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Discharge of Debts of Insolvent Entrepreneurs Under the Restructuring and Insolvency Directive

RESEARCH ARTICLE

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ABSTRACT

The article focuses on the discharge procedure for entrepreneurs as prescribed in the Directive on restructuring and insolvency. It analyses the elements of the discharge procedure for entrepreneurs that are harmonised with the Directive and whether it ensures a proper balance between the interests of the debtor and creditors. The author assesses how the concept of an 'entrepreneur' should be perceived under the scope of the Directive, the requirements of commencement of discharge of debt procedure and whether it indeed provides a fresh start for entrepreneurs after the end of this procedure. Where relevant, the article focuses on the comparison between the discharge procedure in the Directive and the rules of personal bankruptcy established in the US Bankruptcy Code (Chapters 7 and 13) which served as an inspiration to the Directive. Comparison of the relevant rules on the discharge procedures established in the Directive and the US Bankruptcy Code allows us to better understand the aims and goals of certain provisions of the discharge procedure in the European Union insolvency law and provide a conclusion on whether the proposed model of discharge procedure is effective. The author discusses whether the discharge procedure in the Directive managed to establish a fair balance between the interests of the debtor and creditors and whether it will improve entrepreneurship conditions in the European Union.

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INTRODUCTION

Until the adoption of the Directive on restructuring and insolvency (hereinafter – Directive),[1] the discharge of the debt of individuals (consumers and entrepreneurs) was only a matter of the national law of each Member State of the European Union (hereinafter – EU). However, the need for harmonisation of insolvency proceedings concerning individuals engaging in economic activities (entrepreneurs) has been on the agenda of the EU legislator for a long time.[2] It has been argued that from an economic perspective, personal insolvency (bankruptcy) laws which are more forgiving vis-à-vis the debtor and ready access to personal insolvency procedures may significantly enhance entrepreneurial activities.[3] Personal bankruptcy law also has a statistically and economically significant effect on self-employment rates.[4]

Empirical research has revealed that in the case of insolvency of the small business entrepreneurial firm which depends on the key individual is better served by the bankruptcy principles which were designed for the personal debtor rather than the corporate debtor.[5] Also, one study found that a debtor-friendly bankruptcy law regime results in higher risk acceptance among entrepreneurs, which in turn results in higher levels of entrepreneurship and innovation.[6] Thus, specific personal insolvency proceedings which differ from the general corporate insolvency proceedings should be established for cases of entrepreneurial types of business (individual or family business). The EU law should regulate the tools to respond to entrepreneurs' insolvency problems due to its importance for the proper functioning of the EU's internal market and its removal of obstacles to exercising the fundamental freedoms, such as the free movement of capital.[7] Harmonisation of the rules on the national discharge procedures for entrepreneurs (hereinafter referred to as discharge procedure) should ensure that relocation of entrepreneurs to other jurisdictions between the Member States of the EU (hereinafter – Member States) (*forum shopping*) is avoided and tackle low recovery rates of creditors.[8]

The need to harmonise the rules on insolvency proceedings concerning entrepreneurs in the EU led to the adoption of Articles 20–24 of the Directive which establish the rules on the discharge procedure. These rules require that certain elements, such as access to all entrepreneurs to the discharge procedure, no longer than 3 years discharge period, the disqualification period and consolidation of proceedings regarding professional and personal debts would be established in the national law of the Member States. The main rationale of these rules is based on the need to provide a fresh start to entrepreneurs after the discharge procedure and to decrease the stigmatisation of business failures.[9]

The Directive does not establish a separate autonomous discharge procedure but instead requires that the Member States should ensure at least one procedure for the full discharge of entrepreneurs' debts is available under their national laws (Article 20(1) of the Directive). Thus, though the discharge procedure remains in essence a matter of each individual Member State, the question arises what are the goals of the discharge procedure under the Directive? Is it only a mechanism to release a debtor from the debts or does it also include some elements of corporate insolvency proceedings, such as collectivism, a need for active participation of all creditors, supervision of insolvency administrator and others? What are the economic and social purposes behind the proposed elements of debt discharge? How, if at all, should the interests of the creditors be protected in the discharge procedure?

The analysis of the discharge procedure under the Directive has already attracted scholars' attention.[10] This article focuses on the problems related to the provision of a fresh start for insolvent entrepreneurs and compares the relevant provisions of the Directive with the rules of personal bankruptcy established in the US Bankruptcy Code which served as the inspiration for the adoption of the Directive. Thus, the goal of this article is to assess the key aspects of the discharge procedure, analyse whether it would contribute to the effective solution of entrepreneurs' insolvency and provide a fair balance between the interests of a debtor and creditors. The article consists of four parts: i) eligibility to ask for opening of the discharge procedure, ii) requirements for the opening of the discharge procedure, iii) fresh start for insolvent entrepreneurs, iv) analysis of the balance of debtor's and creditors' interests in the discharge procedure.

The author shall argue that the harmonisation of discharge procedure at the EU level is needed and falls under the scope of the EU law and harmonisation of the rules relevant to the proper functioning of the internal market. The Directive does not regulate other relevant aspects of individual insolvency proceedings, such as the exercise of creditors' rights, administration and realisation of the assets, participation of the insolvency practitioner and others. The proposed level of harmonisation only sets the guidelines for how entrepreneurs' insolvency should be treated instead of providing the full-scale harmonisation of entrepreneurs' personal insolvency proceedings.

1. WHO IS ELIGIBLE FOR THE DISCHARGE PROCEDURE?

To start with the analysis of the discharge procedure, it is relevant to establish who is eligible to ask for the opening of this procedure and benefit from it. In general discharge procedure should be applicable to all natural persons and cover all types of debts (contractual, tors, taxes and others). However, the Directive aims to provide a discharge procedure to deal primarily with the "professional" debt deriving from business activities, but

not consumption. This is an important shift of the general goals of discharge proceedings in insolvency law which is applicable to deal with insolvency problems of the consumers. Thus, this section deals with the question of who is eligible to apply for the discharge procedure under the Directive and what are the relevant criterion for the debtor who seeks commencement of this procedure.

One of the major aspects of the discharge procedure under the Directive is that it is designed for insolvent entrepreneurs. It seems correct to note that the distinction between "professional" and "personal" debt can be quite blurred in the context of small businesses where entrepreneurs often have to finance their businesses with credit cards and similar personal loans.[11] The national insolvency laws of various Member States, such as Latvia and Lithuania do not distinguish between personal insolvency proceedings concerning entrepreneurs and consumers. All individuals may apply for the same personal insolvency proceedings. The same approach to individuals' insolvency problems is applied under US bankruptcy law, as Chapters 7 and 13 of the US Bankruptcy Code which regulate personal bankruptcy proceedings do not establish separate procedures for consumers, respectively entrepreneurs. The main requirement for the opening of these US bankruptcy proceedings is the financial situation of the debtor (insolvency). The all-inclusive approach of avoiding the distinction between personal and professional debt in personal insolvency proceedings is also prescribed in the United Nations Commission on International Trade and Law (UNCITRAL) legislative guidelines for micro and small enterprises.[12]

Although Recital 21 of the Directive emphasizes the importance of effective mechanisms to deal with consumer over-indebtedness, it expressly states that this Directive does not include binding rules on consumer over-indebtedness. Also, the Directive does not apply to the procedure which concerns natural persons who are not entrepreneurs (Article 1(2)(h) of the Directive). Thus, the discharge procedure is primarily designed to deal with the over-indebtedness of insolvent entrepreneurs, and not of consumers. However, the maximum flexibility provided in the Directive allows the Members States of the EU to apply the discharge procedure to persons who are not consumers.[13] Pursuant to Article 1(4) of the Directive, the Member States may extend the application of the procedures referred to in point (b) of paragraph 1 to insolvent natural persons who are not entrepreneurs. Therefore, the Directive also does not exclude the application of discharge procedures for insolvent consumers.

Article 2(1)(9) of the Directive defines an entrepreneur as a natural person exercising a trade, business, craft or profession. The vagueness of this definition raises a question of who is eligible to use the discharge procedure and how the national legislators and courts should determine whether the debtor is an entrepreneur under the Directive. For instance, is it relevant for what period of time the person has exercised a trade, business, craft or profession? Is it relevant what proportion of the income comes from the entrepreneurship activities and (or) the debts directly derive from these activities? Should it also cover the situation when small business activities are carried out by a few persons, such as family members, and business partners?

To better understand the notion of an entrepreneur, one may also analyse the difference between this notion and the definition of a consumer in the EU law which is the opposite to the notion of an entrepreneur. According to Article 2(1) of the Directive on the Rights of Consumers,[14] a consumer means any natural person who, in contracts covered by this Directive, is acting for purposes which are outside his trade, business, craft or profession. It also defines a 'trader' as any natural person or any legal person, irrespective of whether privately or publicly owned, who is acting, including through any other person acting in his name or on his behalf, for purposes relating to his trade, business, craft or profession in relation to contracts covered by this Directive (Article 2(2)). Pursuant to the case law of the CJEU, the concept of a consumer is objective in nature and is distinct from the concrete knowledge the person in question may have, or from the information that person actually has.[15] To conclude whether, in a certain legal relation, a person is regarded as a consumer, it requires to assess the nature of the goods or service covered by the contract in question, capable of showing the purpose for which those goods or that service is being acquired.[16] Therefore, to answer whether a person is eligible to apply for the discharge procedure under the Directive, they should prove that their debts in essence derive from entrepreneurial activities which are unrelated to the provision of goods and services outside the professional activities (consumer activities).

The difficulties to separate debts of an entrepreneur and a consumer were noticed in the Proposal of the Directive according to which, entrepreneurs take personal loans to start and run their business, for example, because they guarantee their business loan with their personal assets such as a car, while natural persons use consumer credits to buy assets for their professional activity. Under the Proposal of the Directive, it was suggested that both types of debt can be consolidated, where applicable when incurred by individuals in their entrepreneurial activity.[17] The position of inclusion of all individual debts in the discharge procedure is also reflected in the text of the Directive. Recital 21 of the Directive establishes that it is often not possible to draw a clear distinction between the debts incurred by entrepreneurs in the course of their trade, business, craft or profession and those incurred outside those activities. Entrepreneurs would not effectively benefit from a second chance ("fresh start"), if they had to go through separate procedures, with different access conditions and discharge periods, to discharge their business debts and other debts incurred outside their business. This idea is reflected in Article 24(1) of the Directive which establishes that Member

States shall ensure that where insolvent entrepreneurs have professional debts incurred in the course of their trade, business, craft or profession as well as personal debts incurred outside those activities, which cannot be reasonably separated, such debts, if dischargeable, shall be treated in a single procedure for the purposes of obtaining a full discharge of debt. Therefore, one may argue that the Directive accepts that not all individuals' debts derive from entrepreneurship activities and the debts can also include the ones which derive from consumption. However, the strong indications of the insolvency of entrepreneurs in the Directive suggest that the discharge procedure is primarily designed to tackle the debts which derive from entrepreneurship activities and insolvency of the debtor is caused namely by the business failure, but not irresponsible consumption or other reasons.

The Directive is primarily designed to address insolvency problems of entrepreneurs deriving from professional activities, though it also encompasses personal debts (Article 1(4) of the Directive). Thus, the nature of the debts for the application of the Directive *ratione personae* is not that relevant. The discharge procedure is based on the general notion of insolvency proceedings which are based on an all-encompassing approach instead of an approach per legal relationship (the "certain legal relationship" approach).

Entrepreneurial activities of several entrepreneurs may intertwine. For instance, some persons can collaborate and share resources (assets), knowledge of certain commercial activities and pursue the same business goals. Also, there can be other persons related to the entrepreneur, for instance, a guarantor or a person who is jointly liable with the debtor to the creditors. This could be common in a small or family business when a member of the family may be the guarantor for the entrepreneur's civil liability. Unfortunately, the Directive is silent on whether discharge procedure is applicable to any extent to other persons related to the business activities of the entrepreneur, for instance, those who provide loans to the entrepreneur and (or) guarantee the performance of the debts. Some insolvency reports suggest that personal insolvency proceedings do not extend to joint debtors or guarantors who remain liable to their secured creditors. However, the discharge does prevent these co-debtors from recourse against the debtor.[18] This failure of the Directive to regulate the impact of discharge procedure on the persons legally related to the insolvent entrepreneur is a shortcoming which may impede the effective harmonisation of personal insolvency proceedings in the EU. The Directive should establish the rules which would address the impact of the commencement of the discharge procedure on other persons who are related to the debtor's entrepreneurship activities and their debts derive from their coordinated business activities, such as the persons who provide a guarantee to secure performance of entrepreneur's business. Noteworthy, such regulation is mentioned in the Proposal for a Directive of the European Parliament and of the Council harmonising certain aspects of insolvency law which requires the Member States to ensure that in simplified winding-up proceedings entrepreneur debtors, as well as those founders, owners or members of an unlimited liability microenterprise debtor who are personally liable for the debts of the microenterprise subject to simplified winding-up proceedings, are fully discharged from their debts (Recital 46, Article 56).

The failure of the Directive to establish the criteria to separate the insolvency of an entrepreneur and a consumer leaves a legal gap (omission) which may be filled by the national regulation and the national case law. Noteworthy, some Member States allow a combination of personal and professional debts in insolvency proceedings, if the creditors agree. For instance, in the Czech Republic, it is also possible to be allowed to undergo debt relief even with a part of the liabilities coming out of business operations, if the creditors agree to do so.[19] For this reason, the author argues that the Directive should include as least some guidelines on how the insolvency of an entrepreneur and a consumer could be separated, for instance, it could be established that in order to benefit from the regulation of the Directive the person has to prove that at least the majority of debts are incurred from the business activities and not merely consumption. In other words it should be demonstrated that substantial entrepreneurship activity represents most or all the indebtedness giving rise to the situation of insolvency of a natural person.[20]

2. REQUIREMENTS FOR OPENING THE DISCHARGE PROCEDURE

The requirements for commencement of insolvency proceedings are generally a question of significant importance since they trigger notable economic and social consequences (the debtor is allowed and/or obligated to suspend payments, individual enforcement actions against the debtor are stayed, restrictions for disposition of debtor's assets are applied etc.). Also, insolvency proceedings should be commenced timely since the over-indebtedness of the debtor may lead to a situation where the creditors will not be able to satisfy their claims at least to some extent and there are no assets to pay the costs of insolvency administration.[21]

A few rules on the commencement of the discharge procedure are established in Article 20 of the Directive. It requires that each Member State provides as least one procedure that can lead to a full discharge of debt in accordance with this Directive.[22] It establishes that irrespective of what personal insolvency proceedings are established under the Member States' national law, at least one of them should allow a natural person to be discharged from all debts except when the Directive allows derogations from this rule. Also, the Directive establishes additional criteria for the commencement of the discharge procedure.

First, the national law of the Member States may require that the debtor's business activities have ceased in order to apply for the discharge procedure (Article 20(1) of the Directive). This requirement is debatable. Modern insolvency law requires one to act promptly on solvency problems and continue running the business. In contrast, a requirement that the debtor's business activities are ceased to request for the commencement of the discharge procedure may lead to more over-indebtedness and fewer chances to return at least part of the debts. A debtor should not wait until the debts pile up but should react diligently to a deteriorating financial situation and apply for the discharge procedure. As such, the inclusion of this requirement may unfortunately hamper the effective application of the discharge procedure, depending on the implementation of Member States' laws.

Second, if the Member States' laws prescribe that the access to the discharge procedure is based on partial repayment of debts, such requirement should be based on the individual situation of the debtor and should consider the equitable interest of creditors.[23] The purpose of these two requirements is to facilitate access to full discharge of debt in case the national insolvency law requires that at least part of the debts should be returned. In essence, this requirement of partial payment is based on the test of proportionality, requiring to assess the entrepreneur's seizable or disposable income and assets during the discharge period and the equitable interest of creditors.

Noteworthy, the Directive does not establish a duty to commence the discharge procedure meaning that an entrepreneur has only the right, but not the duty to commence it. In contrast, a director of an insolvent enterprise usually has a duty to commence insolvency proceedings when the company becomes insolvent and is liable for the violation of this duty (civil liability may be imposed).[24] Article 19 of the Directive establishes duties for directors when a company reaches the likelihood of insolvency. Although the Directive is silent on whether entrepreneurs have such duty when they become insolvent, one may argue that the duty to commence the discharge procedure in time could be derived from Article 23(1) of the Directive. That article establishes certain derogations from the general availability of discharge procedure where the insolvent entrepreneur acted dishonestly or in bad faith under national law towards creditors or other stakeholders when becoming indebted and article 23(2)(c) of the Directive which establishes derogations when there are abusive applications for a discharge of debt. Nevertheless, these rules do not specify when a debtor should apply for the commencement of the discharge procedure. It should be noted that in some Member States, the failure to commence personal insolvency proceedings by a person whose debts derive mostly from the business activities in time may be regarded as an action in bad faith which may lead to the refusal to open these proceedings.[25]

Another important aspect of the Directive related to the commencement of the discharge procedure is how it deals with abusive applications. International insolvency law standards recognise the problems of abuse of insolvency proceedings when dishonest entrepreneurs look for a way to escape their creditors.[26] However, it seems preferable not to establish a strict check for abuse at the stage where proceedings are initiated (which usually entails strict duties of the debtor to provide a lot of information). Instead, the course of proceedings should be used to gather information and decide about a possible abusive strategy of the debtor. Also, it is recognised that the honesty of debtors is not simply taken from the fact that they lose all their assets due to insolvency alone. Instead, a debtor has to prove the worthiness of being discharged.[27] The goal of the honesty requirement is not to allow to take benefits of insolvency proceedings for persons who are culpable for intentionally negligent decisions, such as knowingly disadvantaging creditors in some way or taking on debt with no intention of paying.[28]

The standard of honesty varies greatly between the Member States. Some personal insolvency laws deny the discharge of debts to those who have acted in a notably culpable manner, a few Member States require debtors to demonstrate their "good faith" in the onset of their over-indebtedness and/or in their effort to obtain relief from that debt.[29] For instance, Article 6(8) of Insolvency Law of the Republic of Latvia establishes that in insolvency proceedings the general principle of good faith is applicable which means that persons involved in proceedings shall use their rights and fulfil their duties in good faith. Latvian insolvency law does not establish how to determine when a person with financial difficulties is in good faith, but rather establishes certain conditions of bad faith. For instance, Article 130(1) of the Law on Insolvency of the Republic of Latvia establishes that insolvency proceedings of a natural person shall not be applicable for a person who in the last three years prior to the commencement of insolvency proceedings of a natural person has deliberately provided false information to the creditors.

The insolvency law of Lithuania sets no clear requirements for the good faith of the debtor and leaves the individual evaluation of the position of the debtor for the courts but establishes that are bad faith actions which prohibit the opening of bankruptcy proceedings of a natural person. Pursuant to Article 5(8)(2) of the Law on Bankruptcy of the Republic of Lithuania, a court shall decline to open personal bankruptcy proceedings when it is established that, within three years preceding the filing of a bankruptcy petition, a natural person became insolvent as a result of entering into transactions defined in Article 6.67 of the Civil Code of the Republic of Lithuania and violating creditors' rights, without having the obligation to enter into such transactions, or other actions that, according to the Civil Code, are deemed fraudulent.

The Directive follows the path of the national regulations and establishes a list of examples of bad faith actions of the debtor in its recital 79 pursuant to which the nature and extent of the debt; the time when the debt was incurred; the efforts of the entrepreneur to pay the debt and comply with legal obligations, including public licensing requirements and the need for proper bookkeeping; actions on the entrepreneur's part to frustrate recourse by creditors; the fulfilment of duties in the likelihood of insolvency, which is incumbent on entrepreneurs who are directors of a company; and compliance with Union and national competition and labour law. The list of such situations may be helpful, but since they are listed in the recital of the Directive, it lacks binding power and should be interpreted only as a recommendation since the Member States are free to establish certain criteria for how bad faith behaviour may be interpreted. One may argue that due to the importance of the good faith criterion in the discharge procedure (separating honest and dishonest debtors) the EU law should establish a binding rule for establishing the good faith criteria as a necessary element for the commencement of the discharge procedure. The absence of binding examples of bad faith behaviour may encourage debtors to search for more favourable personal bankruptcy regimes in the Member States and this may lead to fraudulent forum shopping which is unacceptable in the EU insolvency law.[30]

3. FRESH START AS THE LEADING GOAL OF THE DISCHARGE PROCEDURE

Fresh start (a second chance) is vital for an effective discharge procedure. There is no surprise that a fresh start for an insolvent entrepreneur is one of the main goals of the discharge procedure in the Directive.[31] However, the mere recognition in the text of the Directive of fresh start does itself provide an effective discharge procedure. The key is to assess what elements constitute a fresh start and how they are regulated in the Directive. Thus, it is important to analyse what elements of fresh start are established in the Directive and whether it specifically aims to improve the effectiveness of the discharge of debts of entrepreneurs. The author argues that fresh start policy for consumers and entrepreneurs' insolvency proceedings differ since after a successful discharge procedure an entrepreneur should have a chance to pursue new economic activities which is not that relevant in the case of insolvency of a consumer. The elements of fresh start are established in different articles of the Directive and this section discussed whether they are enough to ensure effective insolvency proceedings of entrepreneurs.

The fresh start bankruptcy policy is deeply embedded in the US bankruptcy law. In 1934 the U.S. Supreme Court found that the fresh start in bankruptcy means that <…> *the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt*.[32] Moreover, it is even recognised that a fresh start for the debtor is the principal purpose of the US Bankruptcy Code.[33] According to Thomas H. Jackson, discharge not only releases the debtor from past financial obligations but also protects him from some of the adverse consequences that might otherwise result from his release.[34] Other authors argue that personal insolvency allows freeing debtors from the burden of lifelong indebtedness in order to achieve increased economic productivity and entrepreneurship, as well as to serve social justice aims and humanitarian goals.[35] Another important element is the protection of the debtors from other adverse consequences which they may face after or absent of this procedure. This protection is necessary to achieve the economic and social goals of the discharge procedure.

The discharge procedure aims to release a good faith debtor from debts (with some exceptions established in the Directive and the Member States' national laws), but it also should not deny creditors' interests since the procedure is collective and based on the accumulation of all creditors' claims. One of the problems in such cases is how to separate good faith (honest) and dishonest debtors who only seek the discharge of debt without intentions of payment of that debt. Such distinction is important not only for the commencement of the discharge procedure but also during this procedure and even after it. It has been already recognised that honest debtors can be stigmatised through association with the dishonest, especially in terms of social acceptance of the failed entrepreneur and burdensome debt repayments will make it difficult to begin a business.[36] However, the notion of good faith and its assessment vary greatly among the Member States and in some countries, this is not even the necessary requirement to commence these proceedings. Also, the question arises who has the burden to prove the debtor's good (or bad) faith and what is the role of the court (administrative authorities) in such proceedings?[37] Moreover, in entrepreneurial activities professional and personal debts business and personal are often used interchangeably and it remains unclear how to deal with the assets and debt which do not derive from the entrepreneurial activities but rather from the debtor's activities as a consumer (such as credits for a house and other assets).

The author argues that the discharge procedure does not solely aim to discharge the debtor of pre-bankruptcy debts. The main principles of insolvency proceedings, such as equality of creditors (*pari passu*) and maximisation of the value of the debtor's assets, remain applicable. Moreover, this article raises the question of whether bad faith (dishonest) debtors should take advantage of the discharge procedure and how dishonest behaviour should be determined. The Directive also recognises that the debtor may be dishonest and abuse the discharge procedure and

in this case, the derogations from the general rules of the discharge procedure may be applicable.[38]

The economic and social importance of "fresh start" and relief of individual debtors (consumers and entrepreneurs) from pre-bankruptcy debts has been recognised in the US bankruptcy law which apparently served as an inspiration for the discharge procedure in the Directive. Nevertheless, it seems that the discharge procedure in the Directive does not correspond to the personal insolvency models in the US Bankruptcy law *sensu stricto*. Chapter 7 of the US Bankruptcy Code regulates liquidation proceedings and Chapter 13 of US Bankruptcy Code regulates the adjustment of debts of an individual with a regular income when the debtor implements the repayment plan in a certain period. The discharge procedure is also based on the premise that the debtor receives relief from the debts (full discharge of debt),[39] but it also establishes a repayment plan which the debtor should implement in 3 years period.[40] Moreover, in personal bankruptcy proceedings under Chapters 7 and 13 of the US Bankruptcy Code, the participation of a trustee is mandatory while the Directive does not regulate the participation of insolvency administrators in the discharge procedure. Thus, it seems that the discharge procedure in the Directive includes the elements of both types of a personal insolvency proceeding in the US bankruptcy law and the comparative analysis between models of the discharge of debt in the US bankruptcy and EU insolvency law may serve as an important tool for the better understanding of the development of discharge procedure of entrepreneurs in the EU.

The Directive does not explain what a fresh start (a second chance) means. Instead, it requires that a fresh start should be provided in a reasonable period of time (Recital 5 of the Directive). Also, pursuant to Recital 73 of the Directive, the negative economic and social consequences of entrepreneurs' insolvency may be avoided by allowing for a full discharge of debt after a certain period of time and by limiting the length of disqualification orders issued in connection with a debtor's over-indebtedness or insolvency. Thus, the analysis of the fresh start concept in the Directive requires assessing when it should be provided and what economic and social advantage it brings to entrepreneurs.

First, according to Article 21(1) of the Directive, the period of discharge of debt cannot be longer than 3 years starting from the date of confirmation of the plan or the start of the implementation of the plan, or in case of another type of procedure, the commencement of those personal insolvency proceedings. There is no indication in the Directive why 3 years period should be the maximum period for the discharge procedure. It is indeed hard to argue whether 3 years of discharge of debt period is the best choice. Nevertheless, the fact that the common maximum period of the discharge procedure found a consensus on the EU level provides more legal certainty and helps to combat fraudulent forum shopping of debtors seeking to run from the creditors and search for more favourable insolvency regimes in other Member States. However, the *travaux préparatoires* of the Directive indicate that one of the main goals of the Directive was to reduce the period of discharge since shorter discharge periods are linked to improved entrepreneurship.[41]

Another facilitation (simplification) of the discharge procedure is related to its closing. The Member States shall not require any additional procedure for closing the discharge procedure when the debtor meets all obligations. However, the judicial or administrative authority should verify whether the entrepreneurs have fulfilled the obligations for obtaining a discharge of debt.[42] Also, the end of 3 years discharge period does not automatically mean that the realisation and distribution of assets of an entrepreneur that formed part of the insolvency estate should be hindered.

After the 3 years period of the discharge procedure, any disqualifications from taking up or pursuing a trade, business, craft or profession on the sole ground that the entrepreneur is insolvent shall cease. It means that the debtor after the 3-year period is not only discharged from all debts but should also enjoy a fresh state for new business activities. Also, a fresh start seems to be automatic and should not require the commencement of additional proceedings before the court or administrative authority.[43] This element of fresh start is reflected in Article 22(1) of the Directive which prohibits disqualification of insolvent entrepreneurs from taking up or pursuing a trade, business, craft or profession on the sole ground that the entrepreneur is insolvent at the latest, at the end of the discharge period. The aim of this provision is to ensure that entrepreneurs should not be prohibited from pursuing new entrepreneurship activities of the entrepreneur after the end of the discharge procedure. This also reflects the social goals of EU law to treat insolvency not as a social stigma, but only as an unsuccessful attempt to pursue entrepreneurial activities. The fresh start policy in the discharge procedure suggests that the aim of this procedure is not to rescue entrepreneurs' businesses, but rather to rescue and rehabilitate the entrepreneur who failed to run business activities. The strict time limit of the discharge procedure and prohibition to disqualify an entrepreneur from pursuing entrepreneurship activities only because of unsuccessful business decisions significantly contribute to the effectiveness of the discharge procedure and social protection of entrepreneurs.

Nevertheless, it remains debatable whether the elements of a fresh start in the Directive are enough to allow an entrepreneur to begin new entrepreneurship activities and take advantage of the discharge procedure. Does it provide the legal instruments to ensure that the insolvency entrepreneur will have real chances to start new business activities after the discharge procedure? The Directive is silent on whether an entrepreneur should continue entrepreneurship activities after the opening

of the discharge procedure and how necessary funding should be attracted for such activities. In contrast, it emphasizes the importance and protection of transactions which provide interim and new financing which may be crucial for the rescue of the viable enterprise and proper implementation of the restructuring plan in restructuring proceedings.[44] It would be also hard to argue that such financial support and the need to ensure that the insolvent entrepreneur does not stop business activities during the period of the discharge procedure and after it. The need for financing in the discharge procedure was also noted by the European Commission before the adoption of the Directive: *Access to finance is paramount for a second chance. Suitable financing solutions for re-entrepreneurs need to be put in place. Re-starting entrepreneurs need capital, cash flow and credit, with few, if any, restrictions on future trade, without being encumbered with long repayment periods of debts captured by a bankruptcy proceeding.*[45] Nevertheless, the Directive is silent on the access to new (additional) financing for the debtor to maintain entrepreneurship activities during the period of the discharge of debt and does not provide any mechanisms to support the insolvent entrepreneurs after the end of this procedure. Thus, though the Directive makes great emphasis on a fresh start for entrepreneurs, it does not establish any rules on how the debtor should continue business activities during the discharge procedure and after it. This omission of the common rules related to the need to continue entrepreneurship activities during the discharge procedure is one of the missing elements of the fresh start policy in the Directive. Without the needed financial support an entrepreneur may not be able to effectively commence entrepreneurship activities after the discharge procedure.

4. SEARCH FOR THE BALANCE OF DEBTOR'S AND CREDITORS' INTERESTS

The discharge procedure is a type of insolvency proceeding. In insolvency proceedings, the balance of the debtor's and creditors' interests should be ensured. This balance becomes more socially sensitive in personal insolvency proceedings which on the one hand seek to maximise returns on creditors' legitimate claims, but on the other, to preserve the human dignity of debtors and their families.[46] The need to ensure a fresh start for the debtor, as well as fairness to the creditors is also recognised in the US bankruptcy law.[47] As it was recently mentioned by the US Supreme Court, the Bankruptcy Code strikes a balance between the interests of insolvent debtors and their creditors.[48] This section deals with the problem of whether the rules on the discharge procedure in the Directive establish such balance between the interests of the debtor and creditors. Though the debtor in such a procedure aims for a prompt full discharge of pre-bankruptcy debt, the interests of creditors to receive the satisfaction of their claims do not disappear. Thus, it is relevant to analyse whether the Directive establishes a fair balance between the interests of the debtor and creditors.

The Directive does not regulate creditors' participation in the discharge procedure and there are no indications of what the role of courts should be in such procedure and how active they should be to ensure the protection of creditors' interests. Also, it does not establish any rules on whether the participation of insolvency practitioners is mandatory in the discharge procedure and what functions they have. All these questions are left for the Member States' national laws. The Directive as such fails to regulate the protection of creditors' interests at all. The derogations set out in Article 23 of the Directive could be regarded namely as an attempt to establish the balance rules for the protection of creditors and avoidance of abuse of the discharge procedure. However, since the transposition of most of the said derogations is left to the discretion of the Member States the author argues that the Directive lacks harmonisation of creditor's protection in the discharge procedure. These aspects also suggest that the interests of the debtor to get a full discharge of the debts do not outweigh the interests of creditors.

Article 23 of the Directive establishes derogations from the application of Articles 20–22 of the Directive which aims to protect the interests of creditors and avoid abuse of the discharge procedure. These derogations demonstrate that a full discharge of debt shall not be interpreted as an absolute (unconditional) discharge from all debts irrespective of the debtor's behaviour and the nature of the debts. However, the wording of the derogations of Article 23 of the Directive suggests that they do not seek harmonisation of the national regulations of the Member States, but rather aim to provide certain guidance. It is important to make a difference between the wording in paragraphs 1 and 5 of Article 23 of the Directive. Article 23(1) of the Directive uses strict wording "shall" while other paragraphs employ a more flexible word "may". Thus, it seems that the Member States have only a duty to implement and transpose Article 23(1) of the Directive into the national law while the transposition of other derogations set out in this article should be decided by each Member State. Such options for the implementation of the Directive legislative, on the one hand, give more flexibility to the national legislator to regulate insolvency proceedings, but on the other, open doors for abusive forum shopping since these derogations constitute important aspects of insolvency proceedings.

Pursuant to Article 23(1) of the Directive, by way of derogation from Articles 20 to 22, Member States shall maintain or introduce provisions denying or restricting access to the discharge of debt, revoking the benefit of such discharge or providing for longer periods for obtaining a full discharge of the debt or longer disqualification periods, where the insolvent entrepreneur acted dishonestly or in bad faith under national law towards creditors or

other stakeholders when becoming indebted, during the insolvency proceedings or during the payment of the debt, without prejudice to national rules on burden of proof. In other words, the Directive allows the Member States to restrict access to the discharge procedure when a debtor acts in bad faith. This derogation shall be interpreted together with Recital 1 of the Directive which establishes that only honest insolvent or over-indebted entrepreneurs can benefit from a full discharge of debt after a reasonable period of time. This derogation from the general rules to access the discharge procedure is of fundamental importance even despite its vagueness. It means that, first, full discharge of debt is permitted only to good faith debtors. Second, bad faith actions could be directed at the debtors' creditors or other interested persons. Third, a debtor may be able to prove that they acted in good faith before indebtedness. Also, this derogation can be applied when the debtor acted in bad faith: i) when becoming indebted; ii) during the insolvency proceedings; iii) during the payment of the debt. This is particularly important since the Directive requires debtors to act in good faith and honestly not only before the discharge procedure but also during it. Therefore, the Directive allows full discharge of debt only when the debtors act in good faith before and throughout the discharge procedure.

Article 23(2) of the Directive is a supplement to Article 23(1) of the Directive. This article requires that the circumstances when derogations of Article 23(1) of the Directive can be applied should be justified and establishes a list of such examples. Such a list is useful since it gives a direction how the Member States should modify their insolvency acts. A particularly important example of derogation is established in Article 23(2)(f) of the Directive which requires to ensure the balance between the interests of the debtor and creditors. Though the wording of this example is vague, the rationale of this example is that in the debtor's insolvency proceedings, the interests of creditors should be ensured and respected. This provision leaves room for the courts to react to the bad faith actions of the debtor which violate the interests of the creditors.

Another derogation concerns the period of the discharge procedure. Pursuant to Article 23(3) of the Directive, Member States may provide for longer discharge periods in cases where: (a) protective measures are approved or ordered by a judicial or administrative authority in order to safeguard the main residence of the insolvent entrepreneur and, where applicable, of the entrepreneur's family, or the essential assets for the continuation of the entrepreneur's trade, business, craft or profession; or (b) the main residence of the insolvent entrepreneur and, where applicable, of the entrepreneur's family, is not realised. This derogation has already received some criticism since it provides less protection for the debtor's "tools of trade" and "main family residence"[49] instead of providing that certain types of property (assets) do fall within the insolvency estate of the debtor. However, this derogation draws a subtle balance between the vital interests of the debtor and his family members and the interests of creditors. Since in some cases the family dwelling may be used as a security for financial means (credits, loans) and work as collateral to secure the debts deriving from entrepreneurship activities, the national laws should prescribe additional requirements for the protection of the family residence and similar types of assets which have significant social importance. Such protection of the vital interests of the debtor and his family members has been already recognised in the US bankruptcy law. For instance, Section 522 of the US Bankruptcy Code establishes a list of exemptions of the property (necessities of life) which are excluded from the insolvency estate. Also, some national laws of the Member States. According to Article 8(9) of the Law on Bankruptcy of Natural Persons of the Republic of Lithuania, the debtor may conclude an agreement with the secured creditor that the pledged property (collateral) would not be part of the insolvency estate and remain protected if the applicants and the mortgagee have entered into an agreement for the preservation of the pledged property; the pledged property is the only residential dwelling necessary to meet the needs of the natural person and/or his/her dependents; the funds allocated to the mortgage creditor for monthly payments under the agreement are less than the funds required for renting a dwelling to a natural person on a monthly basis in the case of the sale of a mortgaged property, which is the only residential dwelling. The aim of this right is to exclude certain assets which are necessary to protect the vital interests of the debtor and his or her family member from the general insolvency estate which is used to satisfy creditors' claims.

Another derogation relates to the discretion of Member States to establish the debts from which the debtor is not discharged. The idea that the debtor may not be discharged from certain types of debts shows that the interests of certain creditors are more economically and socially important than the ones of the debtor. The exceptions to discharge are often established in the national laws and in many cases relate to the debts which derive from alimony and spousal support, taxes, damages from injury and crimes.[50] Nevertheless, it is debatable whether the exception of secured debts is fair, particularly considering the importance of the principle of equality of creditors (*pari passu*) and the need for a full discharge of debt.

According to Article 23(4) of the Directive, Member States may exclude specific categories of debt from discharge or restrict access to discharge procedure or lay down a longer discharge period where such exclusions, restrictions or longer periods are duly justified. Also, this article provides a list of types of non-dischargeable debts.[51] The list of non-dischargeable debts also reflects the social interests which are protected in personal insolvency cases and are rather common in these proceedings.

The last derogation relates to a fresh start for the debtor after the discharge procedure. According to Article 23(5) of the Directive, Member States may provide for longer or indefinite disqualification periods where the insolvent entrepreneur is a member of a profession: (a) to which specific ethical rules or specific rules on reputation or expertise apply, and the entrepreneur has infringed those rules; or (b) dealing with the management of the property of others. Considering the policy of a fresh start and the main in entrepreneur's insolvency, such exceptions should be interpreted narrowly and indeed applicable in exceptional cases. The idea that a person may be longer or even indefinitely disqualified from taking entrepreneurship activities should be an *ultima ratio* solution which has a clear punitive purpose.

To sum up, the derogations set out in Article 23 of the Directive should be regarded as an attempt to establish a fair balance between the interests of the creditors and the debtor. The rules establishing these derogations provide a lot of discretion for the Member States on how to reach this balance, but also serve as an important tool for the harmonisation of these relevant aspects of individuals' insolvency proceedings in the EU insolvency law.

CONCLUSIONS

Effective discharge procedure is necessary for the improvement of the environment of entrepreneurship-type businesses. The main elements of the effectiveness of this procedure are full discharge of debt within a certain time limit and a fresh start to continue and pursue business activities. This article found that the discharge procedure in the Directive contributes to these goals and is an important impetus for the improvement of the conditions for entrepreneurship type of business in the EU. Also, the article focuses on the comparison of discharge procedures established in the Directive and the US Bankruptcy Code and found that the US bankruptcy law served as an inspiration for the discharge procedure in the EU insolvency law. This comparison allows us to reveal the purpose and aims of certain provisions of the Directive and whether they ensure a proper balance between the interests of the debtor and creditors.

The Directive does not lay down a specific model of how insolvency problems of natural persons (entrepreneurs) should be tackled. Instead, it merely sets out the main goals which the Member States shall reach when establishing the rules of the discharge procedure. It harmonises some basic aspects of the current national regulation of personal insolvency without tackling the systematic differences between these proceedings. Also, particularly relevant practical aspects of the discharge procedure such as the content and adoption of a repayment of debts plan, duty to commence such procedure, and order of realisation of debtor's assets are not harmonised under the Directive at all. Nevertheless, the recitals of the Directive, though lacking binding legal nature, should be considered by the national court interpreting the national rules of insolvency of natural persons.

The Directive is primarily designed to tackle the insolvency problems of entrepreneurs and provide a fresh start after the discharge procedure. Since the Directive deals with the insolvency problems of an entrepreneur, it should establish at least some guidelines to separate debts which are incurred by entrepreneurs from business and consumption activities. For instance, it could be established that in order to benefit from the discharge procedure the person has to prove that at least the majority of debts are incurred from business activities and not merely consumption. In other words, it should be demonstrated that substantial business activity represents most or all the indebtedness giving rise to the situation of insolvency. Also, the Directive is silent on whether the discharge procedure is applicable to any extent to other persons related to the business activities of the debtor, such as a guarantor or a person who is jointly liable to the creditors. The failure of the Directive to regulate the impact of the discharge procedure on the persons legally related to the insolvent entrepreneur is a significant shortcoming to the effectiveness of the discharge procedure.

Though the Directive clearly aims for the impetus of the fresh start policy, it is debatable whether the rules of the Directive are sufficient to reach this goal. One of the main problematic questions remains the need for additional financing for an entrepreneur for continuing entrepreneurship activities during the discharge procedure or after it.

The derogations from the rules in Articles 20–22 of the Directive aim to protect the interests of the debtor's creditors and provide a fair balance of their interests. Nevertheless, since most of the derogations are optional, the Member States are free to choose to implement (or not) them into the national insolvency laws. The Directive does not regulate creditors' participation in the discharge procedure. Moreover, it even recognises that there is no requirement that a repayment plan be supported by a majority of creditors. Also, there is no indication of the role of the court in the discharge procedure and how active it should be to ensure the protection of the interests of all stakeholders in this procedure.

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