjustified failure by the debtor to keep accounts and record will bar the right to discharge.[198] These include; conceal, falsify or destroy documents, engage in any fraudulent act on accounts etc.[199] Fourth, commission of bankruptcy crimes.[200] Finally, debtor should not have received bankruptcy discharge under chapter 7 within eight years.[201] If the debtor was discharged under chapter 12 or chapter 13 he has to wait for six years to file for chapter 7

[191] *See* Michelle J. White, *supra note 19*, p. 205; *See* Barry Adler *et al, supra note 86*, p. 587; *see* Thomas H. Jackson, *supra note 40*, pp. 1396-97; BARRY E. ADLER et al, *supra note 114*, p.559
[192] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7*, p. 482
[193] *See* Douglas G. Baird, *supra note 45*, p. 44
[194] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7*, p. 500, see §
[195] *Id.; see also* 11 U. S. C. -Bankruptcy, supra note 187, § 727
[196] *See* Douglas G. Baird, *supra note 45*, p. 31
[197] *Id.* p. 35
[198] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7, p.* 500; § 727 of the Bankruptcy Code
[199] *See* § 727 of Bankruptcy Code
[200] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7*, p. 500
[201] *See* Douglas G. Baird, *supra note 45*, p. 37; *see* § 727 (a) (8) of the Bankruptcy Code

discharge.[202] But this condition does not apply if the debtor files the second case for discharge based on chapter 12 or 13.[203]

Moreover, not all debts are dischargeable.[204] There are certain debts that are 'non-dischargeable'[205] by their nature and the individual whose debt has been discharged is still obliged to pay non-dischargeable debts.[206] These 'non-dischargeable' debts include taxes and custom duties, those debts obtained by false representations or fraud, domestic support obligations, tort claims, etc. These exceptions fall into two categories[207] and the rational for 'excepting' them is justified out of public policy considerations.[208] Most often these debts are obtained by 'wrongful' act of the debtor or they are very 'essential' for the creditor.[209] In the first category, "there is either a "moral turpitude" or intentional wrongdoing' on the part of the debtor".[210] And no sensible legal system is willing to bless a debtor who acted with such moral and intent with discharge. Reprehensible and malicious conducts of the debtor need to be discouraged by the denial.[211] In the second category, the repayment of the debt, no matter how difficult it will be, is very essential for the creditor. Hence, it is in the interest of the general public that these debts are 'excepted' from discharge.[212] And creditors are allowed to ask repayment of these non-dischargeable debts, even, after bankruptcy.

In addition to those two exceptions there is also a possibility the debtor may not be given discharge of certain debts. The debtor has to list out all creditors while filing for

[202] *See the Bankruptcy Code, supra note 187,* § 727(a) (9)
[203] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7,* p. 500
[204] *See* Douglas G. Baird, *supra note 45*, p. 46
[205] *See the Bankruptcy Code, supra note 187,* § 523
[206] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7,* p. 511
[207] *Id.* ; see also Douglas G. Baird, *supra note 45*, p. 47
[208] http://govinfo.library.unt.edu/nbrc/report/07consum.html last visited on 8th March 14
[209] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7,* p. 511
[210] *Supra note 208*
[211] *See* Douglas G. Baird, *supra note 45*, p. 48
[212] *Supra note 208*

bankruptcy.[213] If s/he failed to do that a creditor who is not notified of the proceeding and did not share in the assets will not see his claim discharged.[214]

Fresh start from chapter 7 discharge in United States has two sources.[215] The first source is from section 727 of the Bankruptcy Code.[216] It states that the individual debtor who gives up his/her assets will be discharged and creditors cannot encroach future income or assets of that debtor.[217] The main reason for the debtor to file individual bankruptcy is discharge. The second source for fresh start is section 522 plus state and federal non-bankruptcy laws.[218] These second sources allow the individual a certain level of exempted property.[219] Future income and a property exempted constitute fresh start.[220] Care must be taken, however, that policy of individual bankruptcy law is financial fresh start for the debt-troubled individual shielding the future income (fruits of labor) and not to protect his/her wealth.[221] Exemption is an exception to the creditors' right to the assets of the individual debtor. Issue of exemption is left for states and this also can show that it is not the core policy of United States bankruptcy law.[222]

The individual bankruptcy under chapter 7 gives financially troubled individuals a fresh start by shielding the exempt assets and future income of the individuals. It is a kind of insurance for the debtor who otherwise does not have viable options to pass through difficult times (loss of job, illness etc.). The debtor required being honest in disclosing and giving up his assets to the creditors' questioning. The bankruptcy rules are designed to release the "honest but unfortunate debtor" from yoke of debt s/he incurred and cannot repay. There are

[213] *See* Douglas G. Baird, *supra note 45*, p. 46
[214] *Id.*
[215] *See* Barry E. Adler et al, *supra note*, p. 565
[216] *Id.*
[217] *Id.*
[218] *Id.*
[219] *Id.*
[220] *Id.*
[221] *See* Thomas H. Jackson, *supra note 163*, pp. 254-255
[222] *Id.*

also problems associated with individual bankruptcy. The discharge available will inevitably create ground for dishonest debtors to abuse the system. To tackle such abuse the United States bankruptcy law provides certain rules to make sure of the integrity of the system. The system starts by making some debts non-dischargeable.[223] When the debtor acted out "moral turpitude" then discharge is denied. When the debtor acted fraudulently and transfers or conceals a property s/he cannot obtain discharge.[224] Additionally, there is a limitation of time within before the lapse of which the debtor cannot go for another petition under chapter 7. If s/he has to file for a chapter 7 case again s/he has to wait for an 8 years period.[225] Of course, it works the debtors' favor as well. It will be easy for the debtor to get credit but creditors can also chase the debtor for payment before he can file for bankruptcy.[226]

There are also rules that prevent the debtor from abusing the system as a tactic to delay creditor's collection efforts.[227] The debtor, once s/he file for bankruptcy has to provide all the necessary information or risk dismissal of her/his case.[228] There is doubt on this rule that it may work in favor of the debtor who wanted to avoid bankruptcy against creditors will by failing to provide the information required.[229] But I think in individual bankruptcy case, especially chapter 7, where the creditor is not usually paid there is no incentive for the debtor to go that way and it does not have potential harm to the creditor.

The debtor education and credit counseling introduced under the 2005 Bankruptcy Abuse and Consumer Protection Act[230] is also the other way to keep the integrity of the bankruptcy system. All individual debtors, no matter which chapter they use, have to take

[223] *See* § 523 of the Bankruptcy Code, *supra note 187*
[224] *See* Douglas G. Baird, *supra note 45, p.* 37
[225] *Id.*, see § 727 (a) (8) of the Bankruptcy Code, *supra note 187*
[226] *See* Douglas G. Baird, *supra note 45, p.* 37
[227] *Id.*
[228] *Id. pp*. 37-38 see § 521 (i) of the Bankruptcy Code, *supra note 187*
[229] *See* Douglas G. Baird, *supra note 45*, p. 37
[230] Joseph Satorius, *Strike or Dismiss: Interpretation of the BAPCPA 109(h) Credit Counseling Requirement, 75 Fordham L. Rev. 2231(2007),* pp. 2233-2234

credit counseling and debtor education before and after filing bankruptcy respectively. It is compulsory requirement[231] to qualify as a debtor within the meaning of the Bankruptcy Code. The credit-counseling course should be taken 180 days before filing for bankruptcy.[232] This course is about the existing debts the debtor owe the creditors. It will help the debtor in organizing a plan of payment even without filing for bankruptcy if the creditors agree.[233] Failure to take this counseling will result in the dismissal of the bankruptcy case. On the other hands, the debtor education course required after the filing of bankruptcy is to help the debtor manage his financial affairs in the future. It is to equip the debtor with personal financial management skills.

The bankruptcy code also designed a mechanism to tackle abuse of chapter 7 filing. The problem with this chapter is that consumer debtors, in most cases, walk-off without paying even though they have a means to pay part of their debt.[234] "There was a concern that consumer are using the bankruptcy system as a means of financial planning than as a relief when they honestly fail to repay their debt."[235] In response to this section 707 (b) was added to the 1984 amendments of Code.[236] The court may, therefore, dismiss a petition by individual debtor whose debts are consumer debts when it is found that the filing is "substantial abuse" of chapter 7.[237] This was designed to limit the access to chapter 7 and force debtors to chapter 13 filing.[238] There was no agreement on what constitutes "substantial abuse".[239] One view was that criterion was that the individuals' ability to pay their debt

[231] *See* § 109 (h) (1) of the Bankruptcy Code, *supra note 187;* There are exceptions to this requirements as provided under 109 (h) (2). See generally, Joseph Satorius, *supra note 230,* p. 2234

[232]*See* Joseph Satorius, *supra note 230, p.* 2234
[233] *See* Robert H. Scott, III, *supra note 178, p.* 946
[234] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7,* 103
[235] *See* Mann, Ronald J., Bankruptcy Reform and The 'Sweat Box' of Credit Card Debt. University of Illinois Law Review, 2006; U of Texas Law, Law and Econ Research Paper No. 75. Available at SSRN: http://ssrn.com/abstract=895408, pp. 377-378
[236] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7,* p. 104
[237] *Id. pp.* 103-104; see also David G. Epstein et al, *supra note 41*, pp. 56-57
[238] *See* Ronald J. Mann, *supra note 235,* p. 377
[239] *See* Carl Felsenfeld, *supra note 179,* p. 1369

without undue hardships amounts abuse.[240] Another view advocates for the 'totality of circumstances' test such as unconscionable spending or fraud.[241]

The 2005 Bankruptcy Act responds to the problem and come up with grounds of dismissal of chapter 7 claims when there is abuse.[242] The first ground to be used to filter what can be brought under chapter 7 is 'means test'.[243] This test will make sure that the debtor's income is low enough to chapter 7 filing. If debtor's income is below the applicable median, then that is the end of the story. S/he can file a chapter 7 bankruptcy. If the debtor's income, including his/her spouse if married, is more the applicable median for the family size considered, an application for chapter 7 may be dismissed up on the application of trustee, interested parties, or court on its own motion.[244] If there is disposable income, necessary expenses (food, cloth, health care, etc.) deducted from average monthly income for the last six months, abuse is presumed debtor will not qualify for chapter 7.[245] By this filtering process individuals with high income will be forced to go for chapter 13.[246]

Means test solely rests on the ability to pay.[247] But means test has pitfall of its own. It does not distinguish between unforeseen financial trouble (sudden illness, loss of job, divorce) and reckless indebtedness (using credit for luxuries and recreations).[248] Accordingly, there still exist the possibility of abuse of the system by later categories of debtors.

Qualifying the 'means test', however, is not the end of the story. Still the court may find chapter 7 applications abusive and dismiss or convert it to chapter 13 accordingly.[249] Abusive or bad faith petitioners will see their case dismissed under the "totality of

[240] *Id. p. 1369; see also* David G. Epstein et al, *supra note 41,* pp. 57-58
[241] *See* Carl Felsenfeld, *supra note 179,* p. 1369
[242] *See* Barry E. Adler et al, *supra note 114,* pp. 79-80
[243] *Id.*, see section 707 (b); See also Robert H. Scott, III, *supra note 178,* p. 947
[244] *See* Barry E. Adler et al, *supra note 114,* pp. 79-80
[245] *See* Ronald J. Mann, *supra note 235,* p.380
[246] *Id.*
[247] *See* Barry E. Adler et al, *supra note 114,* p. 80
[248] *Id.*
[249] *Id.* p. 81

circumstances test".[250] This test will catch debtors who escaped the filtration process under means test. It does not have a clear formula as in the case of means test, a supplementary case-by-case analysis.

The 2005 Bankruptcy Abuse Prevention and Consumer Protection is, therefore, trying to make chapter 7 discharge less attractive and want to limit it to those who really need it. Accordingly, those individuals capable of earning and paying a certain portion of their debt should use the chapter 13 procedure.

2.1.2 Chapter 13

Chapter 13 is a debt adjustment plan[251] for individual bankruptcy, like reorganization of businesses. It is intended for the use of individuals with regular income[252] and those who want to keep some of their assets.[253] Its use has become much more popular by debtors who own small businesses and debtors who failed in payment for debt secured by mortgage.[254] Unlike chapter 7 bankruptcies, under chapter 13 there is no liquidation and all the debtor has to do is to come up with a plan of repayment[255] that should be accepted by the bankruptcy judge.[256] Debtor is not required to give up his/her assets, exempt or otherwise, and only has to propose a plan for repayment to be executed in the future, usually lasts between 3 to 5 years.[257] Under chapter 13 the debtor keeps his/her assets but has to give up his/her future income.[258] That means the debtor has to pay the creditors in installments out of his 'disposable income'.

[250] *Id.*
[251] *See* Michelle J. White, *supra note 19,* p. 210; see also David G. Epstein *et al, supra note 41,* p. 13
[252] *See* Michelle J. White, *supra note 160,* p. 691
[253] *See* Elijah M. Alper, *supra note 178,* p.1914
[254] *See* Douglas G. Baird, *supra note 45,* p. 50
[255] *See* § 1322, of the Bankruptcy Code, *supra note 187*
[256] *See* Michelle J. White, *supra note 19,* p. 210;
[257] *See* Michelle J. White, *supra note 19,* p. 210; see also Barry Adler *et al,* supra note 175, p. 587; See also Michelle J. White, *supra note 160,* p. 691;
[258] *See* Barry E. Adler et al, *supra note 114,* p. 621

Chapter 13 discharge allows discharge of some of the debts that are 'excepted' under section 523(a).[259] With the exceptions of "alimony and child support, student loan, DUI (driving under influence) debts, and debts for restitution of criminal fine,"[260] all other debts that were 'excepted' under chapter 7 case are dischargeable under chapter 13. In this regard a chapter 13 discharge is much broader than chapter 7 discharge. This is intended to incentivize filing under chapter 13 where the debtor has to pay a portion of his debts allowing creditors' a repayment to a certain extent. The discharge under this chapter is, therefore, called "super discharge" making only very few debts non-dischargeable.[261] Hence, under chapter 13 plan it is possible for the debtor to keep all his assets while enjoying wider scope of dischargeable debts.[262]

Unlike in chapter 7, there is a restriction on the use of chapter 13.[263] Debtor with a debt of more than 250,000 for unsecured and 750,000 for secured debts are not eligible for chapter 13 bankruptcy.[264] One can see from the above figures that "chapter 13 is designed for working individual debtors or couples with limited financial affairs, typically consumers or proprietors of small businesses."[265]

Chapter 13 plan is subjected to important conditions. First, the plan shall provide for the full satisfaction, in differed payments, of all claims entitled to priority under section 507 unless the holder of the priority claims agrees to a different treatment of such claim.[266] The plan should not discriminate between claims of a particular class, if any.[267] Second, the debtor has to pay his/her disposable income for five years, if not the creditor should receive,

[259] *See* Charles J. Tabb & Ralph Brubaker, *supra note 7, p.* 511; *see* Michelle J. White, *supra note 160,* p. 210; *see* also Barry E. Adler et al, *supra note 114*, p. 621
[260] See Douglas G. Baird, *supra note 45*, p. 49 *See also Charles* J. Tabb & Ralph Brubaker, *supra note 7,* p. 511
[261] See Douglas G. Baird, *supra note 45*, p. 48
[262] *Id. pp.* 49-50
[263] *Id. p.* 50; *See also* BARRY E. ADLER et al, *supra note 114,* p. 621
[264] Id.; *See also §* 109 of the Bankruptcy Code, *supra note 187*; the amount is subject to change every 3 year by regulation to reflect inflation.
[265] *See* Douglas G. Baird, *supra note 45*, p. 49
[266] *See* § 1322 (2) of the Bankruptcy Code, *supra note 187*
[267] *Id.*

as of the effective debt of the plan, an amount he/she would have received if the debtor opted for a chapter 7 bankruptcy.[268] This will ensure that the creditor is not going to be treated less favorably than he would have been under chapter 7.

Generally, chapter 13 has several advantages over chapter 7 bankruptcy. First, creditors are more protected under chapter 13 than chapter 7. They are paid from a projected 'disposable income' in 3 and 5 if income is less than the median and above the median respectively.[269] And chapter 13 cases pay creditors more than chapter 7 do. As it is discussed under section 1.4, most often, chapter 7 cases left no asset and chance of the creditors getting paid is very slim. The second benefit is, the debtor can keep his/her assets and collaterals under chapter 13. This will avoid the giving up of an asset to the creditor who may value the property less than the debtor value it. Finally, under chapter 13 there are only few non-dischargeable debts than under chapter 7.

Chapter 7 and chapter 13 have, therefore, basic differences. Chapter 7 is designed for lower middle class working persons while chapter 13 is intended to be used by wage earners and working individuals with limited financial affairs. In a chapter 7 case the debtor has to give up all his non-exempt assets to the creditors but in chapter 13 debtor keeps the assets and pay out of future income. So in the former case future income is protected but in the later assets and existing property is protected. Discharge under chapter 7 is automatic and it bars any move by the creditor for the enforcement of his/her claim but the discharge under chapter 13 is after the completion of the plan.[270]

[268] *See* Douglas G. Baird, *supra note 45*, pp. 50-51
[269] *See* Douglas G. Baird, supra *note 45*, p. 51
[270] *See* § 1328 of the Bankruptcy Code, *supra note 187*

2.1.3 Chapter 12

Chapter 12 is a special chapter intended for the use of family farmers and fishermen with regular income.[271] Special treatment for farmers under bankruptcy dates back to 1898[272] but the protection was on temporary basis.[273] This was in response to the farm crises that affected many farmers forced to bankruptcy that may culminate in foreclosure of their farm. [274] It become part of the Bankruptcy Code on permanent basis after the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[275]

What is peculiar in chapter 12 from chapter 13 is that the former restricted to farmers and fishermen use while the later can be used by individuals with regular income irrespective of the source of such income.[276] The two chapters are also different in the type of debtor entitled to relief under. In chapter 12 partnerships and corporations can file for relief but chapter 13 is restricted to individuals with regular income.[277] The debt ceiling is also higher in chapter 12, than in chapter 13, making debt adjustment opportunity wider.[278]

The chapter tries to strike a balance between two conflicting interests.[279] On the one hand the law makes sure that the farmers still hold their farms and fishermen their boats even when they owe secured debt more than the value of their assets (land or boat).[280] On the other hand the law has to ensure the security interest and rights on the property creditors have.[281]

[271] *See* David G. Epstein et al, *supra note 41, p.* 15; see also § 109 (f) of the Bankruptcy Code
[272]*See* Katherine M. Porter, *Phantom Farmers: Chapter 12 of the Bankruptcy Code, 79 Am. Bankr. L.J. 729 (2005),* p. 730

[273] *See* Douglas G. Baird, *supra note 45,* p. 57
[274] *See* Katherine M. Porter, *supra note 272,* p. 731

[275] *See* Douglas G. Baird, *supra note 45,* p. 57
[276] *See* David G. Epstein et al, *supra note 41,* p. 16
[277] *See* Katherine M. Porter, *supra note 272,* p. 732
[278] *Id.*
[279] *See* Douglas G. Baird, *supra note 45,* p. 56
[280] *Id.*
[281] *Id.*

Despite long history and ambition, the achievement of chapter 12 is being criticized as insignificant.[282] There are very few chapter 12 bankruptcy cases.[283] One reason is farmers in United States are very few in number (the number is dropping) and chapter 12 filings are few compared to other types of bankruptcies.[284] Another possible reason is that farmers opt for chapter 7 or 13 bankruptcies because farmers face similar grounds for being in financial distress, such as illness or divorce, and not necessarily secured farm debt. There are also evidences that bankruptcy contribution to decline in farms in United States is insignificant making the response by way of chapter unviable.[285] These reasons might have a hand in the limited use of chapter 12 filing while the number is soaring in chapter 7 or 13 bankruptcy.

2.2 Individual Insolvency Law in Germany

Before the enactment of the 1999 Insolvency Act, individual debtors in Germany were not allowed to file for bankruptcy. Pre-1999 German insolvency laws were not favorable for consumer debtors.[286] It was possible, theoretically, to enter into settlement agreements, though court imposed, between debtors and creditors that offers for less than full payment of the debt.[287] But there were hurdles from realizing the benefits of such arrangement. On the one hand the creditors consent is required for the settlement that may in most cases go against the interest of the debtor.[288] On the other hand the debtor has to have a plan for payment of at least certain percentage of the claims, which was not affordable by most consumers.[289] Moreover, the debtor should have a certain level of minimum assets to defray costs of proceedings.[290] This made individuals access to the then insolvency laws a theoretical possibility than practical reality. Even for those who passed the hurdle there was

[282] *See* Katherine M. Porter, *supra note 272*, p. 741
[283] *Id.*
[284] *Id.*
[285] *Id.* p. 742
[286] *See* Jason J. Kilborn, *supra note 162*, p. 262
[287] *Id.*
[288] *Id.*
[289] *Id.* pp. 262-263
[290] *Id.* p. 263

no such a thing called discharge and [291] the law was meant to facilitate creditors collection efforts.[292]Debtors were supposed to repay their debt no matter how difficult it might be. The core of this policy was protection of the principle of party autonomy, and intervention by way of discharge was seen as against this principle.[293] Accordingly, before the 1999 German Insolvency Act individuals' access to bankruptcy was very limited and discharge was not possible.[294] The first time individual bankruptcy and discharge was introduced is in the 1999 Insolvency Act.[295] This was as a reaction to rising over-indebtedness problem that is exacerbated by the deregulation of consumer credit in Germany since 1970s and 1980s. [296]

Currently, honest debtors are entitled to relief by way of individual insolvency.[297] Individual can request the court for the discharge of his/her debt pursuant to section 287 of the Insolvency Act of 1999.[298] The discharge and fresh start under German law is intended to protect the individual from undue harassment by the creditors and reintegrate him/her economically.[299] The requirement to file for individual insolvency under German law is inability to pay debts, illiquidity, when they are fallen due.[300] And the insolvency should be permanent one.[301] Over-indebtedness is not requirement to institute consumer bankruptcy proceedings.[302]To institute individual insolvency proceeding the debtor has to cover

[291] *See* Susanne Braun, *German Insolvency Act: Special Provisions of Consumer Insolvency Proceedings and the Discharge of Residual Debts, 7 German L. J. 59 (2006), pp. 65-66, available at* http://www.germanlawjournal.com/index.php?pageID=11&artID=686, last visited on 29 March 2014
[292] *See* Jason J. Kilborn, *supra note 162*, pp. 264-265 & 269
[293] *See* Susanne Braun, *supra note 291, p.* 66; *see also* Jason J. Kilborn, *supra note 162, p.* 268
[294] *See* Robert Anderson *et al, (Ed.) supra note 6*, p. 21
[295] *Id.*, pp. 21 & 59; *See* Johanna Niemi, *et al, supra note 3, p.* 274
[296] *See* Susanne Braun, *supra note 291, p.* 60; see generally Jason J. Kilborn, *supra note 162, pp.* 260-262; *See also* Johanna Niemi, *et al, supra note 3*, p. 273

[297] See German Insolvency Code of 5 October 1994 (BGBl. [Federal Law Gazette] I p. 2866), last amended under Art. 2 G dated 21 October 2011 (Federal Law Gazette I p. 2082), (Here in after German Insolvency Code) Section 286 & ff

[298] *See* Susanne Braun, *supra note 291, p.66*
[299] *Id.*
[300] *See* German Insolvency Code, supra note 297, section 17
[301] *See* Susanne Braun, *supra note 291, p.* 63
[302] *See* German Insolvency Code, supra note 297, Section 19

proceeding cost under the pain of dismissal[303] and should have assets to pay certain portion of his/her debt to the creditors.

The German model of discharge is known as "an earned fresh start" and the individual debtor has to pass through different stages and a long six year of hard work, paying a portion of his/her debt and showing good behavior.[304] Individual insolvency proceeding in Germany involves four stages.[305] The first stage is out-of-court settlement phase.[306] It is a compulsory requirement for the debtor to try to reach an amicable settlement of the debt before opting for insolvency proceeding and a certificate, from attorney or credit counseling institution, to that effect is necessary.[307] In the second phase the same attempt, with the discretion of the court, may be repeated before courts.[308] This is because the out-of-court settlement could be easily defeated by refusal of one single creditor.[309] In this phase the court may force dissenting creditors to accept the plan on condition that the plan does not discriminate those creditors unduly.[310] The importance of this phase is declining through time.[311] If all efforts of negotiated settlement, out of court or court supervised, fails simplified liquidation procedure will follow.[312] This is the third phase of individual bankruptcy process.[313] The debtor is required to turn over all non-exempt assets, if any, to the trustee appointed by the court, the same will be sold and be paid to the creditors [314] and cover the cost of proceedings. But like in the United States chapter 7 cases, this phase has no

[303] *See* Susanne Braun, *supra note 291, p. see also* 61, see section 26 (1) of the German Insolvency Code.
[304] *See* Robert Anderson *et al, (Ed.) supra note 6*, p. 21; *See* Susanne Braun, *supra note 291, p.* 66
[305] *See* Johanna Niemi, *et al, supra note 3, p.* 274-75; M. Gerhardt, *Consumer Bankruptcy Regimes and Credit Default in the US and Europe: A comparative study, CEPS Working Document No. 318, 27 July 2009*, p. 8, available at http://aei.pitt.edu/11336/, last visited on 11 March 2014

[306] *See* Jason J. Kilborn, *supra note 162, p.* 272: Johanna Niemi, *et al, supra note 3, p.* 274-275
[307] *See* Robert Anderson *et al, (Ed.) supra note 6,* pp.21 & 60 *see* section 305 (1) of the German Insolvency Code, supra note 297
[308] *See* Robert Anderson *et al, (Ed.) supra note 6*, p. 21
[309] *See* Jason J. Kilborn, *supra note 162*, pp. 275-276
[310] *Id. p.* 276
[311] *Id. pp.* 276-277
[312] *Id*. p. 278
[313] *See* Johanna Niemi, *et al, supra note 3*, p. 275
[314] *See* Robert Anderson *et al, (Ed.) supra note 6*, p. 21

practical use because consumer debtors, at least in most cases, do not have assets.[315] The last phase is where the debtor will be put to a six-year-long "good behavior period", successful completion of which will bless the debtor with discharge.[316] This is followed by a kind of probation-type period, known as "good behavior", where the debtor has to show good character paying a certain portion of his/her income, engage in gainful employment, transfer to the trustee half of the value of the property from inheritance, inform his change of addresses, etc. for a period of six years.[317] After successful six-year payment period discharge will be granted, save for exceptional cases where it may be denied.[318] The grounds of denial of discharge include criminal conviction, fraudulent or false written statements about his economic situation, grant or refusal of discharge in ten years time, impaired creditors interest by wasting assets or delaying insolvency proceeding etc.[319]

There are certain debts that are 'excepted' from discharge, hence non-dischargeable. These include tort claims, fines, administrative penalties and incidental consequences of administrative or criminal offence, liabilities from interest-free loans granted to the debtor to pay costs of insolvency proceedings.[320]

If the court decides to give discharge and fresh start for the debtor, the trustee will be appointed and garnishable emoluments will be vested to the trustee, by way of statement of assignment.[321] The trustee is responsible for monitoring the distribution of assets during the debtor's "good behavior" period.

[315] *See* Jason J. Kilborn, *supra note 162, pp.* 278-79; Johanna Niemi, *et al*, *supra note 3,* p. 336
[316] *See* M. Gerhardt, *supra note 305, p.* 8; *see also* Jason J. Kilborn, *supra note 162,* p. 272

[317] *See* Robert Anderson *et al, (Ed.) supra note 6,* p. 21; *See* Susanne Braun, *supra note 291,* p. 66; *see* also section 295 of the German Insolvency Code, *supra note 297*
[318] the German Insolvency Code, *supra note 297,* Sections 300 & 296
[319] *Id*. Section 296
[320] *Id*. Section 302
[321] *Id*. Section 291 & 287

The scope and nature of discharge introduced is, however, different, by far, from that of United State's concept of discharge.[322] There is no full discharge as in United States and it is not European way to let the debtor walk-off without paying anything.[323] The European understanding of individual bankruptcy is rather re-adjustment and rehabilitation where by the individual debtor has to earn the fresh start by his effort. This recognizes "human capital" as valuable economic interest both for debtor and creditor in credit transaction.[324] This is a departure from the conventional view that credits are provided against tangible assets.[325] The debtor will be released only of the residual debts and enjoy fresh start. Accordingly, all creditors, even those who did not file a claim, are bared from any collection efforts against the debtor.[326]

Under German individual insolvency proceedings, it is not true that the creditors will be paid during the "good behavior" period. As in the case of United States Chapter 7 cases, in most cases the plan may not pay at all.[327] This is due to high level of exemption on the future income of the debtor. There are scholars who question the need for such six-year-long financial probation period of "good behavior" if is proved that it is not paying the creditors, at least in most cases.[328] According to them the German model of discharge is rigid, as it does not distinguish between those who really are able to make a certain percentage of payments (those who can cope with the "good behavior period") and those who cannot.[329] No matter how penniless the debtor is or in urgent need immediate fresh start, the six-years-long process

[322] *See* Robert Anderson *et al, (Ed.) supra note 6,* p. 21; Indeed United States Chapter 13 discharge has similarity with the German model. In both laws there is repayment plan for a certain period of time. But still they have differences in that the German model is applicable for all debtors irrespective of their income or ability to pay but United States chapter 13 is available only for those with regular income.
[323] *See* Jason J. Kilborn, *supra note 162, p.* 281; *See also* Ramsay, Iain D. C, *supra note 10, pp.* 250-251
[324] *See* Jason J. Kilborn, *supra note 162, pp.* 281-282
[325] *Id. p.* 282
[326] The German Insolvency Code, supra note 297, Section 301
[327] *See* Jason J. Kilborn, *supra note 162, pp.* 285-86 as cited in Johanna Niemi, *et al, supra note 3,* p. 341
[328] *See* Johanna Niemi, *et al, supra note 3, p.* 288
[329] *See* Robert Anderson *et al, (Ed.) supra note 6,* pp. 21-22

and accompanying obligations nevertheless has to be followed.[330] There are two European approaches in this regard. Some jurisdictions such as France and Sweden have such distinction with the view of helping those penniless debtors get immediate discharge without going through the period of repayment plan.[331] This is what some scholars call it the "mercy model".[332] But the German approach, known as "liability model",[333] and sticks on the repayment the debt. This is the weakness of the German individual insolvency law, which is not tailored according to the need of different types of debtors.

Some other scholars see that rule in a positive way than letting the debtor walk-off right after the conclusion of the insolvency proceeding.[334] According to this later view, by doing so the hidden policy of the German law is to teach the debtor financial responsibility and reintegrate him to the society than paying creditors.[335] In fact such good behavior period is a kind of financial responsibility lesson for the debtor. So the six-year period have a rehabilitative function. However, it is still questionable whether this lesson's value is worth for penniless debtors who will be doomed to lead poor living standard abandoning several social activities, cutting nutrition, engaging in illicit economic activities etc.[336]

Another shortcoming in the individual insolvency practice in Germany is the limited availability of debt counseling institutions.[337] This will put the viability of out-of-court

[330] *Id.*
[331] *See* Johanna Niemi, *et al*, *supra note 3, p.* 340
[332] *See generally* Jan-Ocko Heuer, Social Inclusion and Exclusion in European Consumer Bankruptcy Systems, Paper for the conference Shifting to Post-Crisis Welfare States in Europe? Long Term

and Short Term Perspectives, Berlin, 4-5 June 2013 available at https://www.academia.edu/3992692/Social_Exclusion_in_European_Consumer_Bankruptcy_Systems , last visited on 29 March 2014

[333] *Id.*

[334] *See generally* Jason J. Kilborn, *supra note 162*
[335] *Id. p.* 296
[336] *See* Johanna Niemi, *et al*, *supra note 3,* pp. 287-88
[337] *Id. p.* 288

settlement phase in question for the indigent debtor.[338] Debt counseling has become very crucial instrument of dealing with consumer bankruptcy problems and the access and quality of the service has significant impact in the individual insolvency legal regime. Despite these benefits there seem a limited access to the service in Germany.

[338] *Id.*

Chapter Three - Overview of Ethiopian Bankruptcy Law and Viability of Introducing Individual Bankruptcy Law to Ethiopia

Bankruptcy issues under Ethiopian law are, in principle, governed under Book V of the Commercial Code of Ethiopia adopted in 1960.[339] The sources of this law are the 1955 French bankruptcy legislation and Italian Insolvency Act of 1942.[340]

Ethiopian bankruptcy law is one of the most unsuccessful legal transplants in terms of practical utility.[341] Several factors accounted for the disuse of the bankruptcy provisions of the Commercial Code in court of law. The first reason was socialist political economy that prevailed in the country from 1974 through 1991 where the government controlled almost all economic activities.[342] Entrance and exit in the market was not determined by economic factors. There was no competition in the market and the only player was the government. That had affected the use of bankruptcy procedure until 1991. The other reason is that bankruptcy has not bee in the academic curriculum of Ethiopian law schools and legal professional have little knowledge and experience in the subject.[343] Finally, different legislations such as foreclosure laws undermined the role bankruptcy could have played in the business.[344] So the bankruptcy law of Ethiopia is least used and least developed subject. Close look at the provisions of the code reveals that Ethiopian bankruptcy law is pro-liquidation.[345]

Ethiopian Law limits the application of the bankruptcy law to traders and excludes

[339] The Commercial Code of the Empire of Ethiopia, *Negarit Gazzette*, Birihanina Selam Printing Press, Procl. No. 166 of 1960, Neg. Gaz. 19/3, (here in after the Commercial Code) Articles, 968-1168; there are some other legislations such as Banks Foreclosure Law or legislations only applicable for public Enterprises.
[340] *See* Lencho Taddesse, *supra note 5,* p. 62
[341] *Id. p.* 57
[342] *Id. p.* 58
[343] *Id. pp.* 58-59
[344] *Id. p.* 59
[345] *Id. p.* 63

non-traders individuals from its scope.[346] Hence, the subjects of Bankruptcy law are only "traders" i.e. persons engaged in commercial activities within the meaning of Article 5 of the Commercial Code. Therefore, Ethiopian bankruptcy law is concerned with businesses and individuals are not subjects of bankruptcy law. Individuals can only file for bankruptcy if they qualify as traders and the debt is commercial debt.[347] It is consistent with the old times classical bankruptcy law philosophy that is restricted the access for merchants only. Before and during the era Ethiopian bankruptcy law was adopted, the traditional function of bankruptcy law in most, if not all, jurisdictions was liquidating and reorganizing businesses.

Ethiopian legislatures adopt the same philosophy the revised 1955 French bankruptcy legislation had towards bankruptcy. But the latter has departed from the philosophy that restricted bankruptcy law to merchants in 1989 and today individuals are entitled to relief in the form of discharge.[348]

The justifications for excluding individuals from the 1960 bankruptcy law are some how obvious; access to credit and indebtedness used to be issues for businesses and not consumers. And some how important moral and legal principle under Ethiopian contract law that "failure to keep a promise is worse than losing a descendant" an equivalent of *'Pacta sunt servanda'* demands debts be paid than the law intervene to free individuals from their repayment obligations. In this regard Ethiopian bankruptcy law was perfect of its time.

There were several reasons that make the 1960 Commercial Code bankruptcy provisions adequate enough for the needs of the time, at least until 1991. In Ethiopian business activities were least developed and dominated by small and medium government

[346] *Id. pp. 69-70; see* the Commercial Code, *supra note 339*, Article 968 69-70; *See also* Booz/Allen/Hamilton, infra 347, p., 54; See also Teshome, Tilahun *et al, Position of the Business Community on the Revision of the Commercial Code of Ethiopia*, July 2008, pp. 82-83

[347] Booz/Allen/Hamilton, ETHIOPIAN COMMERCIAL LAW AND INSTITUTIONAL REFORM AND TRADE DIAGNOSTICS, Jan 2007, p. 54

[348] *See* Robert Anderson *et al, (Ed.) supra note 6*, p.19

owned (public) enterprises. There was no competition in the market and there was no risk of failure and exiting the market. Publicly financed companies or businesses will continue operating even at loss. It is only after 1991 that shifted the Ethiopian economic policy to market economy that private businesses and entrepreneurial activities started to emerge. Another reason accounted for the kind of merchant oriented bankruptcy law is that in Ethiopia debt was not something good and access to consumer credit was very limited. Failure to repay one's debt is still highly stigmatized. With these factors, the bankruptcy law as incorporated under the Commercial Code was adequate enough to ensure creditors protection, only concerns of bankruptcy law of the time. But the law failed to keep track of changed bankruptcy philosophies and developments[349] in response to the development of commerce, entrepreneurship, availability of consumer credit, consumer over-indebtedness, and absence of government social safety net programs.

Currently the Ethiopian Commercial Code is under revision and there are recommendations from some scholars and experts for the inclusion of individual bankruptcy to the upcoming amendment.[350] Others simply call for the policy makers to reconsider the issue of individual bankruptcy emphasizing on the benefits it has towards entrepreneurship.[351] Therefore, whether Ethiopia has to introduce individual bankruptcy law, factors calling for change of paradigm, the model it has to follow, if at all individual bankruptcy is demanding, will be discussed in the coming sections.

[349] *See* Lencho, Taddese, *supra note 5, p.* 95
[350] *See* Teshome, Tilahun *et al*, *supra note 346, pp.* 82-83; In fact these experts suggest, as I agree, that individual bankruptcy matters being non-commercial will fit into separate legislation or civil procedure code.
[351] *See* Booz/Allen/Hamilton, supra *note 347, p.* 54

3.1 Individual Bankruptcy Law for Ethiopia

As pointed out so far in this thesis[352] bankruptcy law used to be restricted to the use of merchants and to protect creditors and help them in debt collection process, mainly through liquidation. Accordingly, only businesses were concerns of most bankruptcy legislations worldwide. This is still true under Ethiopian law where only businesses can apply for bankruptcy and not consumers.

Today the scope of bankruptcy law has been extended to individuals as well. In United Kingdom and United States individual bankruptcy was introduced as a reaction to liberalization of credit and the accompanying over-indebtedness.[353] In Germany the individual insolvency rules were introduced in the 1999 Insolvency Act with a view of giving relief to debtors after the consumer over-indebtedness that occurred since 1970s and 1980s. In France consumer bankruptcy and debt readjustment was introduced in 1989 because of consumer over-indebtedness. This is true for most European countries that liberalized their bankruptcy law to include consumer debtors.

As discussed in section 1.2 several factors led to (justify) adoption of individual bankruptcy into the legislations of many jurisdictions. Some of the reasons include but not limited to, industrialization, expansion of trade and commerce, deregulation of credit, individuals access to credit and indebtedness, entrepreneurial friendly policies, reduction in the welfare activities of governments etc. The question worth to ask at this point is whether there is a need to introduce individual bankruptcy rules to the Ethiopian legal system. There are no empirical studies of increasing consumer debt or over-indebtedness in Ethiopia. And nothing is written on the issue. But taking the experience of the different jurisdictions studied

[352] *See section 1.1 of this paper*
[353] *See sections 1.1 and 1.2 of this paper*

in this thesis introducing individual bankruptcy procedures to Ethiopia will have paramount importance.

Generally, bankruptcy law provides an alternative to judicial procedures of enforcing claims. As such, it solves the following problems inherent in non-bankruptcy procedure of enforcement of claims. Non-bankruptcy law provides for a procedure where creditors, individually, using state's power seize non-exempt assets of the debtor to satisfy their claims. But non-bankruptcy law only regulates relationship between debtor and creditor and not creditors *inter se*. This will lead to several wasteful litigations, in terms of courts' time and parties' costs, as there are creditors. The debtor will also be harassed as many times as there are creditors. It may also happen that first comer will take everything and hence inequitable for the other creditors. So individual bankruptcy will solve collective action problem in the same way business bankruptcy does.[354] The assets of the individual will be given to a person, trustee, who has to liquidate and distribute to the creditors according to their share in the claims. This justification of bankruptcy, though the pioneer reason, is becoming obsolete because the debtor has no assets in most straight bankruptcy cases. Nevertheless, this justification for individual bankruptcy is still cited as one of the most important justification. Individual bankruptcy and fresh start is also good incentive for debtor's cooperation in the collection process. If the debtor knows that he will be forgiven he will not hide or transfer assets and disrupt the opportunity to start afresh. Generally there is an incentive not to engage in any fraudulent activities and disrupt the debt collection procedure.

It is discussed that many countries have adopted individual bankruptcy laws after they deregulated their credit markets. In Ethiopia there is no such deregulation and rather the financial sector is highly regulated and dominated by state banks.[355] Nevertheless individuals,

[354] *See* Margaret Howard, *Supra note 27, p.* 1049
[355] http://www.mfw4a.org/ethiopia/ethiopia-financial-sector-profile.html last visited on 16 March 2014

especially from urban areas, are getting access to credits.[356] In addition to state banks, there are several private banks, micro-finance institutions and saving and credit associations. Individuals are having access to consumer credit directly or indirectly and are therefore exposed to the risk of misguided indebtedness problems. This will make more sense when Ethiopia introduces credit card system in the future.

From the debtors perspective individual bankruptcy will solve the dis-incentive of the debtor to acquire property or engage in gainful employment in the future if there is a judgment creditor who is waiting to enforce a claim against the debtor. Without discharge and fresh start, "honest but unfortunate debtor" will be alerted perpetually be judgment creditor looking to satisfy his claims. Individual bankruptcy will play a role in giving relief and rehabilitation and reintegration tool.

Like in other jurisdiction the social-insurance function of bankruptcy can be a good reason to adopt individual bankruptcy law to the Ethiopian legal system. Studies show that in countries where there are extensive welfare and safety net programs by the government there are limited relief or no relief at all under their bankruptcy law.[357] Conversely, in countries where there are no social safety net programs there is a generous relief under their individual bankruptcy law. In Ethiopia the governmental social security scheme and safety net programs are very limited and inadequate. And this gap can be addressed by having well-crafted individual bankruptcy law. It will be safety net for troubled individual debtors to pass through difficult times.

Entrepreneurial analysis of bankruptcy also suits the current entrepreneurial policy of Ethiopia. Entrepreneurship is an area where Ethiopia is trying hard as part of the poverty

[356] http://www.agrifinfacility.org/enabling-environment-access-financial-services-ethiopia; See also http://www.combanketh.et/DomesticBanking/CreditFacilities.aspx; http://www.ifad.org/evaluation/public_html/eksyst/doc/profile/pf/rfip.htm last visited on 16 March 2014

[357] *See* R Adam Feibelman, , *supra note 86*, pp. 184-186

reduction strategy. The first debt before starting a business is usually a personal (consumer) debt. Not being trader entrepreneurs will not be allowed to file for bankruptcy under Ethiopian law. When the entrepreneur failed to repay the amount he owed for his start up he will be treated under non-bankruptcy law and will be harassed by judgment creditor indefinitely. This is not good for entrepreneurship. When entrepreneurs are punished for their failure they will have less incentive to take risks. In order to encourage entrepreneurship and risk taking, among other things, an individual bankruptcy law that will forgive genuine debtors who failed in their startups is important. This will complement the current entrepreneurial policy of Ethiopia.

Furthermore, in Ethiopia most of the businesses are carried out under mid-scale, small and micro enterprises that include partnerships and sole proprietorships. In fact the persons engaged on any of those business vehicles have the access to bankruptcy law because they are traders within the meaning of Article 5 of the commercial code.[358] But the fact that the liability of the owners is unlimited in these unincorporated businesses will make it very risky for individuals to engage in these businesses.[359] Individual owner will not benefit out of bankruptcy once the business is gone. Creditors still can have an action against the debtor because of unlimited liability, in most cases. This will have negative impact on entrepreneurship and self-employment. So adopting individual bankruptcy law insures such risk taking by entrepreneurs.

Moreover, today indebtedness is not a matter for businesses only. That phenomenon has gone long ago when credit was only available for businesses. Today credit is available for consumers as well and indebtedness also affects real people. To this effect, individual bankruptcy with adequate discharge is proved to be a good solution. There should be the

[358] See The Commercial Code, *supra note 339,* Article 5 & 968
[359] *See* Ramsay, Iain D. C. *supra note 115,* p. 79

chance for those who defaulted in their obligation to start life as productive members of the society. They should be forgiven and rehabilitated.

In conclusion, indebtedness is a universal problem. All countries, industrialized or otherwise, face the problem of indebtedness. If it is a real problem for developed countries with high per-capita, high employment rate and developed insurance schemes, it should be a problem, stronger reason, in Ethiopia, which is at the opposite tail of those indicators. Different jurisdictions adopt individual bankruptcy and give relief for those debtors in the form of discharge and fresh start. The primary goal of individual bankruptcy and fresh start is tied with the problem of indebtedness but it is also justified out of the reasons discussed above and other parts of the thesis. It is, therefore, my thesis that Ethiopia should adopt individual bankruptcy law.[360]

3.2 Model to be Followed

The question worth to be asked at this juncture is the kind of debt relief system can be adopted to suit the special situation of the country. The models of relief and scope of fresh start differs from jurisdiction to jurisdiction and depends on several factors such as the socio-economic and political situations of each country. Some jurisdiction, like United States, give generous relief and automatic discharge while others, such as Germany, gives the relief in a different way from the former. In United States the individual bankruptcy has three categories namely chapter 7 (for all individuals), chapter 12 (farmers and fishermen) 13 (wage earners and working couples).[361] The United States model is tailored to fit the special needs of different segments of the society. Chapter 7 is designed for those debtors who have not the ability to pay their debts. Chapter 12 is designed for the special need of farmers and

[360] This suggestion is, however, based on theoretical findings than empirical studies for the later is lacking in the current context of the country's research and legal/business and economics scholarship.

[361] See section 2.1 of this paper

fishermen who need to keep their land and farm instruments even when those assets are given as a security for debts. Chapter 13 is a repayment plan for those who are able to pay out of their future income. Chapter 13 is, therefore, some how similar to the German repayment plan procedure. In Germany there is only one procedure for all individuals and they have to go through series of procedures such as negotiated settlement, both out-of-court and in-court, and culminated in the repayment plan the successful completion will earn the debtor fresh start.[362]

For Ethiopia, I will suggest that German type individual bankruptcy would fit to the realities of the country. Ethiopia is one of the world's poorest countries[363] but also one of the fastest growing economies.[364] There is a need for individual bankruptcy as the economy is growing and credits are becoming available. But also a generous discharge of debts will not be a viable option for a very infant economy Ethiopia has. So the individual bankruptcy I am advocating should take into consideration of these factors. To have a United States type generous discharge and tailored to the different segments of the society will not be viable solution for the country for reasons that are socio-economic. One the one hand a generous discharge as in the United States will hurt the financial sector. More importantly it will be unbearable burden for Ethiopia if there happens to be financial crises the world has witnessed like the 2008 financial crises. The other reason against United States type individual bankruptcy is that credit is not available for every one in Ethiopia. Credits are, mostly, available for people living in urban areas. Most of the entrepreneurial activities and start-ups are also concentrated in major cities and urban areas making the risk of indebtedness more acute for this segment of the society. In rural areas, for farmers, access to credit is very

[362] See section 2.2 of this paper

[363] http://www.gfmag.com/component/content/article/119-economic-data/12537-the-poorest-countries-in-the-world.html#axzz2w9Xb7SEc last visited on 17 March 2014

[364] http://www.worldbank.org/en/news/press-release/2013/06/18/ethiopia-economic-update-laying-the-foundation-for-achieving-middle-income-status; http://time.com/22779/forget-the-brics-meet-the-pines/ last visited on 18 March 2014

limited and they are not exposed to the risk of over-indebtedness. Indeed farmers have access to credit through micro finance and rural saving and credit associations. But those credits are highly regulated and monitored by government and saving and credit associations on a day-to-day basis and the risk on farmers is not serious one. Moreover, ownership of land belongs to the government and individuals are not exposed to the risk of losing their land because of debt.[365] So farmers do not need special protection like their United States counterpart. The other reason for not adopting United States-type individual bankruptcy is the societies' attitude towards failure to pay one's debt. In Ethiopia failure to pay one's debt is not a good thing and is stigmatized highly. As the saying goes "failure to keep a promise is worse than losing a descendant." This is the equivalent of *pacta sunt servanda,* which is a grand norm in contract law. So to devise a rule like The United States bankruptcy law where the debtor just walks-off without paying a penny will be against the belief of the people. So the individual bankruptcy to be adopted shall be just a single type of procedure, as in Germany, to every one.

Another issue that comes with adopting individual bankruptcy procedure is the issue of who will finance the system. It will be huge burden for a country like Ethiopia, especially in case of financial crises, to cover costs of proceeding in individual bankruptcy cases where they debtor may not have sufficient assets to cover that. In order to solve this problem the conditions of discharge should be devised in such a way that the individual debtor has to cover the costs of proceedings and come up with a plan of repayment for a certain period of time. That should be the price individual has to pay to get fresh start. This will make sure that the financial/ credit market is not going to be hurt and the individual after successful completion of the plan will get fresh start. Introducing individual bankruptcy law does not require separate institution or bankruptcy courts in Ethiopia. It will be brought to the same

[365] The Constitution of the Federal Democratic Republic of Ethiopia, Procl. No. 1/1995, Article 40 (3)

court and judges before who business bankruptcy cases are handled. The trustee system is also already in place. And therefore there is no additional cost to set up institutions in this regard.

In conclusion, designing an individual bankruptcy regime where honest and deserving debtors will get fresh start, consumers are protected from bad lending practices, worth entrepreneurship ideas are encouraged, failed individuals are rehabilitated and reintegrated back to the society needs a careful considerations of socio-economic situations of the country. In Ethiopia introducing individual bankruptcy with discharge and fresh start for "worthy debtors" will have paramount importance in several aspects of life. For one thing, individuals may be in imminent need of credit due to changed circumstances such as illness, loss of job, divorce, as do people from other jurisdictions. Without individual bankruptcy and discharge the creditor who has got a court judgment for the enforcement of his claims will make the debtors life miserable by continuous harassment. And this may continue forever making the debtor, restless, hopeless and unproductive. Individuals may also have entrepreneurship ideas that are worth to be put in the market and credit is important tool for such startups. With credit, however, there is risk. The new entrepreneurial idea may not work and may bring with it indebtedness which the individual may not be able to repay it working for the whole of his life.

On the other side of the spectrum, individual bankruptcy and fresh start carry with it some costs. A system where most debtors walk-off without paying something significant will be a huge burden for growing economy like ours. The issue of financing the system is another worry. Abuse of the system can be added to the problems. It is, therefore, very crucial to have an individual bankruptcy law where a benefits will outweigh the costs by far. Repayment plan with discharge and fresh start for successful debtors who will pay cost of proceeding and a certain portion of debt will be a good option.

Conclusions

Bankruptcy law used to be a tool for businesses for most history of use of the concept. But also it has been long ago since the same is extended to individuals as well. Several reasons accounted for this shift. At the forefront of reasons for such departure is the availability of credit and resultant over-indebtedness that many countries have experienced prior to the adoption of their individual bankruptcy laws. Indebtedness is becoming a universal problem. And different jurisdictions are reacting to the problem by adopting an individual bankruptcy law where by the debts of the debtor are wiped-out and the debtor starts life afresh.

The scope of fresh discharge and fresh start varies across jurisdictions and some are pro-debtor with generous relief, exemptions and fresh start while others have provided restrictive conditions in their individual bankruptcy laws. United States and Germany can contrasted in this regard. The former has a generous debt relief and discharge while the later a series of procedures and efforts are needed from the debtor to earn a fresh start. There are several reasons for the difference between the two countries laws. Availability of safety net programs, attitude towards entrepreneurship, economic policy, stigma towards debt and consumer credit are just some of the reasons.

Currently several countries are moving towards the adoption of individual bankruptcy law. It is being justified out of several reasons and is considered as multi-faceted tool that serves several socio-economic functions. The issue of introducing the same law is under discussion in Ethiopia. A group of experts have made it clear that introducing such law is good for Ethiopia.[366] I am also of agree that individual bankruptcy law designed after the German Model will benefit Ethiopia. It will solve the problem of debt collection and

[366] *See* Teshome Tilahun *et al,* supra note 346, pp. 82-84

individuals will be able to start life anew and join the society as a productive member. Individual bankruptcy will help in entrepreneurial development reducing the risk of investing in new ideas. It will also be a kind of substitute for the lack of safety net and inadequate social security schemes for individuals who would otherwise cannot survive the changed circumstances they will face such as illness, loss of job, divorce etc.

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