



CENTRAL EUROPEAN UNIVERSITY

**FRESH-START POLICY OF BANKRUPTCY LAW IN VISEGRAD COUNTRIES:
ECONOMIC AND LEGAL ANALYSIS**

by

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To Grandmother, Parents and Zuzana

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ABSTRACT

The fresh-start policy is one of the key concepts of modern bankruptcy laws. It provides a debtor with a remedy in the form of a discharge of debts and an opportunity to start anew. Since its application entails a departure from non-bankruptcy law and implies significant implications, the fresh-start policy needs to be justified.

The thesis first examines the reasons behind the fresh-start policy and identifies positive effects based on efficiency grounds while also pointing out negative impacts. Further, the emphasis is put on the assessment whether and to what extent the rationales have been implemented in Visegrad countries. As the title suggests, apart from comparative approach, the main focus is on legal and economic analysis.

The author asserts that the fresh-start policy is a useful legal device but since it also has a set of negative potential effects, careful consideration is required. In this respect, the thesis briefly outlines how to mitigate the drawbacks. The author further concludes that the bankruptcy regimes in Visegrad countries vary significantly from virtually complete omission to implement the fresh-start policy to more or less efficient implementation.

1. INTRODUCTION

Credit or money is deemed to be at the root of the progress the Western world has made.¹ On the other hand, it has been also framed as the source of evil.² Instead of achieving the American dream that the credit promises, it may indeed induce a dream of a different sort – bankruptcy nightmare.³ With the arrival of economic crisis, the issue of regulation of bankruptcy is topical not only for business entities.

Personal insolvency law has attracted a considerable amount of attention and so the fresh-start policy has become an important feature of modern bankruptcy laws. It essentially relieves a debtor from incurred debts and provides him with a new opportunity in life unhampered from the incurred debts.⁴ This might be exactly the point where the possibility of a better future replaces the bankruptcy nightmare.

Outside of bankruptcy law, the underlying principle is that debts ought to be paid. Since the fresh-start policy entails a departure from non-bankruptcy law, it needs to be well reasoned.⁵ The main research question is what considerations may justify the fresh-start policy on efficiency grounds, and how these findings are reflected in bankruptcy regulations in particular Visegrad countries. Due to the limitations of this work, the thesis shall focus more on the first part of the question. Moreover, as the title suggests, the emphasis is put on legal and economic analysis. Therefore, the thesis does not consider other possible rationales

¹ FERGUSON, Niall. *The Cash Nexus: Money and Power in the Modern World, 1700-2000*. New York: Basic Books, 2001, p. 1.

² The famous quote from the Bible, 1 Timothy, 6:10 speaks for itself: “*The love of money is the root of all evil.*” Quoted in *idem*.

³ A paraphrase of the introductory sentence in WILLIAMS, Winton E. *Games Creditors Play: Collecting from Overextended Consumers*. Durham: Carolina Academic Press, 1998, p. vii.

⁴ See the famous US Supreme Court ruling *Local Loan Co. v. Hunt*, 294 U.S. 234, 244 (1934).

⁵ See *infra* chapter 2.4.

behind the fresh-start policy.⁶ Further limitation is that the thesis examines only bankruptcy statutes.⁷

The paper is divided into seven chapters including this part. The following chapter deals with a number of basic notions and outline the fundamentals of bankruptcy law. The third chapter discusses potentially positive effects substantiating the adoption of the fresh-start policy. On the other hand, chapter 4 observes the negative impacts and briefly also solutions that might mitigate the drawbacks. The subsequent part examines the implementation of the fresh-start policy in Visegrad countries and seeks to identify weaknesses and differences. Chapter 6 presents several conclusions. The last chapter enlists sources that were used in the course of the research.

The fresh-start policy has been discussed mainly in the USA. The most cited paper seems to be Jackson's *The Fresh-Start Policy in Bankruptcy Law*.⁸ However, the ideas put forward by Professor Jackson were neither accepted by all scholars⁹ nor they were completely inclusive. Other academics have considered the topic of the fresh start policy. Some of them took an economic approach,¹⁰ whereas other commentators preferred rather

⁶ It may be briefly added that apart from efficiency grounds, other rationale that might be mentioned is the protection of personal integrity as one of the justification for paternalism based on (1) the behavioural approach (incomplete heuristics and impulsiveness) that is linked mainly to Professor Jackson's article *The Fresh-Start Policy in Bankruptcy Law*. *Harvard Law Review*, 1985, Vol. 98, No. 7, pp. 1393 – 1448, and (2) the idea of humanity, forgiveness and rehabilitation that is suggested *inter alia* by Professor Karen Gross in *Failure and Forgiveness: Rebalancing the Bankruptcy System*. New Haven: Yale University Press, 1997. 302 pages. As for paternalism and its justification, see Anthony T. Paternalism and the Law of Contract. *The Yale Law Journal*, 1983, Vol. 92, No. 5, pp. 763 – 798.

⁷ I am fully aware that there might be other statutes implementing the fresh-start policy such as company laws limiting the access of bankrupt individuals to statutory bodies of companies, etc.

⁸ JACKSON, Thomas H. *The Fresh-Start Policy in Bankruptcy Law*. *Harvard Law Review*, 1985, Vol. 98, No. 7, pp. 1393 – 1448. Professor Jackson focused mainly on grounds that would defend the non-waiveability of a right to discharge.

⁹ See for instance harsh criticism in CARLSON, David G. *Philosophy in Bankruptcy*. *Michigan Law Review*, 1987, Vol. 85, No. 5, pp. 1341 – 1389.

¹⁰ WEISTART, John C. *The Costs of Bankruptcy*. *Law and Contemporary Problems*, 1977, Vol. 41, No. 4, pp. 107 – 122; EISENBERG, Theodore. *Bankruptcy Law in Perspective*. *UCLA Law Review*, 1981, Vol. 28, No. 5, pp. 953 – 999; HARRIS, Margaret. *A Theory of Discharge in Consumer Bankruptcy*. *Ohio State Law Journal*, 1987, Vol. 48, No. 4, pp. 1047 – 1088; or HOWARD, Steven L. *Reply to Theodore Eisenberg's Bankruptcy Law in Perspective*. *UCLA Law Review*, 1982, Vol. 30, No. 2, pp. 327 – 365.

sociological approach¹¹ or philosophical approach.¹² Also, one cannot forget about comparative literature¹³ or a historical insight presented by bankruptcy law professors.¹⁴ A growing number of analyses have focused on empirical issues concerning the effect of a body of debt collection laws¹⁵ and there is at least one work focusing on the implementation of the fresh-start policy.¹⁶ Yet, there has not been any noticeable discussion about fresh-start policy in Visegrad countries.

This paper seeks to fill that gap. The outcome is the analysis that might serve not only as a source of information for legal scholars or practising lawyers but also as a guideline for future legislative changes.

Apart from law and economics approach, the thesis uses also comparative as well as logical methods.

¹¹ GROSS, Karen. *Failure and Forgiveness: Rebalancing the Bankruptcy System*. New Haven: Yale University Press, 1997. 302 pages; McINTYRE, Lisa J. Sociological Perspective on Bankruptcy. *Indiana Law Review*, 1989, Vol. 65, No. 1, pp. 123 – 140; or EFRAT, Rafael. The Evolution of Bankruptcy Stigma. *Theoretical Inquiries in Law*, 2006, Vol. 7, No. 2, pp. 365 – 393.

¹² E.g. FLINT, Richard E. Bankruptcy Policy: Toward a Moral Justification for Financial Rehabilitation of the Consumer Debtor. *Washington and Lee Law Review*, 1991, Vol. 48, No. 2, pp. 515 – 578.

¹³ NIEMI-KIESILAINEN, Johanna, RAMSAY, Iain, WHITFORD, William C. (eds.). *Consumer Bankruptcy in Global Perspective*. Oxford: Hart, 2003. 368 pages; KILLBORN, Jason J. *Comparative Consumer Bankruptcy*. Durham: Carolina Academic Press, 2007. 114 pages; or NIEMI, Johanna, RAMSAY, Iain, WHITFORD William C. (eds). *Consumer Credit, Debt and Bankruptcy: Comparative and International Perspectives*. Oxford: Hart Publishing, 2009. 453 pages.

¹⁴ COUNTRYMAN, Vern. Bankruptcy and the Individual Debtor - And a Modest Proposal to Return to the Seventeenth Century. *Catholic University Law Review*, 1983, Vol. 32, No. 4, pp. 809 – 827; McCOID, John C. The Origins of Voluntary Bankruptcy. *Bankruptcy Development Journal*, 1988, Vol. 5, No. 2, pp. 361 – 390; TABB, Charles J. Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate. *George Washington Law Review*, 1990, Vol. 59, No. 1, pp. 56 – 113; or McCOID, John C. Discharge: The Most Important Development in Bankruptcy History. *American Bankruptcy Law Journal*, 1996, Vol. 70, No. 2, pp. 163 – 194.

¹⁵ HAN, Song, WENLI, Li. Fresh Start or Head Start? The Effect of Filing for Personal Bankruptcy on Work Efforts. *Journal of Financial Services Research*, 2007, Vol. 31, No. 2, pp. 123 – 152. See also particularly papers of Michelle White and her co-authors: e.g. GROPP, Reint, SCHOLZ, John K., WHITE, Michelle J. Personal Bankruptcy and Credit Supply and Demand. *The Quarterly Journal of Economics*, 1997, Vol. 112, No. 1, pp. 217 – 251; WANG, Hung-Jen, WHITE, Michelle J. An Optimal Personal Bankruptcy Procedure and Proposed Reforms. *The Journal of Legal Studies*, 2000, Vol. 29, No. 1, pp. 255 – 286.

¹⁶ EFRAT, Rafael. The Fresh-Start Policy in Bankruptcy in Modern Day Israel. *American Bankruptcy Institute Law Review*, 1999, Vol. 7, No. 2, pp. 555 – 600.

Since the thesis in many respects refers to the US Bankruptcy Code (hereinafter as “US BC”) as the benchmark for comparison,¹⁷ the thesis adheres to the US terms. First of all, the concept of discharge of debts and the fresh-start policy must be explained. Discharge is a legal reflection of the fresh-start policy¹⁸ in the sense that unpaid debts are no longer enforceable against the debtor.¹⁹ Two main legal avenues to achieve this purpose exist.²⁰ The first is the US Chapter 7 procedure that entails collection of debtor’s non-exempt assets, their conversion to money and subsequent distribution among creditors. The debtor is concurrently granted a discharge with his human capital being freed.²¹ This model is entitled “liquidation.”²² The second basic model is based on the US Chapter 13 “wage earner” or “repayment plan.” In this respect, before a discharge of debts is granted, a debtor is required to repay debts over a specific period of time.

Part of scholarship links the fresh-start policy solely with liquidation and discharge that follows upon collection and distribution of all assets. Conceptually, the term fresh-start is the desired end.²³ Either upon the distribution of all assets or after the repayment plan is

¹⁷ References to the US BC are mostly in footnotes.

¹⁸ EPSTEIN, David G., NICKLES, Steve H., WHITE, James J. *Bankruptcy*. St. Paul: West Publishing, 1992, Vol. 2, p. 312.

¹⁹ WHITE, James J. *Bankruptcy and Creditors' Rights: Cases and Materials*. St. Paul: West Publishing, 1985, p. 63.

²⁰ The thesis will not deal with procedures akin to Chapter 11 reorganizations since they are mainly aimed at continuance of business and resolving corporate bankruptcy.

²¹ See e.g. WHITE, Michelle J. *Bankruptcy and Consumer Behavior: Theory and U.S. Evidence* in BERTOLA, Giuseppe, DISNEY, Richard, GRANT, Charles (eds.). *The Economics of Consumer Credit Demand and Supply*. Cambridge: MIT Press, 2006, p. 242.

²² Liquidation is in some jurisdiction used as the term meaning dissolution of a legal entity. Likewise, Chapter 7 procedure is by some authors in Europe entitled “a bankruptcy.”

²³ Black's Law Dictionary defines a fresh start as “*The favorable financial status obtained by a debtor who receives a release from personal liability on prepetition debts or who reorganizes debt obligations through the confirmation and completion of a bankruptcy plan.*” BLACK, Henry C., GARNER, Bryan A. *Black's Law Dictionary*. 8th ed. St. Paul: West, 2007, p. 692.

completed, a debtor is granted a relief.²⁴ This paper employs the notion “fresh-start policy” broadly to cover both instances.²⁵

Other notions might need clarification as well. Although there may be distinctions between the terms “bankruptcy law” and “insolvency law”, this paper uses these notions interchangeably.²⁶ The term “insolvency” is interpreted as a state of affairs that triggers insolvency procedure.²⁷

At this point, I would like to express my gratitude to Central European University, Cornell University Law School and International Visegrad Fund. Thanks to Central European University I was able to undertake a study trip to Cornell University where I had an ample opportunity to do my research. International Visegrad Fund granted me with the Intra-Visegrad Scholarship and has financially supported my studies at Central European University. Moreover, I would like to thank to Professor Tibor Tajti who introduced me to the area of comparative bankruptcy law and to Dr. Tomáš Richter for suggesting me to do a research in personal insolvency law. Finally, my debts are owed particularly to my family who has always supported me.

²⁴ The former might be entitled a “straight” fresh-start, whereas the latter is rather a “conditional” fresh-start.

²⁵ Professor Eisenberg also seems to suggest a broader view on the fresh-start policy when he mentions: “*For cooperating debtors, however, mandatory chapter 13 plans do not have any effect on whether they will obtain a discharge and fresh start. They merely alter when that discharge and fresh start will be available.*”

²⁶ Professor Tab notes that bankruptcy law was viewed as intended to provide a relief for creditors whereas insolvency law was seen as a device for debtors’ relief. TABB, Charles J. *The Law of Bankruptcy*. Westbury: Foundation Press, 1997, p. 2. See also decision of the federal circuit court *In re Klein* 14 F. Cas. 716 (1843) where the court essentially did not recognize any meaningful difference between “a bankrupt law” and “an insolvent law.”

²⁷ ZYWICKI, Todd J. An Economic Analysis of the Consumer Bankruptcy Crisis. *Northwestern University Law Review*, 2005, Vol. 99, No. 4, p. 1478.

2. BASIC CONCEPTS AND THE ROLE OF BANKRUPTCY LAW

2.1 Economic approach to law

This section briefly outlines the approach of scholars of the law and economics as the thesis largely draws upon some of their theories.²⁸ The core of the law and economics analysis is to consider problems from the economic standpoint, i.e. from the view of maximizing behaviour, market equilibrium and preferences.²⁹ Seen from this perspective, the role of the law is to modify incentives of people.³⁰ In other words, the theory postulates that the law and its change has an impact on incentives of people and ultimately change the economic performance.³¹

Economists posit that every rational agent seeks to maximize, be it utility in case of consumers or votes in case of politicians.³² The subject-matter of law and economics is not only money but rather use of resources.³³ In real world, individuals have alternatives as to their choices what to do in everyday life. The option that brings about the most under the set of constraints entails maximizing.³⁴ The overall system should lead to efficiency.³⁵

²⁸ It must be noted that the law and economics movement is not homogenous. See MERCURO, Nicholas, MEDEMA, Steven G. *Economics and the Law. From Posner to Post-Modernism*. Princeton: Princeton University Press, 1997, p. ix

²⁹ *Idem*, p. 3; BECKER, Gary. The Economic Approach to Human behaviour cited in KATZ, Avery W. *Foundations of the Economic Approach to Law*. New York: Oxford University Press, 1998, p. 5;

³⁰ POSNER, Richard A. *The Economics of Justice*. Cambridge: Harvard University Press, 1981, p. 75.

³¹ For more elaborate explanation see MERCURO, Nicholas, MEDEMA, Steven G. *Economics and the Law. From Posner to Post-Modernism*. Princeton: Princeton University Press, 1997, pp. 21 – 24.

³² The movement of law and economics is based largely on microeconomics. COOTER, Robert, ULEN, Thomas. *Law and Economics*. 4th ed. Boston: Pearson, 2004, p.15.

³³ Richard Posner observes that the most tenacious mistake about economics is that it is concerned only about money. Posner points out that money is just “a claim on resources,” whereas the focus is on “use of resources.” POSNER, Richard A. *Economic Analysis of Law*. 7th ed. New York: Aspen Publishers, 2007, p. 6.

³⁴ COOTER, Robert, ULEN, Thomas. *Law and Economics*. 4th ed. Boston: Pearson, 2004, p.15.

³⁵ Due to limitation, it might be briefly stated that several concepts have been developed ranging from rather illusionary *Pareto optimal* to more realistic *Kaldor-Hicks efficiency*. See e.g. MERCURO, Nicholas, MEDEMA, Steven G. *Economics and the Law. From Posner to Post-Modernism*. Princeton: Princeton University Press, 1997, pp. 14 – 18; POSNER, Richard A. The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication. *Hofstra Law Review*, 1980, Vol. 8, No. 2, pp. 488 – 489.

In this respect, as far as bankruptcy law is concerned, it should have two objectives of efficiency.³⁶ First, it should be *ex post* efficient in the sense of providing efficient post-petition treatment. Second, bankruptcy law should be also *ex ante* efficient and thus deliver proper incentives to parties and provide framework that would create good environment balancing the interests of debtors, creditors and society.

Finally, it might be added that scholars from different field have waged a debate over the normative value of the economic analysis and validity of its conclusions.³⁷ Notwithstanding the possible limits of the economic approach to law it may still be in many respects a helpful analytical tool and a source of inspiration.³⁸

2.2 Credit, moral hazard and risk aversion

The word “credit” comes from Latin, in which it means “to believe.”³⁹ Indeed, trust or belief that undertaken obligations shall be fulfilled is usually at the heart of every promise. However, not all creditor-debtor relationships are based on “trust” or “belief.” It is important to note that some kinds of debts are created non-consensually.⁴⁰ The distinction is important particularly in terms of policy. Consensual creditors might take into account a possibility of

³⁶ CLAESSENS, Stijn, DJANKOV, Simeon, MODY, Ashoka. *Resolution of Financial Distress: An International Perspective on the Design of Bankruptcy Laws*. Washington: World Bank, 2001, pp. 3 – 7.

³⁷ See for instance DWORKIN, Ronald M. Is Wealth a Value? *The Journal of Legal Studies*, 1980, Vol. 9, No. 2, pp. 191-226; KRONMAN, Anthony T. Wealth maximization as a normative principle. *The Journal of Legal Studies*, 1980, Vol. 9, No. 2, pp. 227-242; or POSNER, Richard A. Reply to Some Recent Criticisms of the Efficiency Theory of the Common Law. *Hofstra Law Review*, 1981, Vol. 9, No. 3, pp. 775- 794.

³⁸ As it is often quoted, Milton Friedman argued that “*Economics should not be judged on whether the assumptions are realistic or valid, but rather on the quality of its predictions.*” FRIEDMAN, Milton. *Essays in Positive Economics*. Chicago: Chicago University Press, 1953, p. 15.

³⁹ McINTYRE, Lisa J. Sociological Perspective on Bankruptcy. *Indiana Law Review*, 1989, Vol. 65, No. 1, p. 136. William Meckling stresses that the word “promise” captures the essence of credit arrangement as the credibility of a borrower is crucial. MECKLING, William H. Financial Markets, Default, and Bankruptcy: The Role of the State. *Law and Contemporary Problems*, 1977, Vol. 41, No. 4, pp. 14 – 15.

⁴⁰ The paper does not attempt to make a comprehensive analysis of types of claims. For the purpose of this discussion it suffices to note the differences in practice.

bankruptcy and adjust the terms of their contracts accordingly.⁴¹ Being a victim in a car crash does not give a room for any negotiation.

As two prominent professors in economics state “*Money is lubricant that facilitates exchange.*”⁴² If one does not have money, he can borrow it. However, borrowing is a risky business. Particularly in debt contracts, creditors face the problem of asymmetry of information. It is connected to the issue of hidden information in situations when one party knows more than the other.⁴³ This asymmetry creates the so-called adverse selection problem.⁴⁴ Economists suggest that lenders react by virtue of credit rationing. Lenders presumably fix an interest rate lower to attract “good” borrowers.⁴⁵ Moreover, big lending institutions can partially overcome the asymmetry in information regarding prospect of repayment by virtue of what is known as “the law of large numbers.”⁴⁶

Another problem that arises in the context of bankruptcy and credit industry is moral hazard. It is known as “the problem of hidden action.”⁴⁷ Moral hazard entails a situation where a person systematically and rationally gets involved in risky activities as the costs

⁴¹ As soon as in 1843 it has been noted that “*If his debtor fails, he loses; if not, he has his own. He charges, too, for this risk-in the shape of interest, premium, or commission.*” Report from Congress cited in HOWARD, Margaret. A Theory of Discharge in Consumer Bankruptcy. *Ohio State Law Journal*, 1987, Vol. 48, No. 4, p. 1064, ft. 134.

⁴² NORDHAUS, William D., SAMUELSON, Paul A. *Economics*. 14th ed. New York: McGraw-Hill, 1992, p. 30.

⁴³ In comparison to what information lenders possess borrowers have more information concerning their propensity to default, willingness to repay, and care of financial risks after the credit is extended. See HYNES, Richard M., POSNER, Eric A. The Law and Economics of Consumer Finance. *American Law and Economics Review*, 2002, Vol. 4, No. 1, p. 173.

⁴⁴ See also illustration concerning marketing of cars in AKERLOF, George A. The Market for “Lemons”: Quality Uncertainty and the Market Mechanism. *The Quarterly Journal of Economics*, 1970, Vol. 84, No. 3, pp. 492 – 494. In practice, it implies that less creditworthy individuals are not discouraged by higher interest rates. See explanation in BERTOLA, Giuseppe, DISNEY, Richard, GRANT, Charles. The Economics of Consumer Credit Demand and Supply in BERTOLA, Giuseppe, DISNEY, Richard, GRANT, Charles (eds.). *The Economics of Consumer Credit Demand and Supply*. Cambridge: MIT Press, 2006, pp. 12 – 13.

⁴⁵ *Idem*, p. 13.

⁴⁶ This rule states that “*unpredictable events for individuals become predictable among large groups of individuals.*” COOTER, Robert, ULEN, Thomas. *Law and Economics*. 4th ed. Boston: Pearson, 2004, p. 53.

⁴⁷ BAIRD, Douglas, GERNTNER, Robert, PICKER, Randal. *Game Theory and the Law*. 1st ed. Cambridge: Harvard University Press, 1994, p. 153.

thereof are borne by others, or at least not proportionately to the amount of the undertaken risk.⁴⁸

In the context of business engagement it is also worth mentioning one notion related to the attitude of individuals towards risk known as “risk aversion.”⁴⁹ Risk aversion entails the attitude of weighting a prospect of certain amount of money higher in comparison to a prospect of uncertain equal expected monetary amount of money.⁵⁰ It stems from the fact that many people do not like to gamble.⁵¹ The appropriate allocation of risks is important for it might lead risk-averse party to get involved in socially desirable activities which would be otherwise left untouched.⁵²

2.3 Labour and productivity

Concepts related to labour are of utmost importance as regards the discharge of debts. Thus, they deserve a particular attention.

First of all, it is critical to observe how the notion of opportunity costs arises in the context of work efforts. The idea is that the wage paid to workers must cover *inter alia* the opportunity costs of leisure.⁵³ In practice a worker can choose to either spend some of his time by working or by doing something else. What affects his decision is what he weighs

⁴⁸ JACKSON, Thomas H. The Fresh-Start Policy in Bankruptcy Law. *Harvard Law Review*, 1985, Vol. 98, No. 7, p. 1402.

⁴⁹ Risk aversion is associated with utility function. COOTER, Robert, ULEN, Thomas. *Law and Economics*. 4th ed. Boston: Pearson, 2004, pp. 50 – 51.

⁵⁰ *Idem*, p. 51. One example suffices. A person is risk-averse if he prefers the certain gain of 100 euro to the gain of 200 euro with fifty percent certainty.

⁵¹ More precisely individuals prefer certainty to uncertainty. *Idem*, p. 51.

⁵² SHAVELL, Steven. The Allocation of Risk and the Theory of Insurance. Cited in KATZ, Avery W. *Foundations of the Economic Approach to Law*. New York: Oxford University Press, 1998, p. 212. See *infra* chapter 3.6.

⁵³ Leisure in this respect connotes any other activity than working. See brief analysis in LANCASTER, Kevin. *Modern Economics: Principles and Policy*. Chicago: Rand McNally, 1973, p. 321.

more. For certain hours dedicated to work, a worker obtains earnings that he can exchange for goods. The more he works, the more he can presumably earn.⁵⁴

In this respect, a peculiar feature regarding labour supply is that the labour supply curve is backward-bending due to a substitution and an income effect.⁵⁵ When the income increases in real monetary value, a worker enjoys a greater utility of work.⁵⁶ Consequently, the worker prefers work over leisure. However, this substitution effect at certain point faces the income effect. In order to meet the given consumption the worker can afford to work less. Putting it simply, the income effect makes the worker to prefer leisure at certain level of income stream.⁵⁷

What is of interest of employees as well as society is the productivity. Productivity can be defined as the ratio between the invested input and gained output.⁵⁸ On part of workers, the main factors are work efforts and number of hours. It is arguably in the interest of the growth of economy that workers increase both. As it has been outlined above, the number of hours depends on wage. The lower is wage, the higher is the probability that an individual will choose leisure.⁵⁹ However, difficulties arise in case of heavy indebtedness of workers.

If a person cannot repay his debts, he lacks motivation for higher earnings as everything above non-exempt income is anyway garnished. Whatever his efforts are, the gains are the same.

⁵⁴ It must be noted, however, that it always depends on the remuneration system. When the remuneration is fixed, then the wage is not higher. Still, with more work, there might be a better chance of promotion. Also, a worker may also accept an additional job and earn more.

⁵⁵ NORDHAUS, William D., SAMUELSON, Paul A. *Economics*. 14th ed. New York: McGraw-Hill, 1992, p. 235.

⁵⁶ An hour spent at work generating higher income means that the worker can buy more.

⁵⁷ *Idem*, p. 235. To cover the needs of a worker, the worker can afford to stay at work less time.

⁵⁸ *Idem*, p. 112.

⁵⁹ Richard A. *Aging and Old Age*. Chicago: The University of Chicago Press, 1995, p. 82.

2.4 Bankruptcy law and its role

The word “bankruptcy” comes probably from the Medieval Italy where it was allegedly a custom to break benches of bankers and merchants who left without satisfying the claims of their creditors.⁶⁰ Although the history and different legal systems show that debtors have been dealt with differently, one seems clear. Rules have secured that at least in civilized countries the treatment of debtors is incomparably more lenient. Debtors are no longer deprived of their freedom and put into slavery as in the times of the Romans. What is distributed among creditors is not the debtor himself but his assets.⁶¹

One of the first “bankruptcy acts” was the English statute of Henry VII of 1542. Quite expectedly, the statute was not drafted to help “unfortunate but honest debtors” but rather served a different aim – to deter fraudulent behaviour.⁶² Afterwards, several acts were passed that concerned bankruptcy; the most notable was the statute of 1705 that introduced a discharge of debts.⁶³ However, what should be noted is that bankruptcy could have been initiated originally only by creditors⁶⁴ and the bankruptcy relief was for a long time available merely to traders. It seems that the statute reflected the policy of a carrot and a stick.⁶⁵ A discharge was granted as a reward upon compliance with all the conditions. On the other hand, the statute provided for imposition of serious criminal punishments.⁶⁶ As regards the opposite side of Atlantic, the first federal bankruptcy in the USA was enacted in the end of

⁶⁰ BAIRD, Douglas G. *The Elements of Bankruptcy*. 5th ed. New York: Foundation Press, 2010, p. 4.

⁶¹ See the text of the Roman Twelve Tables translated in COUNTRYMAN, Vern. Bankruptcy and the Individual Debtor - And a Modest Proposal to Return to the Seventeenth Century. *Catholic University Law Review*, 1983, Vol. 32, No. 4, pp. 809 – 810.

⁶² Professor Tabb noted that “... relief was not for debtors but from debtors.” TABB, Charles J. History of the Bankruptcy Laws in the United States. *American Bankruptcy Institute Law Review*, 1995, Vol. 3, No. 1, p. 8.

⁶³ DUNCAN, Andrew J. From Dismemberment to Discharge: The Origins of Modern American Bankruptcy Law. *Commercial Law Journal*, 1995, Vol. 100, No. 2, p. 198.

⁶⁴ First bankruptcy law that allowed debtors to commence bankruptcy was the US Bankruptcy Act of 1841 as Professor Tabb notes. TABB, Charles J. History of the Bankruptcy Laws in the United States. *American Bankruptcy Institute Law Review*, 1995, Vol. 3, No. 1, p. 8.

⁶⁵ TABB, Charles J. Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate. *George Washington Law Review*, 1990, Vol. 59, No. 1, p. 90.

⁶⁶ DUNCAN, Andrew J. From Dismemberment to Discharge: The Origins of Modern American Bankruptcy Law. *Commercial Law Journal*, 1995, Vol. 100, No. 2, pp. 198 – 199.

the 19th century.⁶⁷ However, the statute proved to be unstable and several bankruptcy codes followed.⁶⁸ It was not until 1898 that the modern and more permanent act was adopted.⁶⁹

In Central Europe, the application of bankruptcy law and a discharge of debts in particular do not have such a long uninterrupted tradition.⁷⁰ Economic, social as well as legal conditions certainly played its role.⁷¹ In a communist regime, in the absence of market economy, the bankruptcy is not that needed.⁷² Yet, with the rise of credit-based economy a possibility of fall of economic agents can be expected and thus more attention has been devoted to this area of law.⁷³

Outside bankruptcy, the law envisages individual collection remedies. Unlike individual collection laws that are centred on a debtor-creditor relationship, bankruptcy law can be associated rather with a creditor-versus-creditor relationship.⁷⁴ The question that must be answered in the first place is why to have bankruptcy at all.

The justification of bankruptcy law lies in the shortcomings that individual enforcement remedies otherwise have.⁷⁵ The bankruptcy law is by a part of the scholarship substantiated

⁶⁷ *Idem*, pp. 218 – 219.

⁶⁸ The first act offered a discharge only for merchants. The acts were generally repealed shortly after their adoption. See COUNTRYMAN, Vern. Bankruptcy and the Individual Debtor - And a Modest Proposal to Return to the Seventeenth Century. *Catholic University Law Review*, 1983, Vol. 32, No. 4, pp. 813 – 816.

⁶⁹ DUNCAN, Andrew J. From Dismemberment to Discharge: The Origins of Modern American Bankruptcy Law. *Commercial Law Journal*, 1995, Vol. 100, No. 2, p. 217.

⁷⁰ It does not say that there was no bankruptcy law at all. On the contrary, the history dates back to the 18th century. However, discharge has not been enacted until recently. See KOZÁK, Jan. Nové úpadkové právo v České republice [New Insolvency Law in the Czech Republic]. *Právní zpravodaj*, 2008, Vol. 9, No. 2, p. 3.

⁷¹ GROSS, Karen. *Failure and Forgiveness: Rebalancing the Bankruptcy System*. New Haven: Yale University Press, 1997, p.6.

⁷² Michael Kim noted that “Until CEE nations create an environment conducive to capitalist behavior, bankruptcy law simply is not needed as a prominent economic mechanism.” KIM, Michael. When Nonuse is Useful: Bankruptcy Law in Post-Communist Central and Eastern Europe. *Fordham Law Review*, 1996, Vol. 65, No. 3, p. 1047.

⁷³ See in *Idem*.

⁷⁴ WARREN, Elizabeth. Bankruptcy Policy. *The University of Chicago Law Review*, 1987, Vol. 54, No. 3, p. 785.

⁷⁵ See JACKSON, Thomas H. Of Liquidation, Continuation and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules. *American Bankruptcy Law Journal*, 1986, Vol. 60, No. 4, pp. 401 – 402.

on the basis of the theory of “creditors’ bargain.”⁷⁶ The underlying principle of the theory is that it should generally reflect the agreement which would be presumably struck by creditors *ex ante* if they were in the position to negotiate together.⁷⁷ Overall, the theory offers three advantages.⁷⁸ The first advantage is that bankruptcy law seeks to eliminate strategic costs linked to the race of diligence.⁷⁹ The second advantage is that it provides solution to the “*problem of common property*.”⁸⁰ And finally, the third advantage might be viewed in terms of administrative efficiencies.⁸¹

One of the critical issues in bankruptcy is its relationship to non-bankruptcy law.⁸² More precisely, the issue is to what extent it should honour non-bankruptcy entitlements. The prevailing approach seems to be the one advocated by the proceduralists.⁸³ It is asserted that the bankruptcy law should serve as a tool how to collect debts. Bankruptcy law should

⁷⁶ The thesis does not attempt to question the theory. Still, it must be noted that such theory is not at all shared by all the scholars. The theory has been criticized *inter alia* in COUNTRYMAN, Vern. The Concept of a Voidable Preference in Bankruptcy. *Vanderbilt Law Review*, Vol. 38, No. 4, p. 827; or CARLSON, David G. Philosophy in Bankruptcy. *Michigan Law Review*, 1987, Vol. 85, No. 5, pp. 1341 – 1389. See also a thorough explanation and criticism in MOKAL, Jameel R. *Corporate Insolvency Law. Theory and Application*. Oxford: Oxford University Press, 2005, p. 33. For more comprehensive review, see excerpts in TABB, Charles J. *Bankruptcy Anthology*. Cincinnati: Anderson Publishing, 2002, pp. 51 – 133.

⁷⁷ JACKSON, Thomas H. Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain. *The Yale Law Journal*, 1982, Vol. 91, No. 5, p. 860. Thomas Jackson explains that no actual negotiation takes place. *Idem*, 866.

⁷⁸ *Idem*, p. 861. The arguments are particularly for the benefit of general creditors. The theory also elaborates advantages regarding the position of secured creditors. However, the explanation goes beyond the scope of this work.

⁷⁹ See TABB, Charles J. *The Law of Bankruptcy*. Westbury: Foundation Press, 1997, p. 4.

⁸⁰ WHITE, Michelle J. Bankruptcy procedures in Countries Undergoing Financial Crises in CLAESSENS, Stijn, DJANKOV, Simeon, MODY, Ashoka. *Resolution of Financial Distress: An International Perspective on the Design of Bankruptcy Laws*. Washington: World Bank, 2001, pp. 26 – 27.

⁸¹ JACKSON, Thomas H. Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain. *The Yale Law Journal*, 1982, Vol. 91, No. 5, p. 866.

⁸² There has been also a debate as to the goals of bankruptcy. Unlike Professor Baird who argues that bankruptcy law should enhance collection of debts, Professor Warren posits that the bankruptcy should properly distribute losses. See WARREN, Elizabeth. Bankruptcy Policy. *The University of Chicago Law Review*, 1987, Vol. 54, No. 3, pp. 777 – 778, 811 – 814.

⁸³ Proceduralists and traditionalists differ in many respects. See BAIRD, Douglas G. Bankruptcy's Uncontested Axioms. *The Yale Law Journal*, 1998, Vol. 108, No. 3, pp. 577 – 580 and the US Supreme court case *Butner v. United States* 440 U.S. 48 (1979).

regulate how the right is collected and not what is the right itself.⁸⁴ Thus, the bankruptcy law should follow non-bankruptcy entitlements.⁸⁵

2.5 Specific features of personal bankruptcy law with respect to a fresh start

“I know how to liquidate over-committed businesses but I cannot imagine how I should liquidate an individual.”⁸⁶ This quote illustrates a fundamental difference between an individual and a legal entity when it comes to bankruptcy law. On one hand, personal bankruptcy shares a lot of features with bankruptcy of legal entities and is in many ways no different. Resolution of competing interests in the situation of the scarcity of assets to satisfy debts poses challenges in both sorts of bankruptcies. However, there are significant differences that not only justify but also require distinct approaches towards certain issues, including the standpoint towards the fresh-start policy. It is argued that only individuals should be eligible.⁸⁷

Bankruptcy of individuals creates a peculiar problem associated with the difference in statuses between natural persons and legal entities. Legal entity is *only* a juridical entity whose existence is not independent. It can be established and dissolved at any time. Although some costs are always involved, there is “*no virtue in preserving a corporate charter for its own sake.*”⁸⁸ After bankruptcy the legal entity ceases to exist unless it is reorganized. Therefore, there is no reason to give a fresh-start to legal entities.

⁸⁴ See BAIRD, Douglas G. Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren. *The University of Chicago Law Review*, 1987, Vol. 54, No. 3, p. 818. One of the key questions seems to be to what extent rights of secured creditors should be kept. *Idem*, p. 823.

⁸⁵ This principle is commonly known in the USA as *Butner principle* after the US Supreme court case *Butner v. United States* 440 U.S. 48 (1979).

⁸⁶ Quote of Jobst Wellensiek cited in REIFNER, Udo. “Thou Shalt Pay Thy Debts’ Personal Bankruptcy Law and Inclusive Contract Law in NIEMI-KIESILAINEN, Johanna, RAMSAY, Iain, WHITFORD, William C. (eds.). *Consumer Bankruptcy in Global Perspective*. Oxford: Hart, 2003, p. 144.

⁸⁷ See RICHTER, Tomáš. Insolvenční zákon: od vládního návrhu k vyhlášenému znění [Insolvency Act: from the Government Proposal to the Published Version]. *Právní rozhledy*, 2006, Vol. 14, No. 21, p. 774.

⁸⁸ BAIRD, Douglas G. *The Elements of Bankruptcy*. 5th ed. New York: Foundation Press, 2010, p. 59.

However, the situation of individuals is in this respect substantially different. Unlike legal entities, the debtor's existence is not dependent on bankruptcy.⁸⁹ In the absence of a discharge of debts, the unpaid debts survive. It might be said that claims of creditors are practically not only on the debtor's assets but on the debtor's human capital.⁹⁰ This creates a set of problems described below.⁹¹

Be the fresh start one of the goals of bankruptcy law or not,⁹² the underlying and prevailing opinion is that bankruptcy should not change non-bankruptcy law unless there is some reasonable ground. The fresh-start policy entails precisely such departure from the non-bankruptcy law. In the following chapters, it will be argued why the fresh-start policy should be embraced and what its implications are from the view of law and economics.

⁸⁹ See REIFNER, Udo. "Thou Shalt Pay Thy Debts" Personal Bankruptcy Law and Inclusive Contract Law in NIEMI-KIESILAINEN, Johanna, RAMSAY, Iain, WHITFORD, William C. (eds.). *Consumer Bankruptcy in Global Perspective*. Oxford: Hart, 2003, pp. 144 – 145.

⁹⁰ MECKLING, William H. Financial Markets, Default, and Bankruptcy: The Role of the State. *Law and Contemporary Problems*, 1977, Vol. 41, No. 4, p. 13.

⁹¹ The issues are dealt with *infra* in chapter 3.

⁹² Professor Tabb pointed out that regardless of its appealing character, a fresh start is not the primary function of bankruptcy law. See TABB, Charles J. *The Law of Bankruptcy*. Westbury: Foundation Press, 1997, p.3.

3. THE FRESH-START POLICY AND ITS POSITIVE EFFECTS

As it has been pointed out, the debtor's existence is independent on bankruptcy. What might die in the process of bankruptcy is not the debtor but his debts.⁹³ The fresh-start policy seeks to achieve this relief. However, it does not suffice at all to merely claim that giving an unfortunate but unlucky debtor a fresh start provides justification for the fresh-start policy.⁹⁴ This chapter identifies efficiency grounds substantiating the adoption of fresh-start policy.

3.1. Enhanced cooperation

Originally, a discharge was introduced to ensure cooperation between a debtor and his creditors.⁹⁵ Debtors were required to disclose their assets and comply with other duties, which arguably led to maximization of the value of a bankruptcy estate. The underlying principle was that debtors, who behaved in the prescribed manner and fulfilled the preconditions, were rewarded by virtue of an extinguishment of debts. On the contrary, those debtors who showed signs of misbehaviour were punished. In this perspective, a discharge operated as the policy of a carrot and a stick.⁹⁶

Even though, the law no longer provides for harsh punishment as the original statutes used to, the mentioned argument behind the fresh-start policy is still valid. Nowadays, the law sets standards that are expected from debtors such as full disclosure of assets or good behaviour requirements during the life of a repayment plan.⁹⁷ If such duties are not fulfilled,

⁹³ REIFNER, Udo. "Thou Shalt Pay Thy Debts" Personal Bankruptcy Law and Inclusive Contract Law in NIEMI-KIESILAINEN, Johanna, RAMSAY, Iain, WHITFORD, William C. (eds.). *Consumer Bankruptcy in Global Perspective*. Oxford: Hart, 2003, pp. 144 – 145.

⁹⁴ BAIRD, Douglas G. A World without Bankruptcy. *Law and Contemporary Problems*, 1987, Vol. 50, No. 2, p. 178.

⁹⁵ TABB, Charles J. *The Law of Bankruptcy*. Westbury: Foundation Press, 1997, p. 700.

⁹⁶ See chapter 2.4, *supra* ft. 66.

⁹⁷ Compare e.g. sec. 727(a)(2) of the US BC denying a discharge to debtors who has *inter alia* concealed property.

negative consequences in the form of a denial of a discharge or revocation of the previously granted discharge follow. The discharge is in this respect a tool giving the bankrupts incentives to cooperate with creditors and refrain from any misbehaviour.

3.2. Reduction of enforcement costs

The economic benefits of a discharge might be illustrated on the example of a heavily indebted person with virtually no assets and little earnings. For such debtor, the chance of repayment is very little if not zero. Enforcement of such claims will be mostly wasteful. In the absence of a discharge, creditors might spend resources on monitoring; the court might supervise the debtor having the case pending for years without actual benefits. Given the lengthy and costly collection procedure, there can be much more to be lost than to be gained.⁹⁸

The discharge of debts is the alternative solution. Creditors might not actually suffer significant losses as the chance of repayment would be little anyway. In bankruptcy a trustee or a court seeks to locate assets, ascertain their value and determine potential earning capacity of the debtor. It has been argued that many creditors would stop chasing their debtors upon finding that the debtors are not in the position to satisfy the debts.⁹⁹ Adoption of the fresh-start policy saves both public as well as private spending.¹⁰⁰

⁹⁸ CZARNETZKY, John M. The Individual and Failure: A Theory of the Bankruptcy Discharge. *Arizona State Law Journal*, 2000, Vol. 32, No. 2, p. 451.

⁹⁹ BAIRD, Douglas G. *The Elements of Bankruptcy*. 5th ed. New York: Foundation Press, 2010, p. 31.

¹⁰⁰ Moreover, Richard Posner notes that such costs on the part of courts are not fully borne by those who benefit from them (i.e. creditors). POSNER, Richard A. *Economic Analysis of Law*. 7th ed. New York: Aspen Publishers, 2007, p. 436.

3.3. Inclusion of debtors to the economy as productive members

One of the most cited and perhaps the most appealing¹⁰¹ ground for the fresh-start policy is that it enhances the inclusion of bankrupts to the economy as productive members.¹⁰² Interestingly, even Sir William Blackstone attributed an economic function to a discharge as he observed that it rendered the bankrupts clear of debts so they could join the society as full members.¹⁰³

When a debtor has a minimum chance to meet all his obligations, he can prefer leisure to work at practically no costs.¹⁰⁴ Given an option to work and have the wage garnished with no prospect of repayment on one hand, and a choice to enjoy leisure on the other hand, the presumption is for the latter since creditors bear the costs of such option.¹⁰⁵ Whatever the debtor gains above the exempted level, the creditors grab. The debtor lacks incentive to work *more* when the fruits of such work are reached by his creditors.¹⁰⁶

Once the discharge has been granted, future income stream is untouched. Substitution effect¹⁰⁷ suggests that an individual will make bigger efforts because of a higher utility of work. The debtor is thus motivated to find higher-paying job, take an additional job or simply make more efforts.

¹⁰¹ HOWARD, Margaret. A Theory of Discharge in Consumer Bankruptcy. *Ohio State Law Journal*, 1987, Vol. 48, No. 4, pp. 1069 and 1087.

¹⁰² TABB, Charles J. Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate. *George Washington Law Review*, 1990, Vol. 59, No. 1, p. 94.

¹⁰³ Sir Blackstone wrote that "... the bankrupt becomes a clear man again; and by the assistance of his allowance and his own industry may become a useful member of the commonwealth ..." BLACKSTONE, William. *Commentaries on the Laws of England*. Baton Rouge: Claitor's Publishing, 1976, Vol. 1, p. 1359.

¹⁰⁴ JACKSON, Thomas H. The Fresh-Start Policy in Bankruptcy Law. *Harvard Law Review*, 1985, Vol. 98, No. 7, p. 1421.

¹⁰⁵ If debtors work, their wages are garnished for the benefit of creditors. If debtors stop working and prefer leisure, they at least to a certain extent do not lose anything (earnings above the exemption level are anyway garnished) whereas creditors potentially lose a source of repayment. It must be noted, though, that a due regard must be paid to the social security network and garnishment rules.

For Jackson's analysis see JACKSON, Thomas H. The Fresh-Start Policy in Bankruptcy Law. *Harvard Law Review*, 1985, Vol. 98, No. 7, p. 1421.

¹⁰⁶ TABB, Charles J. *The Law of Bankruptcy*. Westbury: Foundation Press, 1997, p. 3. See chapter 2.3.

¹⁰⁷ In comparison to a debtor's previous financial situation, he is better off as he earns more.

3.4. Elimination of shadow economy

The availability of a fresh-start brings another advantage to the economy. In the situation when a debtor's salary is garnished, he can possibly switch to a shadow labour market.¹⁰⁸ The gained earnings would be neither taxed nor garnished. It goes without saying that both the state purse and the creditors do not benefit from such scenario.

The discharge diminishes such incentives.¹⁰⁹ Consequently, it brings benefits to public budget as less tax evasions will be arguable committed.

3.5. Inclusion to the society and mitigation of externalities

At the outset it might be noted that different kinds of losses emerge in bankruptcy.¹¹⁰ Costs arise on part of creditors, debtors, insolvency administrators as well as state bodies. As regards creditors, bankruptcy is associated with "actual" losses in terms of a failure to recover debts owed to creditors, including opportunity costs.¹¹¹ Moreover, creditors incur losses with respect to enforcement of their claims. State bodies bear administrative costs regarding the procedure. Bankruptcy might significantly limit such costs since many steps are not undertaken manifold.¹¹² Still, not all costs can be measured. Bankruptcy creates many externalities.¹¹³ Individuals might suffer psychological harm as a result of anxiety over their financial situation. The whole family might be affected.¹¹⁴

¹⁰⁸ RICHTER, Tomáš. Slovenská rekodifikace insolvenčního práva: několik lekcí pro Českou republiku (a jedna sázka na divokou kartu [Slovak Recodification of Insolvency Law: Several Lessons for the Czech Republic (and One Bet on a Wild Card)]. *Právní rozhledy*, 2005, Vol. 13, No. 20, p. 736.

¹⁰⁹ Analysis of Song Han and Li Wenli points out such effect. HAN, Song, WENLI, Li. Fresh Start or Head Start? The Effect of Filing for Personal Bankruptcy on Work Efforts. *Journal of Financial Services Research*, 2007, Vol. 31, No. 2, p. 150.

¹¹⁰ Compare HALPERN, Paul, TREBILCOCK, Michael, TURNBULL, Stuart. An Economic Analysis of Limited Liability in Corporation Law. *The University of Toronto Law Journal*, 1980, Vol. 30, No. 2, p. 131.

¹¹¹ As regards opportunity costs see analysis in NORDHAUS, William D., SAMUELSON, Paul A. *Economics*. 14th ed. New York: McGraw-Hill, 1992, p. 27.

¹¹² See the third advantage provided by the bankruptcy law outlined *supra* in chapter 2.4.

¹¹³ Professor Tabb points out the "fabric of society argument" saying that a large class of hopelessly insolvent people creates political unrest and hardship for other members of the society. TABB, Charles J. Scope of the

The fresh-start policy arguably helps to bring debtors back to society, decrease the likelihood of abusing drugs and engagement in other forms of bad behaviour.¹¹⁵ The fresh-start policy thus reduces externalities.

3.6. Entrepreneurship encouragement

The fact that in business one necessarily incurs debts has been recognized long time ago.¹¹⁶ These debts imply risks and even with due diligence, a failure is sometimes inevitable. Still, taking reasonable risks might be efficient. In order to cope with the risk aversion of individuals and induce debtors to undertake risks, several legal devices have been developed. One of them is a limited liability company. However, limited liability does not diminish the risks of business itself. Yet, simply by shifting them to other parties – creditors,¹¹⁷ the limited liability fosters business engagement.

In case of the fresh-start policy a parallel might be illustrated.¹¹⁸ By virtue of the limited liability, shareholders reduce the exposure to risks as they are insulated from liabilities of the entity. Likewise, by way of a discharge, the debtor's human capital is insulated as creditors have recourse solely against present assets.¹¹⁹ The human capital is thus protected.

Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate. *George Washington Law Review*, 1990, Vol. 59, No. 1, p. 94.

¹¹⁴ KILBORN, Jason J. Two Decades, Three Key Questions, and Evolving Answers in European Consumer Insolvency law: Responsibility, Discretion and Sacrifice in NIEMI, Johanna, RAMSAY, Iain, WHITFORD William C. (eds). *Consumer Credit, Debt and Bankruptcy: Comparative and International Perspectives*. Oxford: Hart Publishing, 2009, p. 313.

¹¹⁵ *Idem*, p. 242.

¹¹⁶ BLACKSTONE, William. *Commentaries on the Laws of England*. Baton Rouge: Claitor's Publishing, 1976, Vol. 1, p. 1360.

¹¹⁷ POSNER, Richard A. *Economic Analysis of Law*. 7th ed. New York: Aspen Publishers, 2007, p. 424.

¹¹⁸ See LoPUCKI, Lynn. A General Theory of the Dynamics of the State Remedies/Bankruptcy System. *Wisconsin Law Review*, 1982, Vol. 26, No. 1, p. 324.

¹¹⁹ In the absence of the discharge, the creditors can reach both the debtor's assets and have the debtor's income garnished until the repayment. POSNER, Richard A. The Rights of Creditors of Affiliated Corporations. *The University of Chicago Law Review*, 1976, Vol. 43, No. 3, p. 503; JACKSON, Thomas H. The Fresh-Start Policy in Bankruptcy Law. *Harvard Law Review*, 1985, Vol. 98, No. 7, p. 1400.

Most of people are risk-averse.¹²⁰ Individuals do not like running risks. It has been observed that the degree of risk aversion has an impact on the decision whether to become an entrepreneur or prefer to be an employee. It is presumably less risky to be employed than to become an entrepreneur. Therefore, the less is a person risk-averse, the more he is prone to engage in business.¹²¹ Potential entrepreneurs can *ex ante* expect that if they engage in risk-taking and fulfil requirements under bankruptcy law, they will not be left in servitude of debts in case of a failure.¹²²

3.7. Wealth insurance

It has been mentioned that the fresh-start policy serves as a business enhancing mechanism since it provides a sort of insurance. A similar rationale can be established outside the risk-encouraging scenario.

Discharge of debts provides a mechanism for the allocation of losses.¹²³ Inability to repay debts might be well caused by events that are completely out of debtor's control¹²⁴ and creditors, particularly lenders, are arguably in a better position to bear such losses. They may

¹²⁰ COOTER, Robert, ULEN, Thomas. *Law and Economics*. 4th ed. Boston: Pearson, 2004, p. 51.

¹²¹ KIHLSSTROM, Richard E., LAFFONT, Jean-Jacques. A General Equilibrium Entrepreneurial Theory of Firm Formation Based on Risk Aversion. *The Journal of Political Economy*, 1979, Vol. 87, No. 4, p. 719.

¹²² CZARNETZKY, John M. The Individual and Failure: A Theory of the Bankruptcy Discharge. *Arizona State Law Journal*, 2000, Vol. 32, No. 2, p. 414; POSNER, Richard A. *Economic Analysis of Law*. 7th ed. New York: Aspen Publishers, 2007, p. 431. It has been also noted that such protection has no externalities as the risks are internalized by virtue of a higher interest rate. POSNER, Richard A. The Rights of Creditors of Affiliated Corporations. *The University of Chicago Law Review*, 1976, Vol. 43, No. 3, pp. 501 – 503.

¹²³ However, it is debated whether creditors are superior risk-bearers. See e.g. EISENBERG, Theodore. Bankruptcy Law in Perspective. *UCLA Law Review*, 1981, Vol. 28, No. 5, pp. 981 – 983; HOWARD, Margaret. A Theory of Discharge in Consumer Bankruptcy. *Ohio State Law Journal*, 1987, Vol. 48, No. 4, pp. 1064 – 1065; JACKSON, Thomas H. The Fresh-Start Policy in Bankruptcy Law. *Harvard Law Review*, 1985, Vol. 98, No. 7, p. 1400; or HARRIS, Steven L. Reply to Theodore Eisenberg's Bankruptcy Law in Perspective. *UCLA Law Review*, 1982, Vol. 30, No. 2, p. 363.

¹²⁴ See also an interesting concept of “*social force majeure*” employed particularly in Scandinavian countries, which is explained in WILHELMSSON, Thomas. “Social Force Majeure”: A New Concept in Nordic Consumer Law. *Journal of Consumer Policy*, 1990, Vol. 13, No. 1, pp. 1 – 14.

better absorb them due to a large number of transactions.¹²⁵ The discharge serves as a form of insurance¹²⁶ protecting human capital.¹²⁷

As Michelle White puts it, insurance argument applies not only to unincorporated businesses but also to consumers. The fresh-start policy provides them with insurance against negative consumption shocks.¹²⁸ By the same token, it has been also argued that the fresh-start policy actually protects also the government since the government in return does not have to “bail out” indebted individuals.¹²⁹

¹²⁵ RAMSAY, Iain. Models of Consumer Bankruptcy: Implications for Research and Policy. *Journal of Consumer Policy*, 1997, Vol. 20, p. 275.

¹²⁶ Professor Posner provides an argument on the basis of risk-aversion stating that a discharge is a sort of insurance against going bankrupt. It is seen as a useful device, particularly given the absence of such insurance in the market. POSNER, Richard A. *Economic Analysis of Law*. 7th ed. New York: Aspen Publishers, 2007, p. 436.

¹²⁷ ADLER, Barry, POLAK, Ben, SCHWARTZ, Alan. Regulating Consumer Bankruptcy: A Theoretical Inquiry. *The Journal of Legal Studies*, 2000, Vol. 29, No. 2, p. 587; SCHWARTZ, Alan. Valuation of Collateral in RASMUSSEN, Robert K. *Bankruptcy Law Stories*. New York: Foundation Press, 2007, p. 104.

¹²⁸ WHITE, Michelle J. Bankruptcy and Consumer Behavior: Theory and U.S. Evidence in BERTOLA, Giuseppe, DISNEY, Richard, GRANT, Charles (eds.). *The Economics of Consumer Credit Demand and Supply*. Cambridge: MIT Press, 2006, p. 242.

¹²⁹ *Idem*, p. 260

4. NEGATIVE EFFECTS OF THE FRESH-START POLICY

The fresh-start policy implying a discharge of debts entails potentially significant effects. If the discharge of debts is to be labelled as medicine for symptoms caused by the debtor's indebtedness, it is not the medicine with any side-effects. Legislature must certainly consider not only the advantageous but also the disadvantageous effects.

The main drawbacks include potentially reduced collection and satisfaction of debts, erosion of debtors' responsibility, moral hazard problem and limited availability of credit. Apart from examining these downsides, the thesis also briefly outlines what may help to cope with them.

4.1. Reduced satisfaction of debts

A debtor's failure to satisfy his creditor's debts certainly indicates that something is going wrong. Bankruptcy clearly makes the concerns well-grounded, whereas a discharge of debts translates them into certain losses. Depending on the degree of indebtedness, it is more or less obvious at what stage the worries become legitimate. It is argued that in many cases the chance of repayment is little if not null.¹³⁰ Also, sometimes the costs to pursue one's claim might be even higher than the subsequent gains.¹³¹ A debtor might be unable to work and have no assets left. One might actually think of various desperate scenarios when debts are uncollectible.¹³² In those situations, the worries are legitimate even prior to the discharge

¹³⁰ BAIRD, Douglas G. *The Elements of Bankruptcy*. 5th ed. New York: Foundation Press, 2010, p. 30.

¹³¹ See chapter 3.2.

¹³² One might think of the case *United States v. Kras* 409 U.S. 434 (1973). See WEISTART, John C. The Costs of Bankruptcy. *Law and Contemporary Problems*, 1977, Vol. 41, No. 4, p. 110.

and the fresh-start policy does not change the relative factual value of the claims. Accordingly, the impact is rather limited.¹³³

Still, there are situations when a debtor has either a non-negligible amount of assets left, or actual as well as potential future income stream. The crucial question is whether the debtor would be able to repay debts or at least a reasonable portion thereof outside of bankruptcy.¹³⁴ If the answer is in the affirmative, the fresh-start policy generally leads to reduced satisfaction of the debts. Such consequence is without any doubts perceived negatively from the creditors' points of view.

The solution to the problem lies *inter alia* in distinguishing between debtors who cannot repay their debts and those who can but are simply unwilling to do so. The law should not protect those who simply try to hide behind the false premise that the fresh-start policy should help them to *avoid* their liabilities.¹³⁵

4.2. Erosion of debtors' responsibility and moral hazard

Outside of bankruptcy a debtor is not relieved of liability and is fully responsible for the repayment of debts.¹³⁶ Once the debts have been wiped out by virtue of a discharge the debtor effectively bears fewer burdens. This leads to an assertion that the fresh-start policy might undermine responsibility of individuals.¹³⁷ Such claim is linked with the problem of moral

¹³³ In this respect, it is *ex post* effect that is limited. It does not mean that *ex ante* effect is limited as well. See text below.

¹³⁴ The possibility of repayment of a significant amount of debts might be taken into account with respect to decisions regarding whether to allow liquidation or rather repayment plan.

¹³⁵ Compare chapter 3.2. It might be concluded that the fresh-start policy might play a role in efficient sorting out situations when a repayment of debts is worth pursuing and when it simply does not pay off.

¹³⁶ The Latin maxim "*Pacta sunt servanda*" applies.

¹³⁷ It appears that the elimination of the moral hazard is behind the substantial revision of the US BC by virtue of the so-called 2005 BAPCA that seeks to avoid the misuse of Chapter 7. See e.g. EISENBERG, Theodore. *Bankruptcy and Debtor-Creditor Law. Cases and Materials*. 4th ed. New York: Foundation Press, 2011, p. 686.

hazard. In this respect, it might be reminded¹³⁸ that moral hazard implies a situation when an individual gets involved in risky activities whereas the costs are not borne proportionately to the degree of the undertaken risk.¹³⁹

In practice, the fresh-start policy might theoretically lead to encourage individuals in imprudent borrowing.¹⁴⁰ The same concern emerges in the context of businessmen. On one hand the availability of a discharge encourages risk-taking and fosters entrepreneurship. On the other hand, the discharge might actually encourage individuals to carry out too risky activities.¹⁴¹ In the absence of the possibility of having human capital freed up from liabilities, a person may tend to arrange his affairs more reasonably as to diminish the risks of indebtedness to a minimum.¹⁴²

The solution to the problem will be in greater details discussed below. At this point it suffices to say that the key to the problem actually lies in the roots of the moral hazard – costs. If the discharge is easily available, the problem is intensified and *vice versa*.¹⁴³

4.3. Impact on credit market: availability of credit and redistribution

All creditors are to a certain degree affected by bankruptcy of their debtors. With reference to the division of classes of creditors to consensual and non-consensual, it is clear

¹³⁸ For further explanation see chapter 2.2 and the relevant literature therein.

¹³⁹ JACKSON, Thomas H. The Fresh-Start Policy in Bankruptcy Law. *Harvard Law Review*, 1985, Vol. 98, No. 7, p. 1402.

¹⁴⁰ WEISTART, John C. The Costs of Bankruptcy. *Law and Contemporary Problems*, 1977, Vol. 41, No. 4, p. 110.

¹⁴¹ CZARNETZKY, John M. The Individual and Failure: A Theory of the Bankruptcy Discharge. *Arizona State Law Journal*, 2000, Vol. 32, No. 2, p. 414.

¹⁴² BAIRD, Douglas G. A World without Bankruptcy. *Law and Contemporary Problems*, 1987, Vol. 50, No. 2, p. 175.

¹⁴³ The discharge should be conditioned on reasonably stringent requirements. WEISTART, John C. The Costs of Bankruptcy. *Law and Contemporary Problems*, 1977, Vol. 41, No. 4, p. 110.

that only consensual creditors can in practice take bankruptcy of their debtors into account. Still, there seem to be differences even among consensual creditors.¹⁴⁴

The class of creditors whose core business activity is to provide credit in various forms is presumably the most prone to consider the applicable bankruptcy regime. Borrowing is their daily business and so is the possibility of defaults on their loans. Thus, lenders will be arguably more sensitive to bankruptcy law which will be in turn reflected in the availability of credit.¹⁴⁵ In this regard, the availability of credit might be discussed mainly in terms of its size, rate of denial and price in the form of an interest rate.

Overall risk assessment certainly takes into account a lot of variables.¹⁴⁶ It goes without saying that lenders seek to attract borrowers that are the least likely to default. Sophisticated techniques have been developed to cope with such evaluation.¹⁴⁷ However, to the extent that lenders do not avoid providing the so-called bad debts,¹⁴⁸ they incur losses.¹⁴⁹ Lenders who want to be profitable take these losses into account. Therefore, losses will be arguably shifted

¹⁴⁴ See the discussion in EISENBERG, Theodore. Bankruptcy Law in Perspective. *UCLA Law Review*, 1981, Vol. 28, No. 5, p. 983; and HOWARD, Margaret. A Theory of Discharge in Consumer Bankruptcy. *Ohio State Law Journal*, 1987, Vol. 48, No. 4, p. 1064.

¹⁴⁵ Professor Michelle White with other co-authors has undertaken several quantitative analyses regarding availability of credit. One empirical study reveals e.g. that higher exemptions has an impact on the availability of credit. See GROPP, Reint, SCHOLZ, John K., WHITE, Michelle J. Personal Bankruptcy and Credit Supply and Demand. *The Quarterly Journal of Economics*, 1997, Vol. 112, No. 1, p. 245. See also FAN, Wei, WHITE, Michelle J. Personal Bankruptcy and the Level of Entrepreneurial Activity. *Journal of Law and Economics*, 2003, Vol. 46, No. 2, pp. 543 – 567.

¹⁴⁶ A crucial factor is whether a loan is provided on a secured or an unsecured basis. There is a great deal of literature on the function of a security interest. For instance Professor Jackson and Kronman consider security interest among others as a solution to the problem of policing. JACKSON, Thomas H., KRONMAN, Anthony T. Secured Financing and Priorities among Creditors. *The Yale Law Journal*, 1979, Vol. 88, No. 6, pp. 1150 – 1153.

¹⁴⁷ See chapter 2.2.

¹⁴⁸ These are debts that are not repaid as they come due.

¹⁴⁹ MECKLING, William H. Financial Markets, Default, and Bankruptcy: The Role of the State. *Law and Contemporary Problems*, 1977, Vol. 41, No. 4, pp. 23 – 24.

to borrowers by virtue of a higher interest rate.¹⁵⁰ Given perfect market conditions, the interest rate mirrors the risk of default.¹⁵¹

However, it must be noted that bad debts may have in its complexity inter-debtor effects. Those borrowers who repay in effect bear the costs of the increased unavailability in general.¹⁵² Thus, good borrowers presumably subsidize bad borrowers.¹⁵³ Since the discharge of debts possibly raises the interest rate, liberal discharge law leads to such wealth-distribution.¹⁵⁴ Apart from that, one-shot redistribution from creditors to debtors can be assumed in case of unexpected changes in law.¹⁵⁵

When it comes to personal bankruptcy, lenders mainly consider the availability and the scope of the discharge. It has been suggested that on the scale from the most lenient to the most stringent regimes of the discharge of debts, the regimes that would be located at both ends of such scale would lead to the least number of discharge.¹⁵⁶ On one hand, if the law provides for harsh conditions, hardly anybody would comply with them. Thus, a discharge would be granted only exceptionally and one cannot help thinking that it would become essentially meaningless. On the other hand, freely available discharge would lead to

¹⁵⁰ Consequently, it will be reflected in the overall access to the credit. *Idem*, p. 27.

¹⁵¹ HYNES, Richard M., POSNER, Eric A. The Law and Economics of Consumer Finance. *American Law and Economics Review*, 2002, Vol. 4, No. 1, p. 170; see also JACKSON, Thomas H., KRONMAN, Anthony T. Secured Financing and Priorities among Creditors. *The Yale Law Journal*, 1979, Vol. 88, No. 6, p. 1149.

¹⁵² The so-called “good debtors” paid the costs in the form of the interest rate for the increased risk they have actually managed. On the contrary, debtors who defaulted actually contributed to the rise of the interest rate. See e.g. EISENBERG, Theodore. Bankruptcy Law in Perspective. *UCLA Law Review*, 1981, Vol. 28, No. 5, p. 983.

¹⁵³ *Idem*. See also HOWARD, Margaret. A Theory of Discharge in Consumer Bankruptcy. *Ohio State Law Journal*, 1987, Vol. 48, No. 4, p. 1066.

¹⁵⁴ The ground for such redistribution of wealth is curious as pointed out by Professor Posner. POSNER, Richard A. *Economic Analysis of Law*. 7th ed. New York: Aspen Publishers, 2007, p. 436.

¹⁵⁵ *Idem*. It follows that the changes in bankruptcy law should be discussed publicly and the time should be granted to creditors to adjust their interest rates.

¹⁵⁶ See graphical illustration of a curve and explanation in MOSS, David A., JOHNSON, Gibbs A. Rise of Consumer Bankruptcy: Evolution, Revolution, or Both. *American Bankruptcy Law Journal*, 1999, Vol. 73, No. 2, pp. 344 – 345.

unavailability of credit.¹⁵⁷ Lenders would be reluctant to extend credit and thus there would be few debts to discharge.¹⁵⁸

However, it was also observed that in case of genuine inability to fulfil a promise to pay a debt, bankruptcy procedure which allows some adjustment may provide “*valuable consumption-smoothing opportunities.*”¹⁵⁹ The real problem is presented in the situation when the fresh-start policy is abused.

The solution is that the law should implement a reasonable balance. What is decisive is the overall “price” for a discharge.¹⁶⁰ The price implies the burdens in a broad sense that the debtor must bear. Two basic methods have been identified - surrender of non-exempt assets and repayment of debts over a period of time.¹⁶¹ These methods may be used either separately or in a combination. Moreover, other aspects such as future implications of a discharge in private life such as credit rating¹⁶² or possibility to engage in future business activities also matter.

It follows that in order to diminish the effect of the fresh-start policy on the credit market the discharge should not be overly generous towards debtors. Otherwise, lenders might be less willing to extend credit and more prone to raise their interest rate. Accordingly, the credit would be less available.

¹⁵⁷ See also argumentation elaborated on the basis of game theory, more particularly on extensive form game, in BAIRD, Douglas, GERNTNER, Robert, PICKER, Randal. *Game Theory and the Law*. 1st ed. Cambridge: Harvard University Press, 1994, pp. 53 – 58

¹⁵⁸ BERTOLA, Giuseppe, DISNEY, Richard, GRANT, Charles. The Economics of Consumer Credit Demand and Supply in BERTOLA, Giuseppe, DISNEY, Richard, GRANT, Charles (eds.). *The Economics of Consumer Credit Demand and Supply*. Cambridge: MIT Press, 2006, p. 19.

¹⁵⁹ *Idem*, p. 19.

¹⁶⁰ JACKSON, Thomas H. The Fresh-Start Policy in Bankruptcy Law. *Harvard Law Review*, 1985, Vol. 98, No. 7, p. 1428.

¹⁶¹ *Idem*, p. 1428.

¹⁶² *Idem*.

5. IMPLEMENTATION OF THE FRESH-START POLICY

Starting alphabetically with the Czech Republic and ending with the Slovak Republic, this part applies the findings from previous chapters. It analyses whether and to what extent the fresh-start policy has been implemented in Visegrad countries.

Before considering particular legal regimes, it must be noted that in bankruptcy, the fresh-start policy implies a discharge of debts. Thus, the focus will be on procedures that envisage allowing such bankruptcy relief. Still, the discharge does not *per se* fully achieve the fresh start.¹⁶³ Focus is to be put on particular aspects of the given process such as the scope of the discharge, respective steps of the proceeding and eligibility.

5.1. Implementation in the Czech Republic

The current bankruptcy regime is regulated primarily by the Act No. 182/2006 Coll., on Insolvency and its Resolution (hereinafter as “the Czech IA”) which became effective July 1, 2007 and replaced the previous Liquidation and Composition Act.¹⁶⁴ The Czech IA provides for four basic resolutions of insolvency: liquidation, reorganization,¹⁶⁵ discharge procedure

¹⁶³ It may be reminded that the fresh start is rather the status. See BLACK, Henry C., GARNER, Bryan A. *Black's Law Dictionary*. 8th ed. St. Paul: West, 2007, p. 692. It may be said that the discharge of debts is a critical feature of the fresh start but rather a means than the end itself.

¹⁶⁴ The legislative move has been welcomed. The EBRD survey from 2004 ranked the Czech Liquidation and Composition Act as being in medium compliance, whereas the effective Czech IA has gained much better score of 83 % compliance rate. EBRD. *EBRD Insolvency Law Assessment Project – 2009* [online]. EBRD, 2009 [cited March 4, 2011]. Available on <http://www.ebrd.com/downloads/legal/insolvency/czechre_ia.pdf>; UTTAMCHANDANI, Mahesh. *Insolvency Law and Practice in Europe's Transition Economies*. *Butterworths Journal of International Banking and Financial Law*, 2004, Vol. 19, No. 10, p. 452.

¹⁶⁵ Reorganization is available only for business debtors. The problem not only for individuals is that stringent criteria of eligibility based on a size test apply. The debtor must have had the turnover of at least approximately 4 million euro in the preceding accounting year or at least 100 employees. Alternatively, reorganization can be allowed on the basis of an agreement with creditors (pre-packaged petition). See sec. 316 Czech IA. As of the middle of 2010, there has been one confirmed reorganization case of a businessman since 2007. See also the dataset prepared by Tomáš Richter available on <<http://ies.fsv.cuni.cz/default/file/download/id/14273>>. Tomáš Richter in his empirical study concludes that for those who do not meet the size test, reorganization is only exceptionally available. See RICHTER, Tomáš. *Reorganizing Czech Businesses: A Bankruptcy Law Reform Under a Recession Stress-Test* [online]. SSRN, January 5, 2011 [cited March 10, 2011]. Available on <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1735334&>, p. 10.

and special procedures for specifically enlisted debtors. An individual, depending on the circumstances of the case, can avail of the first three procedures. The fresh-start policy is enshrined in the discharge procedure, as the name suggests, and is available solely to non-business debtors.

At the outset, it might be noted that the explanatory note accompanying the adoption of the Czech IA explicitly reveals the intention to adhere to the fresh start policy. Apart from embracing social policy grounds, the bill specifically purports to endorse the idea of reduction of enforcement costs, elimination of incentives to engage in shadow market, and wealth-insurance.¹⁶⁶ Also, it naturally seeks to maximize the satisfaction of the debts.

The discharge might be achieved by virtue of either liquidation of all non-exempt assets or by virtue of repayment plan.¹⁶⁷ What is common to both variations is that the law generally requires mandatory repayment¹⁶⁸ of at least 30 per cent of the allowed unsecured claims.¹⁶⁹ Obviously, such generally applicable requirement precludes some debtors from reaching a fresh-start.¹⁷⁰ On the other hand, it might *ex ante* induce debtors to deal with their insolvency or expected insolvency earlier at the time when they can still repay the mentioned portion of their debts.¹⁷¹

¹⁶⁶ The latter ground is meant in the sense that the creditors eventually rely on the purchase power of consumers. The explanatory note to the Czech IA is available on <http://www.psp.cz/sqw/text/tiskt.sqw?o=4&ct=1120&ct1=0>.

¹⁶⁷ Unlike in the USA, where a debtor is arguably even after the adoption of 2005 BAPCA less constrained as to whether to choose chapter 7 or chapter 13 procedure, under the Czech IA, the debtor chooses the method in the petition but the creditors are given an opportunity to vote over it. See sec. 399 – 402.

¹⁶⁸ The US BC does not generally dictate any repayment threshold. However, see e.g. indirect threshold for Chapter 13 bankruptcy in sec. 1325(a)(4) of the US BC.

¹⁶⁹ The treatment of the secured claims differs. The holders of secured claims can choose to (1) file them as unsecured, (2) file them as secured and get the collateral sold, or (3) enforce the security interest later. See particularly sec. 409 of the Czech IA. There is no bifurcation of claims.

¹⁷⁰ Those who cannot repay such percentage of their debts cannot be generally granted a discharge unless the creditors agree with lower repayment proportion.

¹⁷¹ However, such regime leaves no relief for those who became too indebted before the adoption of the Czech IA and who could take these requirements into account.

The repayment plan lasts 5 years with no flexibility given as to the extension of the time frame. During the life of such plan all non-exempt income is distributed to creditors.¹⁷² At first glance such provision seems not to provide debtors with many incentives to make bigger work efforts during these five years.¹⁷³ An important change has been introduced in the midst of the financial crisis by the Act. No. 217/2009 Coll., on the Modification of Insolvency Act and Some Other Acts. The amendment contemplates to enable a debtor to keep some portion of his non-exempt income that would be otherwise garnished. The move seeks to promote productivity and social policy.¹⁷⁴ In any case, during the repayment period, the debtor is naturally obliged to make reasonable work efforts or search for a job if he becomes unemployed. The overall assessment suggests that the regime of repayment plan is inflexible. The legislature should consider enacting some reward mechanism in order to induce debtors to make greater work efforts during the repayment period.¹⁷⁵

The Czech IA seeks to ensure the cooperation between the debtor, his creditors and other participants in order to maximize the value of the debtor's bankruptcy estate. The law commands the debtor to *inter alia* reveal all income. Besides that, it forbids the debtor to give any special consideration to any creditor and to incur new excessive liabilities.¹⁷⁶ The failure

¹⁷² To illustrate, non-exempt income for an unmarried person with no children is generally about 330 euro monthly (7,989 CZK). See online calculator available on <<http://insolvencni-zakon.justice.cz/kalkulator-splatek.html>>.

¹⁷³ Two arguments may be raised. The first is that the mandatory repayment requirement constitutes such incentive because if it is not met, the discharge petition is either dismissed or the discharge proceeding is converted into liquidation with no discharge according to sec. 395 and 418(1)(b) of the Czech IA respectively. Second, under certain circumstances a court has discretion to grant a discharge even if the repayment threshold has not been met. Understandably, the absence of the debtor's fault is one of the factors. See sec. 415 of the Czech IA which is remarkably akin to sec. 1328(b) of the US BC. However, such arguments lose their ground when a debtor has already repaid 30 % of the claims.

¹⁷⁴ One of the requirements of such lenience is that the debtor repays at least 50 % of the unsecured debts. Thus the repayment rate is higher. The provision might strengthen the positive *ex ante* effect mentioned above. See particularly sec. 398 of the Czech IA.

¹⁷⁵ German model might serve as an example. Accordingly, at the end of the third and fourth year, a debtor may receive some portion of the collected income. See KILBORN, Jason J. *Comparative Consumer Bankruptcy*. Durham: Carolina Academic Press, 2007, p. 79.

¹⁷⁶ See sec. 412 of the Czech IA.

to comply might invoke revocation of the confirmation of a discharge procedure and automatic conversion into liquidation with no possibility of a fresh start.

The subjective scope of application of a discharge procedure is defined in sec. 389 of the Czech IA. The section reads that it applies to non-business debtors.¹⁷⁷ This is an innovative¹⁷⁸ and criticized solution¹⁷⁹ in the sense that it enables non-business *legal entities* to file petition for a discharge procedure while keeping *entrepreneurs* as *individuals* out of the reach of such bankruptcy relief.¹⁸⁰ The inclusion of legal entities alone seems to be inconsistent with the fundamentals of the fresh-start policy.¹⁸¹ Concurrently, the exclusion of businessmen means that the Czech IA has clearly failed to encourage entrepreneurship. It seems inappropriate that the Act prioritizes consumption over business encouragement.¹⁸² One might argue that potential businessmen may set up a limited liability company.¹⁸³ However, given the uneasiness of starting a business in the Czech legal environment, the legislature has simply missed a chance to encourage entrepreneurship.¹⁸⁴

¹⁷⁷ There have been also doubts as to the meaning itself. See EXPERT GROUP ON INSOLVENCY LAW. *Výkladové stanovisko č. 2. K otázce přípustnosti zadlužení* [Interpretative Opinion No. 2. On the issue of Eligibility with Respect to Incurred Debts] [online]. Ministry of Justice, 2008 [cited March 4, 2011]. Available on <http://insolvencni-zakon.justice.cz/downloads/vykladove_stanovisko_02_2008.pdf>; see also the decision of the Czech Supreme Court from 21. 4. 2009, Ref. No. 29 NSČR 3/2009-A.

¹⁷⁸ It contrasts markedly with the US approach where the risk-encouragement seems to be the key idea.

¹⁷⁹ RICHTER, Tomáš. *Insolvenční zákon: od vládního návrhu k vyhlášenému znění* [Insolvency Act: from the Government Proposal to the Published Version]. *Právní rozhledy*, 2006, Vol. 14, No. 21, p. 774.

¹⁸⁰ Some authors assert that the exclusion of entrepreneurs is justified as the entrepreneurs can to file for reorganization. However, empirical data seems to contradict the validity of such assertion. See *supra* ft. 165.

¹⁸¹ See chapter 2.5 explaining that fresh-start policy is for natural persons.

¹⁸² On one hand, the Act supports consumption by rendering discharge available to non-business debtors, when on the other hand it rules out entrepreneurs. RICHTER, Tomáš. *Insolvenční zákon: od vládního návrhu k vyhlášenému znění* [Insolvency Act: from the Government Proposal to the Published Version]. *Právní rozhledy*, 2006, Vol. 14, No. 21, p. 774.

¹⁸³ Reorganization is also a possible avenue how to reach a discharge of some debts. However, the numbers stated above show that such option is unrealistic. See *supra* ft. 165.

¹⁸⁴ According to the latest data elaborated by the World Bank, the Czech Republic was ranked as 130th out of 183 economies. See WORLD BANK. *Doing Business 2011. Czech Republic* [online]. Doing Business, 2011 [cited March 4, 2011]. Available on <<http://www.doingbusiness.org/~media/FDPDKM/Doing%20Business/Documents/Profiles/Country/DB11/CZE.pdf>>, p. 3.

The discharge is not granted automatically but solely upon the motion of a debtor and after a careful consideration.¹⁸⁵ The scope of the discharge is rather broad and unlike the US BC, the Czech IA contains only two exceptions.¹⁸⁶ These exceptions include pecuniary punishments imposed for intentional criminal offences and claims for damages arising out of intentional breaches of duties.¹⁸⁷

One of the critical questions is “how often” a debtor can file a petition for a discharge. There is a disagreement among the scholarship as to whether the text of sec. 395(2)(a) of the Czech IA should be strictly interpreted as to preclude a debtor from effectively filing a second petition anytime in his life.¹⁸⁸ I would rather adhere to the opinion that previous filing or even a previously granted discharge does not prevent the debtor from filing in the future.¹⁸⁹ The court has discretion to consider whether the filing is abusive. In this respect, the court is directed to consider whether any insolvency proceeding was held against the debtor in the preceding five years.¹⁹⁰ This power might serve as a safeguard mechanism against the abuse of the discharge.

¹⁸⁵ Sec. 414 of the Czech IA.

¹⁸⁶ See generally sec. 523 of the US BC and sec. 416 of the Czech IA. Also, perhaps due to the unbinding nature of choice as to the possible discharge procedures, the Czech IA enacts a single set of exemptions to the discharge. The US BC provides two sets of exceptions, one being broader for Chapter 13 cases in order to make Chapter 13 more attractive to debtors.

¹⁸⁷ Obviously, unlike the exception enacted in the US BC, the Czech IA does not require malicious conduct. Intentional behaviour suffices. See sec. 523(a)(6) and 1328(a)(4) of the US BC and sec. 416(1) of the Czech IA. See e.g. *Kawaauhau v. Greiger* 523 U.S. 57 (1998).

¹⁸⁸ Sec. 395(2)(a) of the Czech IA reads that the court shall dismiss a petition if the petition has been filed by a person whose petition for a discharge has been already considered. Some authors argue that the petition for a discharge might be filed only once in a life. See KOTOUČOVÁ, Jiřina et al. *Zákon o úpadku a způsobech jeho řešení (insolvenční zákon) – komentář [Act on Insolvency and its Resolution (Insolvency Act) – Commentary]*. Praha: C. H. Beck, 2008, p. 953.

¹⁸⁹ Strict adherence to the text of the provision would arguably lead to interpretation that would be too restrictive. Moreover, efficiency grounds as well as social policy enshrined in the explanatory note favour more liberal approach. See also HAVEL, Bohumil. Oddlužení - zbraň nebo hrozba? [Discharge – a Weapon or a Threat?] *Právní rozhledy*, 2007, Vol. 15, No. 2, pp. 52 – 53.

¹⁹⁰ Compare the grounds for objection to Chapter 7 discharge procedure in sec. 727(a)(8) and (9), and to Chapter 13 case in sec. 1328 (f)(1) and (2) of the US BC. The time gap between filings ranges from two to eight years. The tendency in the USA is to render the discharge less available.

Finally, from statistical data¹⁹¹ it follows that out of 1904 petitions for a discharge procedure in 2009 about the half of them was confirmed.¹⁹² The overwhelming majority accounting for more than 98 % represent repayment plan procedures, whereas the remaining less than two percents of the cases involve liquidation. As for liquidation cases, the debtor is close to a decision granting him the discharge of unsatisfied debts.¹⁹³ As regards repayment plans, the debtor has to follow the plan for the subsequent five years. Naturally, the debtor may complete the plan earlier. The future will show to what extent the debtors are successful in such completions. Interestingly, the available data from the first quarter of 2010 and 2009 show a sharp increase in filing by nearly 260 %.¹⁹⁴

5.2. Implementation in Hungary

The situation in Hungary is much less optimal when it comes to personal bankruptcy.¹⁹⁵ The bankruptcy law is regulated by the Act XLIX of 1991 on Liquidation and Dissolution (hereinafter as “Hungarian LDA”). The Hungarian LDA does not make individuals subject to bankruptcy at all. Accordingly, the fresh-start policy of bankruptcy law has not been implemented. Since other areas of laws are beyond the scope of this thesis, it might be only briefly pointed out that the “alternative protection” of the debtors might lie in enforcement laws regarding exempted assets and income stream, and social security laws.¹⁹⁶

¹⁹¹ See figures from the year of 2009 available on <http://insolvencni-zakon.justice.cz/downloads/statisticke_udaje_za_rok_2009.pdf>.

¹⁹² Confirmation essentially implies either that liquidation proceeds or that the repayment period starts.

¹⁹³ See sec. 414 and 415 of the Czech IA.

¹⁹⁴ Data used for year-to-year comparison are available on <<http://insolvencni-zakon.justice.cz/expertni-skupina-s22/statistiky.html>>. The unofficial data accounting for the whole year suggest the increase by “only” 150 %. <http://web.creditreform.cz/cs/resources/pdf/20110103_TZ_vyvoj_insolvenci_spotrebitele__20109947.pdf>.

¹⁹⁵ EBRD. *EBRD Insolvency Law Assessment Project – 2009. Hungary* [online]. EBRD, 2009 [cited March 4, 2011]. Available on <http://www.ebrd.com/downloads/legal/insolvency/hungary_ia.pdf>.

¹⁹⁶ Other branches of law provide arguably the protection on the basis of humanity rather than on the efficiency grounds. Still, it can be said that properly structured collection law and social security law can provide in certain respect incentives to increase the debtor’s productivity. As regards social security, the comprehensive outline is in NATIONAL EMPLOYMENT AND SOCIAL OFFICE. *Social Security in Hungary* [online]. NPK, 2010 [cited March 5, 2011]. Available on <http://www.npk.hu/public/kiadvanyaink/2010/social_security.pdf>.

It is true that as regards the business environment Hungary generally fares well, being ranked as the first among Visegrad countries in easiness of starting business and second closely behind Slovakia in general assessment of doing business.¹⁹⁷ However, this does not justify the failure to change the bankruptcy law.¹⁹⁸ Given the time of financial crisis, the current law has been criticised since no proper mechanism to deal with individual's indebtedness exists.¹⁹⁹ After all, careful implementation of the fresh-start policy might improve the business environment. In any case, introduction of discharge should be properly considered and time should be granted to potential lenders to adjust to the new regime.²⁰⁰

5.3. Implementation in Poland

The Polish insolvency law is currently regulated by the Liquidation and Reorganization Act (hereinafter as "Polish LRA") enacted on February 28, 2003 and published in Journal of Laws of 2003, No. 175, as Item 1361.²⁰¹ It replaced two old acts dating back to 1934.²⁰² The Polish LRA was significantly amended in 2009. One of the crucial changes was that non-business individuals were allowed to go bankrupt.²⁰³

¹⁹⁷ WORLD BANK. *Doing Business 2011. Hungary* [online]. Doing Business, 2011 [cited March 4, 2011]. Available

on<<http://www.doingbusiness.org/~media/FPDKM/Doing%20Business/Documents/Profiles/Country/DB11/HUN.pdf>>.

¹⁹⁸ One proposal was presented in 2009. VIIMSALU, Signe. *The Over-Indebtedness Regulatory System in the Light of the Changing Economic Landscape* [online]. Juridica International [cited March 3, 2011]. Available on <http://www.juridicainternational.eu/public/pdf/ji_2010_1_217.pdf>, p. 222.

¹⁹⁹ CZOKE, Andrea. *Hungary – Insolvency Law and Practice* [online]. Konferencja Szablon, 2009 [cited March 3, 2011]. Available on

<http://konferencja.szablon.pl/web_documents/csoke_hungary_insolvency_law_and_practice_konspekt.pdf?PH_PSESSID=64e995676479ce5bf5789493cce5a67b>.

²⁰⁰ Note a possible one-shot redistribution effect; see chapter 4.3.

²⁰¹ The compliance score of the Polish was 73 %. However, it seems that it did not consider the latest amendment. EBRD. *EBRD Insolvency Law Assessment Project – 2009. Poland*. [online]. EBRD, 2009 [cited March 4, 2011]. Available on <http://www.ebrd.com/downloads/legal/insolvency/poland_ia.pdf>.

²⁰² BINKOWSKA, Maja, NIEMIRSKA-FIDO, Karolina, WALAWENDER, Richard A. *The Bankruptcy and Reorganization Law*. 2nd ed. Warsaw: C.H.Beck, 2010, p. X. All references in this part to the Polish LRA stems from the cited book which is a translated version of the Polish LRA.

²⁰³ *Idem*, p. XI.

First of all, the Polish LRA distinguishes between individuals who are engaged in business and those who are not.²⁰⁴ Discharge is available for both of them, albeit under different conditions. As regards insolvent businessmen, two possible procedures exist.²⁰⁵ The first method is a kind of bankruptcy composition partially akin to reorganization²⁰⁶ which implies that the business will continue in operation according to a proposed plan.²⁰⁷ Naturally, if the plan is not confirmed or is unfeasible, it is converted to the alternative method of resolution – liquidation.²⁰⁸

The second avenue is the mentioned liquidation which implements the fresh-start policy. At the end of the procedure, upon the motion of a debtor, the court *may* discharge the debtor's unpaid debts. The discharge is not granted automatically as quite strict requirements apply.

The Polish LRA seeks to promote cooperation between a debtor and his creditors and concurrently to control the access to the discharge by setting three preconditions. First, the discharge may be granted only if the insolvency has been caused by extraordinary events that were out of the debtor's control. Second, based on the evidence, there is no ground to conclude that the debtor does no longer deserve a right to run business and hold specified positions related to business engagement. Third, the debtor has complied with his duties in

²⁰⁴ Sec. 5 of the Polish LRA employs the term “*entrepreneur*” and refers to the Polish Civil Code; according to the sec. 43 of the Polish Civil Code, entrepreneurs are legal as well as natural persons. Moreover sec. 5(2) states that the same regulation applies also to shareholders of companies who bear the liability for the obligations of legal entities. This thesis shall collectively refer to these individuals as *businessmen*.

²⁰⁵ It might be added that the Polish LRA provides also for Chapter 11-type reorganization proceeding which is available for debtors who reasonably expect insolvency. All novelties are briefly described in REWALD, Roman. *Poland's New Bankruptcy Law: Cross-border and Reorganization Aspects* [online]. Weil, 2003 [cited March 4, 2011]. Available on <<http://www.weil.com/news/pubdetail.aspx?pub=3450>>.

²⁰⁶ The Polish version entitles this procedure as “*układ*” whereas the English translation of the Polish LRA refers to it as “*arrangement*.” BINKOWSKA, Maja, NIEMIRSKA-FIDO, Karolina, WALAWENDER, Richard A. *The Bankruptcy and Reorganization Law*. 2nd ed. Warsaw: C.H.Beck, 2010, p. XV.

²⁰⁷ The debtor might *inter alia* restructure his debts by writing some of them off. See sec. 270 of the Polish LRA. The procedure envisages a possibility of a cramdown. For more information, compare sec. 1129(b) of the US BC and sec. 285(3) of the Polish LRA.

²⁰⁸ Sec. 286 of the Polish LRA.

the course of the liquidation.²⁰⁹ Due to the strict assessment of the cause of failure, it is questionable to what extent the Polish LRA meaningfully fosters the entrepreneurship encouragement *ex ante*.²¹⁰

The law seems to be flexible as regards the scope of the discharge. Further to sec. 369(1) and 370 of the Polish LRA, the debts might be discharged either fully or partially.²¹¹ The court takes into account the potential income stream of a debtor, the amount of unpaid allowed claims and the probability of their satisfaction in the future. Moreover, the bankruptcy relief does not apply to certain enlisted non-dischargeable debts.²¹²

The Polish LRA does not endorse the fresh-start for the most heavily indebted individuals for if the liquidation is dismissed because the assets would not cover the expenses of the proceeding, the discharge will not be granted. Finally, as regards time aspects, the discharge might be granted only once in 10 years which is more stringent in comparison to criteria under the US BC.²¹³

At this point, the thesis turns to consider the discharge provisions regarding individuals not engaged in business activities.²¹⁴ As has been already mentioned, the provisions on bankruptcy of non-businessmen have been adopted quite recently. The Polish LRA strongly emphasises the importance of the debtor's previous prudent behaviour by imposing an obligation on courts to consider what cause of insolvency and whether the debtor has

²⁰⁹ Sec. 369 of the Polish LRA.

²¹⁰ At the time of the decision whether to run a business or not, a potential businessman cannot predict what might cause his failure in business.

²¹¹ The law distinguishes between those who can and who cannot repay their debts.

²¹² Such claims include compensations for workers and alimonies. See sec. 369(3) of the Polish LRA.

²¹³ See *supra* ft. 190.

²¹⁴ The provisions are sometimes referred to as "*consumer bankruptcy*," which is certainly not completely ungrounded. On the other hand, *consumer* should be in this sense interpreted within the meaning of the notion "*consumption*" as opposed to business engagement. Otherwise, the term *consumer* may evoke consumer protection legislation when the term *consumer* is employed in relation to only B2C relationships. See e.g. the Council Directive 93/13/EEC on Unfair Terms in Consumer Contracts, art. 2(b).

committed any act to the detriment of his creditors in the preceding 10 years.²¹⁵ Similarly as in the case of businessmen, the law enacts strict requirements.

Only individuals whose bankruptcy is caused by extraordinary circumstances not attributable to their own fault may reach a discharge.²¹⁶ Thus the assessment of the debtor's situation is needed. Sec. 491⁴ makes it clear that not only the past behaviour but also present behaviour of a debtor is under the court's scrutiny. Failure to disclose all assets or perform any other duty in the course of the proceeding entails its discontinuance. The Polish LRA seemingly purports to promote cooperation between a debtor and his creditors in order to maximize the debtor's bankruptcy estate.

What is different from the bankruptcy of businessmen is that the liquidation of the debtor's non-exempt assets does not suffice to grant him a discharge. Unlike the Czech and US insolvency laws that provide a discharge for the price of *either* giving up all the non-exempt assets *or* non-exempt income stream for a specified period of time, the Polish Insolvency Act automatically combines both methods. The bright side for a debtor is that when it comes to the sale of the debtor's residence the Polish LRA adheres to social policy. The debtor is not left completely empty-handed as he gets a portion of the proceeds corresponding to a 12-month rental payment.

The court embarks on consideration of the proposed repayment plan only after the residence has been sold out and a debtor has left the premises.²¹⁷ In this respect, the court has quite a strong position since it has the last word on the content of the plan. The repayment plan lasts up to five years and generally sets the portion of debts that are to be repaid. The court is instructed to take the debtor's earning capacity into account. What is important to

²¹⁵ Sec. 491³(2) of the Polish LRA.

²¹⁶ Sec. 491³(1) of the Polish LRA states that a debtor whose employment relationship was terminated on the basis of mutual consent is unable to undertake a discharge procedure.

²¹⁷ Sec. 491⁷(7) attempts to ensure the debtor's cooperation and avoid subsequent eviction proceedings.

note from a comparative perspective is that upon the approval of the plan, the insolvency administrator's role expires.²¹⁸

Obviously, good and bad things might happen during the life of the plan and the Polish LRA thus contemplates the possibility of changes. In case of temporary events that negatively affects the debtor's ability to work, the courts are empowered to reduce the amount of money payable to creditors or may extend the repayment period by two additional years.²¹⁹ Still, if the debtor does not meet his obligations arising out of the repayment plan, he might lose the chance to benefit from the bankruptcy procedure as the court might revoke the plan upon the creditor's motion.

On the other hand, if the debtor's overall situation improves, the creditors might petition the court to direct the debtor to pay more on account of his debts. However, the Polish legislature refrained from allowing higher payments solely because the debtor has achieved higher remuneration thank to his own efforts. This arguably provides debtors with an incentive to join the economy as productive members during the time of the repayment of debts.

Finally, the discharge is granted upon the completion of the repayment plan. The scope is very broad and excludes practically only the debts that arise on a regular basis. It must be said that the debtor cannot avail of a discharge more than once in ten years.²²⁰

The discharge of debts with respect to individuals under the Polish LRA is broad in its scope. However, the preconditions to the discharge are highly restrictive.²²¹ A peculiar

²¹⁸ See sec. 491 of the Polish LRA. Unlike in Poland, in the Czech Republic and Slovakia, the role of the insolvency administrator is not extinguished. The most significant role of the administrator is perhaps in the Czech Republic, where he monthly collects and distributes the income in case of repayment plan procedure and regularly supervises the debtor.

²¹⁹ See sec. 491¹⁰ of the Polish LRA. Unlike the Czech IA, the Polish IA seems to be more flexible as it allows possible extension of the plan for additional time. Therefore, the law favours to provide a discharge of debts and avoid its denial in exchange for the additional "price" of up to two years.

²²⁰ Sec. 491³ of the Polish LRA contains other barriers to a discharge procedure.

feature of the Polish LRA seems that everything turns on the cause of bankruptcy. Unlike in other Visegrad countries, the Polish regulation requires that the cause of bankruptcy is not attributable to the debtor. This certainly leaves a great deal of discretion to judges. Concurrently, it leaves a lot of debtors outside the regime and the system loses its appeal as well as efficiency.²²² It appears that the Polish LRA goes beyond simple prevention of abuse since this might be dealt with assessment of filing in good faith. The legislature rather promotes the sanctity of the contract and seems to stick rigidly to the idea of providing a bankruptcy relief merely to truly “honest but unfortunate debtors.”

5.4. Implementation in the Slovak Republic

The Slovak insolvency law is mainly governed by the Act. No. 7/2005 Coll., on Liquidation and Restructuring (hereinafter as “Slovak LRA”) and provides debtors with three main avenues – liquidation, reorganization²²³ and discharge procedure. The latter implements the fresh-start policy. Although the explanatory note to the Slovak LRA does not reveal any information about specific goals²²⁴ that the government sought to achieve, it discloses its intention to generally move towards a pro-creditor regime.²²⁵

²²¹ Unfortunately, I was not able to collect any data as the competent authorities either denied their availability, or did not reply until the date of the submission of the thesis. Some articles claim that upon the adoption of the amendment, hundreds of petitions were filed whereas only few petitioners were successful. See VIIMSALU, Signe. *The Over-Indebtedness Regulatory System in the Light of the Changing Economic Landscape* [online]. *Juridica International* [cited March 3, 2011]. Available on <http://www.juridicainternational.eu/public/pdf/ji_2010_1_217.pdf>, p. 222.

²²² On the other hand, the moral hazard problem seems to be diminished.

²²³ In Slovak the procedure is called “reštrukturalizácia.”

²²⁴ However, the guidelines published on behalf of the Ministry of Justice states that the aim was to make the position of individuals equal to the position of legal entities whose debts are extinguished by virtue of the end of their existence. It seems that the authors might have argued more persuasively rather on the basis of the fresh-start policy which is not mentioned in the document. DURICA, Milan, HUSÁR, Ján. *Sprievodca konkurzným právom [Guide to the Bankruptcy Law]* [online]. Ministry of Justice of the Slovak Republic, 2008 [cited March 7, 2011]. Available on <<http://www.justice.gov.sk/dwn/r0/sprievodca/SprievodcaKonkurznymPravom.pdf>>, p. 63.

²²⁵ The explanatory note mentions that the previous regime did not work and the Act sought to rectify it. The explanatory note is available on <<http://www.nrsr.sk/Default.aspx?sid=zakony/zakon&ZakZborID=13&CisObdobia=3&CPT=835>>.

The aforementioned policy of giving creditors meaningful protection seems to be enshrined in the very first section on the discharge procedure.²²⁶ The Slovak LRA does not provide two separate methods like the US BC. The Act virtually combines both of them and is in this respect akin to the Polish LRA. A fresh-start for debtors is preconditioned on the completion of liquidation during which a debtor might propose the commencement of the “discharge procedure.” In order to protect debtors’ interests, the court is directed to advise the debtors about their right to such proposal. The prerequisite of the commencement of the case is that the debtor has duly fulfilled his duties during the liquidation. Since one of the most crucial duties is the obligation to provide assistance to an insolvency administrator,²²⁷ the Slovak LRA has embraced the policy of a carrot and a stick.²²⁸ The carrot is the discharge whereas the stick of the Slovak fresh-start policy is *inter alia* sec. 171 empowering the court to dismiss the case upon repeated or serious failure to fulfil the debtor’s duties.

The Slovak LRA also seems to promote the inclusion of the debtor to the economy as a productive member even during the mandatory three-year “*probation period*” of the discharge procedure. The law does not set any threshold for mandatory repayment of debts. Yet, the debtor is required to transfer certain fixed amount at the end of each year which is set by a court. In fixing the amount, courts have certain degree of discretion as the limit is 70 % of the total generated income of that year.²²⁹ A debtor has arguably an incentive to make more work efforts. By the same token, the debtor is presumably less prone to get involved in an underground market. Although, up to 70 % of the fruits of his labour are transferred for

²²⁶ Sec. 166 of the Slovak LRA.

²²⁷ See e.g. sec. 73 of the Slovak LRA enacting the duty to cooperate backed even by possible pecuniary penalties.

²²⁸ See *supra* chapter 2.4 **Error! Reference source not found.**

²²⁹ Sec. 168(1) of the Slovak LRA.

the benefit of the creditors, the more income the debtor generates, the greater his portion will be in total.²³⁰

On the other hand, the absence of the mandatory percentage of repayment might lead debtors not to care that much about the income or the previously incurred debts. Sec. 168(2) of the Slovak LRA seeks to address any possible misbehaviour by setting an obligation to make adequate efforts. Moreover, in order to have the case open the debtor must annually transfer at least 332 euro²³¹ to an insolvency administrator. This entails that the debtor must save at least the mentioned amount from his income and set it aside. The lump sum corresponds to less than a half of the average monthly nominal wage.²³² Debtors who do not generate this amount per year have their case dismissed. Finally, the period of three years does not seem to be too long to render a debtor to lose motivation and shrink.

As regards eligibility, one notes that unlike in the neighbouring Czech Republic, the discharge is available to business as well as non-business individual debtors. By including also entrepreneurs, the Slovak implementation of the discharge policy seeks to encourage not only consumption but also entrepreneurship. In comparison to Poland, the Slovak LRA does not distinguish between businessmen and non-businessmen.²³³ Overall, out of the three regimes, it seems to be arguably the most straightforward as to the conditions.

However, this is not to say that every indebted individual can reach the fresh-start. As it has been pointed out, the discharge procedure is preconditioned on previously completed

²³⁰ It seems that if the debtor does not earn the set amount and on the assumption that the actual earned amount is still above the mandatory 332 euro mentioned below, the debtor has to distribute only 70 % of the actual income.

²³¹ The amount corresponds to the least minimum equal to the remuneration of an insolvency administrator. See MICHALIČOVÁ, Zuzana. *Oddlženie - spôsob ako sa zbavit' svojich dlhov* [Discharge of Debts Procedure – Method of Writing Off the Debts] [online]. e-pravo.sk, 2009 [cited March 5, 2011]. Available on <<http://www.e-pravo.sk/articles/view/82/oddzlenie-sposob-ako-sa-zbavit-svojich-dlhov>>.

²³² The average nominal wage in 2010 was 769 euro. The data are available on <<http://portal.statistics.sk/showdoc.do?docid=24135>>.

²³³ The major difference is that Slovak courts are not specifically directed to dismiss the petition upon finding that debtor's insolvency has been caused by any particular cause. Compare the mentioned preconditions for a discharge under the Polish LRA.

liquidation. In order to have the liquidation commenced the debtor must pay fees²³⁴ and his non-exempt assets must have at least the value of 1659.70 euro. Therefore, the poorest with little assets are excluded from the regime.²³⁵

Furthermore, it might be remarked that the discharge render the claims that were not satisfied in the process of liquidation and during the probation period unenforceable. The court rules on the discharge on its own motion. The scope of the discharge is not limited and in comparison to the US BC the discharge is thus much broader.

The Slovak LRA does not specifically address the question when a second discharge procedure may be initiated. It seems that courts can determine the possibility of further filings within the confines of the requirement of good faith.²³⁶

While ensuring the maximization of the collection of debts, the Slovak LRA provides a debtor with a chance to discharge his debts. The price for the fresh-start is not low²³⁷ and given the monetary thresholds relating to fees and minimum value of the bankruptcy estate, the discharge may be out of the reach of a considerable number of people. The problem seems to be that only a few debtors have so far availed of the discharge provision in practice.²³⁸ Even though the system is effective for a relatively short period of time, the small number of pending cases suggests that the system has not worked properly. A more thorough investigation should be undertaken. Yet, it has been observed that the debtors are not well-

²³⁴ According to sec. 7(1) and 8(1) of the Regulation No. 655/2005 Coll. the fee as a deposit for expenses and remuneration for an insolvency administrator is about 1660 euro. Moreover, proceeds from bankruptcy estate distribution should fully cover certain priority claims such as administrative expenses, certain post-petition tax claims, etc. See sec. 87 and 102 of the Slovak LRA. Otherwise, the discharge procedure cannot follow.

²³⁵ It appears that the legislature wanted to provide a discharge solely to debtors who can afford to pay at least part of the costs of the procedure.

²³⁶ See sec. 167(1) of the Slovak LRA.

²³⁷ See RICHTER, Tomáš. Slovenská rekodifikace insolvenčního práva: několik lekcí pro Českou republiku (a jedna sázka na divokou kartu [Slovak Recodification of Insolvency Law: Several Lessons for the Czech Republic (and One Bet on a Wild Card)]. *Právní rozhledy*, 2005, Vol. 13, No. 20, p. 739.

²³⁸ In 2010 only 82 debtors filed a petition and 9 discharge procedures were commenced. See figures available on <<http://www.justice.gov.sk/dwn/stat/konk/konkos10.pdf>>. The number of applications is very small.

informed, face the mentioned pecuniary barriers and consider the system to be too complex.²³⁹

²³⁹ HOJČUŠOVÁ, Miriam. *Osobný bankrot môžete vyhlásiť, len ak máte majetok. Záujem je nízky* [You Can Declare Yourself Bankrupt Only If You Have Sufficient Assets] [online]. SME, 2010 [cited February 23, 2011 Available on <<http://nitra.sme.sk/c/5251323/osobny-bankrot-mozete-vyhlasit-len-ak-mate-majetok-zaujem-je-nizky.html>>].

6. CONCLUSIONS

The fresh-start policy enshrined in bankruptcy law provides a debtor with a promise to start anew by virtue of a discharge of unpaid debts. Since the fresh-start policy entails clear departure from non-bankruptcy law, where the underlying principle dictates that the debts ought to be paid, it should be justified. The objective of the thesis is to identify reasons behind the fresh-start policy and determine to what extent the rationales have been implemented in Visegrad countries. Different methods can be used to analyse the topic. The thesis approached the mentioned issues mainly from the view of law and economics.²⁴⁰

It has been observed that by giving a debtor the opportunity to start anew the legislature has a chance to promote several goals based on efficiency. The implementation of the fresh-start policy can serve to achieve cooperation between a debtor and his creditors in order to maximize the value of the bankruptcy estate. Prerequisites for a discharge indeed include commonly the fulfilment of the debtor's duties in the course of the proceeding which *inter alia* entails the obligation to reveal all the assets. In this respect, the discharge adheres to the policy of a carrot and a stick.²⁴¹ Moreover, the fresh-start policy leads to reduction of enforcement costs as the claims are mostly finally resolved. Besides that, properly structured personal bankruptcy law leads to the diminution of the debtor's incentives to operate in the shadow market. By the same token, it arguably integrates debtors back to the economy as well as to the society. Finally, the fresh-start policy provides a sort of insurance both for non-businessmen and businessmen. It protects the human capital and fosters entrepreneurship.

On the other hand, the fresh-start policy may bring about several negative effects. The possible drawbacks include reduced satisfaction of creditors' claims, debtors' undermined

²⁴⁰ See chapter 2.1.

²⁴¹ In all Visegrad countries where the fresh-start policy has been implemented, the discharge is conditioned on the debtor's compliance with his duties.

responsibility, moral hazard problem as well as limited availability of credit and possible distribution effects. Once a debtor has been granted a discharge of unpaid debts, creditors can no longer enforce their claims. Creditors do not only incur losses but such regime might undermine debtors' responsibility. The availability of the discharge of debts may *ex ante* induce debtors to be less prudent than they would otherwise be in the absence thereof. Finally, adjusting creditors in order to recoup potential losses takes the possibility of discharge into account. Accordingly, the credit market reacts by raising an interest rate that can in turn lead to reduced availability of credit and redistribution.²⁴²

In order to mitigate the negative effects of the fresh-start policy two main considerations should be taken into account. First, it has been argued that the discharge law has significant impact particularly in situations when the debts would be collectible outside bankruptcy.²⁴³ Second, the discharge should not be freely available. To address the former, the law should in certain respects distinguish between debtors who cannot repay their debts and those who are simply trying to avoid their liabilities. As regards the second, the legislature needs to carefully consider the preconditions for the discharge of debts. A debtor must pay some "price."²⁴⁴ While too generous regime intensifies the negative effects, too stringent requirements render the system practically useless. However, there seems to be no one-size-fits-all system suitable to all the countries. The fresh-start policy must be seen in context.

As the law stands, Visegrad countries have taken distinct attitudes. Hungary has not yet adopted insolvency law that would allow individuals to go bankrupt. Consequently, on one hand Hungary has avoided any difficulties arising out of the fresh-start policy. On the other hand, it does not effectively address personal indebtedness by virtue of insolvency law.

²⁴² See chapter 4.

²⁴³ See chapter 4.1.

²⁴⁴ See chapters 4.2 and 4.3.

In the Czech Republic, Poland and the Slovak Republic the fresh-start policy has been recently implemented. It is interesting to compare how they cope with the possible abuses of the discharge of debts and the mentioned drawbacks.

The Czech law seems to rely primarily on the mandatory repayment requirement and on the assessment of whether the petition has been filed in good faith. The debtor must either give up all his non-exempt assets or complete a five-year repayment plan. The main deficiency of the system is that it fails to fully ensure that debtors make more work efforts even during the life of the repayment plan. Moreover, the legislature has missed chance to foster entrepreneurship. It is suggested to render the procedure available also for businessmen and adopt more incentive-oriented regime for repayment plan procedure.

The Polish insolvency regime puts an emphasis on individual assessment of causes of insolvency and pre-petition behaviour in general. The discharge procedure is available only when the insolvency occurs as a result of extraordinary events which are not attributable to the debtor's fault. The law distinguishes between businessmen and non-businessmen. While a non-businessman has to liquidate all his non-exempt assets *and* complete a repayment plan, in case of a businessman the discharge may be granted upon liquidation of his assets. Generally, the law seems to set too stringent criteria so that many debtors might be kept out of the system. However, due to the unavailability of the data, such hypothesis can be neither confirmed nor rejected.

The Slovak law contemplates a discharge of debts for both businessmen and non-businessmen under the same set of conditions. Debtors have to firstly undertake liquidation of their assets. At the end thereof the debtors might apply for a discharge procedure which envisages the three-year repayment period. The empirical data show that only few debtors

have so far successfully filed the discharge petition. Thus, a review needs to be done in order to effectively translate the fresh-start policy into practice.

It might be concluded that although the majority of Visegrad countries have implemented the discharge procedure, not all efficiency grounds substantiating the fresh-start policy have been fully attained. Legislators might have coped better with negative effects while promoting positive impacts. Thus, careful consideration together with the assessment of empirical data should be made in order to implement the fresh-start policy. Only meaningful²⁴⁵ implementation provides benefits to debtors, creditors as well as society.

²⁴⁵ See EFRAT, Rafael. The Fresh-Start Policy in Bankruptcy in Modern Day Israel. *American Bankruptcy Institute Law Review*, 1999, Vol. 7, No. 2, pp. 555 – 556.

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