

# Designing a personal bankruptcy law

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## Consumer bankruptcy

- Bankruptcy is giving the debtor a time-bound relief from a creditors collection process
- The collection process needs to establish balanced and predictable burden sharing between the debtor and creditors and to maintain credit discipline by maximizing the payoff for all creditors.
- Ultimately, it is providing *debt relief* after a certain period.
- Quick and easy debt relief may give rise to moral hazard
- Thus, the central questions around individual bankruptcy are about:
  - What is the *process* by which creditors enforce obligations and collect debt from insolvent debtors?
  - How is *discharge* designed?

## Questions around process and discharge

### ■ Process

- When does an insolvency proceeding commence?
- Who may request commencement? Should the nature of commencement criterion differ depending on who is requesting commencement?
- What limitations, if any, should be imposed on the contents of a re-organisation plan? What conditions are required for its approval and effectiveness?
- How should creditors be ranked for purposes of distributing the proceeds of a liquidation sale?

### ■ Discharge

- What exemptions are permitted?
- How many years does it take to get discharge?

## Process of bankruptcy

- Two main functions:
  - Administrative: For example, recording, collection and evaluation of the assets and liabilities, etc
  - Judicial: For example, adjudication of disputes.
- What should be placed outside the court of law?
- What should be conducted under the authority of the court of law?
- The trend is towards placing administrative proceedings outside of the courts.
- Pre-packaged bankruptcy regulations

## Discharge

- Trend toward liberalising debt relief and bankruptcy law across the globe
- Most countries have modest measures of debt relief relative to the fresh start approach in the USA
- In Europe it is called *earned start* instead of fresh start. The duration of the plan varies from 3 to 7 years.
- In the UK, fresh start underlies the policy of small-business insolvency legislation.

## Models of fresh start (or debt forgiveness)

- No debt forgiveness to consumers (non-merchant individuals).<sup>1</sup>
- Consumers can apply for forgiveness, but no guarantee that it will be granted. A judge, exercising discretion and guided by statutory guidelines, decides whether, and under what circumstances, that individual's debts should be forgiven.<sup>2</sup>
- Forgiveness offered with a high degree of certainty, and relative promptness.<sup>3</sup>

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<sup>1</sup>Brazil provides bankruptcy relief for individuals, but only if they operate or engage in business or trade.

<sup>2</sup>India falls here, as do most European countries.

<sup>3</sup>Chapter 7, USA

## Part I

# Country studies

## United Kingdom: The main legislation

- The Second Group of Parts: Insolvency Act, 1986



## Three formal processes

- Debt Relief Orders
- Individual Voluntary Arrangements
- Bankruptcy

## Debt Relief Orders (DRO)

- Designed for those with relatively low levels of debt and few or no assets
  - Maximum debts of £15,000
  - Maximum assets of £300 (excluding some defined assets)
  - Maximum surplus income of £50 per month.
- Discharge after twelve months apart from certain excluded debts, however remains on credit history for six years from the date of the order.
- No distribution to creditors

## Debt Relief Orders (DRO)

- An application for a debt relief order must be made to the Official Receiver through an approved intermediary
- The application must include
  - a list of the debts to which the debtor is subject at the date of the application, specifying the amount of each debt
  - details of any security held in respect of any of those debts
- The entry fee into a DRO is £90
- The OR either refuses the application (only by provisions of the law), or accepts the application and makes a DRO.
- The order is made in the prescribed form
- It includes a list of the debts which the official receiver is satisfied were qualifying debts of the debtor at the application date, specifying the amount of the debt at that time and the creditor to whom it was then owed.

## Individual Voluntary Arrangements (IVAs)

- A formal binding agreement between an individual and their creditors
  - Usual a set of manageable payments in order to pay off a percentage of what they owe, without incurring further interest.
  - Combination of debt rescheduling, contributions towards the outstanding debts by the debtor and third parties and a structured sale of assets to repay creditors.
- Includes all secured debts. Rights of secured creditors cannot be affected without the consent of the creditor.
- Usually last for five years. Remains on credit history for six.
- No bankruptcy petition relating to the debtor may be presented or proceeded with
- Fewer restrictions than bankruptcy or DRO.

## Individual Voluntary Arrangements (IVAs)

- Proposal to creditors put together with the help of an Insolvency Practitioner (IP)
- Creditors vote to approve the IVA (in person or by proxy)
  - The IVA needs to be supported by 75% or more of creditors by value voting at the meeting and
  - Less than 50% by value of non-associated creditors vote against the proposal
- The IP reports the decision to the court.
- Once the IVA is in place it is supervised by an IP
- IVA Protocol compliant IVAs introduced in 2008. These are standardised processes for dealing with straightforward, consumer IVAs
- In a Fast-Track IVA, the debtor submits a plan to the OR, and the OR makes a decision on inviting creditors for approval.

## Bankruptcy

- Petitions made to the court, by the debtor or the creditor (unsecured).
- The debt need not be only unsecured if secured creditor is willing to give up his security for the benefit of all the bankrupt's creditors or the petition is expressed not to be made in respect of the secured part of the debt
- If the debtor files for bankruptcy, the court appoints an IP to either prepare a report stating whether the debtor is willing to make a proposal for a voluntary arrangement.
- The estate is administered by the Trustee in bankruptcy: either an Insolvency Practitioner (IP) or a Government official, the Official Receiver (OR).
- £700 up-front fee (£175 court fee + £525 case administration fee)
- Discharge after twelve months apart from certain excluded debts, however remains on credit history for six years from the date of the order.

## Australia: The main legislation

*Bankruptcy Act 1966*: The Commonwealth legislation which covers personal insolvency, including bankruptcy, Part IX (debt agreements) and Part X (personal insolvency agreements) arrangements. It deals with individuals. Corporate entities are covered by the Corporations Law administered by the Australian Securities and Investments Commission.

## Australia: Institutional framework

- The Australian Financial Security Authority (AFSA) is responsible for the administration and regulation of the personal insolvency system
- Operates the bankruptcy registry, where debtors petitions are lodged, debt agreement proposals are processed and public records on insolvency are maintained
- Exercises Official Receiver powers to assist trustees to obtain information and recover property.
- Investigates possible offences under the Bankruptcy Act and prepares briefs of evidence for prosecution
- Regulates the administrations and activity of the Official Trustee and private registered trustees, and licenses private trustees.
- Advises Government on appropriate legislative reform to the Bankruptcy Act 1966 and related legislation, and acts as a special trustee for government agencies, pursuant to court orders, particularly by locating, controlling and selling property under the Proceeds of Crime Act 1987 and the Customs Act 1901.



## Options to deal with unmanageable debt

- Suspension of creditor enforcement by presenting a declaration of intention (DOI) to present a debtor's petition.
- Debt agreement (Part IX of the Act)
- Personal insolvency agreement (Part X of the Act)
- Bankruptcy (Part IV of the Act)
- If debtors income and assets are under specified thresholds, free to choose either agreement. If they exceed these amounts, the debtor becomes ineligible for a Debt Agreement and can only then consider a Personal Insolvency Agreement.

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## Option 1: Declaration Of Intention option

- Provides temporary relief to allow upto 21 days to decide with bankruptcy or another option
- Unsecured creditors cannot take any action in these 21 days
- Can make suitable arrangements to avoid entering into a formal option under the Bankruptcy Act
- A DOI is not recorded on the National Personal Insolvency Index (NPII).
- Some unsecured creditors and secured creditors not bound during this stay period.
- A creditor can petition the court to make the debtor bankrupt during the 21 days, or after the end of the period if an arrangement has not been reached.

## Option 2: Debt agreement

- Binding agreement between debtors and creditors where creditors agree to accept a sum of money that the debtor can afford.
- Details appear on the NPII. Ability to obtain further credit affected for upto seven years.
- During the voting period, creditors cannot take debt recovery action or enforce action against the debtor or his property
- Unsecured creditors bound by the debt agreement and paid in proportion to their debts
- Secured creditors may seize and sell any assets mortgaged to them
- Released from most unsecured debts when all obligations have been met

## Debt agreement: Procedure

- Debtor reads and signs an information page
- Debtor appoints a debt administrator (either registered or non registered)
- Debtor lodges the following with AFSA within 14 days of being signed by the debtor:
  - A debt agreement proposal
  - An explanatory statement (informing creditors about income and assets)
  - A statement of affairs (detailed explanation of personal information and circumstances not sent to creditors and not put out in public)
- AFSA sends proposal to creditors to assess and vote on. Creditors to send their vote (with a yes or no) to AFSA in five weeks.
- If majority of creditors accept, then it is registered on the NPII as a debt agreement and the debtor begins to comply. If a majority of creditors do not accept, then this voting outcome is recorded on the NPII. Creditors can commence or continue with action to recover the debts.
- The debt agreement can be changed by lodging a variation proposal if the debtor's circumstances have changed.

## Option 3: Personal insolvency agreement (PIA)

- This allows debtors to come to an agreement with creditors to settle debts without being bankrupt.
- Debtor must be *insolvent* to propose a PIA
- A PIA may involve one or more of the following:
  - A lump sum payment to creditors either from own money or money from third parties (eg family or friends)
  - Transfer of assets to creditors or the payment of the sale proceeds of assets to creditors, and/or
  - A payment arrangement with creditors (this could include deferral of repayments)

## PIA: Procedure

- Debtor appoints a controlling trustee to take control of the property and put forward a proposal to creditors
- Only a registered trustee, AFSA or a suitably qualified solicitor can act as a controlling trustee
- The controlling trustee examines the proposal, makes enquiries into debtors financial affairs and reports to creditors.
- The report will advise creditors of the amount they can expect from the proposal compared to the amount they could expect if the debtor became bankrupt, and make a recommendation whether it is in creditors' interests to accept the proposal.
- A creditors' meeting must be held within 25 working days of the controlling trustee's appointment
- This creditors' meeting is advertised on AFSA's website
- Debtor must attend the meeting unless excused by the controlling trustee
- Creditors consider and vote on the proposal.
- Acceptance requires a yes vote from a majority of creditors who represent at least 75% of the dollar value of the voting creditors' debts (referred to as a special resolution).

## PIA: Procedure, contd.

- If proposal is accepted, the creditors are bound by the terms of the PIA
- Secured creditors' rights in relation to dealing with their security are not affected by a PIA
- If proposal is rejected, creditors will either:
  - Vote in favour of the debtor becoming bankrupt,
  - Or leave it up to the debtor to decide how to resolve financial difficulties.
- If the proposal is rejected or lapses, the debtor cannot appoint another controlling trustee for six months without the permission of the court.



## Option 4: Bankruptcy

Two ways to become bankrupt

- Presenting the debtor's petition, referred to as voluntary bankruptcy
- A creditor (someone the debtor owes money to) makes an application to court to make the debtor bankrupt, referred to as involuntary bankruptcy.

## Voluntary bankruptcy

- The debtor will face certain restrictions and have obligations placed
- The debtor will need to complete and lodge a debtor's petition and a statement of affairs with AFSA within 28 days of signing the forms
- When the forms are accepted by AFSA, generally within 24-48 hour period, the debtor becomes bankrupt

## Involuntary bankruptcy

- A creditor to whom the debtor owes \$5000 or more may apply to the court to have the debtor made bankrupt.
- The creditor applies for a bankruptcy notice, and serves it on the debtor demanding that the debtor pay the money owed to the creditor within 21 days
- A notice can only be issued if the creditor has obtained a court judgment within the last six years and the total amount owing under the judgment (or two judgments combined) is \$5000 or more.
- If the debtor does not pay the creditor by the time given in the notice, the debtor commits an “act of bankruptcy”
- A creditor can then apply to the court (called a creditor’s petition) to have you made bankrupt
- If after hearing the creditor’s case and any submissions the debtor makes, the court is satisfied that the debtor has not paid the creditor, the court makes an order (called a sequestration order) making the debtor bankrupt
- A trustee is appointed and the debtor is then required to file a statement of affairs with AFSA within 14 days of being notified of the order

## Consequences of bankruptcy

- Assets may be sold
- Income, employment and business may be affected
- May not be released from all debts
- Ability to travel overseas will be affected
- Name will appear on the National Personal Insolvency Index (NPII) forever
- Ability to obtain future credit will be affected

## End of bankruptcy

- If voluntary bankruptcy, the debtor will be due for discharge three years and one day after the debtor filed that petition and statement of affairs with AFSA
- If involuntary bankruptcy, the debtor will be due for discharge three years and one day after AFSA accepted the completed statement of affairs.
- The Bankruptcy Act says that a discharged bankrupt must still:
  - Assist the trustee to finalise the administration of the bankruptcy
  - Advise trustee of any change of address
  - Provide information about their financial circumstances if requested to do so
  - Pay outstanding income contributions.
  - Give up secured assets if required by the relevant secured creditors
  - Pay debts that are not released by bankruptcy
- In some cases, bankruptcy can be extended to five or eight years if the trustee lodges an objection to discharge for the debtors failure to:
  - Provide information to, and assist the trustee
  - Disclose to the trustee all income
  - Explain how money was spent
  - Reveal all assets to creditors

## What happens after discharge

- Name will appear on the NPII forever as a discharged bankrupt
- Credit reporting organisations also keep records of bankruptcies for seven years
- A discharged bankrupt must still
  - Assist their trustee to finalise the administration of the bankruptcy
  - Advise their trustee of any change of address
  - Provide information about their financial circumstances if requested to do so
  - Pay outstanding income contributions
- The debtor may have continuing obligations to
  - Give up secured assets if required by the relevant secured creditors
  - Pay debts that are not released by bankruptcy.

## Part II

### India: Way forward

## Categories of potential individual bankrupts in India

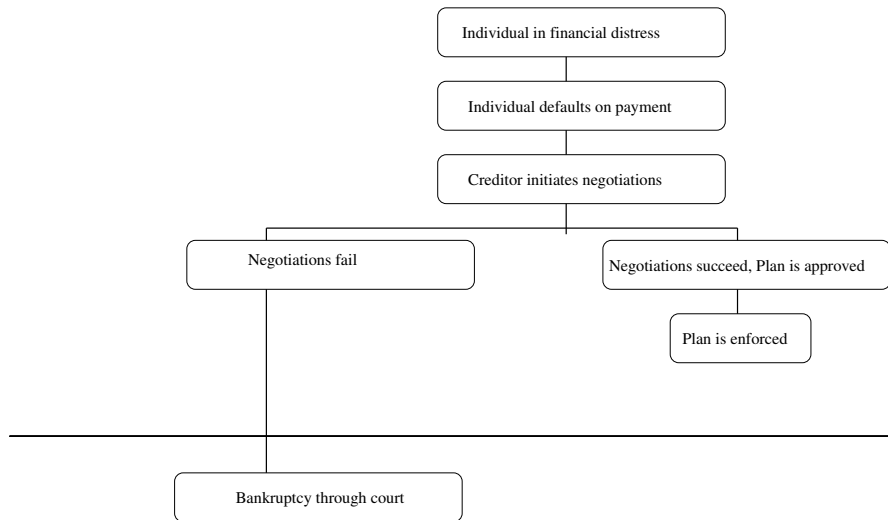
- Farmers (usually on PSL loans)
- Micro-finance borrowers (usually in groups)
- Small scale industry (sole proprietorships)
- Personal guarantors (possibly for larger limited liability companies)
- Consumer finance borrowers (home loans, vehicle loans, credit card debt)
- Student loans



## Institutional machinery

- Bankruptcy Law
  - Defines trigger of insolvency
  - Lays down principles for procedural regulations
  - Lays down principles of fresh start
  - Lays down principles of exemptions of assets/income
- Bankruptcy regulator formed by the Law and oversees
  - Insolvency practitioners
  - Other practitioners
  - Credit information bureau
  - Information registry
- Courts that settle disputes when out of court plans fail.

## Process structure



## Trigger of bankruptcy

- Conditions that must be met for an individual to trigger a process
  - Declaration of insolvency
  - Move to negotiate on repayment

## Procedure: Courts vs. out of court

- Out of court overseen by bankruptcy regulator
  - Entity default or insolvency is declared to
  - Entity that does the assessment of insolvency
  - Entity prepares a plan for repayment and negotiates with creditors.
  - Entity that oversees enforcement of plan if the plan is approved.
- Court procedure if the plan is not approved.
- Rules that make it difficult to game the choice between out of court and court procedures.
- Discharge