

CONSUMER BANKRUPTCY LAW FOR ETHIOPIA: LESSONS FROM UNITED STATES AND GERMANY

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Abstract

After deregulation of consumer credit and resultant availability, over-indebtedness became a problem for many countries. As a response to this, many jurisdictions have departed from their “merchant-oriented” bankruptcy law to include consumers giving them discharge and fresh start. Germany, United States, United Kingdom and France are some of the countries that have adopted consumer bankruptcy laws after experiencing over-indebtedness problem. In Ethiopia, credit market is still highly regulated. Nevertheless, consumers have access to credit and are potentially exposed to risk of indebtedness and there is a move towards that. Adopting consumer bankruptcy law can also be an ex ante solution. More importantly, introducing such law to Ethiopia is more convincing based on the entrepreneurship, social insurance, development policy and rehabilitative function of discharge and fresh start. The author argues that Ethiopia should follow the global trend by adopting consumer bankruptcy law with adequate discharge and fresh start. This law should be based on German model, repayment plan and then discharge: repayment of certain portion of the debt and covering cost of proceeding by the debtor.

Keywords: bankruptcy, debt, discharge, exemption, fresh start, insolvency, merchant-oriented, over-indebtedness, rehabilitation, repayment

I. INTRODUCTION

Recent trends in bankruptcy show that many countries, industrialized or otherwise, have been introducing consumer bankruptcy law¹ to solve the problem of consumer over-indebtedness and concomitant social and economic

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¹ Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L.J. 81 (2002), at 81.

problems.²The previously “merchant-oriented” bankruptcy system is considered to be vital tool for consumers as well. Indebtedness ceased to be a problem of merchants and corporations only.³But with the deregulation of credit market and individuals’ access to consumer credit, over-indebtedness is becoming a problem for consumers, the society and the economy.⁴ Countries such as United Kingdom, United States, Germany and France adopted consumer bankruptcy laws as a reaction to availability of consumer credit and accompanying indebtedness. There are, however, countries like Ethiopia that still restricted their bankruptcy law to merchants only. Under Ethiopian law, only merchants are entitled to file for bankruptcy and non-traders are excluded from the scope of the law. That was based on the French approach⁵though France has departed from that philosophy and introduced bankruptcy for consumers in 1989.⁶ The reasons for such departure are almost universal and there is only a difference in the approaches with the solutions. It is, therefore, interesting to see if Ethiopia has to abandon its restriction and allow consumers to knock the door of courts for relief when they do not have a means to pay their debt.

Accordingly, the article is organized as follows. Following this introduction part, Section II will deal with the historical development of consumer bankruptcy discharge and fresh start and its theoretical underpinnings. It mainly discusses the Anglo-American jurisprudence, the pioneer of bankruptcy discharge and fresh start, as a benchmark for the theoretical and philosophical underpinnings of consumer bankruptcy. History of discharge, justifications for it and associated costs to discharge and fresh start are discussed in this section. Section III is dedicated to deal with the comparative discussion of the United States and German consumer bankruptcy laws. The two leading countries with contrasting fresh start policy are chosen to see the strengths and weaknesses of each system with a view of finding a suitable fit for Ethiopia. Section IV is reserved to discuss the Ethiopian context and to examine the need to adopt consumer bankruptcy law to Ethiopia. The *pros* and *cons* of adopting consumer bankruptcy law and fresh start are

² Adam Feibelman, *Consumer Bankruptcy as A Development Policy*, 39 SETON HALL L. REV. 63 (2009), at 96.

³ JOHANNA NIEMI ET AL, CONSUMER CREDIT, DEBT AND BANKRUPTCY: COMPARATIVE AND INTERNATIONAL PERSPECTIVES, Hart Publishing, (2009), at 225.

⁴ G. Stanley Joslin, *The Philosophy In Bankruptcy: A Re-Examination*, 17 U. FLA. L. REV. 189 (1964-1965), at 189-191.

⁵ Tadesse Lencho, *Ethiopian Bankruptcy Law Commentary Part I*, XXII: 2 J. ETH. L 57 (2008), at 69.

⁶ Robert Anderson et al, (ed.) *Consumer Bankruptcy in Europe: Different Paths for Debtors and Creditors*, 09 EUI Working Papers (2011), at 19.

discussed from the experience of the jurisdictions mentioned above. Finally, concluding remarks will be made under Section V.

II. GENERAL OVERVIEW OF CONSUMER BANKRUPTCY LAW

A. Historical Development of Consumer Bankruptcy Law

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

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

⁷ See G. Stanley Joslin, *supra* note 4, at 189; see also Nathalie Martin, *Common Law Bankruptcy Systems: Similarities and Differences*, 11 AM. BANKR. INST. L. REV. 367 (2003), at 372-373; CHARLES J. TABB & RALPH BRUBAKER, *BANKRUPTCY LAW PRINCIPLES, POLICIES AND PRACTICE*, Anderson Publishing Co. (2003), at 479.

⁸ Rafael Efrat, *The Evolution of Bankruptcy Stigma*, 7 THEORETICAL INQ. L. 365 (2006), at 367-368 & 372

⁹ *Id.*, at 366;

¹⁰ *Id.*, at 367-368; See also John C. McCoid, II, *The Origins of Voluntary Bankruptcy*, 5 BANKR. DEV. J. 361 (1988), at 387; Ramsay, Iain D. C., *Comparative Consumer Bankruptcy*, U. ILL. L. REV., at 241 (2007), at 256, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=958190 (last visited on 28 March 2014).

¹¹ See Rafael Efrat, *supra* note 8, at 370-374.

¹² *Id.*, at 374-385.

¹³ See Nathalie Martin, *supra* note 7, at 370; see also G. Stanley Joslin, *supra* note 4, at 192-193.

¹⁴ See G. Stanley Joslin, *supra* note 4, at 190

¹⁵ *Id.*; see also Rafael Efrat, *supra* note 8, at 366-368, 372; Nathalie Martin, *supra* note 7, at 371; Charles J. Tabb, *The History of The Bankruptcy Laws in The United States*, 3 AM. BANKR. INST. L. REV. 5 (1995), at 7.

may transfer or sell it and change his location to escape the consequences of his/her act.¹⁶

It was inevitable that the bankruptcy system had to be reformed. The severe treatments of the debtor had to be abandoned while giving creditors an effective debt collection and distribution tool.¹⁷ Factors that led to the reform of bankruptcy law into a debt collection tool were the expansion of credit, trade and commerce.¹⁸ Around the end of 17th century, individual debt collection mechanisms became inadequate to cope up with the development of commerce - distance traders have to travel - and the increase and diversity of creditors. In addition, the “race of diligence” among creditors over the assets of the debtor prompted this change. Race among creditors with the rule “first come first served” was inequitable and as a solution to the problem of race among creditors situated in the same footing¹⁹, a common debt collection mechanism needed to be created.²⁰ This bankruptcy philosophy was not only protection of creditors against the debtors but also among creditors as well.²¹ Accordingly, bankruptcy was recognized as a debt-collection tool while, incidentally, the debtor started to be treated humanely.²²

In 1705, discharge as a legal doctrine was invented under English law²³ and “honest but unfortunate debtors” started to be released against surrendering all their non-exempt assets in satisfaction of the full amount they owed creditors.²⁴ For example, doctrine of discharge was incorporated in the law of England at the beginning of the eighteenth century.²⁵ This change in bankruptcy philosophy was the result of industrial revolution that has created positive environment towards credit.²⁶ This marked the shift of bankruptcy philosophy from treating failure to

¹⁶ See G. Stanley Joslin, *supra* note 4, at 190.

¹⁷ *Id.*, at 191

¹⁸ See Charles J. Tabb, *supra* note 15.

¹⁹ See Michelle J. White, *Why don't More Households File for Bankruptcy*, 14 J. L. ECON. & ORG 205 (1998), at 211.

²⁰ See Charles J. Tabb, *The Historical Evolution of Bankruptcy Discharge*, 65 AM. BANKR. L. J 325 (1991), at 328; see also Malhotra, Vibhooti, *Debtor's Discharge Under United States Bankruptcy Code: Mechanisms and Consequences* (March 21, 2010), at 9, Available at SSRN: <http://ssrn.com/abstract=1646608> or <http://dx.doi.org/10.2139/ssrn.1646608> (last visited 26 March 2014).

²¹ See Charles J. Tabb, *supra* note 15; see also Charles J. Tabb, *supra* note 20.

²² See Charles J. Tabb, *supra* note 20, at 333; see also Malhotra, Vibhooti, *supra* note 20, at 7.

²³ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7.

²⁴ See G. Stanley Joslin, *supra* note 4, at 191-192.

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

²⁶ See Charles J. Tabb, *supra* note 15, at 12.

pay harshly towards a rehabilitation tool of the debtors.²⁷ Punishing debtors or subjecting them to barbarous treatment proved to serve no one and this change was one of the most important developments in the history of bankruptcy law. The other development in bankruptcy law was the discovery of exemptions and discharge that revolutionized bankruptcy philosophy in the world and particularly in United States into one that sympathizes with the debtor than the earlier creditor-oriented approach.²⁸ This changed the philosophy and practice of United States bankruptcy law into rehabilitating and reorganizing tool than a punishment and liquidation instrument.

Despite the negative attitude society had towards consumer bankruptcy, there is a trend towards adoption of consumer bankruptcy into laws of many countries.²⁹ The scope and protection afforded by these laws vary throughout history and across jurisdictions. It ranges from being totally creditor's collective remedy to a 'debtors' relief' in the form of discharge and fresh start.³⁰ So, it is conceivable to imagine rough variations from "no relief" to 'automatic debt relief' jurisdictions."³¹ In some jurisdictions, either there is no access for individuals to opt for bankruptcy or no relief is going to be granted even if there is access.³² In jurisdictions where individuals have access, it may simply be a debt collection tool for the creditors and not intended to benefit the debtors in the form of discharge and fresh start. In other jurisdictions, consumers are entitled to discharge and fresh start as part of the bankruptcy process. Notable example where debt forgiveness and discharge is available is United States.³³

Hence, there is a trend towards convergence with regard to extending bankruptcy law to consumer though there still are significant differences in approaches.³⁴ These disparities in the treatment of consumer debtors are attributed

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

²⁸ See G. Stanley Joslin, *supra* note 4, at 194.

²⁹ See Rafael Efrat, *supra* note 1.

³⁰ See John C. McCoid II, *Discharge: The Most Important Development in Bankruptcy History*, 70 AM. BANKR. L.J. 163 (1996), at 164-165.

³¹ See Rafael Efrat, *supra* note 1.

³² *Id.*, at 84.

³³ *Id.*, at 87.

³⁴ For example United States and Germany both have consumer bankruptcy law. Debtors are entitled to file for bankruptcy. But the relief for bankrupt debtor is very different in the two countries. United States gives relaxed and automatic discharge while Germany the debtor has to wait and act in a particular way to earn the fresh start. For more explanation, see Section III below.

to several factors including but not limited to colonization,³⁵ deregulation of credit markets,³⁶ availability of social welfare,³⁷ and differing policy emphasis for entrepreneurship.³⁸ Worth to note at this point, however, is that countries that traditionally restrict their bankruptcy law to merchants are shifting towards allowing non-traders to be part of the bankruptcy process and benefit from discharge and fresh start.³⁹

B. History of Discharge and Fresh Start in Bankruptcy

Discharge and fresh start is at the heart of consumer bankruptcy.⁴⁰ It is a release of the debtor of his pre-petition debts against full surrender of all his non-exempt property to the creditors.⁴¹ This doctrine was invented in England and developed into a comprehensive legal doctrine in United States.⁴² The invention of discharge was one of the turning points in history of bankruptcy law that marked the shift from being only creditors' remedy to that of debtors' remedy. The first time discharge was invented in the Anglo-American jurisprudence was when it was first used under English law at the beginning of 18th century. It was the time where "honest but unfortunate debtors" started to be released against giving their remaining property in satisfaction to their whole pre-petition debt.⁴³ At first, it was not intended to benefit debtors and rather the impact was incidental.⁴⁴ It was a kind of incentive for the debtor's cooperation and hence it was purely a collection device.⁴⁵ This first English discharge law was problematic in two ways.⁴⁶ First, the scope was limited to that of merchant debtors and it was out of the reach of non-

³⁵ See Rafael Efrat, *supra* note 1, at 91.

³⁶ *Id.*, at 92.

³⁷ *Id.*, at 96.

³⁸ *Id.*, at 98.

³⁹ *Id.*, at 81 & 108; see also Lencho Tadesse, *supra* note 5, at 69-70.

⁴⁰ Thomas H. Jackson, *The Fresh Start Policy in Bankruptcy Law*, 98 HARV. L. REV., 1393(1985), at 1393.

⁴¹ See Charles J. Tabb, *supra* note 20, at 351; see also Douglas R., *Bankruptcy Revision: Procedure and Process*, 53 N.C.L. REV. 1197 (1974-1975), at 1200; see also DAVID G. EPSTEIN ET AL, *BANKRUPTCY, PRACTITIONER TREATISE SERIES*, West Publishing Co., (1992), at 12-13.

⁴² See John M. Czarnetzky, *The Individual and Failure: A Theory of Bankruptcy Discharge*, 32 ARIZ. ST. L.J. 393 (2000), at 400.

⁴³ See Charles J. Tabb, *supra* note 20, at 333.

⁴⁴ *Id.*, see also Malhotra, Vibhooti, *supra* note 20, at 7; Margaret Howard, *supra* note 27, at 1049.

⁴⁵ See Margaret Howard, *supra* note 27, at 1049; see also DOUGLAS G. BAIRD, *ELEMENTS OF BANKRUPTCY*, The Foundation Press, (2010), at 37.

⁴⁶ See Charles J. Tabb, *supra* note 20, at 334.

traders. Second, voluntary bankruptcy was not put in place and it hampered the possibility of getting discharge.⁴⁷

The use of credit by individuals was a condemned act that remedy of forgiveness was not available.⁴⁸ Rather, the use of credit and accompanying risk was accepted by the society and the remedy for failure was available for merchants only.⁴⁹ Even for the merchants, the full utilization of the remedy was impacted by the fact that there existed only creditor-triggered bankruptcy, i.e., involuntary bankruptcy.⁵⁰ The consent of the creditor was also necessary for discharge.⁵¹ This requirement was abolished later in 1883⁵² and replaced by courts' discretion either to grant or deny discharge.⁵³ In addition, the application of discharge was not automatic and should be raised as a defense by the debtor when approached by the creditor seeking repayment.⁵⁴ All these reveal that the then English law of discharge was intended to help creditors' collection efforts and not to release the debtors as its objective. This, however, was an important development and shift from a barbarous treatment to a more humane view of the debtors. This move was followed by the recognition of consumer into the realm of bankruptcy in 1861 and voluntary bankruptcy for merchants.⁵⁵

The United States first bankruptcy Act, the 1800 Act, was not different from its English parent. Consumers were not recognized in the bankruptcy system; bankruptcy was involuntary, and discharge was not automatic as in English law.⁵⁶ Bankruptcy with debtor protection as its objective came only after the 1841 Act.⁵⁷ Though with creditors' consent, voluntary bankruptcy was allowed for the first time and scope of bankruptcy was extended to non-traders.⁵⁸ This pro-debtor attitude later resulted in different reforms that favored the debtor to a certain extent. Invoking discharge, as an affirmative defense by the debtor, was abolished

⁴⁷ *Id.*, at 334-336.

⁴⁸ *Id.*, at 335.

⁴⁹ *Id.*, See G. Stanley Joslin, *supra* note 4, at 189.

⁵⁰ See Charles J. Tabb, *supra* note 20, at 336.

⁵¹ *Id.*, at 337 & 339.

⁵² *Id.*, at 354 & 357.

⁵³ *Id.*, at 363.

⁵⁴ *Id.*, at 340-343.

⁵⁵ See Charles J. Tabb, *supra* note 20, at 354.

⁵⁶ *Id.*, at 345-346. As it was in English law, in order to benefit from discharge the debtor has to pay substantial percentage of the debt, get confirmation from the commissioners and finally the consent of the creditor.

⁵⁷ *Id.*, at 349.

⁵⁸ See Charles J. Tabb, *supra* note 20, at 349-350, see also Charles J. Tabb, *supra* note 15, at 17.

and it became the duty of the creditor to file dissent.⁵⁹ Another change was, although creditors' consent for discharge remained in operation, the majority vote required in favor of consenting for discharge was reduced.⁶⁰ The debtor was also granted right of appeal against denial of discharge for the first time.⁶¹ This right of appeal was the result of the availability of discharge to all persons - individuals and businesses and expanded grounds of denial of discharge.⁶² Subsequent amendment to the 1841 Act, i.e. the 1867 Act, made discharge very difficult to obtain because there existed several grounds of denial.⁶³

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

⁵⁹ See Charles J. Tabb, *supra* note 20, at 351-352.

⁶⁰ *Id.*, at 352. In the 1800 ACT the requirement was that two-third vote in favor of discharge. But this was changed to simple majority, in number and value, in the 1841 Act.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.* at 356-358. No discharge will be granted or will not be valid if granted, when the debtor sworn falsely, concealing estate, cause/permit destruction of estate, destroyed, falsified or mutilated books and accounts, made fraudulent conveyance, payment or gift, etc.

⁶⁴ *Id.*, at 364.

⁶⁵ *Id.*, at 364.

⁶⁶ *Id.*, at 364-365.

⁶⁷ *Id.*, at 365.

⁶⁸ *Id.*, at 366.

⁶⁹ See John M. Czarnetzky, *supra* note 42, at 425-426.

⁷⁰ See Charles J. Tabb, *supra* note 20, at 368. The exceptions were debts based on taxes, fraud, or obtaining property by false pretenses, willful and, malicious injuries, unscheduled claims and fiduciary misconduct

debtors were using the bankruptcy law as an escaping mechanism of their obligation while they could have paid their obligation out of their future income.⁷¹

As it is discussed earlier under Section 1.1, the first use of proper bankruptcy law was a means of debt collection and equitable distribution among creditors.⁷² Even discharge introduced at the earliest point of the invention of the concept was as a means of securing the cooperative hand of the debtor in the debt collection process⁷³ and discharge was just a kind of incentive for that. Later in the 20th century, however, the philosophy in bankruptcy discharge was changed to a relief to “honest but unfortunate debtors”.⁷⁴ This doctrine of discharge of debts of “honest but unfortunate debtor” was articulated in *Local Loan Co. v. Hunt*.⁷⁵ Accordingly, the debtor started to be released from pre-petition debts he incurred. Any asset acquired or income earned after bankruptcy petition could not be attached to the claims of the creditor.

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

At the end of 19th century and beginning of 20th century, debtor protection and relief became the corner stone of the consumer bankruptcy system. Accordingly, discharge became and is one of the means to give such protection. Further reforms to bankruptcy discharge and fresh start were motivated by the need to protect consumers who are overwhelmed by the availability and complexity of the credit market in particular and trade in general.⁷⁶ This was justified on the idea of protecting the weaker party, which other social security systems failed to address adequately.⁷⁷ In most cases, it is consequential that discharge and fresh

⁷¹ See generally Irving A. Breitowitz, *New developments in Consumer Bankruptcy: Chapter 7 Dismissal on the Basis of Substantial Abuse*, 59 AM. BANKR. L.J. 327 (1985).

⁷² Douglas R., *The Bankruptcy Discharge: Towards A Fresher Start*, 58 N.C. L. REV. 723 (1979-1980), at 724 & 893; see also Douglas R, *supra* note 41, at 1200.

⁷³ Douglas R, *supra* note 72, at 724 & 893.

⁷⁴ *Id.*

⁷⁵ See Charles J. Tabb & Ralph Brubaker, *supra* note 7, at 479-80.

⁷⁶ See Vibhooti, *supra* note 20, at 4; see also Douglas R, *supra* note 41, at 1202.

⁷⁷ See Douglas R, *supra* note 41, at 1202-1203.

start is available to individuals and not businesses.⁷⁸ Discharge is not any more a debt collection mechanism. It is justified out of several reasons that are not necessarily protecting the creditor.

C. Justifications for Discharge and Fresh Start

The philosophy of bankruptcy law that admitted individual debtors to its scope has to be backed by strong justifications. It is against State collection law that requires debtors to fulfill their obligations. Discharge is an exception to the conventional norm of repaying one's debt. And as an exception, it needs overwhelming justifications.⁷⁹ Different scholars have tried to provide answer for this problem. To this effect, they came up with justifications such as bankruptcy discharge as a debt-collection device,⁸⁰ incentive of debtor cooperation in the debt collection process,⁸¹ incentive towards entrepreneurship and risk taking,⁸² social insurance,⁸³ development policy,⁸⁴ debtors' rehabilitation tool to keep him/her as a productive member of the society,⁸⁵ relief for honest but unfortunate debtors,⁸⁶ societal act of forgiveness,⁸⁷ correction of human weakness,⁸⁸ reducing moral hazard in connection with lending⁸⁹ and consumer protection,⁹⁰ etc. But comprehensive legal research on the normative justifications on why discharge is

⁷⁸ See Vibhooti, *supra* note 20, at 7.

⁷⁹ See Margaret Howard, *supra* note 27, at 1047-1048.

⁸⁰ Douglas J Baird, *A world Without Bankruptcy*, 50 L. & CONTEMP. PROBS.173 (1987), at 183-184.

⁸¹ See John M. Czarnetzky, *supra* note 42, at 395-96.

⁸² See generally, Seung-Hyun Lee & Mike W. Peng, *Bankruptcy Law and entrepreneurship Development: A Real Option Perspective*, 32 ACADEMY OF MANAGEMENT REVIEW, 257(2007), 257-272; see generally Wei Fan & Michelle J. White, *Personal Bankruptcy and The Level of Entrepreneurial Activity*, 46 J. L. & ECON. 545 (2003), at 545-567.

⁸³ See generally, Adam Feibelman, *Defining the Social Insurance Function of Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129 (2005), at 129-186; see also Todd J Zywick, *An Economic Analysis of consumer Bankruptcy Crisis*, 99 NW. U. L. REV.1463 (2005), at 1473; See Douglas J Baird, *supra* note 83, at 175; see also Barry Adler *et al*, *Regulating Consumer Bankruptcy: Theoretical Inquiry*, 29 J. LEGAL STUD.585 (2000), at 587.

⁸⁴ See generally, Adam Feibelman, *supra* note 2.

⁸⁵ See Douglas J Baird, *supra* note 83, at 176; see also John M. Czarnetzky, *supra* note 42, at 396; see Douglas R., *supra* note 72.

⁸⁶ See Todd J Zywick, *supra* note 83, at 1471.

⁸⁷ See John M. Czarnetzky, *supra* note 42, at 395-396.

⁸⁸ *Id.*

⁸⁹ See Barry Adler *et al*, *supra* note 83, at 608.

⁹⁰ See Ramsay, Iain D. C, *supra* note 10, at 262-263.

becoming an important part of consumer bankruptcy law is lacking.⁹¹ Most of the existing literatures reviewed in this article also confirm this fact. Despite the overwhelming effort scholars have dedicated, comprehensive normative justification is far from being achieved.⁹² Different scholars rather try to justify it from the perspectives they see it better justified.

The above justifications are not features of consumer bankruptcy laws of every jurisdiction. In any legal system, one or a combination of some of them may be the justifications of the consumer bankruptcy system.⁹³ The decision to adopt consumer bankruptcy differs across jurisdictions based on the socio-economic and political structures of a given country. The bottom line, however, is that many jurisdictions that restricted their bankruptcy to traders only are shifting their philosophy to include consumer bankruptcy and fresh start.⁹⁴ This move has its backing from one or several of the above justifications.

The next discussion is dedicated to the review of these theoretical justifications forwarded to back the need for discharge and fresh start in consumer bankruptcy.

1. Entrepreneurial Analysis

Consumer bankruptcy with discharge and fresh start has something to do with an entrepreneurship. One's bankruptcy system shapes (is shaped) the (by) entrepreneurship culture of a given jurisdiction. Some scholars argue that discharge and fresh start increases the level of entrepreneurial activity.⁹⁵ According to them, access to credit coupled with availability of filing for discharge gives individuals an incentive to go for business.⁹⁶ Individuals will be encouraged to take risks. The level of entrepreneurial activity will be good in jurisdictions where there is room for individuals in bankruptcy legislations and where the same provides for higher personal exemption levels.⁹⁷ This is because, according to those scholars, consumer bankruptcy with discharge and fresh start gives entrepreneurs 'partial wealth insurance'.⁹⁸

⁹¹ See Thomas H. Jackson, *supra* note 40, at 1394; see also John M. Czarnetzky, *supra* note 42, at 393.

⁹² *Id.* Thomas H. Jackson, at 1394; John M. Czarnetzky, at 394.

⁹³ See Margaret Howard, *supra* note 27, at 1087-88.

⁹⁴ See Rafael Efrat, *supra* note 1, at 108-109.

⁹⁵ See generally Wei Fan & Michelle J. White, *supra* note 85.

⁹⁶ *Id.*, at 547 & 552.

⁹⁷ *Id.*, at 563.

⁹⁸ *Id.*, at 547 & 552.

It is a blunt fact that entrepreneurship and investing in new venture involves risk-taking. Stated otherwise, if investors are punished for failure too heavily, they will be hesitant to take risk.⁹⁹ The risk may be exacerbated by the unlimited liability their unincorporated startup could bring if it is not successful.¹⁰⁰ The market place should be convenient for learning from mistakes and that environment will help us get the best entrepreneurs.¹⁰¹ Individuals' incentive to take such risk and foster their entrepreneurial activity can be motivated by generous discharge and fresh start. Studies show that pro-entrepreneurship jurisdictions have generous debt forgiveness while jurisdictions where investment and entrepreneurial activities are limited have tight bankruptcy rules with less or no discharge and fresh start.¹⁰² Fresh start has a direct positive impact on entrepreneurial activity.¹⁰³ The availability of discharge and the time it will take to obtain discharge are very important in this regard.¹⁰⁴ When generous discharge is available and it is automatic or can be obtained in a short time, it has good signal for entrepreneurs. The release of "honest but unfortunate debtors" will hurt creditors for sure, but the aggregate gains from entrepreneurship are higher than losses to the creditors.¹⁰⁵

The assertion that consumer bankruptcy with meaningful discharge is pro-entrepreneurship is neither a well-recognized theory nor there is clear evidence of a bankruptcy system crafted based on the assertion.¹⁰⁶ But empirical studies of consumer bankruptcy show that the 'entrepreneurial analysis' is consistent with the assertion.¹⁰⁷ Of course, it is logical that when failure is not punished severely, there will be enthusiasms for entrepreneurship. There is, however, a legitimate concern that generous discharge may increase interest rates. Yet, studies show that fresh start encourages entrepreneurship.¹⁰⁸ It is, therefore, quite possible for countries to

⁹⁹ John Armour & Douglas Cumming, *Bankruptcy Law and Entrepreneurship*, 10(2) AMERICAN LAW AND ECONOMICS REVIEW, 303-350 (2008), at 4; *see also* John M. Czarnetzky, *supra* note 42, at 398-399.

¹⁰⁰ *See* Rafael Efrat, *supra* note 1, at 98-99.

¹⁰¹ John M. Czarnetzky, *Time, Uncertainty and The Law of Corporate Reorganizations*, 67 FORDHAM L.REV. 2939 (1999) *as cited in* John M. Czarnetzky, *supra* note 42, at 405.

¹⁰² Rafael Efrat, *supra* note 1, at 98-99.

¹⁰³ John Armour and Douglas Cumming, *supra* note 102, at 6.

¹⁰⁴ *Id.*, at 7.

¹⁰⁵ *See* John M. Czarnetzky, *supra* note 42, at 414.

¹⁰⁶ *Id.*, at 448.

¹⁰⁷ *Id.*, at 414.

¹⁰⁸ Frank M. Fossen, *Personal Bankruptcy Law Wealth and Entrepreneurship-Theory and Evidence from the Introduction of "Fresh Start"*, German Socio-Economic Panel Study (SOEP) (2011), at 28.

consider their bankruptcy law while dealing with their entrepreneurship policy. The more generous and predictable bankruptcy discharge is, the more entrepreneurship will be enhanced. Studies also show that bankruptcy discharge and fresh start stimulates self-employment.¹⁰⁹

2. *Social Insurance Function*

Consumer bankruptcy is also justified out of the social insurance function it provides.¹¹⁰ Proponents of this view see bankruptcy as a cure for capitalist state that has either abandoned or cut its welfare activities.¹¹¹ Indebtedness is not voluntary and different circumstances contribute for failure to pay one's debt.¹¹² Losses of job, illness of the individual or his/her family, divorce, and business failures are some of the circumstances that will force someone into financial distress.¹¹³ The financial distress out of such changed circumstances is responsible for the increase in consumer bankruptcy cases in United States.¹¹⁴ Conventionally, such problems are dealt with under unemployment insurance, health insurance or other social assistance provided by the government based on the need. But the above insurances are private ones and may be unavailable because of market failure. In a system where social insurance is unavailable or otherwise inadequate, bankruptcy discharge can be a substitute.¹¹⁵ This, however, is not a complete substitute and is only applicable to certain cases such as for unsecured debt.¹¹⁶ A bankruptcy system that provides discharge and fresh start for unsecured debt can

¹⁰⁹ See John Armour and Douglas Cumming, *supra* note 102, at 18.

¹¹⁰ TERESA A. SULLIVAN, ELIZABETH WARREN & JAY WESTBROOK, *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* 3-5 (2000) as cited in Admam Feibelman, *supra* note 86, at 130; see Todd J Zywick, *supra* note 83, at 1473; see also BARRY E. ADLER ET AL, *BANKRUPTCY CASES, PROBLEMS AND MATERIALS*, Foundation Press (2007), at 560.

¹¹¹ See Ramsay, Iain D. C., *Individual Bankruptcy: Preliminary Findings on Socio-Legal Analysis*, 37 *OSGOODE HALL L. J.* 15 (1999), at 17.

¹¹² *Id.* at 22; see also Todd J Zywick *supra* note 83, at 1473.

¹¹³ *Id.* Ramsay, Iain D. C at 22; Todd J Zywick, 1473; see also Robert Anderson *et al (ed.) supra* note 6, at 7.

¹¹⁴ See Todd J Zywick, *supra* note 83, at 1473-1474: There are studies that show that medical costs are, partly, responsible for the rise in personal bankruptcy filings in United States. This is because United States has the weakest safety net programs for its citizens. In Europe where there are several safety net programs the bankruptcy filing rate is lower, significantly, to that of United States. For more information see generally, Sarah Emami, *Consumer Over-indebtedness and Health care Costs: How to Approach the Question from a Global Perspective*, (World Health Report 2010, A back Ground paper No-3), Available at <http://www.who.int/healthsystems/topics/financing/healthreport/3BackgroundPaperMedBankruptcy.pdf?ua=1>, (last visited on 12 March 2014).

¹¹⁵ See Admam Feibelman, *supra* note 83, at 132.

¹¹⁶ *Id.*, at 141.

replace the social insurance function. This is the limitation of bankruptcy discharge unlike other social insurance tools.

Studies show that bankruptcy system with adequate pre-petition discharge of debts can be justified out of social insurance (welfare) functions against some financial difficulties that may arise from loss of job, divorce, sickness, etc.¹¹⁷ There appears to exist a direct relationship between the design of social insurances and bankruptcy system.¹¹⁸ The more generous the bankruptcy discharge is, the less social safety net programs are available and vice versa.¹¹⁹ The United States bankruptcy law fits into this formulation.¹²⁰ The bankruptcy system is generous enough to allow troubled debtors to see their debt wiped-out against surrender of non-exempt assets; the social safety net programs are, however, less extensive.¹²¹

The conclusion that can be drawn from the discussion made so far is that where welfare activities of the government are limited, individuals will opt to credit.¹²² This will expose individuals for financial troubles.¹²³ This vulnerability is dealt with in some jurisdictions under their bankruptcy law that provides generous relief.¹²⁴ Welfare states have less bankruptcy filings compared to states that do not have significant welfare programs.¹²⁵ Hence, the more welfare state a government is the less debt forgiveness available in the bankruptcy law and vice versa.

3. *Deregulation of Consumer Credit*

The availability of consumer credit is another reason for adopting consumer bankruptcy system¹²⁶ with generous discharge and fresh start. There are evidences that countries have liberalized their discharge rules after deregulation of consumer credit.¹²⁷ Access to consumer credit will make it possible for individuals to finance their own startups or pursue self-employment;¹²⁸ improve demand for products in

¹¹⁷ *Id.*, at 185-186; *see also*, Douglas R, *supra* note 41, at 1203 as cited in Douglas R, *supra* note 72, at 724.

¹¹⁸ *See* Admam Feibelman, *supra* note 83, at 185-186.

¹¹⁹ *See* Rafael Efrat, *supra* note 1, at 82-91 (2002) as cited in Admam Feibelman, *supra* note 83, at 184.

¹²⁰ Admam Feibelman, *supra* note 83, at 142.

¹²¹ *See* Rafael Efrat, *supra* note 1, at 82-91 (2002) as cited in Admam Feibelman, *supra* note 83, at 184.

¹²² *Id.*, at 102-104.

¹²³ *Id.*, at 96-97.

¹²⁴ *Id.*

¹²⁵ *Id.*, at 103-104.

¹²⁶ *See* G. Stanley Josling, *supra* note 4, at 189.

¹²⁷ *See* Rafael Efrat, *supra* note 1, at 92-93.

¹²⁸ *See* Adam Feibelman, *supra* note 2, at 66.

the market; smooth consumption across income gaps, reduces income shocks¹²⁹ and increases consumption of some “discretionary goods” (food, health care, education, transportation etc.), which can be considered as indicators of development.¹³⁰ But it will be a source for competition in consumer lending industry, which will expose individuals to huge risks and then to over-indebtedness.¹³¹ These risks are dealt by those jurisdictions by adopting debt forgiveness provisions in their consumer bankruptcy rules.¹³² In jurisdictions where there is strict regulation of consumer credit, there is less relief from bankruptcy discharge.¹³³ This is because individuals’ access to credit is very restricted and consequently exposed to less risk than in countries where consumer credit is easily accessible.

4. Consumer Bankruptcy as a Development Policy

There are also arguments that adoption of consumer bankruptcy with automatic discharge contributes to public development policy. They argue that, consumer bankruptcy will potentially create efficient consumer finance market while solving the problem of over-indebtedness.¹³⁴ According to this line of argument, well-crafted consumer bankruptcy system benefits both creditor and debtor. The debtor will have an opportunity to finance businesses or ideas that are worth put into market. Creditors are also compensated for the consequences of discharge in the form of high interest rates.¹³⁵ It will also solve the collective action problem, as it does in corporate bankruptcy, among creditors.¹³⁶ Coordinated collective action among creditors will increase probability of getting paid.¹³⁷ On the contrary, race to the debtor’s assets, under non-bankruptcy law, may hurt the debtor and incapacitate his ability to earn in the future.¹³⁸ So, consumer bankruptcy law, with adequate discharge and fresh start, may help promote consumer financial market.¹³⁹

¹²⁹ *Id.*, at 66 & 75-76.

¹³⁰ *Id.*, at 75.

¹³¹ *Id.*, at 66.

¹³² See Rafael Efrat, *supra* note 1, at 92-93.

¹³³ *Id.*, at 92-94.

¹³⁴ See Adam Feibelman, *supra* note 2, at 89-90, 104.

¹³⁵ *Id.*, at 92.

¹³⁶ *Id.*, at 92-93.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

5. *Rehabilitating the Debtor*

Another most important justification for consumer bankruptcy and discharge is to keep the bankrupt individual as a productive member of the society.¹⁴⁰ It is a rehabilitation and reintegration of an individual to the society. If the individual bankrupt is discharged from part or whole of his/her debt, he will have an incentive to earn income and own property in the future.¹⁴¹ The income is shielded, in whole or in part, from the reach of creditors¹⁴² and psychologically, the debtor will get relief from the distress out of the indebtedness.¹⁴³ That is a huge incentive to start life afresh as a productive member of the society.¹⁴⁴ Therefore, treating debtors harshly because they failed to pay their debt will make things more complicated. Otherwise, the bankrupt individual may engage in different undesirable activities such as dependence on someone or engage in crimes that lead to social problems.

6. *Human Act of Forgiveness*

Bankruptcy discharge is also seen as a human act of forgiveness and rehabilitation of the debtor.¹⁴⁵ This is what is called “*humanistic view*” of consumer bankruptcy.¹⁴⁶ According to this view bankruptcy is a real problem affecting real people as opposed to people the neo-classical economists talking about. It rejects the hypothetical people and assumptions that economists use in order to understand the market.¹⁴⁷ According to this view, real persons are not simply self-interested profit maximizers but they are also highly concerned about the wellbeing of others.¹⁴⁸ “*Humanistic view*” of ‘fresh-start’ justification values people more than the money.¹⁴⁹ This view takes ‘humanity’ as essential element in bankruptcy discharge policy and not simply an incidental element to be considered when pursuing another end.¹⁵⁰ Accordingly, this view has its backing from biblical reasons than economic justifications.

¹⁴⁰ *Id.*, at 92.

¹⁴¹ See Margaret Howard, *supra* note 27, at 1062.

¹⁴² See Adam Feibelman, *supra* note 2, at 92.

¹⁴³ See Rendleman, Douglas R, *supra* note 72, at 726.

¹⁴⁴ See John M. Czarnetzky, *supra* note 42, at 415.

¹⁴⁵ See generally Susan Block-Lieb, Book Review: *A Humanistic Vision of Bankruptcy Law*, 6 AM. BANKR. INST. L. REV. 471 (1998), at 471-493, reviewing “KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM” (Yale University Press 1997).

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*, at 473 & 486-487.

¹⁴⁸ *Id.*, at 473.

¹⁴⁹ *Id.*, at 477.

¹⁵⁰ *Id.*, at 477.

Another economic justification for “*non-waivable*” right to fresh-start is based on the theory of risk allocation.¹⁵¹ The idea is that one in a better position to avoid the risk should be able to bear it.¹⁵² Accordingly, the law has to choose one victim out of two innocents and it has to be the creditor. But this justification does not escape from criticism because, according to some scholars, it is not possible to identify with certainty the superior risk bearer.¹⁵³

The discussion made so far shows some of the socio-economic and political justifications forwarded to back why doctrine of discharge in consumer bankruptcy law is becoming an important policy tool. A consumer bankruptcy regime in any jurisdiction will have its theoretical underpinning in one or more of the justifications discussed above. These justifications are benefits of well-crafted consumer bankruptcy law. However, there are costs consumer bankruptcy will bring to different stakeholders such as the creditor, the state and the community. The following section is dedicated to point out those pitfalls the doctrine of discharge in consumer bankruptcy law.

D. Costs of Consumer Bankruptcy

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

Consumer bankruptcy provides a solution. It provides a mechanism by which all the non-exempted assets, such as expensive musical instruments unless the debtor is a musician, collections of stamps, coins, and other valuable items, family heirlooms, cash, bank accounts, stocks, bonds, a second car, second home, etc., of the debtor will be liquidated and paid to the creditors and the debtor will be set free and starts life afresh. So it serves both the debtor and the creditor. The debtor will be freed of his pre-bankruptcy obligations and creditors will be treated equitably avoiding the problem of race among themselves.

¹⁵¹ See Thomas H. Jackson, *supra* note 40, at 1398-1401.

¹⁵² *Id.*

¹⁵³ *Id.*

But there are certain costs the creditor, the society and the state have to bear. And this is the “*bitter-sweet paradox*” of consumer bankruptcy. The release of the debtor comes at a huge cost to those stakeholders. The first criticism of consumer bankruptcy is that creditors’ return is exposed to the risk of discharge.¹⁵⁴ Generous consumer bankruptcy law that releases debtors from their obligation will hurt creditors. In consumer bankruptcy, creditors, more likely, will see the debtor *walk-off* without paying a penny. This will also affect the institution of contract and principle of freedom of contract. Bankruptcy as a ‘debt collection tool’ is not true, at least in most cases, because consumer debtors usually do not have assets left.¹⁵⁵ Studies show that most of the consumer bankruptcies in the United States are based on *Chapter 7*¹⁵⁶ and the same do not distribute any asset to unsecured creditors.¹⁵⁷ It is also true in Germany that most plans do not pay creditors and debtors are seen *walk-off* free.¹⁵⁸ Moreover, discharge policy is not intended to solve the creditors’ collection problem.¹⁵⁹ It is intended for the debtor and debtor only. This will hurt creditors by reducing their return.

The availability of generous discharge in consumer bankruptcy also makes credit very expensive for debtors. The creditors will increase the premium charging high interest rates for the credit they provide.¹⁶⁰ There will be reaction from lenders in the form of increasing the rate of interest to *offset* the losses because there is less chance of repayment.¹⁶¹ This will affect the credit market by making credit expensive or limiting its availability.¹⁶² There will also be direct cost on the particular individual debtor whose access to credit will be limited or just come at

¹⁵⁴ See Adam Feibelman, *supra* note 2, at 68.

¹⁵⁵ See Richard M. Hynes, *Why (Consumer) Bankruptcy?* 56 ALA. L. REV. 121 (2004/5), at 123.

¹⁵⁶ See Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Law and a Proposal for Change*, 65 U. CHI. L. REV. 685 (1998), at 688.

¹⁵⁷ See Richard M. Hynes, *supra* note 155, at 123 & 129.

¹⁵⁸ Jason J. Kilborn, *The Innovative German Approach to Consumer Debt Relief: Revolutionary Changes in German Law, and Surprising Lessons for the United States*, 24 NW. J. INT’L L. & BUS. 257 (2003/4), at 278-79; see also JOHANNA NIEMI ET AL, *supra* note 3, at 336.

¹⁵⁹ THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW*, Beard Books (2001), at 225.

¹⁶⁰ Michelle J. White, *Economic Analysis of Corporate and Personal Bankruptcy*, (NBER Working Paper Series, at 64), available at <http://www.nber.org/papers/w11536.pdf> (last visited on 29 March 2014); see Adam Feibleman, *supra* note 2, at 92; Adam Feibelman, *supra* note 83, at 171.

¹⁶¹ See Frank M. Fossen, *supra* note 112, at 28.

¹⁶² See Michelle J. White, *supra* note 164; see Adam Feibelman, *supra* note 83, at 171.

high cost.¹⁶³ But it can be argued against it in that the debtor who has no creditors anymore because of discharge can find it easy to get credit.¹⁶⁴ There are also other costs on the individual bankrupt debtor. In order to get discharge he has to give up all his non-exempt assets to the creditor. The creditor and the debtor may value such assets differently and when it means so much for the debtor than the creditor then that is the cost the debtor has to bear.¹⁶⁵

The other concern is that the failure of debtors to repay their debt will hurt financial markets. There are studies, however, that show on comparison the benefits of discharge outweigh the costs of making entrepreneurial activity smooth.¹⁶⁶ Social Insurance benefits of consumer bankruptcy also outweigh the costs of increased interest rates.¹⁶⁷ Two other problems associated with the insurance analogy of consumer bankruptcy are moral hazard and adverse selection problems.¹⁶⁸ According to this view, knowing that s/he will file for bankruptcy discharge, individuals may be reckless in loan and spending decisions. And the customers of this insurance are those who are most likely to fail to repay; adverse selection problem.¹⁶⁹ But the reputation and stigma associated with being bankrupt will work against the moral hazard problem.¹⁷⁰ That means even with discharge and fresh start; individuals will lose so much when they go bankrupt.¹⁷¹ Reputation, the inconvenience of getting registered as bankrupt and inability to get further loans, etc., will work as a counter-incentive against moral hazard.

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

¹⁶³ See Michelle J. White, *supra* note 19, at 211; see Michelle J. White, *supra* note 156, at 691; see Thomas H. Jackson, *supra* note 40, at 1426-1427; see BARRY E. ADLER *ET AL*, *supra* note 110, at 560.

¹⁶⁴ See BARRY E. ADLER *ET AL*, *supra* note 110.

¹⁶⁵ See Thomas H. Jackson, *supra* note 40, at 1427.

¹⁶⁶ See Frank M. Fossen, *supra* note 112.

¹⁶⁷ *Id.*

¹⁶⁸ See BARRY E. ADLER *ET AL*, *supra* note 110.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*, at 561.

¹⁷¹ *Id.*

Stigma is another cost the bankrupt individual has to bear¹⁷² while using consumer bankruptcy. Even in United States, failure to pay one's debt is still seen as immoral and stigmatized though the degree of stigma is less now than it used to be.¹⁷³

III. CONSUMER BANKRUPTCY LAWS IN UNITED STATES AND GERMANY

In this section the laws and experiences of United States and Germany will be discussed. The comparative discussion of the two systems is justified out of the following reasons. Firstly, the two leading countries with contrasting fresh start policy are chosen to see the strengths and weaknesses of each system with a view of finding a suitable fit for Ethiopia. Secondly, these countries' laws have been also major legal exports to different countries in the world.

A. Consumer Bankruptcy Law in United States

In United States individual debtors have two options while considering filing for consumer bankruptcy: Chapter 7 or Chapter 13.¹⁷⁴ The most important benefit associated with consumer bankruptcy, under both chapters, is the benefit of discharge and thereby fresh start.¹⁷⁵ Unless the debtor committed any of criminal acts of bankruptcy (fraud, concealment etc.), the debtor, as a rule, will be released of his obligation to repay.¹⁷⁶ Under Chapter 7 the debtor has to surrender all assets in excess of the relevant exemption level; the trustee liquidates the assets, pay the creditors and debtor *walk-off*.¹⁷⁷ No creditor can ask for repayment from the debtor after bankruptcy. There will also be benefit of automatic stay soon after the debtor petitioned for bankruptcy. Consumer bankruptcy under Chapter 7 is counterpart to that of business liquidation, also known as straight bankruptcy.

¹⁷² See Michelle J. White, *supra* note 156, at 691.

¹⁷³ See BARRY E. ADLER *ET AL*, *supra* note 110.

¹⁷⁴ See Robert H. Scott, III, *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: How the credit Card Industry's Preservance paid off*, 41 J.ECON. ISSUES, 943 (2007) at 944; see Elijah M. Alper, *Opportunistic Informal Bankruptcy: How BAPCPA May Fail to Make Wealthy Debtors Pay Up*, 107 COLUM. L. REV. 1908 (2007), at 1913.

¹⁷⁵ See THOMAS H. JACKSON, *supra* note 159; see Carl Felsenfeld, Denial of discharge for Substantial abuse: refining-Not Changing Bankruptcy law, 67 FORDHAM L. REV. 1369 (1999), at 1369-1370.

¹⁷⁶ THOMAS H. JACKSON, *supra* note 159.

¹⁷⁷ See Robert H. Scott, III, *supra* note 174.

Chapter 13 is about adjustment of debts of an individual with regular income.¹⁷⁸ The debtor will put a plan to the creditors based on what s/he earns and the amount s/he need for living. The debtor will pay creditors according to the plan out of the disposable income for a certain period of time (3-5 years); then, he will be discharged.¹⁷⁹ And this is counterpart to that of reorganization in business bankruptcy. Goal of chapter 13 is, hence, rehabilitation of the debtor. Chapter 7 has advantages over chapter 13 and vice versa. Under chapter 7 there is an immediate discharge and the procedure is somehow simple.¹⁸⁰ Chapter 13 requires the debtor to come up with a plan and the debtor has to perform his repayment obligation for a certain period of time.¹⁸¹ Discharge will come after the plan is executed. Chapter 13 will allow the debtor to keep his/her assets while under Chapter 7 such options are not available. Despite this, however, most of the consumer bankruptcy cases are based on chapter 7.¹⁸²

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

1. Chapter 7

Chapter 7 governs the process of liquidation of the debtors’ assets, individual or business, under the United States Bankruptcy Code.¹⁸³ The debtor will give up all his non-exempt assets in exchange for discharge.¹⁸⁴ This is “*non-waiveable*” right for every individual. When filing under Chapter 7, there are two important concepts. The first is automatic stay, which stops any action of the creditor against

¹⁷⁸ See Michelle J. White, *supra* note 19, at 210; see David G. Epstein et al, *supra* note 41, at 13; see Michelle J. White, *supra* note 691.

¹⁷⁹ See Robert H. Scott, III, *supra* note 174.

¹⁸⁰ See Elijah M. Alper, *supra* note 174, at 1914.

¹⁸¹ See Richard H.W. Maloy, “*She’ll Be Able to Keep Her Home Won’t She?*”- *The Plight of a Homeowner in Bankruptcy*, MICH. ST. DCL L. REV. 315 (2003), at 339-40, as cited in Elijah M. Alper, *supra* note 174, at 1914.

¹⁸² See Richard M. Hynes, *Why (Consumer) Bankruptcy?*, 56 ALA. L. REV 121, 127 n.32 (2004), as cited in Elijah M. Alper, *supra* note 178, at 1914.

¹⁸³ 11 UNITED STATES CODE BANKRUPTCY, (*hereinafter*, *Bankruptcy Code*), available at, <http://www.law.cornell.edu/uscode/text/11/chapter-7/subchapter-II> (last visited on 16 March 2014).

¹⁸⁴ See generally Michelle J. White, *supra* note 19, at 205-231; see BARRY ADLER ET AL, *supra* note 83; See Michelle J. White, *supra* note 156, at 687.

the debtor, judicial or extra-judicial.¹⁸⁵ This is temporary order, pending the final decision of the court, which protects the debtor from harassment. The second important concept under Chapter 7 filing is discharge.¹⁸⁶ The exempt assets and future income of the debtor and human capital are shielded from the demand of the creditors.¹⁸⁷ Only debts incurred before the order of relief are subjected to discharge.¹⁸⁸ The individual is not required to give the exempt assets or pay debt out of his future income. Creditor is prohibited from pursuing collection efforts once discharge is granted to the debtor.¹⁸⁹ But that is restricted to the individual's pre-bankruptcy life and not future debts/obligations.

In order to be eligible for a Chapter 7 discharge there are certain conditions that should be fulfilled. The first condition is that only individual debtors are entitled for 'Chapter 7 discharge'.¹⁹⁰ Chapter 7 filing is available for both businesses and individuals but 'discharge' is available only for individuals. Second, the debtor should not commit fraudulent acts such as mutilate, conceal or transfer assets within one year of filing or property of the estate after filing.¹⁹¹ To benefit from discharge, the debtor has to disclose the whereabouts of all his assets and turn them over to the creditors' consideration.¹⁹² This will make sure that no property is hidden from the creditors¹⁹³ and this builds the integrity of the bankruptcy system. Third, unjustified failure by the debtor to keep accounts and record will bar the right to discharge.¹⁹⁴ These include conceal, falsify or destroy documents, engage in any fraudulent act on accounts etc¹⁹⁵ and commission of bankruptcy crimes.¹⁹⁶ Finally, debtor should not have received bankruptcy discharge under chapter 7 within eight years.¹⁹⁷ If the debtor was discharged under Chapter 12 or Chapter 13, he has to wait for six years to file for Chapter 7

¹⁸⁵ See Richard M. Hynes, *supra* note 155, at 129.

¹⁸⁶ *Id.*

¹⁸⁷ See Michelle J. White, *supra* note 19, at 205; See BARRY ADLER *ET AL*, *supra* note 83, at 587; see Thomas H. Jackson, *supra* note 40, at 1396-97; BARRY E. ADLER *ET AL*, *supra* note 110, at 559.

¹⁸⁸ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 482.

¹⁸⁹ See DOUGLAS G. BAIRD, *supra* note 45, at 44.

¹⁹⁰ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 500.

¹⁹¹ *Id.*; see also 11 U. S. C. -Bankruptcy, *supra* note 183, § 727.

¹⁹² See DOUGLAS G. BAIRD, *supra* note 45, at 31.

¹⁹³ *Id.*, at 35.

¹⁹⁴ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 500; the Bankruptcy Code, § 727.

¹⁹⁵ See THE BANKRUPTCY CODE, § 727.

¹⁹⁶ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 500.

¹⁹⁷ See DOUGLAS G. BAIRD, *supra* note 45, p. 37; THE BANKRUPTCY CODE, § 727 (a) (8).

discharge.¹⁹⁸ But this condition does not apply if the debtor files the second case for discharge based on chapter 12 or 13.¹⁹⁹

Moreover, not all debts are dischargeable.²⁰⁰ There are certain debts that are ‘non-dischargeable’²⁰¹ by their nature and the individual whose debt has been discharged is still obliged to pay non-dischargeable debts.²⁰² These ‘non-dischargeable’ debts include taxes and custom duties, those debts obtained by false representations or fraud, domestic support obligations, tort claims, etc. These exceptions fall into two categories²⁰³ and the rationale for ‘excepting’ them is justified out of public policy considerations.²⁰⁴ Most often these debts are obtained by ‘wrongful’ act of the debtor or they are very ‘essential’ for the creditor.²⁰⁵ In the first category, “there is either a ‘moral turpitude’ or intentional wrongdoing on the part of the debtor”.²⁰⁶ And no sensible legal system is willing to bless a debtor who acted with such moral and intent with discharge. Reprehensible and malicious conducts of the debtor need to be discouraged by the denial.²⁰⁷ In the second category, the repayment of the debt, no matter how difficult it will be, is very essential for the creditor. Hence, it is in the interest of the general public that these debts are ‘excepted’ from discharge.²⁰⁸ And creditors are allowed to ask repayment of these non-dischargeable debts, even, after bankruptcy.

Apart from these two exceptions, it is also possible that the debtor may not be given discharge of certain debts. It is a condition precedent that the debtor has to list out all creditors while filing for bankruptcy.²⁰⁹ If s/he failed to do that a

¹⁹⁸ See *the Bankruptcy Code*, *supra* note 183, § 727(a) (9)

¹⁹⁹ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 500.

²⁰⁰ See DOUGLAS G. BAIRD, *supra* note 45, at 46.

²⁰¹ See THE BANKRUPTCY CODE, *supra* note 183, § 523.

²⁰² See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 511.

²⁰³ *Id.*; see also DOUGLAS G. BAIRD, *supra* note 45, at 47.

²⁰⁴ National Bankruptcy Review Commission, Discharge, Exceptions To Discharge, And Objections To Discharge; <http://govinfo.library.unt.edu/nbrc/report/07consum.html> last visited on 8th March 14

²⁰⁵ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 511.

²⁰⁶ See *infra* note 208.

²⁰⁷ See DOUGLAS G. BAIRD, *supra* note 45, at 48.

²⁰⁸ These includes unscheduled debts, certain taxes, debts for spousal or child support, debts to government, student loans, debts for personal injury caused by the debtor’s operation of a motor vehicle while intoxicated etc.

²⁰⁹ See DOUGLAS G. BAIRD, *supra* note 45, at 46.

creditor who is not notified of the proceeding and did not share in the assets will not see his claim discharged.²¹⁰

Fresh start from Chapter 7 discharge in United States has two sources.²¹¹ The first source is from section 727 of the Bankruptcy Code.²¹² It states that the individual debtor who gives up his/her assets will be discharged and creditors cannot encroach into future income or assets of that debtor.²¹³ The second source for fresh start is section 522 plus state and federal non-bankruptcy laws.²¹⁴ These second sources allow the individual certain level of exempted property.²¹⁵ Hence, future income and exempted property constitute fresh start.²¹⁶ Care must be taken, however, that policy of consumer bankruptcy law is financial fresh start for the debt-troubled individual shielding the future income (fruits of labor) and not to protect his/her wealth.²¹⁷ Exemption is an exception to the creditors' right to the assets of the individual debtor. Issue of exemption is left for states and this also can show that it is not the core policy of United States bankruptcy law.²¹⁸

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

There are also problems associated with consumer bankruptcy. The discharge available will inevitably create ground for dishonest debtors to abuse the system. To tackle such abuse the United States bankruptcy law provides certain rules to make sure of the integrity of the system. The system starts by making some debts non-dischargeable.²¹⁹ When the debtor acted out of "moral turpitude" then discharge is denied. When the debtor acted fraudulently and transfers or conceals a

²¹⁰ *Id.*

²¹¹ See BARRY E. ADLER ET AL., *supra* note 110, at 565.

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ See THOMAS H. JACKSON, *supra* note 159, at 254-255.

²¹⁸ *Id.*

²¹⁹ See § 523 of THE BANKRUPTCY CODE, *supra* note 183.

property s/he cannot obtain discharge.²²⁰ Additionally, there is a limitation of time within before the lapse of which the debtor cannot go for another petition under chapter 7. If s/he has to file for a chapter 7 case again, s/he has to wait for eight years period.²²¹ Of course, it works to the debtors' favor as well. It will be easy for the debtor to get credit but creditors can also chase the debtor for payment before he can file for bankruptcy.²²²

There are also rules that prevent the debtor from abusing the system as a tactic to delay creditor's collection efforts.²²³ The debtor, once s/he files for bankruptcy, has to provide all the necessary information or risk dismissal of her/his case.²²⁴ There is doubt on this rule that it may work in favor of the debtor who wanted to avoid bankruptcy against creditors will by failing to provide the information required.²²⁵ But the writer thinks, in consumer bankruptcy case, especially Chapter 7, that where the creditor is not usually paid, there is no incentive for the debtor to go that way and does not have potential harm to the creditor.

The debtor education and credit counseling introduced under the 2005 Bankruptcy Abuse and Consumer Protection Act²²⁶ is also another way to keep the integrity of the bankruptcy system. All individual debtors, no matter which chapter they use, have to take credit counseling and debtor education before and after filing bankruptcy respectively. It is compulsory requirement²²⁷ to qualify as a debtor within the meaning of the Bankruptcy Code. The credit-counseling course should be taken 180 days before filing for bankruptcy.²²⁸ The course will help the debtor in organizing a plan of payment even without filing for bankruptcy if the creditors agree.²²⁹ Failure to take this counseling will result in the dismissal of the bankruptcy case. On the other hands, the debtor education course required after the filing of bankruptcy is to help the debtor manage his financial affairs in the future. It is to equip the debtor with personal financial management skills.

²²⁰ See DOUGLAS G. BAIRD, *supra* note 45, at 37.

²²¹ *Id.*, see THE BANKRUPTCY CODE, *supra* note 183, § 727 (a) (8).

²²² See DOUGLAS G. BAIRD, *supra* note 45, at 37.

²²³ *Id.*

²²⁴ *Id.*, at 37-38; see THE BANKRUPTCY CODE, *supra* note 183, § 521 (i).

²²⁵ See DOUGLAS G. BAIRD, *supra* note 45, at 37.

²²⁶ Joseph Satorius, *Strike or Dismiss: Interpretation of the BAPCPA 109(h) Credit Counseling Requirement*, 75 FORDHAM L.REV. 2231(2007), at 2233-2234.

²²⁷ See THE BANKRUPTCY CODE, *supra* note 183, § 109 (h) (1). There are exceptions to these requirements as provided under 109 (h) (2); see generally, Joseph Satorius, *supra* note 226, at 2234.

²²⁸ See Joseph Satorius, *supra* note 226, at 2234.

²²⁹ See Robert H. Scott, III, *supra* note 174, at 946.

The bankruptcy code has also designed a mechanism to tackle abuse of Chapter 7 filing. The problem with this chapter is that consumer debtors, in most cases, *walk-off* without paying even though they have a means to pay part of their debt.²³⁰ Ronald claims that “There was a concern that consumer are using the bankruptcy system as a means of financial planning than as a relief when they honestly fail to repay their debt.”²³¹ In response to this, section 707 (b) was added to the 1984 amendments of Code.²³² The court may, therefore, dismiss a petition by individual debtor whose debts are consumer debts when it is found that the filing is “substantial abuse” of chapter 7.²³³ This was designed to limit the access to Chapter 7 and force debtors to chapter 13 filing.²³⁴ There was no agreement on what constitutes “substantial abuse”.²³⁵ One view was that criterion was that the individuals’ ability to pay their debt without undue hardships amounts abuse.²³⁶ Another view advocates for the ‘totality of circumstances’ test such as unconscionable spending or fraud.²³⁷

The 2005 Bankruptcy Act responds to the problem and come up with grounds of dismissal of Chapter 7 claims when there is abuse.²³⁸ The first ground to be used to filter what can be brought under Chapter 7 is ‘means test’.²³⁹ This test will make sure that the debtor’s income is low enough to chapter 7 filing. If debtor’s income is below the applicable median, then that is the end of the story. S/he can file a Chapter 7 bankruptcy. If the debtor’s income, including his/her spouse if married, is more the applicable median for the family size considered, an application for Chapter 7 might be dismissed up on the application of trustee, interested parties, or court on its own motion.²⁴⁰ If there is disposable income, necessary expenses (food, cloth, health care, etc.) deducted from average monthly income for the last six months, abuse is presumed and debtor will not qualify for Chapter 7.²⁴¹ By this filtering process, individuals with high income will be forced to go for chapter

²³⁰ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7,103.

²³¹ See Mann, Ronald J., *Bankruptcy Reform and The 'Sweat Box' of Credit Card Debt*, U. ILL. L. REV., 2006, at 377-378.

²³² See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 104.

²³³ *Id.*, at 103-104; see also David G. Epstein et al, *supra* note 41, at 56-57.

²³⁴ See Ronald J. Mann, *supra* note 231, at 377.

²³⁵ See Carl Felsenfeld, *supra* note 175, at 1369.

²³⁶ *Id.* p. 1369; see also DAVID G. EPSTEIN ET AL, *supra* note 41, at 57-58.

²³⁷ See Carl Felsenfeld, *supra* note 175, at 1369.

²³⁸ See BARRY E. ADLER ET AL, *supra* note 110, at 79-80.

²³⁹ *Id.*; see section 707 (b); see also Robert H. Scott, III, *supra* note 174, at 947.

²⁴⁰ See BARRY E. ADLER ET AL, *supra* note 110, at 79-80.

²⁴¹ See Ronald J. Mann, *supra* note 231, at 380.

13.²⁴² Means test solely rests on the ability to pay.²⁴³ But means test has pitfall of its own. It does not distinguish between unforeseen financial trouble (sudden illness, loss of job, divorce) and reckless indebtedness (using credit for luxuries and recreations).²⁴⁴ Accordingly, there still exists the possibility of abuse of the system by later categories of debtors.

Qualifying the ‘means test’, however, is not the end of the story. Still the court may find Chapter 7 applications abusive and dismiss or convert it to chapter 13 accordingly.²⁴⁵ Abusive or bad faith petitioners will see their case dismissed under the “totality of circumstances test”.²⁴⁶ This test will catch debtors who escaped the filtration process under means test. It does not have a clear formula as in the case of means test, a supplementary case-by-case analysis.

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

2. Chapter 13

Chapter 13 is a debt adjustment plan²⁴⁷ for consumer bankruptcy, like reorganization of businesses. It is intended for the use of individuals with regular income²⁴⁸ and those who want to keep some of their assets.²⁴⁹ Its use has become more popular by debtors who own small businesses and debtors who failed in payment for debt secured by mortgage.²⁵⁰ Unlike Chapter 7 bankruptcies, under Chapter 13 there is no liquidation and all the debtor has to do is to come up with a plan of repayment²⁵¹ that should be accepted by the bankruptcy judge.²⁵² Debtor is not required to give up his/her assets, exempt or otherwise, and only has to propose a plan for repayment to be executed in the future, usually lasts between 3 to 5

²⁴² *Id.*

²⁴³ See BARRY E. ADLER *ET AL*, *supra* note 110, at 80.

²⁴⁴ *Id.*

²⁴⁵ *Id.*, at 81.

²⁴⁶ *Id.*

²⁴⁷ See Michelle J. White, *supra* note 19, at 210; see also DAVID G. EPSTEIN *ET AL*, *supra* note 41, at 13.

²⁴⁸ See Michelle J. White, *supra* note 156, at 691.

²⁴⁹ See Elijah M. Alper, *supra* note 174, at 1914.

²⁵⁰ See DOUGLAS G. BAIRD, *supra* note 45, at 50.

²⁵¹ See THE BANKRUPTCY CODE, *supra* note 183, § 1322.

²⁵² See Michelle J. White, *supra* note 19, at 210.

years.²⁵³ Under Chapter 13 the debtor keeps his/her assets but has to give up his/her future income.²⁵⁴ That means the debtor has to pay the creditors in installments out of his ‘disposable income’.

A Chapter 13 discharge allows discharge of some of the debts that are ‘excepted’ under section 523(a).²⁵⁵ With the exceptions of “alimony and child support, student loan, DUI (driving under influence) debts, and debts for restitution of criminal fine,”²⁵⁶ all other debts that were ‘excepted’ under Chapter 7 case are dischargeable under Chapter 13. In this regard, a Chapter 13 discharge is much broader than Chapter 7 discharge. This is intended to incentivize filing under Chapter 13 where the debtor has to pay a portion of his debts allowing creditors’ a repayment to a certain extent. The discharge under this chapter is, therefore, called “super discharge” making only very few debts non-dischargeable.²⁵⁷ Hence, under Chapter 13 plan, it is possible for the debtor to keep all his assets while enjoying wider scope of dischargeable debts.²⁵⁸

Unlike in Chapter 7, there is a restriction on the use of chapter 13.²⁵⁹ Debtor with a debt of more than 250,000 for unsecured and 750,000 for secured debts are not eligible for chapter 13 bankruptcy.²⁶⁰ One can see from the above figures that “chapter 13 is designed for working with individual debtors or couples with limited financial affairs, typically consumers or proprietors of small businesses.”²⁶¹

Chapter 13 plan is subjected to important conditions. First, the plan shall provide for the full satisfaction, in differed payments, of all claims entitled to priority under section 507 unless the holder of the priority claims agrees to a different treatment of such claim.²⁶² The plan should not discriminate between claims of a particular class, if any.²⁶³ Second, the debtor has to pay his/her

²⁵³ See Michelle J. White, *supra* note 19, at 210; see also Barry Adler *et al*, *supra* note 175, at 587; Michelle J. White, *supra* note 156, at 691.

²⁵⁴ See BARRY E. ADLER ET AL, *supra* note 110, at 621.

²⁵⁵ See CHARLES J. TABB & RALPH BRUBAKER, *supra* note 7, at 511; Michelle J. White, *supra* note 156, at 210; see also BARRY E. ADLER ET AL, *supra* note 110, at 621.

²⁵⁶ See DOUGLAS G. BAIRD, *supra* note 45, at 49; see also Charles J. TABB & RALPH BRUBAKER, *supra* note 7, at 511.

²⁵⁷ See DOUGLAS G. BAIRD, *supra* note 45, at 48.

²⁵⁸ *Id.*, at 49-50.

²⁵⁹ *Id.*, at 50; see also BARRY E. ADLER ET AL, *supra* note 110, at 621.

²⁶⁰ *Id.*; See also THE BANKRUPTCY CODE, *supra* note 183, § 109. The amount is subject to change every 3 year by regulation to reflect inflation.

²⁶¹ See DOUGLAS G. BAIRD, *supra* note 45, at 49.

²⁶² See THE BANKRUPTCY CODE, *supra* note 183, § 1322 (2).

²⁶³ *Id.*

disposable income for five years, if not the creditor should receive, as of the effective debt of the plan, an amount he/she would have received if the debtor opted for a Chapter 7 bankruptcy.²⁶⁴ This will ensure that the creditor is not going to be treated less favorably than he would have been under chapter 7.

Generally, Chapter 13 has several advantages over Chapter 7 bankruptcy. First, creditors are more protected under Chapter 13 than Chapter 7. They are paid from a projected 'disposable income' in 3 and 5 years if income is less than the median and above the median respectively.²⁶⁵ And Chapter 13 cases pay creditors more than Chapter 7 do. As it is discussed under section 1.4, most often, Chapter 7 cases leave no asset and chance of the creditors getting paid is very slim. The second benefit is the debtor can keep his/her assets and collaterals under Chapter 13. This will avoid the giving up of an asset to the creditor who may value the property less than the debtor values it. Finally, under Chapter 13, there are only few non-dischargeable debts than under Chapter 7.

Chapter 7 and Chapter 13 have, therefore, basic differences. Chapter 7 is designed for lower middle class working persons while Chapter 13 is intended to be used by wage earners and working individuals with limited financial affairs. In a Chapter 7 case, the debtor has to give up all his non-exempt assets to the creditors, but in Chapter 13, debtor keeps the assets and pay out of future income. So, in the former case, future income is protected, but in the latter, assets and existing property are protected. In addition, discharge under Chapter 7 is automatic and it bars any move by the creditor for the enforcement of his/her claim, but the discharge under Chapter 13 is after the completion of the plan.²⁶⁶

3. Chapter 12

Chapter 12 is a special chapter intended for the use of family farmers and fishermen with regular income.²⁶⁷ Special treatment for farmers under bankruptcy dates back to 1898²⁶⁸ but the protection was on temporary basis.²⁶⁹ This was in response to the farm crises that affected many farmers and subjected them to bankruptcy proceedings that may culminate in foreclosure of their farm.²⁷⁰ It

²⁶⁴ See DOUGLAS G. BAIRD, *supra* note 45, at 50-51.

²⁶⁵ See DOUGLAS G. BAIRD, *supra* note 45, at 51.

²⁶⁶ See THE BANKRUPTCY CODE, *supra* note 183, § 1328.

²⁶⁷ See DAVID G. EPSTEIN ET AL, *supra* note 41, at 15; see also the Bankruptcy Code, *supra* note 183, § 109 (f).

²⁶⁸ See Katherine M. Porter, *Phantom Farmers: Chapter 12 of the Bankruptcy Code*, 79 AM. BANKR. L.J. 729 (2005), at 730.

²⁶⁹ See DOUGLAS G. BAIRD, *supra* note 45, at 57.

²⁷⁰ See Katherine M. Porter, *supra* note 268, at 731.

became part of the Bankruptcy Code on permanent basis after the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.²⁷¹

What is peculiar in Chapter 12 from Chapter 13 is that the former is restricted to farmers and fishermen use while the later can be used by individuals with regular income irrespective of the source of such income.²⁷² The two chapters are also different in the type of debtor entitled to relief under the respective chapters. In Chapter 12, partnerships and corporations can file for relief while Chapter 13 is restricted to individuals with regular income.²⁷³ The debt ceiling is also higher in Chapter 12 than in Chapter 13 making debt adjustment opportunity wider.²⁷⁴

The Chapter tries to strike a balance between two conflicting interests.²⁷⁵ On the one hand the law makes sure that the farmers still hold their farms and fishermen their boats even when they owe secured creditors more than the value of their assets (land or boat).²⁷⁶ On the other hand, the law has to ensure the security interest and rights on the property creditors have.²⁷⁷

Despite its long history and ambition, the achievement of Chapter 12 is being criticized as insignificant.²⁷⁸ There are very few Chapter 12 bankruptcy cases.²⁷⁹ One reason is that farmers in United States are very few in number (the number is dropping) and Chapter 12 filings are few compared to other types of bankruptcies.²⁸⁰ Another possible reason is that farmers opt for Chapter 7 or 13 bankruptcies because farmers face similar grounds for being in financial distress, such as illness or divorce, and not necessarily secured farm debt. There are also evidences that bankruptcy contribution to the decline in farms in United States is insignificant making the response by way of chapter 12 unviable.²⁸¹ These reasons might have a hand in the limited use of chapter 12 filing while the number is soaring in Chapter 7 or Chapter 13 bankruptcy.

²⁷¹ See DOUGLAS G. BAIRD, *supra* note 45, at 57.

²⁷² See DAVID G. EPSTEIN ET AL, *supra* note 41, at 16.

²⁷³ See Katherine M. Porter, *supra* note 268, at 732.

²⁷⁴ *Id.*

²⁷⁵ See DOUGLAS G. BAIRD, *supra* note 45, at 56.

²⁷⁶ *Id.*

²⁷⁷ *Id.*

²⁷⁸ See Katherine M. Porter, *supra* note 268, at 741.

²⁷⁹ *Id.*

²⁸⁰ *Id.*

²⁸¹ *Id.*, at 742.

B. Individual Insolvency Law in Germany

Before the enactment of the 1999 Insolvency Act, consumer debtors in Germany were not allowed to file for bankruptcy. Pre-1999 German insolvency laws were not favorable to consumer debtors.²⁸² Theoretically, it was possible to enter into settlement agreements between debtors and creditors that provide for less-than-full payment of the debt.²⁸³ But there were hurdles from realizing the benefits of such arrangement. On the one hand, the creditors' consent is required for the settlement that may in most cases go against the interest of the debtor.²⁸⁴ On the other hand, the debtor has to have a plan for payment of at least certain percentage of the claims, which was not affordable by most consumers.²⁸⁵ Moreover, the debtor should have a certain level of minimum assets to defray costs of proceedings.²⁸⁶ This made individuals' access to the then insolvency laws a theoretical possibility than practical reality. Even for those who passed the hurdle, there was no such a thing called discharge²⁸⁷ and the law was meant to facilitate creditors' collection efforts.²⁸⁸ Debtors were supposed to repay their debt no matter how difficult it might be. The core of this policy was protection of the principle of party autonomy, and intervention by way of discharge was seen as against this principle.²⁸⁹ Accordingly, before the 1999 German Insolvency Act, individuals' access to bankruptcy was very limited and discharge was not possible.²⁹⁰ For the first time, consumer bankruptcy and discharge was introduced in the 1999 Insolvency Act.²⁹¹ This was as a reaction to rising over-indebtedness problem that was exacerbated by the deregulation of consumer credit in Germany since 1970s.²⁹²

²⁸² See Jason J. Kilborn, *supra* note 158, at 262.

²⁸³ *Id.*

²⁸⁴ *Id.*

²⁸⁵ *Id.*, at 262-263.

²⁸⁶ *Id.*, at 263.

²⁸⁷ See Susanne Braun, *German Insolvency Act: Special Provisions of Consumer Insolvency Proceedings and the Discharge of Residual Debts*, 7 GERMAN L. J. 59 (2006), at 65-66, available at <http://www.germanlawjournal.com/index.php?pageID=11&artID=686>, (last visited on 29 March 2014).

²⁸⁸ See Jason J. Kilborn, *supra* note 158, at 264-265 & 269.

²⁸⁹ See Susanne Braun, *supra* note 287, at 66; see also Jason J. Kilborn, *supra* note 158, at 268.

²⁹⁰ See Robert Anderson *et al.*, (ed.) *supra* note 6, at 21.

²⁹¹ *Id.*, at 21 & 59; see JOHANNA NIEMI *ET AL.*, *supra* note 3, at 274.

²⁹² See Susanne Braun, *supra* note 287, at 60; see generally Jason J. Kilborn, *supra* note 158, at 260-262; see also JOHANNA NIEMI *ET AL.*, *supra* note 3, at 273.

Currently, honest debtors are entitled to relief by way of individual insolvency.²⁹³ Individual can request the court for the discharge of his/her debt under Section 287 of the Insolvency Act of 1999.²⁹⁴ Discharge and fresh-start under German law is intended to protect the individual from undue harassment and reintegrate him/her economically.²⁹⁵ The requirement to file for individual insolvency is inability to pay debts, illiquidity, when they fallen due.²⁹⁶ The insolvency should be permanent.²⁹⁷ Over-indebtedness is not a requirement to institute consumer bankruptcy proceedings.²⁹⁸ To institute individual insolvency proceeding, the debtor has to cover proceeding cost under the pain of dismissal²⁹⁹ and should have assets to pay certain portion of his/her debt to the creditors.

The German model of discharge is known as “*an earned fresh start*” and the individual debtor has to pass through different stages and a long six-years of hard work, paying a portion of his/her debt and showing good behavior.³⁰⁰ Individual insolvency proceeding in Germany involves four stages.³⁰¹ The first stage is out-of-court settlement phase.³⁰² It is a compulsory requirement for the debtor to try to reach an amicable settlement of the debt before opting for insolvency proceeding. To that effect, a certificate from attorney or credit counseling institution is necessary.³⁰³ In the second phase, the same attempt, with the discretion of the court, may be repeated before courts.³⁰⁴ This is because the out-of-court settlement could be easily defeated by the refusal of one of the creditors.³⁰⁵ In this phase, the court may force dissenting creditors to accept the plan on condition that the plan

²⁹³ See GERMAN INSOLVENCY CODE OF 5 OCTOBER 1994 (BGBl. [FEDERAL LAW GAZETTE] I, at 2866), last amended under Art. 2 G dated 21 October 2011 (Federal Law Gazette I, at 2082, hereinafter, German Insolvency Code), Section 286 & ff.

²⁹⁴ See Susanne Braun, *supra* note 287, at 66.

²⁹⁵ *Id.*

²⁹⁶ See GERMAN INSOLVENCY CODE, *supra* note 293, section 17.

²⁹⁷ See Susanne Braun, *supra* note 287, at 63.

²⁹⁸ See GERMAN INSOLVENCY CODE, *supra* note 293, Section 19.

²⁹⁹ See generally Susanne Braun, *supra* note 287; see also the German Insolvency Code, section 26 (1).

³⁰⁰ See Robert Anderson *et al.*, (*ed.*) *supra* note 6, at 21; See Susanne Braun, *supra* note 287, at 66.

³⁰¹ See JOHANNA NIEMI, *ET AL.*, *supra* note 3, at 274-75; M. Gerhardt, Consumer Bankruptcy Regimes and Credit Default in the US and Europe: A Comparative Study, (CEPS Working Document No. 318, 27 July 2009, at 8), available at <http://aei.pitt.edu/11336/> (last visited on 11 March 2014).

³⁰² See Jason J. Kilborn, *supra* note 158, at 272; JOHANNA NIEMI *ET AL.*, *supra* note 3, at 274-275.

³⁰³ See Robert Anderson *et al.*, (*ed.*) *supra* note 6, at 21 & 60; see THE GERMAN INSOLVENCY CODE, *supra* note 293, sec. 305 (1).

³⁰⁴ See Robert Anderson *et al.*, (*ed.*) *supra* note 6, at 21.

³⁰⁵ See Jason J. Kilborn, *supra* note 158, at 275-276.

does not discriminate those creditors unduly.³⁰⁶ The importance of this phase is declining through time.³⁰⁷ If all efforts of negotiated settlement, out of court or court supervised, fail simplified liquidation procedure will follow.³⁰⁸ This is the third phase of consumer bankruptcy process.³⁰⁹ The debtor is required to turn over all non-exempt assets, if any, to the trustee appointed by the court, assets will be sold and proceeds thereof will be paid to the creditors³¹⁰ in addition to covering the cost of proceedings. But like in the United States Chapter 7 cases, this phase has no practical use because consumer debtors, at least in most cases, do not have assets.³¹¹

The last phase is where the debtor will be put to a six-year-long “good behavior period”, successful completion of which will bless the debtor with discharge.³¹² This is followed by a kind of probation-type period, known as “good behavior”, where the debtor has to show good character paying a certain portion of his/her income, engage in gainful employment, transfer to the trustee half of the value of the property from inheritance, inform his change of addresses etc for a period of six years.³¹³ After successful six-year payment period, discharge will be granted, save for exceptional cases where it may be denied.³¹⁴ The grounds of denial of discharge include criminal conviction, fraudulent or false written statements about his economic situation, grant or refusal of discharge in ten years time, impaired creditors interest by wasting assets or delaying insolvency proceeding etc.³¹⁵

There are certain debts that are ‘excepted’ from discharge, hence non-dischargeable. These include tort claims, fines, administrative penalties and incidental consequences of administrative or criminal offence, liabilities from interest-free loans granted to the debtor to pay costs of insolvency proceedings.³¹⁶ If the court decides to give discharge and fresh start for the debtor, the trustee will be appointed and emoluments will be vested to the trustee by way of statement of

³⁰⁶ *Id.*, at 276.

³⁰⁷ *Id.*, at 276-277.

³⁰⁸ *Id.*, at 278.

³⁰⁹ See JOHANNA NIEMI *ET AL*, *supra* note 3, at 275.

³¹⁰ See Robert Anderson *et al (ed.)*, *supra* note 6, at 21.

³¹¹ See Jason J. Kilborn, *supra* note 158, at 278-79; JOHANNA NIEMI *ET AL*, *supra* note 3, at 336.

³¹² See M. Gerhardt, *supra* note 305, at 8; see also Jason J. Kilborn, *supra* note 158, at 272.

³¹³ See Robert Anderson *et al, (ed.) supra* note 6, at 21; See Susanne Braun, *supra* note 287, at 66; see also THE GERMAN INSOLVENCY CODE, *supra* note 293, section 295.

³¹⁴ The GERMAN INSOLVENCY CODE, *supra* note 293, Sections 300 & 296.

³¹⁵ *Id.*, Section 296.

³¹⁶ *Id.*, Section 302.

assignment.³¹⁷ The trustee is responsible for monitoring the distribution of assets during the debtor's "good behavior" period.

The scope and nature of discharge introduced is, however, different, by far, from that of United States' concept of discharge.³¹⁸ There is no full discharge as in United States and it is not European way to let the debtor walk-off without paying anything.³¹⁹ The European understanding of consumer bankruptcy is rather re-adjustment and rehabilitation where by the individual debtor has to earn the fresh start by his effort. This recognizes "human capital" as valuable economic interest both for debtor and creditor in credit transaction.³²⁰ This is a departure from the conventional view that credits are provided against tangible assets.³²¹ The debtor will be released only of the residual debts and enjoy fresh start. Accordingly, all creditors, even those who did not file a claim, are barred from any collection efforts against the debtor.³²²

Under German individual insolvency proceedings, it is not true that the creditors will be paid during the "good behavior" period. As in the case of United States' Chapter 7 cases, in most cases, the plan may not pay at all.³²³ This is due to high level of exemption on the future income of the debtor. There are scholars who question the need for such six-year-long financial probation period of "good behavior" if it is proved that it is not paying the creditors, at least in most cases.³²⁴ According to them, the German model of discharge is rigid because it does not distinguish between those who really are able to make a certain percentage of payments (those who can cope with the "good behavior period") and those who cannot.³²⁵ No matter how penniless the debtor is or in urgent need of immediate fresh start, the six-years-long process and accompanying obligations nevertheless

³¹⁷ *Id.*, Section 291 & 287.

³¹⁸ See Robert Anderson *et al*, (*ed.*) *supra* note 6, at 21; indeed, United States Chapter 13 discharge has similarity with the German model. In both laws, there is repayment plan for a certain period of time. But still they have differences in that the German model is applicable for all debtors irrespective of their income or ability to pay, but United States chapter 13 is available only for those with regular income.

³¹⁹ See Jason J. Kilborn, *supra* note 158, at 281; see also Ramsay, Iain D. C, *supra* note 10, at 250-251.

³²⁰ See Jason J. Kilborn, *supra* note 158, at 281-282.

³²¹ *Id.*, at 282.

³²² The GERMAN INSOLVENCY CODE, *supra* note 293, Section 301.

³²³ See Jason J. Kilborn, *supra* note 158, at 285-86, as cited in JOHANNA NIEMI *ET AL*, *supra* note 3, at 341.

³²⁴ See JOHANNA NIEMI *ET AL*, *supra* note 3, at 288.

³²⁵ See Robert Anderson *et al* (*ed.*), *supra* note 6, at 21-22.

has to be followed.³²⁶ There are two European approaches in this regard. Some jurisdictions such as France and Sweden have such distinction with the view of helping those penniless debtors get immediate discharge without going through the period of repayment plan.³²⁷ This is what some scholars call it the “*mercy model*”.³²⁸ But the German approach, known as “*liability model*”,³²⁹ sticks on the repayment of the debt. This is the weakness of the German individual insolvency law because it is not tailored according to the need of different types of debtors.

Some other scholars see that rule in a positive way than letting the debtor walk-off right after the conclusion of the insolvency proceeding.³³⁰ According to this later view, by doing so, the hidden policy of the German law is to teach the debtor’s financial responsibility and reintegrate him to the society than paying creditors.³³¹ In fact such good behavior period is a kind of financial responsibility lesson for the debtor. So the six-year period have a rehabilitative function. However, it is still questionable whether this lesson’s value is worth for penniless debtors who will be doomed to lead poor living standard abandoning several social activities, cutting nutrition, engaging in illicit economic activities etc.³³²

Another shortcoming in the individual insolvency practice in Germany is the limited availability of debt counseling institutions.³³³ This will put the viability of out-of-court settlement phase in question for the indigent debtor.³³⁴ Debt counseling has become very crucial instrument of dealing with consumer bankruptcy problems and the access and quality of the service has significant impact in the individual insolvency legal regime. Despite these benefits there seem to be a limited access to the service in Germany.

³²⁶ *Id.*

³²⁷ See JOHANNA NIEMI ET AL, *supra* note 3, at 340.

³²⁸ See generally Jan-Ocko Heuer, Social Inclusion and Exclusion in European Consumer Bankruptcy Systems, Paper for the conference Shifting to Post-Crisis Welfare States in Europe? Long Term and Short Term Perspectives, (Berlin, 4-5 June 2013) available at https://www.academia.edu/3992692/Social_Exclusion_in_European_Consumer_Bankruptcy_Systems (last visited on 29 March 2014).

³²⁹ *Id.*

³³⁰ See generally Jason J. Kilborn, *supra* note 158.

³³¹ *Id.*, at 296.

³³² See JOHANNA NIEMI ET AL, *supra* note 3, at 287-88.

³³³ *Id.*, at 288.

³³⁴ *Id.*

IV. OVERVIEW OF ETHIOPIAN BANKRUPTCY LAW AND VIABILITY OF INTRODUCING CONSUMER BANKRUPTCY LAW TO ETHIOPIA

Bankruptcy issues under Ethiopian law are, in principle, governed under Book V of the Commercial Code of Ethiopia adopted in 1960.³³⁵ The sources of this law are the 1955 French bankruptcy legislation and Italian Insolvency Act of 1942.³³⁶

Ethiopian bankruptcy law is one of the most unsuccessful legal transplants in terms of practical utility.³³⁷ Several factors accounted for the disuse of the bankruptcy provisions of the Commercial Code in court of law. The first reason was socialist political economy that prevailed in the country from 1974 through 1991 where the government controlled almost all economic activities.³³⁸ Entrance and exit in the market was not determined by economic factors. There was no competition in the market and the only player was the government. That had affected the use of bankruptcy procedure until 1991. The other reason is that bankruptcy has not been in the academic curriculum of Ethiopian law schools and legal professional have little knowledge and experience in the subject.³³⁹ It is only recently that this subject is in the curriculum of law schools. Finally, different legislations such as foreclosure laws undermined the role bankruptcy could have played in the business.³⁴⁰ So, the bankruptcy law of Ethiopia is least used and least developed subject.

The stance of Ethiopian bankruptcy law, as applied to businesses, is not even business friendly. A look at the structure of the Code reveals that Ethiopian bankruptcy law is pro-liquidation than reorganization of businesses.³⁴¹

Ethiopian law limits the application of the bankruptcy law to traders and excludes non-trader individuals from its scope.³⁴² Hence, the subjects of bankruptcy law are only “traders” i.e., persons engaged in commercial activities

³³⁵ THE COMMERCIAL CODE OF THE EMPIRE OF ETHIOPIA, NEGARIT GAZZETTE 19TH YEAR NO 3, Birihanina Selam Printing Press, Proclamation No. 166 of 1960, (hereinafter, the COMMERCIAL CODE OF ETHIOPIA) Articles, 968-1168; there are some other legislations such as banks foreclosure law or legislations only applicable for public enterprises.

³³⁶ See Tadesse Lencho, *supra note 5*, at 62.

³³⁷ *Id.*, at 57.

³³⁸ *Id.*, at 58.

³³⁹ *Id.*, at 58-59.

³⁴⁰ *Id.*, at 59. To-date, there are only two court cases. For a legislation with this age it is shows a kind of ineffectiveness of the legal transplant.

³⁴¹ *Id.*, at 63.

³⁴² *Id.*, at 69-70; see the COMMERCIAL CODE OF ETHIOPIA, *supra note 335*, Article 968 69-70; See also Booz/Allen/Hamilton, *infra* 343, at 54; see also Tilahun Teshome *et al*, *Position of the Business Community on the Revision of the Commercial Code of Ethiopia*, July 2008, at 82-83.

within the meaning of Article 5 of the Commercial Code. Individuals can only file for bankruptcy if they qualify as traders and the debt is commercial debt.³⁴³ It is consistent with the old times classical bankruptcy law philosophy that restricted the procedure to merchants only.

Before and after Ethiopian bankruptcy law was adopted, the traditional function of bankruptcy law in most, if not all, jurisdictions was liquidating and reorganizing businesses. Ethiopian legislatures adopt the same philosophy the revised 1955 French bankruptcy legislation had towards bankruptcy. But the latter has departed from the philosophy that restricted bankruptcy law to merchants in 1989 and today individuals are entitled to relief in the form of discharge.³⁴⁴

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

There were several reasons that make the 1960 Commercial Code bankruptcy provisions adequate enough for the needs of the time, at least until 1991. In Ethiopian business activities were least developed and dominated by small and medium government owned (public) enterprises. There was no competition in the market and there was no risk of failure and exiting the market. Publicly financed companies or businesses will continue operating even at loss. It is only after 1991 that the Ethiopian economic policy was shifted to market economy giving the way for private businesses and entrepreneurial activities to emerge. Another reason accounted for the merchant oriented bankruptcy law is that in Ethiopia debt was not something good and access to consumer credit was very limited. Failure to repay one’s debt is still highly stigmatized. With these factors, the bankruptcy law as incorporated under the Commercial Code was adequate enough to ensure creditors protection, the only concerns of bankruptcy law of the time. But the law failed to keep track of changed bankruptcy philosophies and developments³⁴⁵ in response to the development of commerce, entrepreneurship, availability of consumer credit, consumer over-indebtedness, and absence of government social

³⁴³ Booz, Allen & Hamilton, *Ethiopian Commercial Law And Institutional Reform And Trade Diagnostics*, (USAID Jan 2007), at 54.

³⁴⁴ See Robert Anderson *et al (ed.) supra* note 6, at 19.

³⁴⁵ See Taddese Lencho, *supra* note 5, at 95.

safety net programs.

Currently, the Ethiopian Commercial Code is under revision and there are recommendations from some scholars and experts for the inclusion of consumer bankruptcy into the upcoming amendment.³⁴⁶ Others simply call for the policy makers to reconsider the issue of consumer bankruptcy emphasizing on the benefits it has towards entrepreneurship.³⁴⁷ Therefore, whether Ethiopia has to introduce consumer bankruptcy law, factors calling for change of paradigm, the model it has to follow, if at all consumer bankruptcy is demanding, will be discussed in the coming sections.

A. Consumer Bankruptcy Law for Ethiopia

As pointed out so far in this article³⁴⁸ bankruptcy law used to be restricted to the use of merchants and to protect creditors and help them in debt collection process, mainly through liquidation. Accordingly, only businesses were concerns of most bankruptcy legislations worldwide. This is still true under Ethiopian law where only businesses, and not consumers, can apply for bankruptcy.

Today, in other jurisdictions the scope of bankruptcy law has been extended to individuals as well. In United Kingdom and United States, consumer bankruptcy was introduced as a reaction to liberalization of credit and the accompanying over-indebtedness.³⁴⁹ In Germany, the consumer insolvency rules were introduced in the 1999 Insolvency Act with a view to giving relief to debtors after the consumer over-indebtedness that occurred since 1970s. In France, consumer bankruptcy and debt readjustment were introduced in 1989 because of consumer over-indebtedness. This is true for most European countries that liberalized their bankruptcy law to include consumer debtors.

As discussed in section II (C) several factors led to justify the adoption of consumer bankruptcy into the legislations of many jurisdictions. Some of the reasons include, but are not limited to, industrialization, expansion of trade and commerce, deregulation of credit, individuals' access to credit and indebtedness, entrepreneurial friendly policies, reduction in the welfare activities of governments, etc. The question worth asking at this point is whether there is a need to introduce consumer bankruptcy rules to the Ethiopian legal system. There are no

³⁴⁶ See Tilahun Teshome *et al*, *supra* note 342, at 82-83; In fact these experts suggest, as I agree, that consumer bankruptcy matters being non-commercial will fit into separate legislation or civil procedure code.

³⁴⁷ See Booz, Allen & Hamilton, *supra* note 347, at 54.

³⁴⁸ See Section II of this article.

³⁴⁹ *Id.*

empirical studies on increasing consumer debt or over-indebtedness in Ethiopia. And nothing is written on the issue. But taking the experience of the different jurisdictions studied in this article, introducing consumer bankruptcy as well as discharge and fresh start to Ethiopia will have a paramount importance.

Generally, bankruptcy law provides an alternative to judicial procedures of enforcing claims. As such, it solves the following problems inherent in non-bankruptcy procedure of enforcement of claims. Non-bankruptcy law provides for a procedure where creditors, individually, using state's power, seize non-exempt assets of the debtor to satisfy their claims. But non-bankruptcy law only regulates relationship between debtor and creditor and not creditors *inter se*. This will lead to several wasteful litigations, in terms of courts' time and parties' costs, as there are multiple creditors. The debtor will also be harassed as many times as there are creditors. It may also happen that first comer will take everything and hence, inequitable for the other creditors. So, consumer bankruptcy will solve collective action problem in the same way business bankruptcy does.³⁵⁰ The assets of the individual will be given to a person, trustee, who has to liquidate and distribute to the creditors according to their share in the claims. This justification of bankruptcy, though the pioneer reason, is becoming obsolete because the debtor has no assets in most straight bankruptcy cases. Nevertheless, this justification for consumer bankruptcy is still cited as one of the most important justification. Consumer bankruptcy and fresh start is also a good incentive for debtor's cooperation in the collection process. If the debtor knows that he will be forgiven he will not hide or transfer assets and disrupt the opportunity to start afresh. Generally, there is an incentive not to engage in any fraudulent activities and disrupt the debt collection procedure.

It is discussed that many countries have adopted consumer bankruptcy laws after they deregulated their credit markets. In Ethiopia, there is no such deregulation and rather the financial sector is highly regulated and dominated by state banks.³⁵¹ Nevertheless, individuals, especially from urban areas, are getting access to credits.³⁵² In addition to state banks, there are several private banks, micro-finance institutions and saving and credit associations operating in the

³⁵⁰ See Margaret Howard, *Supra note 27*, at 1049.

³⁵¹ Ethiopia; Financial Sector Profile, available at <http://www.mfw4a.org/ethiopia/ethiopia-financial-sector-profile.html> (last visited on 16 March 2014).

³⁵² Commercial Bank of Ethiopia; <http://www.combanketh.et/DomesticBanking/CreditFacilities.aspx>; Ethiopia: Providing poor people living in rural areas sustainable access to financial services, available at http://www.ifad.org/evaluation/public_html/eksyst/doc/profile/pf/rfip.htm (last visited on 16 March 2014).

country. Individuals are having access to unsecured consumer credit directly or indirectly and are, therefore, exposed to the risk of misguided indebtedness problems. This will make more sense when Ethiopia introduces credit card system in the future.

From the debtor's perspective, consumer bankruptcy will solve the disincentive of the debtor to acquire property or engage in gainful employment in the future if there is a judgment creditor who is waiting to enforce a claim against the debtor. Without discharge and fresh start, "honest but unfortunate debtor" will be alerted perpetually by the judgment creditor looking to satisfy his claims. Consumer bankruptcy will play a role in providing relief, rehabilitation and reintegration tool.

Like in other jurisdictions, the social-insurance function of bankruptcy can be a good reason to adopt consumer bankruptcy law to the Ethiopian legal system. Studies show that, in countries where there are extensive welfare and safety-net programs by the government, there are limited reliefs or no relief at all under their bankruptcy law.³⁵³ Conversely, in countries where there are no social safety net programs, there is a generous relief under their consumer bankruptcy law. In Ethiopia, the governmental social security scheme and safety net programs are very limited and inadequate. This gap can be addressed by adopting well-crafted consumer bankruptcy law.

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

Furthermore, in Ethiopia most of the businesses are carried out at the level of mid-scale, small and micro enterprises that include partnerships and sole proprietorships. In fact the persons engaged in any of those business vehicles have

³⁵³ See R Adam Feibelman, *supra* note 83, at 184-186.

the access to bankruptcy law because they are traders within the meaning of Article 5 of the commercial code.³⁵⁴ But the fact that the liability of the owners is unlimited in these unincorporated businesses will make it very risky for individuals to engage in these businesses.³⁵⁵ Individual owner will not benefit out of bankruptcy once the business is gone. Creditors still can have an action against the debtor because of unlimited liability, in most cases. This will have negative impact on entrepreneurship and self-employment. So adopting consumer bankruptcy law insures such risk taking by entrepreneurs.

Moreover, today indebtedness is not a matter for businesses only. That phenomenon has gone long ago when credit was only available for businesses. Today credit is available for consumers as well and indebtedness also affects real people. To this effect, consumer bankruptcy with adequate discharge is proved to be a good solution. There should be the chance for those who defaulted in their obligation to start life as productive members of the society. They should be forgiven and rehabilitated.

In conclusion, indebtedness is a universal problem. All countries, whether industrialized or not, face the problem of indebtedness. If it is a real problem for developed countries with high per-capita, high employment rate and developed insurance schemes, it should, for a stronger reason, be a problem in Ethiopia, which is at the opposite tail of those indicators. Different jurisdictions adopt consumer bankruptcy and give relief for those debtors in the form of discharge and fresh start. The primary goal of consumer bankruptcy and fresh start is tied with the problem of indebtedness but it is also justified out of the reasons discussed above and other parts of the thesis. It is, therefore, my argument that Ethiopia should adopt consumer bankruptcy law.³⁵⁶

B. Which Model for Ethiopia?

The question worth to be asked at this juncture is the kind of debt relief system that can be adopted to suit the special situation of the country. The models of relief and scope of fresh start differs from jurisdiction to jurisdiction and depends on several factors such as the socio-economic and political situations of each country. Some jurisdiction, like United States, give generous relief and automatic discharge while others, such as Germany, gives the relief in a different

³⁵⁴ See The COMMERCIAL CODE OF ETHIOPIA, *supra* note 335, Article 5 & 968.

³⁵⁵ See Ramsay, *supra* note 115, at 79.

³⁵⁶ This suggestion is, however, based on theoretical findings than empirical studies for the later is lacking in the current context of the country's research and legal/business and economics scholarship.

way from the former. In United States the consumer bankruptcy has three categories namely chapter 7 (for all individuals), chapter 12 (farmers and fishermen) and 13 (wage earners and working couples).³⁵⁷ The United States model is tailored to fit the special needs of different segments of the society. Chapter 7 is designed for those debtors who have not the ability to pay their debts. Chapter 12 is designed for the special need of farmers and fishermen who need to keep their land and farm instruments even when those assets are given as a security for debts. Chapter 13 is a repayment plan for those who are able to pay out of their future income. Chapter 13 is, therefore, similar to the German repayment plan procedure. In Germany, there is only one procedure for all individuals and they have to go through series of procedures such as negotiated settlement, both out-of-court and in-court, and culminated in the repayment plan the successful completion of which will earn the debtor fresh start.³⁵⁸

For Ethiopia, I will suggest that *German-type* consumer bankruptcy that would fit to the realities of the country. Ethiopia is one of the world's poorest countries.³⁵⁹ Yet, it is one of the fastest growing economies.³⁶⁰ There is a need for consumer bankruptcy as the economy is growing and credits are becoming available. But also, a generous discharge of debts will not be a viable option for a very infant economy Ethiopia has. So, the consumer bankruptcy I am advocating should take into consideration these factors.

To have a United States type generous discharge and tailored to the different segments of the society will not be viable solution for the country for reasons that are socio-economic. One the one hand a generous discharge as in the United States will hurt the financial sector. More importantly, it will be unbearable burden for Ethiopia if a financial crisis, such as the global financial crisis in 2008, occurs in Ethiopia. The other reason against United States-type consumer bankruptcy is that credit is not available for everyone in Ethiopia. Credits are, mostly, available for people living in urban areas. Most of the entrepreneurial activities and start-ups are also concentrated in major cities and urban areas making the risk of indebtedness more acute for this segment of the society. In rural areas, for farmers, access to

³⁵⁷ See *supra* Section 2.1 of this article.

³⁵⁸ See Section 2.2.

³⁵⁹ Global Finance, The Poorest Countries in the World, available at <http://www.gfmag.com/component/content/article/119-economic-data/12537-the-poorest-countries-in-the-world.html#axzz2w9Xb7SEc> (last visited on 17 March 2014).

³⁶⁰ Ethiopia Economic Update – Laying the Foundation for Achieving Middle Income Status, available at <http://www.worldbank.org/en/news/press-release/2013/06/18/ethiopia-economic-update-laying-the-foundation-forachieving-middle-income-status>; also at <http://time.com/22779/forget-the-brics-meet-the-pines/> (last visited on 18 March 2014).

credit is very limited and they are not exposed to the risk of over-indebtedness. Indeed, farmers have access to credit through micro finance and rural saving and credit associations. One could also state that in Ethiopia farmers do take credits in the form of fertilizers and improved seed varieties and are thus exposed to the risk of indebtedness. But all these credits are highly regulated and monitored by government and saving and credit associations on a day-to-day basis. Hence, the risk on farmers is not a serious one. Moreover, ownership of land belongs to the government and individuals are not exposed to the risk of losing their land because of debt.³⁶¹ This is true for small-scale individual farmers and the assertion may not apply to mechanized farming owned by investors. Therefore, farmers do not need special protection like their United States' counterpart. The other reason for not adopting United States-type consumer bankruptcy is the societies' attitude towards failure to pay one's debt. In Ethiopia, failure to pay one's debt is highly stigmatized. As the saying goes, "failure to keep a promise is worse than losing a descendant." This is the equivalent of '*pacta sunt servanda*', which is a grand norm in contract law. Devising a rule for Ethiopia like the United States bankruptcy law, where the debtor just walks-off without paying a penny, will be against the belief of the business community. Also consumer bankruptcy law to be adopted shall be just a single type of procedure, as in Germany, to everyone.

Another issue that comes with adopting consumer bankruptcy procedure is the issue of who will finance the system. It will be huge burden for a country like Ethiopia, especially in case of financial crises, to cover costs of proceeding in consumer bankruptcy cases where the debtor may not have sufficient assets for that purpose. In order to solve this problem, the conditions of discharge should be devised in such a way that the individual debtor has to cover the costs of proceedings and come up with a plan of repayment for a certain period of time. That should be the price individual has to pay to get a fresh start. This will make sure that the financial/ credit market is not going to be hurt and the individual after successful completion of the plan will get fresh start. Introducing consumer bankruptcy law does not require a separate institution or bankruptcy courts in Ethiopia. It will be brought to the same court and judges that handle business bankruptcy cases. The trustee system is also already in place. Therefore, there is no additional cost to set up institutions in this regard.

In conclusion, designing consumer bankruptcy regime needs careful considerations of socio-economic situations of the country. The effect of consumer

³⁶¹ THE CONSTITUTION OF THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA, FDRE CONSTITUTION, Proclamation No 1/1995, FED. NEGARIT GAZETTE, 1st Year No.1, 1995, Art. 40 (3).

bankruptcy system is that honest and deserving debtors will get fresh start. In doing so consumers are protected from bad lending practices. With fresh start worth entrepreneurship ideas are encouraged and failed individuals are rehabilitated and reintegrated back to the society. In Ethiopia introducing consumer bankruptcy with discharge and fresh start for “worthy debtors” will have paramount importance in several aspects of life. For one thing, individuals may be in serious need of credit due to changed circumstances such as illness, loss of job, divorce, as do people from other jurisdictions. Without consumer bankruptcy and discharge, the creditor, who has got a court judgment for the enforcement of his claims, will make the debtors life miserable by continuous harassment. This may continue forever making the debtor, restless, hopeless and unproductive. Individuals may also have entrepreneurship ideas that are worth putting in the market and credit is important tool for such startups. With credit, however, there is a risk. The new entrepreneurial idea may not work and may bring with it indebtedness, which the individual may not be able to repay even after working for the whole of his life.

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

V. CONCLUSIONS

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

The scope of fresh discharge and fresh start varies across jurisdictions and some are pro-debtor with generous relief, exemptions and fresh start while others have provided restrictive conditions in their consumer bankruptcy laws. The United States and Germany can be contrasted in this regard. The former has a generous debt relief and discharge while the later has a series of procedures and

efforts that are required of the debtor to earn a fresh start. There are several reasons for the difference between the two countries' laws. Availability of safety net programs, attitude towards entrepreneurship, economic policy, stigma towards debt and consumer credit are just some of the reasons.

Currently, several countries are moving towards the adoption of consumer bankruptcy law. It is being justified out of several reasons and is considered as multi-faceted tool that serves several socio-economic functions. The issue of introducing the same law is under discussion in Ethiopia. A group of experts have made it clear that introducing such law is good for Ethiopia.³⁶² I also agree that consumer bankruptcy law designed after the German Model will benefit Ethiopia. It will solve the problem of debt collection and help individuals start life anew and join the society as a productive member. Consumer bankruptcy will help in entrepreneurial development reducing the risk of investing in new ideas. It will also be a substitute for the lack of safety net and inadequate social security schemes for individuals, who cannot otherwise survive the changed circumstances they will face such as illness, loss of job, divorce, etc.

³⁶² See Tilahun Teshome *et al*, *supra* note 342, at 82-84.