Philosophies of Business Bankruptcy Law: An International Overview

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1. INTRODUCTION: WHY BANKRUPTCY LAW PHILOSOPHY?

Bankruptcy procedure is a drastic remedy: at the outset the debtor will be dispossessed or be placed under supervision, and the creditors will be denied their right to enforce their claims. At the end of the procedure there may be expropriation: of the debtor through the liquidation of his assets, and of the creditors through the extinction or reduction of their claims or through conversion of their claims to shares in the debtor company or other lower-ranking entitlements. It seems natural then that from time to time we should explore the reasons that justify such drastic treatment of private (and very often simply unfortunate) debtors and creditors.

The need to think about the purposes and perspectives of the law of bankruptcy is felt most vividly when the law is being revised. This has been the case in Europe and the United States. For example, England and France have reformed their laws in the 1980s,[1] in Germany a bill for a completely new insolvency code is at the committee stage in the Bundestag,[2] and it seems that in the United States, only fifteen years after the enactment of the Bankruptcy Code, reform of bankruptcy law is again on the agenda. Most of these legislative movements have been accompanied by debates about bankruptcy law's wider purposes. Taking account of the current state of bankruptcy law philosophy may also facilitate the international understanding of particular national bankruptcy laws because legislation in this field is all too often barely penetrable due to its emphasis on detail and technicality.

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[1] *England*: Insolvency Act 1986; *France*: Loi no. 85–98 relative au redressement et la liquidation judiciaire des entreprises.

[2] Entwurf einer Insolvenzordnung, Bundestags-Drucksache 12/2443. The bill is explained by Reinhart, 'Germany's Insolvency Bill', in (1993) 2 *Intern. Insolv. Rev.* 29.

I shall try to give an overview of the current philosophies of business bankruptcy law to be found in Europe and America, and shall then add a few tentative comments.

2. DEVELOPMENT AND PRESENT STATE OF THE LAW

Early law very much looked to the person of the debtor and his conduct. Not only was he to surrender his remaining property to the creditors, but he could be subjected to punishment, including imprisonment.[3] The emphasis on the person of the debtor and his conduct may have been the reason for the former English and American view that bankruptcy procedure is based on 'acts of bankruptcy', and is still the basis of the rules making a discharge available to unfortunate and honest debtors.

In the nineteenth century attention began to shift from the debtor to his property and his business. Based on practical considerations, this movement also reflected a change in ethical views about the attitude of society towards failure and wro[illegible]ing. For commercial bankruptcies the shift from the debtor to his assets had in any event become inevitable because of the fact that the business world became increasingly dominated by incorporated debtors who, besides liquidation of their assets, were not amenable to punishment.

At the same time, liquidation as the sole remaining purpose of bankruptcy law was being questioned, and most prominently so in the American railroad reorganizations. They proved that insolvency could be dealt with not only by converting assets into distributable cash but, as well, by reducing the legal claims of creditors to a level compatible with the economic capacities of the debtor, that is, ultimately, by eliminating the debt or by converting it into equity.[4]

Over time, and in all developed economies, the view came to prevail that bankruptcy law should offer not only straight liquidation but also reorganization, including a restructuring of debt and equity, as a solution to insolvency. The American Bankruptcy Act of 1938, with its chapters X and XI, was the first piece of legislation in a capitalist and free-market economy fully to incorporate this idea. Since then it has become commonplace in modern business bankruptcy legislation to provide for alter-

[3] For the historical background see e.g. Kohler, *Lehrbuch des Konkursrechts* (1891), 3; Fletcher, *The Law of Insolvency* (1990), 5; Baird/Jackson, *Cases. Problems and Materials on Bankruptcy*, 2nd edn. (1990), 26; Hilaire, *Introduction historique au droit commercial* (1986), 305; Dupouy, *Le droit de faillites en France avant le Code de Commerce* (1960).

[4] For a recent account of railroad reorganization procedure, see Baird/Jackson, above n. 3, 35, 959; Flessner, *Sanierung und Reorganisation* (1982), 33.

natives to piecemeal liquidation of insolvent enterprises.[5] In France the rehabilitation of the insolvent enterprise (*le redressement*) has even been declared the primary goal of bankruptcy law.[6]

3. BASIC ATTITUDES AND CURRENT DEBATES

The development of insolvency law summarized above makes it necessary to look on bankruptcy procedures as being multi-purpose or open-ended, and to explain or criticize them from this perspective. We can find a spectrum of philosophies that openly or covertly seem to be in conflict with each other.

1. At one end of the spectrum we find *pragmatism*. Pragmatism as an attitude takes bankruptcy law as it is and tries to apply it, case by case, according to business necessities. It is suspicious about comprehensive legislation, and it would rather not produce literature for academics or university instruction.

Pragmatism can lead to impressive achievements. It was the driving force in the gradual buildup of the American law of reorganization through the device of the federal railroad receivership.[7] It appears to have been the dominant approach in England where the law of bankruptcy and company winding up seems to have functioned until very recently without much support from theory or academic exposition. It is instructive that until Professor Fletcher published his treatise on insolvency law in 1990[8] the law of insolvency in England could be found only in detailed practice manuals, which made the law not easily accessible to non-bankruptcy lawyers, let alone foreign lawyers.

In Germany pragmatism has even started a counter-offensive against comprehensive law reform. Some of the most prominent insolvency practitioners have elaborated and published a remarkable counterproposal to the comprehensive reform bill presently pending in the Bundestag.[9] The gist of the counter-proposal is to change the existing law only at a few central points in order to enable the parties and insolvency practitioners to achieve any business arrangement that seems feasible under the circumstances.[10] As of this writing (October 1993), one cannot exclude the possibility of the legislators being sufficiently impressed by the

[5] See e.g. the English and French statutes and the German government bill, above nn. 1 and 2, and the new legislation in Australia and Canada, described by Harmer in Ch. 4 of this volume and Tay in 2 *Int. Ins. Rev.* 44 (1993).

[6] See the title of the law, above n. 1.

[7] See Baird/Jackson and Flessner, above n. 4.

[8] See above n. 3.

[9] See above n. 2. For fuller development see n. 26.

[10] 'Alternativentwurf des *Gravenbrucher Kreises zum Regierungsentwurf einer* Insolvenzordnung', in *Zeitschrift für Wirtschaftsrecht* (ZIP) (1993), 625.

pragmatism, limited ambition, and intelligent arguments of this counter-proposal to be willing to embrace it.

2. At the other end of the spectrum we find *government and juridical activism*. It is apt to flourish in countries where the government is strongly involved with economic activity. Italy, some time ago, introduced a special procedure for large enterprises that are owned by the state or otherwise financed by state funds.[11] The procedure is conducted under governmental supervision and is designed to avoid the liquidation of such enterprises at almost any cost, whether to the state or private creditors.

The more prominent and less special case is France. Here, in a sweeping reform of 1985, the general law of insolvency was expressly given the task of rescuing an insolvent enterprise, preserving employment and eliminating liabilities.[12] To achieve this, the act places all the decision-making powers in the insolvency court. It accords creditors not a right to vote but only the right to be heard through a court-appointed representative. It also provides for the extinction of creditors' claims (including those of secured creditors) and of the rights of owners where the court has approved the transfer of the enterprise to a new owner and the purchase price does not cover the existing claims.[13] The act is based on the belief that insolvent commercial enterprises of substantial size, although originally financed by its owners and creditors, may be so important to the local or national economies that the state is justified in using the insolvency court to roll back existing creditors' and owners' claims in order to make the enterprise attractive for new capital; and, if that should prove impossible, at any rate to set the debtor free to engage in new economic activity.

The act was conceived in the face of political fear about rising unemployment.[14] However, it is more than a political measure. Rather, it is a reflection of a French centuries-old belief that the government has direct responsibility for the proper development of the national economy and must be given the instruments necessary for the task. Only a year before the enactment of the present insolvency act, extensive legislation had been passed for the *prevention* of business failures, and this was complemented

[11] Act no. 95 of 3 Apr. 1979, concerning 'Provvedimenti urgenti per l'amministrazione stradordinaria delle grandi imprese in crisi'.

[12] Art. 1 provides: 'Il est institué une procédure de redressement judiciaire destinée à permettre la sauvegarde de l'entreprise, le maintien de l'activité et de l'emploi et l'apurement du passif.'

[13] There can also be reorganization plans (*redressement judiciaire*), but with less drastic effects on claims and ownership interests. For the details see Derrida, Godé, and Sortais, *Redressement et liquidation judiciaires des entreprises* (3rd edn., 1991), no. 543; Jeantin, *Droit commercial—instruments de paiement et de crédit, entreprises en difficulté* (3rd edn., 1992), no. 701.

[14] A detailed account of the legislative history is given in Derrida *et al.* (previous n.), no. 1.

by a system of agencies at the local, regional, and national levels for the provision of government credits and subsidies for businesses in difficulties.[15]

Given this background, it should come as no surprise that in some modern French textbooks the law of bankruptcy is only presented as a part of this wider state-organized prevention and rescue system.[16]

3. Turning now to the middle of the spectrum, we find two philosophies in close competition, and at times in fierce opposition to each other.[17] Both are concerned with the basic questions of bankruptcy procedure: why, if at all, for whom, and to what end should we have bankruptcy procedures in a modern free-market economy?

On the one side—politically speaking, 'centre-Right'—*there is a capitalist philosophy* focusing on the assets of the debtor. In this philosophy, the assets are seen as being subject to the claims of the creditors (and of others having provided capital) and are therefore regarded as in truth belonging to them. Individual, uncoordinated claim enforcement would destroy the overall value of this common pool of assets, to the detriment not only of the debtor but of the creditors themselves. Bankruptcy procedure, on the contrary, allows the claimants to liquidate the assets collectively, 'as one man', and thus, by removing the threat of uncoordinated, destructive claim enforcement, to enhance the value of the debtor's estate for all the potential claimants.[18] Every aspect of bankruptcy must be measured against this central idea. Rules and decisions are unsound when they are not oriented towards (or do not in fact achieve) the overriding goal of value maximization for creditors and other capital claimants. The baseline of the proceeding is that it must guarantee the claimants at least as much as, in the aggregate, they would have received with the normal workings of individual claim enforcement.

It follows that under this philosophy the sheer delay in the realization of claims inherent in the organization of a collective proceeding is suspect, and even more so any attempt by the law to provide for reorganization of enterprises; for reorganization tends to take even more time and enables the debtor or the trustee to manage the common pool at the cost of its principal owners, the creditors.

In the United States the common pool philosophy has been vigorously expounded in the influential writings of Professors Baird and Jackson.[19]

[15] The system is described by Jeantin above n. 13, no. 514.

[16] Jeantin above n. 13; Chartier, *Droit des Affaires—Entreprises en difficulté, Prévention—Redressement—Liquidation* (1989).

[17] See e.g. Warren, 'Bankruptcy Policy', 54 *Univ. Chi. L. Rev.* (1987) 775; Baird, 'Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren', ibid. 815.

[18] The theory has been expounded most explicitly by Jackson in *The Logic and Limits of Bankruptcy Law* (1986), 7.

[19] Jackson above n. 18 and Baird/Jackson, above n. 3, 37.

In Germany we have seen a variant of it, which also focuses on the assets of the debtor and the outside claims to it but viewing them from a market perspective. Bankruptcy decides the fate of the firm and therefore, viewed from the claimants' side, the future of their investment in the firm's assets. Decisions about market entrance and market exit, about investment and disinvestment, will be sound only when taken under market conditions. Bankruptcy policy, we are told, should erect a framework enabling claimants to mimic the market in deciding whether to leave their investment in the enterprise or to withdraw it.[20] It follows that one of the core demands of this market philosophy is that a reorganization of the insolvent enterprise, as opposed to a liquidation, must as a minimum also guarantee claimants the amount or value that could have been realized in an immediate liquidation of the assets.[21]

4. The opposite view may be called an *enterprise and forum philosophy*. In political terms it is 'centre-Left'. It argues that modern economies are made up of enterprises, and that any enterprise of relevance is the focus of many more interests than merely the interests of owners and creditors. In the event of insolvency, the employees, suppliers, customers, neighbours, and government can be as much affected by the fate of the enterprise as creditors and owners. The interests of those participants may not be immediately translatable into present monetary claims but they are nevertheless very real, and those who hold them may be willing to give money or money's worth to protect them. The function of bankruptcy procedure is therefore to establish a forum where all the interests—whether directly in monetary terms or not—which may be affected by the business failure of the enterprise can be heard from. The forum would enable the participants either to adjust gradually and more easily to the inevitable closure of the firm, or, if it is feasible, to agree on a rescue plan and on the contributions necessary to support it.

There are proponents of this forum philosophy both in America and in Europe.[22] In their view, bankruptcy is not geared to particular economic results, and certainly not to provable value maximization in the interests of assets claimants. Rather, its function is, first, to co-ordinate and civilize debt collection, and secondly, to organize and rationalize the hard decision-making that is inevitably called for in any major business insolvency.

[20] Market philosophy is endorsed in the explanatory report accompanying the German government bill, above n. 2. See also Balz, *Sanierung von Unternehmen oder von Unternehmensträgern?* (1986), 18.

[21] This has been written into the government bill of an Insolvency Code, above n. 3, ss. 293, 298.

[22] See e.g. Warren, above n. 17; Flessner, above n. 4, 194.

4. COMMENTS

Where are we going with our basic attitude towards business bankruptcy law, or to put it differently, where and how far do the various philosophies sketched in this paper carry us?

1. *Pragmatism* helps to manage the day-to-day work under a given bankruptcy law structure. It is also an appropriate attitude when the details of legislation need to be worked out. It does not contribute, however (and does not pretend to contribute), to a legislative or theoretical discussion about the type of insolvency that should be adopted and how it should relate to a country's overall economic and legal system. Nor does pragmatism help to explain the law to outsiders, for instance, to students or to foreign lawyers.

Governmental and juridical activism of the French type, on the other hand, certainly warrants a theoretical debate on a wider plane. Nevertheless, it seems to be peculiar to the French political and economic culture and is an expression of the mercantilist reflexes still so visible in the very able and self-confident French administrative élite. It is difficult to believe that the almost contemptuous lack of concern for the creditors and other claimants with capital positions that lies at the heart of the French philosophy will hold a significant appeal in other Western countries with free-market economies.

2. So this leaves us to weigh the philosophies competing at the centre of the spectrum, that is, the asset and market philosophy on the one side, and the enterprise and forum philosophy on the other.

I shall turn first to the assets philosophy so vigorously expounded in the United States. In my opinion it is seriously defective. Its central thesis is that in any given moment there is an identifiable pool of assets in the hands of the debtor to which the creditors can lay claim. Professors Baird and Jackson even refer to these claimants as 'owners' of that pool of assets, and they derive from this premiss their conclusion that the sole purpose of bankruptcy is to protect the value of this pool from the destructive effects of individual claim enforcement, or (to put it the other way round) that bankruptcy is dysfunctional if it in any way undermines the value of the creditors' pre-bankruptcy ownership position.

This central assumption is not in accord with basic economic facts and legal structures. There is no common pool of assets to which creditors wish to have and could have a claim before bankruptcy. Credit, unless it is secured by specific pieces of property, is normally extended with the expectation that not only payment of interest but also repayment of capital will come from the debtor's income, not from a sale of fixed assets. The debtor's income is normally produced not by the assets themselves,

but rather by the activities of the debtor which only partly consist in using the assets. This means that, if the debtor is (or has) an enterprise, income is produced by the organizational set-up consisting of owners, management, employees, and a functioning network of relations with the outside world, particularly with customers, suppliers, and, under modern conditions, with various government agencies; and it is the expected stream of income produced by the ongoing enterprise that allows for the normally peaceful coexistence of creditors with claims of different maturities.

These economic facts and expectations have been accurately translated into a legal structure. Apart from security interests in specific pieces of property, creditors can only ask for payment, not for assets. Of course, they have a right of recourse against assets in the case of non-payment at maturity, either by individual attachment or by the collective enforcement procedure called bankruptcy. But even then they have no right to the assets but only a right to be paid out of the proceeds of a forced sale of the assets or according to the value of the assets, and this method of securing payment is very different from the one to which the creditor was entitled originally, that is, to payment by the debtor. Consequently, even given overdue payments and a debtor who is on the brink of insolvency, the law leaves unimpaired the debtor's power over his assets and to manage his liabilities as long as no enforcement measures have been taken. The debtor's freedom is only restrained by the rules against fraudulent preferences and the avoidance powers of a trustee appointed in a subsequent bankruptcy proceeding.

In other words: it is not economic facts or the law of obligations but only bankruptcy procedure itself that establishes, on the one hand, a 'pool of assets' (called 'the estate') by fixing the assets which are to serve as the pledge for the existing liabilities, and, on the other, a community of creditors regardless of source, size, and maturity of their claims and their individual reactions to non-payment. This basic structure undermines seriously any assertion that bankruptcy procedure should maximize the value of a pre-existing pool of assets for a 'given' aggregate of claimants, and that it must not disturb in any respect pre-bankruptcy entitlements. It seems, rather, that insolvency and the legal reaction to it in the form of a collective procedure creates a new situation. In this situation it may be wise to respect pre-bankruptcy rights as much as possible but there is nothing to preclude new considerations, peculiar to the situation, being added in the search for appropriate solutions to this kind of business failure. There is no 'logic of bankruptcy law'[23] to be derived exclusively from the pre-bankruptcy situation.

[23] See Jackson, above n. 18.

Similar reservations are called for by the twin of asset philosophy, which I have called 'market philosophy'. It says that decisions in the bankruptcy proceeding about the assets, the firm, and claims against the firm's assets should as much as possible be market decisions. But what kind of a market is there after the bankruptcy court has dispossessed the debtor, has disarmed and bound together the previously independent creditors, and is supervising collective decisions and making decisions itself on the deployment of assets, on the substance of claims and, all in all, on the fate of the business? By trying to make bankruptcy procedure look like a market process this theory fails to explain the very attributes of bankruptcy procedure and thereby quietly acknowledges that the procedure is in fact something different from the market process and debt management outside of bankruptcy.

3. The *enterprise and forum philosophy*, on the other hand, does address and emphasize the special character of the insolvency situation and the resulting procedure. It remains vague, however, on the role bankruptcy should play when it comes to taking the final decisions. It is fine to claim relevance for those interests that are not representing capital claims but ongoing and future relations (employees, suppliers, customers, governments), and to let them be heard from in the forum. But the conversation about the situation cannot go on indefinitely. At bottom the insolvent enterprise is in urgent need, not of good intentions, but of money and economic prospects. So, at the end of the day, only those can have a say who are about to lose their money or who are willing to invest money or money's worth for the decisions to be taken about the firm's future. The forum theory does not and cannot give us guidelines for this final stage of bankruptcy procedure.

4. A *market* is a place where goods and money are exchanged. A *forum* is a place where rights and interests can be vindicated. In this abstraction, the two places seem to be very far apart. But in bankruptcy, market theory and forum theory may also complement or even substitute for each other. Forum thinking is able to explain why, and for whom, bankruptcy law should suspend the normal course of events, and why it should organize an interim regime. Asset and market thinking, on the other side, pays particular attention to the question of who should be admitted to the final decision-making and to what extent dissenters should be protected against the court or against majorities. There are occasions when the two philosophies do compete. For instance, forum philosophy is less concerned than asset philosophy with upholding the rank of pre-bankruptcy claims with a strict rule such as the absolute priority doctrine. But in many instances the opposing philosophies will differ only with respect to the light they shed on basically inevitable and unalterable facts and institutions, such as the 'emergency' regime of

bankruptcy on the one hand, and the very normal and raw need for, and lack of, capital on the other hand.

It may thus appear at times that whether we choose this or that brand of bankruptcy philosophy makes a difference only for those distant, mostly academic, observers who are neither affected by actual bankruptcy nor running a bankruptcy practice. However, bankruptcy theory is also used to advocate legislative or judicial solutions to serious and difficult policy problems. Examples are whether and to what extent secured creditors should be bound by, and burdened with, bankruptcy rules, or whether it is useful or harmful to provide for reorganization proceedings. For example, in the United States as well as in Germany the protection of security interests against curtailment and erosion in bankruptcy seems to be the principal objective of asset and market philosophies,[24] while forum and enterprise philosophy is being used to prove the opposite by asserting that secured creditors basically belong to the same universe as unsecured creditors and should therefore not be immune from the peculiar demands of a bankruptcy proceeding.[25]

So, after all, discussing the differences between asset and enterprise, market and forum philosophies, centre-Right and centre-Left, does matter politically and sometimes practically. Without a doubt it has secured bankruptcy law a place among the sophisticated academic disciplines.[26]

[24] See Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 *Univ. Chi. Law Rev.* 97; Balz, 'Aufgaben und Struktur des künftigen einheitlichen Insolvenzverfahrens', *Zeitschrift für Wirtschaftsrecht* (ZIP) (1988) 273 290.

[25] Warren, above n. 17; Flessner, above nn. 4, 208, 244.

[26] However pragmatism continues to appeal to legislators. The text of the new Insolvency Code approved by the German legislature (as of July 1994) has been streamlined and shortened compared with the government bill (see above at n. 2). This may be due to the counter-offensive mentioned above at n. 10. The Code is to come into force on January 1, 1999. Official promulgation of the text is expected in early autumn 1994.