

# The New Age of Debt

## ...and the common function of insolvency and restructuring law

Prof. Dr. Stephan Madaus presents his thoughts on debt cancellation in an essay based on his after-dinner presentation at the recent Academic Forum Annual Conference in Cascais (Lisbon, Portugal)



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**W**e are witnessing a new, unprecedented “Age of Debt”<sup>1</sup>.

**Almost ten years after a financial crisis that was triggered by the accumulation of unsustainable debt in the household and financial sectors, debt levels have not declined.**

Years of economic stagnation and the costs of the financial sector bailouts in Europe, but also excessive growth in China and other developing countries, account for a continued increase in global debt. According to a 2015 study by the McKinsey Global Institute, global debt rose by \$57 trillion since 2007 to a total amount of \$199 trillion in 2015, clearly outpacing the world GDP growth.<sup>2</sup> High levels of debt across different sectors (government, household, corporate and financial) are a problem, as they reduce the capacity to finance investments or consumption using new lines of credit, which is bad for any economic recovery.

High debt levels are all but new. Debt and over-indebtedness have been constant companions to economies at all times. Debt crises were common in the ancient Near East already.<sup>3</sup> Structural over-indebtedness was demonstrated in Europe from the 13th to the 19th century.<sup>4</sup> To give credit and to live and work on short-/long-term credit lines has always been a common denominator of human interaction. In a past world in

which credit relationships were personal, credit was given based on social norms and responsibilities of the creditor (sic!) rather than on the expectation of a prompt repayment. Historical research<sup>5</sup> shows that a common way to handle an insolvent debtor in a personal credit relationship in rural communities in 13th century England, but also in 19th century Germany, was to suspend payments on the principal amount for decades while expecting payment on interest and waiting for a setoff with unpaid credit. It was the repayment of credit from (tax or church) officials or “outsiders” (foreign traders or Jews) which was usually legally enforced. Today, most of our creditors are such “outsiders” as they are not bound or restricted by social norm when enforcing their legal rights.

Over time, different strategies have been developed to address a high level of debt in an economy. For a larger part of societies, a network of debt was the very fabric of social cohesion, never really meant to be paid.<sup>6</sup> If it was, a high debt level was always a menace to social peace. Debtors would try to get rid of their creditors by violent means. Peasants, in particular, would rebel against their landlords (and creditors).<sup>7</sup> An early response to a debt crisis that had the potential to spark uprisings was a “clean slate” policy. Already under the Law of Hammurapi of ancient

Mesopotamia, it was customary for rulers taking the throne for their first full year to “restore order” and “righteousness” by cancelling the debt of their peasants (barley debt and mortgage liens)<sup>8</sup> – a tradition that found its way into the Bible with the Jubilee Year (the cancellation of debt every seven years)<sup>9</sup> – but has not been practiced in a relevant economic way for centuries. Another way to quickly lower the overall level of debt is hyperinflation. However, this option involves socio-political consequences that are less than welcome, as one could witness in the 20s in Germany, with all the traumatic repercussions. Hyperinflation means a hard and uncontrolled debt restructuring for everyone in the market at the same time. It is a “brutal mechanism for reducing the real value of debts”.<sup>10</sup>

For centuries, the most practical way to handle high debt levels and over-indebtedness has been to wait for the dissolution of the debtor (and their debt). This solution is obvious for a corporate debtor where a liquidation can be done under company law, but (if over-indebted) also under insolvency law. The process has always resulted in paying creditors (partially) from remaining assets and cancelling all unpaid debt with the dissolution of the corporate entity. In case of an individual being the debtor, the debt cancellation has actually not been affected much differently if



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we consider common insolvency proceedings relating to a deceased (insolvent) estate. The only major difference is the sequence of events: in a corporate winding-up, the liquidation of the insolvent estate precedes the dissolution (death) of the entity, while for individual debtors, their death precedes the liquidation of their insolvent estate. From this perspective, insolvency law and insolvency proceedings have always played a key role in handling over-indebtedness and non-performing loans in market economies.

The role of insolvency law seems even more relevant when we add restructuring procedures to the analysis. Over-indebted, but honest merchants have always enjoyed contractual debt

restructurings within their networks of merchants.<sup>11</sup> Corresponding statutory rules, which have facilitated a renegotiation of contractual agreements by allowing for a majority vote in case of formal insolvency proceedings relating to a merchant (composition or accord), were common to insolvency laws of all major medieval trading capitals like Ferrara, Florence or Milan.<sup>12</sup> The privilege of a composition was extended to non-merchants only rather recently. Today, modern civil law expects any consumer to act like a merchant – handling credit and liquidity, comparing competing offers, taking insurance and risk in the market for consumer goods and services. A facilitated debt restructuring

option would, thus, be consistent with our consumer image.

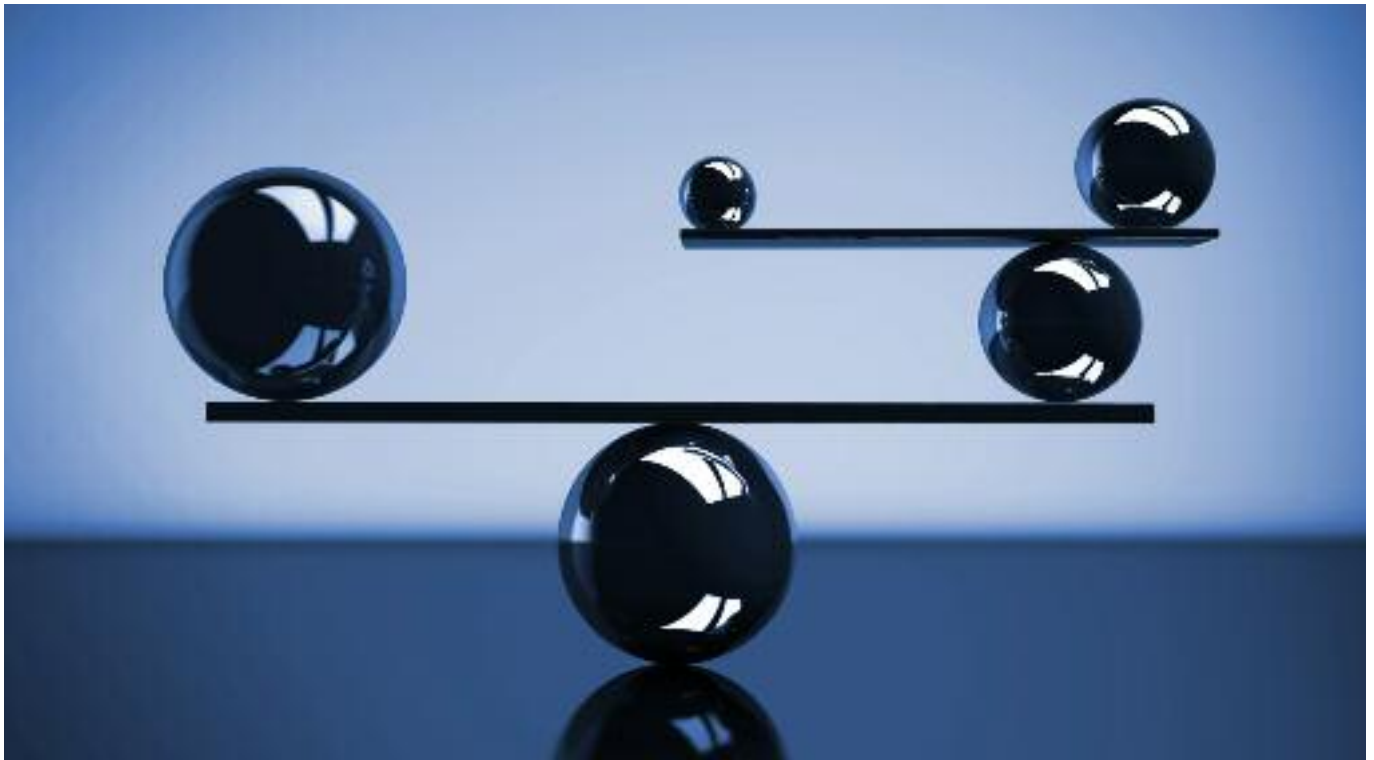
A functional analysis of insolvency and restructuring proceedings reveals that all such proceedings share one common effect: debt cancellation. This seems to be common knowledge to macroeconomists when they praise the decentralised debt reduction “handled routinely by private renegotiations or formal bankruptcy procedures [...] without causing more than low-intensity ‘background noises’ for the system as a whole.”<sup>13</sup>

At the same time, such procedures have another common function: they provide a procedural mechanism able to identify what fraction of a debt a debtor is still able to serve. It is only non-performing loans in a

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## THE COMMON DEBT CANCELLATION EFFECT OF INSOLVENCY AND RESTRUCTURING PROCEEDINGS SHOULD MAKE THE FURTHER DEVELOPMENT OF SUCH PROCEDURES A PRIORITY



debtor's debt pile that is cancelled. This mechanism is obvious in liquidation proceedings. Here, the collection of all debts, plus the sequestration and liquidation of all assets, results in a precise determination of the capacity of the debtor to pay the debt at the end of the proceedings. For a corporate debtor or deceased individuals, this is also the moment when they (more exactly their estates) exit the market. Unpaid debt ceases to exist. In restructuring proceedings, it is a contract between all or some creditors and the (individual or corporate) debtor by which the ratio of non-performing credit is fixed and cancelled. Here, a delay of payment may also increase the nominal ratio of performing loans. Nevertheless, the basic function of such procedures remain the same. They determine what a financially troubled debtor is able to pay and cancel out the exceeding fraction of debt.

Finally, insolvency proceedings for consumers show the very same effect if they are connected with a discharge. Here, the liquidation of the debtors' estates (and/or a possible

additional payment period) also determines their ability to pay and the fraction of non-performing credit which is then dissolved by a discharge.

### Conclusions

Several conclusions could be drawn from this insight.

The common debt cancellation effect of insolvency and restructuring proceedings should make the further development of such procedures a priority for all economies with an unhealthy level of debt.

Compared with the alternative instruments of immediate debt cancellation (clean slates, hyperinflation), such proceedings deserve a favourable treatment and image. Where paying all non-performing loans is impossible (over-indebted debtor), continuing the *status quo* (e.g. by granting payment periods for decades, with little or no interest) leads to a stagnation not only of the overburdened debtor (who is hardly able to finance new investments with a new line of credit), but also of the economy as a whole. It is as much in the macroeconomic

interest of policy-makers, as it is in the interest of the debtor, to find a better solution. At the same time, each creditor affected by an orderly debt cancellation only absorbs the risk of default which is imminent to any credit relationship and which is often reflected and counterbalanced by the interest rates.

The academic discussion about the function and principles of insolvency and restructuring proceedings should not only focus on assessing the creditor/asset side of such proceedings. The common factor may instead be better found on the debt side of the very same medal. The collective nature of such proceedings might, thus, be as much a secondary effect as the desire to maximise the creditors' payoff (which is a fraction of the performing loan). They are certainly not common features of all insolvency and restructuring proceedings which exist in Europe. Theories with a purely creditor-oriented view (e.g. the famous creditors' bargain theory) could, therefore, miss an essential aspect from the outset. A debt- (not debtor-) oriented perspective

on insolvency and restructuring procedures would potentially allow for a more open discussion about the stakeholders' or the public interest within such frameworks.

If we look at insolvency and restructuring proceedings as instruments of debt assessment and debt cancellation, their procedural aspect becomes less dominant in the definition of their characteristics. Overall, such proceedings may rather be considered an essential part of the law of obligations, than only a section of the law of civil procedures, or even of the law of enforcement.

Old fashioned and strict consumer insolvency proceedings which assess the NPL (*Non-Performing Loan*) fraction by liquidating all assets without allowing for a discharge are a remnant of a time when defaulting debtors were held to be criminals, and when the bankruptcy law was designed to

punish the debtor for a breach of trust and promise. In the market economy of today, insolvency law assumes a different function: it cancels debt and – in the process – terminates failed businesses; it reallocates not only the debtors' assets to a more efficient use, but also the entrepreneurship or workforce of the individual debtors. ■

#### Footnotes:

- 1 The classic term commonly refers to periods in 14th to 16th century Europe; see Delloyd J. Guth, *The Age of Debt, the Reformation and English Law*, in: Delloyd J. Guth and John W. McKenna (eds.), *Tudor Rule and Revolution, 1982*, at 69; see also Peter Schuster, *The Age of Debt? Private Schulden in der spätmittelalterlichen Gesellschaft*, in: Gabriele B. Clemens (ed.), *Schuldenlast und Schuldenerwert, Kreditnetzwerke in der europäischen Geschichte 1300-1900*, 2008, at 37.
- 2 McKinsey Global Institute, *Debt and (Not Much) Deleveraging*, February 2015, at 15.
- 3 See Michael Hudson, in: Michael Hudson/Marc van den Mieroop (eds.), *Debt and Economic Renewal in the Ancient Near East*, 2002, 5 (28).
- 4 See e.g. the articles edited by Gabriele B. Clemens (ed.), *Schuldenlast und Schuldenerwert, Kreditnetzwerke in der europäischen Geschichte 1300-1900*, 2008.
- 5 In the book edited by Gabriele B. Clemens (ed.), *Schuldenlast und Schuldenerwert, Kreditnetzwerke in der europäischen Geschichte 1300-1900*, 2008, such practice is mentioned repeatedly; see e.g. Philipp R. Schofield, *Die Kreditvergabe im englischen manor court 1250-1350*, 21 (27-36); Peter Schuster, *The Age of Debt? Private Schulden in der spätmittelalterlichen Gesellschaft*, 37 (43-51); Gerald Grommes, *Netzwerke und Geschäftsstrukturen kastilischer Messebankiers im 16. Jahrhundert*, 84 (99-102).
- 6 See also Laurence Fontaine, *Die Bauern und die Mechanismen der Kreditvergabe*, in: Gabriele B. Clemens (ed.), *Schuldenlast und Schuldenerwert, Kreditnetzwerke in der europäischen Geschichte 1300-1900*, 2008, 109 (118-130).
- 7 For historical examples see e.g. David Graeber, *Debt. The First 5,000 Years*, 2012, at 231.
- 8 Michael Hudson, in: Hudson/Van den Mieroop (eds.), *Debt and Economic Renewal in the Ancient Near East*, 2002, 5 (30).
- 9 See Deuteronomium, 15:1-3. In Levitikus, 25:8-31, only every 50th year was a Jubilee Year.
- 10 Josef E. Stiglitz and Daniel Heymann, *Life after Debt, The Origins and Resolutions of Debt Crises*, 2014, at 19.
- 11 See Gerald Grommes, *Netzwerke und Geschäftsstrukturen kastilischer Messebankiers im 16. Jahrhundert*, in: Gabriele B. Clemens (ed.), *Schuldenlast und Schuldenerwert, Kreditnetzwerke in der europäischen Geschichte 1300-1900*, 2008, 84 (99).
- 12 See Josef Kohler, *Lehrbuch des Konkursrechts*, 1891, at 447.
- 13 Josef E. Stiglitz and Daniel Heymann, *Life after Debt, The Origins and Resolutions of Debt Crises*, 2014, at 18.

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**OLD FASHIONED AND STRICT CONSUMER INSOLVENCY PROCEEDINGS ARE A REMNANT OF A TIME WHEN DEFAULTING DEBTORS WERE HELD TO BE CRIMINALS**

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