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Second chance mechanisms in Insolvency Law

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ABSTRACT

Traditionally, the procedures for dealing with over-indebtedness have their origin in Anglo-Saxon countries, which are much more pragmatic when it comes to dealing with situations of distress and the dysfunctions of citizens who cannot pay their debts. In contrast, countries with a Latin tradition have always been more reluctant to allow debt restructuring mechanisms for individuals.

The European Economic and Social Committee already said in 2014 that over-indebtedness could not be considered as an individual problem of each individual, but was now a reflection of a social and societal crisis. Within the framework of the European Union, we have Directive 2019/1023 of the European Parliament and of the Council of 20 June 2019, which establishes a debt discharge procedure for entrepreneurs and, as the regulation itself states, in many cases it is not possible to establish a clear distinction between the debts of the entrepreneur derived from his commercial, industrial, craft or professional activity and those incurred outside the framework of these activities. Therefore, entrepreneurs would not effectively enjoy a second chance if they had to go through different procedures, with different conditions of access and time limits for discharge, to obtain discharge of their business debts and their other debts outside the framework of their business activity. The Directive assumes that there are no binding rules on consumer over-indebtedness and recommends that Member States implement consumer rules on debt relief.

Member States should ensure that at least one of the procedures gives the insolvent entrepreneur the opportunity to achieve full discharge of debts within a period not exceeding three years, and shall determine any restrictions on the discharge of certain debts, provided that they do not concern maintenance debts arising from family relationships.

1. Introduction

The objective of the DIRECTIVE (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 is to contribute to the proper functioning of the internal market and remove obstacles to the exercise of fundamental freedoms, such as the free movement of capital and freedom of establishment, which result from differences between national laws and procedures concerning preventive restructuring, insolvency, discharge of debt, and disqualifications.

The Directive aims to ensure that viable companies and entrepreneurs in financial difficulties have access to effective national preventive restructuring frameworks allowing them to continue operating, and that honest insolvent or over-indebted entrepreneurs can benefit from a full debt discharge after a reasonable period of time, thus allowing them a second chance. In addition, the effectiveness of restructuring, insolvency and debt discharge procedures should be improved, in particular with a view to shortening their duration.

The restructuring sought by the directive should enable debtors in financial difficulties to continue their business, in whole or in part, by modifying the composition, terms or structure of their assets and liabilities or any other part of their capital structure - including through the sale of assets or parts of the company or, where provided for by national law, of the company as a whole - as well as by making operational changes. In view of this, preventive restructuring processes should, above all, enable debtors to restructure effectively at an early stage and avoid insolvency, thus limiting the unnecessary liquidation of viable companies.

The question arises because of differences between Member States in the range of procedures available to debtors in financial difficulties to restructure their business. Some Member States have a limited range of procedures that allow the restructuring of companies only at a relatively late stage, in the context of insolvency proceedings. In other Member States, restructuring is possible at an earlier stage, but the procedures available are not as effective as they could be, or are very formal, in particular because they limit the use of out-of-court settlements. It is certainly true that preventive solutions are a growing trend in insolvency law, thus favoring approaches that, unlike the traditional approach of liquidating a company in financial difficulties, aim to restore its healthy state or, at least, to save those of its units that are still economically viable.

Similarly, national rules giving entrepreneurs a second chance, in particular by granting them discharge from the debts they have incurred in the course of their business, vary between Member States in respect of the length of the discharge period and the conditions for granting such a discharge. In many Member States, it takes more than three years for entrepreneurs who are insolvent but honest to be discharged from their debts and make a fresh start. Inefficient discharge of debt and disqualification frameworks result in entrepreneurs having to relocate to other jurisdictions in order to benefit from a fresh start in a reasonable period of time, at considerable additional cost to both their creditors and the entrepreneurs themselves.

The differences among Member States in procedures concerning restructuring, insolvency and discharge of debt lead to uneven conditions for access to credit and to uneven recovery rates in the Member States. Enterprises, and in particular Small and Medium-size companies (SMEs), which represent 99 % of all businesses in the Union, should benefit from a more coherent approach at Union level. SMEs are more likely to be liquidated than restructured, since they have to bear costs that are disproportionately higher than those faced by larger enterprises.

Consumer over-indebtedness is a matter of great economic and social concern and is closely related to the reduction of over-indebtedness. Moreover, it is often not possible to draw a clear distinction between debts incurred by entrepreneurs in the course of their trade, business, craft or profession and those incurred outside these activities. Entrepreneurs would not effectively benefit from a second chance if they had to undergo different procedures, with different access conditions and different discharge periods, to settle their business debts and other debts incurred outside their activity. For these reasons, although the Directive does not include binding rules on consumer over-indebtedness, it does advise Member States to apply the Directive's provisions on debt forgiveness to consumers as well.

2. DISCHARGE OF DEBT AND DISQUALIFICATIONS

Title III of the Directive covers different aspects, such as access to discharge, the time limit for discharge, the period of disqualification, exceptions and consolidation of proceedings regarding professional and personal debts.

2.1. Access to discharge

The Directive establishes the obligation for Member States to implement at least one procedure for insolvent entrepreneurs, which may result in the full discharge of the debt provided that the requirements of the Directive are met.

Indeed, in those Member States where the full discharge of the debt is conditional upon a partial repayment of the debt by the entrepreneur, they must ensure that the corresponding

repayment obligation is based on the individual situation of the entrepreneur and, in particular, is proportionate to the entrepreneur's income and attachable or available assets during the period of discharge, and takes into account the equitable interest of the creditors.

2.2. Discharge period

As regards the period after which insolvent entrepreneurs may be fully discharged from their debts, the Directive stipulates that it may not exceed three years. The date from which this three-year period is to be counted is at the latest from the date of one of the following situations, as the case may be:

(a) in the case of a proceeding involving a redemption plan, the decision of a judicial or administrative authority confirming the plan or the commencement of the implementation of the plan; or
(b) in the case of any other proceeding, the decision of the judicial or administrative authority to open the proceeding, or the establishment of the insolvency estate of the employer.

However, it should be considered that, as provided for in the Directive, full discharge should not prevent the continuation of insolvency proceedings involving the realization and distribution of an entrepreneur's assets that were part of the insolvency estate of that entrepreneur at the date of expiry of the discharge period, and Member States should therefore put in place appropriate mechanisms to ensure that this is possible.

2.3. Disqualification period

According to the Directive, periods of disqualification for accessing or exercising a trade, business, trade or profession shall cease to have effect at the end of the exemption period and, therefore, upon expiration of the exemption period, such disqualifications shall cease.

2.4. Exceptions

By exception to the above, Member States may maintain or introduce provisions denying or restricting access to debt discharge, revoking the benefit of debt discharge, or providing for longer periods for obtaining full discharge or longer periods of disqualification, where the insolvent entrepreneur has acted dishonestly or in bad faith under national law towards creditors or other interested parties at the time of becoming indebted, during the insolvency proceedings or during the payment of the debt, without prejudice to national rules on the burden of proof.

But also, in certain well-defined circumstances and where such exceptions are duly justified, Member States may maintain or introduce provisions denying or restricting access to debt relief, revoking the benefit of debt relief or providing for longer periods to obtain full debt relief or longer periods of disqualification. This is established in the European rule, for example when (a) the insolvent entrepreneur has substantially failed to comply with the obligations deriving from a repayment plan or any other legal obligation aimed at safeguarding the interests of creditors, including the obligation to maximize returns for creditors; (b) the insolvent entrepreneur has failed to comply with the information or cooperation obligations provided for in Union and national law; (c) there are abusive applications for debt discharge; (d) a new application for discharge is submitted within a certain period of time after the insolvent entrepreneur has been granted full discharge or has been refused full discharge due to a serious breach of information or cooperation

obligations; (e) the cost of the procedure leading to discharge is not covered; or (f) a derogation is necessary to ensure a balance between the rights of the debtor and the rights of one or more creditors.

With respect to discharge periods longer periods may be established in the following cases: (a) when precautionary measures are approved or ordered by a judicial or administrative authority for the purpose of safeguarding the principal residence of the insolvent entrepreneur and, if applicable, of his family, or the assets essential to the continuation of the entrepreneur's trade, business, craft or professional activity; or (b) the principal residence of the insolvent entrepreneur and, if applicable, of his family is not realized.

The Directive also includes the possibility for Member States to exclude specific categories of debts from the exemption from liability, or to restrict access to the exemption from liability or to establish a longer period of exemption when such exclusions, restrictions or longer periods are duly justified. We are talking about the following cases: (a) secured debts; (b) debts arising from or related to criminal sanctions; (c) debts arising from non-contractual liability; (d) debts relating to maintenance obligations arising from a family, kinship, marriage or affinity relationship; (e) debts incurred after the application or the opening of the discharge proceedings; and (f) debts arising from the obligation to pay the cost of the discharge proceedings.

As an exception to the period of disqualification referred to in the preceding paragraphs, Member States may provide for longer or indefinite periods of disqualification where the insolvent entrepreneur is a member of one of the following professions: (a) to which specific ethical rules or specific rules on reputation or expertise apply, and the entrepreneur has infringed such rules; or (b) which is engaged in the management of other people's property.

2.5. Consolidation of proceedings regarding professional and personal debts

The Directive provides for consolidation of proceedings in the case of personal and professional debts of the entrepreneur. In such cases, where insolvent entrepreneurs have professional debts incurred in the course of their trade, business, craft or professional activities, as well as personal debts incurred outside such activities, which cannot reasonably be separated, such debts, if dischargeable, in order to obtain full discharge of the debt, must be dealt with in a single proceeding. However, if professional debts and personal debts can be separated for the purpose of obtaining full discharge of the debt, such debts shall be dealt with either in separate but coordinated proceedings or in the same proceeding.

3. The Spanish case

In Spain, work is currently underway on the transposition of the Directive, and we have the Bill to reform the revised text of the Insolvency Law approved by Royal Legislative Decree 1/2020, of May 5. It is currently in the parliamentary process and more than 600 amendments have been presented by the political parties.

Among the changes introduced in the first book are those relating to the exoneration of unsatisfied liabilities, an institution that dispenses with the noun "benefit" in its own definition. As we have just mentioned in previous sections, although the Directive does not impose it, it does advise, and in fact it has been opted for, to maintain the exoneration

regulation also in the case of individuals whose debts do not derive from business activities (consumers).

The macroeconomic benefits of the "second chance" have been highlighted in repeated studies by international economic organizations, such as the International Monetary Fund or the World Bank. Likewise, a growing number of legislations already welcome the figure of the fresh start, incorporated for the first time in our law through Law 25/2015, of July 28, on second chance mechanism, reduction of the financial burden and other measures of social order. However, statistics show that in Spain little use has been made of the waiver of unsatisfied liabilities in comparison with what happens in other European Union countries.

The reason for this lower incidence in the practice of this institute in our country is to be found, perhaps, in two basic imbalances in the current regulations: on the one hand, the basic modality of exoneration presupposes the payment of a minimum threshold of debt, which is fixed normatively without any consideration of the personal and patrimonial circumstances of the debtor. On the other hand, the model in force up to now of exoneration of unsatisfied liabilities is based on or presupposes the prior liquidation of the debtor's assets, which is illogical with respect to the debtor who aspires to keep part of his assets -precisely those that would allow him to develop the business or professional activity from which those future incomes or revenues will result-. It is essential to overcome this limitation of our exoneration system, so that the debtor can choose between an immediate exoneration with prior liquidation of his assets and an exoneration by means of a payment plan, in which he allocates his future income and revenues during a period of time to the satisfaction of his debts, The natural person debtor who is in actual or imminent insolvency must go to the insolvency proceeding in order to benefit from the exoneration, but without the need to waste time or incur the cost of trying a preinsolvency solution in whose success he does not trust.

Regarding the modifications proposed in the project, two modalities of discharge are articulated: (i) discharge with liquidation of the active mass and, (ii) discharge with payment plan. These two modalities are interchangeable, in the sense that the debtor who has obtained a provisional discharge with payment plan can at any time cancel it and request the discharge with liquidation.

With these two routes or itineraries for the discharge of liabilities, our law is close to others such as American law, in which there is an immediate discharge for debtors who lack resources (in the so-called Chapter 7) and a discharge with payment plan and without compulsory liquidation of the assets (in Chapter 13), French law (art. L 742-24 of the Consumer Code), or Finnish law (art. 36.1 of the Debt Restructuring Act for Natural Persons), in which the debtor can obtain a discharge after a repayment plan, while keeping part of his assets.

Likewise, the good faith of the debtor remains a cornerstone of the discharge. In line with the recommendations of international organizations, a normative delimitation of good faith is established, by reference to certain objective conducts that are listed in a taxonomy (numerus clausus), without appealing to vague patterns of conduct or without sufficient concreteness, or whose proof imposes a diabolical burden on the debtor. The requirement that the debtor must not have refused an offer of employment in the four years prior to the declaration of insolvency in order to benefit from the discharge is eliminated. The obligation to have entered into, or at least attempted to enter into, an out-of-court payment agreement is also eliminated.

As for the discharge of debts, it is extended to all bankruptcy debts and debts against the mass. The exceptions are based, in some cases, on the special relevance of their satisfaction for a fair and solidary society, based on the rule of law (such as debts for alimony, public law debts, whose discharge is subject to limits, debts arising from criminal offenses or even debts for non-contractual liability).