

ADVISORY GROUP
PAPER 4-B PRESENTATION

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Essential Elements of an Effective Personal Insolvency Regime

Essential Elements

- Balance: creditor, debtor, society
- Out of court procedures
- Standards for commencement, reduce entry barriers
 - Abuse and moral hazard address through supporting infra, criminal/civil law
- Discharge
- Dischargeable vs non-dischargeable – balance
- Exemptions from automatic transfer to estate
 - Consider to enable debtor to return to productive life as quickly as possible

Essential Elements

- Trustee – critical role, give sufficient powers, responsibilities
- Infrastructure to provide information on debtor
- Enforcement mechanisms
- Cross-border insolvency
- Personal insolvency regime is last resort
 - Work to help people prevent becoming insolvent

ESSENTIAL ELEMENTS OF AN EFFECTIVE PERSONAL INSOLVENCY REGIME

Introduction

The link between economic progress and entrepreneurship has been a constant theme in global economic history that has never been as obviously clear as in today's digital age. For developing economies aiming to achieve prosperity, fostering the emergence and growth of innovative businesses is essential. This means creating an ecosystem that is conducive to entrepreneurship by addressing obstacles that prevent it from flourishing.

One such obstacle is the existence of ineffective and inefficient personal insolvency regimes. Studies confirm that roughly half of all business start-ups fail within five years after their establishment. Where personal insolvency regimes are inefficient, many entrepreneurs who fail in their first attempt are prevented from making a fresh start for many years. The barriers facing those who try once and fail present huge risks that discourage people from starting businesses, especially those based on new ideas.

Where personal insolvency regimes are efficient, on the other hand, many entrepreneurs that fail at their initial attempt are able after a short time to start new businesses that go on to become successful. More people are encouraged to start enterprises, knowing that the consequences of failure can be overcome with hard work and persistence. Economies benefit from a large and dynamic entrepreneurial base and a continuous flow of innovation made possible by such conditions.

The growing realization of benefits from harnessing entrepreneurship for growth and the increased availability of information are changing attitudes toward personal insolvency. Where traditional views had emphasized the importance of maximizing repayment, the danger of abuse and of avoiding moral hazard, newer perspectives stress the importance of achieving a balance among three interests – those of the creditor, the debtor and the society. The low percentage of system abuse observed in the market has also encouraged a more open attitude toward reducing entry barriers. The inability of long payment plans to benefit creditors, together with their high administrative costs, has led various jurisdictions to shorten the time for insolvent debtors to qualify for discharge relief.

The USA has a long history of a bankruptcy regime that provides an efficient process for dealing with personal debt and encouraging entrepreneurship and risk-taking, which is enshrined in Chapters 7 and 13 of the Bankruptcy Code. Starting with Denmark in 1984, all jurisdictions in the EU with the exception of Bulgaria and Malta have introduced or reformed personal bankruptcy laws that facilitate debtors' access to bankruptcy and greater efficiency in the discharge of debt, with positive results. Japan, Korea and Australia have also introduced well-developed personal insolvency regimes.

In China, the existing bankruptcy law from 2006 did not include natural persons, as conditions then were not yet considered ripe. Since then, however, China has entered the age of mass consumption, innovation and entrepreneurship, while many MSMEs are being increasingly dragged down by heavy debts. Related legal reforms have also been initiated, with the introduction of a property law and ongoing work on the Civil Code. Progress in developing the credit infrastructure, and more recently, the advent of big data, are now making it easier to get information about debtors' assets. With these developments, China's legal community now believe that the time has come to begin work on a personal insolvency law, which could take several years.

In this context, the APEC Business Advisory Council (ABAC), through the Asia-Pacific Financial Forum (APFF), collaborated with the International Finance Corporation/World Bank Group, the China Banking Law Society, the China Council for the Promotion of International Trade (CCPIT), and the Tiantong & Partners Law Firm to convene a conference on 15 June 2018 in Beijing. The conference

ADVISORY GROUP MEETING PAPER 4-B

aimed to discuss the essential elements of an effective personal insolvency regime that could serve as a guide to policy makers in undertaking reforms to stimulate the growth of MSMEs and innovation in APEC member economies.

These essential elements have been derived from the experience of various jurisdictions that were discussed during the conference, as well as from well-established principles acknowledged by leading insolvency legal experts from within and outside the Asia-Pacific region who participated in the discussions. They have been formulated with the jurisdictions in APEC member economies in mind, and with the understanding that the wide diversity of economic and social conditions, cultures and legal traditions among these economies will require the careful adaptation of these essential elements to the realities in each economy.

Essential Elements of an Effective Personal Insolvency Regime (PIR)

1. The personal insolvency regime (PIR) should strike a balance among the interests of the creditor, the debtor and the society. While it should remain the objective of the law to reward honesty, integrity and hard work and to discourage dishonesty and mitigate moral hazard, the PIR should also recognize that business failure is a normal reality and so seek to facilitate a fresh start for entrepreneurs who happen to fail, in order to promote a dynamic economy and sustained and inclusive growth. This balance should be reflected in the allocation of the costs of failure between creditors and debtors and in the design of the law and its enforcement mechanisms, which should strive for efficiency and reduced transaction and administrative costs and risks. To ensure that the legal framework reflects the realities in its jurisdiction, it should be designed through consultations with a broad range of relevant stakeholders and experts.
2. Out-of-court procedures for dealing with insolvent debtors should be made available in conjunction with an effective legal framework for personal insolvency, including their facilitation through guidelines developed by the lending industry and the legal community. This will help avoid overloading the courts with bankruptcy proceedings. Examples are composition and extension agreements between debtors and creditors in the USA,¹ voluntary and legally binding debt agreements² and personal insolvency agreements between debtors and creditors³ (Part IX and Part X of the Bankruptcy Act, respectively) in Australia, where most bankruptcies are also commenced out-of-court and are then administered by the Australian Financial Security Agency (AFSA) through the Official Trustees; the Individual Voluntary Arrangement (IVA) provided for in Hong Kong's Bankruptcy Ordinance⁴; and the Consumer Proposal under Canada's Bankruptcy and Insolvency Act. In Japan, the Committee, consisting of practitioners, scholars and other

¹ Voluntary agreements in the USA may be a composition agreement or an extension agreement. In a composition agreement, the debtor pays less than the full amount of the debt. In an extension agreement, the due date for the debt is extended to facilitate the rehabilitation of the debtor's business.

² A debt agreement involves the debtor negotiating to pay a percentage of his/her combined debt that he/she can afford over a period of time, repayments made to the debt agreement administrator (rather than the creditor), and protection of the rest of the money owed from recovery by creditors after the agreement ends upon completion of the payments. Creditors normally prefer this option if they believe that they can receive more money than if the debtor becomes bankrupt.

³ A personal insolvency agreement involves the appointment of a trustee who takes control of a debtor's property and oversees the debtor's offer to the creditors to pay part or all of the debt either by instalment or as a lump sum payment, or otherwise provide more money than if the debtor becomes bankrupt.

⁴ This involves the application to the court for an Interim Order, for the duration of which the debtor is protected from the initiation or continuation of any bankruptcy petition or other legal proceedings. It requires the debtor to make a repayment Proposal to the creditors, which becomes binding on all creditors once approved. Creditors benefit from expected better repayment from the debtor, while a debtor can benefit from avoiding the stigma of bankruptcy, avoiding legal restrictions and being able to retain his/her job or profession.

ADVISORY GROUP MEETING PAPER 4-B

members established by the Japan Chamber of Commerce and Industry and the Japanese Bankers Association with the support of the Financial Services Agency of Japan (FSA) and the Japan Small and Medium Enterprise Agency issued guidelines on 5 December 2013 to encourage financial institutions to deal with personal guarantee debts given by directors and managers in relation to corporate debt, especially of SMEs, in certain circumstances.⁵ Where debtors have significant capacity to repay, respected and credible intermediaries may be assigned to administer negotiated personal debt workouts.⁶

3. Standards for commencement of insolvency proceedings for natural persons should be clear, transparent and reasonable, and entry barriers that could be prohibitive under existing conditions in any particular jurisdiction avoided. Such entry barriers that work against many failed entrepreneurs include excessive hurdles for proving debtors' distress (e.g., means test), overly stringent criteria for accepting applications for relief (such as limiting entry only to those whose insolvency arises from circumstances beyond their control), and high thresholds for the amount of debt and its proportion to the debtor's income and assets. Other entry barriers that work against debtors who are overly distressed include minimum payment capacity requirements, requirements to demonstrate benefit to creditors, mandatory pre-filing negotiations with creditors (which in most cases have only resulted in fruitless prolongation of the process due to inability of debtors to make any payment), and high fees debtors must pay to file for bankruptcy.⁷ Concerns about abuse and moral hazard should not be addressed through entry barriers, but through the supporting infrastructure that provides transparency on debtors and through the criminal and civil law regimes.
4. Discharge relief, which eliminates outstanding liabilities specified by the law (e.g., personal liability in the case of USA), should be expedited to enable a "fresh start" for the debtor within a short a period of time as practicable, unless the debtor is found guilty of inappropriate behavior such as fraud or non-compliance with reasonable requirements (e.g., to undergo instructional courses on financial management), or if there is an objection from the trustee or creditors (e.g., due to lack of cooperation in the bankruptcy administration). In the USA, debt can be discharged as early as within 4 months after the debtor files the petition before the bankruptcy court under Chapter 7, or as soon as practicable after the debtor completes all payments under the plan under Chapters 12 and 13 of the Bankruptcy Code. Outstanding personal debts can be automatically discharged after as early as 9 months in Canada,⁸ 3 years in Australia⁹ and 4 years in Hong Kong. In 2016, the European Commission proposed a 3-year maximum period after

⁵ Stacey Steele and Chin Jun, "Some Suggestions from Japan for Reforming Australia's Personal Bankruptcy Law," *QUT Law Review*, Volume 17, Issue 1, pp. 92-94 [<https://lr.law.qut.edu.au/article/view/711/626>]

⁶ Examples of regimes where this approach has been successfully undertaken include France, Netherlands and Ireland. See Jason Kilborn, *Determinants of Failure...and Success in Personal Debt Mediation*, 2017 (electronic copy available at: <https://ssrn.com/abstract=3015419>).

⁷ Jason Kilborn, *Elaborating UNCITRAL's Legislative Guide on Insolvency Law: Principles for Natural Persons* [http://www.uncitral.org/pdf/english/congress/Papers_for_Congress/131-KILBORN-UNCITRALs_Legislative_Guide_on_Insolvency_Law.pdf]

⁸ For first time bankrupts, debts can be automatically discharged after 9 months for those with no surplus income and 21 months for those with surplus income. For those who are bankrupt again, automatic discharge can be granted after 24 months for those with no surplus income and 36 months for those with surplus income.

⁹ Australia is currently considering a law reform proposal [Bankruptcy Amendment (Enterprise Incentives) Bill] to reduce the period of bankruptcy (unless a successful objection to discharge is made) from three years to one year. This also proposes to reduce other time periods associated with bankruptcy to one year (e.g., disclosure of bankrupt status when applying for credit, seeking permission for overseas travel and the attainment of certain licences and entering into certain professions) while, in effect, maintaining the time period of existing income contribution obligations, that is for three years (or longer if a bankruptcy is extended due to non-compliance).

ADVISORY GROUP MEETING PAPER 4-B

which over-indebted entrepreneurs may be fully discharged from their debts.¹⁰ Laws and regulations that hinder discharged debtors from resuming business and professional activities, such as laws that prohibit their employment in certain jobs, also need to be revised.

5. Dischargeable and non-dischargeable debt should be defined in ways that balance the interests of the debtor, the creditor and society. Under the US Bankruptcy Code, for example, discharge is limited to the debtor's personal liability, which excludes collateral pledged for loans. The Code also identifies as non-dischargeable several categories of debt, which include spousal or child support obligations, certain taxes, most government funded or guaranteed student loans, debts for malicious injuries to person or property and debts owed to certain tax-advantaged retirement plans. PIRs in other jurisdictions have similar features. How such practices, which may be relevant in certain developed economies, are applied in a particular jurisdiction should take into account prevailing conditions which may differ, particularly in developing economies, with a view to providing practical solutions that help achieve the goals of the PIR.
6. The delineation between the property of the estate (those automatically transferred from the debtor to the estate upon commencement of the case) and exempt property that the individual debtor may keep should be made in a way that enables the insolvent debtor to move as quickly forward into productive work as possible. Exempt property should include personal effects that have little or no economic value such as ordinary clothing, as well as tools of the trade and basic housing. Others that may be considered exempt as in certain jurisdictions, depending on practical considerations, include ordinary vehicles, certain pension plans and cash necessary for decent livelihood of the debtor and his/her family, including in cases where debtors become insolvent due to major natural disasters that have resulted in destruction of lives, livelihood, homes and property. Standards and guidelines for determining the exempted portion of debtors' current and future income should be based on a consideration of various factors, including inflation, and developed through robust studies and consultations with a wide variety of local sources.
7. The Trustee in bankruptcy (whose equivalent entities in some jurisdictions are referred to as insolvency officer, administrator or bankruptcy manager) plays a critical role in ensuring the effectiveness and efficiency of the personal insolvency regime and preventing fraud, with respect to both court and out-of-court procedures. To enable the Trustee to play such a role, he/she should be given sufficient powers to investigate the debtor's financial affairs and personal behavior and to access information on the debtors' assets. The Trustee should be invested with the responsibility to deal with all matters regarding the administration of the bankrupt's estate, including keeping creditors of the estate informed of relevant matters, ensuring compliance by the debtor with his/her legal obligations, securing funds to which the estate is entitled, distributing dividends from available funds to creditors, and reporting any evidence of abuse to the relevant authority.
8. The necessary infrastructure for obtaining sufficient information about debtors' assets and financial conditions should be put in place in order to ensure effective implementation of laws and bankruptcy administration and minimize and deter fraud. This will also reduce lenders' reliance on personal guarantees given by directors of MSMEs to their companies, which is a major factor behind the rise of chronically debilitated companies that only survive by paying interest but are unable to pay the principal.¹¹ The infrastructure also includes regulatory

¹⁰ Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU [<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0723&from=EN>].

¹¹ Stacey Steele and Chin Jun, "Some Suggestions from Japan for Reforming Australia's Personal Bankruptcy Law," *QUT Law Review*, Volume 17, Issue 1, pp. 74-96 [<https://lr.law.qut.edu.au/article/view/711/626>].

ADVISORY GROUP MEETING PAPER 4-B

agencies responsible for the operations of the PIR, comprehensive and easily searchable registries of assets that are consolidated, including real estate property (with consideration of variations in value across cities and provinces) and collateral registries, as well as full-file and comprehensive credit information systems, including credit bureaus, registries and other mechanisms that can provide accurate information to trustees and creditors on insolvent debtors' financial assets and transactions. Data on bankruptcy, including bankruptcy applications by individuals and discharges, should also be collected and made available to credit bureaus. Effective and enforceable requirements for the use of real names in registering properties should be in place. Digital technology, artificial intelligence and data analytics should be deployed to facilitate the timely collection of comprehensive information on debtors.

9. Well-developed enforcement mechanisms play an important role in building the trust of debtors, creditors and the public in a more open and accommodating PIR. These include the development of regulatory frameworks and industry standards to ensure the fairness and effectiveness of debt collection agencies and practices, criminal and civil laws (including complementary and coordinated credit, contract, property, matrimonial, secured transactions and privacy laws), and effective judicial procedures based on unified standards across the jurisdiction that can effectively punish and deter abuse of the system, especially dishonesty and fraudulent behaviour, and mitigate moral hazard.
10. The development of personal insolvency regimes in each jurisdiction should be pursued in light of the realities of business in the 21st century, which has as one of its characteristics the growth of cross-border business and supply chains. While insolvency laws heretofore have typically been premised on resolving issues between debtors and creditors within the same jurisdiction, a large and rapidly growing portion of financial activities today is cross-border in nature. Given APEC's aspiration of free and open trade and investment and expanding the role of MSMEs in this process, it is important to undertake the development and reform of personal insolvency regimes across member economies (especially those with the most vibrant cross-border business activities) in a coordinated manner, so as to provide mechanisms for the orderly liquidation and resolution of cross-border debt and to encourage the expansion of MSMEs' participation in international trade and investment activities.
11. A personal insolvency regime is a last resort for debtors who fall into insolvency. While personal insolvency is and will always be a normal fact of life for entrepreneurs and many economically and socially vulnerable individuals everywhere as a result of natural catastrophes, financial and economic crises and international and domestic conflicts, it is incumbent on policy makers to create an economic, political and social environment that can help people avoid becoming insolvent. Financial education should be promoted to help individuals make prudent decisions, and made available especially to those who are in danger of being, or already are, financially distressed. Creating such an environment involves measures such as facilitating the expansion of insurance coverage, promoting healthy lifestyles, pursuing sound macroeconomic and monetary policies, creating a policy and regulatory environment that rewards and encourages responsible risk management, and stronger efforts to resolve social and political conflicts, among many others.

ADVISORY GROUP MEETING PAPER 4-B

ANNEX: List of Speakers and Moderators of the *International Symposium on Personal Insolvency Legislation and Business Environment*, 15 June 2018, Beijing, People's Republic of China

Organized by the:

- APEC Business Advisory Council (ABAC) / Asia-Pacific Financial Forum (APFF)
- China Banking Law Society
- International Finance Corporation (IFC) / World Bank Group (WBG)
- China Council for the Promotion of International Trade (CCPIT)
- Tiantong & Partners Law Firm

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1. **Liu Guixiang**, Justice and Full Time Member, Adjudication Committee and President of the First Circuit Court, Supreme People's Court of China
 2. **Wang Weiguo**, Chairman, China Banking Law Society
 3. **Shinjiro Takagi**, Former Justice and Director, Tokyo High Court and former Chairman, Japan Industrial Revitalization Committee
 4. **Liu Chao**, Deputy Director General, Legal Affairs Department, CCPIT
 5. **Lai Jinchang**, Lead Financial Sector Specialist and Lead for Infrastructure, East Asia and Pacific, IFC / WBG
 6. **Chi Weihong**, Senior Partner, Tiantong & Partners Law Firm
 7. **Rosalind Mason**, Professor, Queensland University of Technology
 8. **Liu Jing**, Associate Professor, Law School, Beijing Foreign Studies University
 9. **Andres Martinez**, Senior Financial Sector Specialist, IFC and Global Practice, World Bank Group
 10. **Tang Weijian**, Professor, Law School, Renmin University of China
 11. **Jason Kilborn**, Professor, John Marshall Law School, Chicago
 12. **Long Guangwei**, Vice President, Shenzhen Intermediate People's Court of Guangdong Province
 13. **Wang Fubo**, Presiding Judge, Second Civil Division, Supreme People's Court of China
 14. **Wang Xinxin**, Professor, Law School, Renmin University of China
 15. **Xu Jianxin**, Vice President, High People's Court of Zhejiang Province
 16. **Li Yongjun**, Professor, Civil, Commercial and Economic Law School, China University of Political Science and Law
 17. **Huang Lin**, Senior Financial Sector Specialist, East Asia and Pacific, IFC / WBG
 18. **Xu Yangguang**, Professor, Law School, Renmin University of China
 19. **Peter Shaw**, Queen's Counsel, 9 Stone Building Barristers' Chambers, London, UK
 20. **Jin Chun**, Professor, Doshisha University, Japan
 21. **Ren Yimin**, Partner, Capital Equity Legal Group
 22. **Ye Bingkun**, Director, Sixth Civil Division, Xiamen Intermediate People's Court of Fujian Province
 23. **Ju Haiting**, President, Rui'an People's Court of Zhejiang Province
 24. **Casey Watters**, Assistant Professor, University of Nottingham
 25. **Zhao Kuncheng**, Partner, King & Wood Mallesons
 26. **Lu Shaohong**, Partner, Dentons
 27. **Ding Haihu**, Director, Second Civil Division, High People's Court of Guangdong Province
 28. **Wu Yue**, Director, Financial Consumer Education Section, Financial Consumer Protection Bureau, People's Bank of China
 29. **Toshikazu Fujimoto**, Professor, Osaka University, Japan
 30. **Yin Huifen**, Associate Professor, Law School, Shanghai University of Political Science and Law
 31. **Jiang Tairen**, Director, Second Civil Division, Guangxi Zhuang Autonomous Region High People's Court
 32. **Su Jieche**, Associate Professor, Civil, Commercial and Economic Law School, China University of Political Science and Law
 33. **Qi Lijie**, Associate Professor, Law School, Shenzhen University
 34. Yin Zhengyou, Senior Partner, W&H Law Firm
 35. **Ji Nuo**, Partner, Fangda Partners
 36. **Xiao Bin**, Deputy Director, Second Civil Division, High People's Court of Shandong Province
 37. **Du Wanhua**, Deputy Director, Advisory Committee, Supreme People's Court of China
 38. **Julius Caesar Parreñas**, APFF Coordinator and Senior Advisor, Mizuho Bank Ltd.