Essential principles of debt adjustment/settlement schemes across Europe

A summary of the Kilborn paper with an emphasis on how those principles can be incorporated into the forthcoming Irish Personal Insolvency Bill

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1. Introduction

In his paper - Expert recommendations and the Evolution of European Best Practices for the Treatment of Overindebtedness, 1984 – 2010, first published in August 2010, Jason Kilborn, Professor of Law at the John Marshall School of Law, Chicago, tracks the development of what he classifies as debt adjustment schemes across the Member States of the European Union[1]. Although Professor Kilborn is based primarily in the United States, he has a recent track record of publishing detailed papers on comparative insolvency issues and has conducted an in-depth examination of many of the most prominent debt settlement schemes in Europe. This latest paper is a synthesis of this comparative work over the past number of years.

Through the prism of the growing expertise of European researchers in the area and the 'trial and error' lessons of the various legislative schemes on debt adjustment put in place since the first attempt (the Danish legislation of 1984), Kilborn distils down the essential principles that now inform policy in this area across Europe and how these principles have developed and evolved from jurisdiction to jurisdiction. It is worth noting that although this paper is fleetingly referred to in the Law Reform Commission's (LRC) final report[2]; it is referred to as a working paper and was only accessed by the LRC in November 2010, the month before its final report was published in December of that year. Thus, it is doubtful whether the LRC had the opportunity to consider in depth the ordered set of principles outlined in Professor Kilborn's paper before publication of its final report, though much of his other work is cited in the LRC material.

It is submitted that this paper offers the most up-to-date and coherent guidance on the key principles of debt adjustment/settlement in Europe and that accordingly, any country, such as Ireland, preparing to introduce such legislation for the first time should pay very close attention to this guidance. Thus, there follows a brief exploration and summary of the key recommendations of Professor Kilborn's paper and, where appropriate, a treatment of how they might implemented in an Irish context, particularly in light of the recommendations made by the LRC in its final report in December 2010. It should be noted that this analysis does not consider the question of how existing mortgage arrears and mortgage debt generally might be factored into any debt settlement regime in Ireland. However, FLAC is extremely concerned that the advent of a new debt settlement infrastructure in Ireland may cause a sharp rise in

[1] As Kilborn points out, the terms used by Member States to describe their legislative schemes vary but broadly speaking, all encompass a formal, legal response to an individual's inability to service his or her debt burden that will generally involves a write-off of a portion of that indebtedness.
[2] See page 87.

house repossessions and every effort must be made to minimise this. FLAC therefore intends in the coming months to research this particular issue in further detail and to present further material as appropriate.

The Kilborn paper begins with a summary of many of the major research pieces carried out on the subject of legislative responses to consumer over-indebtedness in Europe. For the purposes of this paper, these include in chronological order:

- the Huls report developing recommendations for legal responses to overindebtedness commissioned by the EU Consumer Policy Directorate General (1993)
- the INSOL International (Federation of Insolvency Professionals) Consumer Debt report (2001)
- the IFF (*Institut fur finanzdienstleistungen*, Hamburg) report on Consumer Overindebtedness and Consumer Law in the European Union commissioned by the same Directorate General, now called Health and Consumer Protection (2003)
- the 'Debt Amnesty' Peer Review carried out by the EU Employment Directorate General focusing on the Dutch system for treating overindebtedness (2006)
- the Council of Europe recommendation on legal solutions to debt problems following the expert report compiled by Niemi-Keisilainen and Henrikson, commissioned by the Council's Committee on Legal Co-operation (2007)

The paper than explores and summarises the essential features of debt settlement schemes, citing examples from every country in Europe that has put such schemes in place, together with details of reforms that have been undertaken to replace or improve that which was not working or was not working efficiently.

2. Principles of debt adjustment

- **Discharge to be at the core of any scheme**

Kilborn suggests that there is now 'complete unanimity' on the necessity for national laws to contain a mechanism that allows debtors personal and household rehabilitation through a procedure that concludes with a discharge (or write-off) of part or most of their debt after a defined period of attempted repayment, what many refer to as an earned discharge. By 2010, 18 of the 27 Member States of the European Union had introduced schemes with the discharge principle and four more countries had produced draft legislation to do so[3].

It is essential that the forthcoming Irish legislation replicate the approach. The question of the length of time that the debtor must make repayments before a discharge will apply will be considered below. However, a separate issue of great importance that should be flagged here initially is the difference between schemes that decide in advance that a set amount of payment will be available to creditors in terms of a percentage of the debts owed (such as the Individual Voluntary Arrangement (IVA) system in the UK or debt adjustment in Denmark or Sweden) and those that oblige a debtor to pay to the best of his or her ability over a defined period of time by assigning any surplus income beyond minimum income to the benefit of his or her creditors (for example in Germany or Austria).

[3] Only Ireland, Spain, Bulgaria, Cyprus and Malta remain. Spain did produce new bankruptcy legislation in 2003 but it does not provide for the early discharge principle.

The LRC in its final report appears to have favoured the former approach without much analysis of the alternative but it is still questionable in the current circumstances in Ireland whether this is the right option. Insisting that a proposal is made to be voted on by creditors at a moment in time that cannot possibly anticipate upward (or downward) changes in disposable income may hamper rather than encourage settlements. In tandem with the necessity for a 60% threshold of creditors, this may see many applications being blocked on the basis that the creditor regards the proposed percentage towards payment of the debt it holds as insufficient. If a rigorous insolvency test is established and that test clearly objectively identifies the debtor as being incapable of meeting his or her debts in the medium to long term, why is there a necessity to also pre-determine in advance the amount that will be paid over the repayment period? Once the question of minimum income is decided, surplus income for distribution to creditors will be what it will be, even though a creditor has a legitimate expectation of receiving some of the money owed. Where the amount available is deemed insufficient over the duration of the repayment period, some jurisdictions insist that a minimum percentage of outstanding indebtedness be paid and thus the repayment period may be extended. On the other hand, where the debtor's situation improves, an incentive can be built in to allow the debtor to retain a percentage of the improvement for their own benefit.

- **Excepted or exempted debts**

Having agreed that discharge is an essential feature of debt adjustment schemes, an immediate difficulty presents itself – should there be exceptions to the principle of discharge for certain classes of debt? Again the thinking on this issue has evolved considerably in Europe over the years to a position where the number of exempted debts in legislative schemes has reduced considerably over time. From a situation where debts concerning maintenance payments to children and spouses, debts concerning student loans, debts to the State in the form of fines, taxes and state owned utilities, and damages to third parties were excluded from debt settlement, the expert report prepared for the Council of Europe in 2007 recommends that maintenance payments to a debtor's child should be the only exception. In summary, Kilborn notes that 'existing laws in Europe seem to have followed the recommendation to avoid eroding the discharge with exceptions'[4]. He contrasts this with the US where a total of 19 broad categories of debt are specifically identified as not subject to discharge.

Kilborn's view is clear – the fewer exempted debts the better - and it is clear that the LRC shares this view, particularly in light of its recommendation that the preferential status of debt to Revenue Commissioners be removed. Nonetheless, it does recommend that liability arising out of a court order made in family law proceedings, damages in personal injuries or other tort cases and liability in fraud cases should be exempted from debt settlement arrangements, though it is difficult to find fault with these exemptions.

Extra-judicial solutions – Access to debt counselling and settlement outside the courts

The twin pillars of access to debt counselling for those in debt and an attempt to settle debts (at least initially) outside of the court structure are identified as two further essential features of debt adjustment schemes. One of the few properly developed aspects of the debt resolution process in Ireland is the Money Advice and Budgeting Service (MABS), a well established debt counselling (or money advice) service with a good track record, although it is highly arguable that particularly in recent years it has been asked to do too much with not enough by way of resources, despite reasonably

[4] Page 16

consistent funding. This has not been helped by the complete absence of the second pillar – a legislative scheme for debt adjustment outside the courts – leaving MABS money advisors reliant upon the goodwill and common sense of creditors to reach informally binding agreements. Even where this is managed, these agreements have no legal force and any creditor may decide upon reflection to take the legal avenue, leaving arrangements made with other creditors potentially compromised.

Kilborn notes with some surprise that the principal rationale put forward for this twin approach is an economic (rather than a social) one, with the Council of Europe in its 2007 report seeking to find easier, faster and cheaper solutions and to avoid an increased workload for the courts. Certainly, without debtors having access to properly funded and trained debt counselling services to enable a proper consideration of financial circumstances to be made, settlements are unlikely to last. In addition, an out-of-court system will in most instances resolve cases more quickly. It is worth contrasting this position with the view sometimes put forward by governmental sources in Ireland that putting in place a new legal infrastructure for dealing with debt in Ireland would create greater expense. Perhaps it might initially, but the savings in terms of court time and the costs of other public and social services would eventually outweigh it and this appears to be the dominant view across Europe.

It is far from clear, however, at this point what role it is envisaged MABS money advisors (i.e. debt counselling) will play in out-of-court debt settlement arrangements in any future regime in Ireland. It is crystal clear that they are envisaged by the LRC to be the main driver of the proposed system of debt relief orders (DRO's) but it would appear that licensed personal insolvency trustees will be the main drivers and proponents of debt settlement arrangements. Whether debtors will have first consulted with MABS money advisors before being referred to a personal insolvency trustee for the purpose of a debt settlement arrangement is similarly not clear. How otherwise will people be aware of their options however? In this context, it is worth noting that the LRC proposes in its final report that '(MABS) money advisors would continue to play an important role in advising over-indebted individuals of their options, statutory and non-statutory, even if they do not act as personal insolvency trustees'[5]

This is turn begs a bigger question about the dissemination of information and the provision of relevant advice to people in very precarious and vulnerable financial and personal situations. Will the State as part of the new regime provide the necessary resources to ensure that debtors receive correct and appropriate information to their situation before entering into potentially binding and far reaching arrangements?

- **Encouraging out-of-court settlements**

Compulsory out-of-court negotiations

The principal method used to promote the use of out-of-court debt adjustment mechanisms in most European schemes has been to initially make its use compulsory for debtors. As a general rule, only those countries with a poor or absent debt counselling infrastructure have tended to bypass this stage. Kilborn does however note, citing the Danish and Swedish experience, that 'resort to a negotiation predestined for failure made little sense' particularly in terms of the time and effort expended. The increasing reluctance of creditors (including in particular, ironically, public agencies) to agree out-of-court settlement is also noted. For example, in the Netherlands, following a steady decline, only 9% of out-of-court proposals were being accepted by creditors by 2004. This decline has been somewhat

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arrested in recent years by removing the compulsory requirement for voluntary settlement, with debt counselling services now permitted to certify that any attempt at such a settlement would be pointless in a particular case, leading to the rate of such settlements in the Netherlands increasing to 33% in 2008.

Cram down

A second and more controversial method of 'encouraging' out-of-court settlement is to impose it upon creditors where a majority of their number accept a debtor's proposal[6]. Kilborn explains that the term used in the US to describe this phenomenon is 'cram-down'. He traces the historically mixed approach to such forced compromises in Europe, from the suggestion by Huls that 'cram-down' should be allowed where 75% of creditors support it to the more vague desire of the Council of Europe in 2007 that creditors should not be allowed to hinder out-of-court settlements 'unreasonably'. The practical application of cram-down across a range of European jurisdictions is explored by Kilborn and the prospects of enforcing such provisions from a legal and practical perspective are noted. It is suggested that the strictest examples occur in Sweden and France.

In the case of Sweden, he explains that in January 2007, Sweden moved from a three step process to one straightforward step. Previously, Step One involved mandatory private negotiation with creditors that would invariably be time consuming and would fail, Step Two saw an application for debt relief then being made to the state Enforcement Agency to be presented for voting to creditors, if (or when) this application was rejected, Step Three saw a court review the proposal and usually impose a 'cram-down'. In effect, the Swedish authorities decided to scrap steps one and three and trust the state Enforcement Agency to make the correct call on the appropriate repayment plan, in light of the fact that courts had up to now upheld the proposed plan in 90-95% of cases. Concerns that the property and European Convention rights of creditors would be affected were allayed by providing for an appeal to the Court against the Enforcement Agency's decisions.

In France, the debt adjustment process generally begins with the filing of a petition to a regionally based commission on individual overindebtedness, administered by the Banque de France (a fact in itself considered to be a powerful incentive for creditors to co-operate with the procedure). The commission acts, in Kilborn's words, as a 'sort of hybrid between debt counsellor and administrative tribunal', drawing up a repayment plan for presentation to creditors. Formerly, where the commission's plan involved a proposal for part payment and the proposal was rejected by a creditor/s[7], it would have to have been subsequently examined by a court which could impose a cram-down. However, with the rate of success for the acceptance of such voluntary plans falling from 70% in 2000 to 55% in 2008 and 2009, from November 2010, the commission is entitled to impose its own plan, again subject to a creditor's right of appeal into the courts.

Implications for the Irish scheme

Two critical points are of note here and they appear very relevant to the current Irish situation. Kilborn suggests that '(voluntary) plan negotiations usually fail either because no majority is likely to accept the debtor's inevitably meagre offering, or because one or a few creditors with large claims refuse to

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[6] In an Irish context, even the justifiably maligned Bankruptcy Act 1988 provides that bankruptcy can be avoided where at least 60% of the debtor's unsecured creditors in number and value vote to accept a proposal for part payment. Equally, an existing bankrupt can be discharged from bankruptcy where at least 60% in number and value of unsecured creditors accept a part payment proposal. However, these arrangements are made under the supervision of the High Court and can hardly therefore be described as out of court.

[7] Liquidation of assets followed by discharge or a payment moratorium for two years are two other options

support the process, likely with no rational economic basis'[8]. As we have repeatedly noted in this paper and elsewhere, the lack of published in-depth statistics on personal indebtedness in Ireland is a major obstacle to informed policy proposals for change. However, it is suggested that there are currently many indebted people in Irish society who will (generally through no fault of their own) be able to produce little surplus income when basic needs have been attended to. There will equally be many whose overindebtedness will be dominated by one or a small number of sources, and in many of these instances that source is likely to be a mortgage shortfall debt, following the repossession or voluntary surrender of a family home. In many cases, these two categories will overlap.

It is suggested that there are very important lessons to be learned here for the forthcoming legislative scheme in Ireland. The resistance of the credit industry in Ireland to the passage of legislation that would potentially impose write-offs of portions of debt is already well flagged, even though on a 'case-by case' basis, such write-offs undoubtedly do occur. It is likely therefore that credit institutions are likely to adopt, for want of a better word, an 'obstructionist' approach to voluntary out-of-court debt settlement arrangements, at least initially. Although the LRC's stated position in its final report is that once a property is repossessed and sold, a mortgage shortfall (or legacy debt) is an unsecured personal debt having the same rank as any other, the Commission also recommends that a threshold of 60% in value of creditors voting at a creditor's meeting must approve the debtor's application for a debt settlement arrangement. It is conceivable that in a number of applications, one creditor (particularly a former mortgage lender) will hold at least 40% (if not substantially more) of the applicant's total overall indebtedness and will be able to block the application. Crucially, the LRC report provides no mechanism for review and the debtor's application then simply fails for want of agreement.

This eventuality may have a considerable bearing on the framing of proposals for repayment. As noted above, the LRC has proposed that a network of licensed but private insolvency trustees will work with debtors to make proposals to their creditors under the new legislation, rather than the Money Advice and Budgeting Service (MABS) who seem destined to administer a separate system of Debt Relief Orders (DRO). Who is likely to apply for such a licence? In a recessionary climate and with financial and legal experience required, perhaps solicitors, accountants, even former mortgage brokers? Faced with a creditor or creditors blocking an application, a practitioner may seek to convince a debtor that a repayment plan will only fly if a commitment to pay a greater percentage of debts is made. This will not be helped by the fact that fees are only likely to be payable to the trustee if a proposal is accepted. In effect, this may sentence the debtor to unaffordable and unsustainable payments over a prolonged period, the antithesis of the purpose of debt settlement.

And what if the debtor ultimately refuses to sign up to a deal that he or she believes is not affordable? It is logical that he or she will then file for bankruptcy under the updated court bankruptcy legislation that is set to compliment the debt settlement scheme outside of the courts. If so, the Official Assignee's office that processes and administers these applications in the High Court can prepare for very busy times ahead. In this respect, it is notable that the Minister for Justice and Law Reform is reported to be concerned that excluding secured debt would make non-court settlements unattractive and people would opt for bankruptcy instead[9]. Handing creditors a veto on repayment plans may lead to the same result, the 'cluttering up' of the High Court route and the efficacy of the proposed DRO, Debt Settlement Arrangement and Judicial Bankruptcy suite of options proposed by the LRC being seriously compromised.

[8] Page 23
[9] Charlie Weston, Irish Independent, Thursday, January 12th, 2012.

We should therefore note carefully Kilborn's suggestion that 'if creditor resistance to the preferred out-of-court solution is to be achieved, a more aggressive approach to cram-down should be pursued'. He goes on to suggest that 'States attracted by the notion of imposing extra-judicial workouts should learn from the Swedish and French experience and keep the entire process out of the courts'. Of course, he adds that there must be a right for creditors to appeal to vindicate their rights. However, he suggests that 'given the small economic stakes involved for creditors, they can be expected to simply to capitulate to the reality of debtors' limited resources and the "pure formality" of engaging the courts to confirm that reality'.

In our view therefore the 60% threshold for creditor agreement may prove too high and it is arguable that no specific creditor approval should be required at all, if an efficient out-of-court system is to be prioritised, especially in the context of the likelihood that a significant number of applicants will have little to offer in terms of asset liquidation and surplus income. The recent Swedish and French initiatives and general European statistical trends of increased resistance to informal out–of–court settlement quoted by Kilborn suggest that if a State is to emphasise informal procedures, a strong enforcement agency must be put in place. However, again, looking at the LRC's final report, it is apparent that the Debt Settlement Office that is recommended (to be a part of a more general Debt Enforcement Office that of itself does not appear to be part of current government plans) is viewed primarily as an administrative body that will license and regulate private insolvency trustees and will register debt settlement arrangements but will not have the power to intervene in individual cases, particularly where a creditor or creditors have refused a reasonable proposal. In this respect, the debt settlement office is more akin to the Insolvency Service in the UK, albeit with better powers of supervision.

In our view, it is vital that an independent agency be set up to facilitate settlements as an alternative to court proceedings in the new regime. It is also essential in our opinion that a legislative scheme be sufficiently robust to give such an agency express powers to impose reasonable settlements upon creditors, subject to the procedural guarantees of appeal required by the European Convention and in the Irish context, Bunreacht na hEireann 1937. Anecdotally, it is apparent that some creditors would regard any attempt to impose debt write-off upon them as a breach of the Irish Constitution in terms of Article 40.3 and Article 43 which in essence both oblige the State by its laws to protect and vindicate the property rights of every citizen and to acknowledges the right to private ownership of external goods. However, critically, Article 43 also provides that the exercise of property rights ought, in civil society, to be regulated by the principles of social justice and may fall to be reconciled with the exigencies of the common good.

- **Representation for debtors in the formal procedure**

The lack of access to representation for debtors should formal court-based legal proceedings commence is noted by Kilborn, with Sweden cited as the only European country that systematically allows debt counsellors to continue to support debtors in formal insolvency proceedings. In this regard, Kilborn suggests that 'this is an area where both existing systems and those under consideration could be improved in a very meaningful way, and very few countries have effectively responded to expert calls for greater low-cost support of debtors in the formal system'.

It is clear that in the new infrastructure envisaged by the LRC, MABS money advisors are set to propose Debt Relief Orders (DRO's) and personal insolvency trustees (which may or may not include MABS money advisors) are to be the main proponents of debt settlement arrangements. In addition the LRC has proposed that personal insolvency trustees could also act on behalf of debtors, presumably when petitioning for their own judicial bankruptcy. However, where a creditor files for a debtor's bankruptcy and that debtor wishes to challenge the application, what legal assistance is or will be available to the debtor? It is submitted that civil legal aid from the Legal Aid Board should in principle be available in appropriate cases within the formal judicial bankruptcy system. In addition, detailed legal advice should be available from the Board in all matters concerning the new legislative regime.

- **Access to procedures at low cost**

Costs as a barrier to entry

Unsurprisingly, there is universal acceptance across the Member States that the costs of access to debt adjustment schemes should be kept to a minimum. However, achieving this has not been as straightforward as it may appear. Kilborn observes that many of the European debt adjustment schemes were designed out of the principles of business insolvency procedures. Whilst intricate procedural formalities may be necessary and appropriate in a high value case, there is little to be gained going through the motions with them in small or even non-existent estates, though a balance must be struck between necessary procedures and efficiency.

Three basic sets of costs are identified in the paper. The first are the costs of representation for debtors before, during and after the case. As noted above, Kilborn suggests that the question of representation is too often dealt with by states providing none at all and this is particularly unfair from an access to justice perspective at the court phase of a debt adjustment procedure. The second set is the costs arising from the carrying out of the various associated administrative tasks, which in a general civil law context will be borne either up front or incrementally by the litigant but which a person filing for debt settlement is unlikely to be in a position to pay. Finally, the most significant set of costs is likely to be incurred in administering payments under the repayment scheme for a period of years, generally in the form of fees charged by a trustee.

The payment of preliminary fees as a condition of entry has been identified as a major obstacle in many of the newer insolvency regimes in Eastern Europe. For example, in Slovakia, a mere 150 cases were opened in the first three and a half years of the legislation, due to the debtor's failure to show that his/her income was sufficient to cover the trustee's fee. Kilborn compares these schemes with the more established regimes in place in Western Europe prior to 2000 where, subject to some exceptions, debtors are not required to pay any upfront fees and the costs of administering payment plans are either absorbed by the State or are paid indirectly by creditors out of the debtor's surplus income that would otherwise be distributed to them.

The particular approach adopted in Belgium to ensure that access to relief for low income debtors is not denied is explained in some detail. Instead of imposing the costs of procedures on either debtors themselves or the State, the creditor is forced to take responsibility on a kind of 'the polluter must pay' principle, i.e. that the institutions that in large part caused the overindebtedness by refusing to comprehensively assess the risk of individual debtor default must underwrite the basic costs of the process. Thus, whilst trustees are in general paid their fees out of distributions to creditors, the state has also set up a separate fund financed by a levy on creditors assessed on the portion of each institution's consumer lending portfolio in default at the end of each year. This fund is used to discharge trustee's fees where the debtor has insufficient surplus income to pay such fees. This levy also has the added bonus of encouraging prudent lending as reducing the portion of the portfolio in default will decrease the amount of the levy payable.

Implications for the Irish scheme

Potential barriers to access in the forthcoming Irish legislation and the financial contribution that the lending industry will be asked to pay towards administrative costs of a debt adjustment/settlement are vitally important issues. We already have an entirely state-funded money advice service in operation since the early 1990's that, as a side-effect to its work, has indirectly organised the payment of millions of euro to credit institutions that have paid nothing in return. Equally, it can hardly be dispute at this point that a considerable amount of reckless and imprudent lending took place during the boom period. Those who created the mess should be involved in paying for the clean-up, not just in terms of write-offs arising from debt adjustment, but also in underwriting some of the administrative costs of the procedures as a formal recognition of responsibility. There may be those who will say that ultimately these costs will revert to the taxpayer as the taxpayer now owns the banks. However, this is not entirely true. Many banks currently operating in Ireland are not state-owned and other lenders - hire purchase finance companies, credit card companies, credit unions and moneylenders - were also responsible for a significant amount of lending that went awry. Most of these institutions continue to trade and many are still profitable.

Ultimately, Kilborn reiterates that the most effective method of ensuring access is to cut out unnecessary formality and complexity and thereby reduce costs. Thus, for example, many systems have capped trustee's fees on a sliding scale and reduced distributions to creditors to once a year to cut down on administrative expenses. The internet is also being used with greater frequency in order to reduce photocopying and printing expenses. However, lack of means on the debtor's part to cover basic costs persists and may require more drastic initiatives. In the UK, the inability of some debtors not only to cover costs but also to realise any surplus income for distribution to creditors resulted in the introduction of 'debt relief orders' in 2009, a new procedure comprehensively reviewed and analysed in the Law Reform Commission's final report in December 2010[10]. The cost of access to this procedure is £90, a considerable reduction on the total bankruptcy upfront payments of almost £700.

DRO's in Ireland

Access to DRO's in the UK is restricted to those whose disposable income, after tax and normal household expenses, does not exceed £50 per month, whose gross asset value does not exceed £300 and whose total amount of indebtedness does not exceed £15,000. It is notable that the LRC recommends that the equivalent of the DRO procedure should be introduced as part of the personal insolvency legislation here, but it stops short of putting a figure on the income, assets and total indebtedness limitations that should apply, instead suggesting that secondary legislation should establish these boundaries by reference to matters such as MABS client data and the research work on minimum income carried out by the Vincentian Partnership for Social Justice.

With each day that passes, it is likely that more and more debtors in Ireland become desperately in need of a debt relief order option. Unlike the debt settlement arrangement option it proposes, the DRO mechanism proposed by the LRC cannot be blocked by creditor vote, although the final report does in theory allow a creditor in limited circumstances to apply to a court to set aside a DRO. The question of

[10] See Chapter Two – Pages 111-144

what level it will be pitched at therefore becomes the vital question. In particular the issue of debtors being barred from a DRO because of having incurred indebtedness beyond a certain level may be relevant. Notwithstanding the absence of proper statistics in Ireland on overindebtedness, it is suggested that there are likely to be substantial numbers of indebted households now largely reliant upon state social welfare payments as their sole source of income or on very low incomes but whose overall indebtedness is substantially above the thresholds that apply in the UK. Should such households who are likely to currently meet any reasonable insolvency test be blocked from accessing DRO's because of the extent of their indebtedness? If they are and are rerouted to apply for a non-judicial debt settlement arrangement, as noted above, their application may be blocked by creditors in the event of a creditor value threshold applying. Again, will such a debtor then be forced to file a debtor's petition for bankruptcy to eventually get relief from their debts? And what will the implications of this be for a carefully designed three tier system?

Thus, it is submitted that the DRO levels recommended in the LRC final report may be too low. For example, they are likely to exclude any debtor with a mortgage shortfall (or legacy debt) following forced repossession or voluntary surrender of a property in negative equity, regardless of the level of surplus income and assets of that person.

- **Access restrictions - the requirement of good faith and the application of an insolvency test**

Good faith

All debt adjustment schemes inherently carry a risk of what many term as 'moral hazard', the risk that those who are not insolvent will attempt to avail of settlement to offload their debts or engineer a fraudulent insolvency to take advantage of settlement. It is therefore very important to ensure that the applicant for debt adjustment is actually insolvent before being admitted to a scheme and obtaining a potential write-off of debt, in whatever terms an individual jurisdiction defines insolvency. However, it is another matter to make value judgments about the conduct of the debtor that led to the insolvency in the first place and prevent access to settlement because of imprudent conduct. For this reason, very few European jurisdictions now impose a specific requirement to demonstrate 'good faith' and most countries now follow the recommendation made by Huls back in 1993 that good faith should be presumed and that bad faith must be proven, with only those who have acted fraudulently being excluded.

It is accepted that this is likely to offend many who have carefully honoured their credit obligations to the letter and have made considerable sacrifices to do so or those who have deliberately refrained from taking on credit obligations. In the debate concerning the introduction of debt settlement legislation in Ireland, some in this position have not been slow to express their displeasure at the potential write-off of consumer debt, especially in light of the even more onerous obligation to effectively underwrite the bank bailout. It is hard not to have sympathy with this viewpoint but the job of government, it is submitted, is to act in the best interests of society as a whole. If resolving cases of chronic overindebtedness is in society's long term interests particularly in terms of the economic benefits that may accrue, then the writing-off of a portion of an individual's debts is in reality a by product of a much wider policy that is argued by many (but by no means all) to be in the public interest.

Nonetheless, it has taken Europe a long time to get to this point and as Kilborn points out, the early Scandinavian schemes that set the tone for subsequent debt settlement systems in much of Europe were extremely restrictive in terms of conditions of access. Both the Netherlands and France still provide for explicit good faith requirements in their schemes but Kilborn suggests that by and large, open access is the norm, apart from barring access for those debtors who have provided false information in the process or where an attempt has been made to defraud creditors. The proviso in the systems in Belgium and Luxembourg that debtors who 'manifestly organised (their) insolvency' will be excluded is worthy of attention. In an Irish context, this formula might provide a litmus test for excluding those applicants who may be perceived to be jumping on the bandwagon to dump their indebtedness and may assuage some of the fears of those who clearly believe that moral hazard is a serious risk in many cases.

Insolvency test

Those fears should also be assuaged by the adoption in the forthcoming legislation of an insolvency test as a condition of access. In this regard, the European systems surveyed by Kilborn vary widely in their approach. The Scandinavian countries are among the most restrictive, with Denmark (the first jurisdiction to introduce debt adjustment/settlement) specifying that the debtor must be in a state of qualified insolvency with no prospect of being able to pay off debts in full in the near future, i.e. five years. The essence of an insolvency test is that it distinguishes between those individuals/households who with more time and access to debt counselling services will be able to pay all or the bulk of their debts over a longer period and those whose overindebtedness is chronic. This is far from easy and involves a wide ranging examination not just of current financial circumstances but also future prospects and projections of income, far from an exact science.

Woven into the insolvency test in many instances is the requirement that the debtor must have incurred a minimum debt level. If indebtedness does not reach this critical level, then, depending on the households financial prospects, the chances of debts being repayed in their entirety are clearly greater. Again, however, a huge amount depends on each applicant's circumstances and it is arguable that the imposition of a minimum debt level may exclude many whose need is genuine and who are fundamentally insolvent within the context of their particular financial situation.

Implications for the Irish scheme

In the Irish context, the LRC recommends an approach not dissimilar to that of the Danish scheme. Either the applicant's assets must be less than his or her liabilities and it is unforeseeable that this situation would change for at least five years or the debtor is unable to pay his or her debts as they fall due and it is unforeseeable that this will change over a five year period (the same length of time as the debt repayment plan). In turn, this assessment must be verified by the production of a Standard Financial Statement (SFS) and the trustee's certification.

However, one can readily foresee that some creditors may be likely to argue that the applicant for a debt settlement arrangement is not in fact insolvent and it would appear that the LRC report is silent on what may then occur if a creditor/s questions or contests the assessment of insolvency. Will this mean that a proposed application will be blocked before it even gets to the trustee 'proposing a repayment plan' stage? Will this mean that the application will automatically fall or will the Debt Settlement Office or other overseeing service be given an adjudication role here? Again without the proper powers and properly resourced infrastructure, our concern would that legitimate applications will be obstructed.

On the question of good faith, it is hard to disagree with the essential argument of the LRC that the infrastructure that it has suggested for non-judicial debt settlement arrangements provides sufficient checks and balances that applicants who are not acting in good faith will be exposed. It does not appear that imposing a minimum debt level was specifically considered by the LRC.

- **Length of repayment period and modifications**

Under this heading, Kilborn suggests that payment plans should not be overly extended but accepts that the question of the length of the repayment plan continues to be a controversial and hotly debated topic. Again, practical experience of the feasibility of lengthy repayment plans has by and large gradually led to a reduction of their duration across Europe. Thus many of the newer and revised schemes provide for three years or five years at a maximum, with some of the older ones still sticking to a longer maximum repayment plan, for example, France up to 8 years, Austria at seven years and Germany at six years. Similarly, the research reports on this tricky issue have also differed, with no agreed optimal duration apparent.

In practical terms, a number of considerations have to be balanced here. Creditors under debt adjustment schemes are inevitably going to have to accept write-offs and in many instances (especially for example in the very difficult economic circumstances in which Ireland finds itself) these write offs will be considerable and conceivably may amount to almost the entire amount of the money owed. To make the repayment period too short may be said to be adding insult to injury, as well as constituting too light a disincentive to incurring high levels of debt in the first place. On the other hand, an overly lengthy repayment plan may risk failure, given that the debtor concerned will have to survive for a long time on a minimum income and may lose heart in the course of what Kilborn describes as a period of 'indentured servitude'.

Implications for the Irish scheme

In the Irish context, the LRC has recommended that the maximum duration of the repayment plan under a debt settlement arrangement should be five years, with the prospect of some flexibility for differing repayment periods depending on the applicant's circumstances. Looking at European schemes in the round, this might be said to be about average, although the more recent trend is for three years. However, Kilborn notes that Huls's early recommendation for 'significant flexibility with respect to duration of the plan' has been roundly rejected and experience shows that the maximum repayment period becomes the norm. Thus, it is likely, especially with a likely conservative response from creditors, that five years in the Irish legislation would amount to just that. It should also be said that some schemes provide for extensions to regain missed payments or to attain a minimum level of payment, although the LRC do not appear to have addressed this issue specifying instead that 'a proposal must provide for the performance of its obligations within a period of five years'.[11]

The LRC has also recommended that bankrupt debtors should be automatically discharged on the expiry of a period of three years from the adjudication of bankruptcy.[12] Thus, the recommended periods differ between discharge from a debt settlement arrangement and discharge from an adjudication of bankruptcy in the courts. In light of the very strong emphasis placed across Europe on out-of-court settlement and the likely cost savings that result, does it make sense in terms of incentivisation that release from a debt settlement arrangement should be less immediate? In our view, that period should

[11] Page 88.
[12] Page 162.

be reduced to three years in principle, and some flexibility could be built in to extend the period where payments are missed or a minimum targeted repayment amount has not been reached.

- **Minimum income levels**

A vitally important and related issue is the level of income that the debtor (and household) will be entitled to retain for living expenses whilst making payments under the plan. In this regard, Kilborn suggests that the 'payment amount should reasonably support human dignity' and it is clear that the Council of Europe, in the context of its recommendations on legal solutions to debt problems, has emphasised this as a critical human rights issue. However, no clear uniform rules in this key area have been adopted across Europe. Not only that, but even in different areas of the same country operating the same debt settlement mechanism, regional variations on minimum income occurred on occasion to the extent that debtors were tempted to move home to more favourable locations. This kind of uncertainty and disparity is wholly unsatisfactory.

Many of the jurisdictions examined in the Kilborn paper appear to derive their rules on minimum retained income for the purposes of debt settlement from their attachment of earnings (AOE) legislation. In this context, FLAC's 2003 report 'An End Based on Means' provides a detailed analysis of attachment of earnings systems then in operation across Europe.[13] As a general rule, AOE systems across Europe vary from a discretionary case by case assessment made by a court (now far less common) to a more rigid application of fixed deductions systems, with variations on taking the number of dependants of the household, the costs of childcare, housing costs and special expenses into account. In general, the minimum budgets expected to be allocated in a debt adjustment arrangement as opposed to an AOE scheme are greater, as the duration of the repayment scheme is likely to be longer.

Implications for the Irish scheme

There is no underestimating the importance of this issue, both in terms of adhering to human rights standards and in terms of ensuring the effectiveness of the scheme. It is simply unconscionable that families would be left to face household expenses on inadequate incomes, in favour of excessive payments being directed to creditors. In any case, debtors may simply not sign up or will not adhere to repayment schemes that are unrealistic or are excessively punitive.

The debate on this aspect of the proposed legislation has not as yet developed to any great extent, but FLAC, together with a number of other non-governmental organisations working in the debt and housing arenas, recently published a document outlining nine key principles that might be adopted to resolve the personal debt crisis. The same day, the nine principles were outlined in the form of a presentation to the members of the Joint Oireachtas Committee (JOC) on Finance and Public Expenditure.[14] On the question of minimum income, this document summarised the position of the organisations as follows:

> *In our view, households should not be forced below the poverty line in an attempt to repair damaged loan books. From a human rights perspective and to ensure that processes are workable and sustainable, there is a clear need to set agreed thresholds of minimum income (dependent on household composition) to meet essential living expenses which are immune from debt repayment.*

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[13] For a detailed treatment, See section 8 and 9, pages 68 – 104 of that report.
[14] 19 October 2011, for further detail and the 'nine principles' document, see www.flac.ie

Any surplus should be available for distribution to creditors. This is the approach taken across Europe in debt settlement schemes.

Echoing a point already made at the beginning of this paper, a more detailed debate is needed on what form of basic repayment plan the Irish legislation will adopt. The LRC report clearly favours a proposal being made by an insolvency trustee to commit the debtor to paying a percentage of the relevant debts over the lifetime of the repayment plan. It is likely that the percentage of the debt to be offered will be based on that trustee's assessment of the debtor's financial situation at that point and his or her prospects of improved income beyond. It is also likely that the periodical amounts to be paid over to creditors during the course of the repayment plan if the offer is approved will be calculated on the basis that the plan will subsist for five years. However, incomes fall as well as rise and in the very difficult and uncertain economic climate in Ireland, is it a good idea to tie down the amount to be repaid in advance with the risk that the plan will disintegrate because of a failure to meet expectations?

The alternative is not to pre-determine the amount to be paid in advance but to focus instead on enshrining detailed rules around calculating minimum income, then consecrating surplus income to be distributed to creditors over the duration of the repayment plan. It is submitted that this may be preferable to set percentages that creditors vote to accept or not, once the fact of the applicant's insolvency is established. Incentives for the debtor to improve his or her earnings position during the course of the repayment plan can be built by allowing the retention of a percentage of that improvement for the benefit of the debtor and his or her family. The LRC has endorsed the need for such incentives to be built in to the system.[15]

Tying minimum income to applicable social welfare or supplementary welfare rates may be regarded as too simplistic, especially given the likely length of the repayment programme, but they do at least provide some initial benchmark and the LRC final report broadly accepts this. In terms of more detailed guidelines, the work of the Vincentian Partnership for Social Justice bears close examination. In particular, that organisation's working paper – 'Minimum Essential Standard of Living and the Retention of Income'[16] – provides detail of the complexity of calculating required minimum income dependent on household type and composition but crucially sets out a methodology that can be used for this purpose, developed with the expert guidance provide by both the Family Budget Unit (University of York) and the Centre for Research in Social Policy (University of Loughborough) in the UK.

It is submitted that the enemy of an effective scheme is the type of inconsistency that would see similar cases being treated differently and in this regard, Kilborn notes the trend away from schemes that allow any significant degree of discretion in calculating retained income, although it is also vital that some degree of flexibility be allowed in particular cases of hardship, for example the illness or disability of a child. One needs only to look to some of the decisions that are made in the District Court in Ireland in maintenance cases to see how the absence of clear rules and guidelines can lead to divergent decisions sometimes based on perception and an assessment of personal characteristics, perceived habits and personal responsibility. Perhaps this is sometimes mirrored too in the results of an individual's informal offers to repay debt on a case-by-case basis to credit institutions with people in similar financial positions obtaining different outcomes, depending on their ability to negotiate.

[15] See Page 95.
[16] August 2011.

In summary, there is no way that debt settlement legislation should be passed into law and proceed to operate without a fair and detailed consideration of the minimum income issue and the adoption of clear, consistent and workable regulations to support the primary legislation. If this issue is not tackled successfully, any new scheme will risk failure from the outset.

- **Zero payment plans**

It is important to observe at this point that despite good intentions, the experience in Europe is that many applicants for debt settlement do not have the capacity to make any payments at all, when minimum income is taken into account. We have also already noted above the difficulty that some applicants have in paying the initial costs and fees in order to access a scheme in order to find out. According to Kilborn, 'zero payment plans' have constituted a 'significant portion' of all payments plans in a number of the older systems from the outset, for example in Denmark, Sweden, the Netherlands and Germany. Thus, he suggests that these should be called debt adjustment or rehabilitation rather than payment plans to reflect their real focus.

If there is no capacity to pay, why then should a plan runs its full projected course? Again there is a divergence of practice in this area too. Some jurisdictions call it quits in the face of the overwhelming evidence – the debt relief order system in the UK which the LRC has recommended here is an example. Others insist on the plan running its course for pedagogical purposes. Kilborn, for example, quotes the Belgian governmental and parliamentary view that no payment plans have a 'symbolic character'. The downside as the IFF has pointed out is the substantial administrative expense on the State 'to achieve moral educational goals.

Implications for the Irish scheme

The realisation that a debt settlement arrangement may yield very little if anything over its lifetime for creditors, particularly in a very poor economic environment such as pertains in Ireland is salutary but necessary. The LRC seems to have understood this by recommending that debt relief orders along the lines of the UK system should be introduced in Ireland as an alternative. However, as already noted above, the notional qualification criteria for DRO's may be far too restrictive in the current context and so many to whom that option might be suitable may be routed into applying for a debt settlement arrangement instead. Again as noted above, the creditor approval threshold may then become a problem and if creditors demonstrate a lack of realism on this score, then a debtor's petition for bankruptcy may follow. The question therefore arises again – should an agency with stronger powers that those envisaged by the LRC for the Debt Settlement Office be put in place to impose repayment plans where creditor refusal may be seen to be objectively unreasonable.

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